State of the Art Research Related to Auditor Professional Skepticism

2013 - 2015

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Task

➡ Summarize academic research in the area of auditor professional skepticism (hereafter, PS) from 2013 to 2015

➡ 59 total studies identified!

➡ Included:
- ➡ Commissioned studies / Syntheses
- ➡ Published papers
- ➡ Unpublished papers (working papers)

* Papers will be color-coded throughout the presentation

Categories of Research

- Commissioned Research / Syntheses
- Incentives
- Time
- Mindset / Prompts (Independence of Mind / Objectivity)
- Environmental & Contextual Factors
- Competence (Fraud Detection & Other)
- Traits (Integrity, Fortitude, & Experience)

Commissioned Research / Syntheses

- Nelson (2009)

- Auditing Practices Board (2010)

- Hurtt et al. (2013)

- Glover and Prawitt (2014)

Professional Skepticism: Interactions and Contextual Factors (Source: IAASB draft ITC)
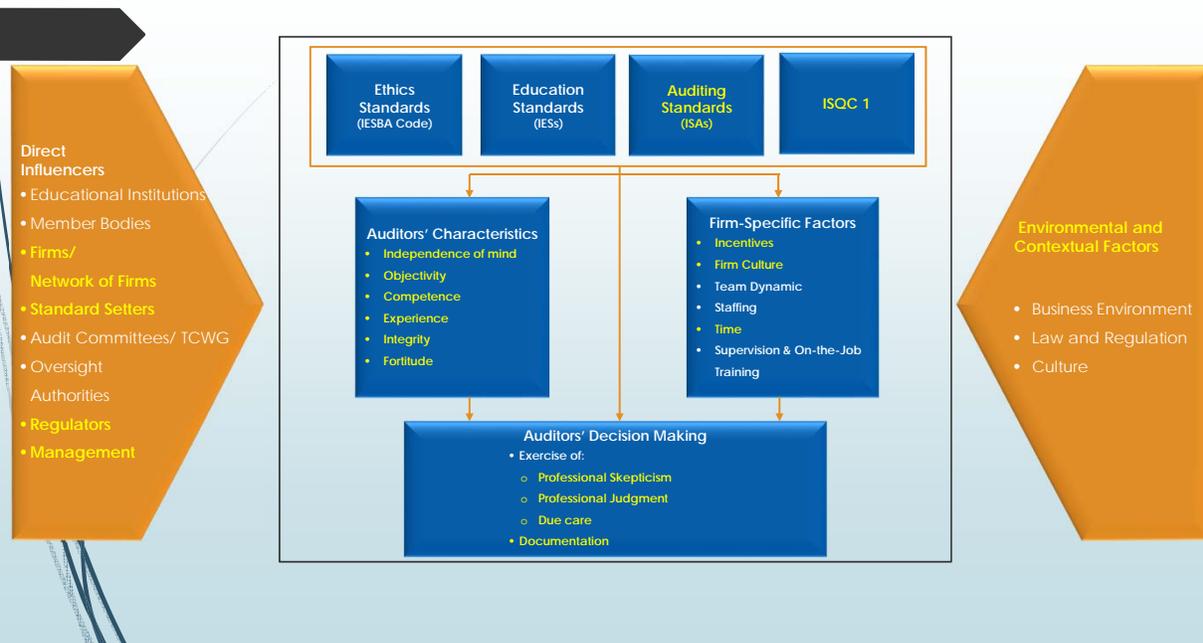
Big Picture Observations

- Most studies being conducted are experimental / US auditors or data from US companies (78%)
  - More international research / qualitative methods

- Many unpublished papers – this is an important, timely issue researchers are attempting to tackle

- Most of the papers on fraud detection are published

Big Picture Observations

- Lots of research starting to examine PS as a trait or auditor characteristic (several working papers)
  - Role of screening and monitoring

- Research often aims to enhance audit practice, not necessarily enhance audit regulation.

Big Picture Observations

- Majority of studies **define** PS as: a questioning mind … critical assessment of audit evidence.

- But the **measurement** of PS varies tremendously based on the study's context:
  - Assessing an account as more risky
  - Collecting more evidence / spending more time / searching for inconsistent evidence(changing NTE of testing, less SALY)
  - Challenging an aggressive accounting treatment
  - Estimates of accounts that differ from client estimates

Big Picture Observations

- Most studies look at what causes **variation** in PS judgments or PS actions (less research on actions)
  - Examples:

        Inherent Risk and Management Personalities
        ⬇
        Likelihood of Inventory Valuation Problem (Low to High)

        OR
        Auditor Knowledge
        ⬇
        Does the auditor gather additional, external evidence to test management estimates (Yes or No)

Incentives

- Evaluators rate staff based on the outcome of skeptical behavior vs. whether the skeptical behavior was appropriate (Brazel et al. 2015)
  - Keeping the superior "in the loop" or gaining their approval before engaging in skeptical behavior did NOT mitigate the problem
- Sources of pressure that increase/decrease PS (Westermann et al. 2015)
  - Increase: sources that hold auditors accountable for quality (inspections / workpaper reviews)
  - Decrease: sources that promote defensibility or profitability (time budget pressure / excessive documentation)

Incentives

- Takeaways:
  - The evaluation of PS may depend more on outcome than process.
  - Can this erode PS behavior over time?
  - Inform inspections of firm evaluation systems / quality control.
  - Inspection pressure "good" for PS, unless excessive documentation is over-riding concern.

- Future Research:
  - What are the roles of mentors / supervisors related to PS?
  - Who are the supervisors that reward PS based on process? How do their experiences differ?
  - Do incentives for PS change as you progress in career?

Time

- Time pressure & workload impact (Brazel et al. 2015)
  - SEC 10-K filing accelerations in the 2000s
  - Audit partners surveyed said the accelerations → more time pressure & less PS

    We had to cram 45 days of skepticism into 30 days and I found that we were not **asking good follow up questions** because we had 50% more questions outstanding at any point in time.

    I was very concerned about the risk that long hours might adversely impact the **degree of professional skepticism** maintained by the staff. Our auditors were very busy and they recognized that **pushing the client for more answers** in areas being audited today would only delay the client's delivery of schedules needed for audit areas scheduled to be started tomorrow.

    Our teams had less time to **sit-back and think** about alternative scenarios for complex client transactions.

Time

- 800 auditors surveyed…workload is high enough that audit quality suffers (Persellin et al. 2015)
  - Workload: deadlines & staffing shortages (still a problem in 2014)
    - 5 – 20 (busy season) hours above threshold: 40% indicate impaired judgment, reduced PS

Towards the end of the audit, there became more of a 'how can I document that this works' instead of a **'does this work' approach**. When professional skepticism **is lowered**, I believe audit quality is greatly impacted .

When there is a time constraint approaching and a pile of work to complete, you work longer hours, you try to become more efficient, but you also feel some pressure to trust your own gut on certain issues. For example if a journal entry doesn't appear in line with expectations and it's late at night, you may try to just explain it yourself, rather than **spending the time to discuss with the client to get a full understanding**.

Time

- Takeaways:
  - Substantial time pressure, particularly at year-end, can impair PS.
  - Will a future reporting acceleration or other regulation curtail year-end audit time?
  - Solutions to year-end time pressure: More interim testing, rescheduling other work, and working more hours.

- Future Research:
  - Budget for PS?
  - Use of IT audit, CAATs, use of IA, and outsourcing not seen as effective strategies, why not? What others?

Mindset / Prompts

- Salience of auditors' professional identity → PS (Bauer 2015)
  - Think about professional norms & values
- Intrinsic motivation for their job → PS (Kadous & Zhou 2015)
- Verification to deliberative mindset → PS (Griffith et al. 2014)
  - Considering pros & cons of achieving a goal
- Process vs. outcome accountability…justification of process → PS (Kim & Trotman 2015)
- Intuitive vs. analytical thinking…thinking intuitively → PS (Wolfe et al. 2015)
- Reading metaphors → PS (Parlee et al. 2015)

Mindset / Prompts

- Takeaways:
  - Can these prompts be tested in audit training sessions with real client evidence and audit documentation?
  - Can effective prompts be practically incorporated into audit software (or be an optional procedure considered during planning)? Field Experiment?

- Future Research:
  - Off-shoring less complex audit areas, more complex areas pushed downward: Understanding Mindset vs. Questioning Mindset?
  - While "more" international research, no current "culture" studies.

Environmental & Contextual Factors

- ► The Client
  - ► Intimidation → avoidance, less evidence collection (Bennett & Hatfield 2013)
  - ► Client personality/behavior…overly nice/available client → greater PS in low risk setting (but not in high risk) (Olsen & Stuart 2015)
  - ► Management can strategically divert auditor's attention to clean accounts → decreases auditor's ability to detect earnings management (Luippold et al. 2015)
- ► The Firm Environment
  - ► IT usage → staff don't learn how to "read people," think critically, & probe for answers (Westermann et al. 2015)

Environmental & Contextual Factors

- ► Standards / Firm Guidance
  - ► When auditing complex estimates, experienced auditors focus on corroborating management's assumptions (Griffith et al. 2015)

  - ► Word choice of guidance → PS (fair value estimates) (Cohen et al. 2015)
    - ► Guidance → "support," "oppose," or both…both = more PS

Environmental & Contextual Factors

- Takeaways:
  - The characteristics and actions of management may impact PS, but in high risk settings auditors appear to generally exercise more PS.
  - The framing/word choice of tasks alters the mindset or approach auditors take, leading to more/less PS.

- Future Research:
  - Are different management tactics more/less successful depending on audit experience?
  - What additional risks/benefits to PS does today's IT environment introduce?

Competency - Fraud Detection

- Partner tone at the top → PS in audit managers (Carpenter & Reimers 2013)
  - More effectively & efficiently ID fraud risks & choose appropriate tests
- Adding "capability" to the fraud triangle → increases PS (higher fraud risk assessments) (Boyle et al. 2015)
- Auditors are not sensitive to NFM fraud red flags (Brazel et al. 2014)
  - Prompts only work if risk is high
- Auditors struggle to detect personality-driven fraudulent tendencies…training auditors to consider management lifestyle as a risk factor might help (Cohen et al. 2015)
  - Examination of corporate fraud cases

Competency - Other

- Singapore study – important skills, knowledge, & attitudes for entry level auditors (Siriwardane et al. 2014)
  - Most important → professional integrity, assessing audit evidence, PS
  - Struggle with the most → business competency
- Divergent & convergent thinking → suspension of judgment (higher PS), higher quality explanations, & more likely to choose the right explanation (Plumlee et al. 2015)
  - Training auditors to generate explanations & then to search for a solution separately

Competency

- Takeaways:
  - The focus of most competency-related studies is on the extent auditors can detect and respond to fraud red flags/risks.
  - Auditors do not generally respond appropriately to personality-driven fraud tendencies in management.
  - Tone at the top matters, suggesting the importance of firm culture on PS.
- Future Research:
  - Is the current accounting curriculum giving auditors a proper understanding of non-financial data, soft skills such as interview, communication, etc.?
  - How can partners/managers establish a tone that promotes PS?

Traits – Integrity, Fortitude & Experience

- Higher trait PS → greater PS (Hurtt et al. 2015)
  - When detecting inconsistencies in audit documentation
- Interaction between state & trait PS (Robinson et al. 2015)
  - When inherent risk increases (state PS), low trait PS auditors increase skepticism more than high trait PS auditors
- In negotiations with clients (simulated), higher PS → more conservative & stand more resolute (Brown-Liburd et al. 2013)

Traits – Integrity, Fortitude & Experience

- Presumptive doubt vs. neutrality → measurement of presumptive doubt is more predictive of PS than neutrality (Quadackers et al. 2014)
- PS → retention (Cohen et al. 2015)
  - Presumptive doubt → negatively associated with job fit and organizational trust, higher turnover intentions
  - Neutral → positively associated with job fit & professional identification, lower turnover intentions
- Trait PS & Experience (Sargent 2015)
  - More experience = higher PS
  - PS changes over the course of a career
- Hurtt scale vs. personality scale (Olsen et al. 2015)
  - Hurtt scale predicts skeptical judgment but not skeptical action

Traits – Integrity, Fortitude & Experience

- Takeaways:
  - Auditor characteristics predict auditors' PS judgments.
  - Auditors with greater PS stand more resolute when issues arise with management.
  - Auditor characteristics impact PS differently throughout the auditor's career.

- Future Research:
  - Auditors that rate high on presumptive doubt measures are more skeptical, but also have the highest turnover intentions. Does this mean the audit profession is failing to retain the "best" auditors?
  - Can these traits be used in the screening/hiring of candidates?

Linking Barriers to Solutions – An Example

Barrier identified → Audit Evaluators reward appropriate PS based on outcomes (identified a misstatement or not)

Auditors testing in the field (seniors/interns) are aware of this bias

If the evaluator's HS bias is "BIGGER" – auditors in the field are less likely to identify and convey **FRAUD** red flags or evidence inconsistencies.

Solution 1: AC SUPPORT may not "help"

Solution 2: CONSULTATION "helps" but does not eliminate the bias

Next Step: Superiors that *do not* exhibit HS bias likely foster staff that identify and convey fraud red flags.

→ Pinpoint how their experiences differ: Increase overall audit (detection of fraud) and financial reporting quality.

More Direction for Future Research

- Can we train auditors to be more skeptical?
  - If so, how?! What types of additional skills do they need?
- There seems to be a disconnect between judgments & actions...how can we close this gap?
- What role can the AC serve to enhance PS?
- Only studies that find results are typically published, can we find out what did not work?
- What can we learn from related research streams outside of accounting that may be applicable?

What are your thoughts?

- What questions do you like or NOT like?
  - How would you tweak them?

- What is the research "wish list" for standard setters?

- What questions should be included in future white papers / syntheses?