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The effect of an Audit Judgment Rule on audit committee members' professional skepticism: The case of accounting estimates

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ABSTRACT

Changes to the audit environment have led to suggested changes to the regulatory framework for evaluating auditors' judgments including the introduction of an Audit Judgment Rule (AJR), whereby courts and inspectors will not second-guess auditors' reasoned judgments provided they are made in good faith and in a rigorous manner. We examine the potential effect of the AJR on the skepticism of Audit Committee Members (ACMs) in terms of the extent to which they ask probing questions to external auditors, CFOs and Heads of Internal Audit concerning an accounting estimate. This level of professional skepticism is a critical element of the duties of an ACM in the oversight of the financial reporting and auditing processes, especially for complex and future orientated accounting estimates. Because an AJR would likely encourage adoption of innovative audit procedures, we further examine the effect of these procedures, as compared to standard procedures, on ACMs' skepticism given an AJR. Our findings show that an AJR increases ACMs' perceived accountability in ensuring the reasonableness of the financial statements, and that a movement towards more innovative audit procedures under an AJR framework increases ACMs' perceived overall comfort regarding the treatment of the accounting estimate. On average, these factors do not affect the overall level of ACMs' skepticism in terms of the number of questions asked or the extent to which the questions are probing. However, these results differ depending on the demographic background of the ACM participants.

Introduction

Internationally, regulatory inspectors have reported audit deficiencies with respect to the audit of estimates, and there have been calls for improved audit quality (ASIC, 2012; European Commission, 2010; FRC, 2013a; IFIAR, 2014; PCAOB, 2013). In turn, there is uncertainty about what is expected of an auditor given the complexity and future orientation of accounting estimates and the difficulty of inspectors concluding on the appropriateness of the auditors' judgments (Peecher, Solomon, & Trotman, 2013). In response to these and related issues, there have been suggestions for change to the regulatory framework (e.g., Peecher et al., 2013; Pozen, 2008). One such change is the introduction of an Audit Judgment Rule (AJR), which Peecher et al. (2013) suggest should be applied by regulators in evaluating auditors' professional judgments and motivating auditors to improve audit quality. This AJR is based on the Business Judgment Rule (BJR), which applies to directors in the USA, where directors cannot have their judgments second-guessed by courts and cannot be held responsible for related third party losses provided they act in good faith and in the best interests of the company (O'Connell and Boutros, 2002; Peecher et al., 2013). Under an AJR courts and inspectors would not second-guess auditors' judgments provided the auditor has used 'reasoned evaluation made in good faith and in a rigorous, thoughtful and deliberate manner'.

We conduct an experiment to examine the effect of the implementation of an AJR on the level of skepticism of Audit Committee Members (ACMs) as measured by their questioning behavior in overseeing the financial reporting and auditing process. Because one purpose of an AJR would be to discourage defensive auditing, and instead encourage a focus on audit effectiveness, we consider how a change to innovative (as compared to standard) audit procedures for those in the AJR treatment procedures further affects ACMs' level of skepticism. We chose ACMs because they have a fiduciary duty to shareholders and are accountable for effectively overseeing the financial reporting and audit process (CAQ, 2014, FEE, 2014, FRC, 2013b, Kang, 2014) by exercising professional skepticism and asking probing questions about the judgments and as-

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sumptions underlying management's significant estimates and auditors' judgments of those estimates (Beasley, Carcello, Hermanson, & Neal, 2009; Cohen, Gaynor, Krishnamoorthy, & Wright, 2007; IAASB, 2014; NACD, 2013).

Examining the potential effects of alternative regulatory frameworks such as the AJR is important given the suggestion that the existing framework for auditors is unlikely to motivate them to target high quality audits or invest in research and development activities aimed at improving long term audit quality (Peecher et al., 2013, p. 597). In addition, the adoption of an AJR is consistent with US Treasury recommendations (Pozen, 2008, p. 93) that both the SEC and the PCAOB should issue policy statements articulating how the reasonableness of accounting and auditing judgments be evaluated including factors to be considered when making this evaluation. An AJR would also make it more difficult for inspectors to second-guess auditors' judgments as long as the judgments were made using 'good faith and in a rigorous, thoughtful and deliberate manner'. We examine the AJR in a setting with accounting estimates given that such a judgment rule is most likely to apply in a setting involving subjective judgments. These accounting estimates are future orientated and are increasingly important to the financial statements (Griffith, Hammersley, & Kadous, 2014; IFIAR, 2014; Peecher et al., 2013; Treasury, 2008). The uncertainty inherent in estimates provides an opportunity for management bias as well as difficulties for auditors in assessing their reasonableness, resulting in potential quality implications for financial statements (Griffith, Hammersley, Kadous, & Young, 2015).

In our study we consider both the existing regulatory framework without an AJR, and another where an AJR is implemented. Under the existing framework, even if auditors' judgments are made in good faith, and irrespective of how reasonable the auditors' judgment process was, courts and regulatory inspectors can determine that alternative judgments should have been made. While there are many ways to operationalize an AJR framework, we chose one where under an AJR a reasonableness test is applied and even if an inspector develops an estimate that differs from an auditor's estimate, uses a different method to reach an estimate than used by the auditor, or believes that his/her own estimation process is superior to the auditor's process, the inspector still can conclude that the auditor's estimate is reasonable.

An additional characteristic of the audit environment is that the auditor faces uncertainty about what is expected of them because it is difficult to make a conclusion on the appropriateness of auditor judgments related to complex estimates that are future orientated. Inspectors have extensive authority to determine when auditor judgments are inappropriate, and deficient judgments have been documented by inspection agencies around the world (e.g., ASIC in Australia; FRC in the UK; PCAOB in the US). One consequence of this situation is the prevalence of "overly cautious audits or 'defensive' auditing" (Treasury, 2008, p. VII: 28),[1] which result in auditor accountabilities primarily related to auditors' judgment outcomes and penalties for not reaching a minimum threshold (Peecher et al., 2013). This leads to compliance-focused behaviors with auditors potentially operating at or close to the minimum required in order to avoid sanctions (Bell, Peecher, & Solomon, 2005; Peecher et al., 2013). As a result, innovative audit procedures are unlikely to be adopted for fear of second-guessing by inspectors, despite suggestions for the need for incentives for auditors "to go beyond the floor and compete on the basis of quality" (Palmrose, 2006). The adoption of an AJR would provide greater incentives for audit firms to adopt more innovative procedures (Peecher et al., 2013). Consequently, we restrict our examination of how the adoption of more innovative procedures would affect ACMs' skepticism regarding a significant estimate to the situation where an AJR is present. If an AJR is likely to encourage adoption of innovative procedures, an understanding of how ACMs will react to these procedures is important in order to gain a fuller understanding of the impact of the introduction of an AJR.

Our findings show that introducing an AJR increases ACMs' perceived accountability in ensuring the reasonableness of the financial statements. Further analysis shows that this is related to ACMs believing that accounting estimates become less conservative, and auditors' due diligence to be negatively impacted, with the introduction of an AJR. We also find that a move towards more innovative audit procedures under an AJR framework increases ACMs' perceived overall comfort regarding the accounting treatment at hand. This result appears to stem from ACMs believing innovative procedures lead to higher audit quality. Despite the greater accountability associated with the introduction of an AJR and more comfort with a move towards more innovative audit procedures, our findings show that this does not necessarily lead ACMs to become more skeptical and ask more probing questions when an AJR is introduced or ask less probing questions when innovative procedures are used. However, further analysis suggests a significant background effect where former audit partners show greater skepticism by questioning the external auditor more when an AJR is implemented than when it is absent, while other ACMs question the auditor less in the presence of an AJR. We also found that the types of questions asked vary with ACM background and, in particular, the questioning behavior of former audit partners is different to other ACMs.

Our paper makes four major contributions to the audit literature. First, there have been calls for changes to the regulatory framework for auditing including the need for a professional judgment framework (e.g., Pozen, 2008) such as an AJR as proposed by Peecher et al. (2013). By examining how audit committee skepticism in overseeing the financial reporting process is affected under an AJR, we answer the call for research on how the adoption of an AJR would affect the execution of ACMs' fiduciary duties (Peecher et al., 2013). Also, given ACMs work closely with auditors, examination of the questions asked and the judgments made by ACMs provides a 'window' to observe how ACMs expect auditors to react to the implementation of an AJR (see Nelson, Elliott, & Tarpley, 2002 for a similar approach).

Second, one of the major criticisms of the present audit regulatory framework is that it results in defensive auditing because of the likely negative consequence of moving to more innovative procedures (Bell et al., 2005; Peecher et al., 2013; Treasury, 2008). One of the proposed benefits of an AJR is the opportunity to reduce defensive auditing and encourage auditors to use more innovative audit techniques. We provide insight on how such a move towards more innovative audit procedures would affect financial reporting quality under an AJR by examining how it influences audit committee skepticism when overseeing the financial reporting process of accounting estimates. This question is important given statements in the professional literature that the way standards are applied "may be seen as an impediment to innovation" and the need for standard setters to ensure that audit standards do not inhibit innovation and developments in practice (FEE, 2014, p. 6).

Third, we contribute to the literature on accounting estimates. Previous research has suggested that estimates are one of the likely cited accounts for auditor errors (ASIC, 2012; Church & Shefchik, 2012; Griffith et al., 2015) with implications for financial report-

[1] There have been criticisms of second-guessing by inspection agencies (see Treasury, 2008). These views can be seen in the responses to PCAOB inspection reports. For example, "While we believe that the PCAOB should continue to challenge judgments and documentation during the inspection process, we do not believe that, in the end, reasonable judgments should be criticized and second-guessed (Grant Thornton, 2009)."