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Commentary on "The effect of an audit judgment rule on audit committee members' professional skepticism: The case of accounting estimates" (Kang, Trotman, and Trotman)

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ABSTRACT

These discussant comments address the Kang, Trotman, and Trotman study on whether introducing an audit judgment rule – which is analogous to the business judgment rule applied to corporate officers and directors – and deploying innovative audit procedures affect audit committee members' questioning on accounting estimates. I believe that the authors have identified a very relevant and timely topic for analysis. In addition, the authors have done a good job motivating the importance of the topic given the increasingly regulated post-Sarbanes-Oxley environment. In these comments, I attempt to place the Kang, Trotman, and Trotman study into context and facilitate generation of research ideas by others. My comments are divided into three sections: introduction, the evolving roles and responsibilities of audit committees and independent auditors, and comments on research design and some directions for future research.

1. Introduction

The roles and responsibilities of independent auditors and audit committees have been evolving over the last two-and-a-half decades, owing in part to the changing economic and regulatory landscape that has shaped this period. First, the wave of corporate scandals in the 1990s provided impetus for new regulatory bodies and regulations that were built on the premise that public companies' stakeholders should understand and have confidence in the work of independent auditors and audit committees.[1] In addition, owing to the volatility of the global markets, business transactions have become increasingly complex, which has led to a growing use of judgments and complex accounting estimates for fair value measurements, asset impairments, and valuation allowances, among others (U.S. Department of the Treasury, 2008). This emphasis on judgments and accounting estimates in the financial reporting frameworks has led auditors' decisions to be increasingly informed by the use of risk-based audit methodologies. In turn, high-risk areas of audit engagements are increasingly being scrutinized by the Public Company Accounting Oversight Board's (PCAOB) inspections.

With the above institutional context as a backdrop, Kang, Trotman, and Trotman (current issue) (hereafter KTT) is based on the premise that auditors in general experience difficulty in auditing complex accounting estimates, thus suggesting that *audit quality* in this area may be compromised (Griffith, Hammersley, Kadous, & Young, 2015). KTT (current issue) reports the results of an experiment that is appropriately motivated by the need for evidence on the effects of (1) introducing (vs. not introducing) an audit judgment rule (AJR) and (2) deploying innovative (vs. standard) audit procedures on audit committee members' (ACM) professional skepticism regarding the reasonableness of a significant accounting estimate related to an inventory write-down. The study uses a $2 \times 1 + 1$ design: an AJR is introduced (vs. not introduced) when a standard audit procedure is deployed; and an innovative audit procedure is deployed when an AJR is introduced.

The AJR for auditors, suggested by Peecher, Solomon, and Trotman (2013), is analogous to the business judgment rule (BJR) applied to corporate officers and directors. The BJR is based on the premise that if in the course of management, officers and directors arrive at a decision that is within their and the corporation's authority, and for which there is a rational basis "*and they act in good*

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[1] For reviews of the extant accounting literature on auditor communications with the audit committee, see Cohen, Gaynor, Krishnamoorthy, and Wright (2007); on the expanded role of audit committee members, see DeZoort, Hermanson, Archambeault, and Reed (2002) and Vera-Muñoz (2005).

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faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be in the best interests of the corporation," then a court will not second-guess the judgment of the officers and/or directors; nor will a court "surcharge the directors and officers for any resulting loss" (O'Connell and Boutros, 2002, p. 385).

KTT (current issue) finds that, given a standard audit procedure is deployed, the ACM perceive greater accountability when an AJR is introduced (vs. not introduced). This is because the ACM believe that introducing an AJR causes the accounting estimate for an inventory write-down to be less conservative and the independent auditors' due diligence to be negatively impacted by the AJR (H1a). However, the ACM do not ask more questions to the auditors, the Chief Financial Officer (CFO), or the chief internal auditor when an AJR is introduced (H1b). KTT (current issue) also finds that the auditors' deployment of innovative (vs. standard) audit procedures when an AJR is introduced increases (albeit marginally) the ACM's perceived overall comfort with the financial statements, as they believe that audit quality is higher when an innovative audit procedure is deployed (H2a). However, given an AJR is introduced, the study finds no significant difference in the number of questions asked by the ACM to the external auditors, regardless of whether or not an innovative audit procedure is deployed (H2b), although the ACM's questions appear to have probative value.

This commentary proceeds as follows. First, I will put in context the importance of the research question addressed by KTT (current issue) by discussing briefly the evolving roles and responsibilities of both independent auditors and ACM in overseeing the integrity of the financial reporting process. Next, I will comment on some aspects of the research design used by KTT (current issue), and will offer some directions and broad questions for future research. My discussion is guided by Fig. 1.

2. The evolving roles and responsibilities of audit committees and independent auditors

As shown in Fig. 1, several issues related to legal/regulatory compliance, coupled with environmental factors have influenced the evolving roles and responsibilities of both the audit committees and independent auditors over the last two-and-a-half decades.[2] Multiple regulators, including the Securities and Exchange Commission (SEC), the PCAOB, and the various exchanges have oversight over both audit committees and independent auditors. The Sarbanes–Oxley Act of 2002 (SOX) enacted by the SEC formally charged audit committees with "overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer" (SOX, Section 2, Definitions, Number [3][A], U.S. House of Representatives, 2002) and established the PCAOB. Although the PCAOB has no regulatory authority over audit committees, the consequences of the Board's inspections, auditing standards, and other initiatives potentially impact the incentives of independent auditors and audit committees, as well as the incentives of the issuers and their financial reporting process (Abernathy et al., 2013; Church & Shefchik, 2012; DeFond, 2010; Palmrose, 2013).

At the same time, the increasing emphasis on judgments and *estimates* in the financial reporting frameworks and the use of risk-based audit methodologies have led the PCAOB to increase their focus on the communications between auditors and audit committees. In particular, in 2012 the PCAOB issued Auditing Standard No. 16 (*AS 16*), "Communications with Audit Committees" (AS No. 16, PCAOB, 2012). *AS 16* is intended to increase existing auditor communication requirements by requiring the auditor to communicate with audit committees certain matters regarding the company's accounting policies, practices, and estimates, including: a description of the process and significant assumptions management used to develop critical accounting estimates that have a high degree of subjectivity, any significant changes management made to the processes or assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements (AS No. 16, PCAOB, 2012, p. A1–7, A1–8). These enhanced communications between the auditors and ACM highlight the importance of ACM's ability to exercise professional skepticism when inquiring about management's assertions related to accounting estimates.

3. KTT (current issue) research design and some directions for future research

3.1. Innovative audit procedures

As mentioned earlier, KTT (current issue) examines the effects of deploying innovative (vs. standard) audit procedures on ACM's professional skepticism when an AJR is introduced. They find that using more innovative audit procedures marginally increases ACM's perceived overall comfort with the financial statements, but find no association between auditors' use of innovative audit procedures and ACM's professional skepticism. These results may be explained by construct validity issues in the operationalization of the audit procedures variable, which raises some concerns regarding the interpretation of the results. In particular, the narrative in the *standard* procedures condition indicates that the audit engagement partner "notes that the audit inspectors expect standard procedures, and that standard procedures are helpful in reducing their criticism of the audit." In contrast, the narrative in the *innovative* procedures condition indicates that the audit engagement partner "notes that innovative audit procedures are helpful in adding a surprise element to the more predictable standard audit procedures."

An unintended consequence of these two different narratives is that the manipulation may have unintentionally introduced between-condition differences in the engagement partner's objective: to attenuate inspectors' criticism of the audit (i.e., "defensive auditing") in the standard audit procedures condition, versus to increase audit effectiveness in the innovative audit procedures condition. To the extent that these different narratives may have caused different perceptions of the engagement partner's objective in the ACM's minds, and/or to the extent that the objectives of the participating ACM were aligned or misaligned with their perceptions of the engagement partner's objectives, this confounding factor makes it difficult to disentangle whether the results are due to the audit procedures manipulation itself, or to the effects of unintentionally introducing differences in the engagement partner's objective.

A second concern regarding the audit procedures manipulation relates to the fact that the narrative in the *standard* procedures condition gives examples of tests that rely exclusively on internal data. In contrast, the narrative in the *innovative* procedures condition gives examples of tests that rely on both internal and external data. Similar to the concern mentioned above, this potentially confounding factor makes it difficult to disentangle whether the results are due to the intended manipulation itself, or to the participating ACM's preferences for internal data vs. both internal and external data.

Notwithstanding the above construct validity concerns, KTT (current issue) provides preliminary evidence of an association between auditors' deployment of innovative audit procedures, given an AJR is introduced, and ACM's perceptions of overall comfort with the financial statements. More research is needed to provide empirical evidence on whether there is an association between deployment of innovative audit procedures and ACM's professional

[2] For a review of PCAOB research, see Abernathy, Barnes, and Stefaniak (2013).