Teaching and educational notes

A classroom example of the deleterious effects of auditor predictability

Eric E. Spires [a,*], C.J. Ward [b]

[a] Fisher College of Business, The Ohio State University, 2100 Neil Avenue, Columbus, OH 43210, USA
[b] Ernst & Young LLP, 155 N. Wacker Dr., Suite 2000, Chicago, IL 60606, USA

A R T I C L E   I N F O

A B S T R A C T

If an auditor employs the same testing strategy (e.g., type of evidence, sample size, scope, selection method) year after year, or otherwise inadvertently discloses information about the audit plan, the auditee can predict auditor behavior on the current audit. The instructional exercise described in this note illustrates the deleterious effects on audit effectiveness of this predictability. Numerical examples and student decisions are used to show that the probability that the auditor will detect intentional misstatements (fraud) may be reduced dramatically if the auditor does not recognize the strategic aspects of auditing.

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1. Introduction

Auditing can be viewed as a game against nature or as a strategic game. In the former, the auditor's "opponent" (e.g., a fraud perpetrator) is assumed not to act strategically. A gambling analogy would be playing roulette, where the probabilities of the outcomes are fixed and unaffected by the player's betting behavior. In auditing, the detection of unintentional misstatements (i.e., "errors") can be viewed as a game against nature. Much in the professional auditing literature (e.g., most standards, textbooks, the audit risk model, and "checklists" used on audits) is written from this frame of mind (Wilks & Zimbelman, 2004, 174).

In a strategic game, on the other hand, a fraud perpetrator is assumed to act strategically, anticipating and/or reacting to the auditor's behavior so as to minimize the probability of being discovered. A gambling analogy would be playing poker, where the opponent anticipates and reacts to the

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* Corresponding author. Tel.: +1 614 292 4422; fax: +1 614 292 2118.
  E-mail address: spires.1@osu.edu (E.E. Spires).

player's betting behavior and other information. In auditing, detection of intentional misstatements (i.e., "fraud") can be viewed as a strategic game. Parts of AU-C Section 240 (American Institute of Certified Public Accountants (AICPA), 2012) and some academic articles (e.g., Bloomfield, 1997; Fellingham & Newman, 1985; Shibano, 1990) take this view.

Several major frauds have been perpetrated in part because the auditor did not act strategically, either by acting predictably or by disclosing details of the audit plan. For example, management of HealthSouth could predict the auditor's scope decisions from past audits and was able to create fictitious transactions that were not detected (Frieswick, 2003). The auditors of Phar-Mor notified management months in advance of the four locations that inventory was to be observed, allowing management to overstate inventory at other locations (Wells, 2001).

In this classroom exercise, designed for use in financial statement auditing or fraud examination courses, students consider the effect on the probability of detecting fraud of treating an audit like a game against nature instead of a strategic game. The main message of the exercise is if the auditor does not consider that the fraudster acts strategically, the auditor may inadvertently provide the fraudster with information that can substantially reduce the probability of discovering the fraud. The exercise illustrates the value of acting strategically in auditing.

2. The exercise

Box 1 contains the exercise, in which the student acts as a fraudster who wishes to misstate inventory. The student decides, based on knowledge of the auditor's testing strategy derived from prior audits and assuming the auditor will employ the same testing strategy as in prior audits, which 20 inventory items in the population of 1000 items to misstate.

The auditor depicted in the exercise is not acting strategically. By having the auditee pull the sampled items, the auditor enables the fraudster to discern that the auditor always uses the same sample size and sampling plan. The fraudster acting strategically can use this knowledge against the auditor to reduce the probability of detection of the fraud. Wilks and Zimbelman (2004) indicate that predictability of audit plans can enable frauds to go undetected. Further, there is archival and empirical evidence that auditors often collect the same types of evidence from year to year (Bedard, 1989; Glover, Prawitt, Schultz, & Zimbelman, 2003; Mock & Turner, 2005). For example, Mock and Turner (2005) evaluate audit program changes for 202 clients from three large accounting firms and report that in the first (second) year following the passage of SAS No. 82, which required the auditor to explicitly consider fraud, the average client audit program contained 0.29 (0.57) changes in the nature, timing or extent of procedures. Given that there are likely hundreds of nature, timing, and extent decisions made on most audits, changes in less than one of these per year certainly enable auditees to at least partially predict auditor behavior. In addition, a Public Company Accounting Oversight Board release concludes that auditors have inappropriately responded to fraud risk factors by, among other things, not incorporating an element of unpredictability into the selection of auditing procedures to be performed (Public Company Accounting Oversight Board (PCAOB), 2007).

Before the student-fraudster can determine the best way to insert the misstatements, another strategic aspect comes into play – how is the auditor likely to react to a detected misstatement? If, in the past, the auditor has typically extended audit testing after detecting even a single misstatement in the sample, the fraudster might insert differently than if the auditor "passed as immaterial" a single detected misstatement. Again, the auditor's past behavior gives information to the fraudster that can be used against the auditor. Fellingham and Newman (1985) suggest that optimal audit plans in a game-theoretic world often involve randomized strategies; in the present case the auditor might sometimes extend testing and sometimes pass on investigating a detected misstatement, with the auditor's choice "random" in the sense that the fraudster cannot predict what the auditor will do. The student exercise is worded such that the fraudster believes that the auditor will extend testing if even a single misstatement is tested; thus, the detection of *any* misstatement should be avoided. Students are also asked to describe how their method of inserting the misstatements would differ under the assumption that the auditor will pass as immaterial a single detected misstatement in the sample.