

Auditors: their mindset and their decisions

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*“Die Schlange, welche sich nicht häuten kann, geht zugrunde. Ebenso die Geister, welche man verhindert, ihre Meinungen zu wechseln; sie hören auf, Geist zu sein”.*¹
Friedrich Wilhelm Nietzsche, 1881.

SUMMARY In the behavioral economics literature it is demonstrated that people that base their decisions on analysis rather than on their intuition are more likely to act: patiently, without losing perspective of the actual topic, without their decisions getting biased by the confidence they have in their own intellectual faculties, independently, and consistent with what new evidence suggests. I argue that it would be of great importance to study these dimensions for auditors as each of these characteristics are related to what society expects of an auditor. I suggest that auditors are studied in their day-to-day operations so that we can increase our understanding of the interplay between the mindset of the auditor and the working conditions auditors face. Data that allow for the design of these studies is now made available through the Foundation for Auditing Research.

PRACTICAL RELEVANCE Audit firms put elaborate Human Resource Systems in place to select, motivate and promote their auditors. In this paper I pay attention to whether auditors make different decisions conditional on them being inclined to analyze situations in preparation of a decision or that they are inclined to let their intuition decide. From previous research it has become clear that the analytical thinker is more accurate when making decisions. This accurateness is relevant when considering mistakes that auditors appear to make in their work. I propose that future research should help practitioners to select, motivate and promote auditors.

1 Introduction

In response to adverse audits public and internal auditors are overwhelmed with remedial actions, such as classes in ethics. In addition auditors must take the oath in which the auditor pledges to act virtuously. All those classes the auditors takes purportedly stimulate them to intuitively always choose to do the right thing. By focusing on ethics and the oath society expects that the auditor does a better job. After all, he is taught to choose ‘what is good to society’. However knowing that does not necessarily lead to the desired actions as

ids that ethicists are more likely to steal books from the library than other library users. Now the question is: Would the auditor trained in ethics have avoided Tesco overstating its income? Or: Would an auditor who took the oath prevent the LIBOR scandal to occur? Would the auditor have taken measures against allegedly inadequate controls in place at financial firms like HSBC Holdings PLC and U.S. Bancorp? The idea of ethics is that people are familiar with dealing with dilemmas and that they will act firmly if a dilemma occurs. But, does the mistakes-making accountant know what the situation is that he encounters? Over the last ten years behavioral economists have identified cognitive abilities as causal determinants of decision making. In general the studies show that people with higher cognitive abilities are more likely to base their choices on analysis rather than experience or emotion (e.g., Frederick, 2005). They also make fewer mistakes than the decision-maker inclined to let experience or emotion speak. Throughout the paper I will refer to the analytic thinker as the individual who is in the habit of breaking down a problem in parts to subsequently examine its constituent parts in order to study the parts and their relations. On the other hand I refer to the intuitive thinker as the individual whose thoughts and preferences come to mind quickly and without much reflection.

Based on behavioral economics research I introduce in the next section how decisions depend on the mindset of the decision maker. In the subsequent section I argue how these findings might impact the decisions made by the auditor. I then continue to argue in the consecutive section that archival data would present a promising avenue to conduct such studies. The final section puts the arguments developed in this paper in the perspective of the current measures of requiring auditors to take classes in ethics and to take the oath.

2 Firm decisions

What does it take for the auditor to act firmly? Companies file their draft financial statements with the auditor who subsequently audits these statements. The financial statements may contain errors deliberately (leadership wants to report higher profits than the underlying economics) or unconsciously made by the

leadership. In order to be able to take issue with both types of error the auditor should see them and he must decide whether he may or may not appeal to the audited company on mistakes. One condition is that the auditor becomes aware of the errors financial statements contain. Studies in cognitive abilities may help auditing research to better understand why mistakes occur and what can be done to prevent them from happening. A large series of studies, including the research by Oechssler, Roider, and Schmitz (2009), shows that the decisions of the “analyzing thinker” trumps in many areas the intuitive thinker, i.e., the decision maker who trusts his intuition to make decisions. This is what these studies find:

1. *Patience.* The analytical thinker understands that (s) he is better off to wait for a few days for his money if his patience leads him to receive a 10 percent premium, the intuitive thinker wants his money right away.
2. *Keeping perspective.* The analytical thinker does understand that the probability that two unrelated events occur at the same time is always less than the probability that one of those events occur; the intuitive thinker does not understand that.
3. *Confidence.* The analytical individual is much less affected by overconfidence than thinker led by intuition.
4. *Independence.* The analyzing thinker is less than intuitive thinkers susceptible to manipulation.
5. *Open to new evidence.* The analytical thinker is more able to adjust his views as new evidence appears than the intuitive thinker who cannot believe that the facts are counter his original thoughts.

How would these findings apply to auditors? In the next section I will elaborate on how these five characteristics apply to the auditor and auditing research.

3 The firm auditor

3.1 Patience

Auditors who have queries may prefer a quick (and dirty) answer over an elaborate answer so as to get an issue from the table. We know little of whether auditors have patience when it comes to the issues they see. For instance, when a lead auditor sees that a subsidiary checked by a component auditor runs specific high risks he may want to make sure that the component auditor adopts a risk approach to account for the higher audit risk. To check on this approach he may want to verify the work of the component auditor. Such check can vary between asking the component auditor

or actually checking on the files of the component auditor and discuss these with the component auditor. Just asking takes little time and effort, but may also provide the lead auditor with an inaccurate answer. The auditing scandals we have witnessed provides us with many questions on whether or not the component auditors did the work the lead auditor would want him to do. One would be the case of US Foodservice who allegedly overstated its profit by having their suppliers sign off for volume motivated rebates. US Foodservice colluded with its suppliers to step up the level of promotional allowances. That allowance would kick in provided that US Foodservice would purchase extreme high levels of products. While the suppliers signed off for those allowances both the suppliers and US Foodservice knew that such high volumes would be unachievable. To get them to sign US Foodservice orally declared to its suppliers that the real rebate would be lower because they would not be able to reach the level of purchase they committed to in the letter. The signature, however, gave US Foodservice the freedom to claim the high rebates and put them in the books accordingly (Soltani & Soltani, 2009, pp. 237-248). Ahold replied that it were two specific executives who had worked in isolation with suppliers to inflate sales in order to claim discounts which were then booked as income. “It boggles the mind. This was collusion between two guys, quite senior fellows. The investigation turned up only these two were involved”, Ahold’s interim finance director Dudley Eustace said at the time (Milner, 2003).

As US Foodservice was owned by Ahold, its financial statements were audited under aegis of a Dutch audit. In the US Foodservice case it would have been useful had the Dutch auditor taken the time to actually inspect the work of its component auditor, rather than to just ask whether or not he did his job. Inspection takes more time than just asking for confirmation, however inspections also enhance the level of assurance.

Future research may tell us whether auditors with an analytical mindset are more likely to rely on their own inspection of the work of others or on the others telling them they did the required work.

More in general it would seem to be conducive to know how patience of auditors affects their working methods in collecting evidence and ascertaining that the work is performed accurately. One could go further to study how auditors’ patience is represented in an audit team. That is, is auditor patience related to working method choice?

3.2 Keeping perspective

A next potential factor to affect quality pertains to the ability of the auditor to analyze situations. For instance, auditing financial instruments not only reflects

on those instruments in isolation but should also be placed in the context of their function. An interest swap is held to hedge against interest risk run by a firm. The auditor thus not only checks whether it is the case that these swaps are valued accordingly, they also are required to examine the link between the swaps and the loans. Do these links exist or does the number of swaps issued exceed the number of underlying loans? In the latter case the swap should be considered a risky asset or even a liability. It would seem important that the knowledge base is enhanced into whether and how auditors put assets and liabilities of the firm in the perspective of the financial and operational risks firms are facing. Is the likelihood that these perspectives are considered impacted by the ability of the auditor? How many auditors taking issue with these perspective are on a team, and how many of such auditors are required on the team?

3.3 Confidence

May I ask every public auditor to consider the following?

Consider how skilled you are in auditing financial statements. All auditors are not equally skilled. Compare your own skills to the skills of your colleagues working for the same Dutch audit firm as you do and working in the same rank (e.g. manager, senior partner, rookie). By definition, there is a least skilled and a most skilled auditor in this group. I want you to indicate your own estimated position in this group (and not, you compared to all other Dutch auditors). Of course, this is a difficult question because you may not know all the people in the group, much less how skilled they are. But please make the most accurate estimate you can. Classify your skill on a 10 point scale, where 1 reflects that your skills are among the 10 percent least skilled auditors and a 10 reflects that you belong to the group of 10 percent most skilled auditors.

In what scale do you classify yourself?

Now remember the number where you would classify yourself.

The experiment we just did was actually done by Ola Svenson (1981) with car drivers in the USA and he finds that the median driver fell in the 61-70 percent interval and that 46.6 percent of the drivers considered themselves to reside in the group of 20 percent most skilled drivers. Of course, this number should be 20 percent. In addition, 93 percent of their US respondents believed themselves to be more skillful than the median driver. Of course this cannot be the case. If we assume that the sample indeed is representative this number should be equal to 50 percent rather than to 93 percent.

In summary, there was a strong tendency among participants to believe they are better than average. This is not a surprise as DeBondt and Thaler (1995) argued that "Perhaps the most robust finding in the psychology of judgment is that people are overconfident". One important task of auditors is to make decisions and judgments. We also know that these judgments are affected by levels of overconfidence. For instance Malmendier, Tate and Yan (2013) find that "managers who believe that their firm is undervalued view external financing as overpriced, especially equity. Such overconfident managers use less external finance and, conditional on accessing risky capital, issue less equity than their peers." In other words, overconfidence affects real decisions. In previous studies it is found that overconfidence impacts also the work performed by auditors. For instance, Moekel and Plumlee (1989) show that auditors are often as confident in their incomplete and inaccurate recognitions as they are in their accurate recognitions. Kennedy and Peecher (1997) find that auditors are overconfident in assessing their own knowledge and their ability to assess the ability of their subordinates.

One may argue that much experimental work is done in this regard. While this is true, we now only begin to understand how auditors behave in the full context of their day-to-day work. It would seem to be important to provide this context as experiments by design control for forces that potentially affect the outcome. Even a survey-based study like the one by Kennedy and Peecher (1997) does not tell us how the overconfidence of supervisors in assessing the technical knowledge of their subordinates affects real actions. For instance Kennedy and Peecher do not examine whether overconfidence could lead the auditor to put too much or too little trust in the work performed by the subordinate. It is entirely possible that overconfidence affects the supervisor's approach in audit planning, task assignment, audit workpaper reviews, or other judgments and decisions based on the assessments of subordinates' technical knowledge. The results of Kennedy and Peecher (1997) would suggest "that suboptimal utilization of and reliance on subordinates could certainly occur in the audit environment. However, because other factors could affect such judgments and decisions (e.g., auditee industry, time and fee pressures, litigation exposure), the extent to which suboptimal use of and/or reliance on subordinates occurs in practice is ultimately an empirical question." In other words to examine the effect of overconfidence, one would need to examine its effect in the context of the work of the auditor, not by isolating the factor of overconfidence.

3.4 Independence

Auditors have the professional obligation to be independent. Hence, the opinion of others – whatever its source – should not influence the opinion of each in-

dividual auditor. Can the auditor be that independent? Two forces affect the auditor's independence: supervisors and the auditees.

Supervisors have the power to direct the activities of the individual auditor such that it may interfere with his independence, e.g. when the supervisor requires the subordinate auditor to limit the scope of his work, while the subordinate auditor believes that a more thorough examination is called for.

The auditee may affect the independence in the extent that he is able to "capture" the auditor, for instance because of economic dependence of the auditor. It would appear to be conducive if individual auditors by nature are less inclined to give in to such forces. But how can one examine whether that is the case? Li (2009) used archival data from public sources to examine whether it is the case that economic dependence of big clients affects the independence of the auditor. Li (2009) operationalizes independence measured by the willingness of auditors to issue a going concern opinion. She finds no support for the thesis that distressed companies contributing higher public-client fees receive more lenient treatment from their auditors leading to an impaired likelihood of stating that the firm is facing going concern issues. In fact, what she finds is that after SOX implementation, companies contributing more fees are more likely to receive going concern reports.

While Li's (2009) findings are consistent with the view that auditors reporting more conservatively for larger clients to protect their reputations and to avoid litigation costs, it also suggests that smaller firms receive disproportionately less audit work or are charged a higher risk premium. No one can tell whether that is the case since audit work is measured through publicly available data on fees. Li's (2009) data does not include hour data which arguable would provide for a more valid measure of audit work than fees.

3.5 Open to new evidence

One impediment people experience is that they have a hard time to believe evidence that challenges their current beliefs. Prior beliefs influence the decisions of individuals such as the decisions of jurors (Hart, Evans, Wissler, Feehan & Saks, 1997; Smith, 1991, 1993). Even when warned, jurors are often unable to ignore their preconceptions when evaluating trial evidence (Babcock & Loewenstein, 1997). Auditors have to make calls that are akin to those of jurors. Yet we know little of how and whether auditors are subject to similar biases as jurors are. Moore, Loewenstein, Tanlu, and Bazerman (2005) suggest that this is the case; however the auditors in their study are professionals who participate in an experiment. Again it is not unlikely that audit firms have de facto systems in place that control for the inclination of individuals who have a hard time to change their opinion with new evidence that counters

their current beliefs. For instance, the fact that more than one pair of eyes look at the same files may decrease the likelihood that original opinions appear to be unwavering. On the other hand the four-eyes principle may also cultivate groupthink (Whyte, 1952; Janis, 1982). We know little of whether and how individual auditors de facto suffer from closed mindedness and hence whether audit firms should care about appointing auditors who are inclined to update their opinion with new data. Again, archival data could help us to examine how open/closed mindedness affect audits.

4 Research implications and value to practice

In the previous sections, I have argued that auditors with an analytical mindset take decisions quite different from how auditors endowed with an intuitive mindset make their decisions. In behavioral economics work it is found that analytical thinkers compared to intuitive thinkers are: more patient, keep perspective, are less subject to overconfidence, are more independent, and more open to new evidence. Some of these questions have been examined using experimental methods (e.g. 'overconfidence', Kennedy and Peecher, 1997; 'open to new evidence', Moore et al., 2005), or with archival data work, where the researchers have access to data that only remotely captures the variable of interest (e.g. Li, 2009, who measures levels of economic dependence with audit fees); 'patience' and 'keeping perspective' have yet to be studied. I would strongly encourage that in future studies the actions of the two auditor types of analytical and intuitive is examined in the context of the working conditions auditors face in their day-to-day work.

While experiments allow researchers to establish causal relations, the evidence does not allow us to establish how forces work in a full context where all working conditions apply, such as career perspectives, social relations, hierarchical relations. It is worthwhile to study auditor actions in situations when all working conditions apply as it is entirely possible for audit firms to account for conditions they face. For instance, when they put overconfident auditors on a team the audit firm may take specific measures to prevent these auditors from taking decisions influenced by this overconfidence. Studying overconfidence in the context of real working conditions would enable us to ask questions as: Do overconfident auditors set work methods for their subordinates that would deteriorate the quality of the audit? Have audit firms systems in place to mitigate the potential negative impact of overconfident auditors? Or: Are overconfident auditors more likely to cut corners when conducting an audit, or do audit firms put systems in place that prevent auditors from cutting corners? Bol, Estep, Moers and Peecher (2015) are looking closer into the issue of auditors' biased view of subordinates. Even the (public) archival data

does only reveal the working of auditing to a limited extent. For instance the study by Li (2009) into whether or not economic independence of the auditor is related to the likelihood of raising going concern issues. While her fee data would suggest that economic dependence does not impair the likelihood of auditors raising going concern issues, it is not clear whether this higher fee represents a risk premium or more work. To establish whether this higher fee is motivated by work or risk premium researchers will need to have access to working hour data. Such data can only be made available by the audit firm.

The Foundation for Auditing Research (FAR) may help future researchers to look into the working hour administration of audit firms to gauge firm level independence. Similarly internal data may also help researchers to establish the auditor's professional independence. To what extent does the relation of the individual auditor to his team and his supervisor affect his independence? Studies into these relation are scant. Nelson, Proell, and Randel (2016) show "that auditors' willingness to raise audit issues is affected by what the auditor has to say and how they think their message will be received, potentially affecting audit effectiveness and audit efficiency." They use survey and experimental data to examine their research question. To further establish the working of hierarchical relations and independence would require again that researchers have access to internal data of audit firms. Again, archival data could help us to examine how open/closed mindedness affect audits.

While auditor patience and the extent to which auditor know how to keep perspective have yet to be studied, I would encourage these topics to also be examined in the day-to-day business of the auditor. Again, while experiments can be used to study their action choice, the relations found in these studies are only true in the context of the laboratory, and these are not the conditions auditors face in practice. For instance, it may be found in an experiment that auditors are more likely to inspect the work of component auditors when they are of an analytical type compared to them being an intuitive type. However, would these conditions hold when an auditor is under real budgetary pressure? A study in the context of actual pressure will tell. Similar reasoning applies to whether or not auditors with an analytical mindset are better at keeping perspective than auditor endowed with an intuitive mindset. Are the first, for instance, more likely to study the working of a financial instrument in the context of its function (e.g. to hedge interest rate risks) than the auditor with an intuitive mindset and do these differences hold even when the auditors of the two types are exposed to budgetary pressure? By studying auditors in their day-to-day environment it will be made possible to take issue with these questions.

Studying the auditor in the context of his day-to-day operations is now made possible through The Foundation for Auditing Research (FAR). The idea of this foundations is that research groups can get access to archival data for audit firms enabling the study of auditors in their day-to-day operations. Opening up these data sources for research purportedly makes it possible for scholars to study auditors' decisions and the effect of those decisions in the context they face. I believe that we can now shed light on questions we could hitherto not investigate because we did not have access to internal data of audit firms. With the provision of internal firm data the Dutch audit firms open up the potential of examining many unexplored questions that live in practice and in academia.

5 Discussion and conclusions

I have argued in this paper that with the provision of internal data we can enhance our knowledge base of how and whether the ability of auditors affects the quality of their work. I believe that looking into the quality of the auditor her/himself is of importance as work in behavioral economics done over the last ten years has produced almost irrefutable evidence to show that analytical thinkers are more likely to make thorough analysis before arriving at a conclusion and are less likely to be biased or opinionated compared to intuitive thinkers. These are all qualities that society expects auditors are endowed with and that they act accordingly. What we see is that professional bodies and society believe that auditors are lacking a moral compass. For instance the Dutch professional body of accountants requires accountants as from 2016 to take the oath where the auditor promises to act in the interest of society. On July 14, 2016 the International Ethics Standards Board for Accountants released new standards aimed at resolving potential conflicts of interest for internal and external accountants and auditors, in case they feel bound by strict client confidentiality rules, or when they uncover wrongdoing (IESBA, 2016). "The standards clarify that professional accountants must be active and not turn a blind eye to noncompliance", said Stavros Thomadakis, chairman of the IESBA, whose rules are used in over 100 jurisdictions. "It's trying to bring about early, early detection, if you will, but also early action by management or authorities." (Wall Street Journal, 11 July 2016). Professor Rajgopal questions what kind of oversight power the IESBA has to bring to bear in order to assure that these new standards are complied with. "Does it have any bite?", he said in the Wall Street Journal.

I wonder whether these new ethical standards are indeed the key to the solution of improving audit quality. Is this emphasis on ethical issues as such the result of a societal bias? It is entirely possible that the pur-

pose of improving audit practice is better served with making sure that auditors are indeed independent minds who can make their own decisions. For it has been demonstrated that analytical thinkers when making their decisions have more patience, are better able to keep perspective, are less likely to be subject to their overconfidence, are less likely to be manipulated by others and are more open to new evidence. We yet have to learn how these qualities apply when auditors' actions are studied in their day-to-day operations.² ■

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Notes

- The snake which cannot cast its skin has to die. As well the minds which are prevented from changing their opinions; they cease to be mind.
- I left out many areas worthwhile of investigating, I did not talk about how big data or XBRL affects auditing as a profession and the object of study. I have also paid no attention to technical

development at large impacting the audit function. I even cast doubt on the importance of ethical standards, but still I cannot rule out that I am wrong in this regard. Indeed the culture inculcated in audit firms would appear to be a research area of interest. There are many research questions that warrant our attention. I believe that we

can now shed light on questions we could hitherto not investigate because we did not have access to internal data of audit firms. With the provision of internal firm data the Dutch audit firms open up the potential of examining many unexplored questions that live in practice and in academia.

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