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Auditor Liability and Professional Skepticism: A Look at Lehman Brothers and MF Global

A White Paper

By Dr. Barry Jay Epstein, CPA, CFF

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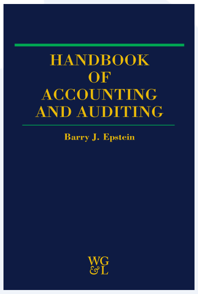

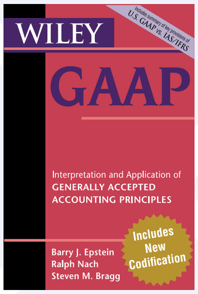

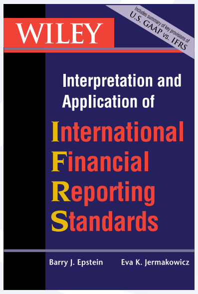

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As Auditors Settle Lehman and MF Global Charges, The Spotlight is Again on Auditor Skepticism

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Prominent among a rogues' gallery-full of actors placed into the spotlight following the commencement of the Great Recession in 2008 were the managements and outside auditors of Lehman Brothers and MF Global. Quite apart from any of the substantive underlying causes of the housing crash and sundry other fundamental factors contributing to this financial debacle, what should be given more attention is the continuing failures by highly trained independent accountants to challenge glib explanations for opportunistic financial reporting of transactions or events, when they departed from established accounting principles, particularly when the accounting methods employed had significant salutary effects regarding the apparent profitability, liquidity, growth trends, or solvency of the reporting entities involved. Indeed, it is now clear that the respective auditors' failures to maintain an attitude of healthy skepticism contributed mightily to the crisis.

In brief: the flawed accounting for Lehman and MF Global repurchase agreements

The failure of the venerable financial goliath Lehman Brothers in 2008 has been cited by some as the official triggering event of the financial collapse that brought on the economic recession that, in some ways, continues even today. Even if that assertion is exaggerated, that collapse undeniably delivered a huge shock to the domestic and international business and financial communities when, on September 15, 2008, what still remains as the biggest-ever Chapter 11 bankruptcy filing was made by the firm. Lehman's underlying problems had developed over a number of years and are not to be revisited here in any depth. However, the financial reporting fraud employed by the firm, apparently intended to conceal its fundamental weaknesses and to "buy time" for their resolution, which went undetected or under-appreciated by the firm's auditors over an extended period, should serve as a lesson for all auditors.

Specifically, Lehman engaged in the use of "repos" (repurchase agreements) to obtain short-term loans using firm-owned securities as collateral. Repos are entirely legitimate financial tools and have long been widely used not only by financial institutions but also by many commercial and industrial corporations. However, repurchase agreements, even though formally structured as immediate sales of securities with concurrently agreed-upon fixed-price forward repurchases of those same securities, are in substance secured borrowings, not independent sales and later re-acquisitions. U.S. accounting standards have long recognized the need to report the substance, not simply the form, of such two-part coordinated transactions. It is thought that most, perhaps almost all, parties engaging in repos – a market of almost $3 trillion before the 2008 crash – properly accounted for these.

Not Lehman, however. It managed to convince its auditors that, by virtue of the fact that its repurchase agreements were generously over-collateralized (105% in the case of those backed by debt instruments; 108% for those secured by equities), they were tantamount to sales, because a default on the second (i.e., repurchase) leg would arguably not have disappointed the counter-parties to those arrangements because, being over-collateralized, they would enjoy a windfall economic benefit, not a loss, in such event.

By reporting these secured borrowings as sales, and then using the proceeds (as much as $50 billion at any given quarterly reporting date) to pay down unrelated liabilities, Lehman grossly distorted its apparent debt-to-equity ratios, presenting itself as less leveraged and thus less risky than was the case. This in turn contributed to Lehman's continuing ability to borrow, at reasonable rates of interest, and to engage in financial transactions with parties which might have otherwise demurred from doing business with what in reality was a near-bankrupt entity that could fold at any moment, leaving counter-parties with commitments that could no longer be fulfilled.

It should be noted that Lehman's auditing firm, Ernst & Young (EY), has maintained that Lehman's so-called *Repo 105* and *Repo 108* accounting did in fact comply with professional accounting standards. On the other hand, the court-appointed examiner in the Lehman bankruptcy, Anton Valukis, was outspoken regarding the existence of "colorable claims" against both management and the auditors. EY recently agreed to settle claims against it for $99 million.

The Lehman experience, an object lesson that should have been readily absorbed, was a reminder that the substance of complex transactions, and not merely the form, must be fully understood, properly accounted for, and adequately disclosed to users of the financial statements. Specifically, the fact that repurchase arrangements are secured loans, not outright sales, should have been underscored for the accounting profession. The fatuous logic peddled by Lehman management, regarding the functional equivalence of over-collateralization of loans with outright sales, should never have been accepted by the auditors, who seemingly suspended their professional skepticism in doing so. The fact that no large U.S.-based law firm would grant the requisite "true sale" opinions for those transactions should itself have been one big clue to the invalidity of the underlying hypothesis upon which the *Repo 105* accounting was predicated.

Notwithstanding long-extant financial accounting rules as well as simple logic, the auditors at PricewaterhouseCoopers (PwC) went one better in their audit of MF Global, the commodities and securities wanna-be powerhouse headed by former New Jersey senator and governor Jon Corzine, who had once run Goldman Sachs and was attempting to replicate its scope and success by building upon the remnants of a failed firm, Refco, that also had been destroyed, in part, by accounting fraud. In the case of MF Global, large, unsuccessful bets had been placed on European sovereign debt issuances, and these were concealed in part via the usage of repurchase agreements improperly accounted for as sales, *a la* Lehman. In this instance, the faux logic accepted by the auditors was founded upon the coincidence of the maturity dates on the underlying debt used as collateral with the dates of the repos' closing transactions, invoking a hitherto unheard of accounting concept called *Repos-to-maturity*. This allowed for the analogizing of these secured borrowings to sales, inasmuch as – if things went as planned – all the repayments and at-maturity payoffs would net out on the same days. The fact that these paired transactions were with different counter-parties – and thus that MF Global was at risk for its repurchase obligations even if the underlying collateral defaulted – apparently was not given its due and full consideration. PwC recently settled claims by paying $65 million.

As with Lehman, the failure of MF Global was heavily abetted by accounting fraud, although in both instances the problems (operating losses, bad bets placed on certain markets, etc.) went well beyond the financial reporting issues. But auditors are supposed to prevent material distortions caused by the employment of unacceptable, GAAP-deviant accounting practices or, more accurately, they are charged with reducing the risk of such occurrences to a very low level.

Since each audit must stand alone in terms of adequacy of procedures applied, scope of testing, and so forth, the successful perpetration of a particular mode of fraudulent accounting (say, *Repo 105s* or *Repos-to-maturity*) undiscovered or tolerated by the auditors, in successive years should be exponentially less than in any single year. For example, if the risk of material error or fraud is controlled at 5% as a consequence of properly planning and conducting a given audit, the probability of that error or fraud remaining undetected should only be 5% x 5%, or 0.25% [one-quarter of one percent] over the course of two successive years' financial statement audits.

Clearly, the audit missteps regarding Lehman, where the use of the bogus *Repo 105* and *Repo 108* accounting continued over several years, implicate systemic audit failure – more so than that in the matter of MF Global, where the fraudulent accounting took place in only a single year.

What, then, was the root cause of this failure? In large part, it appears, it was the auditors' failure to maintain an attitude of healthy skepticism when responding to client assertions regarding the financial statements. Increasingly, this neglect of a fundamental auditing precept underlies failures to detect financial reporting frauds perpetrated by companies ranging from large publicly-held entities to small and privately owned enterprises.

<u>The key to effective auditing: maintaining professional skepticism</u>

The role assigned to auditors in our society is as examiners of the financial statements prepared by company management, followed by the expression of opinions as to whether those financial statements have been *fairly presented* in accordance with a stated basis of accounting, such as U.S. GAAP or IFRS.[1] Auditors plan and then gather evidence to support all of managements' myriad financial statement assertions (e.g., that reported assets exist and have value; that disclosed liabilities are complete) are accurate within the bounds of materiality. In order to be able to express such an opinion, auditors must examine enough evidence to

[1] Note that U.S. auditing standards (including those promulgated by PCAOB, applicable to audits of publicly-held companies, which are known now as *issuers*) use the expression "presents fairly," whereas international auditing standards and international financial reporting standards typically invoke the "true and fair" presentation concept, but these are for all practical purposes equivalent.

conclude that each material financial statement assertion is supported. It is *skepticism* that drives auditors' judgments regarding what, and how much, evidence will be needed to achieve this.

Unlike accounting principles, which are prescriptive and mechanical in nature, auditing rules are essentially *behavioral* in character; the tests and tools to be employed are only generally described and are subject to auditor judgment in their application. For example, auditors are expected to be independent of their clients, both in fact and in appearance, and a good deal of subjective reasoning must be applied to conclude on whether this standard is met in a given circumstance. Also, auditors are required to be objective in how they view audit evidence, and here too objectivity is difficult to reduce to a definitive set of operational criteria. Furthermore, due care must be exercised in the conduct of the audit, and due care is gauged (particularly in litigation) by how the broad mainstream of the profession would behave in similar situations. Thus auditing standards, in large part, instruct not about *what* auditors must do, but rather about *how* they are to behave while doing those things that are necessary in the conduct of a GAAS-compliant audit.

Most importantly, in the author's view, auditors are to exercise professional skepticism,[2] a term that is difficult to precisely define, but which can be roughly explained as maintaining a posture of "trust but verify."[3] For example, PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence.[4] In the international arena, IFAC's International Accounting and Attestation Standards Board (IAASB)

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[2] Professional skepticism is formally identified as being a necessary condition for the planning and conducting of audits with due care.

[3] It might be noted that some academic researchers and practitioners object to the "trust but verify" analogy, asserting instead that "[r]egardless of how apt that concept might have been in the context of Cold War diplomacy, it could be argued that "trust but verify" is actually bad advice when it comes to deterring fraud in general. In fact, 'trust but verify' could be a downright dangerous approach when applied to audit procedures in particular. A much better slogan for fraud deterrence would be, 'Trust is a professional hazard.'" [*Skepticism: A Primary Weapon in the Fight Against Fraud*, a White Paper by Jonathan T. Marks; Crowe Horwath LLP, 2014; at www.crowehorwath.com.] However, many others endorse this analogy, including the AICPA's Center for Audit Quality.

[4] Public Company Accounting Oversight Board (PCAOB), *Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, citing PCAOB Interim Auditing Standards, which adopted U.S. generally accepted auditing standards (GAAS), AU 230.09, which states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest."

deploys a very similar definition in its International Standards on Auditing (ISAs).[5] More broadly, skepticism can be related to the well-known scientific method of inquiry: it requires evidence, ideally developed from valid testing, and gives little or no credence to mere anecdotal indications or personal opinions. Placed into an auditing context, this means that uncorroborated management representations and assertions are no better than anecdotal evidence, and should be treated as such.

Although in the vernacular the term "skepticism" is sometimes taken as being akin to *naysaying*, disbelief or doubt, the etymology of the term suggests something different. The word derives from the Greek *skeptikos* – the verb form of which, *skeptesthai,* means "to reflect, look, view," which thus implies a neutral search for the truth rather than incredulity. Accordingly, there should be no negative connotation attached to this term and, if properly explained, should not give clients the impression that it implies a lack of trust or, even worse, an accusatory stance vis-à-vis management's representations. Auditors have no need to feel ashamed by the need to give effect to this professional requirement.

Given that the concept of skepticism has long been firmly enshrined in auditing standards and that its importance, if not its operationalization, is taught to all nascent auditors during their collegiate training, it is not likely that many practicing auditors are ignorant of this requirement, at least in the abstract. Research reveals that younger staff members (i.e., those recently educated in auditing) approach audits with a highly skeptical frame of mind.

Evidence strongly suggests, however, that compromises are not uncommonly made in applying this behavioral mandate. Staff auditors are implicitly discouraged from giving full effect to their natural enthusiasm and recently acquired understanding of the need to challenge management assertions. This occurs, *inter alia*, as a consequence of conflicting demands placed on auditors, lack of understanding of how the concept is to be operationalized, and confusion regarding the complex interrelationships among skepticism and the other generally accepted auditing standards.

Concerning the matter of conflicting demands, it is not difficult to appreciate that there is a direct correlation between the *degree of skepticism* demonstrated and the *extent of audit testing* and

[5] "Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence." ISA 200, para. 13(l).

of other related *evidence-gathering activities* that will be engaged in by the audit team. If there is excessive skepticism (however this is defined), there could as a consequence be over-auditing (defined as gathering and analyzing more evidence than is actually needed to support the auditors' opinion on the financial statements). Over-auditing would either result in higher billings to clients – who may, in reaction, seek to engage alternative providers for future auditing services at lower cost – or in unbilled time that must be absorbed by the firm, reducing the profitability of the services rendered. A number of researchers have cited staff concerns, e.g., over receiving lower performance evaluations when budgets are exceeded, as being among the likely reasons why warranted levels of skepticism might be consciously or subconsciously suppressed by staff level auditors.[6]

Operationalizing skepticism is a challenge that the profession needs to address, since this rather abstract concept, calling for a certain attitude or perspective, must somehow be transformed into rules for action. No simple method exists, for example, to mathematically transform, say, a 50% increase in skepticism into a specific expansion of required sample size in the testing of inventory. As with many audit processes, these are essentially subjective in nature – meaning that judgments can later be second-guessed, and they will be if, in hindsight, there might have been audit failure, as corroborated by, e.g., insolvency within a year of the balance sheet date, or the discovery of a material defalcation. The mechanisms by which skepticism can be converted into action rules should be a major focus of education and training for auditors, and there is indeed some reasonable basis for the belief this will be given greater attention in the future.[7]

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[6] For example, in one study of actual audit engagements, the researchers found that staff who express heightened skepticism and thus extend or expand planned audit testing but who ultimately fail to find any misstatement receive poorer evaluations than do staff whose skepticisms are corroborated by findings of misstatements perpetrated by management. It follows that fear of unproductive expansions of testing, even if warranted by risk assessments or observation of "red flags," biases staff against giving due attention to matters calling for heightened skepticism. [Joseph F. Brazel, Scott B. Jackson, Tammie J. Schaefer, and Bryan W. Stewart, *Hindsight Bias and Professional Skepticism: Does the End Justify the Means*, November 2013.]

[7] The possibility of formally training auditors on skepticism is receiving increased academic research attention, and will probably be incorporated into college and professional education programs in the future. "We believe ongoing dialogue is best served by considering professional skepticism in terms of a combination of personal traits, knowledge, and skill. A number of personal traits have been described as contributing to the ability of an auditor to exercise appropriate professional skepticism, including a questioning mind, ability to analyze and critically evaluate, problem-solving ability, ethical and moral reasoning, a willingness to suspend judgment, a tendency to search for knowledge, abilities relating to

Existing auditing standards – in the U.S., in effect since at least 1997, when SAS 82[8] was promulgated – require that risk of error and fraud be assessed during the planning phase of every audit, and that the process of "brainstorming" be used as one of the auditor's tools to elicit these evaluations. This is an exercise in which, preferably, the entire audit team contemplates how fraud could be perpetrated by management, *if* that were its intention – which then should be used to frame the strategic responses that will be incorporated into the audit plan. In theory, at least, the results of such assessments should drive the development of an audit plan that reflects the auditors' skepticism.

With reference to the matter of Lehman Bros., that entity's routinized employment of highly material quarter-end financing transactions – which significantly affected the key financial ratios reasonably anticipated to be relied upon by counter-parties, customers and investors – should have caused heightened skepticism. Had this then been followed by a critical review of the professional accounting rules concerning repurchase arrangements, the invalidity of Lehman's *Repo 105/108* accounting would have been manifest. Presumably the auditors would have refused to be associated with the financial statements had proper accounting for these repos, as secured borrowings, not been acceded to by Lehman management.

More mundane matters may also impede the fullest expression of auditor skepticism. For example, the length of tenure of the client relationship is widely understood to create an atmosphere of trust and warmth that is quite separate from objective evidence of management's probity and its expertise regarding accounting matters, and this lies at the heart of periodic arguments for audit *firm* (not simply audit *partner*) rotation. Additionally, allocation of inadequate resources (in terms of staff numbers as well as experience or talent), due to budgetary constraints or for other reasons, can negatively affect the team's innate skepticism. Furthermore, the failure to take steps to counteract the normal human judgmental biases – such

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interpersonal understanding, a sense of autonomy, and confidence based in self-esteem. Recent academic literature also suggests that skepticism involves skills that can be taught. Thus, while understanding and cultivating the personal traits that drive skepticism in auditors is important, additional opportunities likely exist to develop and implement training in universities and at the professional level designed to enhance skeptical thinking, attitudes, skills, and actions by new and experienced auditors." [Steven M. Glover and Douglas F. Prawitt, *Enhancing Auditor Professional Skepticism*, Global Public Policy Committee, November 2013, available at www.thecaq.org/docs/research/skepticismreport.pdf]

[8] Auditing Standards Board, *Statement on Auditing Standards No. 82: Consideration of Fraud in a Financial Statement Audit*. This was superseded by SAS No. 99, which continued and even strengthened this requirement.

as those of confirmation, anchoring and availability[9] – will serve to impede appropriate skepticism.

<u>Research findings bearing on skepticism in actual auditing practice</u>

As noted, the failure to apply requisite quanta of skepticism has been widely noted and documented. One study of matters that have drawn enforcement attention from the Securities and Exchange Commission (SEC) revealed that some 60% of cases examined exhibited deficiencies in skepticism, behind only insufficiency of audit evidence supporting the auditors' opinion (found in 80% of the sample) and failure to exercise due care (71% of sampled audit failures) as being instrumental in audit performance shortfalls. In the preponderance of such instances, one can trace the problem to audit team or firm leadership, which can be described as "firm culture" or "tone at the top" deficiencies, and which in turn often derives from budgetary pressures or client relationship concerns that dampen staffers' inherent traits of curiosity and skepticism.[10] These concerns deserve greater attention.

Research has also examined the role of personality traits or mood in affecting skepticism. Positive-mood individuals were found to be less skeptical than neutral-mood individuals are, and neutral-mood individuals were less skeptical than negative-mood individuals.[11] The judgment and cognition literature reports that good moods may actually have an unconstructive effect, and it is possible that this unconstructive effect may impact the workplace. If positive-mood auditors evaluate information that is consistent with their mood, it is surmised that these auditors could potentially exercise less professional skepticism compared to neutral-mood auditors whose information evaluation is less positively biased.

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[9] Confirmation bias is the tendency to seek out, and/or to give greater weight to, information that supports a preconceived position on an issue; anchoring results from having a fixed starting point for a reasoning process and being too reluctant to move far from that even in light of new information obtained; and the availability bias pertains to the tendency to only consider information that is readily at hand or that easily comes to mind.

[10] Consistent with research findings, in the author's long experience in training new audit staff members for many different firms, new hires, having only recently studied auditing from an academic perspective and, increasingly, having seen forensic accounting as being an exciting sub-area of professional endeavor, are anxious to uncover fraud – arguably, too anxious, given that frauds are still the exception to the rule – and are often dissuaded from becoming obsessed with this possibility. Retaining their youthful enthusiasm and creativity, albeit tempered by the need to be practical regarding the more mundane aspects that dominate most auditing exercises, should be a goal of management.

[11] Janne Chung, Jeffrey Cohen, and Gary S. Monroe, *A Research Note on the Effect of Mood States on Professional Skepticism* [undated].

More specifically, in an audit context the mood maintenance approach of positive-mood individuals may make them avoid difficult and unpleasant situations, such as confronting client personnel over questionable accounting practices or insufficiency of supporting data. Thus, they are less likely to make judgments and decisions that could later be questioned by either their superiors or client management. Negative-mood auditors, however, are less likely to bring this mood maintenance approach to decision-making, and thus, are more willing to confront others and, ultimately, to uncover potentially negative information. If this behavior is perceived by senior audit team members as being harmful to client relationships or at variance with budgetary constraints, it will, over time (e.g., because of negative performance reviews) cause these behaviors to be curtailed – and, with it, healthy and necessary skepticism may be repressed.

Although it is not known whether audit staff assigned to the Lehman and MF Global audits were actively discouraged from pursuing suspicions regarding *Repo 105/108* and *Repo-to-maturity* transactions, or even if field auditors observed these questionably accounted-for arrangements and brought them to their managers' attention, research does strongly suggest lack of support for critically questioning apparent GAAP departures – "tone at the top" issues – is a major cause for inadequate responses to skepticism during audits. Skepticism and its operationalized aspects must be taught, reinforced, encouraged and demanded by firm and team management if auditors are to comply with this professional requirement.

<u>Documented failures by the profession to employ skepticism</u>

Arguably, the audit profession has now become the single most regulated profession in terms of both the number of active regulators and the degree of scrutiny to which CPA firms' audit practices are subject. The audit and assurance practices of the largest U.S.-based firms (those that audit 100 or more public companies) are required to be inspected annually by the Washington, D.C.-based Public Company Accounting Oversight Board (PCAOB, the nominally private-sector entity established by the Sarbanes-Oxley Act of 2002, which effectively reports to the SEC). Similar inspections are also carried out in other parts of the world by other jurisdictional audit regulators, many of which are members of the International Forum of Independent Audit Regulators (IFIAR), the association of overseers of the profession.

The inspection findings of regulators in countries such as Canada, Germany, the Netherlands, Singapore, Switzerland, and the United States have all identified concerns regarding the lack of professional skepticism in audits. This consensus is disturbing because, as previously discussed, professional skepticism is a necessary condition for performing a thorough, objective, unbiased audit.

For example, in its *Audit Quality Inspections Annual Report 2013/14*, issued on 28 May 2014, the U.K. Financial Reporting Council (FRC) declared that:

> *… we are concerned to see insufficient evidence of firms applying professional skepticism, robustly challenging management's assumptions, or requesting that adjustments be made to the financial statements.*[12]

In the same vein, The Canadian Public Accountability Board (CPAB) describes the optimal circumstances as follows:

> *An engaged auditor is an important component to a high quality audit. If the auditor approaches the audit with* ***an appropriate degree of professional skepticism****, engages the right specialists, develops and implements an effective audit plan, and challenges management throughout the process, it will have done its part to ensure a quality audit. (****Emphasis*** *added.)*[13]

In response to its inspection findings of insufficiency of skepticism, PCAOB issued Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits*, stating, in part:

> *Observations from the PCAOB's oversight activities continue to raise concerns about whether auditors consistently and diligently apply professional skepticism. Certain circumstances can impede the appropriate application of professional skepticism and allow unconscious biases to prevail, including incentives and pressures from certain conditions inherent in the audit environment, scheduling and workload demands, or an inappropriate level of confidence or trust in management.*[14]

As though the failures suggested by the foregoing were not of sufficient seriousness to warrant the profession's immediate and close attention, according to statistics cited in the bi-annual 2014 Report to the Nations on Occupational Fraud and Abuse, published by the Association of Certified Fraud Examiners (ACFE), the percent of fraud cases that are uncovered

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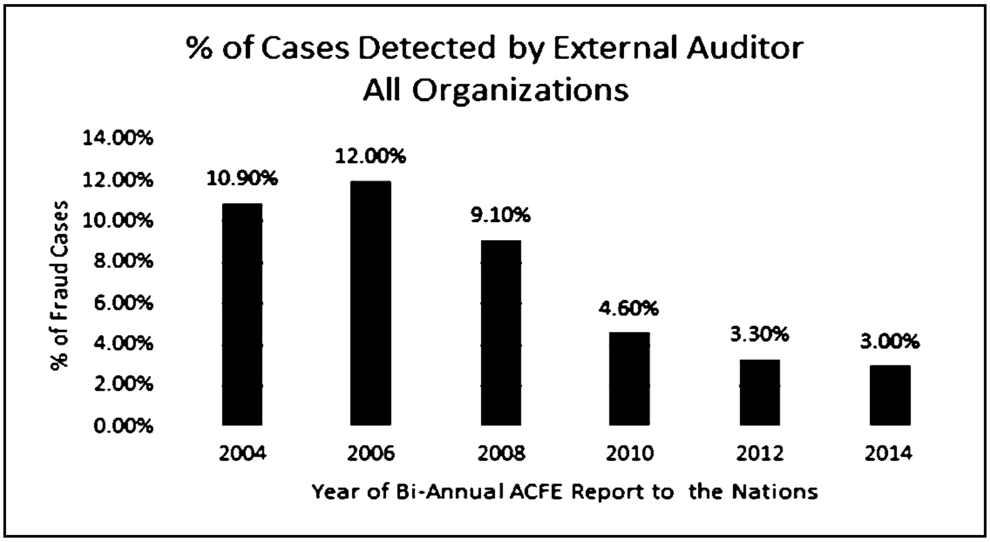
12 https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/Audit-Quality-Inspections-Annual-Report-2013-14-FRC-UK.pdf

13 http://www.cpab-ccrc.ca/Documents/Annual%20Reports/CPAB_2014_Annual_Report_EN.pdf

14 http://pcaobus.org/standards/qanda/12-04-2012_sapa_10.pdf

as a result of the work of external auditors has steadily declined from a peak of 12% in 2006 to a mere 3% in 2014.[15]

Thus, notwithstanding the copious bad publicity regarding the number of frauds occurring and the severity of the losses from those frauds, the seeming efficacy of external audits in detecting frauds has significantly declined, by about 75% from what it was eight years ago (even while noting that the improved performance of other parties, such as internal auditors and employee whistle-blowers, could have contributed to the apparent decline in outside



auditors' contributions). Significantly, the auditors' role in fraud detection, even at its historically highest level, was only minor – and this has long been a source of criticism, as well as a cause of significant litigation against auditing firms.

The fact that few frauds are uncovered by audits is a serious problem for the profession, since it serves to diminish the perceived importance of the audit – which, although a well-established tradition, could conceivably be superseded by some other form of financial reporting insurance.[16] A more immediate concern is that widespread awareness of the relative

[15] http://www.acfe.com/rttn.aspx

[16] Indeed, a longstanding suggestion, particularly as advanced by Professor Joshua Ronen, is that the audit function be subsumed in an insurance *underwriting* process, such as for directors' and officers' insurance. [See, *inter alia*, "Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited," *Stanford Journal of Law, Business & Finance*, Vol 8:1; and *Corporate Audits and How to Fix Them*; Professor Joshua Ronen, Professor of Accounting, New York University Stern School of Business; Journal of Economic Perspectives; Volume 24, Number 2, Spring 2010; Pages 189-210.]

ineffectiveness of audits could encourage the expansion of financial reporting fraud by managements, as well as of asset thefts by lower ranks of employees.[17]

Insights into the Lehman and MF Global audit failures

Skepticism, *per se*, does not correspond to or imply the employment of particular auditing tools. Rather, it is a governing principal that profoundly affects the nature, timing and extent of specific auditing tools, which range from observations and confirmations to analytical comparisons. In the Lehman situation, for example, the quarter-end *Repo 105/108* transactions and related reductions in various payables accounts effected by deploying borrowed funds treated incorrectly as the proceeds of sales of securities, would not necessarily have presented analytical anomalies, if these distorting adjustments were made (as they apparently were) consistently from period to period, if only the common, simplistic "last period vs. this period" mode of analytics were employed. However, if a slightly more creative "as presented vs. as would have been presented" perspective had been brought to bear, the impact of the fraud, and hence a stimulus for further examination, would likely have resulted.

In particular, had the auditors compared the debt to equity ratio as it existed post-*Repo 105/108* quarter-end transactions to what it would have been had those, and the corollary debt pay-downs, not occurred, or had they occurred but had been properly accounted for as secured debt transactions (with or without the associated liabilities reductions), it would have been clear that these transactions were purely for "window-dressing" purposes. This would have then, it is hoped, encouraged a more skeptical re-consideration of the underlying logic of treating the *Repo 105/108* transactions as actual sales. Coupled with the fact that Lehman was unable to obtain a "true sale" opinion from any major U.S. law firm, the failure of these transactions to eliminate counter-party risk should have not only led the auditors to reject this accounting, but also to downgrade its assessment of management integrity, which in turn would have informed the nature, timing and extent of substantive auditing procedures to be applied to other aspects of its audit.

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[17] In the classic Cressey "fraud triangle" formulation, perceived opportunity is one of the necessary ingredients for financial reporting frauds to take place. [See, e.g., W. Steve Albrecht, "Iconic Fraud Triangle Endures," *Fraud Magazine*, July/August 2014.] As the presumed inefficacy of audits is more widely appreciated, fraud becomes "safer" and thus more tempting.

Related to the foregoing, an analytic approach to the patterns of changes in the levels of various debt accounts (including accruals for routine obligations) should have readily detected the practice being engaged in by Lehman management. Although *real* window-dressing, e.g., paying down obligations at quarter-ends to prettify the balance sheet's debt-equity ratio, is not prohibited behavior and is widely engaged in, if it is based on proscribed accounting this would be a clear indication of fraudulent intent. If Lehman used the proceeds of borrowings, properly accounted for as borrowings, to pay off other obligations, there would have been no violation – but also, no reason for it being engaged in, inasmuch the net effect would have been neutral or even detrimental.[18] Simple "back of the envelope" calculations would have been sufficient to provide insight into the purpose for these unorthodox sets of events.

Thus, skepticism, if appropriately brought to bear in the Lehman audits, could have triggered a chain of audit analyses and other procedures that might well have prevented the gross distortions that permitted Lehman to materially misrepresent its financial condition for several years, the climax of which was the firm's collapse in 2008.

Heightened (but fully warranted) skepticism could have also assisted the MF Global auditors, despite the unfortunate (and probably careless) use of language in the accounting standard that probably allowed management to sway its auditors' thinking.[19] However, it appears that MF Global's objective was to benefit from market anomalies in the perceived riskiness of certain sovereign debt issues, which normally would imply that gains would be sought as those anomalies were reduced (i.e., as market perceptions of riskiness were corrected), and these could only be realized if the holdings were sold before maturity, which would have necessitated early cancelation of the repurchase agreements, making the "repo to maturity" argument transparently false, even if it had been conceptually valid in the first place.

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18 If properly accounted for as a secured borrowing, the *Repo 105s/108s* would have increased, not decreased, Lehman's debt-to-equity ratio. If the proceeds were then used to pay down other obligations in an equal amount, this would have restored the debt-to-equity ratio to what it was immediately prior to the repo transactions.

19 Under then then-extant standard, a number of conditions were all to be met for a repurchase agreement to be mandatorily accounted for as a secured borrowing, and "[t]he agreement is to repurchase or redeem them before maturity, at a fixed or determinable price" is one of these conditions. However, this conflicts with an even more fundamental accounting rule, namely, that assets and liabilities cannot be netted against each other unless subject to a netting agreement so that counter-party risks are eliminated, as discussed in the body of this paper, above.

More importantly, and arguably more immediately obvious to skeptical auditors, is the fact that counter-party risk is not eliminated by engaging in a repurchase transaction of any ilk. That is, a failure by the debtor whose securities are used as collateral for a secured borrowing to repay the debt when due does not relieve the ostensible "seller" (i.e., the borrower) in the repurchase arrangement from its obligation to the "purchaser." If MF Global's debtors – the nations issuing sovereign debt – defaulted on their obligations at or before maturity, that would not have eliminated MF Global's duty to repay its repurchase agreement counter-parties. Put simply, *any* repurchase agreement should have been viewed as a secured borrowing, unless the conditions for "net" presentation of the related assets and liabilities were permitted by GAAP.

It remains to be proven (and, given the respective firms' settlements, may never be addressed) whether the Lehman and the MF Global auditors actually lacked sufficient professional skepticism to challenge the accounting those firms employed, or whether they acquiesced to aggressive accounting by their clients with "eyes open." The more general questions regarding the apparent insufficiency of professional skepticism among auditors remain, in either event.

Possible reasons for suboptimal adherence to the skepticism mandate

Although the failures to employ appropriate skepticism are not, apparently, a new phenomenon, there are aspects of the current auditing environment that may have exacerbated this problem. In this regard, the formal testimony to the PCAOB by Dr. Larry E. Rittenberg, former chairman of COSO, articulately characterized the current audit environment as follows:

> *Auditing is a difficult task that should not be underestimated. The audit environment is characterized by increased risk taking by organizations, complex transactions where the economic benefits may be difficult to ascertain, highly technical accounting standards, increased dependence on information technology and related data repositories, increased globalization of commerce, and the speed of change.*[20]

This characterization of the current audit environment raises, as questions for consideration, regarding whether auditors and their skills, competencies, tools, methods, and thought processes have kept up with the velocity of change.

[20] Rittenberg, Dr. Larry E. (Professor Emeritus, University of Wisconsin-Madison, and former Chairman of The Committee of Sponsoring Organizations of the Treadway Commission (COSO)), *Comments on Governance, Professional Skepticism, and Auditor Independence*; 18 October 2012 [available at http://pcaobus.org/Rules/Rulemaking/Docket037/ps_Rittenberg.pdf].

Additionally, the rapid evolution of accounting standards likely impacts the maintenance of a skeptical attitude when conducting audits. As new and complex types of economic transactions are being invented in real-time and the volume and velocity of those transactions have multiplied, accounting standards setters have struggled to ensure that accounting frameworks have kept up. Several of these trends worth noting are that (a) standards are necessarily more complex since the transactions they are designed to depict have become more complex; and (b) the increasing use of fair value measurements[21] has resulted in substantial increases in both quantitative and qualitative information that is now required to be provided to the users of the financial statements.

Furthermore, there has been an ongoing effort, only partially successful, to make U.S. GAAP more akin to IFRS – and thus more "principles based."[22] Whether this effort is warranted or not, it likely would accentuate the need for estimates and assumptions that require the exercise of sound management judgment; increase the consideration of factors or indicators for qualitative consideration; involve the application of valuation models and the development of subjective probability assumptions; expand the role of management's intent with respect to particular assertions; and potentially result in different presentations of information depending upon the business model that management purports to follow.

These developments will only add to the challenge of conducting audits, including the mechanics of applying skepticism. Little if any attention has historically been paid by accounting standard-setters to the vital issue of auditability, and this will not improve in the foreseeable future. This results in a schizophrenic profession, whereby those who are responsible for maintaining and improving the framework used for accounting are insensitive

[21] Fair value measurements are intended to represent hypothetical transactions in orderly markets between marketplace participants. In the absence of observable data, the measurement may require management to make the assumptions that marketplace participants would make, thus requiring the auditor to understand the economic behavior of third parties in assessing the reasonableness of management's inputs.

[22] Over recent decades, the perception has arisen that at least certain of the more notable U.S. financial reporting scandals have been abetted by the fact that U.S. GAAP has historically been "rules based," thus encouraging the clever creation of transactions designed to skirt the strict rules. Partially in response to this, FASB and its corresponding international standard-setting organization, the International Accounting Standards Board (IASB), have been engaged in an effort to converge the two regimes, including making U.S. GAAP more principles-based, which, it has been argued, would encourage auditors to focus more attention on reporting the substance of transactions, giving a truer picture of reporting entities' actual financial positions and results of operations.

to the operational difficulties that arise from application of the framework in situations where little, if any objective evidence exists to corroborate significant amounts presented and disclosed in the financial statements.

There are also difficulties that derive from imprecise and even conflicting terminology and directives found in the auditing literature. Audit standards and the related implementation guidance can send mixed messages to auditors. For example, consider the following two quotes (***emphases*** *added*):

> *The auditor neither assumes that [management] is dishonest nor assumes unquestioned honesty. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.*[23]
>
> ********
>
> *Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of **risk of management override** of controls will vary from entity to entity, the risk is nevertheless **present in all entities**. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.*[24]

The first quotation asserts that the auditor should remain neutral and believe that management is neither honest nor dishonest. The second quotation, inconsistent with its predecessor, asserts that the auditor should assess the risk of misstatement due to fraud as a significant risk. Making such an assessment is seemingly inconsistent with and contradictory to the neutrality mandated by the first quotation.

The language in the auditors' report itself may also contribute to the confusion. The standard auditors' report, under the caption, "Auditors' Responsibility" states (***emphasis*** *added*):

> *Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain **reasonable assurance about whether the financial statements are free from material misstatement**.*

This language asserts to the user of the financial statements that there is an absence of material misstatements. An auditor that starts with that premise may be susceptible to

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23 International Auditing Practice Statement (IAPS) 1005, *The Special Considerations in the Audit of Small Entities;* paragraph 18; International Federation of Accountants (IFAC).

24 International Standard on Auditing (ISA) No. 240, *The Auditors' Responsibilities Relating to Fraud in an Audit of Financial Statements*; paragraph 31; IFAC.

confirmation bias.[25] This can result in the auditor believing that the purpose of the audit is to prove that the financial statements are correct instead of detecting and correcting material misstatements expected to exist in the financial statements as a result of error or fraud.

Also contributing to the difficulty in maintaining the prescribed attitude of skepticism, it is suggested, are certain of the messages delivered by managements of many audit firms, largely for promotional purposes, that may diverge from the traits required by independent auditors. For example, many public accounting firms' websites, mission statements, and internal communications tout the fact that they are "trusted advisors" to their clients – with little or no verbiage that discusses the important role that they play on behalf of investors, lenders, and other third parties. Either explicitly or implicitly many of these statements can be construed by less-experienced staff members as conveying a role as an advocate for the client.

Further, many of the types of services that firms cross-sell to their audit clients (when such cross-selling is permitted by independence rules) are advocacy-oriented services which can put the firm in a position of providing both advocacy and non-advocacy services for the same client.

There are other messages conveyed, sometimes implicitly, by audit firm and team leaders that can detract from emphasis on professional skepticism, e.g., "I've audited this company for many years and have always found management to be honest and ethical," or "This is a 'clean' audit. They've never had fraud and are unlikely to ever have it." These can have inordinate impact, particularly on more impressionable, more insecure-feeling younger staff, and inadvertently establish the wrong "tone at the top."

More broadly, there may be profession-wide structural issues that need to be addressed in any effort to seriously cope with the now well-documented dearth of skepticism manifest in the conduct of many audits. In examining the legal, regulatory, and commercial characteristics of the audit market, a fundamental issue must be discussed and given serious consideration: Is it realistic to expect skepticism and objectivity in a model where the company being audited makes the decisions regarding hiring, retention, compensation, and dismissal of the auditors? Stated another way, does the current system create a commonality of interests between the

[25] As noted previously, confirmation bias is a tendency to search for and give greater weight to evidence that supports a person's preconceptions and, conversely, avoid searching for or giving lesser weight to evidence that contradicts those preconceptions.

audit firm and the company being audited (and its management) that presents an insurmountable barrier to professional skepticism?

The IAASB attempted to address this issue in International Standard on Quality Control (ISQC) No. 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*.[26] This discusses the responsibility of firm leadership for quality. In that context, it identifies the need for the firm's leadership to ". . . recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs."[27] ISQC No. 1 further prescribes that management responsibilities are to be assigned "so that commercial considerations do not override the quality of work performed."[28]

The manner in which firms build and maintain their structure and culture will determine whether they are successful at achieving the goals of ISQC 1 with respect to putting quality first. It is incumbent on leaders of the audit profession to either make a strong case, supported by sound research and improved inspection results, that this structural barrier can be, and is being, overcome or to collaborate with legislators, regulators, and others to design and implement reforms to the system that would be responsive to the problem.

Regulatory responses to indications of audit quality matters

Regulators have expressed their grave concerns about the current situation (i.e., the failure to maintain professional skepticism) and have been working with a sense of urgency in a number of ways to attempt to remediate it. These include PCAOB disclosures of firms that fail to remediate failures identified in the course of routine inspections, and the authoring and dissemination of whitepapers, practice alerts, and Q&A documents to stakeholders that include

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[26] The International Auditing and Assurance Standards Board (IAASB) is the body of the International Federation of Accountants that is responsible for establishing International Standards on Auditing (ISA) and related guidance for auditing professionals.

[27] ISQC No. 1, para. A5.

[28] International Federation of Accountants, *International Standards on Quality Control No. 1: Quality Control for Firms That Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements,* para. A5(b).

lists of action items that firms, engagement partners, and individual auditors can take to enhance their level of professional skepticism.[29]

There have also been proposals or discussions regarding strengthening professional standards to improve communications between auditors and audit committees regarding certain matters. These communications would address such matters as audit strategy; significant risks; the participation in the audit by other firms and specialists; complex accounting estimates; significant unusual transactions; disputes over accounting matters; and the auditors' evaluation of the company's ability to continue as a going concern.

Additionally, there have been serious proposals made, or discussions held regarding, initiatives such as: an expansion of the auditors' standard report to include critical matters that arose on the audit and other informative language that conveys auditor insights gained during the conduct of the engagement. Among the ideas floated are the identification of the lead engagement partner; an indication of the extent to which components in a group audit were audited by other component auditors that were not part of the group auditors' organization; a requirement for periodic rotation of the audit *firm* (not just the engagement *partner*); a requirement for periodic "re-tendering" of the audit; and insulating the audit firm from being terminated (thus attempting to avoid retaliation by management for not assenting to their desired accounting treatment of particular items) without due cause.

Perhaps most important is the fact that several organizations are pursuing research and field testing for the purpose of identifying "audit quality indicators" -- quantitative measures that could potentially be used to determine the optimal firm environment for ensuring, among other things, the robust exercise of professional skepticism. One promising undertaking now ongoing by the SEC is the creation of a new *Financial Reporting and Audit Task Force*, and a related *Center for Risk and Quantitative Analytics*. Together, these efforts at creating and employing a new quantitative data and analysis model may result in devices useful in profiling high-risk behaviors and transactions, with the aim of developing a methodology for the earlier detection of financial reporting misconduct. The ultimate goal, of course, is to identify a set of "red flags"

[29] For example, see: IAASB Staff Questions and Answers, *Professional Skepticism in an Audit of Financial Statements*; Staff of the International Auditing and Assurance Standards Board (IAASB), 28 February 2012; PCAOB Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits*; Public Company Accounting Oversight Board (PCAOB), 4 December 2012; and *Report on 2013 Survey of Inspection Findings*; International Forum of Independent Audit Regulators (IFIAR), 10 April 2014.

that would trigger closer examinations of regulatory submissions for those entities deemed as having a higher risk of being the perpetrator or victim of financial reporting fraud.

Another current undertaking (as of April 2014) that may provide insights for auditors is the creation by the U.S. Department of Justice's (DOJ's) U.S. attorney's office in Chicago of a new section to focus on prosecuting securities and commodities fraud, which may incorporate to some extent the criminal side of the financial reporting fraud pursuits of the new SEC unit. (The SEC has only civil enforcement powers, and routinely refers matters it has identified to the DOJ for criminal prosecution, if circumstances warrant.)

Actions that could possibly alleviate the skepticism shortfall problem

Certain actions could arguably be taken respectively by audit firms, on the one hand, and by legislators, regulators, standard-setters and stock exchanges, on the other hand, which would contribute to an improvement in audit performance, particularly regarding application of skepticism, in the near term. Concerning the former, firms could take actions to transform firm culture and the "tone at the top," such as a commitment to the use of unambiguous language and reference to the company whose financial statements are being audited as "the auditee," rather than the words "client" or "customer" or "consumer," which imply a less arm's-length or objective relationship.

Additionally, firms should do more to ensure that there is the proper alignment of rewards systems with desired audit behaviors. As already required by the International Quality Control Standards (ISQC No. 1, para. A5), firm management is responsible for assigning management responsibilities so that commercial considerations do not override the quality of work performed.

Time and budgetary pressures have been widely cited as contributing to the less-than-needed application of skepticism, particularly by younger, field auditors. One possible approach to addressing this would be for firms administering an anonymous survey of staff and partner attitudes and perceptions.[30] Included in the survey should be a question such as:

[30] Unless it would compromise anonymity, the author recommends asking respondents for their job title. In pilot testing this questionnaire with personnel of several firms, it was found that the less experienced personnel were more likely to score time as the most important factor as a number less than 4 and that the more senior the person answering the question (in terms of job title, not firm tenure), the more likely the

In your experience, what is the level of importance placed on meeting time budgets versus delivering quality (circle one)?

Time is the most important factor			*Time and quality are equally important*			*Quality is the most important factor*
1	*2*	*3*	*4*	*5*	*6*	*7*

Firms could also give renewed attention to human capital management devices that would reinforce or develop staff skepticism. They could consider using an assessment instrument to measure auditors' individual skepticism, to develop individualized learning and mentoring plans, and to evaluate potential new employees. This would begin with a review of the firm's compensation and employee evaluation programs and protocols, to ensure that the firm is not rewarding sales more lucratively than technical skills. It would also seek to ensure that all audit-related training emphasizes the attributes of skepticism necessary for a quality audit.

Concerning audit engagement performance, it has to be acknowledged that, despite the aforementioned challenges presented by the current audit environment, the tools, techniques, and methodologies used by auditors have largely remained static. Although most or all firms have automated the methods they use to document their audit processes, this has been done without changing the fundamental methods that those processes entail. Therefore, at a minimum, firms should be using templates for documenting key audit decisions that include appropriately captioned sections that prompt the auditor to document such matters as (a) the rationale for selecting the alternative course of action that was ultimately concluded to be the most suitable; (b) the counter-arguments that were rejected: the alternative courses of action or conclusions that were considered and rejected and the reasons for rejecting them; and (c) counter-evidence that was examined, that contradicted management's assertions or supported

answer was in the range of 4 or over. This could indicate that more senior personnel are conveying intended or unintended messages in their interactions with those who they supervise.

opposing arguments, and the reasons why such evidence was not given greater weight. Explicating these matters would, it is believed, enhance auditor skepticism.

Although "brainstorming" planning meetings are now standard, firms should consider holding "challenge meetings" where key audit decisions are discussed and specific individuals are expected to make sound counter-arguments to those decisions. Although these sessions could, conceivably, be post-engagement learning assemblies, involving cross-team groupings simultaneously addressing multiple engagements, it is preferable that these be held during the engagement planning process, so that intended courses of action (e.g., audit scope decisions) could be modified on a timely basis, if necessary. Minutes should be taken and included in the engagement documentation to memorialize the fact that alternative viewpoints were expressed, considered and rejected. Individuals performing engagement reviews should be encouraged (and rewarded) for being thorough, asking probing questions and challenging staff to develop alternatives, thinking critically, to obtain credible, high-quality corroborative evidence, and obtaining from engagement staff well-crafted narratives describing the work performed, evidence examined, and conclusions reached.

Almost every audit results in the identification of significant estimates made by management, as well as the need for various adjustments to be made before finalization of the financial statements. Rarely, however, do auditors re-visit material estimates made in the prior period, which could reveal systemic biases that should, logically, impact assessments of fraud and other risks, and affect the level of skepticism brought to the examination procedures. Such retrospective audit procedures should be regularly performed and explicit documentation should be created on each audit that accumulates the results of these procedures applied to significant prior year estimates.

Regarding actions that ought to receive consideration by legislators, regulators, standard-setters, and stock exchanges, a primary recommendation is that there be funding of significant research and development into new audit methods, electronic evidence, data analytic tools, fraud detection methods, ways of minimizing bias, audit decision-making frameworks, end effective training on skepticism and critical thinking processes, etc. Because of commercial considerations, individual firms or networks cannot be relied upon to do this, so this needs to be a partnership between academic researchers and those government and private organizations that serve the public interest.

Accounting standards-setters and regulators must engage with their auditing counterparts and develop action plans by which accounting standards are amended to make them more objective and less subject to opportunistic interpretation, and to consider auditability as a fundamental requirement when considering potential new standards.

Because almost all audits result in a number of proposed adjustments, many of which are material and thus must be accepted by the auditee if an unqualified opinion is to be granted, it would also be beneficial to consider changes to the auditors' unqualified report that emphasize that financial statements are likely, prior to audit, to contain misstatements and that the audit is designed to detect and correct those misstatements:

> *Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance ~~about~~ ~~whether~~* ***that misstatements contained in*** *the financial statements ~~are free from material~~* ~~***misstatement***~~ ***have been detected and corrected in a timely manner.***

It is also urged that standard setters identify and resolve inconsistencies in auditing standards between those passages that imply the auditor should be neutral regarding the honesty and forthrightness of management and those that require the auditor to plan and perform the audit with management override of controls identified as a significant risk.

Many formerly standard audit procedures (such as the once-common "four column bank reconciliation" or proof of cash) have, over the years, been re-designated as being forensic accounting or fraud auditing steps, rarely employed in routine annual audits. As has been previously proposed, but not enacted, consideration should again be given to requiring every audit to include forensic audit procedures directed towards the areas that, based on the auditors' fraud risk assessment, pose the highest risk of material misstatement.

Although all businesses, in the long run, must provide value and satisfaction for their customers, as has been noted by many observers the auditors' true "customers" are the third parties relying on the certified financial reports they issue. Consideration should therefore be given to prohibition of the use of "client satisfaction surveys," to avoid independence problems and conflicts of interest, and to underscore the actual responsibilities involved. Doing so would guard against the threat of audit personnel succumbing to implicit or explicit pressure by the auditee to achieve their desired accounting results. However, if firms wish to obtain feedback from real customers, surveys should be taken regarding the esteem in which third-party users hold the firm's audit opinions.

Consideration should be given to prohibiting an audit firm from performing any services for an auditee that would put the auditor in a role of being an advocate on behalf of the auditee or its board members or members of management. Although this debate has raged for decades, and indeed it is true that little if any solid evidence exists for loss of objectivity by auditors who (or whose firm) also provide other services to auditees, such a prohibition would communicate to the user community that auditors take their independent role with the greatest degree of commitment, as evidenced by the willingness to forego other revenue sources from those already-established client relationships.

It is further proposed that, in tandem with the academic community and professional associations, regulatory organizations perform research on implementing an international audit quality framework, accompanied by transparent reporting of audit quality indicators. The eventual goal would be the development of best practices for matters such as optimizing partner to staff ratios and partner and staff utilization percentages/workloads; appropriate average experience level of firm staff on individual engagements; expected charge hours per professional; staff retention rates; industry experience; training hours per audit professional and curricula that support enhancing of professional skepticism; FTEs devoted to technical resources; and specialist hours as a percentage of overall engagement hours.

Finally, it is proposed that consideration be given to pilot testing, initially on a voluntary basis, structural changes to the audit model, many of which have been suggested in the past:

a. In the public company environment, strengthening audit committee oversight of the audit process including augmenting the accounting expertise on audit committees by requiring that one or more members possess audit expertise.

b. Consideration of creating a quasi-public organization that would appoint auditors of public companies and would adjudicate disputes between auditors and auditees.

c. Conducting research into a model for private company assurance whereby the party needing assurance (in most cases, banks or sureties) decides on the scope of the work sufficient for their decision-making purposes (agreed-upon procedures) and contracts with the firm to perform the work. This type of model can be analogized to the purchase of insurance and would align the interests of the auditor with the interests of the party seeking assurance; presumably, under a model of this nature, auditors who were thorough and found errors and fraud more frequently would be rewarded by obtaining more work at higher fees than those auditors that failed to find misstatements that resulted in the bank or surety incurring credit losses.

Promising academic research bearing upon auditor skepticism

With independence and skepticism being unique attributes of effective and standards-compliant auditors, it is not surprising that academic researchers are devoting considerable time and resources to researching these characteristics. Two studies hold particular promise to assist in improving performance in these areas.

One encouraging research paper, *Training Auditors to Think Skeptically*, concluded that skepticism can be viewed as a diagnostic reasoning process, and the authors were able to develop training materials that could successfully train auditors to improve their use of these skills.[31] The authors represented professional skepticism as a diagnostic reasoning process that incorporates both divergent and convergent thinking. The authors found that training in divergent and convergent thinking can provide a structure for auditors to be more professionally skeptical. Specifically, auditors that were trained in using both divergent and convergent thinking increased both the number and quality of explanations in response to evidence not consistent with their expectations. Additionally, auditors who completed the training demonstrated a greater ability to generate and ultimately choose the correct explanation.

[31] David Plumlee, Brett A. Rixom, and Andrew J. Rosman, *Training Auditors to Think Skeptically,* draft paper prepared for 2012 University of Kansas Audit Symposium, supported by a grant from the Center for Audit Quality (CAQ).

Key concepts set forth in this research paper are synopsized as follows:

Cognitive Processing Activity	Description	Example of Application to a Financial Statement Audit
Problem Identification and Construction	Recognize items or situations that should be considered unusual	The auditor develops expectations and compares those expectations to the amounts recorded in the financial statements. The auditor would consider it unusual if there was a significant difference between the amount expected and the recorded amount.
Divergent Thinking	Generate potential solutions to the problem by recognizing cues and links between available information to find explanations that might not otherwise be discovered. Consider plausible, multiple explanations for the unusual item encountered without an explicit, stringent effort to ensure that each explanation is logically valid in light of other knowledge and evidence. Similar to brainstorming, except that brainstorming is a group activity whereas divergent thinking occurs at the individual level.	The auditor considers the various factors that potentially could cause the identified difference (including reconsideration of whether the auditor identified all of the relevant factors that influence the recorded amount). To comply with ISA 240, the auditor ensures that explanations considered include both intentional and unintentional misstatements.
Convergent Thinking	Focusing the search for a solution. In problem solving, convergent thinking facilitates recognition of weaknesses and limitations in the generated explanations for the purpose of eliminating those explanations that should not be pursued. Convergent thinking enables decision makers to recognize potential areas in which to concentrate their effort and to arrive at a satisfactory solution.	Auditors use convergent thinking to test the plausible explanations they generated during divergent thinking. The auditor makes additional inquiries, gathers additional evidence that either supports or contradicts the various explanations. In light of the evidence gathered, the auditors' knowledge of the business and industry, and considering knowledge gained in performing other segments of the audit, the auditor considers the plausibility of the various alternative explanations generated during the divergent thinking process.
Solution Development	Conclude whether the unusual items or situations warrant additional consideration or if additional evidence needs to be obtained.	The auditor concludes as to whether or not there are any material misstatements in the audit assertions relevant to the account balance or class of transactions being tested. If a misstatement is detected, the auditor proposes an adjusting journal entry to correct the misstatement, and considers whether the failure of the reporting entity to detect and correct the misstatement represents an internal control deficiency.

A second area of promising research pertains to the measurement of professional skepticism. In her 2001 paper, R. Kathy Hurtt created a 30-item instrument for measuring whether a person possesses the characteristics of a skeptic.[32] An instrument of this nature could provide a good starting point for measuring a baseline of a firm's audit personnel to determine the extent to which they presently possess the characteristics of skeptics to examine whether there is any correlation between skepticism and the firm's perception of a person's skills as an auditor. This can serve as a needs analysis for developing targeted training as well as for identifying individuals that possess the characteristics that can serve as mentors to those who require development in this area. It also could potentially be used in the recruiting and hiring process to identify individuals who are more likely to be skeptical auditors.

Clearly, further efforts to more precisely define skepticism and to operationalize it in the context of audit engagements would be welcomed by the profession, and such research efforts should be encouraged and financially supported by the profession.

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[32] R. Kathy Hurtt, *Development of an Instrument to Measure Professional Skepticism*, University of Wisconsin – Madison, November 2001.