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Literature Review
The Effects of Expert Status on the Audit of Complex Estimates

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Research Questions

Auditing complex estimates frequently requires input from specialists.[1] However, auditors struggle to assess specialists' capability and work quality, in part because auditors by definition lack the expertise to precisely evaluate a specialist's skills and work processes (PCAOB 2015a; 2015b). Specialists can improve the audit of estimates, but any potential improvement first requires appropriate assessments of the adequacy of specialist's work. Specifically, scholarly literature provides evidence that complex estimates provide client management with leeway to report in a manner consistent with its incentives, and that specialists are often hesitant to challenge these estimates (Dechow et al. 2010; Griffith et al. 2015; Knechel and Leiby 2016). Thus, overestimating the specialist's skills or work quality may lead the auditor conclude that an estimate is reasonable based on insufficient evidence, increasing audit risk and reducing financial reporting quality.

This study examines whether a specialist's *high status* leads to higher auditor evaluations of specialist work quality and greater reliance on this work as persuasive evidence. By status, we refer to prestige indicated by the respect of peers, elite university or company affiliations, and/or membership in exclusive social circles. U.S. and international auditing standards direct auditors to assess specialists based on information such as the specialist's experience with an audit issue, but also on "softer" factors such as the specialist's credentials, reputation, and standing among peers (IAASB 2009; PCAOB 2016). The IAASB (2013) has recently expressed concern about auditor "over-reliance on the qualifications of the expert with no further consideration as to their appropriateness."

This proposal argues that audit risk can increase when auditors act as though specialist's status equals substance. In particular, we focus on two overarching questions:

1. Do auditors overestimate the skills and work quality of high status specialists?
2. 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?

Specialist Involvement in Auditing Practice

The use of specialists is common in the audit of complex estimates, as evaluating these estimates requires significant judgment and wide bases of knowledge beyond accounting and auditing. For example, a PCAOB (2015a) review of 50 large audit engagements found that 90% used specialists, averaging five specialists per engagement. Because auditors struggle to maintain the knowledge and skepticism necessary to audit these estimates, the use of third-party experts can substantially improve the audit of estimates (Griffith et al. 2015). Regulators have similarly expressed concerns that auditors do not appropriately evaluate specialists' capabilities and work quality (IAASB 2013; PCAOB 2015a; 2015b). In brief, the use of specialists is often a necessary condition to improve the audit of complex

[1] We use the term "specialist" interchangeably with "expert."

estimates, but improving judgment first requires auditors to make appropriate evaluations of the specialist and the specialist's input.

Accordingly, scholars, practitioners, and regulators have placed considerable emphasis on improving how auditors evaluate specialists' capabilities and quality of work. Unfortunately, by definition auditors lack the expertise to precisely evaluate specialists' capability and the work that specialists perform (IAASB 2008; PCAOB 2015a; 2015b). Auditing standards provide guidance on the attributes that auditors can use to evaluate specialists, including past experience with the specialist or demonstrated expertise in the area (e.g., IAASB 2009). However, standards also direct auditors to consider softer cues of the specialist's social standing. For example, AS 1210 states that the auditor should consider "*the reputation and standing of the specialist in the views of peers*...(emphasis added)." ISA 620 notes that auditors should use, among other things, "*expert's qualifications…[and] other forms of external recognition* (emphasis added)." Consequently, the IAASB (2013) has expressed concerns about "over-reliance on the qualifications of the expert with no further consideration as to their appropriateness." Indeed, we argue that there are conditions in which this emphasis on credentials, standing, and recognition is problematic. In extreme cases, focusing on high social standing may lead auditors to ignore more substantive information. This could lead auditors to underweight troubling cues, such as poor work quality or precipitous endorsement of client preferences, or positive cues such as strong justifications for conclusions.

We will provide evidence about two issues involving specialists' status. First, when the specialist agrees with the client, we will examine whether high specialist status hinders auditors' recognition of clear differences in the strength of the specialist's justifications. Second, holding the specialist's justifications constant, we will examine whether high specialist status affects how auditors evaluate specialist input that agrees versus disagrees with the reasonableness of the client's estimate.

Testable Predictions on Status and the Evaluation Specialists

Beyond the guidance of standards, theory suggests that cues of specialists' *status* is likely to affect auditors' evaluations. Status refers to a specialist's social position, often indicated by elite credentials or social ties like media attention or affiliations with prestigious universities, companies, and social organizations (D'Aveni 1990; Jensen and Roy 2008). Because prestige is readily observable unlike true ability, people use prestige as a shortcut and act as though status is a valid signal of quality (D'Aveni 1990; Certo 2003; Lester et al. 2004). While ability and status are sometimes correlated, ability is not a necessary condition for high status. In many instances, high status decision makers underperform their moderate status counterparts (Malmendier and Tate 2009). Nonetheless, sophisticated parties like bankers, venture capitalists, and CFOs use status as a signal of quality (D'Aveni 1990; Lester et al. 2006; Bodalato et al. 2014).

The use of prestige a signal of quality increases with strong accountability pressures (Jensen and Roy 2008). These pressures are particularly strong in auditing settings, due to multi-layered internal reviews, external regulatory inspections, and threats of professional or legal sanction (Peecher et al. 2013).

Moreover, status is likely to be highly salient when auditors use specialists, as these situations involve high-profile decisions and clients, and interactions with successful people from prestigious third party firms (Knechel and Leiby 2016). Moreover, input from high status specialists is likely to increase the justifiability of audit conclusions, as high status individuals command deference and are less frequently second-guessed (D'Aveni 1990). As a result, as status increases, evaluations of the specialist's capability and work quality are also likely to increase.

> **H1: Auditors will evaluate a specialist's capability and work quality as higher when the specialist has high (as opposed to moderate) status.**

In turn, we also expect the specialist's status to affect how auditors process two key attributes of the specialist's input: the strength of the specialist's justifications and the specialist's agreement or disagreement with the reasonableness of the client's estimate. We discuss these factors in the following sections.

When the Specialist Agrees with the Client – Status and Justification Strength

A valid concern for stakeholders is that auditors may rely on specialists' work as persuasive audit evidence when the work is less than persuasive, leading auditors to prematurely conclude a client estimate is reasonable. This is more likely if the specialist agrees with the client's conclusion. Auditors are likely to selectively seek and use evidence that supports their preferences, which are often biased in favor of accepting the reasonableness of management estimates (Griffith et al. 2015). As estimates occupy a wide range of potentially reasonable values, auditors have substantial leeway to engage in motivated reasoning to justify that the client's estimate is reasonable and that their evaluation of the estimate is objective (Kadous et al. 2003). Accordingly, when specialists provide input agreeing with the client's estimate, auditors are likely to strongly weight this input as a signal of the reasonableness of the client's estimate.

However, auditors may confront situations of *well justified agreement* or *poorly justified agreement*. Specialist agreement with the client is unlikely to be problematic, if the specialist provides strong justification for their agreement.[2] However, evidence suggests specialists may not always do so (IAASB 2013; Griffith et al. 2015; Griffith 2016; Knechel and Leiby 2016). While auditors cannot evaluate

[2] Consider this a baseline, relatively unproblematic case. If the specialist concludes that the client's estimate is reasonable and provides strong justification, then there is little conflict between the motivations of the client who wants to report the estimate as-is, the auditor who wants to complete the engagement while minimizing conflict, and the specialist who supports both objectives. In this scenario, it is likely reasonable to conclude that the specialist's work is high quality and the client's estimate is reasonable. The remaining conditions that we discuss vary in the degree to which it is reasonable for the auditor to conclude that the specialist's work is high quality and that the client's estimate is reasonable.

specialists' capabilities and work quality with complete precision, it is possible for auditors to reasonably evaluate the justifiability of a specialist's arguments. Auditors understand that ensuring judgment justifiability is critical, and they associate better justified judgment processes with better decision outcomes (Kennedy et al. 1997; Bell et al. 2005). Auditors also routinely assess the justifications provided by other auditors and by management (Koonce et al. 1995; Tan and Shankar 2010; Kadous et al. 2013). These incentives for justifiability suggest that auditors, even if otherwise prone to motivated reasoning, will try to be sensitive to differences in specialist's justifications.

As discussed above, evaluating specialists and their work is a difficult task, and people use judgment shortcuts to cope with complexity for these tasks (e.g., Tversky and Kahneman 1974; Kahneman and Frederick 2002). In this setting, auditors can easily observe indicators of high specialist status. Thus, auditors can base their evaluations of the specialist's work on status, instead of the more difficult-to-process but substantive cue of justification strength. An analogous case is auditors evaluating the quality of the advice they receive based on their social bonds with an advisor, rather than on the substance of the advice they receive (Kadous et al. 2003).

Thus, in a situation in which the specialist's conclusion agrees with the client's estimate, we expect auditors to be highly likely to conclude that the client's estimate is reasonable when receiving well-justified advice agreeing with the client's conclusion, regardless of status. However, we predict that auditors are likely insensitive to justification strength when receiving input from a high status specialist. By contrast, auditors receiving advice from a moderate status specialist are more likely to differentiate weak from strong justifications. In turn, when the specialist provides weak justification for a conclusion that agrees with the client, we expect auditors to be more likely to evaluate work quality as high and to conclude the client estimate is reasonable when the specialist has high status (as opposed to moderate) status. In these conditions, auditors likely substitute "status" for substance. This leads to our next two hypotheses:

> **H2a: When specialists provide input that agrees with a client's estimate, auditors will *evaluate the specialist's work quality* relatively highly when strong justification is provided, independent of specialist status. However, auditors will evaluate work quality as higher when the high status specialist provides weak justification than when the moderate status specialist provides weak justification.**

> **H2b: When specialists provide input that agrees with a client's estimate, auditors will *evaluate the reasonableness of the client's estimate* relatively highly when strong justification is provided, independent of specialist status. However, auditors will evaluate work quality as higher when the high status specialist provides weak justification than when the moderate status specialist provides weak justification.**

When the Specialist Disagrees with the Client

Even assuming that specialists provide strong justifications, there is also likely to be variation in the degree to which specialists agree or disagree with the reasonableness client's estimates. Scholarly evidence suggests that specialists are willing to challenge clients in some situations (Griffith et al. 2015; Knechel and Leiby 2016). Anecdotal evidence from practice also reports high-profile instances in which specialists challenge client estimates (e.g., Missal 2008, 472 – 474). Thus, we expect disagreement is not a rare occurrence, but it does create difficulty for the engagement team. A variety of pressures motivate the auditor to seek consensus for the client conclusion, including motivations to meet deadlines or to satisfy external inspectors or internal reviewers who emphasize the consistency of documented audit conclusions (Kennedy et al. 1997; Kadous et al. 2003; AICPA 2012). Auditors are also prone to motivated reasoning, and thus may readily accept specialist agreement and scrutinize disagreement (Kadous et al. 2003). This is consistent with evidence that auditors often "push back" when specialists disagree with a client estimate (Griffith 2016).

In evaluating *well justified agreement* versus *well justified disagreement*, using high status as a signal of high underlying quality is likely to have positive implications for audit quality. It may be tempting for the auditor to discount disagreement. However, a benefit of high status in this setting is that high status individuals command deference from others and, if motivated properly, can yield better outcomes (D'Aveni 1990; Bodalato et al. 2014). Auditors are likely to interpret disagreement by a high status specialist as more justifiable than disagreement by a moderate status specialist. Though lending credence to disagreement may lead to potential delays or strained client relations, auditors likely have less difficulty doing so when it is supported by a high status specialist. Hence, in this context, this effect is likely to result in the auditor assessing the client's estimate as less reasonable. This leads to our final hypotheses:

> **H3a: Auditors will *evaluate the specialist's work quality* relatively highly *when the specialist agrees with the client's estimate*, independent of specialist status. However, auditors will evaluate work quality as *higher* when the high status specialist disagrees with the client than when the moderate status specialist disagrees with the client.**

> **H3b: Auditors will *evaluate the reasonableness of the client's estimate* relatively highly *when the specialist agrees with the client's estimate*, independent of specialist status. However, auditors will evaluate reasonableness as *lower* when the high status specialist disagrees with the client than when the moderate status specialist disagrees with the client.**

Status and the Evaluation of Relevant versus Irrelevant Specialist Credentials

A natural follow up question arises: what if an auditor learns that a specialist possessing status characteristics irrelevant to the audit issue also possesses status characteristics more relevant to the audit issue? We argue that drivers of status irrelevant to the audit issue are likely to interact with more relevant drivers of status. Specialists with high social standing may be possess impressive certifications and credentials, or not. Further, these credentials range from highly relevant to the audit issue to completely irrelevant to the audit issue. For example, does a specialist's social standing modify how auditors' consideration of a highly relevant certification? Alternatively, does status cause auditors to treat a "certified" specialist as a guru, even if the specialist's certification is not related to the audit issue?

Normatively, the effect should be additive. An auditor should revise his or her beliefs about the specialist's competence upwards after learning new information about relevant certifications or qualifications that the specialist possesses. Again, this adjustment should increase as the new information is increasingly relevant to the audit issue. For example, a PhD in materials engineering may be a highly credible signal of competence to evaluate the reasonableness of a client's representations about a new medical device's viability. It is a considerably less credible signal of competence for evaluating pension plan assumptions.

The alternative possibility is that social standing desensitizes the auditor to new, relevant information. They may adjust as much for a mildly relevant qualification as for a highly relevant qualification. In other words, assessed competence may be relatively high when social standing is high, regardless of the specialist's certifications. Alternatively, at lower levels of status, certifications may more substantially impact assessments of capability.

> **Research Question: Does high social status affect how auditors evaluate the credentials possessed by a specialist?**

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