

## **FAR Online Masterclass 'The Impact of Auditor Interactions on Audit Quality' by Eddy Cardinaels and Kristof Stouthuysen, held on June 5 2020**

Eddy Cardinaels is a full professor of accounting at Tilburg University and KU Leuven. Kristof Stouthuysen is (associate) professor of management accounting at Vlerick Business School and KU Leuven. The research they presented during the masterclass is based upon the FAR research project (Project 2018B01), of which the original title is: 'How auditors' internal and external interactive relationships impact their judgment and decision-making'. Other members of the project team are Viola Darmawan (KU Leuven) and Evelien Reusen (Rotterdam School of Management, Erasmus University).

On June 5 2020, Eddy Cardinaels and Kristof Stouthuysen presented an online masterclass concerning their study 'The Impact of Auditor Interactions on Audit Quality'. This report provides a summary of the masterclass, including preliminary findings from the experiment they conducted. The study, so far, shows that:

- Concerning *imitation*, junior auditors imitate a more diligent superior more than a lower diligent superior. This effect is even more pronounced under a superior-based promotion system (as opposed to consensus-based promotion system).
- Regarding *audit quality*, junior auditors perform better when facing a diligent superior.
- Furthermore, (self-reported) imitation does not improve audit quality. In particular, when facing a low diligent auditor, audit quality deteriorates. Hence, there seems to be a possibility to imitate a superior too much, particularly in the low diligent situation.

### **Background: learning, imitation and context**

Senior auditors play an important role in knowledge transfer towards junior auditors. For example, to support junior auditors in developing appropriate knowledge and skills, audit standard setters and regulators highlight the importance of on-the-job-training and coaching by more senior auditors. Senior auditors need to be aware of the impact they have on junior auditors and audit quality, and vice versa.

The imitation literature is quite vast, but the importance of imitation is not yet prominently studied in the auditing literature. However, it is very interesting to look at imitation in an auditing context, particularly in the junior-senior auditor setting. An influential perspective on imitation comes from social learning: individuals do not only learn from experience, but also from observing role models. This may make individuals a better version of themselves. A seminal work of Bandura (1977), for example, states that if you want to learn how to drive a car, you will look for a teacher. And by observing that teacher, you will already learn an important part about the actual driving. A good teacher should be an experienced driver. This requires selective imitation: learners preferably imitate the good role models more.

However, literature shows that there are more reasons for imitation, next to learning. For example, research has found that people also mimic other persons because they have a certain authority. And a person in a powerful position could have influence on bonuses or promotion decisions. An individual then may mimic this superior for financial reasons, and not for a desire to learn.

In our study, we examine whether and under what conditions these behaviors exist and whether and how they affect audit quality. We have three main research questions. Firstly, we are interested in studying to what extent junior auditors imitate their superiors. Secondly, we examine what conditions induce junior auditors to imitate more or less. The third question is whether and how imitation influences audit quality.

### **Diligence and promotion**

So, one of our questions is what will drive the level of imitation by junior auditors. We look at two conditions. The first condition is working style. The second is the nature of the promotion system. We manipulate these two conditions.

Concerning the working style role models, we distinguish between high and low diligent superiors. A highly diligent superior is very accurate in following the required audit procedures. It is the ideal auditor in terms of performing high quality audit work. We depict an auditor with a low diligence as a more commercial auditor who might take shortcuts during the audit.

We studied whether junior auditors imitate the role model, which may lead to higher audit quality in case of the highly diligent superior (and to lower audit quality with the low diligent superior). We also look at the promotion system, which may produce a different motivation for imitation. We distinguish between a consensus-based and superior-based promotion system, which both exist in practice. In the superior-based system, the superior has a very decisive voice in the future promotion of the junior auditor. In a consensus-based system, there is a broader base for a promotion decision. We anticipate that imitation in this case may not be related to wanting to become a better auditor, but by wanting to be promoted as soon as possible.

We hypothesize that there will be high *imitation levels* in the case of a highly diligent superior, combined with a superior-based promotion system (as opposed to a consensus-based system).

We also hypothesize (using an audit quality measure as the dependent variable) that there will be a high effect on *audit quality* in case of a highly diligent superior combined with a superior-based promotion system (as opposed to a consensus-based system). So, the idea is that the effect of the level of diligence on decision quality (a fair value estimate of a business unit) depends on the promotion system.

We also expect that (self-reported) imitation will have an influence on audit quality.

In addition, we are interested in observing whether following a highly diligent auditor may not necessarily lead to audit quality improvement. There is evidence that exactly copying will not always lead to success. It may impair your own creativity and thinking. So, there is a tension: mimicking might only be productive until a certain level.

### **Sample, task and variables**

We look at a complex audit task concerning a fair value estimation. Therefore, we needed to have a subject pool of participants which is not familiar with a task like this. We were allowed to approach junior auditors during inhouse training days, which resulted in 138 usable responses. The average age of the participants was about 27 years, two thirds of them were male and the majority had 3 to 4 years of working experience. We believe that this is a representative sample of junior auditors which are usually being supervised by senior auditors in conducting complex tasks.

The task we used is a complex audit estimation task. Participants are asked to make an impairment assessment for a division of an electric car manufacturer. There were cues in the case which suggested that the fair value estimate by management was likely overstated. The idea here is that juniors will try to learn from what a senior role model did in a similar situation and then make a judgment about whether the value is fair or not.

In practice, it is usually possible to check the working style of other auditors. For that purpose, audit firms have working papers available from senior colleagues. In the experiment, we have manipulated the superior's working paper as the basis for the decision of the participating junior auditor. It contains a fair value assessment process of an audit senior, for another division, which may serve as an example, to imitate.

As discussed earlier, we also varied the nature of the promotion system.

The participants had to make a fair value decision by answering the question on a 10-point scale: 'How likely is it that Hybrid's current fair value estimation of EUR 3.2 billion is fairly stated?' The more they agree with this statement, the lower the audit quality, since there were cues in the case that suggested overestimation.

We used a so-called two by two (2x2) subject design: participants were in the high or low diligence setting combined with the superior- or consensus-based promotion setting (leading to 4 different groups).

### **Experimental settings**

Description low diligent setting: 'John is a superior, well-known for his capability to keep engagement within budget, worked very efficiently, with quick, decisive action in completing his tasks. Audit procedures omitted steps under ISA 540. It excluded the evaluation of the assumption of the discount rate and taxation rate in management valuation analysis. Also, less extensive testing was done for projected revenues. Many other steps were not done very meticulously; conclusion was no overstatement'.

Description high diligent setting: 'John performed his tasks very carefully, critically examined available evidence and strove to gather sufficient support before reaching his conclusions. Working paper of Pure Electric SBU depicted more thorough steps and detailed analysis, which eventually led to the conclusion that a goodwill impairment was required for the pure electric division'.

Description of the consensus-based promotion setting: 'As part of your review process, you know that a promotion is determined on the basis of a consensus on your performance in the review committee. Note that the review committee consists of multiple superiors, of which the superior in the current engagement is only one'.

Description of the superior-based promotion setting: 'As part of your review process, you know that a promotion is determined on the basis of an assessment of a performance review. Given that you have been repeatedly matched with your superior John, his voice will have a decisive impact on the eventual decision'.

In addition, participants were also asked to assess their own level of imitation of the audit senior role model. For example, one of the questions was: 'To what extent would your audit opinion be based on similar procedures described in John's working paper?' This resulted in a self-reported imitation variable.

## **Results**

Now let's have a look at the main results. Concerning imitation, junior auditors imitate the 'good guy' more (the highly diligent audit senior). This effect is even more pronounced under superior-based promotion.

Regarding audit quality, junior auditors perform better when facing a diligent superior. There is no significant effect from the promotion system on audit quality, nor on the relationship between diligence and audit quality.

Furthermore, (self-reported) imitation does not improve audit quality, in particular when facing low diligent auditor, quality deteriorates. This seems to be an indication for a possibility to imitate a superior too much, particularly in the low diligent situation. However, also in the high diligent setting, audit quality seems to decrease with imitation.

## **Tentative take-aways**

Concerning the role of imitation behavior in the context of a professional audit firm, the good news is that juniors imitate the high diligent auditor more strongly, in particular under high incentives. Juniors seem to apply professional skepticism. They are not blindly following the bad example. Even when they experience promotion pressure, they don't increase following the bad example. They only seem to take over good advice. However, imitation seems to deteriorate audit quality, when junior auditors face working style of a low diligent auditor.

Audit firms already share working papers for learning purposes. Sharing best practices of 'diligent' working styles can help, but only to certain extent. However, documenting best practices might stimulate more critical thinking by the junior auditors.

We don't find that a superior-based promotion system has a negative impact, if combined with diligent senior.

**For more information regarding the research project, please refer to:**

<https://foundationforauditingresearch.org/files/papers/cardinaels-goris-reusen-stouthuysen-literature-review-21-02-20.pdf>

<https://foundationforauditingresearch.org/files/papers/cardinaels-goris-reusen-stouthuysen-practice-note-21-02-20.pdf>

<https://foundationforauditingresearch.org/files/papers/cardinaels-goris-reusen-stouthuysen-practice-note-dec4-nederlands.pdf>

<https://foundationforauditingresearch.org/en/research-publications/projects/2018b01-how-auditors-internal-and-external-interactive-relationships-impact-their-judgment-and-decision-making-prof-dr-cardinaels/>