DO JURORS HOLD AUDITORS TO A DIFFERENT NEGLIGENCE STANDARD UNDER U.S. GAAP AND IFRS?

by

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A Senior Honors Project Presented to the
Honors College
East Carolina University
In Partial Fulfillment of the
Requirements for
Graduation with Honors
by
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May 2017

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Abstract

In order to fulfill the requirements of East Carolina University’s Honors College, I created the research study described in this paper to examine the effects on auditor liability under United States Generally Accepted Accounting Principles compared to the International Financial Reporting Standards. The Financial Accounting Standards Board and the International Accounting Standards Board have been working towards convergence between U.S. GAAP, a rules-based system, and IFRS, a principles-based system. This research study examines whether potential jurors would hold auditors to a different negligence standard between rules-based and principles-based accounting. This study also explores how juror assessments of auditor responsibility differ when auditor liability is limited, as opposed to, unlimited. An experiment was conducted with students at a large state university representing jurors. I found evidence that auditor liability was held to a higher dollar value under unlimited liability and when relevant accounting standards were rules-based.
Introduction

To fulfill the requirements of my university’s undergraduate Honors College, I created the research study described in this paper to examine the effects of standard types on auditor liability under United States Generally Accepted Accounting Principles (U.S. GAAP) compared to the International Financial Reporting Standards (IFRS). In the United States, the Securities and Exchange Commission (SEC) has given the Financial Accounting Standards Board (FASB) authoritative support to set accounting standards. Companies in the U.S. are subject to U.S. GAAP. These standards are considered rules-based. In most other countries, companies are subject to principles-based IFRS, set by the International Accounting Standards Board (IASB). The FASB and IASB have been working towards convergence between the U.S. GAAP and IFRS. It is important that research is performed to determine how the convergence will be interpreted, as well as how jurors will hold accountants liable for their actions.

Background

Some research suggests that auditors will behave differently in a principles-based environment vs. a rules-based environment. For example, Quick (2015) found that auditors are more likely to report numbers for their clients more conservatively under rules-based standards than under principles-based standards. Auditors may tend to act more conservatively, rather than accurately, in order to avoid legal trouble. Quick (2015) also found that the decisions auditors make are most accurate under a combination of principles-based standards and limited liability. The present study looks at the impact of accounting standards on auditor’s judgement from the
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perspective of jurors. Thus, my study investigates the following question: Do jurors hold auditors to different levels of liability under a rules-based system compared to a principles-based system?

Reffett (2010) found that the more in-depth the auditor went when investigating fraud risks, the more liability increased for the auditor. This can negatively impact the work an auditor performs for a client. The auditor may assume if something is wrong, they will be held less accountable if they don’t thoroughly investigate the procedures a company is using. This can, ultimately, reduce the quality of work performed. This research also examined the impact of auditor liability regimes by addressing how jurors recognize the auditor’s responsibility when they are held to unlimited liability vs. limited liability under both IFRS and U.S. GAAP.

Theory and Hypothesis Development

The research questions this study will address are:

1. Do juror assessments of liability, or negligence, differ under U.S. GAAP vs. IFRS?
2. Do juror assessments of auditor responsibility differ when auditor liability is limited vs. unlimited?

U.S. GAAP vs. IFRS

U.S. GAAP is considered rules-based accounting because accountants are expected to follow detailed steps when preparing financial statements for external users. Thus, the legal liability is reduced due to a stringent set of requirements to follow. Although this method can be complicated, it also improves accuracy because procedures are followed the same way each time. Conversely, IFRS is a principles-based accounting system. This means guidelines of key
objectives are given and can be open to further interpretation. With that said, prior research with U.S. and Dutch auditors found that principles-based accounting standards increase auditors’ process accountability due to the fact that the auditor must have detailed work to support any decisions made and provide a higher quality of audit evidence (Markman and Tetlock 2000; Libby, Salterio, and Webb 2004). This suggests the importance of the ambiguity of accounting standards and how it impacts the auditor’s planning decisions. Furthermore, another study found that 50% of the time, jurors return verdicts against the auditor when standards are imprecise (i.e. principles-based) (Kadous and Mercer 2012). Donelson et al. (2012) also found that it is more likely for federal class action lawsuits to be filed against firms that are using imprecise standards, due to the “safe harbor” created by precise standards, as well as, the reduced tendency to mislead external users or investors. This information leads to my first testable hypothesis:

*Hypothesis 1*: Auditor liability will be assessed at a higher negligent value under IFRS, or principles-based standards, than under U.S. GAAP, or rules-based standards.

Under a rules-based system, auditors are more likely to operate in a precise, black-and-white realm. However, auditors performing work under principles-based standards have more room for interpretation and may be assessed at a higher dollar value than in a rules-based system.

*Unlimited vs. Limited Liability*

Liability determines to what extent the auditor is held accountable. Unlimited liability means the auditor can be liable for any quantity of damages, punitive included; limited liability means there is a set maximum amount the auditor can be sued for. With that said, there is room for further interpretation (no cap on the dollar value an auditor can be sued). Jurors may hold an auditor liable at a higher dollar value than if there was a maximum amount the juror could be sued.
Likewise, if there is a maximum dollar value the auditor can be sued for, the juror may elect to hold the auditor liable for the maximum amount, limiting the auditor from being sued for funds exceeding the cap. This leads us to a second testable hypothesis:

**Hypothesis 2:** Auditor liability will be assessed at a higher dollar value under unlimited liability than under limited liability.

If a juror knows there is a maximum amount for which the auditor can be held responsible, they may simply elect this dollar value. If there is an unlimited amount the auditor can be sued for, the juror may have a verdict with a greater value than the capped amount.

**Methodology**

A 2x2 between-subjects design was used in this study. The manipulations were the type of accounting standard (rules-based vs. principles-based) and auditor liability (limited vs. unlimited). Participants were 47 undergraduate students in an auditing course at East Carolina University. They were asked to assume the role of jurors in a negligence lawsuit against an auditing firm. In the case, the auditors had agreed with a client’s decision to not report a significant goodwill impairment loss.

In the scenario given to participants, the auditors neglected to make a client report an impairment loss and stockholders decide to sue the auditors. In order to avoid artificially creating a result, the scenarios regarding limited liability have a set maximum amount that the auditor can be sued for that is greater than the actual dollar value they were sued for.
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The dependent variable is the dollar value to which the participant holds the auditor liable. There are two independent variables in the study. First, the accounting standard type given was either principles- or rules-based. Second, the liability that the auditor is held was either unlimited liability or limited liability. Participants were randomly assigned to one of four possible scenarios (seen in Appendix):

1) Unlimited liability and U.S. GAAP

2) Limited liability and U.S. GAAP

3) Unlimited liability and IFRS, and

4) Limited liability and IFRS.

Participants were asked (1) if the impairment loss should have been recognized using a scale from 1 (“No”) to 6 (“Yes”), (2) if they believed the auditor was negligent in not requiring the company to recognize an impairment loss using a scale from 1 (“No”) to 6 (“Yes”), and (3) to assign a dollar value for which they believed the auditors are liable. If there is unlimited liability, there is no maximum amount for which the auditor can be sued and may be assessed punitive damages. To gather information regarding the participants’ thought processes, a supplemental question asked participants to identify factors that had influenced the judgements.

Results & Analysis

The first hypothesis was that auditor liability will be assessed at a higher dollar value under principles-based standards than under rules-based standards. This hypothesis was not supported (Figure 1). Participants in this study rated auditors as more negligent under a rules-based system
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than under a principles-based system (p=0.086). Participants were asked on a scale of 1 (not negligent) to 6 (negligent) if the auditor was acting negligent by not recognizing an impairment loss. The mean for principles-based standards was 3.6522 with a standard deviation of 1.5258; the mean for rules-based standards was 4.3750 with a standard deviation of 1.2790. These results show a difference in the mean of 0.7228, with rules-based auditors deemed more negligent. Therefore, the type of standard used did make a difference in how jurors held auditors liable.

The results on how the standard would impact the liability were found to be held more liable under rules-based standards. This could be due to the fact that some jurors may have assumed that since rules-based standards have a stringent set of rules to follow, the auditor must have done something wrong. Others may have felt that principles-based standards required a higher level of due care or conservatism, therefore holding the rules-based country to a higher negligent value.

Figure 1:

![Mean Negligence Assigned to Auditors by Participants](chart.png)

Participants were asked to judge the negligence on a scale of 1 (Not negligent) to 6 (Negligent).

The second hypothesis was that auditor liability will be assessed at a higher dollar value under unlimited liability than under limited liability. Hypothesis two was supported (Figure 2).
Auditors were held to a higher dollar value under unlimited liability. The sample data was restricted to only those participants who had rated auditor negligence at 3 or higher (again, on a 6-point scale, 1 being not negligent and 6 being negligent). The mean and standard deviation for unlimited liability was $268.13 million and $146.39 million; the mean and standard deviation for limited liability was $199.41 million and $161.28 million. This held statistically significant in a one-tailed test (p=0.105); auditors with unlimited liability was held had an average of $68.72 million higher than those with limited liability. When all data was included, whether auditor liability was limited or unlimited made no difference in how jurors assigned auditor liability (p=0.762, two-tailed). Further, Figure 2 demonstrates many participants held auditors liable for a dollar value greater than $75 million, which was supposed to be the highest dollar value they could be held liable. This could be due to participants not paying sufficient attention to the existence of the liability cap or not understanding the concept of liability.
Conclusion

The goal of this research study was to gain a better understanding of how jurors will hold auditors liable under different standard approaches to accounting. With a long-run goal of convergence of the US GAAP and IFRS, it is important we take stigmas into consideration in order to protect both the auditor and the clients or company. For auditors, this information can be useful in determining how they choose to act in certain situations. Further research on the convergence between the two systems is vital to the accuracy and efficiency of the accounting system we have in place in the United States. My student used full time college students as jurors. Future research could run a similar test using a wider variety of participants that would be more similar to a standard pool of jurors. The present study used a scenario involving one specific area of accounting: goodwill impairment. A future study could examine the issue using a different area of accounting to improve the generalizability of the results.
References


Appendix

Introduction

Thank you for participating in this experiment. The purpose of this experiment is to examine how individuals make decisions based on various financial reporting scenarios. You will be given a short case scenario to read. After your read the case you will be asked to answer several questions about the scenario, as well as, basic demographic questions.

Your participation in this survey is completely voluntary. There are no incorrect responses to the scenario and your responses will remain anonymous. By proceeding to the next page, you are indicating your agreement to participate in this study.

Thank you for your participation. If you would like to receive a summary of the results, please contact me at seglave@gmail.com.

Sincerely,

Sarah Glave
Management Accounting, BSBA
Honors College Class of 2017

Under the direction of:
Dr. Dennis O’Reilly
East Carolina University
**Scenario 1**

LAQ Investments Co. is a large, publicly traded company. On December 1, 2015, LAQ acquired QuickDrop Corp. for $300,000,000. QuickDrop designs and manufactures aerial drones. Related to this acquisition, LAQ recognized goodwill of $80,000,000. LAQ’s outside auditing firm, Techno, LLC, agreed to this value of goodwill.

Prior to the acquisition, one of the drone models QuickDrop manufactures, the Model TI, had exploded in trial runs. The company made minor adjustments to the model and continued to sell this model of drone. On July 1, 2016, one of QuickDrop’s largest customers purchased a bulk order of five thousand Model TI drones. The first three failed in flight and exploded. This was the third time a QuickDrop drone had failed since LAQ had acquired QuickDrop. The customer was furious, demanded a refund and dropped QuickDrop as a supplier.

As a part of the 2016 audit, auditors at Techno, LLC reviewed documentation relevant to the problems with the Model TI drones to assess whether the $80 million goodwill account was impaired. The auditors agreed with LAQ’s management that recognition of a goodwill impairment loss was not necessary at this time. Over the next six months, LAQ’s stock price lost more than $500 million of its market value. A group of LAQ’s stockholders has filed a lawsuit against Techno (LAQ’s auditor) to attempt to recover monetary damages based on the argument that Techno auditors performed negligently by not requiring the recognition of an impairment loss.

Techno operates solely in Country X. Country X’s legal regime is such that investors can recover all of their investment losses plus punitive damages from auditors; that is, auditor liability is unlimited. Furthermore, Country X’s accounting standards are rules-based, meaning auditors have detailed rules and processes they must follow while testing for an impairment.
Scenario 2

LAQ Investments Co. is a large, publicly traded company. On December 1, 2015, LAQ acquired QuickDrop Corp. for $300,000,000. QuickDrop designs and manufactures aerial drones. Related to this acquisition, LAQ recognized goodwill of $80,000,000. LAQ’s outside auditing firm, Techno, LLC, agreed to this value of goodwill.

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Techno operates solely in Country X. Country X’s legal regime is such that investors can recover damages up to a maximum of $75,000,000 of their investment losses; that is, auditor liability is limited to a maximum of $75,000,000. Furthermore, Country X’s accounting standards are principles-based, meaning auditors use general guidelines as opposed to rules in making professional judgements.
Scenario 3

LAQ Investments Co. is a large, publicly traded company. On December 1, 2015, LAQ acquired QuickDrop Corp. for $300,000,000. QuickDrop designs and manufactures aerial drones. Related to this acquisition, LAQ recognized goodwill of $80,000,000. LAQ’s outside auditing firm, Techno, LLC, agreed to this value of goodwill.

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Scenario 4

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Instructions:

You are selected as a juror for the stockholders’ lawsuit against Techno, LLC. It is your role to determine whether the auditors were negligent when they **did not** require LAQ to recognize a goodwill impairment loss related to the QuickDrop investment. If the auditors were negligent, you will also need to determine the amount to which the auditors are liable.

1. Do you believe LAQ should have recognized an impairment loss in the previous year? (Circle number)

   No       Yes
   1 2 3 4 5 6

2. Do you believe the auditors performed negligently in **not** requiring LAQ to recognize a goodwill impairment loss in the previous year?

   No       Yes
   1 2 3 4 5 6

3. If you believe the auditors were negligent, for which of the following amounts do you believe the auditors should be held liable? (Circle or write in, responses in millions of dollars)

   0 50 100 150 200 250 300 350 400 450 500
   |--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
   Greater than $500M: ___________

4. Please list up to three factors that most influenced your judgement above:
   i. __________________________________________________________
   ii. _________________________________________________________
   iii. _________________________________________________________
Demographic Questions

1. In the scenario presented in this case, Techno, LLC is headquartered in a country other than the United States. From your memory and without looking back through the case, does Techno, LLC operate in a country that auditor liability is limited or unlimited? (Circle one)

   Limited   Unlimited

2. Age: ________

3. Gender: _____________

4. Years of study in college: ______________

5. Undergraduate major: ________________________________

6. Graduate degree of study (if applicable): _____________________________

7. Have you ever been a member on a jury before? (Circle)

   Yes   No

8. Have you ever taken a course on Auditing? (Circle)

   Yes   No

9. Have you ever traded stocks before? (Circle)

   Yes   No

10. Please provide any comments you may have in the spaces below.

____________________________________________________________________________
____________________________________________________________________________
____________________________________________________________________________

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