Claire: Welcome to this CPA Australia podcast on applying professional scepticism. We're going to find out how firms can enhance auditor's and audit team's scepticism. I'm Claire Grayston, CPA Australia's policy advisor on audit and assurance. And with me, is Professor Robyn Moroney and Dr. Soon-Yeow Phang from Monash Business School. Both Robyn and Soon-Yeow have done extensive research on the drivers of professional scepticism and are here to share insights they've gained from that research. So welcome Robyn and Soon-Yeow.

Robyn: Thank you.

Dr Soon-Yeow: Thank you Claire.

Claire: So first Robyn, if we can start. You've conducted quite a number of different experimental research projects on auditors' application of professional scepticism, so I'm interested in, so what's motivated this focus for you on professional scepticism?

Robyn: Thanks Claire. It really started back in 2012, 13, when I conducted a number of interviews with some colleagues of mine at that time with auditors, regulators and standard setters. And we were looking at the relationship between the firms and the inspectors at that time, to understand more about how that's affecting the way audits are conducted and any tensions between the parties. And that resulted in a paper called The Public Oversight of Audit Firms, the Slippery Slope of Enforcing Regulation, which was published last year. So it shows you how long it takes to get published in-

Claire: Robyn, I'll just interject. And say that we will put on the show notes some links to the publishers, so that listeners can look in more detail to those papers.

Robyn: That's great. Yeah, so it does take quite a while for us to get our papers published. But this paper on, we call it the slippery slope paper, as a short form, has resulted in quite a bit of research that I've conducted with various coauthors including Soon-Yeow. So one of the projects that came out of that was to look at the effect of regulation inspections in partner rotation policy on audited staffing decisions. I've also had a look at how the language used by the regulator when they are reporting on the results of their inspections, how it affects the way people feel about their jobs, their commitment to the firms and their turnover intentions. We've also looked, as part of that project, is about how they feel about the way their firms respond to the inspection reports by either increasing or decreasing the level of rigour, or restrictiveness in the audit process.

     The reason for looking at that particular project was because the firms were quite concerned that inspections and the reports, et cetera, may be having a detrimental effect on people's willingness to work as auditors. And in fact

maybe they were losing their very best and brightest auditors, so that was an interesting project. I've done some work on how shareholders feel about partner versus firm rotation and audit quality, the length of the cooling off period, how it affects audit quality. In fact the ethical standards board asked for that project to be done last year. And then Soon-Yeow and I, with some other colleagues and other colleagues at other universities are looking at the new audit report format and key audit matters. And again, we did some work for the Auditing Standards Board last year, looking at key audit matters.

So coming back to professional scepticism, I haven't forgotten that's what we're here to talk about, what really came out of those interviews back in 2012 and 13 was the view of the regulator at that time, and I know that they still have it, that if it's not documented, it didn't happen. And so it's not just about being sceptical, that they really want to see evidence that auditors are sceptical in the way that they conduct their audits, which means not just confirming what the client has come up with in their estimations, in their accounts, but also actually critically evaluating what the client has arrived at in their estimations.

So just before we go on, I just wanted to point out a couple of things. First of all, when we say that an intervention leads to greater or lesser scepticism, we're not saying that there's low scepticism. We're not coming up to a value judgement on that ourselves, we are just saying that an intervention will lead to relatively higher or lower scepticism based on our research. Also it's important to note that in designing the research, I regularly talk to partners from all of the big six firms, the largest six firms, the standard setters, the regulators, and that informs my research and that means that my research informs practise.

And so I write reports and report back to the firms and we have long discussions on what are the implications for their staff and for the way that they incentivize their staff and so on. Finally, the projects we're going to be talking about today include one published work and two projects which have been generously funded by CPA Australia, so thanks for that. They're not published yet because this data is really hot off the press and so our findings are very much preliminary, as they have not gone through the rigorous review processes yet.

Claire: Yeah. Great. Well Robyn, we'll hear more about those preliminary findings in just a moment. And I'm interested, you were talking about sort of the work you'd done sort of over the last seven years in professional scepticism and related sort of other audit quality areas. And I think the impact you were talking about ASIC and the way they communicate their findings and have you noticed a change? I mean certainly I know that they've said to us they've certainly tried to change the way that they presented their findings. So before we moved back to professional scepticism, because I think this is very relevant to what we'll be talking about later, about how people respond and getting the best out of, I guess auditors. Do you feel that changed ASIC's communications about their findings and what impact did that have?

Robyn:	I know it has. I know that they're being more mindful about the way that they report their findings, or the language used in their findings. They don't want to be controversial, et cetera. It's just about how they can convey the seriousness of their findings and be very clear about where there are problems. But at the same time they always tell me that they are very keen to work with the firms to help them make whatever improvements they think are required.
	How are the firms reacting? Well it depends on their individual firms report and were they sitting. Because of course ASIC's reports for all firms at the moment. So I guess individual firms receive their own individual reports and are processing those themselves. And they're not to be shared, they're confidential, so I don't know any of those details.
Claire:	I know. But we will talk later about your insights in relation to how within the firm those sort of findings are responded to and shared, and how that might drive scepticism. So, look Soon-Yeow, I just wanted to ask you about, before we get into the detail of the findings, in conducting the research, what kinds of measures of scepticism have you been using to assess the extent to which scepticism has been applied? Because it's not that easy. I can imagine it's not that easy to pin down how sceptical the auditor has actually been.
Dr Soon-Yeow:	Yes, I agree with that. Scepticism can be classified as a trait or a state. Trait skepticisms consider how a person in that skepticisms affects the various decisions. So it is measured using a 30 item scaled questions. State skepticisms consider factors that affect the demonstrations of skepticisms in various situations. So our study focuses on state scepticism because the regulator is concerned about the interventions that can be used to enhance the auditor demonstrations of greater skepticisms.
	And state scepticism has generally been considered as comprising judgement and action. Judgement deal with how an auditor thinks and actions deal with what an auditor does. So sceptical judgement is not visible, it has been proxy, as for example, the assessments of measurement estimates, whether the estimate is reasonable or not reasonable. Or assessments of the recent material misstatements, whether this is high risk or low risk. On the other hand, sceptical actions has been proxy as for example, the amounts of evidenced gathered. This means the quantities of evidence gathered by the auditors, or the amount of evidence that should be gathered. And another important concept is the qualities of evidence gathered. Does the evidence challenge it, or merely confirm with the management estimates?
Claire:	Yes. Okay. So corroborating or challenging evidence. Before we explore how you might suppress or enhance scepticism, can you explain the factors that you found that had an influence on skepticism's to start off with?
Robyn:	Yeah. So when we look at professional scepticism, we don't actually look at any of the files or at anything directly that occurred in the past, I guess that's the job of ASIC. So how we go about it is we set up experiments and we run those

experiments using auditors as participants. So the firms have, as I've said, have helped us in designing those projects. And then we send out a link and auditors in their own time, will go through and work through the little cases that we put together. And so as Soon-Yeow pointed out, we use proxies for scepticism because we can't sort of measure directly what a person's thinking and then it's their intentions of how much evidence they would get gather.

So in one of the projects we looked at the tone of the partner. So for example, how they're wording when they're setting auditor's up to do some work affects the way that the auditor's behave on the audit. So within that paper, the context was that you've had another client in the firm has been criticised by the regulator at their most recent inspections and they've been critical of the way an account has been audited and the level of scepticism demonstrated there. And then the partner comes to you and says that you're responsible for auditing that account. And either they say that they're confident that you're going to do the task well, which is their supportive style, or other people have told the same information and then the partner says that they're concerned about whether they will complete the audit well or not.

And so we're just looking at just simple things like that, can partners adjust the way that they behave. And we should say that this is in the context of a complex task. So the research has shown that when people are working on very mundane tasks being told, when you're doing a checklist kind of task, you're being told that, "Oh, you missed out part C. Go back and fix it up." That's appropriate. That's kind of negative. It's pointing out the negative, yet they're not saying, "Oh gee, you ticked off on those other points really well." You don't need to, you can just say, "look, you have to fix up that one." And people will go back and rectify the situation really well.

When it comes to complex tasks that involve very detailed decision-making, what's been found in other research is that you should use more of a positive tone. And so given that audits of complex tasks is a complex task in itself. Complex accounts, sorry, is a complex task in itself for the auditor's, what we're finding is that using a positive tone has a better effect on scepticism, then using it a negative tone.

What we did in that paper is also we introduced team salience. So what's team salience? Well, we know that auditor's work in teams, so what we did was either we didn't mention the audit team and therefore team salience was not raised, so in other the fact that auditor's work within a team wasn't sort of highlighted, or we make team salience high, by saying that, "The rest of the team is relying on you, you're responsible for this account, which we know is problematic and the rest of the team is relying on you to do a good job. So if this fall is inspected then we're going to do well because of you."

And so when team salience is high, that tone used by the partner becomes even more important. People pay more attention to it when they know that the rest of the team is going to rely on them. In terms of our perspective taking paper,

some papers have looked at how taking on somebody else's perspective before you go into a meeting. So it's like in the negotiation literature, if you're on the other side of a negotiation, sometimes lawyers, or psychology, or there's all different ways that this has been used. Putting yourself in the shoes of somebody else or the person you're talking to before you go into that meeting, actually helps you get a more positive negotiation outcome. Because you're not just going in thinking about what you want, you're thinking about what the other party might want and finding a happy medium between the two of you.

So prior research has found that taking on somebody else's perspective helps in all kinds of different outcomes. And so we were thinking about, well what about weather taking a management perspective versus an inspector perspective, does that have a difference on scepticism? So in our case, taking a management perspective, we know from when you go into doing an audit, even when I was back doing audits back in the '80s, you would think about what's a client trying to achieve with their profits this year? And it affects everything in the way that you set up your testing, et cetera. You know where the risks are, you know what kind of testing you want to do because you know there's a risk that the client is trying to overstate profit or understate profit and your testing goes along with that. So you're thinking about what the management is trying to achieve and you do that testing accordingly.

We know that these days a lot of firms are encouraging their staff to think about, "Well, what if we're inspected? Think about, make sure you've documented enough." How does thinking about what the inspector might look for, how does it affect auditor's potentially differently then if they take a management perspective? So that's what we were looking at in that paper. And we'll get to the results in a moment. And we also had to look at incentives because we know that firms are grappling with should we penalise people for poor performance, or should we reward them for good performance? What should the focus be on? And so we were interested in how those different kinds of incentives would might affect the way that auditors behave when it comes to their scepticism.

| Claire: | So you've certainly looked a lot of different factors there, which we'll explore a little bit more in a moment. You're looking at a partner's tone, perspective taking, both the management that you're dealing with, or for inspectors that could be reviewing the file subsequently, you talked about rewards or penalties for a good quality audit. So there's a lot of different factors that you certainly considered. It's certainly a complex area, so we'll delve down a little bit more. First thing I thought Soon-Yeow, could you tell us what doesn't work? So from your research, what method does not work to improve professional scepticism? |

| Dr Soon-Yeow: | Yes, there's a concern that inspection findings are coupled with penalties and we noticed our audit environment is penalty oriented. And our findings suggest that this focus on findings and the focus on penalising auditor's for poor performance could be counterproductive. So in our studies, when auditors are asked to consider what the inspector may focus on in their audit, they tend to |

do more work. That means they gather more evidence in order to please the audit inspectors. And our findings also suggest that this does not necessarily lead to gathering evidence that challenges the management estimates. So I would just suggest that a focus on inspector perspective, combined with a penalty incentive scheme lead to the demonstrations of the list skepticisms.

Claire: Wow, that's interesting isn't it? There might be volume, but not quality.

Dr Soon-Yeow: Yes.

Claire: By the sounds of it in the evidence that they gathering. So that's Soon-Yeow, compliance focus, isn't it? Were you worried about the inspector, how much you can tick off and, "I've got all this evidence, surely that's good enough." And then maybe not having the calmness to sit back and think about what the risks are and what they should be challenging. That's really, really interesting.

So Robyn, what are the key messages then that coming out of your research, ways in which firms can be effective in enhancing professional scepticism in their auditor's?

Robyn: Yeah, thanks Claire. The answer to this question is not simple. And I should say that when I've set with the firms and we've gone through our results, it's very clear that there's not a one size fits all response to this. And so it's really about firms looking at where their concerns are and then applying our suggestions, recommendations, if they should wish to do so, according to where the gaps or the problems are. The reason for that is that it depends which stage of the audit you're talking about. It depends which kind of scepticism you're thinking about.

So it's really about the client. It's not thinking about partner tone on its own or team salience on its own, it's about how they're combine. It's not about the perspective taking and then forgetting about everything else that's going on. So, for example, we know that incentives affect how the auditor's behave as well. So it's about being aware that it's a combination of things that can affect auditors and it's not any one silver bullet that's going to fix everything up.

So for example, with the partner tone experiment, the auditors were told about the inspection at another firm, as I said, and either the language was supportive or unsupportive. And we found that that auditor's were more sceptical in their judgement , in other words, in assessing management's estimates, when the partner used a supportive rather than an unsupportive tone, but that this difference was only statistically significant when the auditors were reminded that their team was relying on them.

When it comes to the perspective taking study, which we combined with looking at incentives, rewards versus penalty, we found that in the absence of incentives when we didn't mention rewards or penalties, auditors demonstrated greater sceptical judgement when adopting a management perspective. In

other words, when assessing managements judgements, the appropriateness of management's judgments, they were far more sceptical when they had that management perspective going into the task. When it comes to their sceptical action saying that they should go and gather more evidence, they were more sceptical when they had an inspector perspective.

So it comes back to your discussion with Soon just now, that really when we have that inspector perspective people are encouraged to do more work. Overall we found that rewards lead to greater scepticism than penalties and when combined, as Soon-Yeow mentioned, an inspector perspective and penalties results in a lower scepticism. That's what we found.

Claire: Some really strong messages I think for managing teams. And I think that taking management perspective is a really interesting one because you'd think you're taking their perspective, you'd be more, how should I say...

Robyn: Confirming what they're doing. [crosstalk 00:21:31].

Claire: Yeah, it's more critical. So thinking about what they would be wanting, whether they might be wanting higher earnings or more positive asset values, for example, and looking at how challenging perhaps some of those... So that's really interesting.

So Soon-Yeow, Robyn did mention that incentives are better and and you had said before the penalties certainly weren't very effective. So looking at incentives being useful in encouraging scepticism, perhaps you could talk about what kinds of incentives or positive rewards do you see as influencing scepticism?

Dr Soon-Yeow: Of the finding that in language priorities, just people more positively to rewards rather than penalties when completing the complex tasks. So we were interested in whether the types of rewards matters. So we look at tangible versus intangible rewards. So in our study participants were either told that if they performed well on the audit tasks, auditors at their firms are rewarded with for example, a generous bonus. So this is tangible reward. If they performed well on an audit, auditors at their firms are rewarded with for example, acknowledgements in the firm newsletters. So this is intangible reward.

So we also consider how auditor motivations, intrinsic motivations, high versus low, or extrinsic motivation, high versus lows, affects their scepticism when rewarded. So overall our findings show that motivation alone does not impact the auditor's scepticism. However, we find that motivations and types of rewards combine to affect scepticism in different ways. So for intrinsic motivations, when auditor's rewarded via acknowledgement in the firm's newsletters, intrinsic motivation does not affect their decision to gather additional evidence. When rewarded by a bonus auditor with higher intrinsic

motivations, indicated that they were more likely to gather additional evidence then those with lower intrinsic motivation. When rewarded by acknowledgement in the firm newsletter, auditor indicated that they would gather more evidence item that challenge management estimate. So this difference is significant for those with low versus high intrinsic motivation.

For extrinsic motivations, when auditors are rewarded via acknowledgement in the firm newsletter, auditor with lower extrinsic motivation indicated that they were more likely to gather additional evidence then those with higher extrinsic motivation. When rewarded by a bonus, extrinsic motivation does not affect that decision to gather additional evidence. When rewarded by acknowledgement in the firm newsletters, auditor indicated that they would gather more evidence item that challenge management estimates.

So in shock, tangible rewards enhanced auditor scepticism for quantitative tasks, which is referred into gathering more evidence. Intangible rewards enhanced auditor skepticisms for qualitative class, which is referring to gathering more challenging evidence items.

| Claire: | Well, it sounds like it's also depends on what motivations they have as an individual. Is that correct? |

| Dr Soon-Yeow: | Yes. We look at the combinations of the types of rewards and the auditors more- |

| Claire: | So do you suggest then that firms need to have a balance of both type of rewards? It's difficult to only cater to one type of personality versus another that you need both the monetary type of rewards as well as the more recognition, like the newsletter that you mentioned, those types of rewards. You need that balance to draw in both types of people? |

| Robyn: | Which comes back to why we said at the beginning, this is really complicated. Because so again, it depends what the firms are facing. Again, when we measured the auditor's motivation in terms of intrinsically and their extrinsic motivation, our findings were that the auditor's that work at the firms, the ones that participated in our studies, are very highly motivated people, both intrinsically and extrinsically. So we're looking at relatively low and relatively high. So compared to the man on the street, whatever, from the prior literature, these are highly motivated people anyway. |

Because we didn't find that motivation alone affects the results, what's interesting to see is, and it is quite complex, our preliminary findings for this study, but I think what Soon-Yeow says is correct, I think it's important to focus on the type of task. Are they gathering enough evidence then one kind of reward makes a difference, it's the bonus? If you're looking at the quality of the evidence, if you're concerned that your staff aren't challenging management enough, then going down the route of acknowledgement in a newsletter, or

something that doesn't involve money, seems to have more of an effect. It's their pride in their work that counts more there.

Claire:
Yeah. Fascinating. So there's certainly a lot there for firms to consider and partners to consider, and how to motivate the teams in gathering the right evidence that that is challenging. In other words, displaying appropriate professional scepticism. So perhaps you can just go over Robyn, we've talked about what firms might do, but perhaps you can just clarify for us some practical ways that firms can respond to your research in terms of enhancing that scepticism for both their partners and their audit teams.

Robyn:
Yeah, I think one of the criticisms that can be made about experiments is that they're not real world. First of all, by talking to the firms and having them help us in designing the experiments, we are using examples or we're using context and scenarios, either that come from the firms that they use in their own training, or that the firms have seen. And the way that we manipulate, or the way that we word things in our experiments are also given the green light by the firms. So I'm not saying that I've spoken to everybody at every firm, but nevertheless there is that work that we do before we conduct the research.

And my argument is that if auditors are responding differently based on something that's on a computer screen in front of them, imagine how much more they're going to react to that when it's in the real world. So we're pretty confident that if the auditor's are reacting to us, there is some, we call it external validity, or there's some chance that they will react like that in the real world as well. So we believe that we have demonstrated, like others have, that interventions do affect how people behave. And we've been able to apply that research into the scepticism space as well.

But again, we need to sort of think about, or firms need to think about, well which types of behaviour are they most concerned about? Is it about their judgements? Is it about the quality of the evidence that they are gathering? Is it about the amount of evidence they gathering? Et cetera. So it's about the type of scepticism they concerned about and then that will have an effect on the type of intervention they can think about. Again, it's not about just one solution that will work every single time. The world is more and people way more complex than that. And so it's thinking about the film culture, there's a whole lot of things that firms will be thinking about in this space.

We know from speaking to junior auditors that saying, "You must be sceptical, you must be sceptical, you must be sceptical," doesn't work. So it's really about having these messages and these interventions on a day to day basis. So we've been able to show the rewards work better than penalties, trusting people and using those positive tones and saying, "That I'm confident that you'll do the right thing." It seems to work as well. Again, it won't work for every single person on every single audit because the world is a lot more complex than that. So we're looking at the law of averages and what seems to be working.

Claire:	Okay. And so you were talking about the outcomes that you'd be seeking. So in addition to the motivators that you were talking about and the rewards, and extrinsic and intrinsic rewards that that Soon-Yeow was talking about. If there was an issue with not challenging the client enough, then taking that management perspective would be a good approach. Whereas if you're having difficulty with getting enough documentation or your auditors to actually detail what they've done, they might've gone through the right thought process and challenge, but not documenting it. Then you might talk about the inspectors perspective to help motivate those responses.
Robyn:	And we should say that the inspector perspective is not terrible because when you combine it with a reward, then people respond a lot better than if it's combined with a penalty. So remember it's the combination of the penalty and the inspector perspective, or focusing in on what that inspector might think, that results in the lower scepticism. But if you have the reward with the inspector perspective, it actually helps to counteract that problem.
Claire:	Yeah. Fantastic. So there's a lot there to take away. So Soon-Yeow, I know you would have looked at a lot of other research to sort of inform these experiments. So are there any other drivers of professional scepticism that other researchers have found that you want to sort of highlight for us?
Dr Soon-Yeow:	Yeah, interventions depends on the auditor trait skepticisms, which we do measure in our study and scepticism is also determined by an auditor personality, their knowledge, their ability to complete a task, their motivations [inaudible 00:32:11] I mean, or the way they think about the information provided by the client. And scepticism can be determined by external factors. For example, the task complexities like complex estimates can be quite complex for the auditors, the firm culture as whether to reward or penalise the auditors, the audit regulations, the auditing standard and the [inaudible 00:32:35] pressures. All these factors can affect the auditor's skepticisms.

and I also agree with Robyn that intervention on scepticism is not as simple as that. You ask auditor to be more sceptical in performing their task, or ask them to think critically, it doesn't work for the auditor in the practise. The simple intervention should be able to prompt auditors to think in a certain way. For example, in our study, the prompts of perspective taking on management could encourage auditor to think how management estimate, or derive, or manipulate the estimates and this could lead them to think more critically in auditing the complex estimates. |
| Claire: | Thank you very much. So just finally Robyn. In addition to appropriate application of professional scepticism, which is really critical for high quality audits. Are there other factors which research has indicated are key drivers for audit quality? |
| Robyn: | Well, audit qualities a central theme in research and it's been the focus of research for many decades. And when we think about audit quality from the |

paper from 1981, we think about audit quality is being defined as a combination of an auditor's competence and their independence. So it's not enough that an auditor can uncover a material misstatement. They actually have to have the independence and the courage to report it to their shareholders, if the client doesn't adjust their financial statements based on their find in that material misstatement in the accounts.

It's not enough for them to believe that the firm is at risk of falling apart in the next year. They actually have to have the courage to issue a going concern opinion on that company. So the drivers of audit quality, of course, I've done lots of research in this area as well. And in fact the main drivers, and this is in no particular order, include that auditors need to have adequate attention to detail, due care, effort, appropriate effort, they need to demonstrate good knowledge of their client, good knowledge of the industry the client operates in. They have to have objectivity, a sceptical attitude of course, and adequate professional judgement .

So current research is considering the link between key audit matters and the demonstration of a good quality audit as well. And whether there's a link between those two concepts as well.

Claire: And more topics to explore in future podcasts. Certainly those key audit matter findings and and how effective that's been, whether that's had an impact on audit quality or not. So I'd like to thank you both Robyn and Soon-Yeow, for joining us today. That was really interesting and a lot of takeaways in relation to how you can improve or encourage the appropriate level of professional scepticism in audit teams. We will look forward to publication of a couple of the papers that you refereed to today and the paper in particular that you've referred to that has been published. We'll put the link in to that. I thank you both very much.

Robyn: Thank you Claire.

Dr Soon-Yeow: Thank you.

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