

PRACTICE NOTE

Can audit committee support improve auditors' application of professional skepticism?

Prof. dr. Anna Gold
Prof. Joseph Brazel
Dr. Justin Leiby
Dr. Tammie Schaefer

KEY TAKE-AWAYS

Despite the recognized importance of professional skepticism, auditors' failure to consistently exercise a sufficient level of professional skepticism continues to be a globally recognized issue. In this study, we seek to gain a better understanding of the role audit committees, who oversee the audit process and can help/aid in improving auditors' application of skepticism. In a survey of audit practitioners, we found that: audit committee support varies substantially between audit engagements; audit committee support is multifaceted; and the support is often not conveyed to the lower-level members of the engagement team. Given our survey findings, we experimentally investigated whether and how audit committee support being explicitly conveyed to the entire engagement team (by either the partner or audit committee chair) impacts the skeptical...

24/12/2020

Project
Number:
2018B04

F
AR Foundation for
Auditing Research

Practice Note

“Can Audit Committee Support Improve Auditors’ Application of Professional Skepticism?”

Grant Number: 2018B04

Presented to:

The Foundation for Auditing Research

Presented by:

Joseph Brazel, *North Carolina State University*
Anna Gold, *Vrije Universiteit Amsterdam*
Justin Leiby, *University of Illinois at Urbana-Champaign*
Tammie Schaefer, *University of Missouri-Kansas City*

December 24, 2020

The authors would like to thank all participants in the survey and the experiment. Furthermore, the authors thank the Foundation for Auditing Research (FAR) for their grant 2018B04. The views expressed in this document are those of the authors and not necessarily those of the FAR.

“Can Audit Committee Support Improve Auditors’ Application of Professional Skepticism?”

Executive Summary

Despite the recognized importance of professional skepticism, auditors’ failure to consistently exercise a sufficient level of professional skepticism continues to be a globally recognized issue. In this study, we seek to gain a better understanding of the role audit committees, who oversee the audit process and can help/aid in improving auditors’ application of skepticism. In a survey of audit practitioners, we found that: audit committee support varies substantially between audit engagements; audit committee support is multifaceted; and the support is often not conveyed to the lower-level members of the engagement team. Given our survey findings, we experimentally investigated whether and how audit committee support being explicitly conveyed to the entire engagement team (by either the partner or audit committee chair) impacts the skeptical judgments and actions of auditors.

We find that an expression of audit committee support conveyed explicitly by the audit partner can increase the skeptical actions of auditors, whereas such an expression of support by the audit committee chair does not. Our findings point to the crucial role audit partners can play in improving auditors’ application of professional skepticism.

Main takeaways from the survey:

- Interactions with the audit committee (AC) are limited to partners, directors and senior managers.
- Key forms of AC support are: openness, availability, and protecting/standing up for the audit team against management.
- Signals of AC support may not be trickling down to lower levels of the team.

Main takeaways from the experiment:

- Auditors’ skeptical *judgments* are adequate, regardless of level of AC support.
- Auditors’ skeptical *actions* are significantly less likely when there is no AC support, combined with a poor management attitude.
- Expression of AC support *by the partner* increases skeptical actions, in the case of a poor management attitude
- There is no effect of AC support *expressed by the AC chair*.

The Issue – Improving Professional Skepticism

A lack of auditor skepticism has been cited as a root cause of many audit failures, regulator enforcement actions, and malpractice claims filed against auditors. One factor causing this lack of skepticism may be related to the incentives auditors face in their audit work.

Specifically, although exercising appropriate levels of skepticism is known to be essential to audit quality, skepticism can also come at a cost to the individual auditor. This occurs when auditors encounter cues suggestive of a potential misstatement and appropriately perform additional work to obtain sufficient and appropriate evidence, but the evidence ultimately results in a non-misstatement explanation. In such a situation, resulting budget overruns or strained client relations may lead to unwarranted penalization of the auditor adequately engaging in skeptical behavior.

Academic research generally finds that auditors are adept at recognizing red flags and identifying potential issues, but fail to take appropriate action to investigate and resolve these potential issues, possibly as a result of perceived costs to skepticism. Our research project aims to inform audit practice and standard setting regarding how support from the audit committee can improve auditors' application of professional skepticism, particularly as it relates to auditor incentives. To do this, we first surveyed over 100 audit practitioners to obtain a baseline knowledge about the current state of and best practices for audit committee support for the audit engagement team and its effect on the application of professional skepticism. In particular, we sought to answer the following questions:

- How do audit committees currently interact with and support engagement teams?
- How does audit committee support affect the professional skepticism exercised by engagement teams?
- What best practices allow audit committees to support audit teams and encourage appropriate professional skepticism?

Using insights gained from this survey, we then experimentally examine the following questions:

- Does audit committee support affect auditors' professional skepticism?
- Does it matter who conveys the audit committee's support (partner or AC chair) to the engagement team?
- Is the effect of support contingent on client management's attitudes (good vs. poor)?

Relevance to Audit Practice

Enhancing auditor skepticism has been of great concern not only at the international level, but also an issue of great interest in the Dutch practice community. For instance, in 2014, the NBA's program committee "Professional Sceptis" presented its final report, in which it not only emphasized the importance of professional skepticism, but also recommended several instruments that could be useful to further promote its exercise. Their primary

recommendation is the performance of further research into audit firm culture and the ways in which audits are structured, with the aim of improving auditor professional skepticism. Our study directly responds to this call by broadening the scope to include the role and involvement of the client's audit committee, which has the potential of to significantly modifying the way in which auditors respond to the challenging audit task of appropriately applying professional skepticism.

Our Survey Findings – The Current State of Audit Committee Support

We surveyed 104 auditors of varying ranks at the eight largest US firms and one Dutch Big4 firm. We sought to find out more about the current state of audit committee support, about whether auditors actually experience such support, and what form that support might take.

We find that interactions between the audit committee and engagement team members is usually limited to partners, directors, and senior managers. Auditors' experiences with audit committee support and whether it is explicitly communicated to the team varies substantially, and audit committee support manifests in many ways. For example, audit committee openness and availability to the auditor are viewed as a key form of support. Related to the primary costs of skepticism, our participants noted the importance of committees standing up for the engagement team when management attitudes toward the engagement team are negative, responses to auditor requests are delayed, and conflicts arise. Surprisingly, our survey respondents did not report that audit committees commonly consider additional audit fees due to budget overages as a notable form of support.

We also find that audit committee support observed by engagement management (e.g., partners) may not actually be trickling down to lower levels of the engagement team who perform the risk assessments and substantive testing where skepticism is crucial. Interestingly, approximately half our respondents indicated that audit committees do not impact the skepticism exercised by engagement teams. The other half of our survey participants described how audit committee support could impact professional skepticism when assessing risks and, more often, when performing substantive testing.

Our Experimental Findings – Improving Professional Skepticism via Audit Committee Support

Motivated by the knowledge gained from our survey and the overall uncertainty surrounding the relationship between audit committee support and skepticism, we experimentally investigated how audit committee support impacts the skepticism of auditors in a setting where a fraud red flag is present.

We conducted the experiment with 184 audit seniors at multiple firms in the Netherlands. We examined if the way audit committee support is conveyed to the entire engagement team, either indirectly by the audit partner or directly from the audit committee chair, plays a role in improving skepticism. Given our findings related to audit committee support being

particularly useful when management has a poor attitude, we also examined the effects of audit committee support under conditions where management's attitude toward the audit team are good and poor.

While we find auditors recognize the red flag in all conditions, it seems audit committee support impacts auditor skeptical actions. When no audit committee support is expressed, auditors are significantly less likely to exercise skepticism/further investigate the red flag when management has a poor attitude towards the audit team. However, an expression of audit committee support conveyed by the audit partner increases the skeptical actions of auditors when management has a poor attitude. Communication of audit committee support by the partner helps to prompt auditors to act when they recognize the red flag. Interestingly, we do not observe this effect when the audit committee support is conveyed directly to the entire engagement team by the audit committee chair.

These experimental findings are supported by responses to the survey. One respondent says that it seems like a decent idea that the audit committee chair would directly communicate their support. However, it would be quite impractical on larger engagements, especially to the extent that teams are dispersed geographically. It is interesting to note that auditors generally responded positively to the audit committee chair communicating the support directly. They self-reported higher motivation and higher effort when the chair communicated, as compared to when the partner communicated. But that did not translate into actions. Auditors were more likely to take skeptical action when the partner was doing the communicating. Thus, to the extent that audit committee support is present, our findings point to the crucial role the audit partner can play in improving auditors' skepticism.

Conclusions and Recommendations

Our work speaks not only to the current state of audit committee support for engagement teams, but also to how simple changes in how such support is communicated may improve the application of professional skepticism. Our results illustrate that there is a disconnect between issues auditors identify (i.e., their skeptical judgments) and whether they do anything about it (i.e., their skeptical actions). Auditors are generally able to recognize when there is a problem, but they do not always follow up when it is warranted to do so. An easy intervention of a supportive audit committee, where the partner communicates support, seems to increase skeptical action. The costlier intervention of having the audit committee chair communicate directly with the engagement team does not seem to do a better job.

Regulation, Standard Setting, and Audit Firm Quality Control

Our research results offer practical recommendations to standard setters, audit practitioners, and those charged with governance at client firms. First, audit partners should consider communicating the audit committee's support to the engagement team, which could be a fairly costless and simple intervention, with excellent potential to enhance auditor professional skepticism, and thus leading to improved audit quality. From a regulatory perspective, our findings may assist international and national standard-setting in providing

guidance on standards intended to enhance professional skepticism. More specifically, our work may suggest the need for additional guidance about the type of information the audit partner should be explicitly sharing with the engagement team. Relatedly, audit firms could consider these findings in designing quality controls around engagement team communications and partner responsibilities. In addition, although direct communications of support by the audit committee chair did not increase skepticism directly, those charged with governance could still learn from the best practices we note in ensuring they are providing the appropriate support for engagement teams so that partners can communicate such support. For example, our survey findings could be used to formulate recommendations toward audit committees which we find to improve auditor professional skepticism, such as increased availability for auditor concerns, sharing insights with the auditor, and standing with the auditor in case of auditor disagreement with client management.