PRACTITIONER SUMMARY

Would an Audit Judgment Rule Improve Audit Committee Oversight and Audit Quality?

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SUMMARY: The current regulatory environment encourages auditors to engage in “defensive auditing.” That is, auditors must show that they complied with widely accepted standard procedures in order to reduce their exposure to PCAOB inspectors and courts. This could discourage innovation in auditing, since new and innovative procedures are not standard practice. A new stream of research examines a proposed change to legal rules that would protect auditors from being second-guessed, even when they make non-standard judgments, provided that they are made rigorously and in good faith. This proposed “Audit Judgment Rule” (“AJR”) could potentially improve audit quality by encouraging innovation. We review two studies that examine the effects of such an AJR on the judgments of audit committee members and auditors. Results of these studies suggest that an AJR may have unintended consequences, reducing audit innovation and audit quality. We discuss implications for implementing an AJR, including directions for future research.

Keywords: audit judgment rule; audit quality; audit committees; audit innovation.

I. INTRODUCTION

In the current audit environment, auditors’ judgments, even those that are complex and involve difficult future estimates, can be second-guessed as courts can rule that alternative judgments should have been reached. In addition, regulatory inspectors, such as the PCAOB, currently have wide authority to determine that the judgments of auditors are deficient, irrespective of the reasonableness of the auditors’ judgment process. Despite the PCAOB’s expressed desire to avoid having such an environment impede the use of innovative audit procedures (PCAOB 2018a, 2018b),
concerns have been raised that such a climate leads auditors to take fewer risks and be less willing to develop ways to improve existing best practices in fear of potential liability (Peecher, Solomon, and Trotman 2013). To address this concern, both regulators and researchers have proposed implementing an “Audit Judgment Rule” (“AJR”) that is intended to provide auditors protection from being second-guessed (Peecher et al. 2013; SEC 2008).

The AJR is modeled after the Business Judgment Rule (BJR), which provides legal protection for corporate directors in the U.S. by regulating that their judgments not be second-guessed, provided that those judgments are made in good faith and are in the best interests of the company (Peecher et al. 2013; O’Connell and Boutros 2002; Johnson 1992). Similarly, under an AJR, inspectors and courts would not second-guess an auditor’s judgment provided that the judgement used reasoned evaluation, and was made in good faith and in a thoughtful, rigorous, and deliberate manner. Even if an inspector would have used other procedures or a different estimation process than the auditor, or would have developed a different estimate, the inspector can still consider the auditor judgment as reasonable (Peecher et al. 2013). Similar legal rules protect psychiatrists and psychotherapists from liability even if their best judgments lead to non-standard procedures, provided that they are backed by reasoned and rigorous judgments made in good faith (U.S. Court of Appeals 1987).

The protection from being second-guessed by PCAOB inspectors under an AJR could enhance financial reporting and auditing quality by allowing auditors to feel more comfortable in adopting innovative (and potentially more effective) audit procedures and by moving away from defensive auditing (Peecher et al. 2013). To the extent this holds, it would be in line with the PCAOB’s desire for auditing standards not to impede the use of innovative practice (e.g., PCAOB 2018a, 2018b, 2018c). Before implementing such change to the regulatory framework, however, it is important to gain an understanding of the likely impact of such action as there may be unintended consequences. In the following section, we discuss two studies that provide some insight into how two key players in the financial reporting process (i.e., auditors and audit committee members) would respond to implementation of an AJR. Given that auditing standards require auditors and audit committees to work together (PCAOB 2012), this new research stream has thus far focused on how an AJR would affect auditors and audit committee members. We first discuss Kang, A. Trotman, and K. Trotman (2015), who examine how audit committee members would respond to implementation of an AJR. Given that auditing standards require auditors and audit committees to work together (PCAOB 2012), this new research stream has thus far focused on how an AJR would affect auditors and audit committee members. We then discuss Kang, Piercey, and Trotman (2019), who directly test the potential effects of an AJR on auditors’ use of innovative and higher-quality audit procedures. We summarize the underlying motivation and research method of each of the papers, discuss the results, and then conclude with a discussion on the studies’ implications.

II. REVIEW OF RESEARCH ON AJR: MOTIVATION, RESEARCH METHOD, AND RESULTS

Effect of AJR on Audit Committee Members: Kang et al. (2015)

Motivation
Kang et al. (2015) examine the effect of an AJR on audit committee members’ questioning of auditors in a setting involving subjective judgments (i.e., in the context of accounting estimates).

1 Similar to the BJR, AJR has only been discussed as a potential regulatory proposal in the U.S. thus far (SEC 2008; U.S. Treasury 2008).
The complexity and uncertainty inherent in accounting estimates present opportunities for management bias as well as difficulties for auditors in assessing their reasonableness (Griffith, Hammersley, Kadous, and Young 2015; see also CAQ 2014; FRC 2013). Moreover, these features of accounting estimates raise difficulty for inspectors in evaluating the appropriateness of auditors’ judgments, which could lead auditors to perceive greater risk of having their judgments second-guessed. The study investigates the potential impact of implementing such change in the audit environment with a particular focus on the effect it would have on audit committee members, given the enhanced expectation for them to work in sync with the external auditors (e.g., Auditing Standard No. 1301, PCAOB 2012).

The study first examines whether an AJR would increase or decrease audit committee members’ level of skepticism in the financial statements, leading them to ask more or less probing questions of the auditor within their oversight responsibilities. On one hand, the additional protections auditors would have under an AJR from being second-guessed by inspectors could also lead audit committee members to perceive less risk associated with adverse inspection reports. To the extent this holds, the presence of an AJR could lead audit committee members to exert less skepticism in overseeing significant accounting estimates, potentially impairing financial reporting quality. On the other hand, the researchers argue that an AJR will more likely lead audit committee members to exhibit more skepticism, by triggering greater salience of their duty to protect investors. Specifically, the reasoning holds that the reduction in potential liability under an AJR is likely greater for auditors than audit committee members, as it directly relates to how inspectors should evaluate auditor judgments. This reduction in auditors’ risk of potential liability, however, may lead to an unintended consequence of leading auditors to become more lenient (U.S. Treasury 2008). Concerned that auditors will partake in such behavior, the study predicts that audit committee members will feel more accountable about ensuring the reasonableness of management’s significant estimates in the presence of an AJR. This, in turn, is expected to lead audit committee members to be more skeptical of management’s accounting estimates than in the absence of an AJR.

While there is the aforementioned possibility of auditors becoming more lenient with the reduction in potential liability risk under an AJR, there is also the prospect of auditors simultaneously feeling more comfortable to develop and conduct more innovative audit procedures (i.e., the original intention behind recommending an AJR). The study also considers this possibility and examines how audit committee members would respond to the use of standard versus innovative audit procedures under an AJR.

**Research Method**

Forty-nine audit committee members from Australia participated in the study (IRB approval was granted by both authors’ institutions). All participants had served on at least one audit committee, and on average had served on 6.77 audit committees. Participants were randomly assigned to read one of three versions of the case study, which differed in whether the case assumed an AJR was in effect, and whether the auditor had used standard or innovative audit procedures. Specifically, the three versions of the case were (1) “AJR absent/standard procedures,” (2) “AJR present/standard procedures,” and (3) “AJR present/innovative procedures.” All other case details were held constant.

In the “AJR present” conditions, participants are told to assume that new regulation has been introduced on an AJR under which courts and regulatory inspectors will not second-guess auditor judgments provided the auditor has used “reasoned evaluation made in good faith and in a
rigorous, thoughtful and deliberate manner.” In the “AJR absent” conditions, participants were provided with information on the “Current Regulations of Auditors in Australia” where “auditors’ judgments, even those that are complex and involve difficult future estimates, can be second-guessed as courts can rule that alternative judgments should have been reached.”

In the two conditions where standard audit procedures are said to have been implemented, participants are told that the audit partner prefers standard audit procedures over innovative audit procedures, and that audit inspectors expect standard procedures and thus, standard procedures are helpful in reducing inspectors’ criticism of the audit. Alternatively, for the innovative audit procedures condition, participants are told that the audit partner prefers innovative audit procedures.

After reviewing the case material, participants were asked to develop questions regarding “a significant accounting issue related to obsolete inventory.” The number and type of questions developed by the participants served as the primary measure of audit committee member skepticism.

Findings

Effect of an AJR Given Standard Audit Procedures

Consistent with the study’s predictions, the results indicate that audit committee members feel significantly greater accountability in ensuring the reasonableness of the financial statements in the presence (compared to the absence) of an AJR (see Figure 1, Panel A). Analysis of supplemental questions asked of participants suggests that this increase in accountability is related to audit committee members believing management’s estimates becoming more aggressive and auditors’ due diligence being negatively impacted with the implementation of an AJR. This increase in accountability, however, does not lead to a significant increase in the overall level of audit committee members’ questioning behavior. Interestingly, the study finds that audit committee members who were also former audit partners behaved differently than other types of audit committee members. Specifically, former audit partners become more skeptical and asked more questions under an AJR (increasing from 62 questions asked to 78), while other audit committee members tended to become less skeptical and ask fewer questions when an AJR is implemented (decreasing from 167 questions asked to 109).

Effect of Adopting Innovative Audit Procedures Given an AJR

With respect to the issue of how audit committee members view auditors’ use of more innovative (compared to more standard) procedures under an AJR, the study finds that audit committee members perceive a higher level of comfort regarding the issues surrounding the accounting estimate when more innovative procedures are adopted (see Figure 1, Panel B). Further analysis of the supplemental questions in the study suggest that this higher level of comfort is likely due to audit committee members’ belief that more innovative procedures will lead to higher audit quality. The greater comfort given more innovative procedures, however, did not significantly affect audit committee members’ questioning behavior. The study conjectures that this is likely due to the offsetting effect of audit committee members’ unfamiliarity with the innovative procedures.

That is, the unfamiliarity with the innovative procedures is thought to increase audit committee members’ questioning behavior, counteracting the potential decrease in their questioning behavior triggered from the feeling of greater comfort from auditors’ use of innovative, more effective, procedures.
FIGURE 1
Observed Results of Perceived Accountability and Overall Comfort in Kang et al. (2015)

Panel A: Perceived Accountability

Panel B: Overall Comfort

“Perceived accountability” is the rating given by participants on a scale of −3 (significantly not accountable) to +3 (significantly accountable). “Given the audit environment presented to you in the case material to what extent did you feel accountable to ensure the reasonableness of the financial statements?”

“Overall comfort” is a weighted combination of participants’ responses to questions about their comfort level with respect to (1) the change in management’s estimate of obsolete inventory, (2) the external auditor’s decision to allow management’s updated, smaller write-down of inventory, and (3) the difference in the net profit that results from the different write-down amounts for obsolete inventory. The responses to each were based on a scale of −3 (completely uncomfortable) to +3 (completely comfortable).

Analysis of the audit committee members’ demographics, again, suggests that their background takes a role, with former audit partners decreasing the number of questions they ask from 78 to 61 when innovative audit procedures are used rather than standard procedures, while those without an audit partner background show a slight increase in their questioning behavior from 109 to 121 questions asked. The authors conjecture that this directional difference is
due to the difference in the two group’s familiarity with audit procedures, especially those that are less traditional and innovative.

Overall, while audit committee members seem to believe in the benefits of auditors adopting more innovative audit procedures (i.e., higher audit quality), the findings of this study suggest that they perceive implementation of an AJR would lead auditors to exert less due diligence rather than being more willing to adopt innovative audit procedures and move away from defensive auditing. To the extent these perceptions hold, implementation of an AJR could potentially result in an unintended decrease in financial reporting quality.

**Effect of AJR on Auditors: Kang et al. (2019)**

**Motivation**

Recall that one of the underlying intentions of implementing an AJR is that the protection from being second-guessed by PCAOB inspectors under an AJR would encourage auditors to use innovative procedures by reducing their concerns over being second-guessed for using non-standard procedures (Peecher et al. 2013). The next study, by Kang et al. (2019), directly tests this assertion by examining whether implementing an AJR will in fact encourage auditors to move away from defensive auditing and pursue innovative, and potentially more effective, audit procedures.

Proponents of an AJR believe that an AJR will provide auditors relief from the second-guessing of their judgments, leading them to perceive greater protection from adverse inspection findings and potential legal liabilities. If this is the case, then the presence of an AJR will likely enable auditors to select audit procedures based more on providing reasonable assurance on the accuracy of the financial statements than on avoiding the risk of facing adverse inspection findings or potential litigation. This, in turn, will likely lead auditors to put greater focus on effectiveness, rather than simply the defensibility, of the procedures they select to conduct. As they do, they will be more likely to choose more innovative—and potentially more accurate—audit procedures, even if they are less defensible from the standpoint of complying with standard procedure and widely used practice.

However, the study’s authors also consider an alternative view on an AJR, in which an AJR could have the opposite effect on audit innovation and audit quality. Specifically, an AJR does not simply give auditors *carte blanche* freedom from second-guessing. Every proposed implementation of an AJR allows auditors more freedom to select less traditional procedures *provided* that the auditors’ decision is made in a rigorous, deliberate, and thoughtful manner (Kang et al. 2015; Peecher et al. 2013; SEC 2008). As a group, auditors tend to be more conservative in taking judgment risks than other types of decision makers (Smith and Kida 1991; Piercey 2011), and the AJR’s stipulation requiring rigorous, deliberate, and thoughtful justification may lead auditors to focus on the safety and defensibility of the procedures they choose more than their effectiveness or accuracy. For example, an AJR could further highlight to auditors the fact that their judgments will be subject to regulators’ evaluation and lead auditors to focus more on the defensibility of the audit procedures. If this is the case, the presence of an AJR could steer auditors to the safety of generally accepted, traditional audit procedures even more than they now do in the current regulatory and legal environment.

Kang et al. (2019) further examine the potential effects of an AJR on auditors under conditions of both higher audit risk and lower audit risk. When audit risk is relatively high, there is a greater need for audit procedures that will be effective in providing reasonable assurance that the financial statements are free from material misstatements. Hence, if an AJR is successful in enabling auditors to consider innovative and potentially more effective audit procedures, high audit risk is
likely to amplify this effect since the freedom to select effective audit procedures is most critical in such situations. Conversely, if an AJR leads auditors to become more defensible, higher audit risk may further amplify this effect as there is a greater chance of regulatory inspection under such situations. This could, in turn, further increase the use of traditional procedures that are widely used. Overall, the study examines whether AJR could potentially backfire from its intended purpose and have a negative influence on audit quality, in particular when audit risk is high, precisely when an AJR might otherwise be most useful.

Research Method

In the Kang et al. (2019) study, experienced auditors read a hypothetical case related to an inventory obsolescence issue. Participants were randomly assigned to one of four versions of the case, in which an AJR is either present or absent, and the audit risk surrounding the inventory valuation estimate is higher or lower (i.e., creating four possible combinations of AJR present or absent, and higher or lower audit risk). All other details are held constant across the different versions of the case.

The “AJR present” and “AJR absent” conditions use similar wording to that used in the previous study performed by Kang et al. (2015) to create differences in whether the case assumed an AJR was in effect. The higher (lower) audit risk version of the case informed participants that the inventory obsolescence estimate is an area of very high (moderate) audit risk, that the market to sell the inventory is far riskier (only slightly riskier) than management are currently recognizing, and there is a possibility that management’s estimate could very significantly (somewhat) misstate earnings. Further, participants are informed that the engagement partner has identified the estimate as being extremely important (important) and therefore the related evidence is critically important (important).

Prior to conducting the study, the authors interviewed a panel of audit partners to obtain a list of more innovative and more effective audit procedures, as well as more traditional and less effective audit procedures. The authors then surveyed a second expert panel to help identify a selection of three procedures that were more innovative and more effective, and three procedures that were more traditional but less effective (see Table 1). Thus, participants in the study who select the more traditional audit procedures over the more innovative audit procedures do so at a cost to audit quality. In contrast, if an AJR leads auditors to select more innovative procedures within this study, then the study illustrates how an AJR could potentially improve audit quality by encouraging auditors to use more innovative, as well as more effective, audit procedures.

Seventy-six audit managers and seniors from the Center for Audit Quality (CAQ) Governing Board firms participated in the study. Participants reviewed case materials related to the inventory obsolescence judgment, and then reviewed the six pre-tested audit procedures discussed above. They then rated each procedure in terms of its innovativeness, effectiveness, and defensibility. They also ranked the six procedures in terms of how likely they would be to include them in the audit plan.

Findings

The study finds that the AJR leads auditors to avoid the more innovative procedures and select the more traditional procedures, particularly when audit risk was high, despite agreeing with the panels of experts that the more innovative procedures were also more effective. Further analysis shows that the AJR had this effect because it led auditors to focus more on the higher
defensibility of traditional audit procedures, rather than on the higher effectiveness of the innovative audit procedures. As a result, the AJR backfired from its intended purpose (cf. Peecher et al. 2013), leading auditors to select fewer effective procedures due to increased concerns over defensibility. Further, this effect was most pronounced when audit risk was high and effective procedures are most critical to audit quality. Findings from a supplementary study suggest that this effect is not mitigated by the audit firm’s national office affirming to the auditors that the audit procedures they are considering are well reasoned, rigorous, and thoughtful.

III. IMPLICATIONS

Together, the two studies provide insight on how the audit committee and auditors, who are expected to work together to ensure high financial reporting and audit quality (PCAOB 2012), could respond to an implementation of an AJR. The findings suggest that there may be unintended consequences and as a result, the intended consequences of implementing an AJR may not be realized. Kang et al. (2015) suggest that an AJR had mixed effects on the performance of audit committee members, and that audit committee members, in general, believe that management’s estimates will become more aggressive and auditors will become less diligent under an AJR. Kang et al. (2019) further provide direct evidence that an AJR actually made auditors less likely to choose more innovative audit procedures, (particularly when audit risk is high), despite believing they are more effective than the more traditional, standard procedures. Rather, the findings of the study indicate that an AJR may even backfire leading auditors to pursue the safety of traditional procedures to a greater extent, even at a cost of audit effectiveness, due to increased concerns over defensibility.

These findings suggest that the effect of an AJR is not as straightforward as it may seem and thus, further research is necessary to identify ways to achieve its intended benefits. For example, the finding that auditors are reluctant to adopt more innovative procedures due to concerns over defensibility (Kang et al. 2019), even when audit committee members prefer innovative procedures and see them as providing higher audit quality (Kang et al. 2015), suggests that regulatory changes aimed at increasing the use of innovative audit procedures will need to convince auditors that inspectors will be accepting of alternative innovative procedures. Additionally, in thinking of ways to encourage auditors to move away from defensive auditing, regulators may want to also consider including statements describing how inspectors would evaluate the reasonableness of accounting and auditing judgments. In both studies discussed in this article, an AJR included the criteria for the evaluation of the reasonableness of auditors’ judgments. However, indicators of

| TABLE 1 |
| List of Innovative/Traditional Audit Procedures Used in Kang et al. (2019) |

Three More Innovative Procedures
- Look at the price of similar goods on eBay, Amazon, and other online retailers.
- Obtain estimates of similar products from an auctioneer with experience in this industry.
- Contact customers, including customers with expired contracts, to determine their plans to continue to purchase the product.

Three Traditional Procedures
- Physically inspect inventory.
- Examine the client’s history of phasing out of products and analyze their phase-out pattern.
- Review all sales transactions and look for a pattern.

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It is also important to note that while the stated intentions of an AJR are to improve decision-making quality, they may in fact only alter how liability rules are perceived by (and/or applied to) various parties in the financial reporting process. Kang et al. (2019), for instance, show that an AJR can increase auditors’ concerns about liability risk with respect to their judgment process, leading them to focus more on the lower defensibility, rather than the higher effectiveness, of innovative procedures. Findings from Kang et al. (2015) also suggest that audit committee members do not perceive that an AJR will lead to an improvement in auditor judgments. Rather, they appear to believe an AJR will lead auditors to perceive lower risk of potential liability and become less diligent as a result. Hence, we encourage regulators and researchers to consider potential changes to the audit environment that can help auditors to focus less on potential liability risks and more on improving the quality of their judgments and decision-making process. This can include examining whether implementing a reward for superior judgment processes (rather than simply penalizing judgments deemed unreasonable) would encourage auditors to move away from defensive auditing and pursue innovative procedures that are more effective in detecting material misstatements (see Cohen, Krishnamoorthy, Peytcheva, and Wright 2019; Peecher et al. 2013).

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