

# The Role of Key Audit Matters in Assessing Auditor Liability: Evidence from Auditor and Non-auditor Evaluators

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## ABSTRACT

**Manuscript type:** Research paper

**Research aims:** This study examines the effects of key audit matter (KAM) disclosures in auditors' report and their impact on auditors' legal exposure in cases of fraud and error misstatements.

**Design/Methodology/Approach:** To determine the effect of KAM on auditor liability, an experiment was employed. The participants included 133 professional auditors recruited from the Big 4 audit firms and 134 MBA students.

**Research findings:** The KAM effect is manifested in different ways for different evaluators. Specifically, auditor participants assess higher auditor liability when the misstatement relates to error than when it is connected to fraud. KAM also appears to reduce auditor's liability in cases of fraud, but not in cases of error. In comparison, nonprofessional investor participants rated a higher auditor liability when the misstatement relates to fraud than to error. KAM also appears to have a non-significant impact on auditor liability. Taken together, the results support the view that instead of increasing legal exposure as audit practitioners fear, KAM disclosures could actually mitigate, if not maintain auditors' risk of legal exposure.

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<https://doi.org/10.22452/ajba.vol13no1.2>

**Theoretical contribution/Originality:** This study contributes to the accounting literature by broadening one aspect of KAM when used in a different audit setting – fraud and error misstatements. The conflicting evidence of the KAM effect on auditor liability in alternative audit settings warrants further investigations. The outcome derived could alter the impact of KAM disclosures on the assessment of auditor liability.

**Practitioner/Policy implication:** The findings of this study, especially the non-significance of KAM disclosures as evaluated by non-professional investors, inform policymakers and related parties that investors need to be educated and better informed about KAM disclosures and their objectives when assessing misstatements.

**Research limitation/Implications:** The design of this study does not accommodate settings where the auditors have the opportunity to communicate with their peers, a factor which could affect their judgment. This is the general limitation of the current study which may be viewed as slightly unrealistic since discussions are often encouraged among committee members while in a courtroom when making judgments.

**Keywords:** Auditor Evaluator, Auditor Liability, Auditor's Report, Disclosure, Key Audit Matter

**JEL Classification:** M40

## 1. Introduction

The 2008 financial crisis had increased the need for the accounting industry to reform the audit reporting model so as to enhance the value of the auditor's report for users referring to financial statements. The current pass/fail audit report has long been criticised for its low informational and communication values. Mock et al. (2013) addressed this concern by conducting a focus group study to learn about the different opinions articulated by the various stakeholders. As users demand more insights from the audits for information that goes beyond a pass/fail evaluation, audit standard setters throughout the world have proposed several changes to be made. Worldwide, organisations like the US Public Company Accounting Oversight Board (PCAOB), the Auditing Practices Board (APB) of the UK and Ireland, the European Commission (EC), and the International Auditing and Assurance Board (IAASB) have made attempts to make the auditor's report more transparent and more effective as a means of communication. Such efforts have led to the consideration of a separate section to be added

to the auditor's report, "*Key Audit Matters*"<sup>1</sup> (hereafter referred to as KAM). This section is expected to communicate such matters which auditors perceive to be most important to the users. Specifically, the KAM is expected to address areas that the auditor feels are complex or subjective, where it is difficult to obtain and evaluate evidence, or that requires significant judgment.

Although KAM provides useful information to investors (e.g., Christensen, Glover, & Wolfe, 2014; Kachelmeier, Schmidt, & Valentine, 2014), one of the most controversial aspects of KAM is its effect on auditor liability (Gimbar, Hansen, & Ozlanski, 2016). In response to this concern, several studies (e.g., Backof, 2015; Backof, Bowlin, & Goodson, 2014; Brasel, Doxey, Grenier, & Reffett, 2016; Brown, Majors, & Peecher, 2014; Gimbar et al., 2016; Williams, 2016; Kachelmeier et al., 2014) have examined the impact of KAM on the assessment of auditors' liability. Most of the evidence tend to align with the argument that KAM reduces auditor liability. However, some studies (e.g., Gimbar et al., 2016) have reached the opposite conclusion. As auditors operate in a litigious environment, the disclosed KAM may impose an increased cost of unreasonable litigation risks on the auditors. Until now, concurrent experimental research has attempted to identify the settings in which KAM disclosures could have no effect, increase, or decrease auditors' liability for misstatements.

Prior studies had investigated KAM in the context of misstatements related to fraud. They also generally used participants with limited auditing knowledge, for example, undergraduates or jury-eligible participants. This highlights a less effective approach for assessing the value of KAM. Financial statements are developed for a purpose and these may also contain false information which has been established as fraud or error (Plumlee & Yohn, 2010). However, the result of the auditors' liability assessment may differ depending on how the financial statements were presented - whether as fraud-related or error-related misstatements. Since there is scarce information on this aspect, this also serves as a significance of the current study.

A number of recent studies have been conducted to examine how KAM affects auditor liability but the outcome derived have been inconsistent. Since this is a crucial matter, there should be more studies conducted to examine whether the findings hold for users with greater

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<sup>1</sup> The Key Audit Matter is referred to as Critical Audit Matter (CAM) in the US Generally Accepted Accounting Principal (GAAP).

levels of financial and audit expertise (Bedard, Coram, Espahbodi, & Mock, 2016). Taking the current studies together, a review showed that there is little evidence to be drawn demonstrating how audit experts and lay evaluators interpret KAM disclosures in the same way or differently when assessing auditor liability. The question of whether the assessed auditors' liability is different for fraud-related misstatements or for error-related misstatement remains to be an issue worth exploring (Brasel et al., 2016). Based on this dearth in information, the current study thus aims to examine the impact of KAM on the assessment of auditors' liability for fraud-related misstatements and error-related misstatements.

The experiment conducted in this study does not use the jury-based system because it does not exist in Thailand. Nonetheless, as noted by Donelson, Kadous and McInnis (2014), legal action against auditors is often settled out of court, and auditors should be more concerned about public opinions which can affect their reputations. Reputational harm, especially in a low-litigation country (e.g., Thailand), is as important as legal liability because it reflects the auditor's loss of reputation (Weber, Willenborg, & Zhang, 2008). This observation is well supported by Kadous and Mercer (2012) who noted that the expected trial outcome is useful for auditors and plaintiffs when making decisions about settlements. Unlike other studies on KAM, the current study provides evidence from two different groups of participants (auditor vs. nonprofessional investors) with regards to the expected litigation risks, based on publicly available information. Therefore, rather than focusing on the judgment court's resolution of litigation, this study investigates the perception of auditors and nonprofessional investors on how KAM may lead to the initiation of litigation against auditors in fraud and error misstatement settings.

The results derived from the auditors showed that the assessed auditor liability was lower when the misstatement was related to fraud than when it was related to error. The assessed liability was even lower when KAM was presented in the misstatements related to fraud. However, results derived from the nonprofessional investors showed that the assessed auditor liability was higher for misstatements related to fraud than to error-related misstatements. KAM had no effect on the auditor's liability judgment. Given the different auditing knowledge and expertise of the auditors and nonprofessional investors, a difference was expected in the way the fraud and error-related misstatements

would be assessed, including with the presence of KAM. The findings from this study should expand on current literature as they offer another perspective of looking at KAM – fraud and error misstatements. The findings should also contribute to current audit literature in three areas. First, previous disclosures of KAM on auditor liability had been inconclusive, thus this warrants a further investigation, especially one of another audit setting which could alter the impact of KAM disclosure on the assessment of auditor liability. Second, while most existing studies emphasised on the effect of different KAM contents and formats on auditor liability, very few studies had investigated its effect on liability assessment, when under different contexts of misconduct. Third, this study investigates the concerns raised in audit litigation literature by looking at auditor liability assessment from two different perspectives: auditor evaluators (representing the independent expert), and non-professional investors (representing the inexperienced evaluator).

This paper is organised as follows. Section 2 of this paper discusses the relevant literature and develops the theory and hypothesis used for this study. Section 3 discusses the methodology. Section 4 reports on the findings and Section 5 discusses the outcomes and the conclusion.

## **2. Literature Review and Hypotheses**

### **2.1 Background**

Concern about the boilerplate of auditor's reports and the wider communication gap that exists between financial statement users and auditors has led to changes in the auditor's reporting model (IAASB, 2015). One of the changes is the inclusion of a KAM section in the auditor's report to increase information, its relevance and its usefulness for financial statement users. Although auditors believe that KAM improves the user's understanding of the audit, they also have some concerns as to whether there is a potential increase in the litigation risk following the disclosure of KAM (Katz, 2014; PCAOB, 2011).

Performance judgment of auditors is often a difficult process because often, there are no judgment criteria for certain types of audit tasks (Pecher, Solomon, & Trotman, 2013). When assessing auditor liability, the outcome of the audit failure (i.e., the plaintiff's losses) is highly weighted by the evaluators (Charron & Lowe, 2008; Hawkins & Hastie, 1990; Jennings, Lowe, & Reckers, 1998). The law, however, states

that auditors should be evaluated based on the quality of the audit they provide rather than the outcome of their audit (Peecher et al., 2013). The over reliance on outcome knowledge is a critical concern, particularly when the evaluators are lay people with little or no understanding of the actual audit process. This could lead to the misattribution of blame on the alleged auditors. Kadous (2000) had noted that jurors or lay evaluators tend to lack a clear understanding of what auditors should be held responsible for. These lay evaluators also tend to rely on irrelevant information, such as the consequence severity instead of the audit process when making decisions. With this perceived limitation of lay evaluators, Palmrose (2006) proposed that experienced auditors be used as evaluators in the case of auditor negligence. Reffett, Brewster and Ballou (2012) later mentioned that the judgment made by experienced auditors differ significantly from that made by lay evaluators in cases of alleged auditor negligence.

## ***2.2 Distinguishing Misstatements Due to Fraud and Error***

Several studies have attempted to investigate the impact of fraud and error differentials (Dechow, Ge, Larson, & Sloan, 2011; Hennes, Leone, & Miller, 2008), but very few have studied how these differences affect the level of the assessed liability. The auditing standard states that the distinct difference between misstatements due to fraud and those due to error is whether the underlying action was intentional or unintentional (IAASB, 2009). Although accounting professionals contend that detecting fraud is not their absolute responsibility, the public believes that it is (Firth, Mo, & Wong, 2005). Thus, it is argued that audit failure cannot be tolerated by investors because the audit has long been legitimised for fraud detection. As fraud-related scandals have severely damaged auditors' reputations, the audit profession and regulators have begun to issue an auditing standard that could reduce auditors' fraud detection responsibility and their litigation exposure (Cohen, Ding, Lesage, & Stolowy, 2015). Nonetheless, Trompeter, Carpenter, Desai, Jones and Riley (2013) noted that these auditors continued to be accused of assisting fraudsters. Therefore, fraud misstatements generate more negative reactions than error misstatements do (Hennes et al., 2008). Kinney (2000) also noted that fraudulent misstatements tend to have more serious implications than error misstatements despite being of the same magnitude.

## **2.3 Hypothesis Development**

### *2.3.1 The Effect of Types of Misstatements on the Assessment of Auditor Liability*

To develop a theoretical support for the hypothesis, counterfactual reasoning and the culpable control model (hereafter, CCM) was leveraged. Counterfactual reasoning posits how counterfactual thought enhances the evaluator's negative affective reaction to an outcome, but it does not provide a link between the affective reaction and the attribution of blame. The CCM complements this theory by supporting this direct relationship. The CCM predicts how a spontaneous evaluation or affective reaction to the harmful outcome influences the blame evaluation. Because the legal judgment of the alleged auditor's negligence is frequently biased by the evaluator's affective reaction (Kadous, 2001), the CCM offers an appropriate perspective. It takes into account the emotional factor, and it assumes that the negative reaction drives the blame judgment. When evaluators determine what the agents should have done or known, they are unable to eliminate their negative reaction from their judgment (Alicke, 2000; Alicke, Buckingham, Zell, & Davis, 2008; Alicke & Rose, 2012). This negative reaction could result in an increase in the assessment of auditor liability.

Individual differences in domain-specific knowledge are argued to be a crucial element in developing expectations (Brown & Solomon, 1991). Not only does expertise cause differences in terms of expectations, it also affects the development of a causal schema which is formed based on prior experience. It frames the way people think about plausible causes in relation to the given effect (Brown & Solomon, 1991; Kun & Weiner, 1973). The underlying mechanism of a schema is that it influences how people construct a narrative when interpreting a case, thus it also influences the individual who is making a liability assessment. Consequently, auditors and nonprofessional investors tend to develop different schema due to their different experiences and knowledge (Taylor, Crocker, & D'Agostino, 1978). If auditors were perceived to have more control over the cause of the misstatement, the counterfactual intensity should stipulate a strong negative affective reaction to the auditors. Given their auditing knowledge, auditors tend to understand that fraud is difficult to detect and that error is more likely to be detected. Based on this, it is predicted that auditor evaluators have lower expectations of discovering fraud than non-auditor evaluators. Moreover, the counterfactual alternative to undo fraud-related

misstatement is less mutable for auditor evaluators because they know that some elements of fraud could be beyond the auditor's control. Therefore, they are expected to have a weaker negative reaction towards a case of fraud-related misstatement. In contrast, when errors occur due to, for example, weak control effectiveness, auditor evaluators are expected to perceive that these errors are more controllable and easier to detect than fraud. This pattern of thought would result in a higher counterfactual intensity, and a stronger negative affective response when evaluating error-related misstatements. Unlike auditor evaluators, nonprofessional investors, lacking the general knowledge of the audit process tend to develop a story that is expected to yield opposite results. As fraud generates a more negative market reaction than error (Hennes et al., 2008), people generally perceive that the result of fraud is more severe than that of error. This is despite the fact that both carry consequences of the same magnitude (Kinney, 2000). Thus, nonprofessional investors were expected to have a more negative feeling about fraud-related misstatements than about error-related misstatements. Based on this, the following hypotheses were formulated:

Auditors

H<sub>1a</sub>: The effect of error-related misstatement on auditor liability is higher than that of fraud-related misstatement.

Nonprofessional investors

H<sub>1b</sub>: The effect of fraud-related misstatement on auditor liability is higher than that of error-related misstatement.

*2.3.2 The Effect of KAM on the Assessment of Auditor Liability*

Despite the fact that the association between counterfactual thinking and CCM activates the identification of the cause of harmful outcomes, and the affective reactions derived in the blame judgment, the evidence of control, for example, the agent's reasonable precautionary actions taken to prevent the harmful outcome, is assumed to moderate the negative emotional response and to discount the blame judgment (Heider, 1958; Weiner, 1995; Mandel & Lehman, 1996; Alicke et al., 2008; Alicke, Rose, & Bloom, 2011; Alicke & Rose 2012). The reason is because such an evidence curtails the evaluators' ability to consider better outcome alternatives. According to the CCM, the effect of a negative affective reaction on the attribution of blame depends on

how much the negative evaluation is available to the evaluators. When there is evidence of control which showed that the alleged auditors have exercised professional due care, have taken all the precautions to avoid misstatements, or that they had no intention of making the misstatements, the evaluators face a higher level of difficulty in identifying the grounds for evaluating the auditors unfavourably. As a result, the magnitude of the negative response is diminished. However, with no proof of the auditor's precautions, the evaluators have more tendency to continuously develop their counterfactual alternative of assuming that the misstatements could have been avoided if the auditors had done a better job. This narrative may trigger feelings of negativity towards the auditors, which in turn, may increase the evaluators' negative assessment of the auditor liability. It is argued that the disclosure of KAM presents an objective evidence of the audit procedure, and the auditor's intention to perform a quality audit. It forewarns the public about the matters which they found difficult to audit (Kachelmeier et al., 2014). It is also a way of showing that the auditors were taking precautions on certain issues. It further demonstrates the prevalence of professional due care being taken, and/or the lack of negligence during their auditing process (Backof et al., 2014). Therefore, KAM tends to reduce the expectation-outcome inconsistency, and the intensity of counterfactual thinking (Brasel et al., 2016).

This study predicts that KAM would reduce the effect of the auditor's underlying behaviour which might arouse the evaluator's feeling of negativity. It offers concrete evidence of the auditor's precautions, and certain standards of care being applied by the auditor during the audit process. As a consequence, the presence of KAM is expected to moderate the evaluator's negative affective reaction and auditor liability. The moderating effect of KAM on the relationship between misstatements and the assessment of auditor liability is separately hypothesised as follows:

Auditor

H<sub>2a</sub>: The effect of fraud and error-related misstatements is lower when auditor's report includes KAM than when the auditor's report includes no KAM.

H<sub>3a</sub>: The moderating effect of KAM is higher in cases of fraud-related misstatements than in cases of error-related misstatements.

### Nonprofessional investors

H<sub>2b</sub>: The effect of fraud and error-related misstatements is lower when the auditor's report includes KAM than when the auditor's report includes no KAM.

H<sub>3b</sub>: The moderating effect of KAM is higher in cases of error-related misstatements than in cases of fraud-related misstatements.

## **3. Data and Methodology**

### *3.1 Experimental Design*

This study demonstrates how participants with and without audit expertise perceive auditors' liability for misstatements. The first experiment was conducted using professional auditors as participants, and the second experiment involved MBA students who were used as proxy for the nonprofessional investors (non-auditor participants). The two groups of participants were informed of their different roles during the experiment because the jury trial setting was not applicable in Thailand. In such cases where accusations have been made against auditors, the Thailand Federation of Accounting Professions would appoint an ethics committee to investigate and to give a verdict on whether the alleged auditors should be penalised (Code of Ethics Charter, n.d.).

To test this hypothesis, the current study employed a 2x2 (KAM x types of misstatements) between-subjects experimental design to conduct two experiments. In the first experiment, the participants would assume the role of the peer evaluator. Their job is to determine the liability of an auditor who had failed to detect the financial misstatement. In the second experiment, the participants would assume the role of an investor who held a stake in the company. Their experimental task was to evaluate the case in which an auditor had failed to detect the misstatements. The misstatements involved the overstatement of revenues with information that would be used by a third party to make investment decisions. In this experiment, the manipulation involved different types of misstatements, specifically fraud- or error-related misstatements. The second manipulation involved the inclusion or the exclusion of the KAM report in the auditor's report. Upon the arrival of the participants, each of them was randomly placed in the different conditions: 1) NO KAM - ERROR, 2) NO KAM - FRAUD, 3) KAM - ERROR, and 4) KAM - FRAUD.

### **3.2 Participants**

The first experiment comprised professional auditors who served as proxy for the members of the ethics committee that was responsible for assessing the conduct of the auditors accused of misconduct. The total number of participants involved was 145. All were from the Big 4 audit firms. After excluding participants who had failed the manipulation check questions, 133 participants remained. A discussion of the manipulation checks is included in the results and discussion section. The use of professional auditors was deemed appropriate because they have audit experience and expertise, one of the requirements for serving as a member of an ethics committee.

For the second experiment, 160 postgraduates in the MBA programme were recruited from three large universities to serve as proxies for the nonprofessional investors or the inexperienced evaluators. After excluding participants who failed the manipulation check questions, 134 participants remained. The use of MBA students was deemed appropriate for this study's setting for at least two reasons. First, they were assumed to possess a sufficient amount of business knowledge to understand the context of the case material in this study. Second, prior research (Bornstein & Rajki, 1994) has shown that the decisions made by students do not significantly differ from those of diverse subjects in the litigation setting.

### **3.3 Material and Experimental Procedure**

The experiment commenced by getting participants to read the pre-experiment questions which informed them about the auditor's report and their initial perception of the detection risk of misstatements related to fraud and error. The experimental materials which comprised publicly available information include: 1) the auditor's report, and 2) the news as published in the newspaper. The instrument was adapted from the experimental case used in Kachelmeier et al. (2014). The reason is because the case material used in this study was not an actual court transcript, and the assessment of the auditor liability was just an initial judgment rather than the resolution of the litigation.

The experimental case material includes three main sections which were separated into three envelopes. The first envelope contains the pre-experimental questions. The second envelope contains the general business environment, the auditor's report of the company,

the published news, and the main experimental questions. The third envelope comprises the manipulation check questions, the demographic questions, and the post-experimental questions. Long-term revenue recognition was selected as the subject of the KAM stated in the auditors' report because it is the most common KAM within the UK and Thailand (Pratoomsuwan & Yolrabil, 2018). It was also frequently noted as a factor leading to high risk litigations (Bonner, Palmrose, & Young, 1998; Demirkan & Fuerman, 2014).

After reading the case in the second envelope, the auditor participants were instructed to assume the role as peer evaluators in the ethics committee. The nonprofessional investors were given the role of shareholders of the company. They were asked to record judgments regarding the likelihood of negligence, and auditor liability for misstatements. They were also told that they could revisit the case while rendering the judgment since reviewing the document is a common practice in a liability judgment. Finally, the participants were required to answer several post-experimental questions regarding counterfactual thinking and affective feelings, demographic information and manipulation check questions. The participants were instructed not to review the case material while answering the questions in the last envelope. They were compensated 500 baht in cash for their participation. The case material was pretested on the final-year undergraduate students in accounting and business (non-accounting) majors. In addition, the case material was completed and amended according to the recommendations of two manager-level professional auditors from two of the Big 4 audit firms. It was also back translated and read by faculty members from the business and accounting areas.

### ***3.4 Independent Variable***

In this study, two variables were manipulated. First is the presence and absence of KAM information. In the condition where KAM is disclosed, the participants would see the KAM section in the auditor's report which describes the long-term revenue contract and also addresses how the auditors responded to this matter. In the condition where there is NO KAM, it was mentioned that no KAM was identified. The first manipulation aims to examine the differences between the presence and absence of KAM, in terms of the professionals' level of perceived due care and precautionary actions displayed by the auditors during the audit. The second manipulation examines whether

the subsequent material misstatement is related to fraud or error. The information in the news should instruct the participants on whether the financial misstatement is error- or fraud-related. In the fraud condition, participants were informed by the news article that the firm misstated its revenue due to collusive fraud by management, subordinates and customers. In the error condition, the news article reported that the misstated revenue occurred because the management had erroneously misinterpreted its long-term revenue contract. In addition, fraud and error were also defined for the participants so that their understanding of these two concepts would be on the same ground.

### *3.5 Dependent Variable*

For both experiments, the dependent variable, interest, served as the assessment for the auditor's liability. Prior studies (Kadous, 2000; Reffett et al., 2012) had measured auditor liability in two ways: 1) the likelihood of auditor negligence, and 2) monetary damages compensating for plaintiff losses. Other studies (Grenier, Pomeroy, & Stern, 2015; Brasel et al., 2016; Brown et al., 2014; Backof et al., 2014; Kachelmeier et al., 2014) have measured auditor liability only by the negligence judgment. In this study, however, both the likelihood of negligence and auditor liability were utilised as the dependent variable. The auditor liability measurement was intended to confirm the strength of the evaluators' response on the negligence level. The first question asks the participants to rate the extent to which the auditors were likely to be negligent, based on an 11-point scale. The second question asks the participants to indicate how liable the auditors should be for the third-party losses, based on an 11-point scale. A brief description of the management and the auditor's responsibility was given to the participants as a guideline for their liability judgments.

Because these two questions were highly correlated, as they pertain to the same general construct, the composite score was computed to reduce these two questions into one overall auditor liability variable. For the auditor participants, the untabulated results showed that the correlation between the likelihood of auditor negligence and liability for plaintiff losses was 0.82 and significant at the 99 per cent confidence level. For the nonprofessional investors, the correlation between these two variables was 0.83 and significant at the 99 per cent level. Therefore, the dependent variable in this study should measure the overall liability for negligence referred to as "auditor liability". The reduction of two

into one dependent variable was calculated by computing the composite score through the unit weight approach. Literature suggests that when the original variables are continuous, the unit weight can be used in two ways: by averaging the (unstandardised) raw scores across variables, or by averaging the standardised scores. The latter approach involves converting all component variables into “z-scores” before applying the unit weight to prevent the composite from being dominated by a component score with large variances (Bobko, Roth, & Buster, 2007). However, after performing the test using z-score values as the dependent variable, the results were similar to those having the original composite score as the dependent variable. Therefore, to enhance the interpretation, the original composite score was used in the study.

## **4. Results and Discussion**

### **4.1 Participants**

The auditor evaluator group comprised 133 professional auditors who were recruited from the Big 4 firms. They represent evaluators with the auditing knowledge and expertise. The average audit experience for these auditor participants was five years, with a maximum of 22 years and a minimum of 0.5 years. The average age of the participants was 28 years old. The nonprofessional investor group comprised 134 participants recruited from the MBA programme of three universities. The average age of the participants was 27 years old.

Results from the post experimental questions showed that all the participants had taken at least two accounting courses during their studies. At the time of the experiment, approximately 63 per cent of the participants had previously invested in debt or equity securities, and more than 90 per cent planned to do so in the future. This condition suggests that they were reasonable proxies and already had basic business knowledge that would enable them to understand the case material.

To confirm that these two groups of participants have different perceptions of fraud and error misstatements in terms of the detection risk, the pre-experimental question asked them to indicate whether fraud, in comparison to error, was more or less difficult to identify in an audit. The result of the pre-experimental questions derived from the auditor participants showed that approximately 92 per cent of them believed that fraud was more difficult to detect than error. This was in

contrast to the 61 per cent of nonprofessional investors who believed that error was more difficult to detect than fraud.

#### **4.2 Manipulation Check**

To ensure the salience of the experiment, three manipulation check questions were included in the post-experiment survey: 1) "What role were you assuming?", 2) "The material misstatement was caused by...", and 3) "Does the auditor's report contain KAM?"

The outcome showed that 91 per cent (133/145) of the auditor participants could correctly identify the cause of the material misstatements, the presence of KAM or both. Twelve participants who were unsuccessful in the second and third manipulation check questions were eliminated from the full sample. The 133 questionnaires included in the analysis consist of eight participants who failed the misstatement, but passed the KAM manipulation, nine participants who passed the misstatements but failed the KAM manipulation, and 116 participants who passed both manipulations. All the participants were able to correctly identify their role in the experiment. To verify that the responses made by the participants who failed one of the three manipulation check questions were not systematically different from those who passed the manipulation checks, the analysis was re-performed to include the responses from those 17 questionnaires. When included, the experimental results showed a slightly stronger statistical significance than when they were excluded.

A total of 84 per cent (134/160) of the nonprofessional investors could correctly indicate the cause of the material misstatement or the presence of KAM correctly. About sixteen per cent (26 participants) failed both questions. They were excluded from the analysis. Nine participants either answered the misstatement or the KAM question correctly, eight participants failed to answer the KAM manipulation check questions correctly, and one participant could not answer the misstatement manipulation question correctly. During the reperforming of the analysis, the nine participants in the sample were added again, and results remained the same. Consequently, only those who failed both manipulation check questions were excluded so as to keep the result conservative. The last manipulation check question which concerns the assumed roles of the participants, all the MBA students answered it correctly.

### 4.3 Hypotheses Tests

The statistics presented in the planned contrast result is shown in Panel C of Table 1. The outcome supports the prediction of  $H_{1a}$  which states that the auditor evaluators perceived the error-related misstatement (mean = 6.46) to be more severe than the fraud-related misstatement (mean = 5.06). This resulted in a higher assessment of the auditor liability ( $p < 0.001$ ). For  $H_{1b}$ , Panel C of Table 2 shows that the nonprofessional investors assigned higher assessment of the auditor liability when the misstatement was related to fraud (mean = 7.13) than when it was related to error (mean = 6.25) ( $p < 0.001$ ). These results thus supported the predictions of  $H_{1a}$  and  $H_{1b}$ .

Table 1: Professional Auditors' Decision Regarding Auditor Liability

<i>Panel A: Mean (Standard Deviation) of Auditor Liability</i>			
	KAM	NO KAM	Total
ERROR	6.32 (1.53) n = 34	6.61 (1.51) n = 33	6.46 (1.52) n = 67
FRAUD	4.35 (2.53) n = 33	5.80 (1.78) n = 33	5.06 (2.29) n = 66
Total	5.35 (2.29) n = 67	6.20 (1.69) n = 66	5.77 (2.06) n = 133

<i>Panel B: ANOVA Results</i>			
Source of Variation	df	F	p-value
Misstatement	1	18.09	< 0.001
KAM	1	7.07	0.005
Misstatement * KAM	1	3.22	0.038

<i>Panel C: Planned Contrast</i>			
Hypotheses	Contrast	t	p-value
$H_{1a}$	Error > Fraud	4.24	< 0.001
$H_{2a}$	Error/KAM < Error/NO KAM	-0.76	0.225
$H_{2a}$	Fraud/KAM < Fraud/NO KAM	-2.70	0.005

*Note:* KAM is the treatment manipulated at two levels: presence of KAM (KAM) and the absence of KAM (NO KAM). Misstatement is the treatment manipulated at two levels: error and fraud. P-value is at one-tailed.

$H_{2a}$  and  $H_{2b}$  predict the interaction between the types of misstatements and the presence of KAM. It is expected that the presence of KAM in the auditor's report would lower the assessment of auditor liability in both the error- and the fraud-related misstatements. To test this hypothesis, a two-way ANOVA was performed to examine the interaction of the misstatements and the KAM variables on auditor liability. It was observed that for the auditor participants, the interaction term in the ANOVA result in Panel B of Table 1 was significant ( $p = 0.038$ ). However, when tested in a separate error- and fraud-related case, the result projected in Panel C of Table 1 showed that the presence of KAM in the report lowered the auditor liability in the case of the fraud-related misstatement ( $p = 0.005$ ). The lower auditor liability rate could be the result of a combination of two factors: 1) the auditor's perception of how difficult it is to detect fraud, and 2) KAM as evidence demonstrates the auditor's precautions taken during the audit. Therefore, failure to detect fraud resulted in less blame being attributed to the auditor when KAM is present than when it is absent. However, in the case of error-related misstatements, results suggest that the presence of KAM in the report did not cause the evaluators to view the auditors as being less liable for error-related misstatements when compared to those with no KAM ( $p = 0.225$ ). Therefore,  $H_{2a}$  was partially supported. A possible explanation for the non-significant result is that auditors generally view misstatements caused by errors as more common and frequent in comparison to misstatements caused by fraud. In this regard, the errors should have been detected during the audit. To the auditors, a misstatement due to error might be essentially so salient that they disregard the additional information from KAM in the auditor's report. As a result, having KAM in the auditor's report yielded no significant difference in the assessed liability even when the material misstatement caused by an error was subsequently uncovered.

For the nonprofessional investors,  $H_{2b}$  predicts that auditor liability would be lower for both fraud and error-related misstatements when KAM is present than when it is absent. When misstatements occur, it is possible that investors interpreted the KAM as a forewarning of the limitations in auditing a difficult area (Kachelmeier et al., 2014). Therefore, KAM could reduce auditor liability. However, the interaction term with the ANOVA in Panel C of Table 2 suggests that the nonprofessional investor (non-auditor) participants did not rate the auditor liability differently, whether with or without KAM in the auditor's report ( $p = 0.363$ ).

Table 2: Nonprofessional Investors' Decision on Auditor Liability

<i>Panel A: Mean (Standard Deviation) of Auditor Liability</i>			
	KAM	NO KAM	Total
ERROR	6.31 (1.15) n = 32	6.19 (1.32) n = 34	6.25 (1.23) n = 66
FRAUD	7.01 (1.16) n = 34	7.24 (1.84) n = 34	7.13 (1.53) n = 68
Total	6.67 (1.19) n = 66	6.71 (1.68) n = 68	6.69 (1.46) n = 134

<i>Panel B: ANOVA Results</i>			
Source of Variation	df	F	p-value
Misstatement	1	12.97	< 0.001
KAM	1	0.04	0.419
Misstatement * KAM	1	0.49	0.241

<i>Panel C: Planned Contrast</i>			
Hypotheses	Contrast	t	p-value
H <sub>1b</sub>	Error < Fraud	-3.62	< 0.001
H <sub>2b</sub>	Error/KAM < Error/NO KAM	0.39	0.363
H <sub>2b</sub>	Fraud/KAM < Fraud/NO KAM	-0.59	0.279

*Note:* KAM is the treatment manipulated at two levels: presence of KAM (KAM) and absence of KAM (NO KAM). Misstatement is the treatment manipulated at two levels: error and fraud. P-value is at one-tailed.

From the manipulation check results noted in the experiment, it appears that the participants were aware of the KAM disclosure. However, this awareness did not significantly reduced or lowered the auditor liability. The non-significant result noted for KAM when evaluators assessed the auditor liability may be because the non-professional investors' decisions were essentially affected by the outcome information. This caused them to overlook more relevant information about the audit procedure (i.e., KAM) during the liability evaluation. Although evaluators were expected to make judgments about the quality of audits at the time of misconduct, research indicates that judges and jurors cannot disregard the outcome information in liability judgments (Charron & Lowe, 2008; Hawkins & Hastie, 1990).

Consequently, the outcome information (i.e., misstatement due to fraud versus error) may have caused the nonprofessional investors to be severely influenced. This occurrence appears to be more prevalent when they were less familiar with the assigned tasks (i.e., liability judgment) (Christensen et al., 2014). As a result, they disregarded the information in KAM. Nonprofessional investors also appeared to be reluctant to recognise the audit information in the KAM section, possibly because KAM is a new standard that was implemented for the first time in Thailand, particularly at the time this experiment was conducted. Due to this, the nonprofessional investors may have not fully understood KAM disclosures, thus it was not incorporated into their judgment.

H<sub>3a</sub> and H<sub>3b</sub> attempt to examine the sensitivity of the interaction with KAM in both the error- and fraud-related misstatements. H<sub>3a</sub> predicts that for auditor participants, the evaluator should be more sensitive to KAM in fraud-related cases than in error-related cases. In particular, the presence of KAM should be more impactful in fraud cases. In addition to the ANOVA test, this hypothesis was tested using contrast coding because Buckless and Ravenscroft (1990) had proposed that the interaction result from the ANOVA test may not indicate the functional form of the particular hypothesised relationship. To better test the hypothesis where the *a priori* functional form of the relationship is specified, a more effective technique, called contrast coding, was used to test the form of ordinal interaction. This is depicted in Figure 1 which demonstrates that the KAM presentation is more sensitive in the case of the fraud-related misstatement than in the error-related misstatement. Result showed a very minor shift in the graph for the error-related case. This highlighted that KAM was not sensitive enough to affect the evaluator's judgment of auditor liability, specifically in error-related cases. The result was further examined by contrast coding in order to test the interaction between the different types of misstatements and KAM. The contrast weights assigned were as follows: 3, -1, 2, and -4.<sup>2</sup> The 3 and 2 codes represent the assessment of auditor liability in the error-related misstatement, with the absence and presence of KAM, respectively. This indicates that presence of KAM in the error-related case could slightly lower the assessed liability, as compared to the

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<sup>2</sup> The contrast code was assigned based on a contrast code in which the code for error-related misstatement did not vary much between the absence and the presence of KAM. For the robustness of the result, a contrast code of 2, -1, 2, and -4 was also tested. The results remained significant ( $p < 0.001$ ).

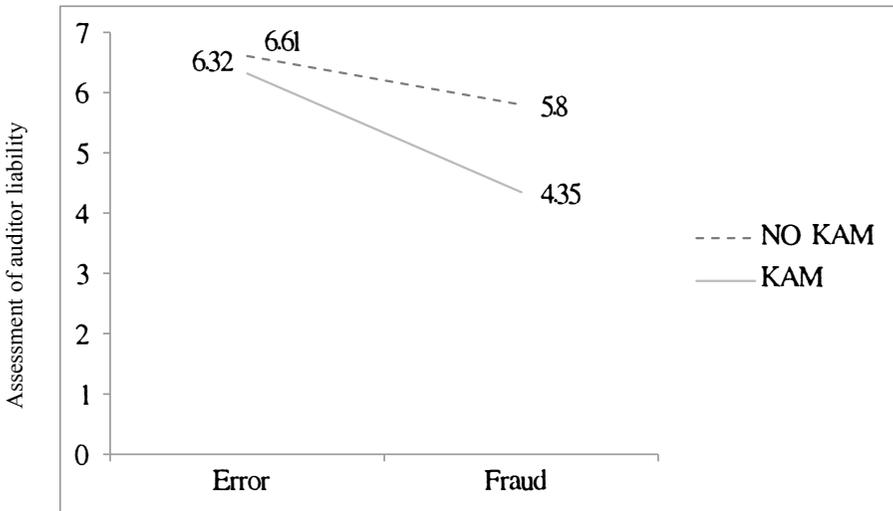


Figure 1: Effect of Misstatement Type and the Presence of KAM on Auditor Liability (Professional Auditors)

Note: Misstatement is a type of undetected misstatement manipulated at two levels - fraud and error. The auditor liability is a composite score of the likelihood of negligence and the liability for third-party losses using the unit weight (average) method. KAM is the disclosure of KAM in the auditor’s report manipulated at two levels - presence of KAM and absence of KAM.

absence of KAM. The -1 and -4 codes represent the liability assessment in fraud-related misstatements in the absence and presence of KAM, respectively. The codes indicate that the liability for fraud misstatement with KAM was lower than that for misstatement without KAM. The overall contrast test was also significant ( $t$ -value = 4.57,  $p < 0.001$ ).

$H_{3b}$  predicts that nonprofessional investors are more sensitive to the presence of KAM in the case of error-related misstatements in comparison to fraud-related misstatements. The ANOVA result which measured the moderating role of KAM on the effect of the relationship between the misstatement and auditor liability indicated no statistical significance ( $p = 0.241$ ). This suggests that the nonprofessional investors were not sensitive to the presence of KAM in terms of change to the liability judgment in both the fraud-related and error-related misstatements. In this regard, hypothesis  $H_{3b}$  was not supported. Figure 2 clearly depicts a pattern that was inconsistent with the hypothesised interaction effect of misstatement types and the presence of KAM. There seemed to be no statistical evidence to indicate that KAM prompted

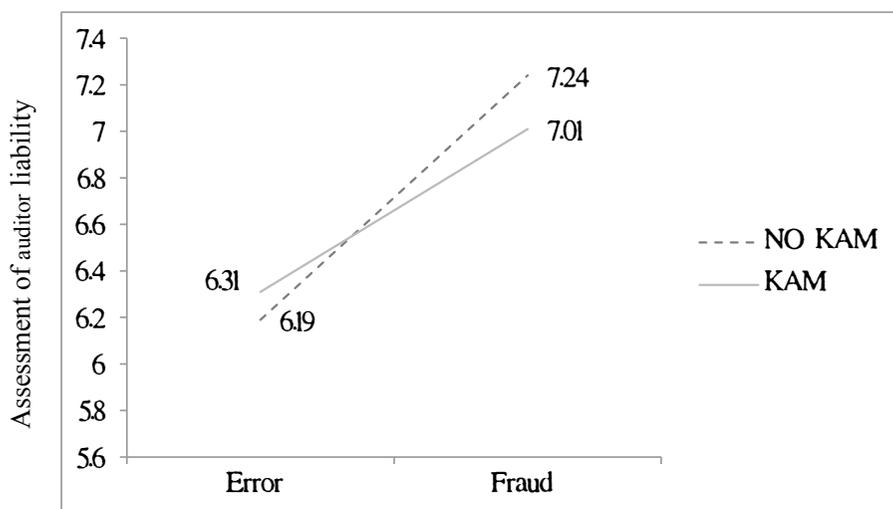


Figure 2: Effect of Misstatement Type and the Presence of KAM on Auditor Liability (Nonprofessional Investors)

Note: Misstatement is a type of undetected misstatement manipulated at two levels - fraud and error. The auditor liability is a composite score of the likelihood of negligence and the liability for third-party losses using the unit weight (average) method. KAM is disclosure of KAM in the auditor's report manipulated at two levels - presence of KAM and absence of KAM.

counterfactual thinking in the nonprofessional investors with regards to the audit procedure, prior to the material misstatement.

#### 4.4 Robustness Test

Judgments of performance are generally determined based on experience and ability. However, the effect of experience on audit judgment can be varied. Several prior studies found no experience effect in their studies (Ashton & Brown, 1980; Hamilton & Wright, 1982). To avoid the possibility of a confounding effect in which audit experience also influenced the liability judgment, the experience variable was included in the analysis to test whether the results were robust when controlling for the participant's audit experience. It was found that after controlling for audit experience, the ANCOVA result (untabulated) showed that audit experience had no significant impact on the assessment of auditor liability ( $F = 1.68, p = 0.09$ , one-tailed), and the interaction term remained significant ( $F = 3.53, p = 0.031$ , one-

tailed). Not only was audit experience added as a covariate, other demographic data of the participants, such as gender, education and age were also considered so as to ensure that they do not significantly vary across experimental conditions, as proposed by Grenier, Reffett, Simon and Warne (2018). The study by Lowe and Pany (1993) found that demographic information had no relationship to the decision in liability cases but Lowe, Reckers and Whitecotton (2002) noted that some demographics affected liability decisions. In the context of the current study, only gender and age were used as potential covariates because all the participants tended to have similar educational backgrounds. Prior studies in auditor liability judgment had generally discussed age and gender as the demographic data that could affect information processing (Chung & Monroe, 2001; Gimbar et al., 2016; Lowe et al., 2002). The ANCOVA was conducted again with the age and gender variables added into the model. Among the auditor participants, it was found that age and gender did not affect the liability judgment ( $p = 0.349$  and  $0.218$ , one-tailed, respectively) but the interactive effect between misstatement types and KAM remained significant ( $p = 0.05$ , one-tailed). Overall, these results suggest that the observed effect on liability judgment was caused by the auditors' evaluation of the misstatement type and KAM, and not by their demographic differences.

In the nonprofessional investors group, age, gender and educational background was added as covariates in experiment two since Grenier et al. (2018) had suggested that educational background served as a demographic factor that could affect liability judgment. Since the MBA students tend to be graduates of different educational backgrounds, this variable was thus categorised as dichotomous, with a value of 1 if they had a business background, and a value of 0, if otherwise. After repeating the analysis with all the covariates, the results were not significantly different.

## 5. Conclusion and Implications

In this study, the model and hypotheses were developed from the counterfactual reasoning, the culpable control model, and the decision affect theory so as to inform the debate regarding the impact of KAM disclosures on the assessments of auditor liability. The results generated from the current study aimed to provide a better understanding of KAM disclosure. It also attempted to test the hypotheses about how professional auditors and non-auditor evaluators assessed auditor liability,

given the fraud-related and the error-related material misstatement setting. Two experiments were conducted whereby the participants acted as members of the ethics committee in experiment one, and as investors who were also shareholders in the failing firm in experiment two. They were given situations to decide whether an auditor who failed to detect material error or fraud was negligent, and therefore liable for the losses. The results derived from experiment one were essentially consistent with the predictions. When the material misstatement was caused by fraud, the auditor evaluators were likely to assess lower on auditor liability than when the misstatement was caused by error. However, KAM disclosure lowered auditor liability only when the misstatement was related to fraud. In addition, the auditor participants appeared to be more sensitive to the presence of KAM disclosure when given a fraud-related misstatement than when given an error-related misstatement.

In experiment two, the results partially supported the predictions. In contrast to the findings of experiment one where fraud triggered a lower assessment of auditor liability, results from experiment two generated an opposing conclusion. For the main effect of misstatement types, the finding was consistent with the prediction, which suggested that the assessed auditor liability would be higher in fraud-related material misstatement than in error-related material misstatement. Without the relevant auditing knowledge, the nonprofessional investors generally had a high expectation of auditors and their ability to detect fraud. As a result, the nonprofessional investors had a more severe assessment of the auditors' liability than the professional auditors, in the case of fraud. However, for the interaction role of KAM disclosure on the liability assessment, there is no statistically significant evidence to support the hypothesis which states that KAM moderated the effect of the financial misstatement on the assessment of auditor liability. The non-significant role of KAM may be attributed to the fact that nonprofessional investors do not fully understand the relevance of KAM disclosures. Therefore, this information was not incorporated into their judgments.

In terms of the theoretical implications, substantial research has been conducted with the objective of examining the consequence of KAM disclosures on various stakeholders. Nonetheless, many of the findings had depicted mixed results. This therefore warranted that further investigations be conducted so as to bring more clarity to the topic. The effect of KAM disclosure on auditor liability had also been examined among different stakeholders, for example, investors, financial analysts and jurors, but the role of the "auditor" has not been included

in previous studies. In particular, cases of investigations involving “fraud and error misstatements” had not been investigated before. Thus, this study fills the research gap and contributes to the previous literature by demonstrating the following.

First, this research has emphasised on the outcome in the context of Thailand which has a legal system that uniquely allows audit experts to make liability judgments. This paper has examined the impact of KAM disclosure on the assessment made by the auditors within the auditing profession. The findings of this study therefore adds to the current literature by extending a finding that involved an Asian context. The outcome also shows that when misstatements are evaluated by an auditor, KAM disclosure can only reduce liability in cases of fraud, but not for errors.

Second, this study is among the first few to have examined the impact of auditor liability based on two different types of misstatements: fraud and error. The new findings suggest that different types of misstatements contribute to the differences in auditor liability judgments, especially when evaluated by evaluators with different levels of auditing knowledge.

Overall, the results revealed an interesting facet which emphasised that the level of auditing knowledge and the expectations of the evaluators contribute to the differences in the weight of the importance of information when making liability judgments. Although it is obvious that the two groups of evaluators would yield different results, this paper provides the “empirical evidence” to prove that auditor and non-auditor evaluators do have different liability judgments. Our study correspond with Bedard et al. (2016), who had addressed the impact of KAM on auditors’ liability by using participants with higher levels of financial and auditing knowledge. Our study is also consistent with Brasel et al.’s (2016) work which showed that auditor liability may differ in cases of fraud-related and error-related misstatements. In particular, the results from this study demonstrate that auditing knowledge is one of the crucial factors attributing to the differences in liability judgments, in cases of KAM disclosure and the different types of misstatements.

For the managerial implications, our work can significantly benefit auditors, the auditing profession and standard setters. First, this study helps to alleviate the key concerns of auditors as to whether KAM practices would affect liabilities that potentially occur after undetected misstatements. Our findings also particularly provide better insights in cases of error, showing that KAM disclosures would not help lower

auditors' liability. Therefore, auditors should be aware that KAM disclosures have attention directing impacts on the assessment of auditor liability. Auditors should also carefully decide on how many and, in particular, what matters are being disclosed as KAM in the auditors' report.

As noted by Peecher et al. (2013), the current process of liability judgment primarily depends on the audit outcome rather than the audit judgmental process, especially during a fraud investigation. The findings of this study has documented that the use of audit experts as evaluators for liability judgments helps to reduce the evaluator's overreliance on the outcome. With KAM disclosures, auditor evaluators incorporated the KAM information while making a liability judgment. The non-significance of KAM disclosures as evaluated by the nonprofessional investors should inform policy makers and other related parties that investors need to be educated, better informed about KAM disclosures and its objectives.

Despite its contributions, this study is not without limitations. First, the experiments in this study were not simultaneously performed. The two groups of participants were independently analysed in the two experiments. This is due to the different roles assumed by the participants in each group. As is noted, the auditor evaluators and the nonprofessional investors were asked to evaluate the auditor liability based on different assumed roles in a context that was deemed realistic for Thailand. Second, the design of this study did not accommodate the setting where the auditors had the opportunity to communicate with their peers, an outcome which could affect their judgment. This is the general limitation of the experiment, which could be considered as somewhat unrealistic since discussions among committee members are encouraged in a courtroom when making judgments. Third, a typical issue associated with experimental research is the use of students as proxies to assess auditor liability. It is deduced that their deliberation process may be different from that of actual judges. However, several previous studies have used undergraduate students to represent jury eligible individuals (Kadous & Mercer, 2012; Peecher & Piercey, 2008, Reffett, 2010; Backof et al., 2014). The study from Bornstein (1999) particularly noted that verdicts provided by student participants did not differ significantly from verdicts provided by more diverse groups of jury eligible adults. Thus, consistent with recent litigation research, undergraduate students' decisions on auditors' liability should be valid. Finally, the results from this study do not imply any possible effects of

multiple KAM disclosures in the same auditor's report. Future research could examine whether auditors would have legal incentives to disclose more, as opposed to fewer, KAM. If multiple KAM disclosures were issued, the question of whether this would undermine the intent of the proposed standard by diluting the impact of more KAM disclosures remains under-researched.

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