



Do auditor judgment frameworks help in constraining aggressive reporting? Evidence under more precise and less precise accounting standards



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ABSTRACT

We experimentally investigate whether alternative judgment frameworks help Big 4 audit managers and partners constrain management's aggressive financial reporting under accounting standards that differ in their precision. We find that a framework based on the SEC's Advisory Committee on Improvements to Financial Reporting's (CIFIr's) recommendation that auditors critically evaluate the pros and cons of alternative accounting methods helps auditors constrain aggressive reporting under less precise standards. While our results highlight a limitation of counterfactual reasoning on its own at enhancing auditors' constraint of aggressive reporting, this study provides evidence on how structured thinking can overcome this limitation. In particular, we find that combining this consideration of the alternatives with a structured thought process that encourages auditors to think about the issue at increasing levels of abstraction effectively shifts auditors' focus away from client considerations and towards substance-over-form considerations, thereby incrementally enhancing auditors' constraint of aggressive reporting across different levels of accounting standard precision. These results should be of interest to academics, regulators, standard-setters, and auditors as they continue to contemplate ways to improve auditors' professional judgments under different levels of accounting standard precision.

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1. Introduction

Auditors are being called on to exercise substantially more professional judgment during the financial reporting process due in part to the global trend towards less precise accounting standards (e.g., the adoption of International Financial Reporting Standards (IFRS) in Australia and the UK in 2005; FASB, 2006, 2010, 2013). Recognizing this growing role of judgment in the financial reporting process, the Advisory Committee on Improvements to Financial

Reporting (CIFIr) recommended that the Public Company Accounting Oversight Board (PCAOB) “develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards” (CIFIr, 2008, p.93).¹ Although the PCAOB has not yet responded to CIFIr's recommendation, audit firms (e.g., Deloitte, 2009; KPMG, 2011) have developed their own judgment frameworks based on CIFIr's identification of key components underlying reasonable accounting judgments. Further, the Center for Audit Quality (CAQ) recently published a professional judgment resource that audit firms can use to enhance their professional judgment process (CAQ, 2014). This study examines how alternative specifications of these judgment frameworks affect auditors' constraint of management's aggressive financial reporting under accounting standards that differ in their level of precision.

Standard setters and regulators are concerned about the quality of auditors' professional judgments. Specifically, the Financial Accounting Standards Board (FASB) worries that auditors rely too heavily on rules and are reluctant to use sound professional

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¹ The Securities and Exchange Commission (SEC) formed the Advisory Committee on Improvements to Financial Reporting (CIFIr) to address concerns about the financial reporting process (CIFIr, 2008). The 17 member committee was comprised of highly experienced professionals and included five representatives of users of financial statements (credit rating agency, investors, securities attorney, etc.), four former regulators, three chief financial officers, two chief executive officers of audit firms, and three members of audit committees. CIFIr issued its final report on August 1, 2008.

judgment when faced with less precise guidance (FASB, 2004). Further, the PCAOB is concerned about the “lack of professional skepticism” as a contributing factor to the identified audit deficiencies in areas that require greater judgment (PCAOB, 2012, p. 5). Accounting literature supports these concerns. For example, Kadous, Kennedy, and Peecher (2003) find that auditors exploit the ambiguity in accounting standards to justify the client-preferred aggressive accounting method. However, more precise standards are not necessarily the solution as auditors tend to allow real earnings management through transaction structuring when the governing rules are precise and transaction structuring is consistent with the rules (Nelson, 2003; Nelson, Elliott, & Tarpley, 2002). Therefore, it is important to identify effective ways to improve the quality of auditors' judgments under both more and less precise accounting standards.

The CAQ advocates the use of a disciplined decision-making process to enhance auditors' professional judgment capabilities (CAQ, 2014). Judgment frameworks currently being used by the audit firms (e.g., Deloitte, 2009; KPMG, 2011) offer a way to encourage auditors to follow a rigorous, thoughtful, and deliberate judgment process when making critical professional judgments. However, effective professional judgments also require auditors to exercise sufficient professional skepticism (AU 230).² Consequently, we investigate how the completion of different judgment frameworks affects auditors' skepticism of managers' aggressive reporting under different levels of standard precision.

We conduct an experiment using a 2×4 factorial design to investigate these issues. Two hundred and nineteen audit managers and partners from a Big 4 accounting firm participated in a case requiring them to audit management's lease classification decision. Given that the economics of the transaction should drive the lease classification decision, our setting is one where auditors stand to benefit from a well-reasoned judgment process that includes the consideration of alternatives and focuses auditors on the big picture economics rather than the transactional details.

Our first independent variable, accounting standard precision, is manipulated between participants. The more precise condition is based on FASB Accounting Standards Codification 840-10-25-1 and the less precise condition is based on International Accounting Standard (IAS) 17. Because less precise accounting standards provide more ambiguity for auditors to exploit and auditors may be less motivated to curb aggressive reporting under less precise standards, we argue that auditors are more likely to allow aggressive reporting under less precise accounting standards compared to more precise standards. Accordingly, we posit there is more opportunity for a judgment framework to significantly reduce aggressive reporting under less precise accounting standards compared to more precise accounting standards.

The second independent variable, judgment framework, is also varied between participants. Participants in the *no framework* condition are only required to consider the applicable authoritative guidance and serve as a control group. The second condition, the *pro/con framework*, requires auditors to consider the pros and cons of the non-client-preferred accounting method. CIFIIR highlights this type of counterfactual reasoning as a key component of well-reasoned professional judgments (CIFIIR, 2008). Counterfactual reasoning has been found to encourage the consideration of the non-client-preferred alternatives (Heiman, 1990; Koonce, 1992) and, thus, has the potential to enhance auditors' skepticism of managers' aggressive reporting. However, Trope and Liberman

(2010) suggest that auditors' goals regarding the event may limit the effectiveness of this type of reasoning. More specifically, auditors' directional goal to please the client (Blay, 2005; Hackenbrack & Nelson, 1996; Kadous et al., 2003) may cause auditors to focus on the ramifications of the accounting treatment for the client rather than the alignment of the economics of the transaction with the accounting principles. Therefore, we posit that auditors' skepticism may further benefit from a framework that shifts auditors focus away from client considerations to substance-over-form considerations. Relying on recent theory in psychology (Liberman & Trope, 1998; Trope & Liberman, 2003; Trope, Liberman, & Wakslak, 2007), we develop a modification to the *pro/con framework* to induce this shift in thinking. In particular, our third condition (the *pro/con why framework*) is a balanced framework that instructs auditors to think broadly about why the transaction should be accounted for in accordance with both the non-client-preferred accounting method and the client-preferred method at three different levels of abstraction. The final condition, the *pro why framework*, is a one-sided framework that goes one step further to distance auditors from the client's preference by requiring auditors to only consider a hierarchy of reasons why the transaction should be accounted for in accordance with the alternative accounting method.

Consistent with our predictions, we find that our judgment frameworks are more effective under less precise standards. In particular, the *pro/con framework* based on CIFIIR's recommendation to consider the “pros and cons for reasonable alternatives” (CIFIIR, 2008, pg. 95) effectively enhances auditors' skepticism of aggressive reporting under less precise standards, but not more precise standards. Our evidence further suggests that both the *pro/con why framework* and *pro why framework* lead to an even greater reduction in auditors' allowance of aggressive reporting under less precise standards. However, only the *pro why framework* curbs aggressive reporting under more precise accounting standards. Thus, our results suggest that structuring auditors' thinking in a way that shifts their focus from the client's preference to their consideration of the alternatives at a more conceptual level has the potential to incrementally enhance auditors' constraint of aggressive reporting across different levels of accounting standard precision.

Our study makes several contributions. First, auditors' failure to consistently exercise sufficient professional skepticism is concerning (PCAOB, 2010, 2012), prompting calls for research (Nelson, 2009; CAQ, 2012; Franzel, 2013; Hurr, Brown-Liburd, Earley, & Krishnamoorthy, 2013). Nelson (2009) specifically urges scholars to think about the underlying causes of these deficiencies and how to restructure audit tasks to enhance auditors' professional skepticism. Our study responds to this call. We posit and test how using three different judgment frameworks to restructure an audit task affects how auditors process information. Analyses of the completed frameworks indicate that all three of the proposed frameworks encourage abstract thinking. However, the majority of the big picture thoughts generated when using the *pro/con framework* center on the client ramifications (i.e., client-oriented thoughts), while the *pro/con why framework* and *pro why framework* encourage abstract thoughts that focus on how the economics of the transaction align with the underlying accounting principles (i.e., principles-oriented thoughts). By examining the cognitive impact of the different judgment frameworks, this study provides academics, practitioners, and regulators with important insight into why counterfactual reasoning and a structured thought process differentially enhance auditors' professional skepticism.

Second, although the PCAOB has yet to issue any judgment guidance, audit firms have relied on the key components to a well-reasoned accounting judgment identified in CIFIIR's final report to

² We define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence throughout the audit (PCAOB, 2012).

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