

# PCAOB Inspections and Auditor Liability

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**SUMMARY:** The PCAOB has been inspecting firms for almost 20 years, yet there is little evidence regarding the effect of PCAOB inspections on auditor liability. We examine conditions under which a clean PCAOB inspection finding (at the engagement level) provides auditor liability protection for an audit subsequently called into question. Using source credibility theory, we predict and find that the defense introducing a clean PCAOB inspection finding for the litigated engagement reduces jurors' negligence assessments by increasing the perceived credibility of the firm's defense. We also find that, if the plaintiff introduces a PCAOB-issued control criticism (firm-wide level), jurors' negligence assessments increase, regardless of whether a clean PCAOB inspection finding for the engagement is present. Collectively, results suggest that PCAOB inspection findings influence jurors' negligence assessments. These findings have implications for audit firms, the PCAOB, and other public policy makers, as well as attorneys and triers of fact in audit litigation.

**Data Availability:** Please contact the authors.

**Keywords:** PCAOB inspections; auditor negligence; quality control; juror.

## I. INTRODUCTION

Since its inception, the Public Company Accounting Oversight Board's (PCAOB 2023b) inspection program has had far-reaching effects on the audit profession. PCAOB activities, including inspections, have adversely affected auditor perceptions of, and behavior related to, the PCAOB (e.g., Johnson, Keune, and Winchel 2019; Westermann, Cohen, and Trompeter 2019). For example, survey evidence indicates audit partners from large firms perceive that PCAOB inspections can increase litigation risk (Houston and Stefaniak 2013). In addition, PCAOB inspection reports that identify deficiencies influence client behavior by increasing the likelihood of auditor dismissal (Abbott,

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We appreciate the helpful comments and suggestions from Tim D. Bauer (editor), two anonymous reviewers, John Keyser, Jordan Lowe (discussant), Eldar Maksymov, Bill Messier, Lynn Rees, Andrew Reffett, Jason Smith, and reviewers and participants at the 2019 Brigham Young University (BYU) Accounting Research Symposium and the 2020 Accounting Behavior and Organizations (ABO) Research Conference. Jesse C. Robertson appreciates support from a University of North Texas G. Brint Ryan College of Business Summer Research Grant. Jeremy M. Vinson acknowledges the generosity of the Charles D. and Katrina M. Way Faculty Fellowship for providing funds to compensate participants in this study.

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Editor's note: Accepted by Tim D. Bauer, under the Senior Editorship of Jayanthi Krishnan.

*Submitted: April 2022*  
*Accepted: April 2024*  
*Early Access: June 2024*

Gunny, and Zhang 2013; Aobdia 2018). We examine both a potential favorable outcome for auditors—liability protection when a specific audit engagement receives a clean PCAOB inspection finding—and a potential unfavorable outcome for auditors when an inspection report reflects poorly on the firm overall by including a quality control (QC) criticism.<sup>1</sup> Thus, this study explores PCAOB findings that either positively reflect on the firm at the engagement level or negatively reflect on the firm as a whole, allowing us to examine how jurors react to the presence of both these aspects of PCAOB inspection reports, which potentially send offsetting or conflicting signals about audit quality for the engagement involved in litigation.

Using source credibility theory, we posit that a clean PCAOB inspection finding overcomes a significant limitation inherent in an audit firm's typical litigation defense: the audit firm generates most of the evidence it can present (e.g., working papers). A clean PCAOB inspection finding for the audit in question in litigation gives the defense the opportunity to introduce evidence from a credible third party that the audit firm was not negligent. Source credibility depends on the source's competence and bias/trustworthiness (e.g., Birnbaum and Stegner 1979). As such, similar to client-provided evidence in an audit, evidence from the audit firm in a litigation setting likely is less persuasive than evidence from an expert, independent third party, such as the PCAOB. Although the PCAOB is the source of this information, source credibility theory indicates credibility transfers from the original source to the individual who cites the original source when communicating the information (O'Keefe 1998, 2016). This suggests that an audit defense attorney who cites a clean inspection finding could reduce jurors' assessments of auditor negligence by increasing the credibility of the audit firm defense. Accordingly, we predict that the incorporation of a clean PCAOB inspection finding by the defense attorney will reduce jurors' negligence assessments, despite an alleged audit failure.

We also examine how a firm-wide factor related to PCAOB inspections, quality control (QC) criticisms, affects auditor negligence assessments.<sup>2</sup> Disclosure of QC criticism signals firm-wide audit quality problems that have not been addressed (Nagy 2014). As jurors find other PCAOB information that is not limited to specific engagements to be decision relevant (Dennis and Goodson 2020), we predict that a QC criticism published by the PCAOB will work in the opposite direction (i.e., increase auditor liability) of a clean PCAOB inspection finding. Regarding whether a QC criticism moderates the effect of a clean PCAOB inspection for the specific audit involved in litigation, source credibility theory suggests that the presence of a QC criticism diminishes the credibility of the audit defense based on a clean inspection finding by suggesting potential firm-wide audit quality problems, which could impact the one involved in litigation. The firm-wide QC criticism likely will cast doubt about the credibility of the audit defense based on an engagement-specific clean inspection finding, which could undermine the credibility of the audit defense based on the clean inspection finding. Thus, we predict that the effect of using a clean inspection finding on jurors' assessments of auditor negligence will be smaller in the presence of a QC criticism.

We conducted multiple experiments to test our hypotheses. In all experiments, jury-eligible individuals assess auditor negligence following an undetected material misstatement. Experiment 1 examines whether a clean PCAOB inspection finding provides liability protection by manipulating whether or not the audit firm defense attorneys incorporate such a finding in their attempts to persuade jurors that the firm was not negligent. We find that jurors assess lower negligence if the audit firm used a clean PCAOB inspection finding as part of its defense, and perceived credibility of the auditor's defense mediates this effect.

Experiment 2 examines whether the plaintiff's inclusion of a firm-wide QC criticism increases jurors' auditor negligence assessments and potentially reduces the liability protection of a clean PCAOB inspection finding. As in Experiment 1, we manipulate the presence or absence of a clean PCAOB inspection finding as part of the due care defense. We also manipulate the presence or absence of a QC criticism as part of the plaintiff argument. Results replicate the main effect of a clean PCAOB inspection finding and related mediation through the perceived credibility of the auditor's defense from Experiment 1. This replication provides additional confidence in our results regarding the liability protection offered to auditors by a clean PCAOB inspection finding (for further discussion of replication, see Basu 2012; Salterio 2017). As predicted, we find a significant main effect where the firm-wide QC criticism increases negligence assessments, an effect mediated by perceived credibility of the auditor's defense when the defense includes a clean

<sup>1</sup> We define a clean inspection finding as the absence of reportable deficiencies for an inspected audit engagement in Part I of an inspection report. For example, in its 2019 inspection of PwC, the PCAOB (2020b, 1) inspected 60 audits and identified 18 audits with deficiencies such that the firm, "had not obtained sufficient appropriate audit evidence to support its opinion." We view the other 42 audits (not the overall inspection report) as clean PCAOB inspection findings. This is consistent with Westermann et al. (2019, 718) conclusion that, for each engagement, "From the PCAOB's perspective, the issuer audit either did or did not achieve a compliant audit; it is a binary pass or fail model." Section II describes how a clean PCAOB inspection finding could occur despite undetected material misstatements.

<sup>2</sup> Unlike engagement-specific deficiencies, the PCAOB only publishes QC criticisms if the inspected firm does not address QC criticisms within a year (PCAOB 2023c). The PCAOB has disclosed QC criticisms for large firms, including each of the Big 4 (Deloitte (PCAOB 2013), EY (PCAOB 2014), KPMG (PCAOB 2019b), PwC (PCAOB 2010), and RSM (PCAOB 2017)). Public release of QC criticisms might become more frequent as the PCAOB has begun modifying the inspection process to focus more on QC (PCAOB 2020d).

PCAOB inspection finding. We do not find evidence that the effects of clean inspection finding and QC criticism interact. Overall, Experiment 2 results suggest the two components of PCAOB inspection reports have opposing, and independent, effects on negligence assessments. That is, the presence of a clean inspection finding for the audit in question or a firm-wide QC criticism does not appear to affect how jurors evaluate auditor negligence in conjunction with the other PCAOB finding. This suggests that jurors incorporate both PCAOB findings into their judgments of negligence as unique, separate pieces of evidence, although the source of the evidence is the same.

We offer several contributions to the auditor liability and PCAOB literatures. First, our study identifies a favorable outcome to auditors of PCAOB inspections, which is important as auditors have expressed negative views about the PCAOB inspection process (e.g., [Johnson et al. 2019](#); [Westermann et al. 2019](#)) and a “culture of resentment toward the PCAOB” may be prevalent in large audit firms ([Ege, Knechel, Lamoreaux, and Maksymov 2020](#), 1). Concerning litigation, PCAOB inspection reports that *identify deficiencies* are associated with an increased number of lawsuits against triennially inspected audit firms, especially following a firm-wide QC criticism ([Christensen, Lundstrom, and Newton 2021](#)). Our study extends this literature by demonstrating the litigation benefits to audit firms of inspection findings that *indicate no deficiencies* and a liability-related outcome different from the number of lawsuits. Our finding of a clean PCAOB inspection finding providing litigation benefits for auditors also complements research examining auditor reactions to inspections (e.g., [Aobdia 2018](#); [Christensen, Newton, and Wilkins 2022](#)). For example, auditors have expressed a concern that inspections could incentivize them to emphasize passing inspections over audit quality ([Johnson et al. 2019](#); [Westermann et al. 2019](#)). Ironically, when considering this concern in light of our results, it is possible that a clean PCAOB inspection finding, lower audit quality, and reduced negligence assessments could occur for the same audit. That is, auditors’ work to appease inspectors might harm audit quality and reduce both PCAOB scrutiny and legal liability.

Second, we help answer a call for research in [Grenier, Pomeroy, and Reffett \(2012\)](#) related to the effect of external party inspection of an audit that involves a highly important client. [Grenier et al. \(2012\)](#) provide evidence that using internal firm inspections, conducted after audit completion, as a defense tactic can reduce auditor liability. However, they find that a firm’s internal inspections backfire by increasing liability for high-importance clients. The PCAOB’s external inspection, at least in part, uses a risk-based approach to select engagements ([PCAOB 2023c](#)). This approach suggests that clients the PCAOB perceives as high importance could be selected more for inspections than less important clients. Our results regarding a clean inspection finding for the audit in question suggest the PCAOB might be a source of sufficient credibility to overcome the backfiring effect of inspections for high-importance clients identified by [Grenier et al. \(2012\)](#).

Third, we extend the auditor-juror judgment literature by providing insight on jurors’ cognitive processes and factors that affect their decisions. Specifically, our results suggest that increasing jurors’ perceptions of the credibility of the auditor’s attorney’s defense reduces auditor negligence assessments, and the defense team’s use of a clean inspection finding increases these credibility assessments. To our knowledge, this is the first study to apply source credibility theory as a theoretical framework to examine juror judgment in the PCAOB inspection setting.

## II. BACKGROUND AND HYPOTHESES

### Part I Inspection Findings

The PCAOB inspects firms that audit public companies to ensure compliance with standards ([PCAOB 2023c](#)). The PCAOB inspects a sample of a firm’s audits, and Part I of the inspection report describes deficiencies if the PCAOB determines the firm did not have enough evidence to support its opinion for specific engagements ([PCAOB 2012b, 2023c](#)).<sup>3</sup> For instance, Part I of the [PCAOB’s \(2020a\)](#) 2019 inspection report of EY describes deficiencies in 11 of the 60 inspected audits, implying a determination that the firm adequately supported its opinions on 49 inspected audits (i.e., 49 clean Part I PCAOB inspection findings within this inspection report).

However, undetected material misstatements can coincide with a clean PCAOB inspection finding for several reasons. First, the PCAOB’s engagement selection process includes a risk-based component and focuses on high-risk areas within selected audits ([PCAOB 2023c](#)), meaning not all audit areas are subject to inspection. Research suggests that auditors have incentives to spend sufficient time on areas the PCAOB could inspect and compromise diligent audit work

<sup>3</sup> Beginning June 2020, after we ran the majority of our experiments, PCAOB inspection reports include Parts I.A and I.B. Part I.A (Part I.B) describes deficiencies that are related (unrelated) to whether the firm supported its opinion. Examples of potential violations of standards in Part I.B include failure to document communications with the audit committee regarding independence and an inaccurate Form AP ([PCAOB 2020c](#)). Importantly, Part I.A of the updated inspection report format parallels what we refer to as Part I throughout our paper.

in other areas (Johnson et al. 2019; Westermann et al. 2019). Indeed, an inspection could conclude that the auditor appropriately planned and performed a risk-based audit program for a given account yet also happen to miss material misstatements. This could occur, for example, if management strategically conceals fraud (Bowlin 2011; Hamilton and Smith 2021; Wilks and Zimbelman 2004) from both auditors and PCAOB inspectors. Second, inspectors focus on reviewing audit workpaper documentation and interviewing audit staff (PCAOB 2023c). It is possible that audit procedures may not have been performed as well as they appear in workpapers or as recalled by audit staff. Third, auditors and clients may agree on subjective accounting issues, such as estimates, and the PCAOB might not find deficiencies where there is room for differences in judgment. However, the SEC or other parties might later question the accounting treatment and audit conclusions in subjective judgment areas.

### Juror Perceptions of Part I Inspection Findings

We draw on source credibility theory (e.g., Birnbaum and Stegner 1979; McGinnies and Ward 1980; O’Keefe 2016; Pornpitakpan 2004) to develop our hypotheses for jurors’ assessments of auditor negligence in light of a clean PCAOB inspection finding. Source credibility theory (e.g., Birnbaum and Stegner 1979; McGinnies and Ward 1980; O’Keefe 2016; Pornpitakpan 2004) indicates that source credibility and persuasiveness depend on two dimensions: competence and bias/trustworthiness.<sup>4</sup> We expect jurors likely will perceive the PCAOB as competent because of its expertise as an audit regulator and the impact it has been shown to have on decisions. For instance, prior research finds that PCAOB reports indicating when triennially inspected audit firms are “seriously deficient” are associated with clients with higher abnormal accruals and a higher incidence of restatements compared with clients of “clean” triennially inspected firms, suggesting that the PCAOB is competent in its inspection of triennially inspected firms (Gunny and Zhang 2013). Moreover, Aobdia (2019) finds that audit quality metrics utilized by practitioners, academics, and the PCAOB are significantly correlated, with this general agreement on what constitutes audit quality providing further evidence of the PCAOB’s competence. Another indicator of the PCAOB’s competence is the influence of PCAOB information on decision-makers in other contexts. Although initial research on auditor switching indicates PCAOB findings do not necessarily affect client decisions (Lennox and Pittman 2010), subsequent research suggests PCAOB inspections can affect client decisions (Abbott et al. 2013; Aobdia 2018; Daugherty, Dickins, and Tervo 2011).

Jurors also likely will view the PCAOB as trustworthy because it is an objective third-party rather than a “hired gun” testifying for the defense (Ivkovic and Hans 2003, 444). In contrast to such a witness, PCAOB inspectors are not hired by auditors and their inspection findings can foster a critical view of the profession by only publishing deficiencies (e.g., Robertson, Stefaniak, and Houston 2014). Therefore, jurors likely will view the PCAOB as competent and trustworthy (i.e., a credible source).

Importantly, source credibility theory suggests the credibility of cited sources transfers to the party providing the information (for a meta-analysis, see O’Keefe 1998). As O’Keefe (2016, 191) explains, “the citation of expert and trustworthy sources of evidence in the message appears to influence the communicator’s perceived expertise and trustworthiness; in a sense, the high credibility of the cited sources seems to rub off on the communicator.” Similarly, accounting research (Grenier et al. 2012) finds that the credibility of internal firm inspections conducted in response to a negligence allegation can transfer to the defense attorney by informing perceptions of the credibility of the defense. In our setting, this suggests the relatively high credibility of the cited source (PCAOB) will lend credibility to a defense strategy in which the defense attorney introduces a clean PCAOB inspection finding as evidence that the audit firm was not negligent.<sup>5</sup> If a defense is viewed as more credible by citing a clean PCAOB inspection finding for the audit, this increased credibility should, in turn, reduce negligence assessments.

Although jurors could view a PCAOB inspection as a credible source if cited by the audit firm’s defense attorney, there is tension regarding whether a clean PCAOB inspection finding will reduce jurors’ negligence assessments. We provide several examples of this tension here. First, jurors might not perceive PCAOB inspectors as sufficiently competent to provide credible inspection reports, especially in the absence of an identified deficiency when a misstatement has been identified by

<sup>4</sup> Our use of source credibility theory as the foundation of our experiments and mediation analyses complements concurrent research regarding the importance of credibility in audit litigation. Maksymov, Peecher, Pickerd, and Zhou (2024) conduct interviews with attorneys and trial consultants and identify the credibility of multiple factors, including evidence, auditor responsibilities, and the audit defense strategy, as important in persuading jurors. Furthermore, archival research (e.g., Abbott, Buslepp, Moon, and Swenson 2023; Abbott et al. 2013; Lennox and Pittman 2010) provides inferences on the credibility of the PCAOB and/or inspections as a signal of audit quality, but these studies neither use source credibility theory as a framework nor investigate liability issues associated with inspections.

<sup>5</sup> As an example of this transfer of credibility from a cited source to a communicator in daily life, consider a used car sale involving a CARFAX vehicle history report (CARFAX 2024). CARFAX is the source, yet a salesperson who provides a CARFAX report likely is perceived as having a more credible sales approach than a salesperson who does not provide a CARFAX report. In that case, the credibility of the source (CARFAX) transfers to the salesperson who uses the CARFAX report as a tactic to persuade the consumer to purchase the car.

the SEC. Second, and related, the PCAOB faces difficulties attracting and retaining experienced auditors to conduct inspections and PCAOB personnel issues create problems, such as the loss of technical expertise when inspectors are out of audit practice for an extended period and potential assignment of inspectors to areas outside their expertise (Glover, Prawitt, and Taylor 2009). Third, jurors might perceive PCAOB inspections as a compliance exercise rather than a critical evaluation of the auditors' due care (e.g., Johnson et al. 2019). Therefore, it is possible that the PCAOB does not have sufficient perceived credibility to transfer to the auditor. Fourth, it is possible that a clean PCAOB inspection finding may not sufficiently mitigate jurors' motivation to blame auditors (e.g., Kadous 2000). Nevertheless, given the whole of the discussion above, we expect a clean PCAOB inspection finding to increase the perceived credibility of the auditor's defense and reduce jurors' negligence assessments. This discussion leads to our first hypothesis.

**H1:** Jurors will assess lower auditor negligence when the audit firm defense strategy includes a PCAOB inspection finding that did not identify audit deficiencies for the audit in question than when the defense strategy does not include this PCAOB finding.

### Firm-Wide Factor: PCAOB Quality Control Criticisms

Audit firms are expected to have effective quality control (QC) systems to promote audit quality. Specifically, each "firm's system of quality control should, among other things, provide reasonable assurance that the firm's audit work will meet professional standards" (PCAOB 2012b, 8). The PCAOB inspects a sample of a firm's audits, and Part II of the inspection report describes QC criticisms of the firm as a whole. These criticisms are provided to the audit firm being inspected and are not initially made public but ultimately are made public if the firm does not effectively respond to the QC criticisms within a year (U.S. House of Representatives 2002, SOX §104(g)(2); PCAOB 2012b, 2023c). Unlike the Part I inspection findings, which we examine in H1, the firm-wide QC criticisms in Part II do not directly relate to a specific engagement but instead apply to the firm as a whole. In other words, a firm can receive both a clean PCAOB inspection finding for a specific engagement and a QC criticism for the firm.<sup>6</sup>

Importantly, a firm-wide PCAOB report will not necessarily have an opposite effect of equal magnitude on negligence assessments compared with a clean PCAOB inspection finding for a specific engagement. The PCAOB likely would be viewed as similarly credible for both a Part I or Part II report. However, the plaintiff likely would cite a Part II report (because it negatively reflects on the auditor), whereas the defense likely would cite a clean Part I report (because it positively reflects on the auditor). Given the plaintiff is the one citing the negative report, it is unclear whether the credibility of the source of the report (the PCAOB) would necessarily transfer to the credibility of the *defense* when it has been introduced by the *plaintiff*. Also, the QC deficiencies in Part II of the reports represent firm-level information, which might not affect juror judgments about the audit engagement involved in litigation to the same magnitude as the Part I information about that specific engagement. However, the question of transfer of credibility provides tension regarding whether and to what extent the credibility of the defense will be affected and, by extension, the effect of QC criticisms on jurors' judgments.

Archival research provides mixed results on client reactions to Part II information. Nagy (2014) finds that auditors are more likely to be dismissed if they have a Part II report released. However, Buslepp, DeLisle, and Victoravich (2018) argue that the publication of a Part II report is not likely to provide new information, as Part II information would likely be conveyed to clients before this report is released. After replicating Nagy (2014), they employ a "difference-in-differences" approach by controlling for market share changes in the year prior to the Part II report being released and do not find a significant reaction to the Part II report public release. Thus, the public release of this content does not necessarily affect client behavior (see Buslepp et al. 2018).

However, public release of firm-wide QC criticisms could affect jurors' judgments by conveying at least two problems related to audit quality. As Nagy (2014) notes, this disclosure discusses QC criticisms in detail (which we infer provides negative information about audit performance) and signals that the firm did not provide a sufficiently effective response to the PCAOB's concerns about the identified issues within the afforded timeframe.<sup>7</sup>

Behavioral research has examined the effect of negative information about audit performance from the PCAOB, in the form of settled disciplinary orders (SDOs), on jurors' judgments (Dennis and Goodson 2020). Like QC criticisms, SDOs do not have to relate to one engagement.<sup>8</sup> Dennis and Goodson (2020) find that jurors are more likely to conclude

<sup>6</sup> For example, in a recent report for KPMG, the PCAOB reported firm-wide QC criticisms, whereas the initial Part I inspection provided clean inspection findings for 29 of 49 issuer audits inspected (PCAOB 2019b).

<sup>7</sup> Nagy's (2014) findings suggest it is the content of the issues in the QC report that has an impact rather than the firm not effectively addressing the issues.

<sup>8</sup> For example, the PCAOB's (2019d) SDO against RSM, a large firm inspected annually (PCAOB 2023a), involves RSM not disclosing it was a defendant in lawsuits and/or disciplinary proceedings initiated by entities other than the PCAOB.

that an auditor was negligent and set lower compensatory damages if the audit firm previously paid a larger PCAOB fine, indicating that PCAOB criticisms related to the firm can affect juror judgments.<sup>9</sup> Importantly, QC criticisms differ from SDOs in that fines do not accompany QC criticisms; large fines can lead jurors to believe that the audit firm has been more sufficiently penalized and thus see less of a need for additional penalty (cf. Dennis and Goodson 2020).

In summary, the audit literature suggests that QC criticisms can send negative signals about audit quality, especially when the evaluator is not previously aware of a QC criticism (Nagy 2014; Buslepp et al. 2018), which likely is the case for jurors. Furthermore, jurors find PCAOB-provided information that is not necessarily limited to a single audit to be decision relevant (Dennis and Goodson 2020). Thus, we propose that jurors will assess higher negligence when the PCAOB releases a QC criticism than when the PCAOB does not release a QC criticism. Stated formally,

**H2:** Jurors will assess higher auditor negligence when the PCAOB has released a quality control criticism than when the PCAOB has not released a quality control criticism.

### Presence of Both Reports

We now consider whether a firm-wide QC criticism moderates the effect of a clean PCAOB inspection finding for the engagement in question that we predict in H1 (i.e., if *firm*-level information that reflects negatively on the audit firm offsets *engagement*-level information that reflects positively on the audit firm). For instance, jurors could focus on the engagement-level information (Part I of the report) and discount the more general QC criticism (Part II of the report) because of their charge to evaluate negligence on the specific audit engagement involved in litigation. In this case, the presence of a QC criticism, although still increasing perceived auditor negligence (H2), would not reduce the benefit of the clean inspection finding.

However, source credibility theory offers a different perspective. The QC criticism is indicative of firm-wide problems, which could include the engagement in question. In this light, a QC criticism could undermine the credibility of the defense's argument based on a clean inspection finding for the audit in question by raising concerns about the quality of the firm's audits in general. The disclosure of a QC criticism indicates the firm was either unable or unwilling to address the QC criticism, despite having a year to do so (cf. Nagy 2014). This could cast doubt on firm-level competence and/or trustworthiness and, by association, the credibility of the related defense of the firm's audit performance for the engagement in question. In other words, jurors likely would still view the clean Part I inspection finding as credible because it is from the PCAOB. However, a firm-wide QC criticism would likely diminish the credibility of such a defense to some extent by providing negative information about firm-wide audit performance.

Thus, we expect the release of a Part II QC criticism to diminish the litigation protection provided by a clean Part I inspection finding. Specifically, in the presence of a QC criticism, there likely will be a relatively small differential effect on negligence when the audit firm defense uses a clean Part I inspection finding for the audit in question. This is because a QC criticism provides negative information from the PCAOB about firm-wide audit performance, offsetting the defense's arguments related to the clean inspection finding for the audit in question. In the absence of a QC criticism, there is no additional information from the PCAOB that reflects poorly on the audit firm to diminish the credibility of the defense strategy that incorporates the Part I finding. Thus, in the absence of a QC criticism, we expect a relatively large differential effect on negligence when the audit firm uses a clean Part I inspection finding defense. This leads to our third hypothesis:

**H3:** The decrease in jurors' assessments of auditor negligence attributable to the audit firm defense strategy including a PCAOB inspection finding will be smaller when the PCAOB has released a quality control criticism.

## III. METHOD AND RESULTS—EXPERIMENT 1

### Participants

Following prior research, we recruited participants using Amazon's Mechanical Turk (MTurk), a frequent source of juror participants in experimental studies of auditor negligence (e.g., Brasel, Doney, Grenier, and Reffett 2016) whose demographics are more representative of the jury-eligible population than traditional participant pools (e.g., students;

<sup>9</sup> Dennis and Goodson (2020, 18) do include a measure of auditor credibility that differs from our measure; theirs is based on a composite of their measures of "audit quality, auditor competence, and the audit firm's intention to conduct a quality audit." They also do not rely on source credibility for their study.

Buchheit, Doxey, Pollard, and Stinson 2018; Farrell, Grenier, and Leiby 2017). See Grenier, Reffett, Simon, and Warne (2018) for a discussion of proxy considerations in juror research.<sup>10</sup>

We took multiple steps to obtain quality responses from MTurk by controlling access to our study *ex ante* and confirming quality of responses *ex post*. To control access, we used CloudResearch (formerly known as TurkPrime) as an intermediary website from which to launch our study on MTurk (Litman, Robinson, and Abberbock 2017). We limited access to our study to MTurk workers who had completed more than 500 human intelligence tasks (HITs) with an approval rating greater than 95 percent (Peer, Vosgerau, and Acquisti 2014). CloudResearch also prevented duplicate and/or suspicious internet protocol (IP) addresses and geolocations (Dennis, Goodson, and Pearson 2020). We required participants to be U.S. citizens and at least 18 years old and used screening questions to ensure participants were appropriate surrogates for jurors who would not be eliminated during *voir dire* (e.g., no work experience as an auditor).

We also took multiple steps to ensure quality of responses *ex post*. Following Hunt and Scheetz (2019), we autocaptured MTurk ID numbers, asked participants to manually enter their MTurk ID number prior to exiting, and rejected any participants with inconsistent ID numbers. Also, we coded Qualtrics to provide each participant a unique confirmation code at the end of the experiment. Participants had to enter the confirmation code into MTurk, which we compared with the Qualtrics data, rejecting participants with inconsistent codes (Hunt and Scheetz 2019). We included an open-ended question following the dependent variables, allowing us to screen for low-quality data and ineligible participants given the jury setting (Dennis et al. 2020). Prior to data analyses, one of the authors read the responses to identify low-quality responses (e.g., answers that were incomprehensible or unrelated to the case), and none were found.

For Experiment 1, we obtained 273 participants, paying each \$3 in compensation. For all experiments, we compensated participants who passed all screening questions, correctly answered 80 percent of review questions, and passed IP address qualifications. We asked manipulation reinforcement questions during the review question portion of the same section of the experiment as the manipulation, consistent with Brasel et al. (2016).<sup>11</sup> Participants spent an average of 39 minutes on the case. Participants varied in education, with 88 having a high school diploma or associate's degree, 114 having a bachelor's degree, and 71 having a master's degree or other. Most participants have some form of employment outside of MTurk (81 percent), their average age is 46, and 37 percent are male. See Table 1 for participant demographics. Inclusion of demographics as covariates in the models does not change our inferences or conclusions.

## Experimental Task

We adapted the instrument from Grenier, Pomeroy, and Stern (2015). The case involves a subjective issue, where the PCAOB could agree with the auditors and other parties could second guess the auditors' judgment. Following screening, informed consent, and general instructions, we provided background information on financial statements, auditing, and PCAOB oversight. This information clarified that inspection reports identify deficiencies in audit procedures but do not describe specific instances where the firm's audit procedures complied with professional standards. We then provided background information on the client, Zoom-Cars, Inc. (ZCI), a public company that provides car rentals for limited periods.

The case centers on a lease agreement for a new fleet of cars that ZCI had leased. We provided information on operating and capital leases, including discussion of potential implications of both types of leases. We gave participants information about GAAP for leases, including a list of "factors to consider."<sup>12</sup> We told participants that management accounted for the transaction in question as an operating lease, that this was management's preferred treatment, and that this treatment was inconsistent with other companies in the industry. Next, participants were provided with information about the audit firm (Smith & Company), including that the lead partner also concluded that ZCI's treatment of the lease as an operating lease was appropriate.

<sup>10</sup> We received Institutional Review Board (IRB) approval to conduct each experiment.

<sup>11</sup> Our inferences for Experiments 1 and 2 are unchanged if we remove participants who failed a manipulation reinforcement question (25 in Experiment 1 and 26 in Experiment 2). We also asked manipulation check questions near the end of each experiment, prior to demographic questions. The higher average failure rate for the manipulation check questions across the experiments in the nontreatment conditions (69 percent) than in the treatment conditions (33 percent) suggests that, when a treatment was absent, participants had difficulty distinguishing whether or not they had seen this specific detail. This does not suggest manipulation failure, as it is not necessary to confirm that control condition participants did not see a nonexistent treatment (cf. Brink, Eaton, Grenier, and Reffett 2019). Thus, we believe these manipulation checks are nondiagnostic as to whether nontreatment condition participants paid sufficient attention, particularly given our numerous other steps to ensure quality responses.

<sup>12</sup> In this discussion, participants were instructed, "For lease accounting, assume GAAP offered the following guidance to determine whether a lease contract should be classified as an operating lease or a capital lease during the period in question." Although the guidance given deviates to some extent from GAAP, our concern is the impact of our manipulations on juror judgments rather than juror reactions to specific accounting guidance. Other areas where inspectors and auditors could agree yet the auditor still face lawsuits for alleged negligence likely would involve other subjective accounts. Such subjective, estimated accounts could include those considered in the juror literature, such as certain liabilities, revenue recognition for real estate development, and inventory valuation (e.g., Backof 2015; Kadous and Mercer 2012; Vinson, Robertson, and Cockrell 2019).

**TABLE 1**  
**Summary of Participant Demographics**

	<b>Experiment 1</b> <b>n = 273</b>	<b>Experiment 2</b> <b>n = 335</b>
<b>Education</b>		
High school or associate's degree	88	147
Bachelor's degree	114	126
Master's degree or other	71	62
<b>Employment</b>		
Full time	161	202
Part time	32	30
Self-employed	28	55
Retired/not employed	52	48
<b>Gender</b>		
Male	100	151
Female	171	177
Prefer not to answer	2	7
<b>Means</b>		
Duration (in minutes)	39	40
Age	46	43

Next, we informed participants that ZCI experienced financial difficulties following the completion of the audit and an SEC examination found that, based on the leasing issue in question, ZCI's financial statements were materially misstated. Specifically, net income was overstated and liabilities were understated. Given its financial difficulties, ZCI was unable to repay all of a loan to a bank (El Banco). When the case could not be settled (by the bank and the auditor), it went to trial. After indicating the plaintiff's main argument (the firm was negligent in that it did not carefully follow standards but was instead concerned about keeping the client happy), we provided information on the auditor's defense, including our manipulations. In the trial, the auditor's standard due care defense across all conditions and all experiments consists of three components: a statement that no client was worth the firm's reputation/integrity, a statement of assigning effective personnel (including an experienced audit partner), and a discussion that the firm shared audit documentation and an explanation of how the audit complied with PCAOB standards. Following the trial information, participants responded to case questions, including our primary dependent variables and process-related measures. The case closed with demographic questions.

### Independent Variable

In Experiment 1, we examine whether the use of a clean PCAOB inspection finding as part of the due care defense reduces negligence assessments (H1). We manipulate *Clean Inspection* as the auditor's defense including a clean PCAOB inspection finding for the ZCI audit engagement in addition to the aforementioned due care defense. In the treatment condition, the defense pointed out that the PCAOB inspected the ZCI engagement and did not identify deficiencies for the ZCI engagement, including audit procedures related to lease accounting, which the defense stated was strong evidence that the auditor was not negligent. In the control condition, there was no mention of PCAOB inspection findings.

Experiment 1 included another between-participants manipulation to examine whether the presence (versus absence) of an audit manager on the engagement team who is a former PCAOB inspector would moderate the litigation protection provided by the clean inspection. This manipulation was not significant in any of the analyses (neither as a main effect nor in the interaction) and is not the focus of the manuscript. Thus, we exclude this variable from our analyses and examine a mediation model rather than a moderated mediation model in the supplemental analysis for Experiment 1. Our inferences and conclusions remain unchanged if the variable is included.<sup>13</sup>

<sup>13</sup> We conducted another experiment prior to Experiment 1 with the same manipulations. The design differences in Experiment 1 included (1) expanded details in the condition with an auditor who is a former PCAOB inspector, which explicitly incorporates the possibility that audit firms might hire former inspectors to prepare for and respond to a PCAOB inspection, and (2) a defense rebuttal against this argument, which enhances external validity (Grenier et al. 2018). We only report Experiment 1; both experiments result in the same statistical inferences for H1, further supporting this hypothesis.



## Dependent and Mediating Variables

Our primary dependent variable is participants' assessment of the likelihood that the auditor was negligent (*Negligent*; 0 = "Certainly not negligent" to 10 = "Certainly negligent"). We also asked participants to indicate whether the auditor was negligent or not negligent (*Verdict*; binary response). We focus on the former continuous variable because recent published studies are trending toward scaled assessments of negligence (e.g., [Backof, Bowlin, and Goodson 2022](#); [Brown, Majors, and Peecher 2020](#); [Grenier et al. 2015](#); [Joe, Luippold, and Sanderson 2022](#); [Kachelmeier, Rimkus, Schmidt, and Valentine 2020](#)) and because prior juror research concludes that continuous measures have the advantage of being more sensitive to manipulated variables ([Brown et al. 2020](#); [Grenier et al. 2018](#)). Given our theoretical framework based on source credibility theory, we measure the credibility of the auditor's defense as a mediator. Using theory to guide the selection of process measures is consistent with [Asay, Guggenmos, Kadous, Koonce, and Libby \(2022\)](#). Although we adapted case content from [Grenier et al. \(2015\)](#), we adapted our measure of the credibility of the auditor's defense from [Grenier et al. \(2012\)](#): "How credible was the defense provided by the [audit firm's] defense attorneys?" (*Credible*; 0 = "Not at all credible" to 10 "Very credible").<sup>14</sup>

Although we captured compensatory damage awards for participants who returned a guilty verdict, we do not report damages as a dependent variable because our theory relates to blame assessments. In such a case, [Grenier et al. \(2018, 107\)](#) recommend against using damages as a dependent variable; for example, they note that [Lowe, Reckers, and Whitecotton \(2002\)](#) "find that jurors consider different factors when assessing negligence and damages, such as the audit firm's ability to pay. In other words, verdicts and damage awards are separate judgments based on unique factors." More recent studies similarly have found that damage assessments often differ from negligence/blame assessments ([Backof 2015](#); [Brasel et al. 2016](#); [Grenier et al. 2015](#)), with [Backof \(2015\)](#) providing theoretical explanation for this phenomenon. Likely for these reasons, several recent juror studies do not report damage assessments (e.g., [Backof et al. 2022](#); [Ballou, Grenier, and Reffett 2021](#); [Barr-Pulliam, Brown-Liburd, and Sanderson 2022](#); [Joe et al. 2022](#); [Kachelmeier et al. 2020](#)).

## Results

H1 predicts that jurors will assess lower negligence when the audit firm defense strategy includes a clean PCAOB inspection finding than when it does not. To test H1, we use an ANOVA with *Negligent* as the dependent variable and *Clean Inspection* as the independent variable. We present descriptive statistics (Panel A) and ANOVA results (Panel B) from Experiment 1 in [Table 2](#). *Clean Inspection* is significant such that participants in the condition where the defense included a clean PCAOB inspection finding assessed lower negligence (mean = 3.72) than those in the control condition (mean = 5.05;  $F_{(1, 271)} = 15.50$ ;  $p$ -value < 0.001), supporting H1. We find comparable results (untabulated) with *Verdict* as the dependent variable.<sup>15</sup> These results suggest that a defense strategy based on a clean PCAOB inspection finding reduces jurors' assessments of auditor negligence.

## Supplemental Analysis

Supplemental analysis suggests that our results for H1 are due, at least in part, to perceived credibility of the auditor's defense, consistent with source credibility theory. We conduct a mediation model (untabulated) using Model 4 in the Hayes PROCESS macro for SPSS ([Hayes 2013](#)) with *Clean Inspection* as the independent variable, *Credible* as the mediator, and *Negligent* as the dependent variable. We estimate the significance of indirect effects using 5,000 bootstrap samples at the 95 percent confidence level. We find the perceived credibility of the firm's defense mediates the relationship between *Clean Inspection* and *Negligent*. Specifically, *Clean Inspection* (coded as 0 = absent and 1 = present) is positively associated with *Credible* ( $b = 1.52$ ;  $t_{271} = 5.02$ ;  $p$ -value < 0.001), *Credible* is negatively associated with *Negligent* ( $b = -0.773$ ;  $t_{270} = -15.68$ ;  $p$ -value < 0.001), and the indirect effect of *Clean Inspection* to *Negligent* through *Credible* is negative and significant (indirect effect =  $-1.18$ ; bootSE = 0.23; lower limit confidence interval (LLCI) =  $-1.64$ ; upper limit confidence interval (ULCI) =  $-0.72$ ). Therefore, using a clean PCAOB inspection finding as part of the firm's defense increases jurors' perceived credibility of the firm's defense, which in turn decreases negligence assessments. Overall, our results from Experiment 1 provide strong evidence that the presence of a clean PCAOB inspection finding

<sup>14</sup> *Credible* was the first process question asked after the questions related to negligence; thus, responses to this measure were less likely to be influenced by other process measures. We also asked participants about the PCAOB's objectivity and expertise, each of which highly correlated with *Credible* ( $r > 0.343$ ) for both experiments, suggesting perceived credibility of the audit defense may be due in part to perceptions of the PCAOB's objectivity and expertise.

<sup>15</sup> Instead of an ANOVA model, we use a logistic regression model with the same independent variable and find negligent verdicts are less likely in the treatment condition (26 percent) compared with the control condition (51 percent) ( $\chi^2 = 16.78$ ;  $p$ -value < 0.001).

**TABLE 2**  
**Participants' Negligence Assessments (Experiment 1)**

**Panel A: Descriptive Statistics for *Negligent*—Mean, (Std. Dev.), [n]**

	Absent	Present	Total
<i>Clean Inspection</i>	5.05 (2.84) [136]	3.72 (2.77) [137]	4.38 (2.89) [273]

**Panel B: Between-Participants ANOVA with *Negligent* as Dependent Variable**

Variable	df	MS	F-test	p-value
<i>Clean Inspection</i>	1	121.84	15.50	<0.001
Error	271	7.86		

Reported p-value is two-tailed. This table presents our analysis of variance test for participants' assessment of auditor negligence. We manipulate *Clean Inspection* as whether or not a PCAOB Part I clean inspection finding was used as part of the audit firm's defense strategy. We define a clean PCAOB inspection finding as the absence of reportable deficiencies for one inspected audit engagement in Part I of an inspection report (not an entire clean inspection report). We measured *Negligent* by asking, "How likely is it that Smith & Company was negligent in its conduct of the 2016 ZCI audit?" The scale endpoints were "Certainly not negligent" (0) to "Certainly negligent" (10).

Variable Definition:

*Clean Inspection* = coded as 0 = absent and 1 = present.

reduces jurors' assessments of auditor negligence, and this effect is mediated by the perceived credibility of the defense attorney's defense.

## IV. METHOD AND RESULTS—EXPERIMENT 2

### Overview

With Experiment 2, we include an additional manipulation to examine whether the introduction of a Part II QC criticism by the plaintiff attorney alters or mitigates the benefit of a clean PCAOB inspection result. We made several other changes in Experiment 2 that affected all conditions, including a change to strengthen the primary due care defense and the plaintiff's primary argument. Specifically, the defense argues that Smith & Company's audit procedures were consistent with what other firms would have done, which is an argument that it was not negligent, whereas the plaintiff rebuttal reiterated the plaintiff attorney's primary argument that Smith & Company did not carefully follow auditing standards and was focused on keeping the client happy. The plaintiff rebuttal also included a discussion that the SEC investigation provided evidence the firm was negligent, thereby providing an argument for negligence in all conditions.

### Participants

For Experiment 2, we recruited MTurk participants following the same methods, screening questions, and common review questions as in Experiment 1. We utilized CloudResearch functionality to prevent participants from participating in more than one experiment. We obtained 335 participants, paying each \$3 in compensation. Participants spent an average of 40 minutes on the case. See [Table 1](#) for participant demographics. Inclusion of demographics as covariates in the models does not change our inferences or conclusions.

### Experimental Task and Variables

For Experiment 2, we utilize the same experimental setting, *Clean Inspection* independent variable, primary dependent variable, and process measures as in Experiment 1. The primary difference from Experiment 1 is the addition of a second independent variable, *QC Criticism*. We employ *Clean Inspection* and *QC Criticism* in a 2 × 2 between-participants design with random assignment. We manipulate *QC Criticism* as whether the plaintiff discusses a publicly issued PCAOB Part II QC criticism related to Smith & Company's process for evaluating independence from its clients (e.g., [PCAOB 2019b](#), 41), a concern that has been noted in practice ([PCAOB 2020d](#)). The treatment condition described

how the plaintiff's attorneys explained the PCAOB's process for releasing QC criticisms, described the specific QC criticism for Smith & Company, and indicated that the QC criticism could negatively impact multiple audits. The QC criticism was related to the inspection in the year prior to the audit in question, allowing further ambiguity as to whether the QC deficiency impacted the audit in question. The defense rebuttal indicated that the firm had time to begin modifying its independence evaluation process before the ZCI audit. The control condition does not mention a PCAOB Part II QC criticism.<sup>16</sup>

There are various timing differences occurring in the experiment that we believe are realistic and relate to practice. Specifically, the Part I clean inspection finding in all experiments relates to the audit subject to the SEC investigation and lawsuit (i.e., audit of the fiscal year 2016 financial statements). The Part II QC criticism was related to the inspection of the audit in the year prior (i.e., audit of the fiscal year 2015 financial statements), which the firm could be working to remediate when the audit in question occurred. The Part II QC criticism would not have been publicly released until after the 2016 fiscal year financial statement audit; however, release dates are not relevant information for jurors in this case. The lawsuit and court case occur sometime after the 2016 fiscal year financial statement audit, which allows for the SEC investigation to occur and the PCAOB to release the Part II QC criticism report.<sup>17</sup>

## Results

In Experiment 2, we examine the presence of a clean PCAOB inspection finding as part of the defense and the presence of a PCAOB Part II QC criticism as part of the plaintiff argument to test our hypotheses. Recall, H1 (H2) predicts that jurors will assess lower (higher) negligence if a clean PCAOB inspection (QC criticism) is present than absent. Additionally, H3 predicts an interaction such that the legal benefit of a clean PCAOB inspection finding as part of the defense is reduced in the presence of a PCAOB Part II QC criticism. To test our hypotheses, we use an ANOVA with *Clean Inspection* and *QC Criticism* as independent variables and *Negligent* as the dependent variable. We present descriptive statistics (Panel A) and ANOVA results (Panel B) in Table 3. Supporting H1 and replicating Experiment 1, *Clean Inspection* is significant such that participants assessed lower negligence in the condition where the defense included a clean PCAOB inspection finding (mean = 4.97) than when this was not included (mean = 5.87;  $F_{(1, 331)} = 8.52$ ; p-value = 0.004). Supporting H2, *QC Criticism* is significant such that participants assess greater auditor negligence when the PCAOB has released a QC criticism report (mean = 5.90) than not (mean = 4.96) ( $F_{(1, 331)} = 9.34$ ; p-value = 0.002). With respect to H3, the interaction term is not significant (p-value = 0.665), suggesting that the QC criticism does not alter or mitigate the litigation protection of a clean inspection defense. We find comparable results (untabulated) with *Verdict* as the dependent variable.<sup>18</sup> We further examine this lack of support for H3 with supplemental analyses.

## Supplemental Analysis

For Experiment 2, we conduct a moderated mediation analysis using Model 8 in the Hayes PROCESS macro for SPSS (Hayes 2013) with *Clean Inspection* (coded as 0 = absent and 1 = present) as the independent variable, *QC Criticism* (coded as 0 = absent and 1 = present) as the moderator, *Credible* as the mediator, and *Negligent* as the dependent variable. We estimate the significance of indirect effects using 5,000 bootstrap samples at the 95 percent confidence level.

Figure 1 presents results of our moderated mediation analysis. We find the perceived credibility of the firm's defense (*Credible*) mediates the relationship between *Clean Inspection* and *Negligent*. Specifically, *Clean Inspection* is positively associated with *Credible* ( $b = 1.28$ ;  $t_{331} = 3.18$ ; p-value = 0.002), *Credible* is negatively associated with *Negligent* ( $b = -0.62$ ;  $t_{330} = -12.96$ ; p-value < 0.001), and the indirect effect of *Clean Inspection* to *Negligent* through *Credible* is

<sup>16</sup> We conducted another  $2 \times 2$  between-participants experiment in which we held constant the *Clean Inspection* present condition from Experiments 1 and 2, manipulated *QC Criticism* as in Experiment 2, and manipulated *Auditor Alum* as the presence or absence of a former Smith & Company auditor serving as the ZCI controller. The design of this other experiment is closer to that of Experiment 1 than Experiment 2. This experiment results in the same statistical inferences as Experiment 2 for H2, further supporting this hypothesis, and neither *Auditor Alum* nor the interaction was significant at conventional levels.

<sup>17</sup> We do not suggest that all of these factors must exist simultaneously; rather, our approach allows us to investigate boundaries of the benefit of a clean PCAOB inspection finding across multiple experiments. This is particularly important in Experiment 2 because both the clean PCAOB inspection finding and the QC criticism are generated by the PCAOB, providing jurors different perspectives from the PCAOB about audit performance.

<sup>18</sup> Instead of an ANOVA model, we use a logistic regression model with the same independent variables and find negligent verdicts are less likely in the condition with a clean inspection finding (45 percent) than without it (64 percent) ( $\chi^2 = 8.86$ ; p-value = 0.003). Negligent verdicts are more likely in the condition with a QC criticism (61 percent) than without it (49 percent), but the difference lacks statistical significance ( $\chi^2 = 1.37$ ; p-value = 0.241). The interaction term is not significant (p-value = 0.565).

**TABLE 3**  
**Participants' Negligence Assessments (Experiment 2)**

**Panel A: Descriptive Statistics for *Negligent*—Mean, (Std. Dev.), [n], Cell**

<i>Clean Inspection</i>	<i>QC Criticism</i>		
	Absent	Present	Total
Absent	5.47 (2.66) 85 A	6.27 (2.54) 86 B	5.87 (2.62) 171
Present	4.45 (3.14) 84 C	5.51 (2.75) 80 D	4.97 (2.99) 164
Total	4.96 (2.94) 169	5.90 (2.66) 166	5.43 (2.84) 335

**Panel B: Between-Participants ANOVA with *Negligent* as Dependent Variable**

Source	df	MS	F-test	p-value
<i>Clean Inspection</i>	1	65.78	8.52	0.004
<i>QC Criticism</i>	1	72.15	9.34	0.002
Interaction	1	1.45	0.19	0.665
Error	331	7.73		

Reported p-values are two-tailed. This table presents our analysis of variance test for participants' assessment of auditor negligence. We manipulate *Clean Inspection* (whether or not a PCAOB Part I clean inspection finding was used as part of the audit firm's defense strategy) and *QC Criticism* (whether or not a Part II PCAOB report was used as part of the plaintiff's argument). We define a clean PCAOB inspection finding as the absence of reportable deficiencies for one inspected audit engagement in Part I of an inspection report (not an entire clean inspection report). We measured *Negligent* by asking, "How likely is it that Smith & Company was negligent in its conduct of the 2016 ZCI audit?" The scale endpoints were "Certainly not negligent" (0) to "Certainly negligent" (10).

Variable Definitions:

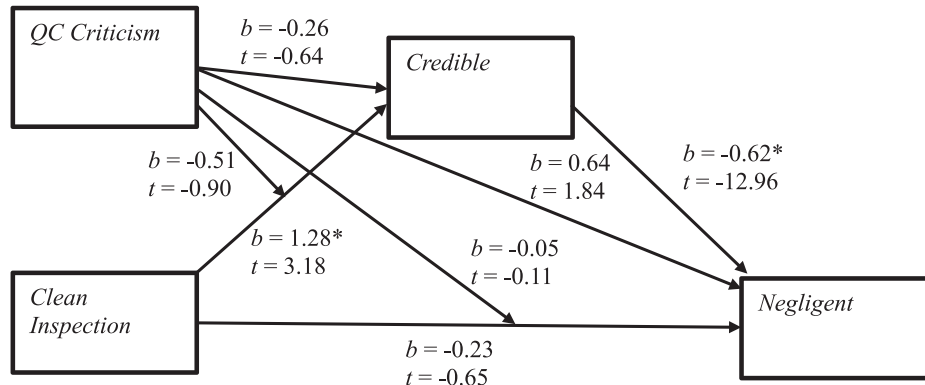
*Clean Inspection* = coded as 0 = absent and 1 = present; and  
*QC Criticism* = coded as 0 = absent and 1 = present.

negative and significant when *QC Criticism* is absent (indirect effect =  $-0.789$ ; bootSE = 0.243; LLCI =  $-1.27$ ; ULCI =  $-0.33$ ), whereas the direct effect of *Clean Inspection* to *Negligent* is not significant in the presence of the mediator ( $b = -0.23$ ;  $t_{330} = -0.65$ ;  $p = 0.517$ ). These mediation results support H1 and replicate Experiment 1.

Regarding *QC Criticism* as a moderator, *QC Criticism* is not significantly associated with *Credible* ( $b = -0.26$ ;  $t_{331} = -0.64$ ;  $p = 0.520$ ), nor is the interaction term significant ( $b = -0.51$ ;  $t_{331} = -0.90$ ;  $p = 0.371$ ). *QC Criticism* has a positive, marginally significant association with *Negligent* ( $b = 0.64$ ;  $t_{330} = 1.84$ ;  $p = 0.067$ ). The indirect effect of *Clean Inspection* to *Negligent* through *Credible* is not significant when *QC Criticism* is present (indirect effect =  $-0.472$ ; bootSE = 0.269; LLCI =  $-1.02$ ; ULCI = 0.03) and the index of moderated mediation is not significant (index = 0.316; bootSE = 0.354; LLCI =  $-0.39$ ; ULCI = 1.00). This result suggests that *QC Criticism* does not moderate the mediation relationship.

We then examine whether *Credible* mediates the impact of *QC Criticism* on *Negligent*, an indirect effect not examined in the previous model. We repeat the moderated mediation analysis described earlier but with *QC Criticism* as the independent variable and *Clean Inspection* as the moderator. Initially, we do not find evidence that *Credible* mediates the relationship between *QC Criticism* and *Negligent*, as the indirect effect of *QC Criticism* to *Negligent* through *Credible* is not significant regardless of whether *Clean Inspection* is absent (indirect effect = 0.159; bootSE = 0.255; LLCI =  $-0.33$ ; ULCI = 0.67) or present (indirect effect = 0.475; bootSE = 0.254; LLCI =  $-0.01$ ; ULCI = 0.98). However, if we lower the threshold for confidence intervals to the 90 percent level, untabulated results support a positive indirect effect of *QC Criticism* to *Negligent* through *Credible* when *Clean Inspection* is present (indirect effect = 0.475;

**FIGURE 1**  
**Moderated Mediation Model Results (Experiment 2)**



**Indirect Effect:** *Clean Inspection -> Credible -> Negligent*

<i>QC Criticism</i>	Indirect Effect	Boot SE	LLCI	ULCI
Absent	-0.789	0.243	-1.27	-0.33
Present	-0.472	0.269	-1.02	0.03

**Indirect Effect:** *QC Criticism -> Credible -> Negligent*

<i>Clean Inspection</i>	Indirect Effect	Boot SE	LLCI	ULCI
Absent	0.159	0.255	-0.33	0.67
Present	0.475	0.254	-0.01	0.98

**Index of Moderated Mediation:**

Index	BootSE	LLCI	ULCI
0.316	0.354	-0.39	1.00

\* Two-tailed p-value is less than 0.01. Other coefficients are not statistically significant at the 0.05 level.

This figure presents our moderated mediation analyses for participants' assessment of auditor negligence. We utilized Model 8 in the Hayes PROCESS macro for SPSS (Hayes 2013) with *Clean Inspection* as the independent variable, *QC Criticism* as the moderator, *Credible* as the mediator, and *Negligent* as the dependent variable. Statistics for the regression model with *Credible* as the dependent variable are  $R^2 = 0.049$ ,  $F_{3,331} = 5.67$ , and  $p < 0.001$ . Statistics for the regression model with *Negligent* as the dependent variable are  $R^2 = 0.372$ ,  $F_{4,330} = 48.88$ , and  $p < 0.001$ . We estimated significance of indirect effects using 5,000 bootstrap samples at the 95 percent confidence level. To calculate indirect effects for both independent variables, we ran the model as described and then a second time switching positions for *Clean Inspection* and *QC Criticism*. The index of moderated mediation was the same for both models. We manipulate *Clean Inspection* (whether or not a PCAOB Part I clean inspection finding was used as part of the audit firm's defense strategy) and *QC Criticism* (whether or not a Part II PCAOB report was used as part of the plaintiff's argument). We define a clean PCAOB inspection finding as the absence of reportable deficiencies for one inspected audit engagement in Part I of an inspection report (not an entire clean inspection report). We measured *Negligent* by asking, "How likely is it that Smith & Company was negligent in its conduct of the 2016 ZCI audit?" The scale endpoints were "Certainly not negligent" (0) to "Certainly negligent" (10). We measured *Credible* by asking, "How credible was the defense provided by Smith & Company's defense attorneys?" The scale endpoints were "Not at all Credible" (0) to "Very Credible" (10).

Variable Definitions:

*Clean Inspection* = coded as 0 = absent and 1 = present; and

*QC Criticism* = coded as 0 = absent and 1 = present.

bootSE = 0.253; LLCI = 0.58; ULCI = 0.90).<sup>19</sup> This mediation result provides evidence supporting H2. Specifically, the plaintiff's use of a QC criticism reduces credibility of the firm defense when the firm utilizes a clean inspection report as part of the defense strategy. If the firm does not utilize the clean inspection report, then the QC criticism does not affect the credibility of the defense.

<sup>19</sup> This mediation result is further supported by a marginally significant simple effects t-statistics (untabulated) examining *Credible* when *QC Criticism* is present (mean = 6.61) or absent (mean = 7.38) in the presence of *Clean Inspection* (contrast = 0.77;  $t_{331} = 1.885$ ;  $p = 0.060$ ).

Taken together with the main effect results from the ANOVA, these supplemental analyses provide several implications. The presence of a clean PCAOB inspection as part of the defense reduces negligence assessments, an effect mediated by credibility of the firm's defense. Specifically, the clean PCAOB inspection finding increases perceived credibility of the defense, which in turn decreases negligence assessments. Meanwhile, the PCAOB Part II QC criticism increases negligence assessments but does not moderate the effect of the clean PCAOB inspection finding. Thus, jurors appear to incorporate the PCAOB's QC criticism in their assessments of firm negligence as a unique factor that does not alter the benefit of the clean PCAOB inspection finding.

We posit that these results could be due to the difference in level to which each PCAOB report speaks, namely, the firm level (QC criticism) compared with the engagement level (clean PCAOB inspection), and/or because the plaintiff introduces the PCAOB findings rather than the defense (note that *Credible* is focused on the credibility of the defense). Specifically, the defense appears to benefit from the PCAOB's credibility when incorporating the engagement-level clean PCAOB inspection directly into the defense, which is associated with an increase in perceived credibility of the defense. Meanwhile, the plaintiff may also benefit from the PCAOB's credibility when incorporating the firm-level QC criticism, as it is associated with an increase in negligence assessments regardless of the defense's use of a clean inspection report. Additionally, in the instance that the firm's defense utilizes a clean inspection report, the plaintiff's utilization of a QC criticism is associated with a decrease in credibility of the firm's defense. Thus, two somewhat competing reports generated by a common credible source (i.e., the PCAOB) do not transfer perceptions of credibility to a third party in an equal manner but are both associated with changes in negligence assessments against the firm.

## V. CONCLUSION

This paper reports the results of multiple experiments that examine whether a clean Part I PCAOB inspection finding for the audit at the center of a litigation case provides legal protection for the audit firm. We provide evidence that a clean PCAOB inspection finding for the audit in question reduces negligence assessments, and this liability protection is mediated by the perceived credibility of the firm's defense. We also examine whether a firm-wide quality control (QC) criticism in Part II of a PCAOB inspection report affects juror judgments and reduces the liability protection of a clean Part I PCAOB inspection finding. Results indicate that a QC criticism increases negligence assessments; however, we do not find a significant interaction between a clean PCAOB inspection finding and QC criticism on negligence. Overall, Experiment 2 results suggest the two components of PCAOB inspection reports have opposing, and independent, effects on negligence assessments that jurors incorporate into their negligence judgments as unique, separate pieces of evidence. We encourage future research to further examine potential interactive effects of the two primary components of PCAOB inspection reports, as there might be other conditions or settings where these components jointly affect judgments.

Our study offers several important policy and practice implications. First, there have been calls for consideration of the transparency of PCAOB information (e.g., [PCAOB 2019c](#), [2020c](#), [2012c](#); [U.S. Senate 2020](#); [National Association of State Boards of Accountancy \(NASBA\) 2017](#)). Our results indicate that jurors find information in both Part I and Part II of PCAOB inspection reports relevant to evaluating auditor negligence. Second, our results should be encouraging to practitioners. Our documented litigation protection from a Part I inspection could help auditors better appreciate the value of the inspection process, which has caused concern and resentment toward the PCAOB amongst auditors ([Johnson et al. 2019](#); [Westermann et al. 2019](#)). A related, practical implication is that auditors could consider including a clean Part I finding as part of a litigation defense, as our Experiment 2 results indicate the inclusion of this information reduced negligence assessments regardless of whether a QC criticism was present or absent (this, of course, would have to be balanced against potentially setting precedence for releasing this information). In addition, our finding that jurors assess firms as more negligent when a Part II QC criticism is released provides additional incentive for firms to respond effectively to QC criticisms, particularly since our study shows that plaintiffs have incentives to include publicly released Part II reports as part of their arguments.

Another area for future research concerns the admissibility of PCAOB inspection findings per SOX §105(5)(A) ([U.S. House of Representatives 2002](#)). Although we investigate effects of an audit firm introducing inspection findings that reflect well on audit quality (i.e., no identified deficiencies), judges have provided inconsistent rulings on the admissibility of inspection findings that reflect poorly on audit quality. For example, one judge ruled that KPMG is not required to produce direct responses to the PCAOB and internal communications discussing PCAOB inquiries ([Bennett v. Sprint Nextel Corp. 2012](#)), whereas other judges ruled that inspection-related materials, except documents prepared specifically for the PCAOB, are admissible ([Silverman v. Motorola, Inc. 2010](#); [Colonial Bancgroup, Inc. v.](#)

*PricewaterhouseCoopers LLP* 2015).<sup>20</sup> Furthermore, it is unclear whether PCAOB transparency initiatives (PCAOB 2019a, 2019e), including increasing access to QC criticisms (PCAOB 2012a) and disclosing client names in inspection reports (PCAOB 2020c), would impact admissibility. Finally, since jurors tend to consider stricken evidence (Stebly, Hosch, Culhane, and McWethy 2006), research could examine how jurors would react to PCAOB findings if a judge instructs them to ignore such information.

Our study is subject to limitations. First, our QC criticism manipulation involved problems associated with the firm's evaluation of its independence from audit clients. It is possible that other QC criticisms could yield different results. Future research can investigate whether other types of QC criticisms and/or the resolution of QC criticisms affects negligence assessments. Second and relatedly, the QC criticism provides an expanded plaintiff argument relative to the control group argument that the auditors did not demonstrate due care and consequently were negligent. Future research can investigate whether other plaintiff arguments beyond the scope of this study (e.g., a history of audit failures) would have differential effects relative to the plaintiff's use of a QC criticism. Finally, our experiments involved a determination by the SEC that the audit client's financial statements were materially misstated due to inappropriate accounting for leases. We do not mention fraud, as the case indicated that the auditor used professional judgment to reach the same conclusion as the client regarding the subjective accounting treatment. Future research can investigate whether PCAOB inspection findings provide legal protection in a definitive fraud case.

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<sup>20</sup> In an anecdotal discussion, a former Big 4 partner who worked in the firm's general counsel office stated that the SOX privilege *belongs to the audit firm*, meaning it can introduce a clean PCAOB inspection finding as evidence. The former partner noted that this could open admission of inspection findings of deficiencies in other cases, although the judge in *Colonial Bancgroup, Inc. v. PricewaterhouseCoopers LLP* (2015) determined that “documents pertaining to...other clients need not be produced.”

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