

**Practice Note “What do we already know about...”:
The Effects of Expert Status on the Audit of Complex Estimates**

Presented to:

The Foundation for Auditing Research

Presented by:

Anna Gold, *Vrije Universiteit Amsterdam*

Kathryn Kadous, *Emory University*

Justin Leiby, *University of Illinois at Urbana-Champaign*

In Consideration of Grant 2017B05

December 31, 2018

Executive Summary. Professional standards dictate that auditors evaluate specialists based on “hard” cues such as the specialist’s direct experience with the audit issue, as well as “softer” cues of the specialist’s social standing (“status”). We examine specialist characteristics that increase status and whether high status leads auditors to ignore more substantive information about the specialist, such as the specialist’s justifications for a conclusion. In a survey, we find that auditors perceive higher specialist status based on a variety of characteristics that are irrelevant to the audit issue, including the specialist’s social activities and self-confidence. In auditing, confusing status for skill may lead the auditor to unduly rely on insufficient evidence, increasing audit risk and potentially reducing financial reporting quality. We propose to conduct a follow up study to determine whether these characteristics inflate auditors’ assessments of the specialist’s capability and work quality, which would lead to overreliance on the specialist and higher audit risk. We provide recommendations relevant to practitioners, standard setters, and regulators, including (1) minimizing auditors’ evaluation of the specialist’s background and instead evaluating the work product, and (2) centralizing specialist assignment within audit firms to prevent auditors from overrelying on specialist status.

The Issue – Overreliance on Specialists

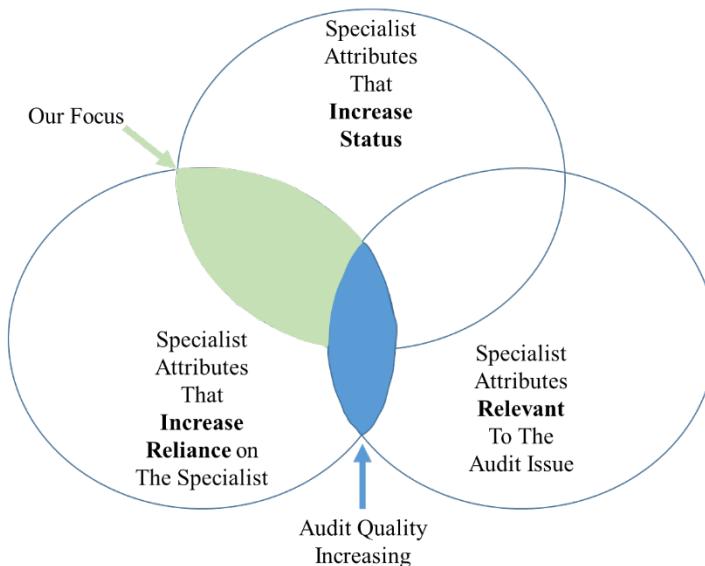
Auditing complex issues often requires the use of specialists. In order for the use of a specialist to improve audit quality, auditors must appropriately assess a specialist’s ability and the adequacy of a specialist’s work. Overestimating a specialist’s skills or work quality can lead to overreliance and conclusions based on insufficient evidence, thereby increasing audit risk and reducing financial reporting quality. While auditors commonly assess specialists based on information such as the specialist’s experience with an audit issue, standards also direct auditors to focus on “softer” factors such as “the reputation and standing of the specialist in the views of peers” in the U.S. and “forms of external recognition” in ISAs. Indeed, the IAASB has recently expressed concern about auditor over-reliance “on the qualifications of the expert with no further consideration as to their appropriateness.”¹

Our research project examines whether a specialist’s *high status* leads to higher auditor evaluations of specialist work quality and greater reliance (potentially over-reliance) on this work as persuasive evidence. By status, we refer to prestige indicated by the respect of peers, membership in exclusive social circles, or impressive credentials. We argue that audit risk can increase when auditors act as though specialist’s status equals quality of work. See Figure 1. In particular, we focus on three overarching questions:

1. What characteristics lead to high specialist status?
2. Do auditors overestimate the skills and work quality of high-status specialists?
3. Does high specialist status interfere with auditors’ evaluation of more substantive cues, such as:
 - a. the strength of specialists’ justifications?
 - b. specialists’ agreement/disagreement with the client?

¹ See AS1210 by the PCAOB and ISA 620 by the IAASB.

Figure 1. Our Focus on Status & Relevance to Audit Issues



Relevance to Audit Practice

Scientific evidence has repeatedly shown that the human mind confuses status with substance. Status does often overlap with skills—indeed, people often have high status because they *earned* it. However, respecting, admiring, or being in awe of someone does not necessarily mean that the person is highly knowledgeable or has provided you with high quality advice. In auditing, confusing status for skill becomes especially troubling when auditors weight status as heavily as more substantive inputs, such as work quality. We believe our research is particularly relevant to regulation and standard setting, as well as to audit planning and field work related to the assignment and evaluation of specialists.

Our Preliminary Findings – What Leads to High Status?

In preparation for our main study (which is currently ongoing, see below), we surveyed 53 experienced auditors (avg. experience = 15 years) to see how they believe 15 characteristics affect a specialist's knowledge, influence, and respect from others. Some of the characteristics, such as experience and early promotion, are relevant to audit knowledge. Others are clearly irrelevant. These include playing tennis with senior leaders and being highly self-confident. Interestingly, the results show that auditors associate several of these irrelevant characteristics with higher status, and they expect individuals with these characteristics to have more influence in group settings. See Figure 2.

Additionally, we asked these auditors to evaluate the value of various certifications in the context of making fair value judgments. We chose one certification that is highly relevant to the task (Register Valuator), one that is moderately relevant (Actuary), and one that is minimally relevant (CEFA). The results show that auditors assigned high status and high knowledge to the possession of a certification, regardless of *what* the certification is. This is consistent with the IAASB's concerns above. Our results lead to a practical recommendation that auditors should carefully evaluate the relevance of a specialist's credential *to the specific audit issue*.

Figure 2. Status Increasing Attributes

Increase Status & Reliance Likely Irrelevant to the Issue	Increase Status & Reliance Likely Relevant to the Issue
Attends Social Events w/ High Profile People	Has A Lot of Experience
Fraternizes with Firm Leaders Outside Work	Earns Early Promotion Throughout Career
Some Certifications*	Some Certifications*
Member in Exclusive Social Organizations	
High Self-Confidence	
Has Many Friends at Work	
Speaks First in Group Settings	

*We find that *any* certification seems to increase reliance and perceptions of status. We tested in a fair value context, and auditors responded positively to a highly relevant certification (Register Valuator) as well as to a less relevant certification (CEFA).

Our Next Steps & Predictions – How Does Status Affect Auditor Reliance on Specialists?

These survey results help inform the next phase of our study, which is in execution as of winter 2018: an experiment to test whether status attributes affect how auditors process the specialist's (1) justification quality and (2) support for the client's preferences in assessing the specialist's capability and work quality. We embed these subtle differences into an auditing case and randomly assign auditors to the different versions. Through this active manipulation of information and random assignment, we can pinpoint the underlying causes of auditor judgments. Our experiment asks auditors to complete a fair value auditing case related to investment properties in which auditors receive input from a specialist. All auditors are told that the specialist has a reasonably good work history. However, our experiment varies the status of the specialist and the specialist's input, such that each auditor sees one of six possible combinations:

- A. High status, agrees with the client, provides strong justification
- B. High status, agrees with the client, provides weak justification
- C. High status, disagrees with the client, provides strong justification
- D. Moderate status, agrees with the client, provides strong justification
- E. Moderate status, agrees with the client, provides weak justification
- F. Moderate status, disagrees with the client, provides strong justification

In brief, we predict that auditors will evaluate the quality of a specialist's skill and work quality as higher when the specialist has high, as opposed to moderate status. Moreover, we expect the "status for substance" substitution to be most noticeable when the specialist provides weak justification or disagrees with the client. See Figure 3. In other words, auditors will tolerate weak arguments from a high-status specialist, which has negative implications for audit quality. On the flipside, auditors will tolerate disagreement from a high-status specialist, which potentially has positive implications for audit quality.

Conclusions and Recommendations

Our work speaks to the question whether auditors confuse status for work quality. Standard setters, audit firm leaders, engagement leaders, and field auditors should all be aware of (1) the characteristics that lead to high status perceptions, and (2) the effects these characteristics may have on information processing. Our findings suggest that audit practice should attempt to form a culture in which status is based on more substantive attributes. Moreover, our findings suggest that status may have its most alarming effect in causing auditors to tolerate and rely upon weaker arguments from high status specialists. This may even argue for separating knowledge about the specialist's status characteristics from evaluation of the specialist's skill and work quality.

Regulation and Standard Setting

For standards, our work may suggest the need for additional guidance about the type of information auditors should consider about specialists. Routine procedures to learn about the specialist's competence and capabilities may expose auditors to status information that inappropriately inflates their assessments of specialist competence. Additional corrective guidance could include requirements to explicitly and directly link the relevance of specialist credentials, skills, and other impressive characteristics to the audit issue in question. Because we propose that status influences not only evaluations of the specialist's capabilities but also the quality of the specialist's work, it may help to provide guidance that audit firms explicitly separate evaluation of the specialist's skills from evaluation of the specialist's work. In some cases, our study suggests it may be better for auditors to *minimize* effort towards evaluating the specialist's background and instead focus effort on judging work quality.

Audit Firm Quality Control

Relatedly, audit firms could consider these findings in designing quality control around assigning specialists and allocating authority to engagement personnel in evaluating specialists. For audit firm leaders, it may be beneficial in certain conditions to encourage some centralization of specialist assignment to engagements. For example, firms could consider first assigning firm-level personnel to assess specialists' capability for a task, and then assigning engagement personnel to assess work quality without having access to cues about status. In the past, audit firms have suggested such centralized arrangements (e.g., PwC 2015, p. 3).

Anna Gold, *Vrije Universiteit Amsterdam*
Kathryn Kadous, *Emory University*
Justin Leiby, *University of Illinois at Urbana-Champaign*

The authors would like to thank all participants and the Foundation for Auditing Research (FAR). The views expressed in this document are those of the authors and not necessarily those of the FAR.

PwC. 2015. *Comment Letter – PCAOB Staff Consultation Paper No. 2015-01: The Auditor's Use of the Work of Specialists.*