Research Related to Auditor Professional Skepticism

A Presentation for the November 30 SAG Meeting

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The views expressed by each of the presenters are their own personal views and do not reflect those of the PCAOB, members of the Board, or the PCAOB staff.
## What do we know:

### Commissioned Research / Syntheses

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<th>Author(s)</th>
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<td>Nelson (2009)</td>
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<td>Auditing Practices Board (2010)</td>
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<td>Hurtt et al. (2013)</td>
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<td>Glover and Prawitt (2014)</td>
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<td>Brazel and Schaefer (2015)</td>
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Big Picture Observations

- Majority of research is based upon Nelson (2009)

- PLUS...

- Many unpublished papers – this is an important, timely issue researchers are attempting to tackle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

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

- PS manifests itself in audit judgments & decisions
  - Measurement of PS varies 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

- Lots of research starting to examine PS as a trait or auditor characteristic
  - Nature and nurture
  - Role of screening and monitoring

- Minimal research on basic incentives for PS

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

- 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

Traits

- Auditor characteristics predict auditors’ PS judgments
- Auditors with greater PS stand more resolute when issues arise with management
Environmental & Contextual Factors

- 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.
Time

- Time pressure & workload impact (Lambert et al. 2017)

  - Audit partners surveyed regarding SEC 10-K filing accelerations in the 2000s → created 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.”

  “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. 2017)
  - During busy season: 5 – 20 hours above threshold: 40% indicate impaired judgment, reduced PS

  “...There became more of a ‘how can I document that this works’ instead of a **does this work** approach.”

  “When there is a time constraint...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**.”
“As far as the auditors were concerned...for things that are hard for them to get their arms around, trying to get them to the “materi ally comfort able” place through confusion...and...just keeping them busy on non-audit related activities, it kind of pulls them away from the basic audit itself.”

“The analysts were much more difficult than the auditors because the analysts were looking more at market/industry comparisons, whereas the auditors were focused on transactions. We could explain away the transactions, but the analyst questions about why we differed from peers were more difficult...[auditors may be more effective] if they focused more on some of those global types of questions...”
Incentives

- 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)
- Inspection pressure “good” for PS, unless excessive documentation is over-riding concern
- Evaluators rate staff based on the outcome of skeptical behavior vs. whether the skeptical behavior was appropriate (Brazel et al. 2016)
Linking Barriers to Solutions

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

Auditors testing in the field are aware of this bias

Auditors in the field are less likely to identify and convey **FRAUD** red flags / evidence inconsistencies

Solution 1: **AC SUPPORT** may not “help”

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

Solution 3: **EVI DENCING skepticism in the budget file** may not “help”

Solution 4: **REWARD skepticism** - this can backfire or help...it depends...
Linking Barriers to Solutions

**Conclusion:** Hindsight bias is robust and extremely difficult to overcome!

- **Good News (latest research)!
  - Supervisors experiencing a culture emphasizing consultation & tone at the top that appropriate PS is valued = LESS BIAS!
  - LESS BIAS, consistently REWARD PS → More PS amongst staff!

- **How can we increase skepticism... create a culture where appropriate skepticism is consistently rewarded, regardless of outcome.**