Prompting the Benefit of the Doubt:
The Joint Effect of Auditor-Client Social Bonds and Measurement Uncertainty on Audit Adjustments

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2016 Illinois Audit Doctoral Consortium
The problem: Why do audits fail?

One reason: Failure of independence
- The auditor found the misstatement but did not correct it.

But, if auditors are willing to “look the other way,” why bother to look for a misstatement in the first place?

Maybe auditors look the other way only when there is uncertainty surrounding the misstatement.
Why this problem is important

Separate streams of research show that
1) impaired \textit{independence}
2) measurement \textit{uncertainty}
are detrimental to auditor judgments.

Prior research does \textit{not} directly show how these constructs impact each other.

This is \textbf{critically important} is a world where
1) even \textit{subtle aspects} of auditor-client relationships can threaten \textit{independence}
2) accounting values are increasingly characterized by measurement \textit{uncertainty}

Social bonds
What we do and what we find

Incentivized experiment in the traditions of experimental economics.

Student participants interact in pairs, with roles analogous to a reporter and an auditor.

Manipulations: the social bond between auditors and reporters and measurement uncertainty present in the available audit evidence.

Primary dependent variable: the amount of audit adjustment required by the auditor.

Results: Lower audit adjustments occur only in the cell with social bonds and measurement uncertainty.
How do auditors respond once they have found a (potential) misstatement?

- Wright and Wright 1997; Libby and Kinney 2000; Braun 2001; Griffin 2014
- The Leniency Heuristic (Ganzach and Krantz 1991)

- Social Identity Theory (Tajfel 1978; Ashforth et al. 2008)
- Bamber and Iyer 2007; Bauer 2015; Koch and Salterio 2015
**Hypothesis**

- **Measurement Uncertainty**
- **Auditor/Client Social Bonds**

- **Audit Adjustments**

**Independence × Uncertainty**

- Independent auditor
- Socially bonded auditor

**Measurement Certainty**

**Measurement Uncertainty**
Research design: Manipulations

Factor 1: Social Bond (Independence)
Before the main experiment, participants spend five-minutes answering general knowledge trivia questions in pairs or individually.

Factor 2: Measurement uncertainty
Later, in the reporter-auditor game, the auditor’s signal either reveals the reporter’s action with certainty or it is highly diagnostic but not definitive.
Research design: The reporter-auditor game

Reporters start out with fixed pay of $15.

Each reporter then adds five marbles to a bag.

Marbles added can be red or white.

Each red marble added pays the reporter $2. Each white marble added pays zero.

The z-Tree computer interface describes the experiment in this manner, but there is no actual bag, nor are there any actual marbles.
Research design: The reporter-auditor game

Each red marble the reporter *adds* to the bag increases the probability that the auditor will incur a $15 penalty.

Auditors can protect themselves from this penalty by removing red marbles.

<table>
<thead>
<tr>
<th>Red marbles remaining</th>
<th>p($15 penalty)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>5%</td>
</tr>
<tr>
<td>1</td>
<td>20%</td>
</tr>
<tr>
<td>2</td>
<td>35%</td>
</tr>
<tr>
<td>3</td>
<td>55%</td>
</tr>
<tr>
<td>4</td>
<td>75%</td>
</tr>
<tr>
<td>5</td>
<td>95%</td>
</tr>
</tbody>
</table>
Research design: The reporter-auditor game

Auditors start out with fixed pay of $25.

Auditors receive a signal about the number of red marbles added, analogous to audit evidence.

Auditors can remove red marbles up to the number signaled.

Each red marble removed by the auditor costs the auditor $2.

With 60% probability, the reporter is charged $3 for each red marble removed.
**Research design:** The reporter-auditor game

**Nash equilibrium:**

Reporters should *add* five red marbles.

Auditors should *remove* the maximum number of red marbles allowed by the signal received.
Certainty condition: The auditor’s signal simply reveals the number of red marbles added, with certainty.

Research design: The auditor’s signal

Bag is empty to begin with

Assume the reporter adds five red marbles

The auditor’s signal
Research design: The auditor’s signal

Uncertainty condition: The auditor’s signal is diagnostic but not conclusive of the number of red marbles added.

Bag has five red and five white marbles to begin with

Assume the reporter adds five red marbles

The auditor’s signal
We use the “strategy method” to elicit how many red marbles the auditor wishes to remove for each potential signal.

<table>
<thead>
<tr>
<th>Signal received</th>
<th>Red marbles removed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>0 or 1</td>
</tr>
<tr>
<td></td>
<td>0, 1, or 2</td>
</tr>
<tr>
<td></td>
<td>0, 1, 2, or 3</td>
</tr>
<tr>
<td></td>
<td>0, 1, 2, 3, or 4</td>
</tr>
<tr>
<td></td>
<td>0, 1, 2, 3, 4, or 5</td>
</tr>
</tbody>
</table>
Results: Primary analysis

Audit adjustments when signal = 5 red marbles:

- No social bond: $p > 0.50$
- Social bond: $p < 0.01$

Red marbles removed

Certainty | Uncertainty
Results: Primary analysis

Audit adjustments across ALL possible signals:

- Red marbles removed
  - $p > 0.50$
  - $p = 0.03$

- No social bond
- Social bond
How do REPORTERS respond to the social bond?

Results: Reporter behavior

- **No social bond**: Red marbles added by reporter
- **Social bond**: Red marbles added by reporter

$p = 0.04$
Results: Possible alternate explanation?

Given reporter behavior, a lower audit adjustment *is justified* in the condition with a social bond.

Supplemental analysis of conditions with measurement uncertainty using Bayes’ Rule allows us to control for:
- auditors’ expectations of reporter behavior
- actual reporter behavior

Auditors face exposure to *more risk* in the presence of the social bonds.
Conclusions

When a misstatement is known, impaired independence does not result in impaired judgments.

Likewise, measurement uncertainty does not bias auditor judgments when auditors are independent.

However, when uncertainty is present, social bonds unrelated to auditors’ economic incentives, prompt auditors to give clients the benefit of the doubt.

Auditing complex or uncertain areas presents not only technical, but behavioral challenges.
Thank You!