

## Assessing fraud risk based on client earnings calls: a FAR Masterclass by Mark Peecher

Audit partners better align how highly they assess fraud risk with their plans to address fraud risk when prompted to watch for signs of cognitive dissonance during earnings calls, as opposed to signs of fraud.

Partners play an important role in transferring their knowledge and skills of detecting fraud indicators to junior team members.

Use of an independent reviewer can help to maintain an open and objective mindset to help better assess and address fraud indicators that arise during earnings calls.

On December 4th 2020 professor Mark Peecher presented a FAR Masterclass concerning the auditor's role in fraud detection and particularly concentrated on the use of earnings calls as evidence for assessing and addressing fraud risk. It seems that asking auditors to focus on signs of 'cognitive dissonance' in earnings calls results in better alignment of their assessments of fraud risk and their plans of how to address fraud risk, as opposed to asking auditors to look for fraud. Cognitive dissonance is the uncomfortable emotion people experience when engaging in behaviors that run counter to their underlying beliefs, such as when a person says something that he knows or believes is not true.

From a standard's perspective, detecting fraud has always been part of the financial statement audit. Until the mid-1900's, detecting fraud was the key responsibility of an audit. Soon, it became clear that an ordinary financial statement audit did not reach a suitable level of assurance about any possibilities of "malicious intent", which could lead to financial misrepresentation. Standards therefore began to explicitly instruct auditors to consider fraud risk factors, to assess the risk of material misstatements due to fraud, and to address these risks with suitable (substantive) audit procedures. Still, according to, for example, Abdullah *et al.* (2020), fraud is rarely discovered.<sup>1</sup> In their model, they predict that 22,3 percent of US corporations engage in financial misrepresentation, of which only 6 percent is detected and pursued.

<sup>1</sup> Alawadhi, Abdullah and Karpoff, Jonathan M. and Koski, Jennifer Lynch and Martin, Gerald S., The Prevalence and Costs of Financial Misrepresentation (January 29, 2020). Available at SSRN: <https://ssrn.com/abstract=3532053> or <http://dx.doi.org/10.2139/ssrn.3532053>

A possible explanation for the gap between actual fraud and detected fraud can be found in the psychology literature. To help identify fraud risk factors and possible risks of material misstatement, audit standards direct auditors to set aside any belief of management's honesty, even if these beliefs are reasonably formed based on years of working with management. Auditors have to maintain a somewhat suspicious mindset while auditing their clients, which actually is against norms in human behavior. People tend to avoid signs of maliciousness with others, especially when the others are close to them. People even prefer to maintain positive beliefs about the character of close others, even when some evidence suggests the contrary. As a result, auditors may also rely on their preferred beliefs about management's intentions instead of more objectively using their knowledge and skills to assess and address fraud risk factors.

So, how can auditors improve their ability to detect fraud? Several studies show that earnings calls can be regarded as audit evidence, for two reasons. On the one hand, earnings calls are used by analysts to write their reports, which routinely contain information regarded as audit evidence by the IAASB. On the other hand, earnings calls can reveal signs of management's cognitive dissonance. As mentioned, cognitive dissonance is the uncomfortable emotion a person feels when he is saying something that he knows is not true. Signs of cognitive dissonance are proven to be indicators of potential misrepresentation in financial statements.

Peecher and his team conducted a field experiment, in which 184 auditors listened to their own client's earnings calls. One group of auditors were asked to look for indicators of fraud, while another group was asked to look for indicators of cognitive dissonance. A third group was asked to look for both indicators. The control group was not asked to look for either of the indicators.

The researchers hypothesize that looking for cognitive dissonance, as opposed to looking for fraud, will lead to a stronger coherence between assessing and addressing the risk of fraud. Cognitive dissonance is a symptom of potential misbehavior and therefore not as confronting as fraud itself. As a result, auditors are more objective in watching for signs of cognitive dissonance, as compared to directly watching signs of fraud, during earnings calls.

The preliminary results of the experiment suggest that coherence between assessed and addressed fraud risk is higher when auditors, especially audit partners, are prompted to look for signs of cognitive dissonance in earnings calls. This observation, however, only holds when auditors are not prompted for fraud. In case they are prompted to look for both, it shows that partners are less able to detect signs of fraud than their senior/junior team members. Also, when not prompted to look for either of them, auditors perform no better than chance in detecting signs of cognitive dissonance or fraud.

Although the results of this study are preliminary, three tentative conclusions may be drawn. First, partners are apparently less willing (or able) to respond to signs of fraudulent behavior when prompted to look for fraud than their more junior team members. This could be explained by greater client familiarity. Due to the familiarity that the audit partner may have with their clients, the risk of aversive behavior when confronted with malicious intent could therefore be higher. In order to reduce this risk, it would be an option to engage more junior team members in attending the earnings calls. Secondly, the study shows that looking for signs of uncomfortable emotion is more effective than looking for fraud itself. This difference in approach could improve the ability to assess and address fraud risks. Also, partners, who appear to possess more knowledge and skills to correctly recognize cognitive dissonance, could transfer their dissonance-detection

knowledge better by teaching their team members how to recognize dissonant behavior, instead of searching for fraud itself. Thirdly, the results emphasize the relevance of an independent reviewer on the team who is less engaged with the client and therefore more objective and open to assess heightened risks of fraud and to address them suitably.

Looking ahead, the research team will merge additional archival data with their field experiment data to test whether differentiation of the assessment of audit risk between auditees is also enhanced by using earnings calls during the audit. Further, the team will work towards a model that sorts auditees into “predicted fraud” vs. “non-predicted fraud” categories, based on available proxies such as reported restatements. This can be used in the analysis of the effectiveness of using cognitive-dissonance prompts while listening to earnings calls to help auditors in assessing and addressing fraud risk factors.

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