

THE INFLUENCE OF A CLIENT PREFERENCE ON AUDITOR JUDGMENT:  
AN INVESTIGATION OF TEMPORAL EFFECTS AND CLIENT  
TRUSTWORTHINESS

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Dissertation submitted to the Faculty of the  
Virginia Polytechnic Institute and State University  
in partial fulfillment of the requirements for the degree of

Doctor Of Philosophy  
in  
Business  
with a major in Accounting

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March 30, 1998  
Blacksburg, Virginia

Key Words: Client Preference, Temporal Placement, Credibility, Trustworthiness

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(ABSTRACT)

The purpose of this dissertation is to investigate auditors' judgments and decisions in the presence of an explicitly stated client preference. This investigation considers two factors. First, the temporal placement (i.e., timing) of the client preference is varied to allow for an examination of differential effects associated with the receipt of an early client preference and a late client preference. Second, client trustworthiness is varied so that participants may have a basis upon which to evaluate the client's representations (i.e., preferences). Practicing auditors, who were either managers or senior managers at a national accounting firm, participated in the study by completing two audit tasks in which the two factors were manipulated.

Findings indicate that explicitly stated client preferences resulted in significantly different decision processes, but did not significantly influence auditors' judgment processes. However, further analysis indicated that there was no significant client preference (CP) effect observed for auditors' final decisions. Therefore, it appears that the influence of the client's preference was transitory. Taken together, these findings suggest that the CP did not result in a loss of auditors' objectivity.

Auditors' judgments and decisions were sensitive to the client's relative trustworthiness. This finding suggests that auditors are responsive to a client's credibility when evaluating the client's representations. This result is expected given since generally accepted auditing standards require auditors to consider a source's credibility. However, it is surprising that auditors' evidence evaluation efforts were not differentially sensitive to the client's trustworthiness. Such a finding may indicate that the participating auditors' evidence evaluation efforts are more influenced by firm policy than individual judgment.

## DEDICATION

This dissertation is dedicated to my wife, Elaine. Without her endless support and sacrifice it would not have been possible for me to pursue this dream. She is a blessing – one that I will always cherish. Truly, I am very fortunate to have a wife who is so loving and caring.

Finally, I would like to thank my family for their support and encouragement. Their wise counsel on many occasions has proven to be invaluable during the course of my program. I will never be able to thank them for their love and the many special gifts that they have given to me. I love each of them very much.

## ACKNOWLEDGEMENTS

I would like to acknowledge the tremendous teaching and contributions of my dissertation committee members – Jordan Lowe, Jim Yardley, Chris Haynes, Neil Hauenstein, and Larry Killough. I would like to extend a special thanks to my two co-chairmen, Jordan Lowe and Jim Yardley. I cannot thank them enough for their enduring patience and enthusiasm. A very special thanks also goes to Chris Haynes for her encouragement during the completion of this dissertation. Her teaching and encouragement during my doctoral program has been very special.

I would also like to acknowledge the financial support of the Department of Accounting during my doctoral program. I would also like to thank Phyllis Neece and Arnita Perfater for their very patient assistance during the last four years. They have made my life much easier than it otherwise would have been. I shall miss each of them.

Finally, I would like to acknowledge a very special person, Stacey Nutt. Even though Stacey was not in Blacksburg during this last year his influence was certainly felt by me. His willingness to teach and encourage me during the early part of my doctoral program was instrumental in the successful completion of this project. I will always be thankful that God allowed the two of us to know one another.

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## CHAPTER 1

### INTRODUCTION

In an economy characterized by absentee ownership and asymmetric information flow, the communication of reliable economic information is a critical component in the transfer of capital between those who wish to invest in the economy and those who are engaged to operate various business entities. External audits provide assurance that company prepared economic information (i.e., financial statements) is reliable and credible.<sup>1</sup> To continue to provide such assurance, auditors must be objective (AICPA 1996a, AU 220.02). Only through the preservation of this objectivity can the audit profession maintain the faith of investors and creditors (Shockley 1982).

In the recent past, members of the financial community and the accounting profession have expressed concerns over auditors' ability to maintain their objectivity. Stanley Sporkin, former director of the Division of Enforcement of the Securities and Exchange Commission (SEC), has stated that audited financial statements are often *unduly* influenced by the audit client's preferred accounting treatment (Sporkin 1993). Similarly, Walter Scheutze (1994), former chief accountant of the SEC, has noted that in many cases auditors assume the role of "cheerleader," often supporting the client's position even in the absence of authoritative support (Scheutze 1994). More recently, Michael Sutton, in his capacity as chief accountant of the SEC, expressed concern over the "...growing perception that there may be a real conflict between the public interest and the broader business interests of the public accounting profession" (Sutton 1997, p. 90).

Concerns such as these have prompted the Public Oversight Board of the American Institute of Certified Public Accountants (AICPA) to appoint an Advisory

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<sup>1</sup> Indeed, financial statement users often view an external auditor's opinion as enhancing the reliability and credibility of a company's financial statements (FASB 1978).

Panel on Auditor Independence. The Panel's charge was to evaluate the status of auditor professionalism and independence and to suggest measures to strengthen the profession's relationships with the SEC and the Financial Accounting Standards Board. Although the Panel concluded that an expansion in specific AICPA regulations or legislative rulings regarding auditor independence was unnecessary at the time of its report, the Panel recommended that auditors take a more proactive role in evaluating clients' accounting treatments. Specifically, the Panel suggested that auditors consider the acceptability and appropriateness of their client's accounting treatments (Public Oversight Board 1994).

Concerns for auditor objectivity and independence have given rise to a growing body of audit client preference (CP) literature. Some of these studies have found that CP has either limited or no influence on auditor judgment, while others have detected significant effects (e.g., Buchman, Tetlock, and Reed 1996; Gramling 1997; Salterio 1996; Salterio and Koonce 1997; Trompeter 1994). Given the crucial nature of auditor objectivity in the continued flow of economic information and resources and the paucity of CP literature, further research into a client's ability to influence auditors is warranted.

The relationship between a CP and audit judgment is not well understood. The purpose of this research is to examine the effects of two factors that may partially explain this relationship. The factors to be examined in the proposed research are the temporal placement effect of a CP and client trustworthiness.<sup>2</sup> The extant literature exhibits neither control for nor examination of these factors. The effect of these two factors was examined using two audit tasks – a measurement task (i.e., estimation of the allowance for doubtful accounts) and a disclosure task (i.e., disclosure or non-disclosure of a contingent liability).

A client's stated preference may have differing effects on auditor judgment depending on its temporal placement. An investigation of a temporal effect is important because of potential biases that a CP may induce when communicated to the auditor at different points in the evidence evaluation process. For example, when a preference is

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<sup>2</sup> For purposes of the proposed study, client refers to a single individual employed by the auditee. In the experimental materials this individual will be the auditee's controller/chief financial officer.

communicated to the auditor early in the evidence evaluation process (i.e., an early client preference, hereafter ECP), the auditor's evidence evaluation may be systematically biased by the client's stated desires. In other words, once aware of the CP, the auditor may not be able to evaluate further evidence in an unbiased fashion (Camerer, Loewenstein, and Weber 1989). In this instance, a *process bias* may be said to have occurred. Alternatively, when a CP is communicated to the auditor late in the evidence evaluation process (i.e., a late client preference, hereafter LCP), the auditor's evidence evaluation may not be influenced; however, the auditor's final judgment may be biased after the CP becomes known. In this instance, the auditor's judgment has effectively been subordinated to that of the client. In this instance, a *decision bias* may be said to have occurred.<sup>3</sup> Notwithstanding these possible biases, the impact of a CP may be dependent upon certain client characteristics such as the client's credibility.

Psychology research has found that competence, objectivity, and trustworthiness are significant determinants of an individual's credibility (e.g., Leathers 1986; McCroskey 1966; Powell and Wanzelried 1995). Moreover, an individual's credibility has been found to significantly influence the decisions and behavior of others (e.g., Haynes 1993; Hirst 1994; Joyce and Biddle 1981; McGinnies and Ward 1980; Rebele, Heintz, and Briden 1988). Investigating the influence of a preference in light of client credibility is important to an understanding of how client preferences impact audit judgments. Further, such an investigation may benefit from a focus on client trustworthiness rather than their objectivity because a stated preference, by its nature, indicates partiality or a *lack* of objectivity.

The proposed study will contribute to the existing literature in several ways. First, the research will provide further evidence on the impact of explicitly stated client preferences on audit judgment. Second, the research will examine the potential biases (i.e., *process* or *decision biases*) that may result from the temporal placement of the CP. Exploring this factor may help explain the inconsistent findings in the extant literature. Third, the study will examine the influence of client trustworthiness on the auditor's

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<sup>3</sup> *Process* and *decision bias* are terms used to describe biases that may occur given the receipt of information at different times in the evidence evaluation process.

willingness to acquiesce to a client's preferred accounting treatment. While other auditing studies have examined the influence of client credibility (operationally defined as competence and/or objectivity), no study has examined the influence of trustworthiness on audit judgment. Finally, the study will investigate whether auditors' evidence evaluation efforts are sensitive to client trustworthiness in the presence of a CP.

The remainder of the dissertation is organized as follows. Chapter Two discusses the literature related to the influence of client preference and the development of the research hypotheses. The chapter also discusses the literature related to source credibility and trustworthiness as well as the development of the associated hypotheses. Chapter Three describes the research methodology. Chapter Four presents the statistical analyses and results. Finally, Chapter Five provides a discussion of the results as well as a discussion of the study's limitations and implications for future research.

## CHAPTER 2

### LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

This chapter provides a discussion of the literature that is relevant to the current study. The first section discusses extant client preference literature which leads to the first hypothesis. The second section provides a discussion of the literature involving the temporal placement issue and formulates a related hypothesis. The final section discusses extant credibility literature, motivates the importance of trustworthiness, and formulates hypotheses.

#### 2.1 Client Preferences

The relationship between an auditor and auditee is unique. An auditor is retained either by a company's management or by an audit committee to provide an independent and objective examination of a company's financial statements. The result of this process is the issuance of a set of financial statements and the related audit opinion. Because multiple parties may rely on these financial statements and the auditor's opinion, the auditor has a responsibility not only to the client, but also to other interested parties such as investors and creditors (AICPA 1996a, AU 220.02). In the recent past, the business community has expressed concern that auditors are not maintaining the requisite objectivity (e.g., Scheutze 1994; Sporkin 1993). Academe's interest in this matter has culminated in a number of studies designed to investigate the influence of client preferences on audit judgments.

##### *2.1.1 Audit Client Preference Studies*

A number of studies have examined the impact of explicit client preferences on audit judgments (e.g., Buchman et al. 1996; Gramling 1997; Jiambalvo and Wilner 1985;

Salterio 1996; Salterio and Koonce 1997; Trompeter 1994).<sup>4</sup> Research by Buchman et al. (1996) and Gramling (1997) is grounded in an accountability framework. Briefly, accountability theory predicts that an individual will be influenced by another's preference or request if the individual is accountable to the initiator of the preference (Tetlock 1983). In an audit context, such accountability may potentially lead to inappropriate judgments. Feelings of accountability may be expected if the auditor believes that gaining the client's approval is important or beneficial in some economic way (Gibbins and Newton 1994). Such approval-seeking is likely given the auditor's economic dependence on the client (Trompeter 1994).

Buchman et al. (1996) examines the extent to which a client's preference impacts auditors' disclosure and audit opinion decisions. The study's findings are only partially consistent with accountability theory. For example, accountable participants were not influenced by a client's preferred litigation disclosure method, but were influenced by the client's audit opinion preference.<sup>5</sup> The researchers suggested that the apparent inconsistency may indicate that accountability pressures are not robust across all judgments. Another possible explanation for the difference may be due to the types of information provided to the participants. More specifically, participants' litigation disclosure judgments may have been *overwhelmed* by the other more objective information included in the experimental case (e.g., details of the company's financial condition and the nature of the litigation), thereby eliminating any possible CP effect. Conversely, participants may have acquiesced to the client's preference regarding the audit opinion because of *insufficient* information. That is, the only substantial information upon which participants could have based their audit opinion decision was the method of litigation disclosure which *they had determined*, and which they would have certainly believed to conform with generally accepted accounting principles.<sup>6</sup>

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<sup>4</sup> A summary of these CP studies is provided in Table 1.

<sup>5</sup> In an earlier study Jiambalvo and Wilner (1985) manipulated the client's preferred litigation disclosure method as part of an investigation of auditors' evaluations of contingencies. No CP effect on the auditor's recommended treatment was found. Accordingly, the discussion of the CP manipulation was quite limited.

<sup>6</sup> In addition to the litigation information, participants also received a brief narrative about the company as well as summarized financial data for the current and preceding years.

Therefore, in the absence of information regarding the numerous factors that determine the appropriate audit opinion, participants may have placed more reliance on the client's preferred audit opinion than would normally be the case.

Gramling (1997) investigates whether client preferences influence managers' decisions. In this study, participants were asked to assess the quality of an internal audit (IA) department and to determine how that assessment would impact the reliance placed on the IA department in the upcoming audit. Participants were told of the client's preference as well as the partner's preference prior to assessing the IA department. The partner's preference was manipulated at two levels: high efficiency (i.e., more reliance on the IA department) and quality audit work (i.e., less reliance on the IA department). The client's preference was also manipulated at two levels: low audit fees (i.e., more reliance on IA department) and quality audit work (i.e., less reliance on IA department).

Results of her study indicate that preferences did not influence the *assessments* of the IA department, but did influence *reliance* decisions. Gramling's analyses show that the influence of the CP was interactively determined. More specifically, when the partner's preference was for a highly efficient audit, the CP was only marginally significant. Alternatively, the CP was not significantly influential when the partner preferred high quality audit work. Gramling's findings indicate that the impact of a CP may depend upon other contextual factors such as the engagement partner's preferences.

Salterio (1996) examines the influence of a CP using the inherited hypothesis literature as a theoretical basis. Salterio hypothesizes that if a client explicitly communicates a preference, then auditors will *inherit* that preference and thus be more likely to acquiesce to the client. Salterio's investigation is interesting not only for the subject matter, but also because he uses archival and experimental data.

In the experimental portion of his study, participants read a brief narrative that explained that the client had entered into a "new type of contract" and that the client preferred to either defer and amortize the related revenue or record all of the revenue in the current year. Following a review of the case, participants were asked to make a preliminary determination of the appropriate revenue recognition for the contract. After

this initial judgment, participants were given information about three “precedent” cases which were similar to the client’s transaction. After reviewing these precedents, participants were again asked to indicate how they would record the transaction. Surprisingly, results indicate that knowledge of the CP had no effect on the auditor’s recommended treatment. However, Salterio suggested that the absence of an effect may have been due to the content of the precedents which, in each case, opposed the client’s preferred treatment.

In the second portion of his study, Salterio (1996) finds evidence of a CP effect. Use of the archival data required Salterio to identify specific instances in which the manager of an accounting firm’s central research unit (CRU) was aware and unaware of the CP. By identifying such occurrences, it was possible to determine whether the recommendations made by the CRU manager to the practice office were consistent or inconsistent with the known CP. Results revealed that CRU managers who knew the CP were more likely to communicate to the practice office those precedents which were consistent with the CP than those CRU managers who did not know the CP.

While the experimental portion of Salterio’s study indicated no *direct* CP influence on the auditor’s recommendations, the archival portion indicated the possibility of an *indirect* effect. Because the recommendations of CRU managers were influenced by a known CP, it is reasonable to conclude that auditors who followed the CRU’s recommendations (i.e., the precedent cases) were actually influenced by the CP, albeit indirectly.

Salterio and Koonce (1997) extends the earlier work of Salterio (1996) by considering the influence of the CP in the presence of mixed or inconsistent precedents. Results indicate that auditors’ recommendations were more consistent with existing precedent cases that were similar to one another than they were with client preferences. Alternatively, if the precedent cases conflicted with one another, auditors generally placed more reliance on the CP. These findings suggest that a CP may not be as pervasive or insidious as some have stated; rather, they indicate that in the absence of consistent precedents auditors are sensitive to clients’ suggested accounting treatments.

Trompeter (1994) investigates whether the level of ambiguity in generally accepted accounting principles (GAAP) moderates the impact of a CP on auditor judgment. Using cases with varying levels of ambiguity, Trompeter finds that a CP has greater influence on auditor judgment when GAAP is less restrictive. In other words, when GAAP allows for greater flexibility in its application, auditors were more likely to be influenced by a CP than when GAAP requirements were more clearly defined. This finding is consistent with Salterio and Koonce's (1997) conclusion that auditors generally support the client's preferred treatment when no clear GAAP guidance exists. On the other hand, Trompeter notes that the impact of a CP may be moderated when GAAP allows for *less* flexibility.

### 2.1.2 Summary of the Research

Extant CP literature provides mixed results as to the influence of an explicit CP on audit judgment. Table 1 provides a summary of this literature. For each previously discussed CP study, this table reports the temporal placement of the CP, participant experience levels, the type of experimental task (i.e., disclosure or measurement), and findings related to the CP effect. The table reveals several interesting issues.

First, as indicated in columns 6 and 7 of this table, studies involving disclosure issues (Buchman et al. 1996; Jiambalvo and Wilner 1985) report no evidence of significant CP effects on either auditors' disclosure *judgments* or disclosure *decisions*.<sup>7</sup> CP studies involving measurement issues, however, find evidence of significant CP effects (see column 6) on auditors' measurement *judgments* (Salterio 1996; Salterio and Koonce 1997; Trompeter 1994).<sup>8</sup> On the other hand, only Salterio and Koonce (1997) find evidence of a significant CP effect on auditors' *decisions* regarding measurement issues.

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<sup>7</sup> Judgments and decisions are distinguished from each other as follows. Judgments are assessments which are used in the decision process. Decisions are action choices that result in some set of consequences.

<sup>8</sup> Measurement issues examined in these studies include revenue recognition, valuation of marketable securities, estimation of bad debt expense, and expense for employee insurance claims.

An additional issue identified during the review of the literature concerns the temporal placement, or timing of the preference. An examination of column 2 in Table 1 reveals that the temporal placement of the CP has been inconsistent across studies. No study has examined an ECP effect in either a measurement task or a disclosure task. Further, the effect of a LCP has only been examined in a measurement task (Salterio 1996; Salterio and Koonce 1997). Both LCP studies identify a significant CP effect on audit judgment, but only one of the studies identified an effect on audit decisions (Salterio and Koonce 1997). Such inconsistent temporal placement of the preference may have masked CP effects or could have had unintended confounding effects in past studies. After reviewing the literature, it is clear that an investigation of the CP phenomenon must not only address the overall issue of whether a preference influences auditors' judgments and decisions, but also whether the temporal placement of the preference differentially influences auditors.

To date, no study has examined CP effects across the two judgment types (i.e., measurement and disclosure) with one group of participants. Such an investigation is important to provide a more rigorous examination of the robustness of the CP. Consistent with past research, this investigation should include a means for evaluating auditors' judgments as well as their decisions. Further, CP research must utilize participants with appropriate levels of experience. As shown in column 2 of Table 1, past studies have generally utilized participants with substantial experience (e.g., managers and partners). A final point to note is that prior CP studies have not considered the credibility of the preference's source. Credibility studies (e.g., Anderson, Koonce, and Marchant 1994; Haynes 1993; Hirst 1994; Rebele, Heintz, and Briden 1988) provide substantial evidence that more credible sources are more persuasive and provide information that is deemed to be more reliable and diagnostic than less credible sources.

Given the mixed findings reported in the literature, it is unclear whether auditors always consider a CP to be judgment or decision relevant information. Accordingly, the following hypotheses (in null form) are proposed:

**H1<sub>A</sub>:** Auditors' judgments will not be influenced by a client preference.

**H1<sub>B</sub>:** Auditors' decisions will not be influenced by a client preference.

## 2.2 Temporal Order Effects

As the above discussion suggests, the temporal placement of the CP may be an important factor in determining its influence on auditor judgment. Accordingly, this section discusses the literature related to information order effects.

### *2.2.1 Hogarth and Einhorn's Belief-Adjustment Model*

An information processing theory which has been the focus of much auditing research is the belief-adjustment model proposed by Hogarth and Einhorn (1992).<sup>9</sup> Under this theory individuals are seen as sequential information processors.<sup>10</sup> The model posits that belief-adjustment is an iterative anchoring and adjustment process through which an individual's current belief is updated for new information. The model is appealing to auditing researchers because of its depiction of belief revision as a sequential process (e.g., Ashton and Ashton 1988; Gibbins 1984).

### *2.2.2 Belief-Adjustment Studies in Auditing*

Early belief-adjustment research generally supports the order effects (i.e., recency) predicted by Hogarth and Einhorn's model.<sup>11</sup> Initial auditing research in the area was conducted by Ashton and Ashton (1988). Though their findings were consistent with the model's predictions, Ashton and Ashton's efforts were primarily aimed at validating Hogarth and Einhorn's model. In fact, they suggested that future research should include richer audit contexts than those used in their study. Tubbs, Messier, and Knechel (1990) followed this directive by conducting a study in which auditors' belief revisions were evaluated in more complex scenarios. Consistent with Ashton and Ashton (1988), they found that auditors' judgments exhibited recency effects. In addition,

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<sup>9</sup> Several versions of the belief-adjustment model existed prior to that which is included in the 1992 paper. Hogarth and Einhorn (1992) represents the final version of this belief-adjustment model.

<sup>10</sup> Individuals are often understood to process information in a sequential manner because they lack the ability to process significant amounts of information simultaneously (Anderson 1981; Hogarth 1987; Hogarth and Einhorn 1992; Hopwood 1976).

<sup>11</sup> See Asare and Messier (1991) for a partial review of the literature.

Ashton and Ashton (1990) found that auditors were more sensitive to sequentially reviewed evidence than to simultaneously reviewed evidence. Much of the subsequent research has focused on the step-by-step (i.e., SBS) response mode rather than the end-of-sequence (i.e., EOS) response mode.

Several belief-adjustment studies have examined the relationship between experience and the *occurrence* and *impact* of recency on auditors' action choices. For example, the potential influence of experience has been investigated by Krull, Reckers, and Wong-on-Wing (1993), Messier and Tubbs (1994), Pei, Reckers, and Wyndelts (1992), and Trotman and Wright (1996). Messier and Tubbs (1994) and Trotman and Wright (1996) noted that increased audit experience generally mitigates the recency effects noted in less experienced auditors.<sup>12</sup>

In the tax domain, Pei, Reckers, and Wyndelts (1990) found that tax preparers were not differentially sensitive to a client's preference across different information orders. However, Pei et al. (1992) found that a preference did have a differential effect on tax managers' recommendations, but the effect was dependent upon the tax manager's experience level. Specifically, inexperienced managers' judgments exhibited a CP effect, while those of the experienced managers did not.

Messier (1992) examined the impact of recency on auditors' decisions in two separate experiments. The first experiment elicited participants' likelihood judgments as to the fair statement of a company's accounts payable balance, while the second experiment elicited likelihood judgments as to a company's viability. Although participants' judgments exhibited recency in each of the experiments, their decisions did not. Specifically, Messier asked participants in the first experiment to indicate what additional audit procedures they would like to perform, if any, and the time budget for such procedures. Results indicated that auditors in the different evidence order conditions did not wish to perform significantly different amounts of "additional" audit

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<sup>12</sup> Several studies have found that recency effects may be mitigated (e.g., Cushing and Ahlawat 1996; Kennedy 1993; Hanno and Kida 1996; Messier and Tubbs 1994; Trotman and Wright 1996). The present study will not include attempts to mitigate recency because, to date, there is no empirical evidence to indicate that the temporal placement of the CP has a differential effect on auditor judgment. Attempting to mitigate the CP effect posited in the present study prior to establishing its existence would appear to be premature.

work. In the second experiment, participants were asked to indicate what type of audit opinion they would issue given the available evidence. Again, the results indicated that auditors' opinion preferences did not differ across the evidence order conditions.

In a similar study, Asare (1992) examined whether judgments regarding a company's viability would lead to the issuance of different audit opinions. Consistent with Messier (1992), Asare found that auditors' viability judgments exhibited recency. Contrary to Messier, he found that the recency effects resulted in the issuance of different audit opinions. Specifically, participants who reviewed information in the "contrary-mitigating" order were more likely to issue an unqualified opinion than those who reviewed information in the "mitigating-contrary" order. Messier (1992) suggested that a possible explanation for the difference between his and Asare's (1992) findings may be due to the different degrees of financial stress being experienced by the companies described in the experiments.

### *2.2.3 The Auditing Standards Perspective*

GAAS does not directly address the temporal placement effect of audit evidence (i.e., recency effect) discussed in the previous section. The standards do, however, require auditors to remain objective throughout the examination of a client's financial statements (AICPA 1996a, AU 220.02; AICPA 1996c, ET 102.01). Being objective, however, does not require auditors to assume an "attitude of a prosecutor", rather, they should undertake a more neutral posture, one of "judicial impartiality" (AICPA 1996a, AU 220.02). Auditors maintain this neutral posture through the practice of professional skepticism.

In the practice of such skepticism auditors obtain evidence which either supports or refutes management's assertions. In the search for this evidence, auditors should obtain "sufficient competent evidential matter." While GAAS does not codify a precise meaning of "sufficient competent evidential matter," GAAS states that auditors generally must rely on evidence that is persuasive rather than convincing (AICPA 1997). Further, GAAS does not delineate the requirements for what is to be considered persuasive; rather, such a decision is a matter of professional judgment. Because auditors must

determine the persuasiveness of evidence on a case by case basis, there is a possibility that certain environmental factors (e.g., a CP) may influence the auditor's evidence gathering/evaluation process.

#### 2.2.4 Summary of the Research

The belief-adjustment model proposed by Hogarth and Einhorn (1992) posits that individuals adjust their beliefs through an iterative anchoring and adjustment process. Moreover, the relevancy of information to this adjustment process is determined by the individual based upon various contextual factors. Therefore, if an auditor considers a CP to be relevant information, then the model predicts that the auditor will adjust his or her belief upon receipt of the preference.

The research findings related to Hogarth and Einhorn's belief-adjustment model indicate that a CP may have a differential effect on auditor judgment and decision making depending upon its temporal placement. The model suggests that a LCP should have a stronger effect than the same preference received earlier (i.e., an ECP). If this is true, then the model is effectively predicting that auditors will subordinate their judgment to the client, and that a *decision bias* is more likely to occur than a *process bias*.<sup>13</sup>

One possible temporal placement result is a recency effect in which information received in the latter phase of the evidence evaluation process has a stronger effect than information received and processed earlier. This effect would occur if auditors' judgments and decisions were significantly influenced by a LCP. This influence may take the form of the auditor's acquiescence to the preference or possibly an overreaction to the preference (i.e., the auditor may perceive the preference as a "red flag" and form judgments and decisions that are opposed to the CP). However, neither of these effects may occur because of the auditor's awareness of the need for objectivity throughout the audit process.

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<sup>13</sup> Although Hogarth and Einhorn's model does not predict a primacy effect in the specific experimental conditions, a primacy effect may occur (cf., Hogarth 1987; Nisbett and Ross 1980). Therefore, to obtain a more robust test of possible temporal placement effects both early and late client preferences were included in the experiment.

Another possible temporal placement result is a primacy effect in which information received early in the evidence evaluation process has a stronger effect than information received and processed later. This effect would be obtained if auditors' judgments and decisions were significantly influenced by an ECP. Such an effect may be due to an insidious and pervasive interference of the CP in the early phases of the auditor's evidence evaluation process.

While GAAS does not address the temporal placement effect predicted by Hogarth and Einhorn's model, auditing standards prescribe that an auditor must remain objective throughout the entire audit process. This requirement suggests that an ECP should have no greater impact on the auditors' judgments and decisions than a LCP. Given the conflict between the literature and GAAS, the following hypotheses (in null form) are proposed:<sup>14</sup>

**H2<sub>A</sub>:** The temporal placement of a client preference will not differentially influence auditors' judgments.

**H2<sub>B</sub>:** The temporal placement of a client preference will not differentially influence auditors' decisions.

These hypotheses differ substantially from H1<sub>A</sub> and H1<sub>B</sub>. Specifically, H1<sub>A</sub> and H1<sub>B</sub> predict that auditors' judgments and decisions will not be influenced by any CP. On the other hand, the above hypotheses predict that the temporal placement of the preference (i.e., ECP versus LCP) will not have a differential effect on either the audit judgment process or the audit decision process.

### 2.3 Source Credibility

An auditor's receipt of a CP necessitates an evaluation not only of the preference, but also a consideration of the *source* of that preference. While the auditor's evaluation of the CP has been examined in past studies, the potential influence of *source* characteristics on the auditor's willingness to acquiesce to a CP has not been examined.

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<sup>14</sup> Tests of H2<sub>A</sub> and H2<sub>B</sub> are appropriate only if H1<sub>A</sub> and H1<sub>B</sub> are rejected (i.e., the omnibus F test is significant).

Psychology and auditing research alike have found that credibility is a significant determinant of an individual's ability to influence the actions or decisions of another. Accordingly, client credibility should be examined to further understand the impact of a CP on audit judgment.

When auditors update their beliefs for newly received information, they must consider the information *source's* credibility (AICPA 1997). Although GAAS does not provide explicit guidance on this evaluation, the process reasonably includes consideration of such factors as the source's competence, objectivity, and trustworthiness. Because auditors frequently rely on information supplied by the client and other client representations, the evaluation of a client's credibility is a crucial step in the audit process. Misjudging this credibility has implications for audit effectiveness and efficiency. If an auditor overestimates (underestimates) a client's credibility, the auditor may under-audit (over-audit) because too much (too little) weight is ascribed to the available evidence. In the former instance, the auditor is likely to perform an *ineffective* audit while in the latter instance, the auditor is likely to perform an *inefficient* audit.

### *2.3.1 Determinants of Credibility*

Research surrounding the determinants of credibility has been conducted for a number of years. Early research in the area was conducted by James McCroskey. In "Scales for the Measurement of Ethos," McCroskey (1966) utilized a factor analytic approach to identify the underlying dimensions of credibility.<sup>15</sup> This effort led to the development of the McCroskey Credibility Scale. This scale was comprised of two dimensions: authoritativeness and character.

The McCroskey Credibility Scale (1966) was not without its critics. Some researchers suggested that the scale suffered from insufficient dimensional detail. For example, Applbaum and Anatol (1973) used techniques similar to McCroskey (1966) and concluded that credibility was comprised of at least four dimensions: trustworthiness, expertness, dynamism, and objectivity. Similarly, Tuppen (1974) concluded that

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<sup>15</sup> Ethos is a term often used in early research in this area. The term is synonymous with credibility.

credibility was comprised of no less than five dimensions. Tuppen labeled these dimensions trustworthiness, expertness, dynamism, co-orientation, and charisma. Later work by McCroskey and Jenson (1975) also seems consistent with a multi-dimensional view of credibility. In this work, McCroskey and Jenson concluded that credibility was appropriately comprised of five dimensions: competence, character, sociability, composure, and extroversion.

Still other research suggests that credibility is less complex. In his “Personal Credibility Scale,” Leathers (1986) proposed a more simplistic model of credibility comprised of three dimensions: competence, trustworthiness, and dynamism. Powell and Wanzenried (1995) concluded that credibility is comprised of essentially two dimensions: competence and trustworthiness. Thus, Powell and Wanzenried (1995) suggested that the credibility scales developed by McCroskey and Jenson (1975) and Leathers (1986) should be collapsed to provide a two dimensional view of credibility.

Although there has been no consensus as to credibility’s underlying constructs, there appears to be some agreement as to the importance of at least two constructs: competence and trustworthiness. A substantial portion of the psychology literature is devoted to the study of these constructs. This research has established a strong relationship between a source’s credibility and the persuasiveness of a message (e.g., Chebat, Filiatrault, and Perrien 1990; Goldberg and Hartwick 1990; Lampinen and Smith 1995; McGinnies 1973; McGinnies and Ward 1980).

### *2.3.2 Credibility Studies in Auditing*

Auditing researchers have devoted considerable efforts to examining the relationship between source credibility and audit judgment. Results of these efforts comprise a body of literature focused primarily on two constructs: competence and objectivity. Hirst (1994) defines competence as an individual’s technical knowledge and expertise, and objectivity as an individual’s independence. Early interest in these two

constructs resulted partly from the auditing standards governing the auditor's evaluation of the internal audit (IA) function (i.e., SAS No. 9).<sup>16</sup>

IA related studies have generally found that auditors assess those departments comprised of highly competent and objective internal auditors as stronger than those comprised of less competent and objective auditors. Brown (1983) found that auditors considered the IA department's objectivity to be critical in assessing the department's reliability. Alternatively, studies by Schneider (1984, 1985) and Messier and Schneider (1988) found that auditors believed competence to be more important than objectivity in assessing the strength of an IA department. Similarly, Margheim (1986) found that auditors reduced budgeted audit hours when IA department personnel were highly competent, but that their budgets were not affected by the department's objectivity.

Other credibility research has also found evidence that both the client's competence and objectivity are important factors in determining an auditor's judgment. Joyce and Biddle (1981) conducted a series of experiments in which the information source's reliability was manipulated. Reliability was manipulated at two levels: a client employee (a credit manager) or an employee of an external credit agency.<sup>17</sup> In a between-subjects experiment, auditors were insensitive to source reliability; however, in a within-subjects design auditors' judgments did exhibit sensitivity to the source's reliability.

Examining the effect of credibility on intra-accounting firm judgments, Bamber (1983) found that audit managers believed that the work of highly competent seniors was more reliable than that of less competent seniors. Rebele et al. (1988) found that auditors deemed account balance estimates provided by highly competent client managers to be more reliable than those of less competent managers. A subsequent study by Anderson et al. (1994) found that auditors considered explanations provided by highly competent

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<sup>16</sup> SAS No. 9 (AICPA 1990) required the auditor's evaluation of the IA function to be based on the consideration of three criteria: competence, objectivity, and work performance. This standard was superseded by SAS No. 65 (AICPA 1996b).

<sup>17</sup> Joyce and Biddle's (1981) reliability manipulation is consistent with the definition of objectivity proposed by Hirst (1994).

client managers to be more plausible than those provided by less competent managers. Furthermore, Hirst (1994) found that auditors considered information to be of greater diagnostic value when provided by more competent and/or more objective managers. In a similar study, Peecher (1996) found that auditors who were instructed to give more “credence” (i.e., increase their reliance) to client explanations provided judgments that were more consistent with the explanations of a “high integrity” client. This finding suggests that a highly trusted client may have greater influence on an auditor than a client who is not as trustworthy.

### *2.3.3 The Importance of Trustworthiness*

Although auditing research has established that highly competent and objective information sources have more credibility than less competent and objective sources, the influence of a source’s trustworthiness has received little attention in the accounting literature. The examination of trustworthiness is particularly relevant to the current study. Objectivity is less relevant because a CP, by its very nature, indicates bias or a lack of impartiality. Therefore, no significant insight may be gained by considering the relationship between a client’s objectivity and the influence of a CP.<sup>18</sup>

An investigation of trust within the audit domain is important because an audit presumes a minimal degree of trust between the auditor and client (Shaub 1996; Anderson and Marchant 1989). Trust may be thought of as the exercise of faith or reliance in another individual or group. Rotter (1967, p. 651) more precisely defines trust as “...an expectancy held by an individual or group that the word, promise, verbal or written statement of another individual or group can be relied upon.” Alternatively, Mayer et al. (1995, p. 712) state that trust is “... the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party.”

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<sup>18</sup> A client manager’s competence may be reasonably expected to affect the auditor’s trust of the manager (cf., Anderson et al. 1994; Hirst 1994, Rebele et al. 1988). Accordingly, the client manager’s competence was held constant in the current study.

Auditors assume a certain level of risk when they conduct an audit (i.e., act in a trusting manner) as opposed to performing a complete examination of all client records and transactions. The presence of this risk makes the auditor's development of a strong trust-relationship with the client a crucial part of the auditing process. Indeed, the auditor's willingness to perform an audit of an business entity is indicative of some minimum level of trust.

The strength of the trust-relationship between an auditor and client partly determines the extent to which an auditor reduces or extends planned audit procedures (Shaub 1996). The extent to which auditors limit or extend auditing procedures is a manifestation of *trusting behavior* (Kee and Knox 1970; Mayer et al. 1995). Anecdotal evidence of the auditor's *trusting behavior* is provided by Hirst and Koonce (1996). In a series of interviews, Hirst and Koonce inquired about the auditors application of analytical procedures. Auditors indicated that during their application of analytical procedures as substantive tests, the amount of corroboration required to explain a finding would be reduced if they had a detailed understanding of the client's business and *trusted* the client.

#### 2.3.4 Summary of the Research

Auditing research has established that highly credible (i.e., competent and objective) individuals provide information which is deemed to be more diagnostic, reliable, and plausible than information provided by less credible individuals (e.g., Anderson et al. 1994; Hirst 1994; Rebele et al. 1988). Psychology research corroborates these findings and has also established that more trustworthy individuals are seen as more credible and more persuasive (e.g., Goldberg and Hartwick 1990; Lampinen and Smith 1995). Accordingly, an auditor who has a highly trustworthy client is expected to make judgments and decisions that are more consistent with that client's position and interests than an auditor who has a client considered to be less trustworthy. Based upon the literature the following hypotheses (in alternative form) are proposed:

**H3<sub>A</sub>:** In the presence of a highly (less) trustworthy client, auditors will make judgments that are more (less) consistent with the client's interests.

**H3<sub>B</sub>:** In the presence of a highly (less) trustworthy client, auditors will make decisions that are more (less) consistent with the client's interests.

There is also a need to consider whether auditors alter the evidence that they evaluate in light of the client's trustworthiness. GAAS suggests that auditors must evaluate the credibility of an information source (AICPA 1997). If the source is evaluated as highly credible, then an auditor may be able to reduce the extent of audit procedures. The contention offered by Mayer et al. (1995) and Kee and Knox (1970) that an individual's trust is manifested in *trusting behavior*, along with the anecdotal evidence provided by Hirst and Koonce (1996), suggests that an auditor will seek less (more) evidence when the client is more (less) trustworthy. To test this expectation, the following hypothesis (in alternative form) is proposed:

**H4:** An auditor's evidence evaluation efforts will be negatively related to the client's relative trustworthiness.

## CHAPTER 3

### RESEARCH METHODOLOGY

This chapter presents the research methodology employed to examine the hypotheses presented in Chapter 2. The experiment was accomplished with a 3 x 2 factorial design in which participants completed two audit tasks: an Allowance for Doubtful Accounts [measurement] task and a Contingent Liability [disclosure] task. The two tasks were treated as independent experiments.

Two independent variables were manipulated: client preference (CP) and trustworthiness. CP was manipulated between-subjects at three levels: no client preference (NCP), early client preference (ECP), and late client preference (LCP). For each task, trustworthiness was manipulated between-subjects at two levels: low trustworthiness and high trustworthiness.

Tests of the research hypotheses were accomplished through the use of four dependent variables. Hypotheses H1<sub>A</sub>, H2<sub>A</sub>, and H3<sub>A</sub> were tested using a continuous measure of participants' change in judgments. Hypotheses H1<sub>B</sub>, H2<sub>B</sub>, and H3<sub>B</sub> were tested using a continuous measure of participants' change in decisions. The aforementioned hypotheses were analyzed through univariate analysis of variance (ANOVA). Hypothesis H4 was tested with two dependent variables: a continuous measure of the budgeted time to evaluate evidence and a discrete measure of the number of additional evidence items to be examined. T-tests were used to test the continuous measure and Wilcoxon rank sum tests were used to test the discrete measure.

The remaining sections of this chapter provide detailed discussions of the research methodology. The experimental design and independent variables are presented in the first section. The second section describes the dependent variables. Section three

describes the study's participants. Section four describes the distribution of the experimental materials. Section five describes the content of the experimental materials.

### 3.1 Design and Independent Variables

Two independent variables were manipulated in a 3 x 2 factorial design (see Figure 1). The two independent variables were client preference and trustworthiness. Client preference was manipulated between-subjects at three levels: no client preference (NCP), early client preference (ECP), and late client preference (LCP). In the NCP condition, participants reviewed the audit task information and the associated audit evidence without receiving explicit information about the client's preference. In the ECP condition, participants reviewed the same audit task information and in addition were told of the client's preference immediately before reviewing the first piece of audit evidence. In the LCP condition, participants reviewed the same audit task information and in addition were told of the client's preference immediately after reviewing the last piece of audit evidence.<sup>19</sup>

The CP manipulation relates to tests of  $H1_A$ ,  $H1_B$ ,  $H2_A$ , and  $H2_B$ . Omnibus F-tests from univariate ANOVAs were used to test  $H1_A$  and  $H1_B$ . Tests of  $H2_A$  and  $H2_B$  assumed the rejection of  $H1_A$  and  $H1_B$ , respectively. Therefore, contrasts between the ECP and LCP conditions were used to test  $H2_A$  and  $H2_B$  only if  $H1_A$  and  $H1_B$  were rejected.

For each task, trustworthiness was manipulated between-subjects at two levels: low trustworthiness and high trustworthiness. The levels of trustworthiness were established by varying factors found to be indicative of an auditor's trust of a client (see Table 2). Factors varied in the manipulation were: the accounting firm's tenure with the audit client, the controller/chief financial officer's length of employment with the audit client, the presence of a financial incentive for the controller/chief financial officer to

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<sup>19</sup> For the ECP and LCP conditions, the preference was not accompanied by the client's rationale or reasoning. By excluding the client's rationale from the manipulation, any significant findings associated with the client preference may be attributed to the preference and not to the client's rationale. Although this approach may have weakened the client preference manipulation, any subsequent findings are more easily interpreted and less subject to confounding.

misstate the company's financial position, the nature of the controller/chief financial officer's representations in prior years, and the quality of the communications between the audit firm and the controller/chief financial officer. These factors were based upon Shaub (1996).

The trustworthiness manipulation is related to the tests of H3<sub>A</sub>, H3<sub>B</sub>, and H4. Omnibus F-tests from univariate ANOVAs were used to test H3<sub>A</sub> and H3<sub>B</sub>. T-tests and Wilcoxon rank sum tests were used to test H4.

### 3.2 Dependent Measures

Four dependent measures were used to test the research hypotheses. H1<sub>A</sub>, H2<sub>A</sub>, and H3<sub>A</sub> were tested using log likelihood ratios to measure change in auditors' judgments. H1<sub>B</sub>, H2<sub>B</sub>, and H3<sub>B</sub> were tested using percentage changes to measure change in auditors' decisions. H4 was tested with two dependent measures: budgeted time to evaluate additional audit evidence and the number of additional audit evidence items to be examined.

#### *3.2.1 Log Likelihood Ratio*

Two types of judgments were obtained: a collectibility judgment in the Allowance for Doubtful Accounts task and a disclosure importance judgment in the Contingent Liability task. Log likelihood ratios were formed to assess the extent to which auditors' judgments were updated upon the receipt of new evidence. This measurement approach is consistent with Bayes' Theorem which provides a method to measure the impact of new evidence on judgments (Slovic and Lichtenstein 1971). A further advantage of Bayes Theorem is that it provides a means by which to capture differences in both prior and posterior probabilities.<sup>20</sup>

The log likelihood ratio was formed as follows:

$$\text{LOGJDG} = \text{Log} (100 - \text{JDG } 4) - \text{Log} (\text{JDG } 4) - \text{Log} (100 - \text{JDG } 1) + \text{Log} (\text{JDG } 1)$$

where:

LOGJDG = the log likelihood ratio  
JDG 4 = participant's fourth judgment  
JDG 1 = participant's first judgment

LOGJDG measures which are close to zero imply smaller revisions in judgments while larger measures imply greater revisions in judgments.

### 3.2.2 Change in Decision

Because past research has found that individuals' judgments are not necessarily consistent with their decisions, a second dependent measure was used in each task (Einhorn and Hogarth 1981). This variable, referred to as CHGDEC, measures the extent to which decisions regarding the need to adjust the Allowance for Doubtful Accounts or disclose the Contingency were revised.

A log likelihood ratio (as in LOGJDG) was not computed for the decision revisions for two reasons. First, Bayes' Theorem is widely accepted as a theoretical approach to measuring judgment processes, not decision processes. Second, the use of the approach was not feasible due to the number of participants whose decision revisions were zero. Accordingly, the CHGDEC variable was computed as follows:

$$\text{CHGDEC} = (\text{DEC 4} - \text{DEC 1}) / \text{DEC 1}$$

where:

CHGDEC = standardized revision in participant's decision  
DEC 4 = participant's fourth decision  
DEC 1 = participant's first decision

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<sup>20</sup> It is not the intention of the researcher to maintain that participants reasoned in a rational manner as suggested by Bayes' Theorem. However, a Bayesian model can be used to measure the extent to which participants' judgments were responsive to new evidence.

### *3.2.3 Evidence Evaluation Efforts*

Two measures were collected to evaluate evidence gathering and evaluation efforts. The first measure was the budgeted time for the examination of chosen evidence items. The second measure was the number of additional evidence items selected for further evaluation. The selection of these two measures is consistent with the audit approach which requires an auditor to determine not only how much evidence to gather (i.e., amount of corroboration required), but also how much time to spend in evaluating that evidence (i.e., establishing time budgets).

### 3.3 Participants

This study was designed to investigate the influence of a client's preference on audit judgment. Accordingly, practicing auditors were recruited. Furthermore, the cooperation of auditors at the same organizational level was solicited in order to control for possible experience effects identified in earlier studies (e.g., Buchman et al. 1996; Krull et al. 1993; Messier and Tubbs 1994; Pei et al. 1992). With these objectives in mind, audit managers were recruited for the experiment.

Notwithstanding the attempt to recruit only audit managers, a number of senior managers also completed the experimental materials. Because this study was not designed or intended to examine the relationship between audit experience, client preference and trust, an experience measure (i.e., audit position) was included in the statistical analysis where experience was found to be significantly related with the dependent variables. While managers and senior managers are not the only audit team members who may encounter client preferences, they may reasonably be expected to encounter such opinion based information more frequently than less experienced auditors.<sup>21</sup>

All participants were recruited from one national accounting firm. While this approach limits the generalizability of the results, the study's internal validity is

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<sup>21</sup> The use of managers and senior managers as participants is consistent with past CP research. Most studies have recruited participants with substantial experience. See column 3 of Table 1 for the experience levels in these past studies.

strengthened by eliminating potential “firm” effects. Such a method also permitted the experimental materials to be adapted to the firm’s audit approach, which allowed the information to be provided to participants in a familiar format (cf., Bonner 1990).

One hundred participants’ names and addresses were obtained from the cooperating firm’s National Human Resources department. Of the 100 participants, thirty-six completed the experimental materials upon the first request and an additional 25 participants completed the materials upon a second request.<sup>22</sup> In total, 61 completed instruments were received. Demographic data for all usable instruments are presented separately for the Contingent Liability and Allowance tasks in Tables 3 and 4.

### 3.4 Distribution of Experimental Materials

Each participant received an instrument package containing two audit tasks: an Allowance for Doubtful Accounts task and a Contingent Liability task.<sup>23</sup> In these instrument packages, the client preference manipulation was held constant while trustworthiness was varied. There were twelve possible combinations of the instrument package.<sup>24</sup> After a participant received a particular version of the first task (e.g., either the Allowance for Doubtful Accounts task or the Contingent Liability task), the second task was automatically determined. For example, suppose a participant received the High Trustworthiness – No Client Preference version of the Allowance for Doubtful Accounts task. The second task would automatically be the Low Trustworthiness – No Client Preference version of the Contingent Liability task. This strategy helped mitigate demand effects associated with the receipt of both levels of trustworthiness.

Several local offices from which participants were recruited employed more than one participant. As a result, a randomization strategy was developed to ensure that no

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<sup>22</sup> Approximately three weeks after the initial request, each participant received a follow-up phone call to solicit their participation. Phone calls were placed rather than sending letters or e-mail messages because it was believed that individuals would be more likely to respond to personal contact or voice mail. No significant differences were noted between those who responded to the first and second requests (p-values ranged from 0.15 to 0.83).

<sup>23</sup> The order in which participants received the two tasks was not significant (p-values ranged from 0.13 to 0.71).

<sup>24</sup> There are six versions of each audit task. To mitigate order effects associated with the receipt of two tasks, the order of the tasks was counterbalanced (i.e., reversed). This resulted in twelve combinations of the instrument packages.

two individuals in an office would receive identical instrument packages. This was especially important because participants completed the experimental materials at their own offices and not in a controlled laboratory setting.

A review of the participant listing indicated that no single office had more than nine participants. Because there were more combinations of the instrument package than there were participants in any single office, it was possible to provide each participant in an office a unique instrument package.

Participants in each office were assigned a participant identifier (ranging from 1 to 102) which increased in intervals of nine. For example, assume Office A had three participants. The first participant would be assigned the participant identifier # 1, the second participant # 10, and the third participant # 19. Participants from Office B would have received identifiers in a similar fashion. For example, the first participant would be assigned the participant identifier # 2, the second participant # 11, the third participant # 20, and so on. Then using the randomization strategy shown in Figure 2 participants were assigned to an instrument package.

### 3.5 Content of the Experimental Materials

#### *3.5.1 Task Instructions*

Participants were mailed a package of materials which included an endorsement letter written by a member of the firm's senior management staff (see Appendix A), a letter of introduction from the researcher (see Appendix B), and the experimental materials. The endorsement letter was included in an effort to encourage the recipient's response and to convey the sponsoring firm's support for the project. The letter of introduction further explained the purpose of the research project and provided the assurance that all responses would remain completely confidential.

Following the introductory letter, participants were instructed to begin the project by reading the "General Instructions" (see Appendix C). Participants were informed that as part of the project they would be asked to provide a number of judgments and decisions. Further, they were told that there were no right or wrong answers for the tasks

as the questions they would be asked dealt with matters of professional judgment. To ensure integrity of the experiment, instructions included a number of specific guidelines which participants were to follow during the completion of the project materials.<sup>25</sup> The following guidelines were provided:

- Materials were to be completed in a specified order. Specifically, participants were told to complete the materials in the order of Case A, Case B, and the debriefing questionnaire. Each of the cases and the debriefing questionnaire were enclosed in a separate sealed envelope.
- After completing the materials in an envelope (e.g., Case A Materials) all materials were to be returned to the same envelope.
- Judgments and recommendations were to be provided as though the participant was engaged in an actual audit situation.
- Participants were instructed not to discuss the case with any other members of the firm.
- Although participants were advised that there was no time constraint on the completion of the materials, they were instructed to complete them in one sitting.

After reading the above introductory materials, participants were instructed to begin the two audit tasks.

### *3.5.2 Audit Tasks*

Participants received two audit tasks – an Allowance for Doubtful Accounts task and a Contingent Liability task (see Appendix D). These two tasks were chosen because they represent two distinct issues identified in past CP research – measurement and

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<sup>25</sup> While participants were instructed to complete the materials in a specified order and in one sitting, compliance could not be ascertained because the materials were completed in each participant's office rather than in a controlled laboratory setting. Participants' self-reported their completion times of the experimental materials. The mean (standard deviation) time was 34.05 (13.26) minutes. There was no significant difference in completion times across the experimental conditions as p-values ranged from 0.52 to 0.93.

disclosure. Specifically, the Allowance task represents a setting in which the auditor may propose an income-reducing adjustment, while the Contingent Liability task represents a setting in which the auditor may require disclosure in the notes accompanying the financial statements, but no loss accrual.<sup>26</sup> Collecting data from two audit tasks provided a more robust test of the research hypotheses.

Each task was constructed with the intention of providing sufficient information to allow participants to form judgments and decisions. Task narratives included a brief history of the audit client (each audit task represented a separate client), summarized financial information for the current and two prior years, and biographical information about the client contact – the company’s controller/chief financial officer.

Following the basic task information, participants received four evidence items (each presented on a separate page). After reading each of the four evidence items, participants answered two questions on separate 11-point scales. In the Allowance task, the first question solicited judgments regarding the collectibility of a customer’s accounts receivable. The second question solicited decisions regarding the need to adjust the Allowance for Doubtful Accounts. In the Contingency Liability task, the first question solicited judgments regarding the importance of disclosing the contingency. The second question solicited decisions regarding the disclosure of the contingency. In total, participants made four judgments and four decisions in each audit task.

Following the final response (i.e., the fourth decision) in an audit task, a list of additional audit evidence related to the accounting issue was provided. Participants were asked to indicate their interest in evaluating some, none, or all of these items. This interest was indicated by having the participants record the amount of time they would budget to evaluate a particular evidence item.

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<sup>26</sup> Reporting for contingent liabilities is outlined in SFAS No. 5. The determination of the correct reporting for a contingent liability is based upon two factors: 1) the degree of uncertainty surrounding an asset impairment or the creation of a liability and 2) the ability to reasonably estimate the loss amount. Depending upon the specific facts, the liability should: not be disclosed; be disclosed in a note accompanying the financial statements; or be accrued and disclosed in a note accompanying the financial statements (FASB 1991). In order to simplify the analysis, the auditor will be asked to determine whether the client should disclose or not disclose the liability.

The final step in the experiment had participants respond to a debriefing questionnaire (see Appendix E). The questionnaire inquired as to the participants' professional and educational background, their understanding of the audit task materials, and their attitudes regarding the auditor-client relationship.

## CHAPTER 4

### RESULTS

This chapter is comprised of five sections. The first section presents and discusses the tests of the assumptions underlying the analysis of variance (ANOVA) statistical model. The section also provides results of the manipulation checks that were included to ensure the effective manipulation of the independent variables. The second through fourth sections present analyses of the data associated with each of the research hypotheses. The chapter's final section presents supplemental analysis.

#### 4.1 Preliminary Analysis

The preliminary data analysis presented in this section was conducted for three primary purposes. First, the assumptions underlying the ANOVA statistical model were tested to provide justification for the performance and interpretation of the results of the hypothesis tests. Second, manipulation checks were performed to assess the effectiveness of the manipulation of the independent variables. Third, a review of all completed instruments was conducted to identify participants who may have failed to understand the experimental instruments.

##### *4.1.1 Tests of Statistical Assumptions*

The ANOVA model has three underlying assumptions: independence of the error terms, normality of the error terms, and homogeneity of variance (Keppel 1991, p. 97). The first assumption, independence of the error terms, may be satisfied by randomly assigning participants to experimental conditions. Accordingly, all participants were randomly assigned an instrument package that contained the experimental conditions.

Graphical and statistical methods were utilized to test the assumption of normality. First, normal probability plots were generated to allow a visual inspection of

the data. Several of these plots were slightly non-normal in appearance and so further analysis was conducted through the use of the Shapiro-Wilk test. This procedure provides a method by which the normality of each experimental condition (i.e., individual treatment cells from the 3 x 2 factorial) may be tested. Results indicated that one of six cells in the Allowance task was not normally distributed. Also, two of six cells in the Contingent Liability task were not normally distributed.<sup>27</sup> The non-normality of several cells is not unexpected given the type of scale (i.e., 11-point scale) used to collect the data. Further, the F-test is robust to such slight violations of normality for fixed effects models (Kirk 1982; Neter, Wasserman, and Kutner 1985).

The homogeneity of variance assumption was evaluated with a procedure developed by Brown and Forsythe (1974). This test was selected because of its robustness to departures from normality. Other procedures commonly used to test homogeneity of variance (e.g., Hartley, Cochran, and Bartlett) often suffer from insufficient power in the presence of non-normality (Keppel 1991, p. 102). Analysis of the data in the two audit tasks reveals homogenous variances (p-values for the Brown/Forsythe test ranged from 0.308 to 0.971).

#### *4.1.2 Manipulation and Reasonableness Checks*

As part of the debriefing questionnaire participants received three manipulation checks for each audit task.<sup>28</sup> First, participants were asked to indicate whether the client explicitly stated a preferred accounting treatment. Second, participants rated their client contact's trustworthiness on an 11-point scale anchored at "Not Trustworthy" and "Very Trustworthy." Third, participants rated the client's competence on an 11-point scale anchored at "Not Competent" and "Very Competent." The first two manipulation checks tested the effectiveness of the independent variable manipulations. The third

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<sup>27</sup> A second evaluation of normality was conducted with the Kolmogorov-Smirnov test. Results of this test were similar to those of the Shapiro-Wilk procedure.

<sup>28</sup> Participants were also asked to rate the realism of each task on a scale ranging from "Not Realistic - 0" to "Very Realistic - 10". Mean (standard deviation) realism ratings were 7.47 (1.85) and 7.62 (1.43) for the Allowance and Contingent Liability tasks, respectively.

manipulation check was included to test the integrity of the trustworthiness manipulation since that manipulation was intended to maintain competence at a constant level.

The first manipulation check was used to test the client preference manipulation. In the Allowance task, seven participants (five from the ECP condition and two from the LCP condition) failed to properly identify the client preference condition to which they had been assigned. In the Contingent Liability task, ten participants (two from the NCP condition, four from the ECP condition, and four from the LCP condition) failed the manipulation check. These individuals were dropped from subsequent analyses.

The second manipulation check was used to evaluate the trustworthiness manipulation. Each participant's instrument package contained two tasks, each with a different level of trustworthiness. A review of the trustworthiness manipulation checks for the two tasks in each instrument package did not reveal any participant who responded in a manner that was inconsistent with the intended trustworthiness manipulation. Furthermore, in the Allowance task, participants' mean (standard deviation) ratings were 7.59 (.983) and 3.55 (1.02) in the high and low trustworthiness conditions, respectively. These ratings are significantly different ( $t = -14.096$ , two-tailed  $p < 0.001$ ). In the Contingent Liability task, participants' mean (standard deviation) ratings were 7.26 (1.30) and 4.74 (1.49) in the high and low trustworthiness conditions, respectively. These ratings are significantly different ( $t = -6.28$ , two-tailed  $p < 0.001$ ). Thus, the manipulation was deemed successful because participants considered the client contacts in the high trustworthiness to be more trustworthy than client contacts in the low trustworthiness condition.

The third manipulation check was used to test the *integrity* of the trustworthiness manipulation. Specifically, this manipulation check was designed to evaluate whether participants believed their client contacts possessed different levels of competence. Given that the trustworthiness manipulation was designed with the intent of holding competence constant, any significant difference in participants' competence ratings is evidence that this effort was partially unsuccessful. In the Allowance task, participants' mean (standard deviation) competence ratings were 7.83 (.877) and 6.39 (1.40) in the

high and low trustworthiness conditions, respectively. These ratings are significantly different ( $t = -4.24$ , two-tailed  $p < 0.001$ ). Notwithstanding this difference, the practical significance of the reported means may be of little consequence. In both trust conditions, participants' ratings are generally reflective of a contact who possesses reasonable competence. Nevertheless, caution should be exercised when evaluating the findings related to the trustworthiness manipulation in the Allowance task.

In the Contingent Liability task, participants' mean (standard deviation) competence ratings were 7.14 (1.57) and 6.43 (1.52) in the high and low trustworthiness conditions, respectively. These ratings are not significantly different ( $t = -1.63$ , two-tailed  $p = 0.108$ ).

During a review of the completed tasks, several instruments were identified which contained nonsensical responses. Further review of these instruments led to the conclusion that several participants had misunderstood the Allowance task. This misunderstanding was evident in that each individual had indicated (via their collectibility judgments) that the account in question was uncollectible yet they believed that it was important to decrease the Allowance for Doubtful Accounts (via their adjustment decisions). Accordingly, four instruments (in the Allowance task only) were dropped from subsequent analyses. Finally, one participant reported having more than nine years of industry experience. To ensure as much homogeneity among participants as possible with respect to past private industry experience, this individual's responses were not included in subsequent analyses.

In summary, twelve participants were eliminated from the Allowance task and eleven participants were removed from the Contingent Liability task. After the elimination of these participants, there were 50 and 49 usable responses in the Contingent Liability and Allowance tasks, respectively.

#### 4.2 Tests of Hypotheses

Tables 6 through 9 report the results of the univariate ANOVAs related to the tests of H1<sub>A</sub>, H1<sub>B</sub>, H2<sub>A</sub>, H2<sub>B</sub>, H3<sub>A</sub>, and H3<sub>B</sub>. Tests of the research hypotheses are

presented separately for the two audit tasks. Tables 6 and 7 report results for the Allowance task, while Tables 8 and 9 report results for the Contingent Liability task. Each of these tables presents analysis related to one dependent variable. Two continuous dependent variables were used to assess the above listed hypotheses. The log likelihood ratio of collectibility/disclosure judgments was used to test H1<sub>A</sub>, H2<sub>A</sub>, and H3<sub>A</sub>. The extent to which decisions to adjust the Allowance for Doubtful Accounts or disclose the contingency were revised was used to test H1<sub>B</sub>, H2<sub>B</sub>, and H3<sub>B</sub>. Two independent variables and their interaction were included in the ANOVAs: trustworthiness (trust), client preference (CP), and the interaction of trust and CP.

Tables 10 and 11 present results for the tests of H4. Two dependent variables were used to evaluate this hypothesis: participants' budgeted time to evaluate additional audit evidence (a continuous measure) and the number of additional evidence items to be examined (a discrete measure).

#### 4.3 Hypotheses One and Two

The first two hypotheses (in null form) are as follows:

**H1<sub>A</sub>:** Auditors' judgments will not be influenced by a client preference.

**H1<sub>B</sub>:** Auditors' decisions will not be influenced by a client preference.

**H2<sub>A</sub>:** The temporal placement of a client preference will not differentially influence auditors' judgments.

**H2<sub>B</sub>:** The temporal placement of a client preference will not differentially influence auditors' decisions.

Given that tests of H2<sub>A</sub> and H2<sub>B</sub> assume the rejection of H1<sub>A</sub> and H1<sub>B</sub>, respectively, tests of these hypotheses are presented together.

##### *4.3.1 Allowance for Doubtful Accounts Task*

Hypothesis H1<sub>A</sub> predicts that a client preference will not influence auditors' judgments. Descriptive measures for the CP variable are included in Panel B of Table 6. Participants in the NCP condition revised their collectibility judgments based solely on

the evidence included in the Allowance task.<sup>29</sup> The mean revision in their collectibility judgments was -0.993.<sup>30</sup> Participants revised their collectibility judgments less in the ECP condition as indicated by the lower mean revision of -0.784. However, when the CP was stated late in the evidence evaluation process participants revised their collectibility judgments more (i.e., -1.492) than in either of the other two conditions.

Panel A of Table 6 indicates that participants' collectibility judgments did not differ in a statistically significant manner across the levels of CP ( $F = 2.23$ ,  $p = 0.1205$ ). Therefore, I fail to reject  $H1_A$  in this task and as a consequence tests of  $H2_A$  were not conducted.

Hypothesis  $H1_B$  predicts that a client preference will not influence auditors' decisions. Descriptive measures for the CP variable are included Panel B of Table 7. The pattern of mean adjustment revisions (i.e., a percentage change) is consistent with the pattern of collectibility judgments discussed above. Specifically, the positive revisions shown in this table indicate that participants were more likely to increase the Allowance account. Again, participants in the NCP condition revised their adjustment decisions based solely on the evidence included in the Allowance task. The mean revision in their adjustment decisions was 34.3 %. Participants revised their adjustment decisions less in the ECP condition as indicated by the lower mean revision of 24.6 %. However, in the LCP condition, participants revised their adjustment decisions more (47.5 %) than in either of the other two conditions.

Panel A of Table 7 reports that participants' adjustment decisions differed in a statistically significant manner across the levels of CP ( $F = 3.19$ ,  $p = 0.0513$ ). Therefore, the hypothesis ( $H1_B$ ) that client preference does not influence auditors' decisions was rejected and tests of  $H2_B$  were performed. A priori contrasts were used to isolate the

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<sup>29</sup> For the Allowance task, the ANOVA model includes a "Position" control variable because correlation analysis indicated that participants' positions (i.e., managers or senior managers) were significantly correlated with their decision revisions ( $\rho = .370$ ,  $p = 0.009$ ). The correlation with the collectibility judgments was not significant ( $\rho = -.200$ ,  $p = 0.169$ ), but was included in the ANOVA to allow for a consistent presentation for the task. No experience measure was significant in tests of the hypotheses related to the Contingent Liability task and so no such variable is included in the ANOVA for the task.

<sup>30</sup> This measure is interpreted to mean that participants revised their collectibility judgments downward reflecting their belief that the account was uncollectible.

significant differences among the levels of the CP effect. These contrasts reveal a statistically significant difference (i.e.,  $F = 6.24$ ,  $p = 0.0165$ ) between the ECP and LCP conditions. Therefore, a significant temporal placement effect was found and  $H2_B$  is rejected.

#### 4.3.2 *Contingent Liability Task*

Descriptive measures for the CP variable in the Contingent Liability task are included in Panel B of Table 8. The pattern of results for the disclosure importance judgments is similar to that observed for the collectibility judgments in the Allowance task. Participants in the NCP condition revised their disclosure importance judgments based solely on the evidence included in the task. Mean revisions in the disclosure importance judgments for those in the NCP condition was  $-1.163$ .<sup>31</sup> Participants in both the ECP and the LCP conditions revised their disclosure importance judgments less than in the NCP condition ( $-0.419$  and  $-0.995$ , respectively).

Panel A of Table 8 indicates that the differences in these judgments are not significantly different ( $F = 2.32$ ,  $p = 0.1114$ ). Therefore, I failed to reject  $H1_A$  in this task as well. Consequently, tests of  $H2_A$  were not conducted.

Panel B of Table 9 includes descriptive measures of the extent to which participants revised their disclosure decisions. The pattern of mean revisions (i.e., a percentage change) indicates that participants in both CP conditions revised their disclosure decisions less than those in the NCP condition. The positive revisions shown in Panel B indicate that participants generally revised their disclosure decisions in such a way as to reflect their growing belief that the client should disclose the Contingency. Participants in the NCP condition revised their disclosure decisions more (126.5 %) than those in either the ECP or LCP condition (18.3 % and 19.9%, respectively).

Panel A of Table 9 reports that the extent to which participants revised their disclosure decisions differed in a statistically significant manner across the levels of CP

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<sup>31</sup> This measure is interpreted to mean that participants revised their disclosure importance judgments to reflect their belief that it was important to disclose the Contingency. More (less) negative measures indicate that it is more (less) important to disclose the Contingency.

( $F = 3.66$ ,  $p = 0.0340$ ). Therefore,  $H1_B$  is rejected. A priori contrasts were used to isolate the significant differences among the three levels of the CP variable. Mean revisions in the NCP condition were significantly different from revisions made in both the ECP ( $F = 5.70$ ,  $p = 0.0213$ ) and LCP ( $F = 4.90$ ,  $p = 0.0320$ ) conditions. However, the difference between ECP and LCP was not significant. Therefore, I fail to reject  $H2_B$ .

#### *4.3.3 Summary of Hypotheses One and Two*

Neither  $H1_A$  nor  $H2_A$  was rejected for either task (see Table 5). Client preferences did not significantly influence participants' collectibility judgments or their disclosure importance judgments. However,  $H1_B$  was rejected for both tasks and  $H2_B$  was rejected in the Allowance task. In the Allowance for Doubtful Accounts task, the extent to which participants revised their Allowance account decisions was significantly influenced by an explicit preference. However, this influence was confined to a significant temporal difference between the ECP and LCP conditions. In the Contingent Liability task, a significant CP effect was also revealed. More specifically, the extent to which participants revised their disclosure decisions was influenced by the client's stated preference. However, this influence did not differ with the preference's temporal placement.

#### 4.4 Hypothesis Three

The third hypothesis (in alternative form) is as follows:

**H3<sub>A</sub>:** In the presence of a highly (less) trustworthy client, auditors will make judgments that are more (less) consistent with the client's interests.

**H3<sub>B</sub>:** In the presence of a highly (less) trustworthy client, auditors will make decisions that are more (less) consistent with the client's interests.

Following these hypotheses, the expectation is that auditors will believe it is more important to increase the allowance account or disclose the contingency if the client is

less trustworthy than if the client is highly trustworthy. Furthermore, auditors' decisions are expected to correspond with these judgments.

#### *4.4.1 Allowance for Doubtful Accounts Task*

Hypothesis H3<sub>A</sub> predicts that auditors will make judgments that are more (less) consistent with a client's interests if the client is deemed to be highly (less) trustworthy. Panel B of Table 6 presents descriptive measures for the trustworthiness variable. Participants whose clients were less trustworthy revised their collectibility judgments less than those with highly trustworthy clients. Specifically, the revisions for those with less trustworthy clients was -0.963. Alternatively, the revisions for participants with highly trustworthy clients was -1.167. These revisions reflect the participants' growing attitudes that the account was uncollectible. Interestingly, participants with highly trustworthy clients believed the account to be slightly more uncollectible than those with less trustworthy clients. Panel A of Table 6 indicates that participants' collectibility judgments did not differ in a statistically significant manner across the two levels of trustworthiness ( $F = 0.66$ ,  $p = 0.2098$ ). Failure to find significant results implies that the judgments did not differ in a meaningful manner. Therefore, my findings are not consistent with H3<sub>A</sub>.

Hypothesis H3<sub>B</sub> predicts that auditors will make decisions that are more (less) consistent with a client's interests if the client is deemed to be highly (less) trustworthy. Descriptive measures for the trustworthiness variable are included in Panel B of Table 7. Participants whose clients were less trustworthy revised their adjustment decisions (i.e., measured as a percentage change) less than those with highly trustworthy clients. Specifically, participants with less trustworthy clients revised their adjustment decisions 27.3 % while those with highly trustworthy clients revised their decisions by 41.9 %. The direction of these revisions is consistent with the participants' judgments that the account was generally uncollectible. Panel A of Table 7 reports that these adjustment decision revisions were different in a statistically significant manner and in the expected direction across the levels of trustworthiness ( $F = 4.62$ ,  $p = 0.0187$ ). Therefore, my findings are consistent with H3<sub>B</sub>.

#### *4.4.2 Contingent Liability Task*

Panel B of Table 8 presents descriptive measures for the trustworthiness variable. As expected, participants whose clients were less trustworthy revised their disclosure importance judgments more than those with highly trustworthy clients. Specifically, the mean revisions for those with less trustworthy clients was -1.151. Alternatively, the mean revisions for participants with highly trustworthy clients was -0.394. These revisions reflect the participants' growing attitudes that it was important to disclose the Contingency. Panel A of Table 8 indicates that participants' disclosure importance judgments differed in a statistically significant manner and in the expected direction across the levels of trustworthiness ( $F = 6.19, p = 0.0086$ ). Therefore, my findings are consistent with H3<sub>A</sub>.

Descriptive measures for the trustworthiness variable are included in Panel B of Table 9. Consistent with the expectation, participants whose clients were less trustworthy revised their disclosure decisions (i.e., measured as a percentage change) more than those with highly trustworthy clients. More precisely, participants with less trustworthy clients revised their disclosure decisions 65.1 % while those with highly trustworthy clients revised their decisions by 48.3 %. The direction of these revisions is consistent with the participants' judgments. However, Panel A of Table 9 reports that the extent to which participants revised their disclosure decisions did not differ significantly across the levels of trustworthiness ( $F = 0.35, p = 0.2776$ ). Although the decisions differed in the predicted direction, the difference is not significant and my findings are not consistent with H3<sub>B</sub>.

#### *4.4.3 Summary of Hypothesis Three*

The findings related to H3<sub>A</sub> and H3<sub>B</sub> are somewhat complex (see Table 5). As predicted, participants' judgments were sensitive to the client's trustworthiness, but only when evaluating a disclosure issue as in the Contingent Liability task. In the Allowance task, auditors' judgments were not differentially sensitive to client trustworthiness. Thus, my findings were not consistent with H3<sub>A</sub> in the Allowance task. However, the findings were consistent with the hypothesis in the Contingent Liability task. Accordingly, I

conclude that auditors' judgments were not sensitive to client trustworthiness in the Allowance task, but were differentially sensitive in the Contingent Liability task.

Participants' adjustment revisions in the Allowance task exhibited significant sensitivity to the client's trustworthiness, but disclosure revisions in the Contingent Liability task did not. The findings in the Allowance task are consistent with H3<sub>B</sub>. Alternatively, my findings were not consistent with the hypothesis in the Contingent Liability task. Therefore, I conclude that auditors' disclosure revisions were not differentially sensitive to client trustworthiness in the Contingent Liability task, but that their adjustment decision revisions were differentially sensitive in the Allowance task.

#### 4.5 Hypothesis Four

The fourth hypothesis (in alternative form) is as follows:

**H4:** An auditor's evidence evaluation efforts will be negatively related to the client's relative trustworthiness.

Following this hypothesis, the expectation is that auditors will accumulate more audit evidence and expend more effort in evaluating that evidence when performing an audit in the presence of a less trustworthy client than in the presence of a highly trustworthy client. Two measures – budgeted minutes and number of items to be examined – were used to test H4. The results for each measure are provided in separate panels in Tables 10 and 11.

##### *4.5.1 Allowance for Doubtful Accounts Task*

Table 10 provides results related to the fourth hypothesis. A t-test was used to determine whether auditors' evidence evaluation efforts (as measured by budgeted minutes) differed across levels of the client's trustworthiness. Panel A of the table indicates that participants' evidence evaluation efforts were not significantly different across the levels of trustworthiness ( $t = -0.443$ ,  $p = 0.3299$ ). In fact, participants who had less trustworthy clients actually indicated that they would budget slightly less time

(i.e., 125.26 minutes) to evaluate additional evidence than participants with highly trustworthy clients (i.e., 134.23 minutes).

Panel B of Table 10 reports results for the second measure. The Wilcoxon rank sum test indicates that participants did not wish to evaluate significantly different numbers of evidence items across the levels of trustworthiness ( $W = 514.0$ ,  $p = 0.2149$ ). In fact, the same reverse pattern found in the first measure (i.e., budgeted time) was revealed. Participants who had less trustworthy clients indicated that they wished to evaluate 4.00 additional evidence items while those who had highly trustworthy clients wished to evaluate 5.00 items. Neither of the tests provides results which are consistent with H4 in this task.

#### *4.5.2 Contingent Liability Task*

Table 11 provides the results for the Contingent Liability task. As in the Allowance task, participants' evidence evaluation efforts were not significantly different across the levels of trustworthiness ( $t = 0.210$ ,  $p = 0.4176$ ). However, the pattern of results was in the expected direction. Specifically, participants who had less trustworthy clients indicated that they would budget slightly more time (i.e., 148.39 minutes) to evaluate additional evidence than participants with highly trustworthy clients (i.e., 142.14 minutes).

Panel B of the Table 11 provides directionally similar results. Participants in the low trustworthiness condition indicated a desire to evaluate more evidence (i.e., 4.50 items) than those in the high trustworthiness condition (i.e., 4.00 items). However, a Wilcoxon rank sum test indicates that this difference is not significant ( $W = 516.5$ ,  $p = 0.3827$ ). Again, neither of the above tests provides results which are consistent with H4 in this task.

#### *4.5.3 Summary of Hypothesis Four*

The above results are not consistent with H4 (see Table 5). In both tasks, participants did not indicate an interest in evaluating more evidence either in terms of budgeted time or number of evidence items when the client was less trustworthy.

## 4.6 Supplemental Analysis

### *4.6.1 Final Judgments and Decisions*

Supplemental analyses were conducted to determine whether participants' *final* judgments and/or decisions were influenced by a client preference or client trustworthiness. Results of the analyses are presented separately for each of the tasks.

#### *4.6.1.1 Allowance for Doubtful Accounts Task*

Table 12 reports results for the Allowance task related to participants' final collectibility judgments. Panel A reveals a marginally significant trustworthiness effect ( $F = 2.45$ ,  $p = 0.0627$ ), a significant "Trust x CP" interaction ( $F = 3.82$ ,  $p = 0.0299$ ), and a significant position effect ( $F = 5.20$ ,  $p = 0.0277$ ). Participants with highly trustworthy clients believed the hypothetical accounts receivable to be less collectible than those with less trustworthy clients (66.3% as compared to 58.5%).<sup>32</sup> However, the main effect must be interpreted with caution because of the significant "Trust x CP" interaction.

Analysis of the mean collectibility judgments for the interaction in Panel B of Table 12 reveals an interesting pattern. In the presence of a less trustworthy client, a client preference caused participants to believe the account to be less collectible. Alternatively, in the presence of a highly trustworthy client, a client preference caused participants to believe the account to be more collectible. Moreover, Panel B also indicates that senior managers generally believed the accounts receivable to be less collectible than managers (69.6% compared to 58.9%).

Table 13 reports results for final adjustment decisions. Trustworthiness is found to be marginally significant ( $F = 2.15$ ,  $p = .0752$ ). However, neither CP ( $F = 0.89$ ,  $p = 0.4167$ ) nor the interaction of "Trust x CP" is significant ( $F = 0.32$ ,  $p = 0.7245$ ). However, senior managers indicated that they felt more strongly regarding the need to increase the Allowance account than managers (79.8% compared to 69.5%).

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<sup>32</sup> Larger percentages indicate that the account is believed to be less collectible.

#### *4.6.1.2 Contingent Liability Task*

Table 14 reports results for the Contingent Liability task related to participants' final disclosure importance judgments. The only effect which approaches significance is client trustworthiness ( $F = 2.67, p = 0.0548$ ). And as expected, participants with less trustworthy clients believed that it was more important to disclose the Contingency than those with highly trustworthy clients (73.9% compared to 65.3%). An examination of Table 15 indicates that participants' final disclosure decisions did not differ across any of the independent variables.

#### *4.6.2 Evidence Evaluation Efforts*

Additional analyses were conducted to assess whether participants' evidence evaluation efforts were influenced by a client preference. The total budgeted minutes served as the dependent variable. Results of an ANOVA for the Allowance task are presented in Table 16. In this task, participants' efforts were not significantly influenced by a client preference ( $F = 1.15, p = 0.3254$ ). However, as shown in Panel B participants in the ECP condition did indicate a desire to budget slightly more time for the evaluation of the additional evidence (144.67 minutes) than those in either the NCP condition (131.55 minutes) or the LCP condition (112.14 minutes).

Evidence gathering efforts in the Contingent Liability task were influenced by the client preference ( $F = 4.08, p = 0.0238$ ). These data are shown in Table 17. Participants in the ECP condition budgeted more time for the evaluation of evidence (181.39 minutes) than those in either the NCP (138.72 minutes) or LCP condition (108.57 minutes). Additionally, senior managers budgeted significantly more time than managers for the valuation of the additional evidence – 191.33 minutes compared to 126.06 minutes ( $F = 7.63, p = 0.0084$ ).<sup>33</sup>

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<sup>33</sup> Correlation analysis indicated a significant relation ( $\rho = 0.3101, p = 0.028$ ) between audit position and evidence efforts in the Contingent Liability task therefore, audit position was included in the ANOVA.

#### *4.6.3 Attitudinal Measures*

Supplemental analysis was also conducted in an attempt to gain further insight into participants' judgments and decisions. In the debriefing questionnaire (see Appendix E), participants were asked to indicate their level of agreement/disagreement with a series of statements designed to measure their attitudes regarding the auditor-client relationship. Descriptive statistics for the responses are provided in Table 18.

The majority (67.2 %) of participants disagreed with the contention that an auditor's primary responsibility is to behave as an advocate for the client. A similarly high percentage of participants (67.2 %) agreed with an opposing statement that auditors are primarily responsible for safeguarding investors' and creditors' interests.

Participants also tended to agree (63.8 %) that the potential loss of a client is an important factor that must be considered when deciding how far to press a disagreement with a client. Further, many participants (65.5 %) agreed that auditors generally support their clients' positions in accounting matters. Consistent with these attitudes, a majority of the participants (58.6 %) did not concur with the contention that auditors who disagree with a client are likely to lose that client.

Finally, most participants (72.4 %) agreed that greater trust between the auditor and client may lead to a reduction in the accumulation of evidence when evaluating client representations. This finding is consistent with the anecdotal evidence presented by Hirst and Koonce (1996), but is inconsistent with the findings related to H4.

## CHAPTER 5

### DISCUSSION, IMPLICATIONS, AND LIMITATIONS

This chapter is comprised of two sections. The first section provides a summary of the research and a discussion of the study's results. This section also discusses implications of the findings and suggests avenues for future research. The final section addresses limitations of the study.

#### 5.1 Summary and Discussion

In this dissertation, I investigated the impact of explicitly stated client preferences on audit judgment and decision making processes. This investigation was undertaken because of growing concerns over the potential loss of auditor objectivity due to a client's ability to exert influence over the auditor via the communication of a preference (e.g., Public Oversight Board 1994; Sporkin 1993; Scheutze 1994; Sutton 1997).

My investigation addressed several issues identified during the review of past client preference studies. First, I examined the effect of varying the temporal placement of the client preference, an issue which had not been addressed in past studies. Second, my study included two distinct tasks – a measurement task and a disclosure task. Previous studies have included only one such task. Moreover, I utilized judgment and decision measures in each task which allowed me to determine the extent of the client preference's influence. In other words, I was able to determine whether a client preference impacts audit judgment and/or audit decision making. Finally, I enriched the study by explicitly considering an issue which had not previously been addressed – client trustworthiness. By including this variable, which is reflective of client credibility, participating auditors were provided a basis upon which to evaluate the client's representation (i.e., preference).

### *5.1.1 Hypotheses Related to the Client Preference Effect*

Explicitly stated client preferences significantly influenced the audit decision making process as indicated by the rejection of hypothesis H1<sub>B</sub> in both tasks. Moreover, results for the measurement task (i.e., the Allowance task) exhibited an interesting pattern in which auditors who received an ECP formulated and revised decisions which were not only significantly different, but also directionally opposite from those made under a LCP. Therefore, hypothesis H2<sub>B</sub> was also rejected in this task.

Interestingly, auditors who did not receive a client preference provided decisions which were consistently between those made in the presence of an ECP and a LCP. These results indicate that an early preference interfered in the decision making process in a manner consistent with the client's preference, but that a LCP lead to unintended negative effects. Auditors' negative reactions to the LCP may reflect their perceptions that the LCP was an attempt to unduly influence the audit process. Nonetheless, the impact of a client preference may be short lived as further analysis did not identify a meaningful difference among auditors' final decisions in the various client preference conditions. This implies that auditors eventually overcame the interference caused by the preference.

Results in the disclosure task while revealing a significant client preference effect as mentioned above did not exhibit a temporal placement effect. Therefore, I failed to reject hypothesis H2<sub>B</sub> for this task. In fact, decisions (and subsequent revisions) by auditors who received an ECP and a LCP were qualitatively identical. Once again, the client preference influence appears to have been short lived because further analysis indicates that auditors overcame the preference's influence by making final decisions which were not significantly different.

Failure to reject hypotheses H1<sub>A</sub> and H2<sub>A</sub> indicates that client preferences did not impact audit judgment in a statistically meaningful manner. Despite the insignificance, the pattern of judgments is essentially identical to the pattern found for the auditors' decisions. Given these results and their similarity to the pattern identified for hypotheses H1<sub>B</sub> and H2<sub>B</sub>, the lack of statistical significance may be due to a lack of power.

Supplemental analyses indicate that the influence of the client preference likely extends beyond judgments and decisions to include the audit process itself. In both tasks, auditors who received an early client preference indicated that they would need to accumulate more audit evidence than auditors who did not receive a preference or received a late client preference. This finding suggests that auditors are sensitive to an early preference and may alter their audit efforts in an attempt to accumulate sufficient evidence to either confirm or disconfirm their own or possibly the client's position. On the other hand, auditors appeared unresponsive to late client preferences. More precisely, auditors who received a late client preference indicated that they would need to evaluate less evidence than auditors who had either received an early preference or no preference at all. This reaction may indicate that the auditors had already formulated their position and simply did not need to accumulate additional evidence.

In summary, my findings do not support the contention that auditors readily acquiesce to a client's stated preference. Even though I found that a client's preference impacted the decision making process, my supplemental analysis revealed that the effect was temporary. In fact, neither auditors' final decisions nor their final judgments exhibited a significant client preference effect.

Supplemental analyses did, however, indicate that auditors' evidence efforts were responsive to an ECP. Specifically, auditors presented with a client preference at the beginning of their evidence evaluation process indicated that they would increase their audit efforts by seeking more audit evidence. This heightened effort may indicate attempts by auditors to accumulate evidence in order to justify their position to the client. Or, these efforts may indicate attempts to gain sufficient evidence in the face of a perceived increase in risk brought about by the communication of the preference. Future research may wish to consider these and other possibilities by empirically determining the basis for this additional audit effort.

#### *5.1.2 Hypotheses Related to the Trustworthiness Effect*

My findings are consistent with hypothesis H3<sub>A</sub> in the disclosure task. Audit judgments were more conservative in the presence of a less trustworthy client than in the presence of a highly trustworthy client. For instance, auditors with highly trustworthy

clients believed that it was less important to disclose the potential contingency than auditors with less trustworthy clients.

My findings were not consistent with hypothesis H3<sub>B</sub> in this task. Although auditors possessed divergent views on the importance of disclosing the contingency, no such difference was revealed in their disclosure decisions. In fact, regardless of the client's trustworthiness, auditors indicated that they would recommend that the client disclose the contingency. This finding is consistent with past research which has found that auditors tend to be conservative in the evaluation of loss contingencies (e.g. Buchman et al. 1996; Jiambalvo and Wilner 1985).

Findings were not consistent with hypothesis H3<sub>A</sub> in the measurement task. I found no evidence that audit judgments were sensitive to client trustworthiness. Auditors' judgments appear to have been based solely on what was perceived to be objective evidence (i.e., the evidence items).

Alternatively, auditors' decisions did exhibit sensitivity to the client's trustworthiness, thus supporting hypothesis H3<sub>B</sub>. Auditors were more likely to increase the allowance account for a highly trustworthy client than for a less trustworthy client. To understand this result, it should be noted that the trustworthiness manipulation portrayed the highly trustworthy client to be conservative while the less trustworthy client was portrayed to be aggressive. Thus, auditors may have behaved in a manner believed to be consistent with their client's interests. Specifically, they may have felt that the more conservative, highly trustworthy client would be accepting of an increase in the allowance account – an observation which is consistent with the auditors' *final* collectibility judgments and adjustment decisions. Alternatively, auditors may have believed that more aggressive, less trustworthy clients would be opposed to such an increase. Thus, in the absence of strong evidence to support their position these auditors may have been less willing to “confront” the client.

Caution should be exercised when interpreting my results for the measurement task. Recall that the manipulation check in this task indicated that auditors perceived not only a difference in the client's trustworthiness, but also a difference in their competence.

As a result, my manipulation does not appear to have been as pure in this task as in the disclosure task.

Finally, my results were not consistent with hypothesis H4. Auditors' evidence evaluation efforts were not meaningfully influenced by the client's trustworthiness. This result is unexpected given my expectation and the anecdotal evidence provided by Hirst and Koonce (1996). Furthermore, the vast majority (i.e., over 72 %) of auditors indicated in the debriefing questionnaire that they would seek less evidence to corroborate a client's representations if they trusted the client. This inconsistency may be due to my failure to include an adequate amount of information in the task (i.e., four evidence items were included in each task) which resulted in auditors wanting additional audit evidence regardless of the client's trustworthiness.

In summary, my results indicate that auditors perceive client trustworthiness to be an important factor in the audit judgment and decision making processes. However, the implications of trustworthiness appear to be partially determined by the context in which auditors find themselves. Therefore, future research efforts may wish to examine the trustworthiness effect in other contexts such as the going concern environment in which client representations are quite important. Moreover, future studies of credibility may benefit by expanding the credibility concept to include not only competence and objectivity as in past studies, but also trustworthiness.

### *5.1.3 Implications of the Study*

This study's findings suggest that auditors are less inclined to acquiesce to a client's preference than has been claimed (e.g., Sporkin 1993; Scheutze 1994). Despite my finding that explicitly stated client preferences resulted in significantly different decision processes, there was no significant CP effect observed for auditors' final decisions in either task. Therefore, it appears that the influence of the client's preference was transitory. Taken together, these findings suggest that the CP did not result in a loss of the auditors' objectivity.

Finally, auditors' judgments and decisions were sensitive to the client's relative trustworthiness. This finding suggests that auditors are responsive to a client's credibility when evaluating the client's representations, a result which is not unexpected given that

GAAS requires auditors to consider a source's credibility (AICPA 1997). However, it is surprising that auditors' evidence evaluation efforts were not differentially sensitive to the client's trustworthiness. Such a finding may indicate that the participating auditors' evidence evaluation efforts are more influenced by firm policy than individual judgment.

## 5.2 Limitations

My dissertation's results are subject to several limitations. First, participants were obtained from a single accounting firm. Although such an approach eliminates potential "firm" effects (cf., Bonner 1990) and strengthens the study's internal validity, it also limits the generalizability of the results. Furthermore, all participants had similar experience levels (i.e., audit positions) and did not represent all of the audit positions present in a public accounting firm. Therefore, the results obtained in this study may not extend to other experience levels. Second, my study likely suffers from a lack of statistical power because of the relatively small sample. Third, participants were forced to respond to my tasks in a step-by-step method. Auditors may not formulate their judgments and decisions in this fashion in real world settings. Therefore, the approach may have interfered in some unintended manner with auditors' actual decision making processes. Fourth, participants may experience other pressures such as accountability in an actual audit setting. The experimental setting used in this study did not capture such pressures. As a result, auditors may respond differently to a client's preference or attend to client trustworthiness in a different fashion in an actual audit setting.

Finally, the study elicited judgments and recommendations from individuals – a common approach in audit research. However, such an approach is limited because it does not allow for the participant's interaction with colleagues at the accounting firm or the client's personnel. These interactions (i.e., the working paper review process and client conferences) may significantly influence an auditor's judgment process (cf., Messier and Tubbs 1994; Cushing and Ahlawat 1996).

Client Preference <sup>a</sup>			
	NCP	ECP	LCP
High Trustworthiness			
Low Trustworthiness			

<sup>a</sup> Client Preference abbreviations are as follows: NCP – no client preference; ECP – early client preference; LCP – late client preference.

FIGURE 1  
Experimental Design

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**Panel A: Experimental Codes**

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Participant #	Instrument Packages	
	First Task	Second Task
1 to 9	1111001 – 1111009	2201001 - 2201009
10 to 18	1112010 – 1112018	2202010 - 2202018
19 to 27	1110019 – 1110027	2200019 - 2200027
28 to 36	1101028 – 1101036	2211028 - 2211036
37 to 45	1102037 – 1102045	2212037 - 2212045
46 to 54	1100046 – 1100054	2210046 - 2210054
55 to 62	1211055 – 1211062	2101055 - 2101062
63 to 70	1212063 – 1212070	2102063 - 2102070
71 to 78	1210071 – 1210078	2100071 - 2100078
79 to 86	1201079 – 1201086	2111079 - 2111086
87 to 94	1202087 – 1202094	2112087 - 2112094
95 to 102	1200095 – 1200102	2110095 - 2110102

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**Panel B: Code Descriptions and Coding Example**

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First Digit (task order):	1 or 2
Second Digit (task):	Accounts Receivable - 1 Contingent Liability – 2
Third Digit (trust level):	Low – 0, High – 1
Fourth Digit (CP):	0 – NCP, 1 – ECP, 2 - LCP
Fifth Digit (participant):	0 to 102

**Coding Example:** Participant received an Accounts Receivable case as the first task with high trustworthiness and early client preference manipulations. The coding for this combination would be “1111001”.

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FIGURE 2  
Randomization Strategy

TABLE 1  
Summary of Client Preference Studies

Study (1)	Temporal Placement of CP (2)	Participant Experience Level (3)	Experimental Tasks		Significant CP Effect	
			Disclosure (4)	Measurement (5)	Judgment Measurement (6)	Decision Measurement (7)
Gramling (1997)	Early	Managers	*	*		✓ (reliance on IA dept.)
Buchman et al. (1996)	Middle	Staff to Partners	✓			✓ (type of audit opinion)
Salterio (1996)	Late	Managers and Partners		✓	✓ (archival data only)	
Salterio and Koonce (1996)	Late	Managers and Partners		✓	✓ (accounting treatment likelihood)	✓ (method of revenue recognition)
Jiambalvo and Wilner (1985)	Not stated	Seniors to Partners	✓			
Trompeter (1994)	Not stated	Partners		✓	✓ (accounting treatment likelihood)	

- Gramling (1997) did not include either type of task, rather auditors' internal audit (IA) department assessments and reliance decisions were examined.

TABLE 2  
Trustworthiness Factors <sup>a</sup>

Factors	Relative Trustworthiness	
	Low	High
Accounting firm's tenure with the client	2 years	10 years
Controller/CFO's tenure with the client	2 years	10 years
Nature of the controller/CFO's representations in prior year(s)	Aggressive	Conservative
Controller/CFO's incentive for misstatement [bonus is (not) contingent on a certain level of net income]	Yes	No
Quality of controller/CFO-auditor communication	Low	High

<sup>a</sup> These factors are based upon Shaub (1996).

TABLE 3  
Demographic Data for Participants for the  
Contingent Liability Task

Panel A. Discrete Measures					
Attribute	Level		N		
Firm Position	Manager		35		
	Senior Manager		15		
Education	Bachelor's Degree		46		
	Master's Degree		4		
Gender	Female		10		
	Male		40		
Industry Experience	No		37		
	Yes		13		
Panel B. Continuous Measures					
Attribute	N	Minimum	Maximum	Mean	Standard Deviation
Age	50	28	49	33.84	5.87
Public Accounting Experience	50	6	27	9.55	3.94
Auditing Experience	50	6	27	9.59	4.19
Industry Experience	13	1	3	1.38	.62

TABLE 4  
Demographic Data for Participants for the  
Allowance for Doubtful Accounts Task

Panel A. Discrete Measures					
Attribute	Level	N			
Firm Position	Manager	32			
	Senior Manager	17			
Education	Bachelor's Degree	45			
	Master's Degree	4			
Gender	Female	8			
	Male	41			
Industry Experience	No	38			
	Yes	11			
Panel B. Continuous Measures					
Attribute	N	Minimum	Maximum	Mean	Standard Deviation
Age	49	28	49	34.08	5.93
Public Accounting Experience	49	6	27	9.57	3.86
Auditing Experience	49	6	27	9.69	4.12
Industry Experience	11	1	6	1.82	1.54

TABLE 5  
Summary of Research Results

Hypothesis	Experimental Task	
	Allowance for Doubtful Accounts	Contingent Liability
H1 <sub>A</sub> : Auditors' judgments will be influenced by a client preference.		
H1 <sub>B</sub> : Auditors' decisions will be influenced by a client preference.	✓	✓
H2 <sub>A</sub> : The temporal placement of a client preference will differentially influence auditors' judgments.		
H2 <sub>B</sub> : The temporal placement of a client preference will differentially influence auditors' decisions.	✓	
H3 <sub>A</sub> : In the presence of a highly (less) trustworthy client, auditors will make judgments that are more (less) consistent with the client's interests.		✓
H3 <sub>B</sub> : In the presence of a highly (less) trustworthy client, auditors will make decisions that are more (less) consistent with the client's interests.	✓	
H4: An auditor's evidence evaluation efforts will be negatively related to the client's relative trustworthiness.		

✓ - Results were statistically significant and consistent with the hypothesis.

Note: All of the above hypotheses are stated in alternative form to allow for a consistent presentation in this table.

TABLE 6  
 Analysis of Variance for the  
 Collectibility Judgments for the  
 Allowance for Doubtful Accounts Task

<i>Panel A: Dependent Variable – Log Likelihood Ratio of Collectibility Judgments</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	0.6195	0.66	0.2098 <sup>a</sup>
CP	2	4.1503	2.23	0.1205
Trust x CP	2	2.3008	1.23	0.3014
Position	1	2.3363	2.51	0.1209
Error	42	39.1469		

<i>Panel B: Treatment Means</i>			
Source	Mean	Standard Deviation	N
<b>Trust:</b>			
Low	- 0.963	1.099	23
High	- 1.167	0.925	26
<b>CP:</b>			
NCP	- 0.993	1.120	20
ECP	- 0.784	0.829	15
LCP	- 1.492	0.926	14
<b>Trust x CP:</b>			
Low/NCP	- 0.665	1.149	11
Low/ECP	- 0.653	0.635	5
Low/LCP	- 1.654	1.076	7
High/NCP	- 1.395	1.000	9
High/ECP	- 0.849	0.936	10
High/LCP	- 1.329	0.799	7
<b>Position:</b>			
Manager	- 0.927	1.096	32
Sr. Manager	- 1.344	0.763	17

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

TABLE 7  
Analysis of Variance for the Adjustment Decisions  
for the Allowance for Doubtful Accounts Task

<i>Panel A: Dependent Variable – Revisions in Adjustment Decisions</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	0.3576	4.62	0.0187 <sup>a</sup>
CP	2	0.4940	3.19	0.0513
Trust x CP	2	0.2073	1.34	0.2729
Position	1	0.7851	10.14	0.0027
Error	42	3.2509		

<i>Panel B: Treatment Means</i>				
Source	Difference <sup>b</sup>	Mean	Standard Deviation	N
<b>Trust:</b>				
Low		0.273	0.343	23
High		0.419	0.291	26
<b>CP:</b>				
NCP	A, B	0.343	0.335	20
ECP	A	0.246	0.317	15
LCP	B	0.475	0.283	14
<b>Trust x CP:</b>				
Low/NCP		0.213	0.344	11
Low/ECP		0.114	0.334	5
Low/LCP		0.481	0.285	7
High/NCP		0.502	0.259	9
High/ECP		0.312	0.304	10
High/LCP		0.469	0.302	7
<b>Position:</b>				
Manager		0.265	0.324	32
Sr. Manager		0.512	0.255	17

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

<sup>b</sup> Means that are significantly different (alpha < 0.05) are denoted by different letters.

TABLE 8  
Analysis of Variance for the Disclosure Importance  
Judgments for the Contingent Liability Task

<i>Panel A: Dependent Variable – Log Likelihood Ratio of Disclosure Importance Judgments</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	7.6193	6.19	0.0086 <sup>a</sup>
CP	2	5.7168	2.32	0.1114
Trust x CP	2	3.7236	1.51	0.2328
Error	39 <sup>b</sup>	47.9833		

<i>Panel B: Treatment Means</i>				
Source	Mean	Standard Deviation	N	
<b>Trust:</b>				
Low	- 1.151	1.210	25	
High	- 0.394	1.121	20	
<b>CP:</b>				
NCP	- 1.163	1.584	16	
ECP	- 0.419	0.832	18	
LCP	- 0.955	1.051	11	
<b>Trust x CP:</b>				
Low/NCP	- 1.996	1.194	8	
Low/ECP	- 0.562	0.884	12	
Low/LCP	- 1.216	1.293	5	
High/NCP	- 0.331	1.538	8	
High/ECP	- 0.134	0.698	6	
High/LCP	- 0.738	0.864	6	

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

<sup>b</sup> Several participants made no revision in their disclosure judgments. Accordingly, the log likelihood ratio was not calculated for these participants.

TABLE 9  
Analysis of Variance for the Disclosure  
Decisions for the Contingent Liability Task

<i>Panel A: Dependent Variable – Revisions in Disclosure Decisions</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	0.6440	0.35	0.2776 <sup>a</sup>
CP	2	13.3292	3.66	0.0340
Trust x CP	2	1.7090	0.47	0.6289
Error	44	80.2279		

<i>Panel B: Treatment Means</i>				
Source	Difference <sup>b</sup>	Mean	Standard Deviation	N
<b>Trust:</b>				
Low		0.651	1.504	28
High		0.483	1.286	22
<b>CP:</b>				
NCP	A	1.265	2.136	18
ECP	B	0.183	0.477	18
LCP	B	0.199	0.328	14
<b>Trust x CP:</b>				
Low/NCP		1.628	2.349	9
Low/ECP		0.235	0.559	12
Low/LCP		0.107	0.344	7
High/NCP		0.902	1.969	9
High/ECP		0.078	0.257	6
High/LCP		0.291	0.308	7

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

<sup>b</sup> Means that are significantly different (alpha < 0.05) are denoted by different letters.

TABLE 10  
Auditors' Evidence Evaluation Efforts  
for the Allowance for Doubtful Accounts Task

<i>Panel A: Dependent Variable – Budgeted Time (minutes) for Evidence Evaluation</i>					
Trust	Mean	Standard Deviation	N	t-statistic	p-value
Low	125.261	72.071	23	- 0.443	0.3299
High	134.231	69.480	26		

<i>Panel B: Dependent Variable – Number of Evidence Items</i>					
Trust		Median	N	W	p-value
Low		4.00	23	514.0	0.2149
High		5.00	26		

TABLE 11  
Auditors' Evidence Evaluation Efforts  
for the Contingent Liability Task

<i>Panel A: Dependent Variable – Budgeted Time (minutes) for Evidence Evaluation</i>					
Trust	Mean	Standard Deviation	N	t-statistic	p-value
Low	148.393	71.441	28	0.210	0.4176
High	142.136	124.757	22		

<i>Panel B: Dependent Variable – Number of Evidence Items</i>					
Trust		Median	N	W	p-value
Low		4.50	28	516.5	0.3827
High		4.00	22		

TABLE 12  
Analysis of Variance for the Final Collectibility  
Judgments for the Allowance for Doubtful Accounts Task

<i>Panel A: Dependent Variable – Final Collectibility Judgments</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	0.0636	2.45	0.0627 <sup>a</sup>
CP	2	0.0247	0.47	0.6258
Trust x CP	2	0.1988	3.82	0.0299
Position	1	0.1353	5.20	0.0277
Error	42	1.0930		

<i>Panel B: Treatment Means</i>				
Source	Mean	Standard Deviation	N	
<b>Trust:</b>				
Low	0.585	0.184	23	
High	0.663	0.170	26	
<b>CP:</b>				
NCP	0.633	0.233	20	
ECP	0.597	0.125	15	
LCP	0.647	0.145	14	
<b>Trust x CP:</b>				
Low/NCP	0.529	0.230	11	
Low/ECP	0.566	0.065	5	
Low/LCP	0.686	0.121	7	
High/NCP	0.760	0.172	9	
High/ECP	0.613	0.147	10	
High/LCP	0.609	0.165	7	
<b>Position:</b>				
Manager	0.589	0.183	32	
Sr. Manager	0.696	0.154	17	

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

TABLE 13  
 Analysis of Variance for the Final Adjustment  
 Decisions for the Allowance for Doubtful Accounts Task

<i>Panel A: Dependent Variable – Final Adjustment Decisions</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	0.0422	2.15	0.0752 <sup>a</sup>
CP	2	0.0352	0.89	0.4167
Trust x CP	2	0.0128	0.32	0.7245
Position	1	0.1403	7.13	0.0107
Error	42	0.8264		

<i>Panel B: Treatment Means</i>				
Source	Mean	Standard Deviation	N	
<b>Trust:</b>				
Low	0.702	0.152	23	
High	0.756	0.141	26	
<b>CP:</b>				
NCP	0.718	0.151	20	
ECP	0.717	0.168	15	
LCP	0.764	0.122	14	
<b>Trust x CP:</b>				
Low/NCP	0.677	0.160	11	
Low/ECP	0.680	0.175	5	
Low/LCP	0.757	0.127	7	
High/NCP	0.767	0.130	9	
High/ECP	0.735	0.170	10	
High/LCP	0.771	0.125	7	
<b>Position:</b>				
Manager	0.695	0.152	32	
Sr. Manager	0.798	0.112	17	

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

TABLE 14  
 Analysis of Variance for the Final Disclosure  
 Importance Judgments for the Contingent Liability Task

<i>Panel A: Dependent Variable – Final Disclosure Importance Judgments</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	0.1093	2.67	0.0548 <sup>a</sup>
CP	2	0.0986	1.20	0.3100
Trust x CP	2	0.0516	0.63	0.5378
Error	44	1.8029		

<i>Panel B: Treatment Means</i>				
Source	Mean	Standard Deviation	N	
<b>Trust:</b>				
Low	0.739	0.196	28	
High	0.653	0.212	22	
<b>CP:</b>				
NCP	0.687	0.219	18	
ECP	0.661	0.173	18	
LCP	0.770	0.223	14	
<b>Trust x CP:</b>				
Low/NCP	0.770	0.124	9	
Low/ECP	0.664	0.199	12	
Low/LCP	0.826	0.242	7	
High/NCP	0.604	0.267	9	
High/ECP	0.653	0.122	6	
High/LCP	0.714	0.204	7	

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

TABLE 15  
 Analysis of Variance for the Final Disclosure  
 Decisions for the Contingent Liability Task

<i>Panel A: Dependent Variable – Final Disclosure Decisions</i>				
Source	df	Sum of Squares	F	p-value
Trust	1	0.0508	1.25	0.1350 <sup>a</sup>
CP	2	0.0483	0.59	0.5570
Trust x CP	2	0.0128	0.16	0.8547
Error	44	1.7903		

<i>Panel B: Treatment Means</i>				
Source	Mean	Standard Deviation	N	
<b>Trust:</b>				
Low	0.755	0.215	28	
High	0.700	0.171	22	
<b>CP:</b>				
NCP	0.742	0.157	18	
ECP	0.692	0.202	18	
LCP	0.766	0.238	14	
<b>Trust x CP:</b>				
Low/NCP	0.789	0.127	9	
Low/ECP	0.698	0.236	12	
Low/LCP	0.807	0.271	7	
High/NCP	0.696	0.178	9	
High/ECP	0.678	0.127	6	
High/LCP	0.724	0.213	7	

<sup>a</sup> This p-value is reported as one-tailed because the hypotheses related to the factor are directional.

TABLE 16  
 Analysis of Variance for the Budgeted Time  
 for the Allowance for Doubtful Accounts Task

<i>Panel A: Dependent Variable – Budgeted Time (minutes) for Evidence Evaluation</i>				
Source	df	Sum of Squares	F	p-value <sup>a</sup>
Trust	1	273.2100	0.06	0.8142
CP	2	11261.2044	1.15	0.3254
Trust x CP	2	17676.3387	1.81	0.1760
Error	43	210056.1075		

<i>Panel B: Treatment Means</i>				
Source	Mean	Standard Deviation	N	
<b>Trust:</b>				
Low	125.261	72.071	23	
High	134.231	69.479	26	
<b>CP:</b>				
NCP	131.550	64.172	20	
ECP	144.667	71.075	15	
LCP	112.143	78.071	14	
<b>Trust x CP:</b>				
Low/NCP	126.909	73.356	11	
Low/ECP	177.000	62.209	5	
Low/LCP	85.714	58.625	7	
High/NCP	137.222	54.664	9	
High/ECP	128.500	72.574	10	
High/LCP	138.557	90.218	7	

<sup>a</sup> All reported p-values are two-tailed.

TABLE 17  
Analysis of Variance for the Budgeted Time  
for the Contingent Liability Task

<i>Panel A: Dependent Variable – Budgeted Time (minutes) for Evidence Evaluation</i>				
Source	df	Sum of Squares	F	p-value <sup>a</sup>
Trust	1	88.6802	0.01	0.9175
CP	2	66725.3785	4.08	0.0238
Trust x CP	2	8114.9024	0.50	0.6122
Position	1	62353.5827	7.63	0.0084
Error	43	351486.9966		

<i>Panel B: Treatment Means</i>				
Source	Difference <sup>b</sup>	Mean	Standard Deviation	N
<b>Trust:</b>				
Low		148.393	71.441	28
High		142.136	124.757	22
<b>CP:</b>				
NCP	A	138.722	76.243	18
ECP	B	181.389	126.466	18
LCP	A	108.571	62.832	14
<b>Trust x CP:</b>				
Low/NCP		147.778	77.222	9
Low/ECP		168.333	70.108	12
Low/LCP		115.000	62.517	7
High/NCP		129.667	78.770	9
High/ECP		207.500	205.761	6
High/LCP		102.143	67.445	7
<b>Position:</b>				
Manager		126.057	68.249	35
Sr. Manager		191.333	136.806	15

<sup>a</sup> All reported p-values are two-tailed.

<sup>b</sup> Means that are significantly different (alpha < 0.05) are denoted by different letters.

TABLE 18  
Descriptive Statistics for Participants'  
Responses to Attitudinal Statements

Statement	Mean	Standard Deviation	Mode	% Agreeing	% Disagreeing
An auditor's primary responsibility is to act as an advocate for his/her client.	- 1.655	2.935	- 4.000	32.8 %	67.2 %
The potential loss of a client is an important factor and must be considered when deciding "how far" to press a disagreement over an accounting matter with the client.	0.379	3.122	3.000	63.8 %	36.2 %
Auditors generally support their clients' positions in accounting matters.	0.966	2.294	3.000	65.5 %	34.5 %
An auditor's primary responsibility is to safeguard investors' and creditors' interests.	1.345	3.209	3.000, 4.000 <sup>a</sup>	67.2 %	32.8 %
Auditors who disagree with a client's position are likely to lose that client.	- 0.845	2.745	- 3.000	41.4 %	58.6 %
The more an auditor trusts a client, the less evidence an auditor will require when evaluating the client's representations.	1.310	2.597	3.000	72.4 %	27.6 %

Note: Positive numbers indicate agreement with a statement; while negative numbers indicate disagreement.

<sup>a</sup> The same number of participants selected 3.000 and 4.000 as indicating their agreement with this statement.

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APPENDIX A  
Endorsement Letter

To maintain the confidentiality of the participating firm, “xs” have been inserted in the place of certain identifying information in the following letter.

To: Managers

From: XXX

Date: September 15, 1997

Subject: Research Project Participation Request

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Greg Jenkins, a Ph.D. candidate at Virginia Tech, is conducting a research project on the auditor's judgment process as part of his dissertation. He has requested our participation in this project. I believe that this is an interesting project and may provide valuable insights as to how we make everyday decisions in the audit environment.

Your cooperation in completing the enclosed materials is appreciated.

## APPENDIX B

### Researcher's Introductory Letter

To maintain the confidentiality of the participating firm, "xs" have been inserted in the place of certain identifying information in the following letter.

September 25, 1997

Dear Audit Professional:

I am currently conducting my dissertation research on the audit judgment process. As indicated by the enclosed letter from xxxx xxxx, this research project has received your firm's approval and endorsement. As a critical part of my research I need to obtain judgments from audit professionals. As part of my project you are asked to read two short audit cases and answer several questions about each case. Finally, you will be asked to respond to a short debriefing questionnaire.

Your responses to the cases and the debriefing questionnaire will remain completely confidential. No one inside or outside of your firm will have access to your information. I would ask that as you complete the project materials that you not consult any firm manuals or other individuals. Finally, carefully read the "General Instructions" prior to starting the project.

I understand that your schedule is a full one. I truly appreciate your taking the time to help me with my project. Obtaining your cooperation in this stage of my research is the last "big" step in my Ph.D. program. Although I cannot compensate you for your time, I have enclosed a pen from Virginia Tech as a small token of my thanks.

Thank you very much for your time and cooperation. I have enclosed my business card so that you may contact me if you have any questions. If possible, please complete the materials within two weeks of receiving them. A self-addressed, stamped envelope is enclosed for your convenience.

Please begin now by reading the "General Instructions."

Sincerely,

Greg Jenkins, CPA

APPENDIX C  
General Instructions

## General Instructions

This research project has been designed to evaluate the audit judgment process. Accordingly, you will be asked to provide various judgments and recommendations as part of this project. Please note that there are no right or wrong as the questions you will be asked deal with matters of professional judgment.

This project is comprised of two **separate and unrelated** audit cases and a debriefing questionnaire. The two cases are labeled Case A and Case B. Because the cases are unrelated, your responses in the second case will not depend upon those in the first case.

Please observe the following guidelines as you complete the materials:

1. Complete the materials in the order in which they are presented. That is to say that you should complete the materials in the following order: Case A, Case B, and the debriefing questionnaire. It is vital that you complete the materials in this order.
2. Provide your judgments and recommendations as though you were in a real audit situation. It is vitally important that your responses correspond to those that you would make if the two cases dealt with actual audit clients.
3. Do not discuss the project or audit cases with anyone. Other employees of your firm are participating in the project. It is crucial that you maintain the confidentiality and integrity of the project.
4. At the bottom of each page you will be instructed on how to proceed through the materials. You should not review a previous page in the case materials unless the instructions explicitly state that it is allowable to do so. Carefully read and follow the instructions provided on each page.
5. Feel free to complete the two cases at your own pace. While you are not required to complete the materials in a fixed amount of time, you should plan to complete them in one sitting.

---

**After you have read and understand the above instructions, please open the envelope labeled "Case A Materials."**

## APPENDIX D

### Audit Tasks

This appendix includes a single version of each audit task administered to the study's participants. The first audit task is the Allowance for Doubtful Accounts case. This case is presented with the high trustworthiness and the early client preference manipulations. The second audit task in the appendix is the Contingent Liability case. This case includes the low trustworthiness and the late client preference manipulations.

## Section I

*The next three pages contain general information about this case. Please read these three pages and then proceed to the next section (labeled Section II).*

### Background Information

Eclectic Fasteners, Inc., founded over 40 years ago, manufactures a wide variety of fasteners (e.g., bolts, nuts, latches, etc.). The company markets and sells its products to many different businesses. Some of the company's products are sold to manufacturing concerns for use in various production processes. Other products are sold to hardware and home improvement stores for direct sale to individual consumers.

Over the last decade, Eclectic has generally experienced strong growth and healthy financial conditions. Although the industry is competitive, Eclectic has developed a strong presence in the marketplace. Company management attributes its growth and overall strength to the diversity of its customer base and its extensive product offerings.

Selected financial information for the current and two prior years is provided below:

	December 31, 1996 (Unaudited)	December 31, 1995 (Audited)	December 31, 1994 (Audited)
Net Sales	\$ 217,085,000	\$ 175,618,000	\$ 166,462,000
Net Income	2,419,000	1,931,000	1,581,000
Total Assets	110,048,000	103,819,000	97,943,000
Total Liabilities	50,981,000	46,910,000	42,811,000
Accounts Receivable	27,819,000	17,753,000	16,161,000
Allowance for Doubtful Accounts	(719,000)	(550,000)	(360,000)

---

**Feel free to refer back to this page as you complete the case. Please turn to the next page.**

### Client Contact Information

You have been assigned to Eclectic's audit as the **engagement manager**. The manager responsible for the engagement in the preceding two years recently left your firm to become the controller for another client. All of the remaining engagement staff was involved with the prior year's audit.

Your public accounting firm has provided various auditing and tax services to Eclectic for **10 years**. As the company has experienced significant growth over the years it has become an increasingly important client to your firm. As in the past, your firm has been engaged to perform an audit of Eclectic's current year financial statements.

Mr. Ben Watson is your primary contact on the Eclectic Fasteners audit. Watson, who is a CPA, has served as the company's controller and chief financial officer for **10 years**. Prior to accepting his current position, he worked in public accounting for 8 years.

While Watson **does not** have an earnings-based bonus plan, a review of last year's Board of Director's minutes indicates that he has received an attractive salary increase for the current year.

Given his responsibilities, Watson frequently conducts business out of the office. However, during past audits members of the audit team have found it quite easy to schedule appointments with him. Furthermore, they have noted that Watson has appeared attentive and concerned during scheduled meetings. Past experience indicates that Watson's representations with regards to various accounting matters tend to **err on the side of conservatism**.

---

**Feel free to refer back to this page as you complete the case. Please turn to the next page.**

### Task Information

In the following task you are asked to evaluate evidence related to Eclectic's **allowance for doubtful accounts**. The evidence that you will receive relates to **one** significant customer's account. The customer's account represents a **material** portion of Eclectic's accounts receivable balance at the end of the current year.

Auditing procedures associated with the accounts receivable and related allowance account have been completed. **With the exception of this one customer's account**, the engagement's in-charge has determined that the client's current allowance for doubtful account balance is adequate.

The engagement's in-charge has come to you for assistance in evaluating the collectibility of the customer's account and to determine whether or not the allowance should be adjusted.

In the evaluation of this customer's account the in-charge has obtained the following evidence. As part of your assistance to the in-charge, you agree to examine the following **four** evidence items.

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**Feel free to refer back to this page as you complete the case. Now proceed by turning to Section II.**

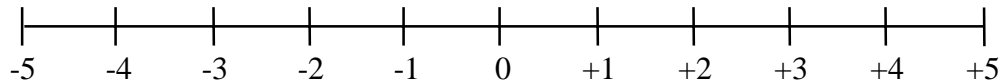
## **Section II**

Evidence Item # 1

*Mr. Watson clearly stated that he does not want to increase the Allowance for Doubtful Accounts for this customer's account.*

Forty accounts were selected for confirmation. The year-end balance on **this** customer's account was \$1,018,732. Because the customer did not return the first confirmation request a second request was mailed. The second request was returned and indicated that the customer agreed with the outstanding balance on the confirmation.

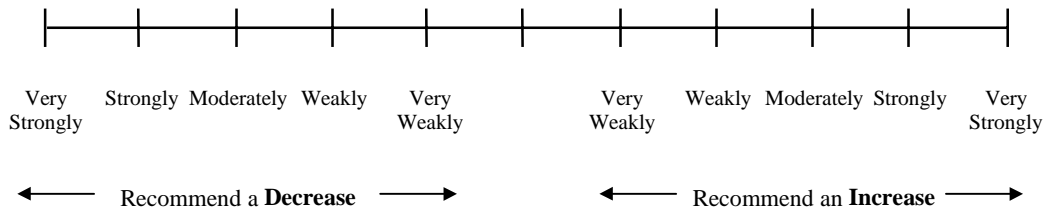
- A. Given this limited initial information, please indicate the extent to which you believe that this customer's account will be **collectible**? Indicate your belief by placing a slash (/) on the following line.



Absolutely  
**Not Collectible**

Absolutely  
**Collectible**

- B. Given this limited initial information, please indicate the strength with which you would convey your recommendation that the client either **increase** or **decrease** the **Allowance for Doubtful Accounts** for this customer's account. Indicate your recommendation by placing a slash (/) on the following line.



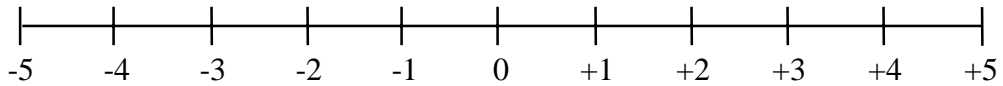
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**Do not make changes to the above responses after you have completed this page.  
Please turn to the next page.**

Evidence Item # 2

A review of the activity in this customer's account since year-end (i.e., December 31, 1996) indicates that the customer has not made any payments on the account in over two months. Prior to this period of non-payment, the customer was paying on the account on a fairly timely basis.

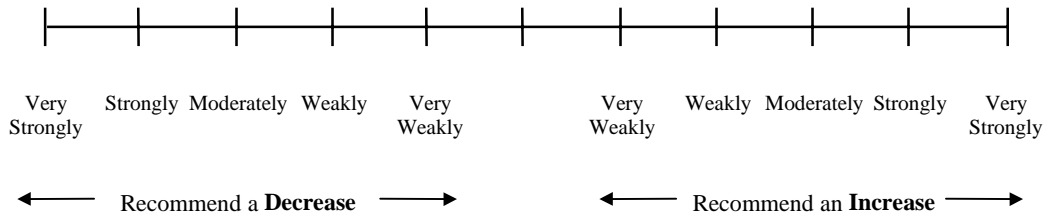
- A. Given this additional information, please indicate the extent to which you believe that this customer's account will be **collectible**? Indicate your belief by placing a slash (/) on the following line.



Absolutely  
**Not Collectible**

Absolutely  
**Collectible**

- B. Given this additional information, please indicate the strength with which you would convey your recommendation that the client either **increase** or **decrease** the **Allowance for Doubtful Accounts** for this customer's account. Indicate your recommendation by placing a slash (/) on the following line.



---

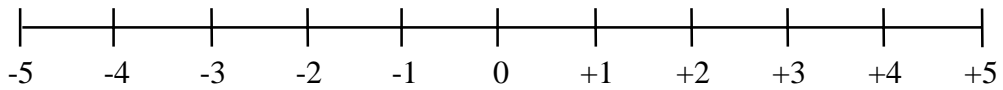
**Do not make changes to the above responses after you have completed this page.  
Please turn to the next page.**



Evidence Item # 4

Eclectic generally extends credit to customers after checks of the customer's credit history. Credit reports are obtained from an independent credit agency. As is normally the case, this customer was granted terms of 2/10, n/30. In the past, Eclectic has not found it necessary to tighten their credit terms.

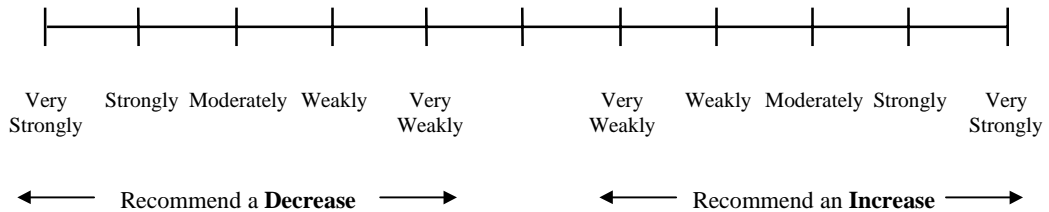
A. Given this additional information, please indicate the extent to which you believe that this customer's account will be **collectible**? Indicate your belief by placing a slash (/) on the following line.



Absolutely  
**Not Collectible**

Absolutely  
**Collectible**

B. Given this additional information, please indicate the strength with which you would convey your recommendation that the client either **increase** or **decrease** the **Allowance for Doubtful Accounts** for this customer's account. Indicate your recommendation by placing a slash (/) on the following line.



---

**Do not make changes to the above responses after you have completed this page.  
Please turn to the next page.**

Additional Audit Evidence

The preceding evidence was obtained during the planned audit procedures outlined in the engagement’s audit program. You now have the option of specifying what additional evidence, if any, that you would like to examine related to this customer's account. You may choose **none**, **some**, or **all** of the additional evidence that follows. It is important that you select the same evidence that you would normally examine if this were an actual audit situation.

The engagement's **total time budget** is 750 hours. The **A/R and the related allowance account time budget** is 62 hours. With the exception of this one customer's account, all procedures related to the accounts receivable and allowance account have been completed. To date, the engagement team has accumulated 59 hours in the A/R area.

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Select **only one** of the following options for the examination of additional audit evidence.

Option 1:

If you **do not** wish to examine additional evidence place an "x" in the box labeled "I do not want additional evidence" and proceed as directed at the bottom of this page.

No, I **do not** want to evaluate additional evidence.

Option 2:

If you **do** wish to examine additional evidence, please indicate which of the following items you would request from the client by placing an “x” in the “Evaluate” column to the right of the desired item(s). Then indicate, to the best of your ability, the time that you would budget for a review of the selected evidence. Please enter your time budget in **minutes** in the "Time Budget" column.

<b>Evidence Type:</b>	<b>Evaluate:</b>	<b>Time Budget: (minutes)</b>
Pay history for preceding 12 months		
Aging of the account (as of balance sheet date)		
Credit report from outside credit agency		
Correspondence file		
Customer's most recent annual financial statements		
Sales activity since year end		
Other ( please specify):		

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**You have now completed this case. Please return all of these materials to the envelope labeled "Case A Materials." After doing so, proceed by opening the envelope labeled "Case B Materials."**

## Section I

*The next three pages contain general information about this case. Please read these three pages and then proceed to the next section (labeled Section II).*

### Background Information

Pinnacle Sporting Goods, Inc. is a manufacturer of sporting goods apparel and equipment. The company began operations in 1973 after the company's current president and chief executive officer retired from a stellar career in the National Football League. Originally, the company manufactured T-shirts, sweatshirts, and other athletic apparel. Over the last two decades, the company has enjoyed double-digit growth due to the celebrity status of its founder and its product development efforts. Today, the company manufactures over 350 different products that include apparel items as well as athletic equipment.

Recently, the company began manufacturing in-line skates. Management decided to start production of their own model after the explosion in the market brought about by the introduction of the well-known Rollerblades. After spending several months developing its "new" in-line skate, Pinnacle introduced its product at an annual sporting goods show in Los Angeles. Pinnacle's in-line skates were so well received by the show's attendees that management decided to begin selling the skates immediately. From the beginning, sales of the new skates were strong and the company has found itself struggling to keep up with demand.

Selected financial information for the current and two prior years is provided below:

	December 31, 1996 (Unaudited)	December 31, 1995 (Audited)	December 31, 1994 (Audited)
Net Sales	\$ 167,918,013	\$ 158,517,628	\$ 154,667,392
Net Income	3,220,385	2,881,994	2,007,615
Current Assets	37,552,839	40,291,315	39,193,550
Total Assets	83,864,117	83,281,396	81,098,357
Current Liabilities	19,654,810	17,905,321	16,220,082
Total Liabilities	42,008,518	42,350,466	40,991,827
Total Owners' Equity	41,855,599	40,930,930	40,106,530

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**Feel free to refer back to this page as you complete the case. Please turn to the next page.**

### Client Contact Information

You have been assigned to Pinnacle's audit as the **engagement manager**. The manager who was previously responsible for the engagement recently left your firm. All of the prior year's engagement team will be returning to work on the current year's audit.

Your public accounting firm has provided tax and auditing services to Pinnacle for **2 years**. Given the celebrity status of its owner and its financial success, Pinnacle is an important client to your firm. As in the past, you have been engaged to perform an audit of Pinnacle's current year financial statements.

Mr. Tom Jorgensen is your firm's primary contact at Pinnacle. Mr. Jorgensen has been the company's controller and chief financial officer for **2 years**. Before becoming Pinnacle's controller/CFO, Jorgensen, a CPA, worked for 8 years in public accounting.

A review of last year's Board of Director's minutes indicates that Jorgensen's influence is such that he managed to secure **an earnings-based bonus plan** and an attractive salary increase for the current year.

Given his responsibilities, Mr. Jorgensen is frequently out of the office. During past audits, audit team members have found it difficult to schedule an appointment with Jorgensen. In addition, these same individuals have noted that Jorgensen has often seemed inattentive and unconcerned during scheduled meetings. Finally, past experience indicates that his representations regarding accounting matters tend to **err on the side of aggressiveness**.

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**Feel free to refer back to this page as you complete the case. Please turn to the next page.**

### Task Information

In this task, you are asked to evaluate evidence related to a liability lawsuit which was filed against Pinnacle Sporting Goods, Inc. The suit alleges that the company's new in-line skates caused serious injuries to the plaintiff's son during a weekend outing. Although the company has been involved in lawsuits in the past, the company is not currently involved in any litigation other than this case.

In accordance with the audit program, the engagement's in-charge has gathered evidence related to the lawsuit. However, given the potential for a **material** settlement, you have decided to evaluate the status of the lawsuit. To date, the in-charge has not made a recommendation as to the treatment of the litigation.

So that this case does not become a test of your memory, the following is a brief summary of SFAS #5, *Accounting for Contingencies*. The Statement identifies two issues that must be considered in evaluating contingencies: the degree of uncertainty and the ability to estimate the amount of the associated claim. The following table provides a brief summary of SFAS #5 and its requirements.

<i>Degree of Uncertainty</i>	<i>Amount of Loss Can Be Reasonably Estimated</i>	
	<i>Yes</i>	<i>No</i>
Probable	Accrue a Loss and Provide Disclosure	Footnote Disclosure
Reasonably Possible	Footnote Disclosure	Footnote Disclosure
Remote	No Disclosure is Necessary	No Disclosure is Necessary

In the evaluation of this lawsuit the engagement's in-charge has obtained the following **four** pieces of evidence.

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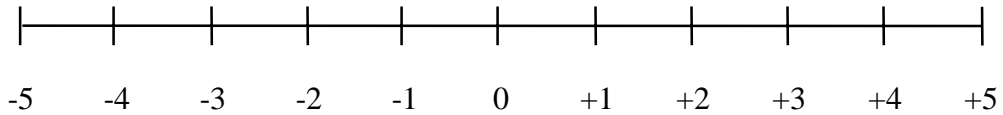
**Feel free to refer back to this page as you complete the case. Now proceed by turning to Section II.**

## **Section II**

Evidence Item # 1

A review of Pinnacle's legal invoices indicates that the company has consulted Marsony and Brighton for several collection matters during the year. In addition, one invoice indicates that Marsony and Brighton is evaluating a recently filed claim which asserts that Pinnacle was negligent in the design and production of their new in-line skates.

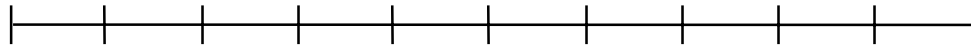
A. Given this limited initial information, how strongly do you feel regarding the need to **disclose** or **not disclose** the litigation in Pinnacle's financial statements? Please indicate your belief by placing a slash (/) on the following line.



Absolutely  
**Not Disclose**

Absolutely  
**Disclose**

B. Given this limited initial information, please indicate the strength with which you would convey your recommendation that the client either **disclose** or **not disclose** the litigation. Indicate your recommendation by placing a slash (/) on the following line.



Very Strongly    Strongly    Moderately    Weakly    Very Weakly

Very Weakly    Weakly    Moderately    Strongly    Very Strongly

← Recommend **No Disclosure** →

← Recommend a **Disclosure** →

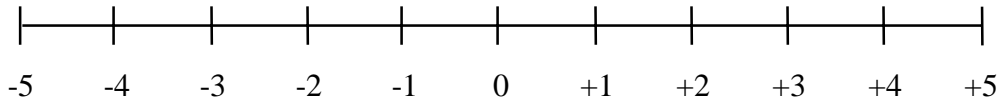
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**Do not make changes to the above responses after you have completed this page. Please turn to the next page.**

Evidence Item # 2

While reviewing the Board of Director's minutes, the in-charge noted that Mr. Jorgensen had discussed the claim of negligence with board members. He explained to them that the company plans to vigorously contest the case and that the company was not negligent in the design or production of the skates as claimed. Furthermore, he indicated that Pinnacle is highly respected by other companies in the industry for its integrity and quality of production. Mr. Jorgensen also stated that the plaintiffs are seeking damages of \$2.5 million, a **material** amount.

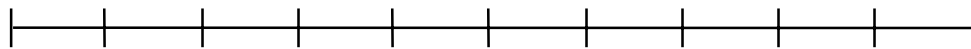
- A. Given this additional information, how strongly do you feel regarding the need to **disclose** or **not disclose** the litigation in Pinnacle's financial statements? Please indicate your belief by placing a slash (/) on the following line.



Absolutely  
**Not Disclose**

Absolutely  
**Disclose**

- B. Given this additional information, please indicate the strength with which you would convey your recommendation that the client either **disclose** or **not disclose** the litigation. Indicate your recommendation by placing a slash (/) on the following line.



Very Strongly    Strongly    Moderately    Weakly    Very Weakly

Very Weakly    Weakly    Moderately    Strongly    Very Strongly

← Recommend **No Disclosure** →

← Recommend a **Disclosure** →

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**Do not make changes to the above responses after you have completed this page. Please turn to the next page.**

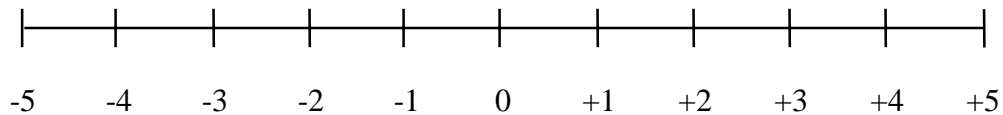
Evidence Item # 3

In response to a letter of inquiry, Pinnacle's outside legal counsel (i.e., Marsony and Brighton) has stated that it is currently evaluating the plaintiff's claim against Pinnacle. Specifically, they stated:

*"The claim filed against Pinnacle Sporting Goods, Inc. seeks damages of \$2.5 million. The plaintiffs assert that Pinnacle's "negligent and careless" product development and production techniques caused "serious injuries." At the present time we are evaluating the plaintiff's claim. Given the stage of our evaluation, we are presently **unable** to express an opinion as to the merits of the negligence claim filed against Pinnacle Sporting Goods, Inc."*

The lawyer's letter also indicated that Pinnacle is **not** currently involved in any other litigation as either defendant or plaintiff.

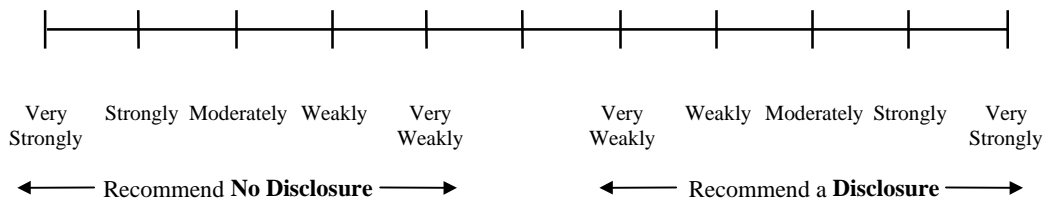
- A. Given this additional information, how strongly do you feel regarding the need to **disclose** or **not disclose** the litigation in Pinnacle's financial statements? Please indicate your belief by placing a slash (/) on the following line.



Absolutely  
**Not Disclose**

Absolutely  
**Disclose**

- B. Given this additional information, please indicate the strength with which you would convey your recommendation that the client either **disclose** or **not disclose** the litigation. Indicate your recommendation by placing a slash (/) on the following line.



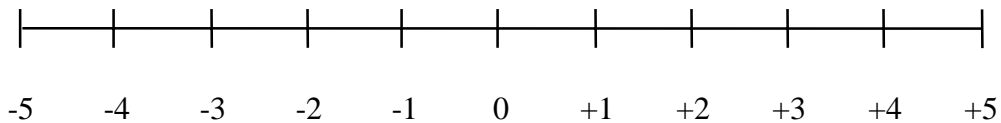
**Do not make changes to the above responses after you have completed this page. Please turn to the next page.**

Evidence Item # 4

The in-charge's inquiry of Mr. Jorgensen regarding the company's policies and procedures for identifying, evaluating, and accounting for litigation revealed the following: The company does **not** employ an in-house legal counsel. The company's officers are responsible for identifying and evaluating all asserted claims as well as identifying possible unasserted claims. In particular, the company's controller/CFO -- Mr. Jorgensen, is vigilant in identifying such claims. Mr. Jorgensen also has responsibility for determining the appropriate accounting treatment for any legal claims.

*Mr. Jorgensen has emphatically stated that he does not want to disclose the liability lawsuit in the footnotes that accompany the financial statements.*

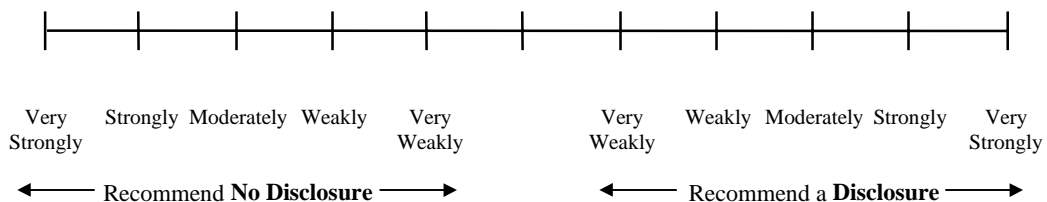
- A. Given this additional information, how strongly do you feel regarding the need to **disclose** or **not disclose** the litigation in Pinnacle's financial statements? Please indicate your belief by placing a slash (/) on the following line.



Absolutely  
**Not Disclose**

Absolutely  
**Disclose**

- B. Given this additional information, please indicate the strength with which you would convey your recommendation that the client either **disclose** or **not disclose** the litigation. Indicate your recommendation by placing a slash (/) on the following line.



**Do not make changes to the above responses after you have completed this page. Please turn to the next page.**

Additional Audit Evidence

The preceding evidence was obtained during the planned audit procedures outlined in the engagement’s audit program. You now have the option of specifying what additional evidence, if any, that you would like to examine related to this litigation. You may choose **none**, **some**, or **all** of the additional evidence that follows. It is important that you select the same evidence that you would normally examine if this were an actual audit situation.

The engagement's **total time budget** is 625 hours. The **commitment and contingencies time budget** is 6 hours. To date, 5 hours have been accumulated in the area.

---

Select **only one** of the following options for the examination of additional audit evidence.

**Option 1:**

If you **do not** wish to examine additional evidence place an "x" in the box labeled "I do not want additional evidence" and proceed as directed at the bottom of this page.

No, I **do not** want to evaluate additional evidence.

**Option 2:**

If you **do** wish to examine additional evidence, please indicate which of the following items you would request from the client by placing an “x” in the “Evaluate” column to the right of the desired item(s). Then indicate, to the best of your ability, the time that you would budget to review the selected evidence. Please enter your time budget in **minutes** in the "Time Budget" column.

<b>Evidence Type:</b>	<b>Evaluate:</b>	<b>Time Budget: (minutes)</b>
Letter to Pinnacle management from plaintiff's legal counsel		
Correspondence file with Pinnacle's outside legal counsel -- Marsony and Brighton		
Conference with Pinnacle's outside legal counsel --Marsony and Brighton		
Details of Pinnacle's insurance coverage for litigation		
Copy of product warranty included with new in-line skates		
Pinnacle's response to plaintiff's claim		
Other ( please specify):		

---

**You have now completed this case. Please return all of these materials to the envelope labeled "Case B Materials." After doing so, proceed by opening the envelope labeled "Questionnaire."**

APPENDIX E  
Debriefing Questionnaire

ABOUT YOU:

1. How many years of **public accounting experience** do you have? \_\_\_\_\_

2. How many years of **auditing experience** do you have? \_\_\_\_\_

3. Have you previously worked in private industry as an accountant?

Yes \_\_\_\_ No \_\_\_\_

If so, how many years of **private industry experience** do you have? \_\_\_\_\_

4. a. Age: \_\_\_\_\_

b. Gender: \_\_\_\_\_

c. Firm position: In-charge      Supervisor      Manager      Senior Manager

d. Number of years at your current position: \_\_\_\_\_

e. Highest level of education:

Undergraduate      Master's      Ph.D.  
Degree              Degree              Degree

5. Approximately how much time did you spend on this exercise? \_\_\_\_\_ **minutes**

**ABOUT THE ACCOUNTS RECEIVABLE CASE:**

6. Did you understand the case? Yes \_\_\_\_ No \_\_\_\_

If not, then what did you not understand? \_\_\_\_\_

\_\_\_\_\_

7. Without looking back at the case, which of the following is most representative of the client's preference as to the treatment of the **Allowance for Doubtful Accounts** in this case? (Check one.)

\_\_\_\_\_ The client stated **before** the **first** evidence item that he did **not** want to **increase** the allowance account.

\_\_\_\_\_ The client stated **after** the **last** evidence item that he did **not** want to **increase** the allowance account.

\_\_\_\_\_ The client **did not state** a preference.

8. To what extent did you find your client contact, Mr. Ben Watson, to be **trustworthy**? Indicate your belief by placing a slash (/) on the following line.

|-----|

Not Trustworthy Very Trustworthy

9. How realistic was the case? Indicate your belief by placing a slash (/) on the following line.

|-----|

Not Realistic Very Realistic

10. Based on his described qualifications, to what extent did you believe Mr. Ben Watson was **competent**? Indicate your belief by placing a slash (/) on the following line.

|-----|

Not Competent Very Competent

**ABOUT THE CONTINGENT LIABILITY CASE:**

11. Did you understand the case? Yes \_\_\_\_ No \_\_\_\_

If not, then what did you not understand? \_\_\_\_\_  
\_\_\_\_\_

12. Without looking back at the case, which of the following is most representative of the client's preference as to the treatment of the **contingent liability for the negligence claim** in this case? (Check one.)

- \_\_\_\_\_ The client stated **before** the **first** evidence item that he did **not** want to disclose the contingency.
- \_\_\_\_\_ The client stated **after** the **last** evidence item that he did **not** want to disclose the contingency.
- \_\_\_\_\_ The client **did not state** a preference.

13. To what extent did you find your client contact, Mr. Tom Jorgensen, to be **trustworthy**? Indicate your belief by placing a slash (/) on the following line.

Not Trustworthy Very Trustworthy

14. How realistic was the case? Indicate your belief by placing a slash (/) on the following line.

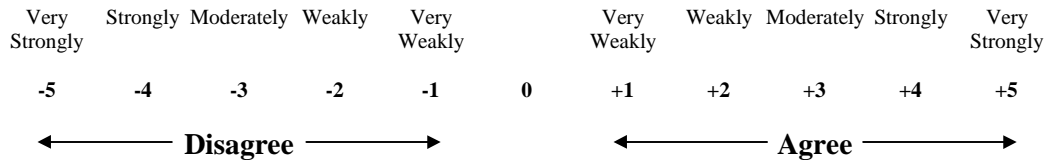
Not Realistic Very Realistic

15. Based on his described qualifications, to what extent did you believe Mr. Tom Jorgensen was **competent**? Indicate your belief by placing a slash (/) on the following line.

Not Competent Very Competent

**ATTITUDINAL QUESTIONS:**

16. Please indicate your level of agreement with the following statements. For each statement write the *number* from the following scale which best corresponds to your level of agreement in the "Response" column.



Response

1. \_\_\_\_\_ An auditor's primary responsibility is to act as an advocate for his/her client.
2. \_\_\_\_\_ The potential loss of a client is an important factor and must be considered when deciding "how far" to press a disagreement over an accounting matter with the client.
3. \_\_\_\_\_ Auditors generally support their clients' positions in accounting matters.
4. \_\_\_\_\_ An auditor's primary responsibility is to safeguard investors' and creditors' interests.
5. \_\_\_\_\_ Auditors who disagree with a client's position are likely to lose that client.
6. \_\_\_\_\_ The more an auditor trusts a client, the less evidence an auditor will require when evaluating the client's representations.

## JAMES GREGORY JENKINS

James Gregory Jenkins was born in Hickory, North Carolina on March 17, 1967. He received a Bachelor of Science and Business Administration with a major in Accounting from Appalachian State University in 1989. He continued his education at Appalachian State University and received a Master of Science in Accounting in 1990. Upon graduation, he worked for Ernst & Young, LLP and McGladrey & Pullen, LLP as a certified public accountant. He entered the doctoral program at Virginia Polytechnic Institute and State University in 1994.