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## An Examination Of Issues Related To Professional Skepticism In Auditing

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AN EXAMINATION OF ISSUES RELATED TO PROFESSIONAL SKEPTICISM IN  
AUDITING

by

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M.S.A. University of Central Florida, 2007  
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A dissertation submitted in partial fulfillment of the requirements  
for the degree of Doctor of Philosophy  
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## ABSTRACT

The third general standard of fieldwork requires auditors to maintain a skeptical mindset with regards to the collection and critical assessment of audit evidence. While professional skepticism is frequently referenced by professional standards, a lack of precision in defining the concept presumably leads to variation in how skepticism is exercised in practice. Drawing on theories from the fields of psychology, economics and organizational justice, this dissertation considers different perspectives of what constitutes sufficient professional skepticism and examines how those perspectives differ between audit practitioners and regulators.

First, I consider competing perspectives of professional skepticism – *neutral* versus *presumptive doubt* – and whether asking auditors to adopt alternative perspectives of skepticism may have implications for audit efficiency and effectiveness. While, too little skepticism may endanger audit effectiveness and lead to audit failure or enforcement action, too much skepticism may arguably lead to unnecessary costs and inefficiency.

Second, I consider whether the nature of the auditor-client relationship threatens an auditor's ability to maintain an attitude of professional skepticism. For example, theoretical perspectives from the fields of psychology and economics suggest that auditors may, consciously or unconsciously, be less skeptical of clients with whom they have developed close, positive working relationships or financial dependencies. More specifically, I consider whether skeptical behavior is impeded by management who display low-risk attitudes towards fraud or by client's who are considered to be highly important to the profitability of the local office.

Finally, I examine how professional skepticism is defined from a regulator's perspective. When a public company is accused of fraudulent financial reporting, regulators may determine

that the audit performed on the fraudulent financial statements was deficient. Prior research has suggested that in such cases, insufficient skepticism is often a leading cause of alleged audit failure. Within a fairness theory framework, this study examines enforcement actions against auditors between 1999 and 2009, and identifies certain factors that are associated with a citation for a lack of professional skepticism. Overall, results suggest that regulators approach the issue by determining whether auditors *should* have been more skeptical. Factors found to affect this determination include whether the auditor was perceived as having been aware of an elevated risk of fraud or whether the client was accused of having provided the auditor with false or misleading information during the course of their investigation.

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## INTRODUCTION

Maintaining an attitude of skepticism has long been recognized in the auditing profession as a requisite ingredient in exercising due professional care, as mandated by SAS No. 1, Due Professional Care in the Performance of Work (AICPA, 1972). The concept of professional skepticism is pervasive throughout auditing standards, which invoke skepticism as a necessary component of planning and performing the audit (SAS No. 109), reviewing confirmations (SAS No. 67), evaluating management estimates (SAS No. 57), and considering the risk of fraudulent financial reporting (SAS No. 99). Regulators have further highlighted the role of skepticism in maintaining auditor objectivity and independence (PCAOB, 2007; CAQ 2011) and have regarded “the application of an appropriate degree of professional skepticism as a crucial skill for auditors (APB, 2010).” Thus, understanding how skepticism influences auditor conduct in practice is an important issue to both practitioners and regulators. This dissertation examines some of the issues and challenges that the auditing profession is currently facing with regards to professional skepticism in theory and in practice.

First of all, as a profession, there is a need for consensus regarding how skepticism should be defined. Currently, competing perspectives of skepticism can be found in both the academic literature and auditing standards (Nelson, 2009). As long as there is disagreement regarding what constitutes skeptical behavior and how much skepticism is considered to be sufficient, audit education and training is impeded. The primary issue in this disagreement involves the initial mindset of the auditor, particularly towards management as a source of information. Some argue that the duty of the auditor is to remain objective and neutral

throughout the entire audit (Hurt, 2010) while others argue that an auditor's mindset should be characterized by doubt and distrust from the onset of an engagement (Nelson, 2009).

Although the difference between perspectives may seem nuanced, adopting one perspective over the other may have significant implications for how auditors plan and conduct their investigations and how audit evidence is evaluated. There is some evidence to suggest that adopting a neutral perspective of skepticism results in greater susceptibility to bias in favor of the client (Bazerman, Morgan and Lowenstein, 1997). On the other hand, adopting a presumptive doubt perspective may result in excessive skepticism and inefficiency (Shaub and Lawrence, 2002; Bell, Peecher and Thomas, 2005; Nelson, 2009). Thus, future research is needed to examine how auditor judgment and decision making is affected by the way professional skepticism is defined by audit standards. More specifically, it is important to understand whether the auditor's initial skeptical mindset affects the delicate balance between efficiency and effectiveness, a crucial element of every audit engagement.

A second issue involves the volatile nature of professional skepticism and the many factors in the audit environment that may threaten an auditor's ability to behave skeptically. The relationship between auditor and audit client is particularly challenging because, while important to audit quality, a positive relationship also creates incentives to compromise objectivity and skepticism. For example, when an auditor perceives client management to possess a low-risk attitude towards fraud (e.g. honesty, integrity, etc.) they may be unconsciously biased in favor of the client's position (Bazerman, Morgan and Lowenstein, 1997). A similar threat to skepticism exists when an audit client is very important to the profitability of the audit firm. For fear of

aggravating or losing an important client, the auditor may be less likely to behave in a skeptical manner.

Auditing standards require auditors to exercise skepticism during the entire audit, beginning in the planning stages and continuing through to completion. If skepticism is compromised during the planning phase of an audit, the auditor may not only be more likely to favor the client's position down the road, but may also be less sensitive to factors suggesting a high risk of fraud. Risk assessments performed during audit planning set the tone for the entire audit engagement. Therefore, it is important to understand how the auditor-client relationship impacts an auditor's ability to behave skeptically.

Finally, the lack of precision in defining the concept and the many threats to professional skepticism have understandably contributed to some confusion between practitioners and regulators regarding what constitutes skeptical behavior. Examination of enforcement actions, filed against auditors for their involvement in cases of alleged fraud, reveals that a lack of professional skepticism is frequently among the reasons given for the citation (Beasley, Carcello and Hermanson, 2001; SEC, 2003; Messier, Kozloski and Kochetova-Kozloski, 2010). However, audit firms have expressed concerns that accusations for a lack of skepticism may be unwarranted and have argued that the real issue is determining how to demonstrate that they have been sufficiently skeptical (APB, 2011). Thus, it is important to understand how regulators determine whether skepticism was insufficient. This information could prove useful to auditors when developing strategies to increase or more visibly demonstrate skepticism.

Overall, much work is needed to develop and foster professional skepticism in the auditing profession. To do so, skepticism must first be clearly and consistently defined. It is

important to also understand the implications of adopting one definition over another to audit efficiency and effectiveness. Behaviors that constitute professional skepticism should be clearly identified to improve consistent application and allow for the development of effective training programs. Furthermore, research must identify threats to professional skepticism and examine possibilities for mitigating or preventing those threats. Drawing on theories from the fields of psychology, economics and organizational justice, this dissertation considers different perspectives of what constitutes sufficient professional skepticism and how those perspectives might differ between audit practitioners and regulators.

The remainder of the document is organized as follows: Chapter 2 considers competing perspectives of professional skepticism – *neutral* versus *presumptive doubt* – and whether asking auditors to adopt alternative perspectives of skepticism may have implications for audit efficiency and effectiveness. Chapter 3 considers whether the nature of the auditor-client relationship threatens an auditor’s ability to maintain an attitude of professional skepticism. Chapter 4 examines how skeptical behavior is evaluated from a regulator’s perspective. Chapter 5 presents concluding remarks.

## **PROFESSIONAL SKEPTICISM DEFINED: NEUTRALITY OR PRESUMPTIVE DOUBT?**

*“If [an auditor] tends to question the evidence produced by the other ways of knowing until he has securely established its reliability, skepticism is useful; if he continues to doubt for the sake of doubting long after a reasonable man would be persuaded by the evidence at hand, skepticism has been permitted to get out of bounds.” Mautz and Sharaf (1961, p 97)*

### **Introduction**

While standards of due professional care define professional skepticism as “an attitude that includes a questioning mind and a critical assessment of audit evidence (AU 230.07),” there is some disagreement among regulators, practitioners and academics on how professional skepticism should be exercised in practice. Early auditing standards suggest a neutral approach to skepticism, while more recent standards seem to promote one of presumptive doubt. From a neutral perspective, the auditor “does not assume any bias ex ante” (Nelson, 2009, p 3) and can be thought to evaluate all evidence equally (Hogarth and Einhorn, 1992; Bamber, Ramsay and Tubbs, 1997). Conversely, a presumptive doubt perspective presumes some level of dishonesty from client management until sufficient evidence has been collected to suggest otherwise (Nelson, 2009).

While both perspectives have their strengths, adopting one perspective over the other may also have consequences for audit efficiency and effectiveness. The remainder of this paper is organized as follows: First, the differences between the two perspectives of professional skepticism are discussed. Next, the implications to audit efficiency and effectiveness, of adopting

one perspective over the other are considered. Finally, potential avenues for future research are suggested and concluding remarks are presented.

### **Perspectives of Professional Skepticism**

#### ***Neutral Perspective***

Authoritative standards have traditionally adopted a neutral perspective of professional skepticism. For instance, SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, 1972) emphasizes “objective evaluation of audit evidence (AU 230.07).” Therefore, a neutral auditor adopts an initial mindset towards audit evidence that is unbiased, either favorably or unfavorably. SAS No. 1 also notes that a skeptical auditor “neither assumes that management is dishonest nor assumes unquestioned honesty” (AU 230.07-09). Accordingly, this approach has been regarded as “symmetric” in nature (Nelson, 2009). Hurtt (2010, p 151) takes a neutral position by defining skepticism as “the propensity of an individual to defer concluding until the evidence provides sufficient support for one alternative/explanation over others.” Thus, a neutral auditor also displays a tendency towards a “suspension of judgment” (Hurtt, 2010) by waiting to determine whether or not a misstatement exists until sufficient competent evidence has been collected.

#### ***Presumptive Doubt Perspective***

On the other hand, more recent standards relating to fraud appear to draw on the non-neutral, presumptive doubt perspective (Nelson, 2009). For instance, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, proposes that “the auditor should conduct the

engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity." International Standards on Auditing (ISA) also highlight a presumptive doubt approach, requiring the auditor to recognize the possibility of misstatement due to fraud, "notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance (ISA 240, Paragraph 12)." From this perspective, a skeptical auditor is more sensitive to the risk of misstatement and presumes some level of dishonesty or bias from management until sufficient evidence has been collected to suggest otherwise.

References to a presumptive doubt perspective of professional skepticism can also be found in the academic literature. For example, Nelson (2009, p 4) defines skepticism from the presumptive doubt perspective "as indicated by auditor judgments and decisions that reflect a heightened assessment of the risk that an assertion is incorrect, conditional on the information available to the auditor." Similarly, Hogarth and Einhorn (1992) and McMillan and White (1993) take a non-neutral approach, where skepticism is viewed as a heightened sensitivity to negative evidence or evidence that reduces the likelihood of audit failure, respectively.

### **Implications for Practice**

Achieving an optimal balance between efficiency and effectiveness is a vital component of the audit engagement and is directly impacted by the degree of professional skepticism exercised. In a discussion paper regarding professional skepticism, the Auditing Practices Board (APB) points out that "too little skepticism endangers audit effectiveness; too much risks



unnecessary cost (APB, 2010).” Based on a recent shift in standards favoring a more “presumptive doubt” or forensic-auditing mindset over a “neutral” approach (Bell, Peecher and Thomas, 2005; Nelson, 2009), audit firms and regulators should understand how favoring one perspective over the other might affect audit cost and quality.

To date, no research has examined how a presumptive doubt approach to professional skepticism might affect auditor behavior (Nelson, 2009). A link between a lack of professional skepticism and audit failure (Nelson, 2009), often due to an over-reliance on management explanations (Feroz, Park and Pastina, 1991; Campbell and Parker, 1992), raises concerns regarding the effectiveness of the neutral perspective. The presumptive doubt perspective, on the other hand, raises concerns for cost and efficiency if it results in the performance of excessive or unnecessary audit procedures.

### *Effectiveness*

As discussed previously, the neutral perspective of skepticism emphasizes a symmetric approach, particularly with regards to beliefs about the honesty and integrity of management. Yet, analysis of audit enforcement actions suggests that auditors are often cited for a lack of professional skepticism due to an over-reliance on the representations of management (Feroz, Park and Pastina, 1991; Campbell and Parker, 1992). To address this issue, auditing standards specifically caution that management explanations “should ordinarily be corroborated with other audit evidence (AU 329.21).” But prior research also finds that auditors often do not confirm management explanations for unexpected differences (Hirst and Koonce, 1996; Trompeter and Wright, 2010). Moreover, a failure to corroborate management representations has been

specifically referenced in the academic literature as a prime example of non-skeptical behavior (Peecher, 1996; Turner, 2001).

One explanation for a tendency to impulsively accept management explanations is offered by Bayes' Theorem, which asserts that the inferential value of information is in part, a function of the reliability of its source (Bamber, 1983; Hirst, 1994). Consistent with this prediction, Caster and Pincus (1996) demonstrate that whether management is perceived as a reliable source of information (e.g. competent, objective and trustworthy) affects the persuasiveness of audit evidence. Kizirian et al. (2005) propose that when management is considered less credible, the auditor will either obtain more evidence to offset the credibility deficiency or require evidence from a more reliable source. As a result, for any given piece of information, an auditor's initial mindset towards management as a credible source of information may have implications for audit effectiveness.

Extensive research has examined the effects of initial hypothesis frame on auditors' subsequent judgments and decisions. These studies primarily examine auditor's evidence evaluation and belief adjustments relative to an initial position that a material error exists in the client's financial statements or not. Overall, results indicate that auditors tend to exhibit confirmation proneness or an increased sensitivity to evidence confirming their initial hypothesis (e.g., Waller and Felix, 1984; Church, 1990; Smith and Kida, 1991; Bamber, Ramsay and Tubbs, 1997; Beeler and Hunton, 2002). Trompeter and Wright (2010) also find evidence suggesting that auditors employ a confirmatory strategy when evaluating client-provided explanations. Thus, confirmation bias theory suggests that initial beliefs about the credibility of management may impair objectivity and reduce audit effectiveness. For example, if an auditor believes that

the client is a reliable source of information they may be less skeptical of management representations, in favor of their initial hypothesis, rather than obtain corroborating evidence or search for evidence that refutes the client explanation. Thus, the symmetric approach required by the neutral perspective may be impeded by unconscious, psychological biases which threaten audit effectiveness.

### *Efficiency*

A presumptive doubt perspective of professional skepticism could mitigate these concerns due to added emphasis on suspicion towards management as a credible source of information. Because the presumptive doubt perspective of skepticism is characterized by asymmetric doubt regarding management as a reliable source of audit evidence (Nelson, 2009), auditors asked to adopt this perspective may be less susceptible to confirmation bias. However, an asymmetric approach could raise the bar for the amount of evidence necessary to support an unqualified audit opinion (Bell, Peecher and Thomas, 2005) and may result in an inefficient and/or an overly expensive audit (Shaub and Lawrence, 2002; Nelson, 2009).

Under a presumptive doubt approach, auditors are expected to be more skeptical of evidence that an assertion is true (Nelson, 2009). Bell, Peecher and Thomas (2005) points out that this approach is likely to raise the minimum levels of evidence required to support an unqualified opinion. Nelson (2009, p. 4) further acknowledges that “under this definition, high professional skepticism may not result in an audit that has an optimal balance of effectiveness and efficiency.” Consequently, requiring auditors to adopt a presumptive doubt perspective could lead to inefficiencies if they are overly skeptical of evidence that an error does not exist,

particularly if the evidence is of sufficient strength to afford confidence that an error does not exist.

### **Avenues for Future Research**

As noted previously, prior research has documented the susceptibility of auditors to confirmation bias when evaluating audit evidence, due to the tendency to favor an initial hypothesis frame (e.g., Waller and Felix, 1984; Church, 1990; Smith and Kida, 1991; Bamber, Ramsay and Tubbs, 1997; Beeler and Hunton, 2002). Adopting a presumptive doubt perspective of skepticism has been suggested as a possible solution to this problem, by asking auditors to presume doubt as their initial hypothesis frame. However, to date, no research has examined the implications of asking auditors to adopt a presumptive doubt over a neutral perspective. Thus, the following research question is proposed:

**RQ1: Does asking auditors to adopt a presumptive doubt perspective, over a neutral perspective, of professional skepticism reduce their susceptibility to bias?**

In order to achieve an optimal balance between audit efficiency and effectiveness, the auditor must exercise skepticism until sufficient, persuasive evidence is acquired to support audit assertions. Spires (1991) identifies verifiability as an underlying construct of audit evidence which contributes to its strength or persuasiveness. Similarly, Mautz and Sharaf (1961) maintain that “verification is the vehicle that carries one to a position of confidence about any given proposition.”

Verifiability has been defined in the literature as the “attribute of information which allows qualified individuals working independently of one another to develop essentially similar measures or conclusions from an examination of the same evidence, data or records (Power, 1996, p. 289).” Furthermore, Hirst (1994) notes that evidence verifiability decreases with the degree to which reported evidence is subjective and judgmental and increases with the degree of objectivity. Evidence which has readily available supporting documentation is likely to produce the same decision outcome upon review by multiple parties. Hirst (1994) argues that because such evidence can be confirmed with relative ease, it is also more likely to be honestly reported. Evidence which involves significant judgment however, presents a greater potential for bias or misrepresentation (Peters, Lewis and Dhar, 1989). A failure to exercise an appropriate level of professional skepticism when evidence lacks sufficient strength to rule out misstatement represents a potential threat to audit effectiveness. Consequently, skepticism should increase as evidence becomes more difficult to verify.

On the other hand, Mautz and Sharaf (1961, p 97) maintain that a skeptical auditor “should be hard to convince, but not impossible.” While a more aggressive position towards skepticism might improve effectiveness in detecting misstatements or fraud, too much skepticism can be inefficient, costly, and potentially damaging to the auditor-client relationship (APB, 2010). Auditing standards require sufficient, competent evidence to support audit assertions. Once such evidence has been collected, continued skepticism would be inefficient. For example, Shaub and Lawrence (2002) describe an overly “aggressive skeptic” as being constantly suspicious, even when evidence indicates a low-risk of material misstatement.

Figure 1 depicts the potential imbalance of efficiency and effectiveness based on the perspective of skepticism and the verifiability of evidence. Depending on the perspective adopted, the degree of skepticism varies as evidence becomes more verifiable. At low levels of verifiability, audit effectiveness may be threatened by a tendency for auditor's to exhibit confirmation bias (e.g., an overreliance on the representations of management). Alternatively, audit efficiency may be threatened if auditors exhibit an elevated degree of skepticism despite strong evidence. Consequently, requiring auditors to adopt a presumptive doubt perspective could lead to inefficiencies if they are overly skeptical of evidence that an error does not exist, particularly if the evidence is of sufficient strength to afford confidence that an error does not exist. Thus, the following research question is proposed:

**RQ2: Does adopting a presumptive doubt approach of professional skepticism lead to unnecessary evidence collection?**

### **Discussion and Conclusion**

Disagreement regarding how to define professional skepticism raises several concerns for the auditing profession. First, standard setters need to determine exactly how they expect auditors to exercise skepticism in practice. If those expectations differ depending on the evidence being evaluated or the level of fraud risk involved, auditing standards should clearly and consistently explain these differences. Second, audit firms need to be informed about the expectations surrounding professional skepticism so that they may conduct audits that are consistent with regulatory expectations and develop training programs to foster and develop

skeptical behavior. Finally, adopting a neutral or a presumptive doubt perspective of professional skepticism can have serious implications for the efficiency and effectiveness of the audit engagement.

Prior research has demonstrated that auditors tend to be susceptible to confirmation bias in favor of their initial hypothesis. While the neutral perspective asks auditors to cast aside any beliefs regarding the honesty of management (SAS No. 1), they may inadvertently be more susceptible to bias in favor of a perceived reliable client. Consequently, neutral auditors may be more likely to rely on management representations rather than collecting sufficient, competent evidence to support assertions. A presumptive doubt auditor however, may be more skeptical to a fault. Presuming doubt may reduce susceptibility to client-favoring bias, yet result in the performance of unnecessary audit procedures. Therefore, future research is needed to determine the implications of adopting one perspective over the other.

# PROFESSIONAL SKEPTICISM IN PRACTICE: INCENTIVES TO BEHAVE LESS SKEPTICALLY

## Introduction

In a recent review of the auditing literature regarding professional skepticism, Nelson (2009) presents a model of skepticism (hereafter, the “Nelson Model”) whereby auditors’ skeptical judgments are a function of 1) evidential input, consisting of as little as background information about the client or as much as all evidence collected during the audit; 2) incentives to increase or reduce skepticism; 3) traits, including problem-solving ability, moral reasoning and trait skepticism, 4) knowledge and 5) experience. Whether skeptical action, such as modification of audit procedures, transpires as a result of skeptical judgments depends on both the level of skepticism an auditor exhibits in his or her judgments and the last 4 of the 5 determinants listed above. Nelson (2009, p 4) defines professional skepticism as follows:

*“A skeptic is one whose behavior indicates relatively more doubt about the validity of some assertion. More specifically, I define [skepticism] as indicated by auditor judgments and decisions that reflect a heightened assessment of the risk that an assertion is incorrect, conditional on the information available to the auditor. Under this definition, an auditor who has high [skepticism] needs relatively more convincing (in the form of a more persuasive set of evidence) before concluding that an assertion is correct.”*

In an initial test of the Nelson Model, Carpenter and Reimers (2009) find that when presented with either evidence indicating fraud or incentives emphasizing skepticism auditors made more skeptical judgments, but only when both conditions were present did they modify audit procedures. Although these results provide support for the Nelson Model by identifying elements which positively impact professional skepticism, attempts to improve skeptical behavior could be thwarted or offset by incentives to compromise objectivity. Nelson (2009, p



11), notes that “offsetting incentives to reduce professional skepticism also exist.” Furthermore, prior research suggests that auditors may be inherently more or less skeptical by nature, defining skepticism as a “multi-dimensional individual characteristic (Hurt, 2010, p 150).” Thus, research is needed to examine incentives which might threaten or reduce skeptical judgment. Examination is also needed to determine whether individuals with varying levels of inherent, or trait skepticism are more or less susceptible to such incentives.

The remainder of this paper is organized as follows: First, incentives which may threaten an auditor’s ability to behave skeptically are considered. Next, research pertaining to trait professional skepticism is discussed. Finally, potential avenues for future research are suggested and concluding remarks are presented.

### **Threats to Professional Skepticism**

While practitioners contend that a well-designed audit protects them from bias (Rennie, Kopp and Lemon, 2010), critics have argued that auditors are unconsciously less skeptical of clients with whom they have developed close working relationships or financial dependencies (Bazerman, Morgan and Lowenstein, 1997). Accordingly, auditing standards pertaining to professional skepticism and fraud (e.g., SAS No. 1 and No. 99) clearly state that auditors should disregard attitudinal factors that suggest low risk (e.g., honesty and integrity) when determining the sufficiency of audit evidence and the risk of misstatement due to fraud. However, Attribution Theory (Heider, 1944; Kelley and Michela, 1980) suggests that setting aside such beliefs may be difficult due to the tendency for dispositional characteristics to be heavily weighted when considering the likelihood that an individual will engage in a particular behavior (Ybarra and

Stephan, 1999). In other words, when assessing the likelihood that management will engage in fraudulent financial reporting, auditors may have trouble disregarding a perception that management possesses low-risk attitudes towards fraud. Furthermore, a high ratio of audit fees to firm revenue, for a particular audit client, also represents an incentive for auditors to behave less skeptically due to fiscal reliance on certain key clients (DeAngelo, 1981).

### ***Attribution of Management Attitudes***

The basic tenets of Attribution Theory (Heider, 1944; Kelley, 1973) hold that when attempting to explain another person's behavior, individuals either attribute cause to the person (internal, or dispositional characteristics) or to the situation (external, or environmental characteristics). This distinction is regarded as a product of certain antecedents to attribution, whereby information about the behavior, beliefs about the actor or the situation, and motivation influence an individual's inference of cause (Kelley and Michela, 1980). Furthermore, whether the perceived cause of a particular behavior is attributed to the actor or the situation also has consequences for how the actor is perceived going forward. If a behavior is attributed to the actor's dispositional characteristics it may also affect such things as likability, trustworthiness or persuasiveness (Kelley and Michela, 1980).

Attributions for past behaviors have also been found to drive expectations of future behavior (Reeder, Henderson and Sullivan, 1982; Ybarra and Stephan, 1999). Accordingly, dispositional attributions, such as assessments of character, are often perceived to have behavioral manifestations – a phenomenon generally known as trait attribution (Ross and Nisbett, 2010). While trait attribution is largely regarded by social psychology as inaccurate in predicting actual behavior, the reality remains that dispositional characteristics are commonly

referred to when developing expectations of how another person will behave (Ross and Nisbett, 2010). For example, a person believed to be of good character would be expected to behave ethically, despite situational pressures to behave otherwise, while moral behavior would rarely be expected from a person of bad character (Ross and Nisbett, 2010)<sup>1</sup>.

### ***Client Importance and Dependence***

Consistent with the economic theory of dependence (DeAngelo, 1981), when audit and non-audit fees from a single audit engagement are considerable, relative to overall firm revenue, a significant incentive exists for auditors to compromise their independence. With the ability to terminate the relationship at any time, clients are in a unique position to affect auditor judgment. Consequently, auditors may be motivated to report favorably in order to ensure retention of a valuable client. While, at the firm level, large numbers of audit clients may offset incentives to cheat, when individual partners, offices or other firm units derive substantial revenues from a single client, the implications to independence are considerable (Wallman, 1996; Reynolds and Francis, 2001).

Extensive research has examined the relationship between economic dependence and various measures of independence with mixed results. Archival research considering reporting outcomes and accrual activity has generally concluded that client importance and fee dependence do not jeopardize independence. For example, Reynolds and Francis (2001) find that auditors do

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<sup>1</sup> Ybarra and Stephan (1999) note that an additional distinction in the attribution literature relates to the attributions that result from either positive or negative behaviors. Results of multiple experiments indicate that when individuals perceive another person to be motivated by dispositional factors (e.g. wants or needs), they will be more likely to expect the actor to engage in negative behavior than when the actor is motivated by situational factors. However, the focus of this study is the distinction between positive and negative dispositional factors (e.g. honesty vs. dishonesty) rather than positive and negative behavior.

not treat larger clients with favoritism with respect to accruals or going concern reports. Similarly, studies investigating an auditor's propensity to issue a qualified opinion have concluded that higher levels of fee dependence are not associated with a decreased likelihood of qualification (Craswell et al., 2002; Li, 2009) or with abnormal accruals (Chung and Kallapur, 2003).

On the other hand, experimental research reveals that economic dependence on important audit clients significantly influences auditor judgment as well as perceptions of independence. Trompeter (1994) addresses the issue of fee dependence by examining the effects of compensation schemes which emphasize profitability and client retention. Findings indicate that audit partners whose compensation is closely tied to client retention are more likely to be influenced by client preferences and less likely to require adjustments which lower income. This relationship was particularly strong when partners were from firms with small profit pools. One explanation for auditor bias in favor of important clients is offered by Beeler and Hunton (2002) who posit that contingent economic rents can lead to bias via the cognitive process of predecisional distortion of information. They find that when auditors develop an initial preference for client retention in order to secure future earnings, they exhibit a tendency to evaluate evidence in a distorted way. This distortion was found to affect auditor judgments regarding going concern and budget hour revisions in a manner favoring the client.

Other academic research has shown that the size of audit fees pertaining to a single client also affects third-party perceptions of auditors' ability to resist management pressure (Gul, 1991) and are perceived by investors as a threat to auditor independence (Khurana and Raman, 2006). Accordingly, Nelson (2009) suggests that pressure to keep audit fees low or to maintain office

profitability creates incentives which offset the likelihood that an auditor will behave skeptically. Previous research has not yet examined the effects of client importance on skeptical behavior.

### **Trait Professional Skepticism**

Professional skepticism has been defined in the literature from several different perspectives. While “neutral” versus “presumptive doubt” refer to alternative degrees of skepticism with which the auditor initially approaches an engagement, Hurtt (2010, p 150) notes that “professional skepticism is a multi-dimensional individual characteristic ... [and] can be both a trait (a relatively stable, enduring aspect of an individual) and also a state (a temporary condition aroused by situational variables.” Moreover, Hurtt (2010) develops a scale (hereafter referred to as the “Hurtt Scale”) which measures an individual’s inherent skepticism based on six characteristics – suspension of judgment, questioning mind, search for knowledge, interpersonal understanding, autonomy, and self-esteem.

The first three characteristics of the Hurtt Scale pertain to the process of evidence evaluation. For example, a questioning mind refers to the extent to which the auditor seeks clarification or corroboration of audit evidence. Next, suspension of judgment refers to the tendency to withhold judgment until evidence has been sufficiently clarified or corroborated. Consistent with the requirement for due professional care (SAS No. 1), a skeptical auditor is expected to continue to gather and objectively evaluate audit evidence until it is considered to be sufficiently persuasive to afford judgment. However, a skeptical auditor does not just question audit evidence because of doubt, but for the sake of knowing and understanding. Thus, a search for knowledge refers to a general attitude of curiosity. Complementary to the first three

characteristics, interpersonal understanding relates to evaluating the source of evidence – their motivation, honesty and integrity. Finally, the characteristics of autonomy and self-esteem deal with the ability of the auditor to respond appropriately to collected evidence. For example, recognizing that audit evidence indicates a higher risk of fraud is not effective if the auditor does not appropriately modify planned audit procedures to address the increased risk.

### **Avenues for Future Research**

When assessing the risk of fraudulent financial reporting, Statement on Auditing Standards (SAS) No. 99, Consideration of Fraud in a Financial Statement Audit (AICPA, 2002) requires auditors to consider the presence of risk factors pertaining to the three components of the fraud triangle – including, “incentives/pressures to perpetrate fraud, opportunities to carry out the fraud and attitudes/rationalizations to justify a fraudulent action (AU 316.31).” While risks related to pressures and opportunities can for the most part be objectively assessed, “observing that individuals have the requisite attitude to commit fraud ... is difficult at best (AU 316.35).” This is primarily due to the possibility that management will attempt to cover up a fraudulent scheme by misrepresenting themselves to the auditors. Consequently, SAS No. 99 argues that attitude factors alone do not constitute sufficient evidence to conclude that fraud is unlikely and recommends that auditors disregard dispositional characteristics which suggest a low risk of fraud (e.g. honesty, integrity, etc.). The concern is that when management is perceived as having a low-risk attitude towards fraud, auditors’ will be less skeptical of the possibility that the financial statements are misstated due to fraud. Wilks and Zimbelman (2004, p 723) warn that

when presented with low-risk attitude cues auditors “may overlook high levels of opportunity and incentive cues that suggest fraud.”

The tendency of individuals to make less extreme (i.e. less skeptical) decisions in the presence of irrelevant information is referred to as the dilution effect (Nisbett et al., 1981). In other words, a dilution effect exists if irrelevant information reduces an auditor’s sensitivity to other relevant factors in the audit environment. Although research on the dilution effect in an accounting setting is limited, Hackenbrack (1992) and Hoffman and Patton (1997) find evidence that auditors’ fraud risk assessments are lower (i.e. diluted) when other factors in the audit environment, which should be irrelevant to the assessment, indicate low-risk. With regards to fraud risk, auditors are directed to consider low-risk management attitudes towards fraud to be irrelevant information which can threaten their ability to behave skeptically and result in diluted fraud risk assessments. Thus, the following research question is proposed:

**RQ1: Are auditors’ fraud risk assessments diluted when the client displays characteristics consistent with low fraud risk (e.g. honesty and integrity)?**

Consistent with the postulates of economic dependence, it is expected that, when a client is especially important to the profitability of the audit firm and local office, auditors may make decisions which favor client retention over skepticism. Consequently, auditors may exhibit decreased sensitivity to high risk factors (e.g. pressures and opportunities), resulting in diluted fraud risk assessments. Furthermore, because both low-risk management attitudes and high client

importance are expected to result in auditor bias, the dilution effect may be stronger when both conditions are present. Thus the following research questions are proposed:

**RQ2: Are auditors' fraud risk assessments diluted when the client is of high importance to the profitability of their local office?**

**RQ3: Are the dilutive effects of low-risk management attitudes and client importance additive?**

Hurt, Eining and Plumlee (2008) find that auditors scoring higher on the professional skepticism scale behave differently than those who score low on the scale. More specifically, they find that more inherently skeptical auditors tend to engage in more skeptical behavior when it comes to the assessment of audit evidence and generation of alternative explanations.

However, research has not yet examined whether susceptibility to bias fluctuates with levels of trait skepticism. Thus, the following research question is proposed:

**RQ4: Are auditors less sensitive to low-risk management attitudes and high client importance when trait skepticism is high?**

### **Discussion and Conclusion**

This paper postulates whether factors pertaining to personal (e.g. management attitudes towards fraud) and economic (e.g. client importance) aspects of the auditor-client relationship may be detrimental to an auditor's ability to exercise professional skepticism. Furthermore, the



role of trait professional skepticism in potentially mitigating auditor susceptibility to bias is discussed. While auditing standards address the need to disregard such information as irrelevant to fraud-related judgments, the basic postulates of attribution theory and the theory of economic dependence indicate that auditors may be more susceptible to bias when their clients exhibit low-risk attitudes towards fraud or when they are particularly important to the profitability of the auditor's local office.

Furthermore, prior research suggests that auditor's fraud risk assessments are susceptible to dilution (Nisbett et al., 1981; Hackenbrack, 1992; Hoffman and Patton, 1997) such that they are less sensitive to the existence of high risk factors pertaining to opportunity and pressure to commit fraud. The possibility that this bias may be unintentional (Bazerman, Morgan and Lowenstein, 1997) is particularly concerning because practitioners have generally argued that a well-designed audit protects them from susceptibility to such biases (Rennie, Kopp and Lemon, 2010). But, a decreased sensitivity to other factors, suggesting an elevated risk of fraudulent activity, is consistent with regulator's concerns that a rigorous audit cannot prevent audit failure if sufficient skepticism is not exercised (SEC, 2009). Therefore, further research is needed to understand how auditor's skeptical behavior can be negatively affected by their relationship with the client.

Such information could be useful in developing specific strategies to prevent diluted fraud risk assessments related to impaired skepticism. For example, an independent assessment of fraud risk, by an auditor who is not a primary member of the engagement team, may be beneficial. Furthermore, emphasis on the consequences related to unconscious biases may be needed in both the classroom and mandatory firm training.

Research is also needed to determine whether auditors who are inherently more skeptical than others are less susceptible to bias. Such findings could have important implications for hiring and promotion decisions within audit firms. Future research could also examine whether trait skepticism can be taught or improved over time with education or training.

# FAIRNESS, ACCOUNTABILITY AND THE DETERMINATION OF AUDIT FAILURE DUE TO A LACK OF PROFESSIONAL SKEPTICISM

## Introduction

Auditing standards require auditors to maintain a skeptical mindset when planning and performing the audit (SAS No. 109), reviewing confirmations (SAS No. 67), evaluating management estimates (SAS No. 57), and considering the risk of fraudulent financial reporting (SAS No. 99). Yet analysis of enforcement actions reveals that auditors are frequently challenged by regulators for failing to exercise a sufficient level of skepticism during the audit (Beasley, Carcello and Hermanson, 2001; SEC, 2003; Messier, Kozloski and Kochetova-Kozloski, 2010). In fact, individuals from both the SEC and the PCAOB have recently expressed concern that a failure to exercise an appropriate level of professional skepticism may be a leading cause of audit failure (PCAOB, 2008; Nelson, 2009; SEC, 2009).

Not surprisingly, practitioners and regulators appear to strongly disagree on the issue. In 2010, the Auditing Practices Board (APB) solicited responses from practitioners regarding the nature of professional skepticism and how it is developed and promoted within the profession (APB, 2010). In particular, the discussion paper asked firms to comment on whether the recent regulatory action for insufficient skepticism is warranted. Much of the feedback reflected the opinion that auditors are in fact, sufficiently skeptical and question the basis on which regulators determine whether sufficient skepticism has been exercised (APB, 2011). Therefore, an important question is raised regarding how regulators determine whether an auditor should be held accountable for insufficient skepticism. A better understanding of how regulators evaluate

skepticism could provide auditors with the necessary insight to more visibly demonstrate skeptical behavior.

The purpose of this study is to examine instances of audit failure, as reported by the SEC in Accounting and Auditing Enforcement Actions (AAERs)<sup>2</sup>, and the conditions under which a lack of skepticism allegedly contributed to that failure. More specifically, this study adopts a fairness-based conceptual framework which predicts that regulators will consider factors pertaining to (1) extent of injury, (2) the auditor-client relationship and (3) adherence to applicable standards, when determining whether to hold auditors accountable for a lack of skepticism. While prior research has examined factors associated with the likelihood of enforcement actions against the auditor (Feroz, Park and Pastina., 1991; Campbell and Parker, 1992), research has not yet examined factors which may be perceived by regulators as indicative of insufficient skepticism.

Findings suggest that the SEC determines whether sufficient skepticism has been exercised by evaluating whether the auditor *should* have been more skeptical, based on guidance provided by relevant auditing standards. With the benefit of hindsight, the SEC can assess whether the auditor was aware of specific risk factors or an elevated level of risk during a particular audit engagement, both of which require a heightened level of professional skepticism (SAS No. 99). SAS No. 99 also cautions auditors of the need for skepticism towards management as a source of audit evidence, and thorough fraud investigations allow for identification of instances where the client either lied to or provided the auditor with false or

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<sup>2</sup> I thank Mark Beasley, Joseph Carcello, Dana Hermanson and Terry Neal for generously sharing their list of fraud-related AAERs between 1998 and 2007 examined by Beasley et al. (2010) analysis of fraudulent financial reporting, sponsored by the Treadway Commission.

misleading information. Results of this study indicate that when the SEC perceives that the auditor was aware of an elevated risk of fraud or when the client has been accused of lying to the auditor, they are more likely to cite a lack of professional skepticism as a reason for the audit failure.

This study makes several contributions to the academic literature and audit practice. It is the first to address the issue of auditor accountability for an alleged lack of professional skepticism. A lack of precision in defining professional skepticism in both the literature and audit standards (Nelson, 2009), allows for considerable variation in what is perceived to constitute skeptical behavior. A better understanding of the basis by which regulators are questioning skepticism could allow auditors to develop strategies to more visibly demonstrate skeptical behavior, thereby reducing the likelihood of unwarranted enforcement action. For example, auditors need to be aware that the way in which they assess and respond to risks related to fraud sends an important message to regulators regarding the level of skepticism being exercised. Professional skepticism should be increased as the risk of fraud increases. Furthermore, auditors should reevaluate how to handle information provided by client management, particularly as a source of audit evidence. Based on this study's findings, if the client is later determined to have been dishonest, the auditor's skeptical behavior may be called into question.

The remainder of this paper is organized as follows. The following section summarizes findings from past examinations of audit enforcement actions followed by development of hypotheses within a fairness theory framework. Next, the methodology, research model and findings are discussed. The final section summarizes and concludes.

## **Background**

AAERs are enforcement actions issued by the SEC against public companies found guilty of an accounting violation, often related to fraudulent financial reporting. Common fraud-related violations by companies include intentional falsification or misstatement of financial statements, overstatement of assets or income and inadequacy or omission of required disclosures. In some instances only the registrant is named in the AAER, while in others both the auditor and the company are named (Rollins and Bremser, 1997).

In a recent COSO-sponsored study on fraudulent financial reporting in the U.S.<sup>3</sup>, Beasley et al. (2010) find that of alleged frauds identified by the SEC between 1998 and 2007, 23 percent cited the external auditor for alleged involvement in the fraud. However, 99 percent of opinions issued on the last set of fraudulently issued financials were unqualified and only 56 percent contained explanatory language. Although simply issuing an unqualified opinion does not constitute reason to initiate action against the auditor, the significant gap between enforcement actions against auditors and unsuccessful detections of fraud raises an important question regarding how the SEC determines whether an audit failure has occurred.

Relevant prior research has reviewed AAERs for evidence of factors which might affect the likelihood of enforcement actions against the auditor. In an analysis of AAERs between 1982 and 1989, auditors were most often cited for a lack of sufficient competent evidence, not performing required audit procedures or failing to corroborate management assertions (Feroz,

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<sup>3</sup> The purpose of the study, Fraudulent Financial Reporting: 1998-2007, was “to provide a comprehensive analysis of fraudulent financial reporting occurrences investigated by the Securities and Exchange Commission (Beasley et al., 2010).” The basis for this analysis was a review of 1,335 AAERs issued by the SEC between January 1998 and December 2007 which identified 347 companies involved in alleged instance of fraudulent financial reporting.

Park and Pastina, 1991). Further, the SEC most often attributed audit failures to insufficient evidence collection and over-reliance on the representations of management (Campbell and Parker, 1992). As these factors are generally considered representative of un-skeptical behavior (Peecher, 1996; Turner, 2001), professional skepticism has unsurprisingly been regarded as a problem area by regulators.

For example, former SEC Chief Accountant George Diacont recognized a lack of skepticism as a major contributor to audit failure (Carmichael and Craig, 1996; Nelson, 2009). Associate Chief Accountant of the SEC Jason Flemmons also commented that “a common thread in many ... enforcement actions against outside auditors is the failure to demonstrate professional skepticism by obtaining persuasive audit evidence” (SEC, 2009, p 6). These views have been echoed by the PCAOB who, after reviewing inspections between 2004 and 2007, noted that “in some cases, the deficiencies appeared to have been caused, at least in part, by the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results” (PCAOB, 2008, p 2). Evidence of regulator concerns is provided by Beasley, Carcello and Hermanson (2001), who find that 60 percent of SEC enforcement actions against auditors between 1987 and 1997 referenced the auditor’s failure to maintain an attitude of professional skepticism. Extending the analysis, the SEC identified an additional 53% between 1997 and 2002 (SEC, 2003)<sup>4</sup>.

While there appears to be a clear link between audit enforcement actions and a lack of professional skepticism, the process by which skeptical behavior is evaluated is extremely

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<sup>4</sup> In accordance with Section 704 of the Sarbanes-Oxley Act of 2002 (SOX), the SEC conducted an examination of enforcement actions over the five years preceding the enactment of SOX in order to identify areas susceptible to fraud, manipulation or earnings management. All enforcement actions filed during the period between July 31, 1997 and July 30, 2002 were reviewed and findings were reported to Congress.

ambiguous. Due to the high incidence of skepticism-related citations (Beasley, Carcello and Hermanson, 2001; SEC, 2003), auditors ought to be concerned with factors perceived to be indicative of insufficient skepticism. In other words, under what circumstances will the SEC consider the auditor “blameworthy” for failing to maintain a skeptical mindset?

### **Theory and Hypothesis Development**

#### ***Fairness Theory***

Fundamental to the process of assigning blame in social justice is the issue of accountability (Folger and Cropanzano, 2001). In a model of justice and accountability, entitled “Fairness Theory”, Folger and Cropanzano (2001) contend that the decision regarding whether to hold a party accountable for the outcome of a specified event is a function of the perceived fairness of their actions<sup>5</sup>. In order to determine perceived fairness, three components of accountability must be considered. First, an event occurs which has negative implications for the well-being of others. In this case, an alleged fraud has occurred which the auditor has failed to detect. Depending on the nature and magnitude of the fraud, investors, creditors and other affected parties may suffer moderate to severe consequences. Regardless, regulators must determine whether or not the auditor bears some responsibility for the outcome. For example, did the auditor exercise an appropriate level of skepticism throughout the audit?

Second, there is an element of perceived volitional control over the chosen course of action. This component refers to the availability of feasible alternatives – with more available

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<sup>5</sup> Closely related to Fairness Theory are Referent Cognitions Theory (Folger, 1987) and Equity Theory (Adams, 1965). While both of these theories discuss the determination and consequences of injustice, neither explicitly emphasize how accountability decisions are made.



alternatives being associated with greater control and a higher likelihood of blame. Similarly, an auditor believed to have the option of behaving more skeptically in a given situation is more likely to be blamed for failing to detect fraud.

Third, actions taken are considered relative to moral tenets or applicable standards. For example, regulators must determine whether audit actions were consistent with guidance outlined in auditing standards regarding professional skepticism and fraud (e.g. SAS No. 1 and SAS No. 99). Thus, the three basic elements of fairness theory include (a) a harmful event, that is (b) attributable to an individual's discretionary actions which (c) violate applicable ethical standards (Folger and Cropanzano, 2001).

Although fairness theory primarily aims to explain how individuals assign blame to other individuals, it is also useful for understanding the determinations of accountability at a firm level. Koonce and Mercer (2005, p 4) argue that application of psychology theory to examinations of archival information allows for an opportunity to gain a better understanding of the "causal mechanisms or processes underlying behavior." In applying fairness theory to the SEC's evaluation of auditor behavior, information documented in enforcement actions is considered representative of the collective decision making of individuals at the SEC regarding the individual and collective behavior of auditors and the firms who employ them<sup>6</sup>.

### ***Counterfactual Reasoning***

Also essential to fairness theory is the process of counterfactual reasoning – a method used to attribute meaning to negative experiences. In simple terms, individuals ask themselves

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<sup>6</sup> For any given case of alleged fraud, enforcement actions can be filed against one or more individuals at the company, the company itself, one or more members of the audit engagement team and/or the audit firm responsible for the engagement.

how the experience might have been different if things had unfolded differently (Roese and Olson, 1995). By engaging in counterfactual thinking, individuals determine how they feel about a negative experience by considering the actual outcome relative to hypothetical alternatives. For example, a negative experience might not seem so bad when compared to an alternative that would have been a lot worse. But if the same experience could have easily been avoided altogether, it may seem far worse than if there had been no viable alternatives.

Folger and Cropanzano (2001) argue that counterfactual thinking is useful in determining whether an individual should be held accountable for the consequences of their actions. By contrasting an actual outcome with what would, could or should have happened had alternative actions been taken, the perceived fairness of a harmful event can be assessed. Effectively, less perceived fairness is associated with a greater likelihood of accountability. In applying fairness theory to evaluating accountability for the degree of skepticism exercised during an audit, counterfactual reasoning can be represented by questions of “Would, Could and Should?”<sup>7</sup> A diagram of the three relevant judgments is presented in Figure 2.

First, an aversive state is compared to alternative, more beneficial states in order to determine extent of injury – Would the outcome have been different had the auditor been more skeptical? Second, the individual’s conduct is considered relative to available alternatives – Could the auditor have behaved more skeptically? Finally, the behavior is considered relative to applicable standards or moral tenets – Should the auditor have behaved more skeptically? The

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<sup>7</sup> While the three judgments of fairness theory are described in order of injury, conduct and standards, this is by no means meant to suggest that they must occur consecutively. Rather, such judgments are interrelated and may even occur simultaneously (Folger and Cropanzano, 2001).

following subsections discuss the three judgments regarding injury, conduct and standards, in more detail.

### ***Injury: Magnitude and Type of Fraud***

Fairness theory predicts that the magnitude of perceived injury is associated with accountability judgments such that the greater the perceived injury, the greater the likelihood that an individual will be held accountable for the event causing the injury. This represents a “would” counterfactual, where the question is “would things have been different had the harmful event not occurred?” Folger and Cropanzano (2001) argue that in order to gauge injury, the outcome of a harmful event (e.g., fraud) must be compared to a referent standard (e.g., no fraud). Generally speaking, individuals are more likely to be held accountable for an event as the discrepancy between the outcome of the actual event and the referent standard increases. This is because, as the magnitude of injury increases, it becomes clearer that things would have been very different had the event not occurred. In this case, the greater the magnitude of the fraudulent scheme the greater the extent of injury to users of the financial statements.

If the outcomes of previous frauds are any indication of the expectations for skeptical behavior, then high-profile cases such as Enron and WorldCom suggest that frauds of extreme magnitudes should also be accompanied by elevated skepticism. In both cases, auditors were held accountable for a failure to exercise due professional care and necessary skepticism to ensure financial statements were presented in conformity with GAAP. Accordingly, the magnitude of the fraud is expected to be considered by individuals at the SEC when determining

whether to hold individual auditors or an audit firm accountable for insufficient skeptical behavior. Thus, the following hypothesis is proposed:

**H1: There is a positive association between the magnitude of the fraud and the likelihood that the SEC will hold the auditor accountable for a lack of professional skepticism.**

While referent standards are useful in assessing the relative damage of a harmful event, Folger and Cropanzano (2001, p 8) note that “the decision-making process is also evaluated relative to referent standards for such processes.” Defining a referent standard in this case, involves determining the circumstances under which a sufficiently skeptical auditor would be expected to detect fraud. In other words, *would* the fraud have been detected had the auditor decidedly been more skeptical? To address this question, counterfactual reasoning is applied to contrast the chosen course of action in an injurious event with a referent standard of well-being. In this case, the chosen course of action is the level of skepticism that the auditor has chosen to exercise and the injurious event is fraud. Thus, an appropriate referent standard would be a case where the fraud was successfully detected.

For example, imagine that two individual auditors – Auditor A and Auditor B – are assigned to separate audit engagements of companies who have each been accused of fraudulent financial reporting. Assume that both auditors failed to detect the fraudulent scheme and that both exercised the same level of skepticism. Also assume however, that the fraud encountered by Auditor A was considered to have a far greater likelihood of detection than the fraud encountered

by Auditor B. Counterfactual reasoning suggests that Auditor A would be more likely to be held accountable for a lack of professional skepticism than Auditor B because it would be easier to imagine circumstances under which sufficient skepticism would have led to successful fraud detection. Thus, an auditor is more likely to be held accountable for actions taken during the audit (e.g. demonstration of skepticism) when it is easier to imagine how things would things have been different (e.g. detection of fraud) had the auditor chosen an alternative course of action.

Financial statement fraud may be perpetrated using a variety of different schemes – some of which include falsifying of records, intentionally misstating information, omitting required disclosures or misapplying existing accounting standards (Rezaee, 2005). However, certain accounts have been linked with a higher incidence of fraud (Hammersley, 2011). For example, improper or premature revenue recognition and recording fictitious revenue have been regarded as the most common fraudulent schemes (SEC, 2003; Beasley et al., 2010; Hammersely, 2011). From a fairness theory perspective, it would be easier to imagine that a sufficiently skeptical auditor would be successful in detecting commonly occurring frauds. Consistent with this notion, Bonner, Palmrose and Young (1998) find that auditors are more likely to be held responsible for failing to detect frauds which are commonly occurring (e.g., fictitious revenues and premature revenue recognition). Accordingly, if an auditor fails to detect a common fraudulent scheme, they may be perceived by individuals at the SEC as lacking an appropriate level of skepticism. Thus, the following hypothesis is proposed:

**H2: There is a positive association between commonly occurring frauds and the likelihood that the SEC will hold the auditor accountable for a lack of professional skepticism.**

***Conduct: Auditor Tenure***

While a “would” counterfactual establishes the aversiveness of a harmful event, a “could” counterfactual involves comparing the behavior in question (i.e. professional skepticism exercised) with alternatives available to the individual at the time (i.e., exercise more skepticism). Folger and Cropanzano (2001, p 11) argue that “when people answer the ‘could’ question they are trying to determine whether an alternative action was a feasible, viable option for the target person.” Fairness theory postulates that when an individual has multiple options for how to behave in a given situation, they are considered to have greater discretionary or volitional control over their actions. Consequently, they are more likely to be held accountable for their chosen course of action because they could have behaved differently. On the other hand, when an individual is perceived to have chosen the only course of action available to them, they are less likely to be blamed for aversive outcomes.

While the auditor presumably has complete discretionary control over the degree of skepticism exercised, determining whether they could have behaved more skeptically is made complicated because alternatives exist on a highly subjective continuum. Rather than comparing actions to mutually exclusive alternatives, as suggested by Folger and Cropanzano (2001), skeptical behavior must be compared to alternative degrees of skepticism. An argument could therefore be made that an auditor could always be more skeptical. Consequently, it is more

practical to consider factors which would prevent the auditor from taking an alternative, more skeptical, course of action. In other words, is there any reason to believe that skepticism may have been impaired?

Prior research has acknowledged that certain factors in the audit environment represent incentives which can offset professional skepticism (Nelson, 2009). Essentially, the argument is that auditors are susceptible to self-serving bias – where audit judgments unintentionally favor the client’s interests – because of an inclination to preserve the auditor-client relationship or retain economic rents in the long-term (Bazerman, Morgan and Lowenstein, 1997). Within a fairness theory framework, the auditor would be more likely to be held accountable for a lack of professional skepticism if objectivity is believed to have been impaired. For example, the length of the auditor-client relationship has been argued to impair objectivity and independence (Bamber and Iyer, 2007; Frankel, Johnson and Nelson, 2002).

Prior research examining the relationship between auditor tenure and audit quality has generated mixed results. Focusing on various measures of audit quality, including discretionary accruals, fraudulent financial reporting, earnings management and earnings quality, some studies have found that longer auditor tenure impairs audit quality (Dopuch, King and Shwartz, 2001; Commission on Public Trust and Private Enterprise, 2003; Casterella, Knechel and Walker, 2004; Myers et al., 2004; Carey and Simnett, 2006). Others have suggested that audit quality actually improves with the length of the auditor-client relationship or is unrelated to tenure (Geiger and Raghunadan, 2002; Johnson, Khurana and Reynolds, 2002; Myers et al., 2003; Carcello and Nagy, 2004; Ghosh and Moon, 2005; Knechel and Vanstraelen, 2007; Chen, Lin and Lin, 2008).

While the majority of studies regarding auditor tenure have discussed auditors' economic incentives to compromise audit quality in the long-term, Bamber and Iyer (2007) point out that threats posed by social incentives are of equal concern. Specifically, they find that the number of years an individual auditor serves on an engagement is directly related to the extent to which they identify with the client. Moreover, client identification was found to impair objectivity – that is, auditors who identified with their clients were more likely to acquiesce to the client's preferred accounting treatment. Similarly, Rennie, Kopp and Lemon (2010) find a positive relationship between the length of the auditor-client relationship and trust, which has been regarded as the complement (or opposite) of suspicion (Shaub, 1996).

Practitioners argue that independence and a rigorous audit process prevents impairment of skepticism due to trust (Rennie, Kopp and Lemon, 2010). However, many enforcement actions have involved well-designed, rigorous audits that failed to detect fraud because principles of due care and professional skepticism were not applied (SEC, 2009). This suggests that despite mixed results of prior studies, decision makers at the SEC are sensitive to the possibility that objectivity may be impaired by the length of the auditor-client relationship. Thus, the following hypothesis is proposed:

**H3: There is a positive association between auditor tenure and the likelihood that the SEC will hold the auditor accountable for a lack of professional skepticism.**



### ***Standards: Response to Elevated Risk***

Suppose that an auditor has failed to detect a large-scale fraud and that the length of their relationship with the client may have impaired their ability to be objective. Both “would” and “could” questions can be answered affirmatively. However, assuming that the auditor performed a quality audit, it may be unreasonable to blame them for not being skeptical enough. Accordingly, fairness theory suggests that in addition to “would” and “could”, consideration for whether things should have been different is essential to determining accountability.

Folger and Cropanzano (2001, p 21) note that “as with would and could judgments, a ‘should’ judgment involves using a standard.” Generally, “should” judgments consider whether a moral or ethical principle has been violated. With regards to determining whether an auditor has behaved inappropriately however, generally accepted auditing standards (GAAS) provide a more relevant point of comparison. In particular, SAS No. 99, Consideration of Fraud in a Financial Statement Audit, outlines auditor responsibilities pertaining to the prevention and detection of fraud. Section 316.46 of the auditing standard requires that auditor’s “response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence (AU 316.46).” Specifically, auditors are expected to perform additional audit procedures or obtain more persuasive evidence. Therefore, in the presence of elevated levels of fraud risk, auditors should exercise heightened professional skepticism in order to be in compliance with GAAS.

To demonstrate the operation of a “should” counterfactual, consider the previous example of an auditor who failed to detect fraud and whose objectivity may have been impaired.

Determining whether the auditor *should* have behaved differently in this situation involves

considering the existence of risks related to fraud, as required by SAS No. 99. If evidence suggests that the audit client displayed certain risk factors suggestive of fraud, regulators would reasonably expect that the auditor *should* have exercised a higher degree of skepticism.

Consequently, if individuals at the SEC perceive that the auditor did not appropriately respond to risk factors (e.g. by modifying or qualifying the audit opinion) they may be more likely to hold the auditor accountable for a lack of professional skepticism. This expectation is consistent with findings that auditors are more likely to be held liable by a jury for failing to detect fraud when they identified risk factors and even investigated for the fraud (Reffet, 2010). Thus, the following hypothesis is proposed:

**H4: There is a positive association between the existence of fraud risk factors and the likelihood that the SEC will hold the auditor accountable for a lack of professional skepticism.**

SAS No. 1, Due Professional Care in the Performance of Work (AICPA, 1972), states that “in exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest” (AU 230.09). However, past examinations of enforcement actions suggest that auditors are often cited for a lack of professional skepticism due to an over-reliance on the representations of management (Feroz, Park and Pastina, 1991; Campbell and Parker, 1992). Although auditing standards caution that management explanations “should ordinarily be corroborated with other audit evidence” (AU

329.21), prior research indicates that auditors often do not confirm explanations for unexpected differences (Hirst and Koonce, 1996; Trompeter and Wright, 2010).

The tendency to over-rely on management representations poses a significant threat to auditor's ability to behave skeptically, particularly because management has incentive to lie or make false and misleading statements to the auditor. Within the context of fairness theory, auditors should be more skeptical of clients who have an incentive to lie to them. Because regulators have the benefit of hindsight when determining accountability, decision makers at the SEC may be more likely to hold the auditor accountable for insufficient skepticism when there is evidence to suggest that the client was lying to the auditor to conceal fraudulent activity<sup>8</sup>. Thus, the following hypothesis is proposed:

**H5: There is a positive association between an accusation that the client lied to the auditor and the likelihood that the SEC will hold the auditor accountable for a lack of professional skepticism.**

## **Research Design**

### ***Methodology for Data Collection***

The sample for this study includes all AAERs between 1998 and 2011 which name either an individual auditor or an audit firm as a respondent in the case of an alleged fraud. For each

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<sup>8</sup> Although a reasonable expectation would be that all companies accused of fraudulent financial reporting would also be accused of lying to their external auditor, this is not actually the case. Other common violations include maintaining overly aggressive positions regarding estimates (e.g. Bally Total Fitness) or failing to provide support for financial statement numbers (Pegasus Wireless Corporation).

case of fraud, multiple AAERs naming individual auditors and/or the audit firm are considered to represent one observation. For example, in the case of fraudulent financial reporting at Adelphia Communications, enforcement actions were filed against the external audit firm, Deloitte & Touche LLP, as well as individual members of the engagement team, including the partner and the senior manager. However, for the purposes of this study, the enforcement actions were treated as one instance of fraudulent financial reporting where the external auditor was also held accountable for an alleged audit failure.

I began with all enforcement actions identified by the COSO sponsored study on Fraudulent Financial Reporting (Beasley et al., 2010). According to the findings of the original study, the external auditor was named in 78 of the 347 fraud cases. Due to limitations regarding the availability of enforcement actions dating before 1999, only 72 of the original 78 were still available on the SEC's website. Twenty-two additional observations were collected from 2008, 2009, 2010 and 2011, resulting in a total of 94. In two cases, both predecessor and successor auditors were named in the enforcement action. These observations were split so that each of the four audit engagements represented a separate observation, adding two observations to the sample and bringing the total to 96. Finally, 11 observations were dropped for a lack of information or because the auditor was named for reasons other than performing a deficient audit (e.g. active involvement in the fraudulent scheme). The final sample included 85 instances of fraudulent financial reporting, documented in an AAER between 1998 and 2011, where the external auditor was named as a respondent<sup>9</sup>.

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<sup>9</sup> Generally speaking, there is a significant time lag between the actual occurrence of fraud and the date that an enforcement action is filed in the form of an AAER. While the sample for this study was pulled from AAERs issued between 1998 and 2009, the fraudulent financial statements were actually issued between 1991 and 2004.

As noted by Bonner, Palmrose and Young (1998), focusing on enforcement actions filed against the SEC is not without limitation. For instance, there is a possibility that the enforcement actions may not provide a representative sample of frauds. Carcello and Palmrose (1994) find that instances of fraudulent financial reporting among public companies are also identified by criminal convictions of management, outcomes of internal investigations or enforcement actions by non-SEC regulators. However, Carcello and Palmrose (1994) also observe the existence of SEC enforcement actions for 80% of companies with both fraud and auditor litigation. While enforcement actions appear to capture a majority of fraud cases involving the external auditor, analysis is also limited by the accuracy and completeness of the data (Beasley et al., 2010). However, the focus of the current study is regulator's perceptions (i.e. the SEC) of the auditor's role in their investigations of fraudulent financial reporting. Thus, the completeness of AAERs does not affect the inferences being made here.

### ***Multivariate Framework***

A multivariate model is used to examine whether the likelihood that the SEC will hold auditors accountable for a lack of professional skepticism in fraud-related enforcement actions is consistent with a fairness theory framework:

$$PS = f(\beta_1MAG + \beta_2COMMON + \beta_3TENURE + \beta_4RISK + \beta_5LIED + \beta_6SOX + \beta_7BIG4 + \beta_8ASSETS)$$

where,

*PS* = An indicator variable equal to 1 when an auditor is cited for a lack of professional skepticism and equal to 0 otherwise.

*MAG* = the aggregate dollar value of fraudulent misstatements divided by the total assets of the company for the period that the last fraudulently stated financials were issued.

*COMMON* = An indicator variable equal to 1 when the fraudulent scheme is considered to be commonly-occurring and equal to 0 otherwise.

*TENURE* = the natural log of the length of the relationship between the audit firm and the client in years.

*RISK* = An indicator variable equal to 1 when the auditor is noted to have been aware of the elevated risk of fraud and equal to 0 otherwise.

*LIED* = An indicator variable equal to 1 when the client is accused of having lied or made false or inaccurate representations to the auditor and equal to 0 otherwise.

*CHAIRMAN* = An indicator variable representing the Chairman of the SEC at the time that the first AAER was issued against an individual auditor or audit firm (1 = Levitt, 2 = Pitt, 3 = Donaldson, 4 = Cox, 5 = Schapiro)

*BIG4/5* = An indicator variable equal to 1 if the auditor or audit firm involved represented a BIG 4 accounting firm (Arthur Andersen included).

The dependent variable is measured as (1) enforcement actions citing the auditor for a lack of skepticism and (0) enforcement actions which cite the auditor for other violations. In both cases, an unqualified opinion was issued on fraudulent financial statements. However, the model predicts that the SEC's determination to hold the auditor accountable for a lack of professional

skepticism will be consistent with counterfactual reasoning within a fairness theory framework.

The following section further describes the test variables and control variables.

### ***Independent Variables***

H1 and H2 pertain to the magnitude and type of fraud, respectively. The magnitude of the fraud is measured as the dollar amount of the misstatement, relative to the total assets of the company for the period that the last fraudulently stated financials were issued. Depending on the fraudulent scheme, this amount may pertain to multiple accounts. For example, in AAER No. 2236, Adelphia was accused of understating debt by \$1.6 billion and overstating equity by \$368 million. For purposes of coding the magnitude of the fraud, these two misstatements would be aggregated.<sup>10</sup>

The type of fraud was first coded based on the ten categories presented in Table 1. These categories were originally developed by Bonner, Palmrose and Young (1998) and then adapted for this study by removing categories which did not appear in the current sample and making a few additions. The first 8 categories are consistent with the original taxonomy developed by Bonner, Palmrose and Young (1998) and are as follows: (A) fictitious revenues, (B) premature revenue recognition, (C) misclassifications or (added) improper recognition of transactions, (D) fictitious assets and/or reductions of expenses/liabilities, (F) omitted or improper disclosures, (G) equity fraud and (H) related party transactions. Categories for (I) cookie jar reserves and (J) improper capitalization were added based on the fraudulent schemes appearing in this sample.

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<sup>10</sup> While some of this information could arguably be collected from company filings on the Edgar database (e.g., magnitude of restatement or auditor tenure), the enforcement action, as documented by the AAER, is considered to be the best resource for information perceived by the SEC to be important in determining whether to take action against the auditor in the first place.

The test variable included in this model however, pertains to whether or not the type of fraudulent scheme involved was considered to be commonly occurring. Therefore, this variable is measured as the presence (1) or absence (0) of commonly occurring frauds. Based on prior research (Bonner, Palmrose and Young, 1998; Loebbecke, Eining and Willingham, 1989), the most frequent types of frauds involve (A) fictitious revenues, (B) premature revenue recognition and (E) overvalued assets or undervalued expenses/liabilities. However, as can be noted from the frequencies presented in Table 1, frauds related to (B) premature revenue recognition only occurred in 18.8 percent of the cases examined in this study. Thus, only categories related to (A) fictitious revenues and (E) overvalued assets or undervalued expenses/liabilities are considered to be commonly-occurring (> 50 percent).

To address H3, a test variable is included for the length of the relationship between the audit firm involved and the audit client, in years and as noted in the AAER. To capture whether the auditor was believed to be aware of specific risk factors pertaining to the alleged fraud or generally aware of an elevated risk of fraud (H4), AAERs were reviewed for specific mention of whether the auditor was believed to have been aware of specific risk factors or an elevated risk of fraud. A test variable is coded as equal to 1 when the auditor is noted to have been aware of the elevated risk of fraud and equal to 0 otherwise. Per review of the description of the fraudulent scheme provided in the AAER, another variable is set equal to 1 when the client is accused of having lied or made false or inaccurate representations to the auditor (H5) and equal to 0 otherwise.

Control variables related to the regulatory environment and they size of the audit firm involved were also included in the model. The views and affiliations of the Chairman of the SEC



can be expected to affect all regulatory decisions made during their tenure. Therefore, a control variable is included to indicate which of five Chairmen was in office at the time that the first AAER was issued against an auditor in an alleged fraud case. The five Chairmen include Arthur Levitt, Harvey Pitt, William Donaldson, Christopher Cox and Mary Schapiro. Table 1 presents the time periods during which each held the position of Chairman. A control variable was also included to indicate whether the individual or firm named in the AAER was associated with a Big 4/5 audit firm. Due to the larger size of these firms, they are likely to have considerably more resources at their disposal. Intuitively, regulators may hold these larger firms to higher standards of audit quality or they may be hesitant to pursue enforcement actions against firms with formidable legal resources.

## Results

### *Descriptive Statistics*

Of the 85 enforcement actions where the auditor is named as a respondent, 69.4 percent cite a lack of professional skepticism as an audit deficiency. This is consistent with claims that professional skepticism is often a leading cause of audit failure (Carmichael and Craig, 1996; PCAOB, 2008; Nelson, 2009; SEC 2009). Table 2 presents descriptive statistics for the sample.

For alleged frauds where the auditor was cited for a lack of professional skepticism (59 cases), the average total assets of the client was \$7.57 billion, the average magnitude of the fraud was \$610 million, the average length of the fraud was 2.9 years and the average length of the auditor-client relationship was 4.6 years. Of those 59 cases, 71.2 percent involved a commonly-occurring fraudulent scheme, 79.7 percent noted that the auditor was actually aware of an

elevated risk of fraud and 49.2 percent involved a client accused of lying or providing false and misleading statements to the auditor. Comparatively, of the 26 cases where the auditor was not cited for a lack of professional skepticism, the client's average assets were \$2.15 billion, the average magnitude of the fraud was \$564 million, the average length of the fraud was 2.7 years and the average length of the auditor-client relationship was 3.53 years. Overall, 84.6 percent of the cases involved a commonly-occurring fraudulent scheme, 42.3 percent alleged that the auditor was aware of the risk of fraud and 19.2 percent involved a client accused of lying to the auditor.

Consistent with prior research (Bonner, Palmrose and Young, 1998; Loebbecke, Eining and Willingham., 1989), Table 1 reveals that the most commonly-occurring fraudulent schemes in this sample include (A) fictitious revenues and (E) overvalued revenue/assets and or undervalued expenses/liabilities. Although Bonner, Palmrose and Young (1998) and Loebbecke, Eining and Willingham (1989) also identified category (B), premature revenue recognition, as commonly occurring, it only appeared in 18.8 percent of the AAERs in this study's sample. However, exclusion of category (B) from the commonly-occurring schemes did not yield significantly different results.

Table 3 presents the breakdown of audit deficiencies identified in the sample. All citations for a failure to exercise sufficient skepticism were accompanied by a citation for a failure to exercise due professional care. As the auditing standard pertaining to due professional care (SAS No. 1) contains the requirements for professional skepticism, this is unsurprising. Other audit deficiencies that were frequently noted were a failure to corroborate/verify

management representations (37.6 percent), a failure to obtain sufficient, competent evidence (75.3 percent) and a failure to perform standard or required audit procedures (40.0 percent).

Table 4 presents a correlation matrix of the 16 audit deficiencies. A review of these correlations reveals that a citation for a lack of professional skepticism is highly correlated with three other audit deficiencies – (2) failure to exercise due professional care, (3) failure to corroborate/verify management representations and (5) failure to obtain sufficient competent evidence. This finding is also consistent with the definition of professional skepticism provided by SAS No. 1, which states that a skeptical auditor “should not be satisfied with less than persuasive evidence because of a belief that management is honest (AU 230.09)” and should “consider the competency and sufficiency of the [collected] evidence (AU 230.08).”

### ***Hypothesis Testing***

A logistic regression model was fitted to the data to test the study hypotheses. These results are presented in Table 5. Overall, the model predicts the likelihood that an auditor will be cited for a lack of professional skepticism significantly better than the intercept-only, or null, model ( $\chi^2=21.85$ ,  $p=0.01$ ). The Hosmer & Lemeshow goodness-of-fit test yielded a  $\chi^2$  of 3.85 and was insignificant ( $p>0.05$ ), suggesting that the model fit the data well.  $R^2$  indices, indicated by the Cox and Snell ( $R^2=0.24$ ) and the Nagelkerke statistics ( $R^2=0.33$ ), also suggest that the model is a good fit.

The logistic regression model uses the independent variables to predict whether an auditor will be cited for a lack of professional skepticism in an enforcement action. Table 6 presents the observed and predicted frequencies for lack of professional skepticism citations by logistic regression, with a cutoff of 0.50. According to Table 6, the model used in this study

correctly predicted that an enforcement action would include a citation for a lack of professional skepticism 85.5 percent of the time. This represents the sensitivity of the model to the independent variables. Comparatively, the model correctly predicted that an enforcement action would include a citation for something other than a lack of professional skepticism 42.3 percent of the time, representing specificity. The prediction for enforcement actions against the auditor where insufficient skepticism was cited as a reason for audit failure was more accurate than the prediction of the opposite. The false positive rate was below 30 percent (24.2 percent) and the overall correct prediction was 71.6 percent. These results further demonstrate the goodness-of-fit of the logistic regression model.

H1 and H2 predict that the likelihood of an auditor being cited for a lack of professional skepticism would be positively associated with the magnitude of the fraud and the fraudulent scheme employed (i.e. whether it was considered “commonly-occurring.”) While results (Table 5) suggest that the magnitude of the fraud (MAG) is positively related to the dependent variable ( $\beta=0.17$ ), the relationship is not significant (Wald’s  $\chi^2=1.02$ ,  $p=0.31$ ). Whether a commonly-occurring fraudulent scheme had been employed (COMMON) was unexpectedly found to be negatively associated with the dependent variable ( $\beta=-0.98$ ), but was also an insignificant relationship (Wald’s  $\chi^2=1.83$ ,  $p=0.18$ ). Thus, the results do not support the predictions of H1 and H2. Within the context of fairness theory, it does not appear that the “would” counterfactual – “*Would* things have been less injurious had the fraud been detected?” or “*Would* the auditor have been more likely to detect the fraud had they behaved more skeptically?” – is relevant to regulator’s determination that an auditor has failed to exercise sufficient skepticism. In other words, auditors associated with frauds of lesser magnitude or rare fraudulent schemes are no

more likely to be cited for insufficient skepticism than when the fraud is of significant magnitude or involves a commonly-occurring fraudulent scheme.

H3 predicted that the length of the auditor-client relationship would be positively associated with the likelihood that an auditor would be cited for a lack of professional skepticism. However, the results suggest the relationship between TENURE and the dependent variable ( $\beta=-0.01$ ) is negative and insignificant (Wald's  $\chi^2=0.01$ ,  $p=0.98$ ). Thus, it does not appear that regulators are sensitive to the number of years an auditor has been involved with a client when determining whether to hold the auditor accountable for a lack of professional skepticism. Although H3 is not supported, the “could” counterfactual might also be extended to other factors in the audit environment that *could* have impaired the auditor's ability to behave skeptically. For instance, providing non-audit services to audit clients is often criticized for impairing auditor independence and objectivity (Frankel, Johnson and Nelson, 2002). Stephen Cutler, Director of the Division of Enforcement for the SEC, stated that “non-audit work allies the audit firm with management, potentially undermining the skepticism necessary to the performance of a rigorous audit (SEC, 2002).” However, due to the time-lag between the occurrence of fraud and the issuance of an enforcement action (approximately 5 years), and the limited availability of audit fee data (only available after 2002), it is outside the scope of this study.

H4 predicted that the likelihood of an auditor being cited for a lack of professional skepticism would be positively associated with whether the auditor was perceived to have been aware of risk factors pertaining to the fraudulent scheme or more generally, aware of an overall elevated risk of fraud at the audit client. Results support predictions of a significant positive

association ( $\beta=1.81$ ) between RISK and the dependent variable (Wald's  $\chi^2=8.03$ ,  $p<0.01$ ). These findings suggest that regulators consider information about risk that was available to the auditor at the time of the audit when determining whether an auditor *should* have behaved more skeptically. Thus, H4 is supported.

Finally, H5 predicted the likelihood of an auditor being cited for a lack of skepticism would be positively associated with accusations that the client was accused of lying or providing false or misleading statements to the auditor. Results also support predictions of a significant positive relationship ( $\beta=1.37$ ) between LIED and the dependent variable (Wald's  $\chi^2=4.49$ ,  $p<0.05$ ). Thus, H5 is supported.

Contrary to H4, results of H5 testing suggest that regulators may also consider information that was *not* available to the auditor at the time of the audit when determining whether more skepticism *should* have been exercised. This finding is notable because it is conceivable that an auditor is sufficiently skeptical of a client who also happens to be a very good liar. However, it appears that while regulators do not expect auditors to unflinchingly detect fraud, they have higher expectations when it comes to detecting whether a client is providing false information.

### **Discussion and Conclusion**

This study examines factors affecting the likelihood that the SEC will perceive auditors to have failed in exercising sufficient professional skepticism during their audit of a client allegedly involved in fraudulent financial reporting. Within the context of fairness theory (Folger and Cropanzano, 2001), specific factors examined include (1) magnitude of fraudulent

misstatement, (2) whether a fraudulent scheme is considered to be commonly-occurring, (3) the length of the auditor-client relationship, (4) whether the auditor is perceived to have been aware of the elevated risk of fraud and (5) whether the client was accused of having lied to the auditor during the course of their examination. Findings indicate that the auditor's awareness of risk and whether they had been lied to were both positively associated with the likelihood that the auditor would be held accountable for a failure to exercise sufficient professional skepticism.

Fairness theory posits that when determining whether to hold the auditor accountable for an injurious event, in this case fraud, the regulator will try to determine whether the auditor could, would and should have behaved more skeptically. Results of this study suggest that the "should" question is most relevant to this highly-subjective decision. In other words, in the event that the auditor is determined to have been aware of fraud risk factors or in the event that the client was determined to have provided false or misleading information to the auditor, regulators are more likely to come to the conclusion that the auditor should have exercised greater professional skepticism during the audit.

Enforcement actions provide an opportunity to remind auditors of the requirement to exercise skepticism when evaluating information provided by management. But it seems that if the client is determined to have been lying to the auditors, regulators may be drawing inferences from this information about the level of skepticism that the auditor must have exercised during the audit. This is valuable information to auditors, who have recently expressed misgivings regarding the basis by which regulatory bodies determine whether sufficient skepticism has been exercised (APB, 2011).

Overall, the findings of this study are limited by the information documented within the enforcement releases, available on the SEC website. There may be instances where information that existed at the time of the investigation was simply not documented in the enforcement action. However, the absence of such information would not be expected to preclude the findings of this study.

As discussed above, this study provides valuable information to both regulators and auditors regarding how their actions are being perceived in either direction. Future research is needed to better understand how regulators can more consistently and fairly determine whether sufficient skepticism has been exercised towards fraudulently stated financial statements. Research should also examine how auditors can more visibly demonstrate sufficient skepticism in audit workpapers and during formal investigations of audit quality.



## CONCLUSION

Overall, this dissertation addresses issues pertaining to professional skepticism that are currently relevant to the auditing profession as a whole. First, competing perspectives of professional skepticism – *neutral* versus *presumptive doubt* – were considered and questions for future research were posed to examine whether asking auditors to adopt alternative perspectives of skepticism may have implications for audit efficiency and effectiveness. Next, research questions were identified which consider how the nature of the auditor-client relationship may threaten an auditor's ability to maintain an attitude of professional skepticism, particularly with regards to fraudulent financial reporting. Finally, an examination of enforcement actions against auditors examined how professional skepticism is defined from a regulator's perspective.

It should be noted that all of these issues seem to share a common theme – that there is a clear lack of agreement amongst academics, practitioners and regulators regarding what it means to be professionally skeptical. As a result of this disagreement, there are many questions which beg for further examination. For example, should a skeptical auditor be neutral or presume some level of doubt regarding the possibility of misstatement or fraud? Is it possible to maintain neutrality, or does the nature of an auditor's relationship with their client threaten their ability to ever be truly skeptical of management? Are some auditors more susceptible to these threats than others? How do regulators evaluate skepticism?

In the preceding chapters, several avenues for future research were proposed, mainly to address some of the implications of adopting one perspective of skepticism over another. While auditing standards have historically recommended that auditors maintain a neutral frame of mind throughout the audit, extremely low rates of fraud detection (< 1%) by external auditors have

raised eyebrows regarding whether auditors should forget neutrality and presume the worst (i.e., adopt a presumptive doubt position) when it comes to the likelihood of fraud (Beasley et al., 2001). As with any notable change to auditing standards or requirements, there are likely to be implications of a stricter, presumptive doubt definition of professional skepticism. Adopting a presumptive doubt perspective of professional skepticism could raise the bar for the amount of evidence needed to support the opinion (Bell, Peecher and Thomas, 2005) and may result in unnecessary expense (Shaub and Lawrence, 2002; Nelson, 2009). Therefore, due diligence is required to determine whether the benefits of such a change outweigh the costs. In this case, the greatest cost is the risk is to audit efficiency.

In order to understand the benefits of a presumptive doubt perspective, it would be helpful to first understand how a neutral perspective of skepticism may be compromised. A common example of insufficient skepticism is a tendency for the auditor to exhibit an overreliance on management representations. This is consistent with criticisms that the nature of the auditor-client relationship leaves the auditor susceptible to unconscious bias in favor of the client (Bazerman, Morgan and Lowenstein, 1997). Essentially, it may be impractical to expect that an auditor will be able to maintain neutrality when evaluating information provided to them by a client with whom they have a close, positive working relationship.

This possibility is particularly concerning with regards to the auditor's assessment of fraud risk. Current auditing standards pertaining to fraud (SAS No. 99) require auditors to assess management attitudes towards fraud as one of the three components of the fraud triangle. While auditors are expected to increase the risk of fraud if those attitudes indicate a high-risk of fraudulent activity, the standard also instructs them to disregard dispositional characteristics

which suggest a low risk of fraud (e.g. honesty, integrity, etc.). The concern is that when management attitudes do not appear to pose a high risk of fraud, auditors' will be less skeptical of the possibility that the financial statements are misstated due to fraud. Furthermore, Wilks and Zimbelman (2004) warn that auditors may even overlook other risk factors which indicate high risk related to opportunities and incentives to commit fraud. A similar concern exists pertaining to the importance of a particular audit client to the profitability of the firm. In order to retain the client and preserve the auditor-client relationship, the auditor may be unconsciously susceptible to client-favoring bias. Therefore, research is needed not only to determine whether neutrality is compromised by the auditor-client relationship, but also whether the auditor's sensitivity to other indications of a high-risk of fraud is reduced.

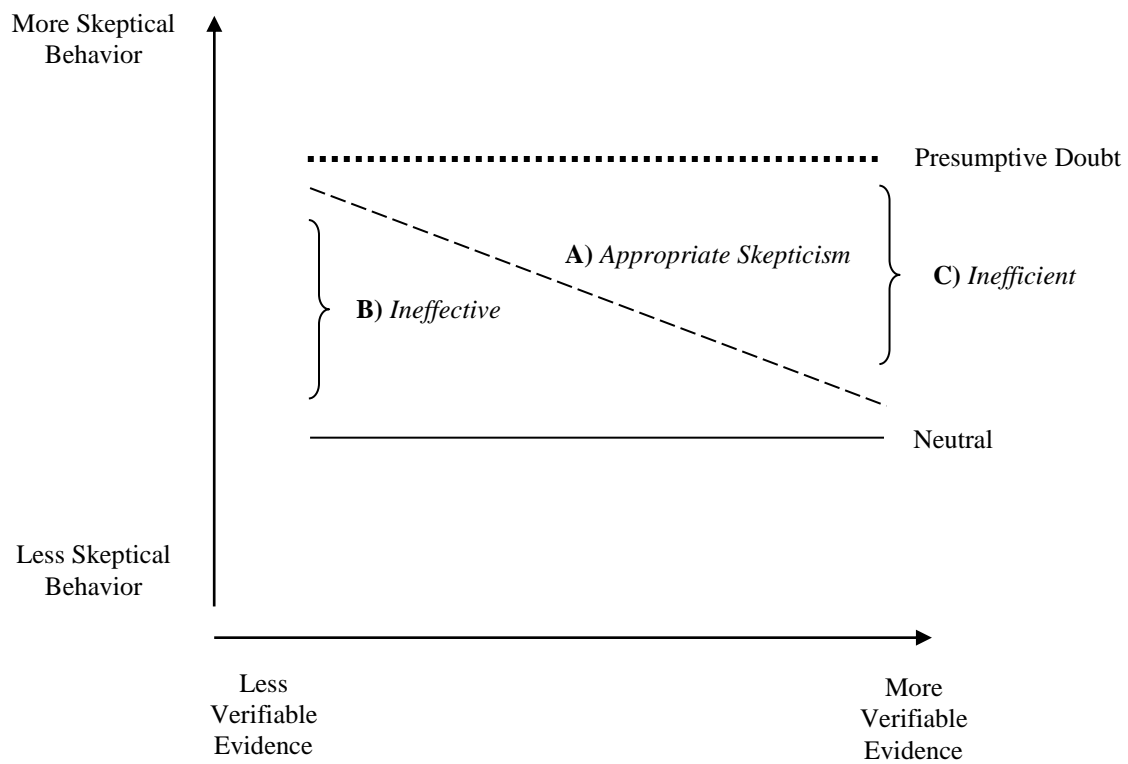
A final issue pertaining to the lack of precision in defining professional skepticism is evidenced by the disconnect between what regulators perceive to be a lack of skepticism and what auditors perceive to have been sufficient. An examination of enforcement actions against auditors reveals that regulators are more likely to cite auditors for a lack of professional skepticism when the auditor was perceived to have been aware of elevated risk and whether client management was accused of having lied to the auditor. This is consistent with a counterfactual reasoning approach, whereby regulators determine whether the auditor *should* have been more skeptical when determining whether to hold them accountable for insufficient skepticism.

These results provide auditors with extremely valuable information regarding how to demonstrate to regulators that they have been sufficiently skeptical. First of all, auditors may want to improve documentation of the procedures done to address existing risk factors. Although

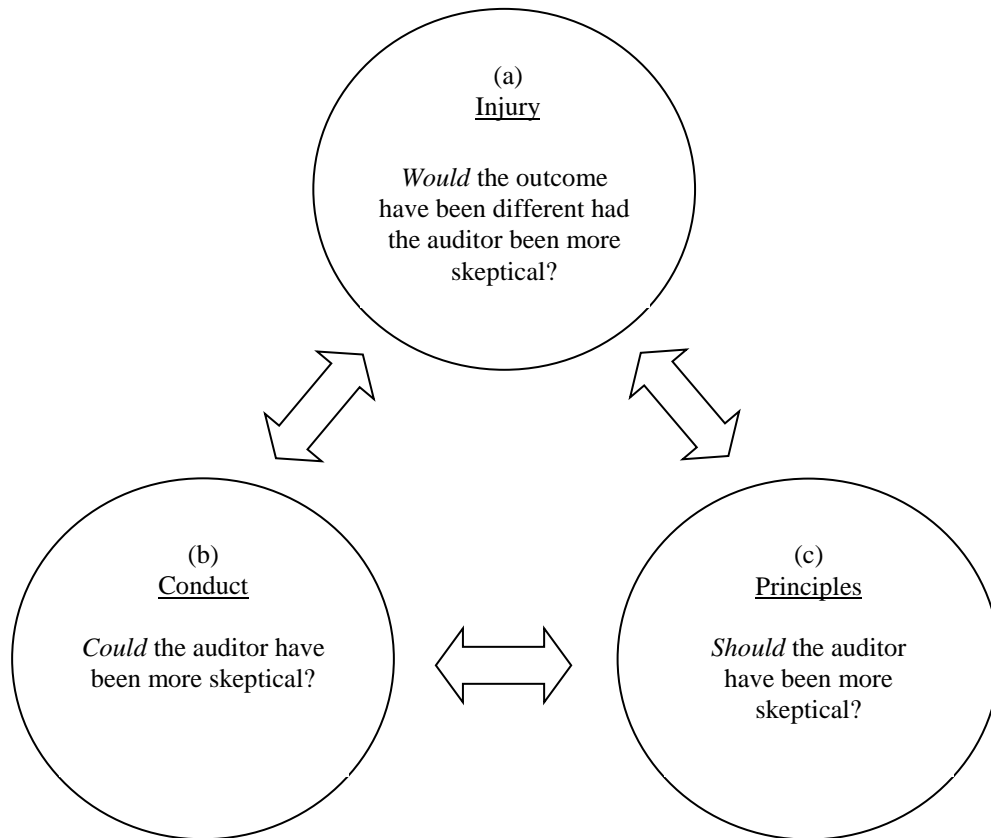
auditors are expected to exercise skepticism with regards to high risk, the possibility remains that they may still fail to detect instances of fraudulent financial reporting. However, they should be able to demonstrate that they appropriately responded to those risks and did everything they could do with the information that they had at the time. Further research should examine what constitutes adequate documentation of skeptical behavior.

Second, the results of this study provide further evidence that an overreliance on the representations of management is a real problem in the auditing profession. Regulators appear to interpret evidence that a company had previously lied or provided false information to their external auditors as an indication that the auditors were not paying attention. Although the difficulties involved in detecting fraud, particularly when faced with collusion, have been recognized by regulators, it is clear that auditors are expected to be more aware of when they are being lied to. The profession may want to reconsider when and if the representations of client management can be used as valid audit evidence. If anything, auditors should be aware that if a client is later determined to have provided false information to the auditor, they may be more likely to be held accountable for a failure to behave skeptically.

## APPENDIX: FIGURES AND TABLES



**Figure 1: Potential Threats to Efficiency and Effectiveness**



*The above model is adapted from Folger and Cropanzano's (2001, p 4) Fairness Theory Model of Accountability.*

**Figure 2:** Evaluating Professional Skepticism in Terms of Fairness Theory

**Table 1: Frequency of Observations by Category of Fraudulent Scheme**

*The taxonomy shown below was adapted from Bonner, Palmrose and Young (1998)*

	Fraudulent Scheme	Number	Percent
A	Fictitious Revenues	28	67.1%
B	Premature Revenue Recognition	16	18.8%
C	Misclassifications or Improper Recognition of Transactions	8	9.4%
D	Fictitious Assets and/or Reductions of Expenses/Liabilities	22	25.9%
E	Overvalued Revenues/Assets and/or Undervalued Expenses/Liabilities	45	52.9%
F	Omitted or Improper Disclosures	3	3.5%
G	Equity Fraud	2	2.4%
H	Related Party Transactions	9	10.6%
I	Cookie Jar Reserves	1	1.2%
J	Improper Capitalization	1	1.2%



**Table 2: Descriptive Statistics**

	Auditor Cited for a Lack of Professional Skepticism?		
	Overall	Yes	No
Total # of cases	85	59	26
Client's total assets	\$5.83 billion	\$7.57 billion	\$2.15 billion
Magnitude of fraud (\$)	\$596 million	\$610 million	\$564 million
Auditor tenure (years)	4.3 years	4.6 years	3.5 years
Length of fraud (years)	2.9 years	3.0 years	2.7 years
Involved a commonly-occurring scheme	75.3%	71.2%	84.6%
Auditor aware of risk	68.2%	79.7%	42.3%
Client accused of lying to auditor	40.0%	49.2%	19.2%
Chairman of the Board:			
Arthur Levitt (7/27/93 – 2/9/01)	18.8%	18.6%	19.2%
Harvey Pitt (8/3/01 – 2/17/03)	18.8%	15.3%	26.9%
William Donaldson (2/18/03 – 6/30/05)	24.7%	23.7%	26.9%
Christopher Cox (8/03/05 – 1/20/09)	21.2%	18.6%	26.9%
Mary Schapiro (1/27/09 – Present)	16.5%	23.7%	0.0%
Respondent:			
Audit firm	34.1%	40.7%	19.2%
Individual auditor	97.6%	98.3%	96.2%
Big 4/5 firm	43.5%	42.4%	46.2%

**Table 3: Frequency of Observations by Audit Deficiency**

	Audit Deficiency	Number	Percent
1	Failure to exercise sufficient professional skepticism	59	69.4%
2	Failure to exercise due professional care	55	64.7%
3	Failure to corroborate/verify management representations	32	37.6%
4	Inadequate independent verification	3	3.5%
5	Failure to obtain sufficient, competent evidence	64	75.3%
6	Lack of independence or objectivity	7	8.2%
7	Failure to perform standard or required audit procedures	34	40.0%
8	Failure to properly supervise subordinates	16	18.8%
9	Did not have adequate technical training and proficiency	7	8.2%
10	Failure to respond appropriately to identified risks	11	12.9%
11	Intentionally altered/destroyed work papers to conceal audit failures	9	10.6%
12	Failure to obtain sufficient understanding of internal controls	7	8.2%
13	Failure to issue accurate/proper audit reports	24	28.2%
14	Failure to properly plan the audit	15	17.6%
15	Failure to notify management or the board of directors of illegal acts	2	2.4%
16	Failure to obtain written representation letter from management	3	3.5%

**Table 4: Correlation Matrix of Audit Deficiencies***Refer to Table 3 for a description of each category of audit deficiency.*

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1	1															
2	0.47**	1														
3	0.25*	0.14	1													
4	0.01	0.13	0.25*	1												
5	0.51**	0.43**	0.33**	0.11	1											
6	-0.08	0.12	-0.14	-0.06	-0.13	1										
7	-0.14	-0.02	0.26*	0.23*	0.02	0.02	1									
8	-0.01	0.09	0.07	0.07	0.07	-0.04	0.10	1								
9	0.11	0.21	-0.06	0.18	0.17	0.07	0.11	0.08	1							
10	0.18	0.05	0.21	0.06	0.06	-0.12	0.04	-0.10	0.14	1						
11	-0.10	-0.15	-0.19	-0.25*	-0.25*	-0.10	-0.05	0.23*	0.04	-0.02	1					
12	0.11	-0.05	0.21	0.17	0.17	-0.09	0.02	-0.04	0.38**	0.27*	0.04	1				
13	-0.04	-0.10	-0.11	-0.01	-0.01	-0.19	-0.03	-0.10	0.01	-0.09	-0.05	0.10	1			
14	0.17	0.01	-0.04	0.27*	0.27*	-0.03	-0.06	0.09	0.20	0.10	0.04	0.31**	0.40**	1		
15	-0.07	-0.05	0.04	-0.09	-0.09	-0.05	0.03	0.12	0.24*	0.17	0.20	0.24*	0.08	0.13	1	
16	-0.01	-0.02	-0.02	0.11	0.11	-0.06	-0.03	0.07	0.18	0.12	0.35**	0.41**	0.16	0.25*	0.40**	1

*Significance levels: \*\* < 0.01, \* < 0.05*

**Table 5: Logistic Regression Analysis**

Predictor	$\beta$	S.E. $\beta$	Wald's $\chi^2$	df	p	$e^{\beta}$ (odds ratio)
Constant	-0.18	0.97	0.04	1	0.85	0.83
(H1) <i>MAG</i>	0.17	0.17	1.02	1	0.31	1.19
(H2) <i>COMMON</i>	-0.98	0.73	1.83	1	0.18	0.38
(H3) <i>TENURE</i>	-0.01	0.37	0.01	1	0.98	0.99
(H4) <i>RISK</i>	1.81	0.64	8.03	1	0.01**	6.10
(H5) <i>LIED</i>	1.37	0.65	4.49	1	0.03*	3.95
<i>CHAIRMAN</i>	0.14	0.23	0.40	1	0.53	1.16
<i>BIG4</i>	-0.92	0.66	1.90	1	0.17	0.40
Test			$\chi^2$	df	p	
Overall model evaluation			21.85	7	0.01**	
Goodness-of-fit test						
Hosmer & Lemeshow			3.85	8	0.87	

$R^2 = 0.24$  (Cox and Snell), 0.33 (Nagelkerke)

*Note:* This table presents the results of a logistic regression analysis of the likelihood that enforcement actions against auditors will cite a lack of professional skepticism as the reason for audit failure, where the dependent variable is an indicator variable equal to 1 when an auditor is cited for a lack of professional skepticism and equal to 0 otherwise.

*All variables are defined as follows:* *PS* = An indicator variable equal to 1 when an auditor is cited for a lack of professional skepticism and equal to 0 otherwise. *MAG* = the aggregate dollar value of fraudulent misstatements divided by the total assets in the final fraud year. *COMMON* = An indicator variable equal to 1 when the fraudulent scheme is considered to be commonly-occurring and equal to 0 otherwise. *TENURE* = the natural log of the length of the relationship between the audit firm and the client in years. *RISK* = An indicator variable equal to 1 when the auditor is noted to have been aware of the elevated risk of fraud and equal to 0 otherwise. *LIED* = An indicator variable equal to 1 when the client is accused of having lied or made false or inaccurate representations to the auditor and equal to 0 otherwise. *CHAIRMAN* = An indicator variable for the chairman of the board at the issuance of the first AAER against the auditor (1 = Levitt, 2 = Pitt, 3 = Donaldson, 4 = Cox, 5 = Schapiro). *BIG4* = An indicator variable equal to 1 if the auditor or audit firm involved represented a BIG 4/5 accounting firm (Arthur Andersen included).

*Significance levels:* \*\* < 0.01, \* < 0.05

**Table 6: Observed and Predicted Frequencies**

Observed	Predicted		% Correct
	Not Cited for a Lack of PS	Cited for a Lack of PS	
Not Cited for a Lack of PS	11	15	42.3%
Cited for a Lack of PS	8	47	85.5%
Overall % Correct			71.6%

Based on a cutoff point of 0.5, this table presents the observed and predicted frequencies of enforcement actions against auditors where the reason for audit failure is a lack of professional skepticism.

Note: Specificity =  $11/(11+15)\% = 42.3\%$ . Sensitivity =  $47/(8+47)\% = 85.5\%$ . False negative =  $8/(8+11)\% = 42.1\%$ . False positive =  $15/(15+47)\% = 24.2\%$ .

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