

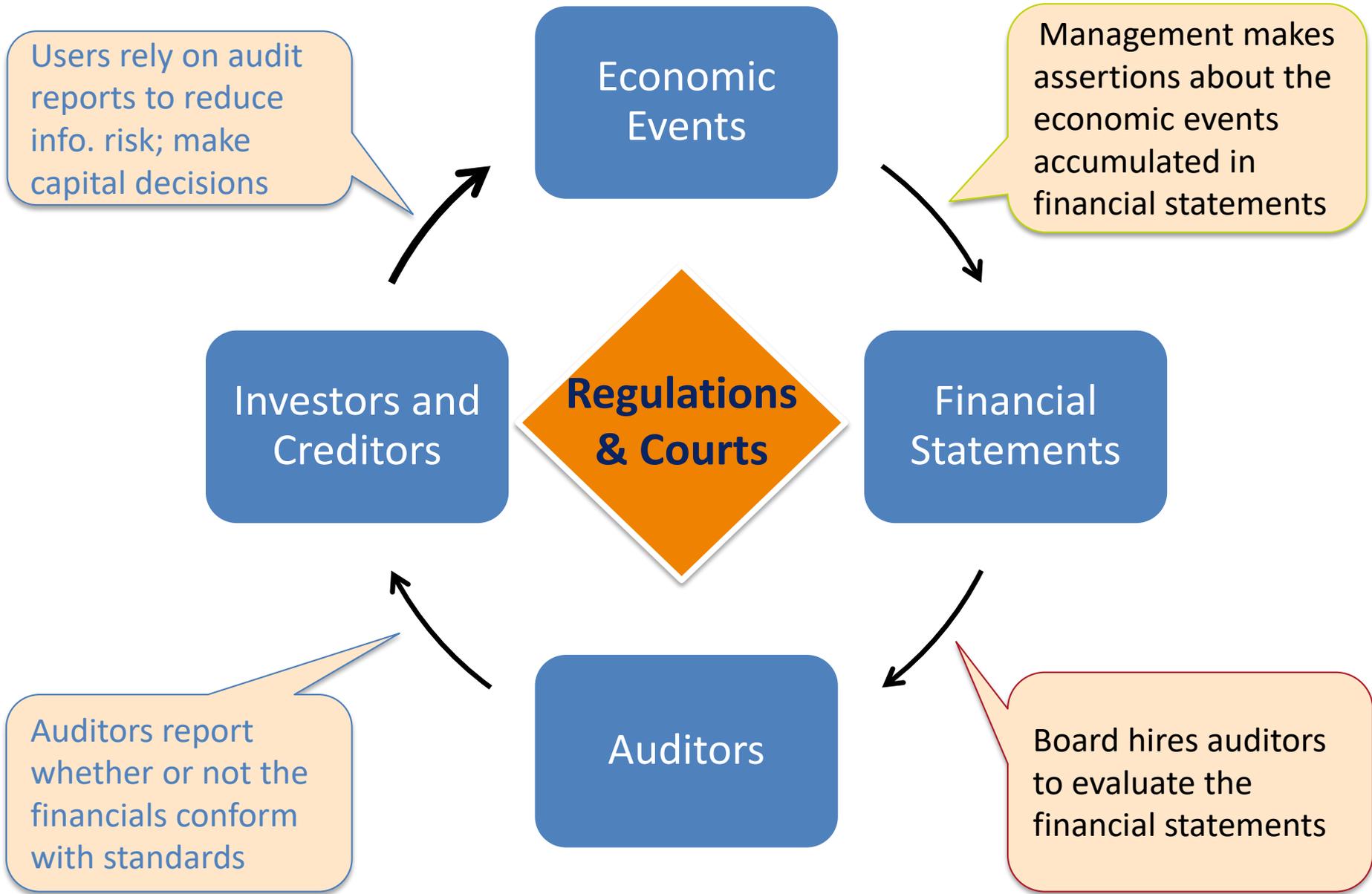


**Accounting research that informs regulators
and enhances reliable financial reporting**

UNIVERSITY OF DELAWARE | Alfred Lerner College
of Business & Economics
Jennifer Joe, Whitney Family Professor of Accounting

Trustees Retreat 2018



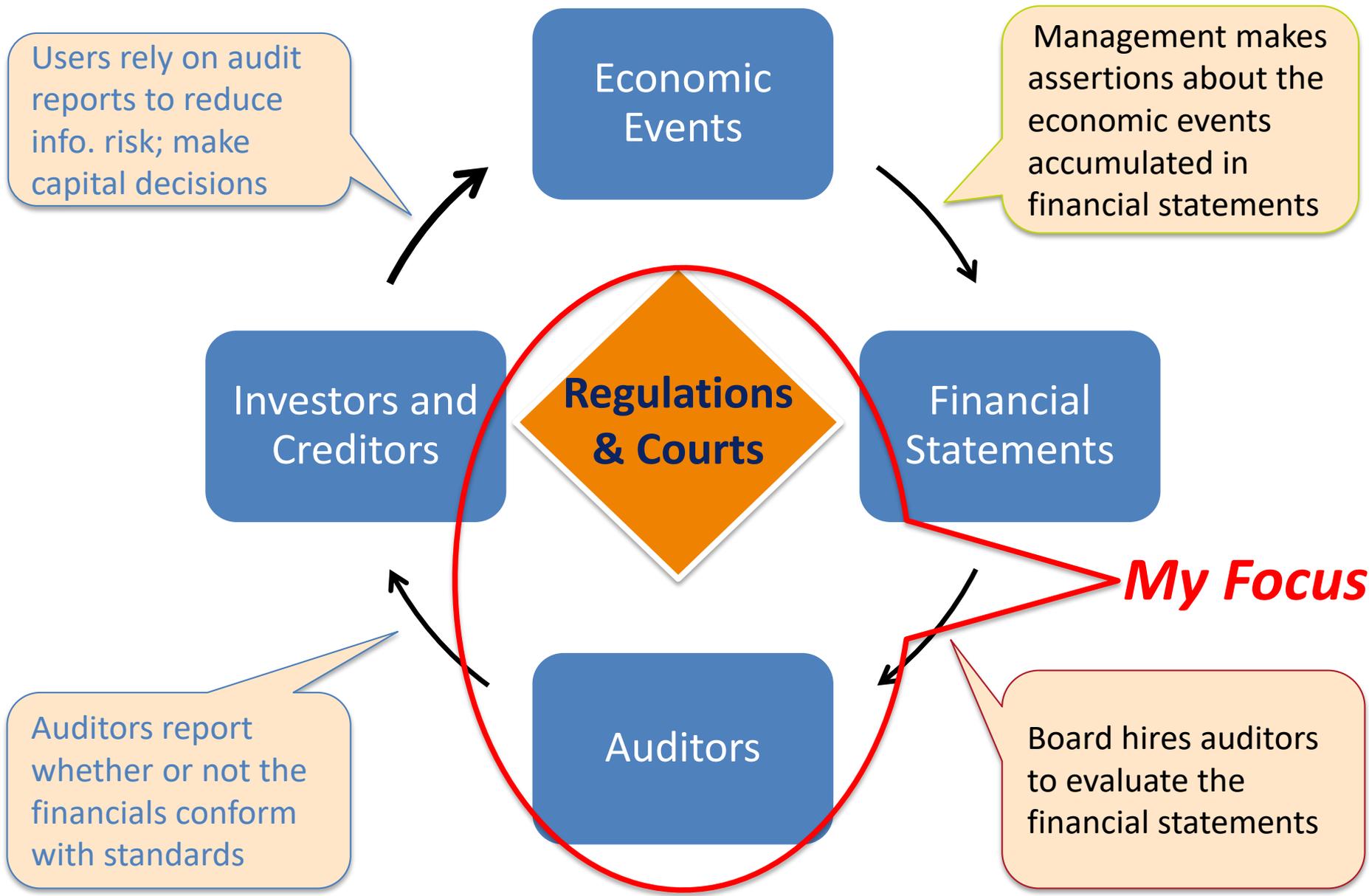


What is accounting research?

Our aim is to understand (**explain, predict, describe**)

- ✓ How market participants (like managers auditors, investors, lenders, etc.,) use and respond to accounting information
- ✓ How accounting is used in contracting
- ✓ How accounting & auditing regulations, or changes in existing regulations, influence financial reporting and the use of accounting information





In the wake of financial scandals, people look for a scapegoat

Forbes

Groupon: Where Were The Auditors?

Francine McKenna Contributor

I cover the accounting industry and accounting issues for investors.

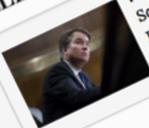


THE WALL STREET JOURNAL

MARKETS

OPINION | The Feds Bungle Frog Hospitality

POLITICS
Scope Of FBI's Kavanaugh Probe Reignites Tensions



Wells Fargo: Where Was the Auditor?

Its longtime auditor, KPMG, is getting questioned as well

By *Michael Rapoport*

Updated Nov. 1, 2016 11:19 a.m. ET

The New York Times

Sunday, March 12, 1989

Section 3

Where Were the Accountants?

C.P.A.'s come under attack as the search widens for culprits in the savings and loan crisis.

By **LESLIE WAYNE**

WHY did accountants throughout the nation fail to detect the shenanigans that triggered one of the biggest financial calamities this country has ever seen?

In Congress, in courtrooms and in private conversations, that question is being asked as observers grapple with the savings and loan crisis — and try to find those with deep pockets who might soften some of the financial blows. A search for culprits has already targeted tax regulators, unenforced econom-

ic downturns and shady industry executives. Now, it's the accountants' turn.

This, of course, is not the first time that the accounting profession has come under fire in the wake of a financial collapse. Accountants have been accused of shoddy work in some highly visible financial fiascos. Peat Marwick had to defend itself against some \$90 million in lawsuits for failing to detect the problems at Penn Square. And the accounting firm of B.D.O. Seidman was nearly ruined in the Equity Funding scandal.

But never before have accountants faced anything as brutal, or as potentially costly, as this onslaught. Whether it is firms within the profession or from outside, many are wondering whether these hard-nosed pencil-pushing professionals lost what they valued the most: their cool logic, their skeptical air, their independent voice. Critics are saying that while accountants could not have stopped the crisis, they could at least have sent up a warning shot.

In recent weeks, the Federal Home Loan Bank Board disclosed it had lawsuits pending against 10 accounting firms that audited the books of failed

savings units, and it said that more suits are on the way. Among the defendants are three of the nation's largest firms — Deloitte Haskins & Sells, Coopers & Lybrand and Touche Ross & Company. The General Accounting Office released an examination of 11 failed savings units in the Federal Home Loan Bank's Dallas district and found that, in six cases, auditors failed "to meet professional standards."

And accounting industry leaders rushed to Washington last month to testify before the House Banking Committee after its chairman, Representative Henry B. Gonzalez of Texas, charged that auditors of savings units were "derelict in their responsibility to sound early alarms about impending disasters."

With their deep pockets and aversion to publicity, accounting firms have long been targets for angry and litigious constituencies. But previous lawsuits have generally been against a specific firm for a specific collapse. The savings crisis is so widespread that accounting firms of every shape and size are potential defendants. But if the relationship between

Continued on Page 12

Search

May 20, 2002, 12:00 AM EDT

And Where Were the Auditors?

There's little doubt that Boeing Co. (BA) could have done a better job of alerting investors to its 1997 production problems. But how much

But as educators we know that

The majority of our graduates entering the profession:

- ✓ Are well-educated
- ✓ Are motivated
- ✓ Score high on ethical and moral reasoning tests
- ✓ Perform well on the CPA exams
- ✓ Etc, etc, etc,

So, why do “bad audits” occur despite best efforts?

And, does a firm's failure necessarily indicate there was a "bad audit"?



These questions drive my research agenda

Financial markets and economic events are by nature filled with uncertainty:

- ✓ Investors have incomplete information about the true state of the company's financial performance and firm value
- ✓ They rely on auditors to help reduce uncertainty
- ✓ But auditors cannot observe and test all transactions
- ✓ Auditors must estimate the true state of the company based on a small sample of data
- ✓ Regulators do not know if the pros of a given regulation will outweigh its potential costs

When individuals make judgments under uncertainty they fall prey to 100+ cognitive biases



I examine

How do biases and heuristics affect the cognitive processing of accounting information?

- ✓ What aspects of the audit task and audit environment taint auditor's judgment and decision making (leading to biased thinking)?
- ✓ How can existing or proposed changes to regulations impact the performance of audits or use of audit reports?
- ✓ What factors can influence jurors' evaluation of the performance of an audit?



1. Are auditors likely to over-rely on confident managers?

- People tend to think of confidence as an asset
“What I look for is confidence” Paul Orzeske, GM, Honeywell
- But research finds management (over)confidence leads to negative outcomes:
 - ✓ Optimistic bias – missed forecasts
 - ✓ Fraudulent and aggressive reporting
 - ✓ Reductions in shareholder wealth



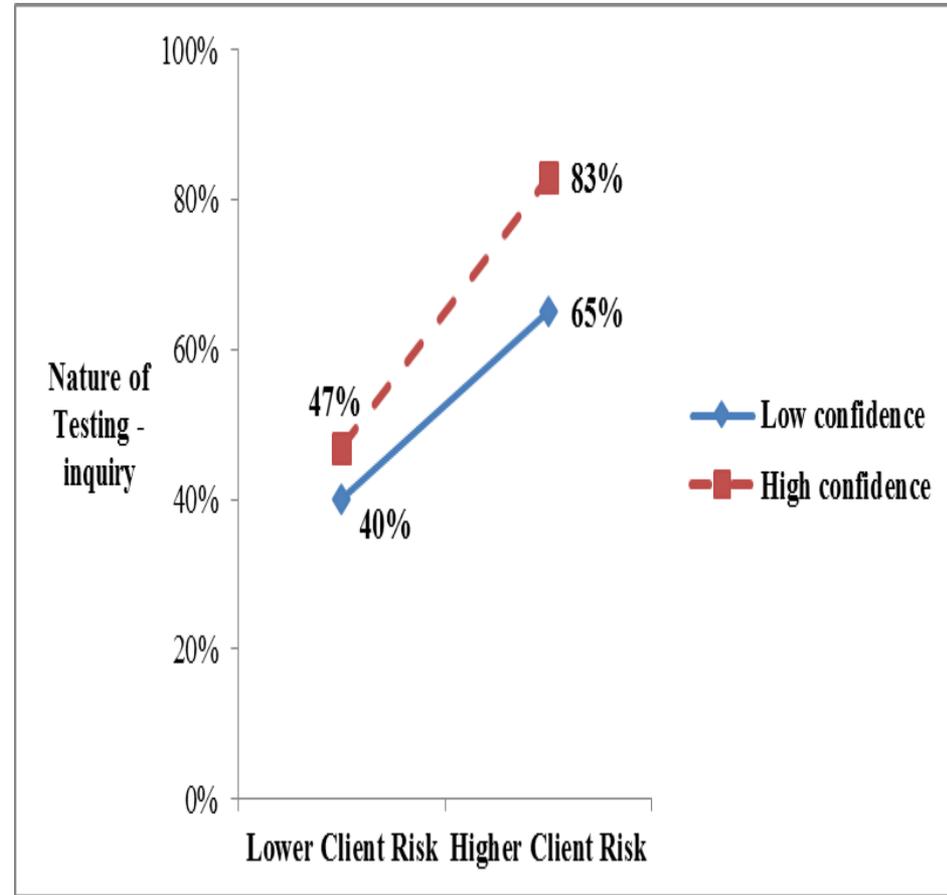
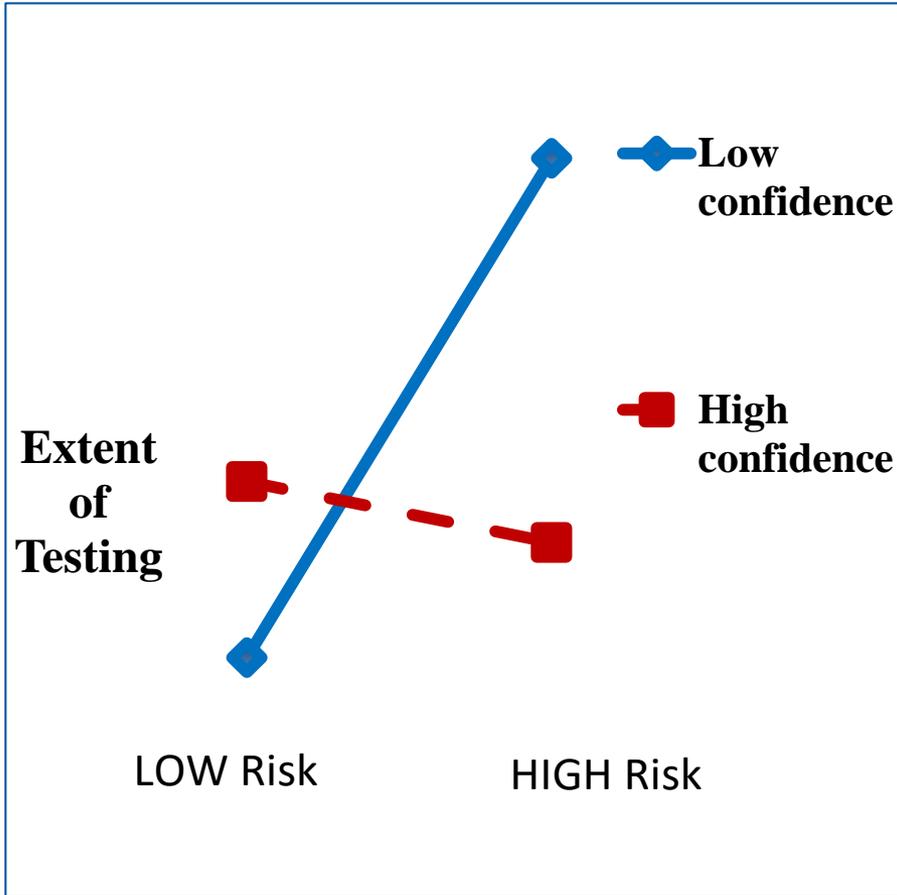
Are auditors likely to over-rely on confident managers?

Auditors can fall prey to *Ironic Processing Effects*

- Based on audit guidance, auditors should discount or ignore managers who express confidence
- But **IP** theory predicts that trying to monitor or ignore information can make it more salient in decisions
- The more auditors work to discount confidence, the more accessible it is in memory, and therefore influential
- For high risk clients, auditors will try harder to ignore management confidence, resulting in a rebound effect where confidence leads to stronger reliance on managers



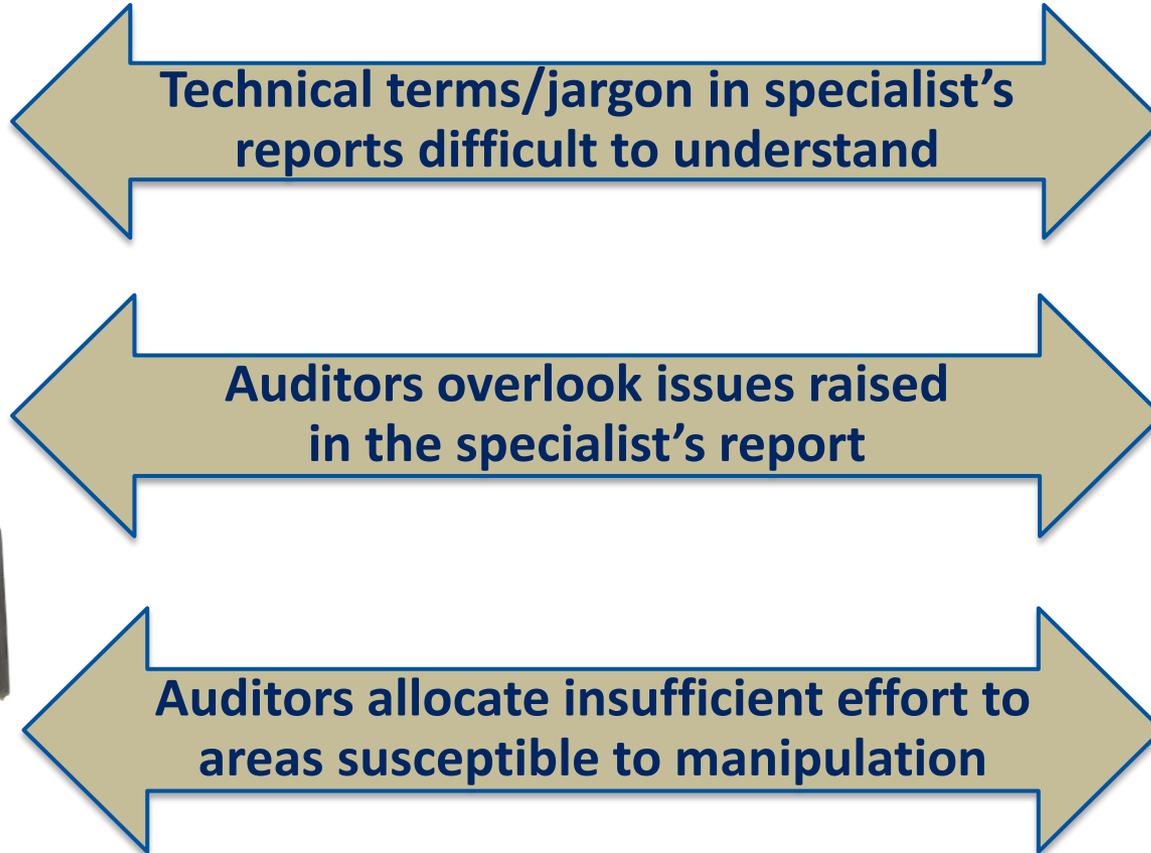
Results: Ironic processing in auditors



2: Can a complex communication style in specialist reports impact the audit of estimates?



Auditors



Specialists

Does communication complexity impact audits of estimates?

High Presentation Complexity

Client as follows: valued the account using an **Income Approach** called the **Royalty Relief Method**. The model is determined

$$FV = PV(r) \sum_{t=0}^t \left(\begin{array}{l} \text{Revenue} \times \\ \text{Royalty} (1 - \text{tax}) \end{array} \right)$$

Income Approach explained in a Business Glossary [Presented at end of the specialist's report]

Low Presentation Complexity

Client valued the account using an **Income Approach** called the **Royalty Relief Method**. *The Income Approach is a way of determining the value of a business.* [explained within the specialist's report]

There are 6 assumptions in the Royalty Relief Method used to derive the fair value estimate: 1) projected revenues, 2) tax rate, 3) tax amortization benefit, 4) royalty rate, 5) long-term growth rate, and 6) discount rate.



Can *perspective taking* improve audits of estimates?

Control Group: Auditor Perspective

As an in-charge auditor, list 3 key factors that would affect which classification level your client should use to account for their financial securities?

As an in-charge auditor, write the conclusion paragraph for the report to the audit file.

Treatment Group: Specialist's Perspective

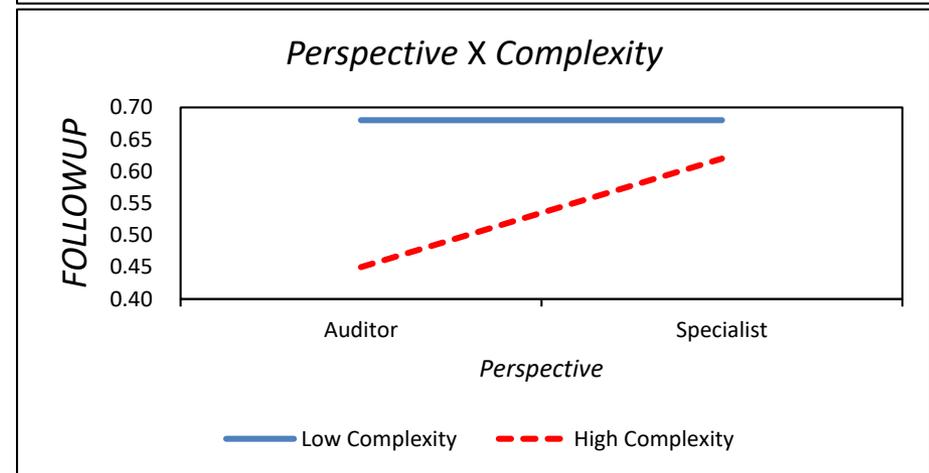
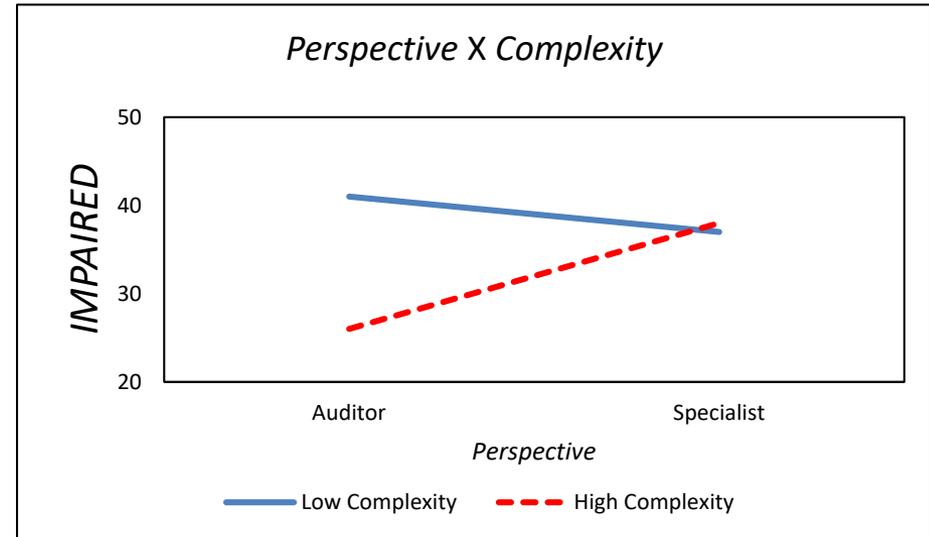
Taking the perspective of an in-house valuation specialist, list 3 key factors that would affect which classification level your client should use to account for their financial securities?

As an in-house valuation specialist, write the conclusion paragraph of the valuation specialist's report to the audit file



Results: Perspective taking can improve audits of estimates

- ✓ Auditors understand both low and high complexity reports BUT
- ✓ They can better identify the critical issues when the specialist opts for a low complexity style vs. high complexity style
- ✓ When auditors take a specialist's perspective, there is:
 - More follow-up on the issues flagged by the specialists
 - More integration of key evidence provided by the specialist
 - More questioning of management bias in estimates



3. Will expanding the auditor's report improve risk disclosures or undermine Audit Committees?

Proponents

- Auditor discussion of Critical Audit Matters (CAMs) will increase the information available to investors so they can evaluate risk
- The more detailed the auditor's report, the more beneficial it will be to investors.

Opposition

- Expanding the auditor's reporting model would supplant the AC's responsibility for investor protection
- Auditors disclosure will not impact managers' voluntary disclosures



Will expanding the auditor's report improve risk disclosures?

Audit Committees

Strong AC:

- ✓ All of the members are financial experts
- ✓ AC is actively involved in key accounting issues, asks a lot of questions

Weak AC:

- ✓ Only one member is a financial expert
- ✓ AC is somewhat involved; doesn't ask many questions

Auditor CAM Reporting

No CAM

- ✓ Auditors decided it is not necessary discuss of the warranty exposure

Less Informative CAM

- ✓ The warranty estimate is based on several subjective assumptions that are high in uncertainty

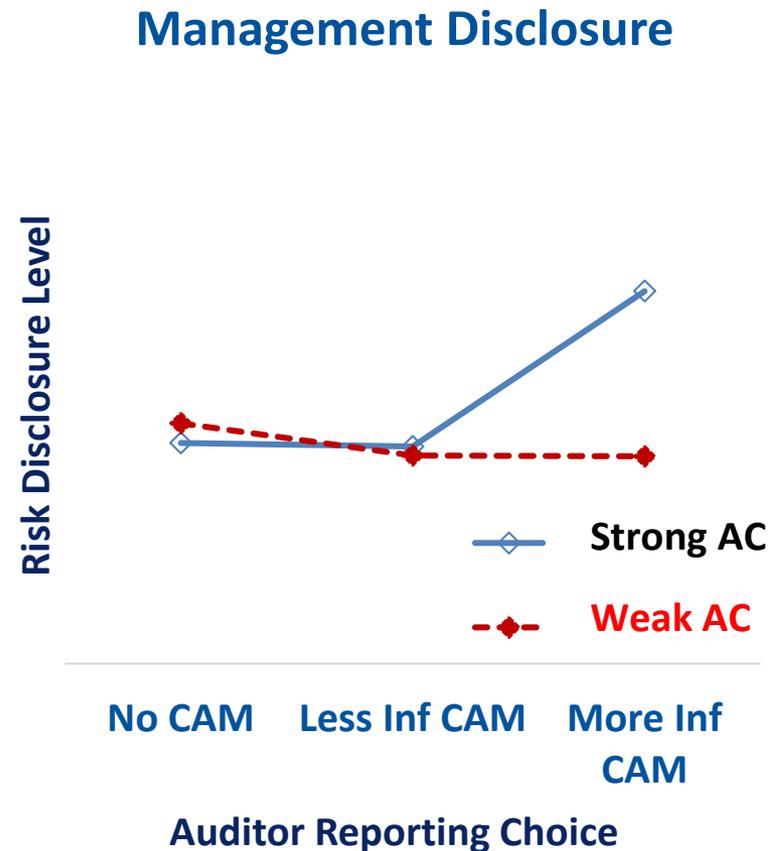
More Informative CAM

- ✓ Recorded warranty liability is at the lower end of the estimate range. The warranty estimate is based on several subjective assumptions that are high in uncertainty



Results: Expanding the auditor's report improves risk disclosures

- More informative CAMs, led managers to increase their own disclosures about the risk in the estimate **only for strong ACs**
- (Less informative) Boiler plate CAM disclosures had no impact on manager's F/R choices



Auditors' legal costs escalate

PwC ordered to pay \$625m over Colonial Bank collapse

US FDIC wins largest ever damages award against an accounting firm

Colonial was the 25th largest bank in the country when it went under, with more than \$26bn in assets and 340 branches. The FDIC, which covers depositors when banks fail, lost an estimated \$2.8bn from its downfall.



4. Juror evaluation of auditor negligence

Can following explicit directives from regulators unintentionally exacerbate auditors' litigation risk?

- **Numerosity heuristic processing:** people focus more on the number of units than the scale or size of the units because it is cognitively easier to process absolute numbers than relationships between numbers
- Greater odds perceived when:

**36,500 people die from
cancer every year**

OR

**8 out of 16 chance of
winning (50%)**

versus

**100 people die from
cancer every day**

OR

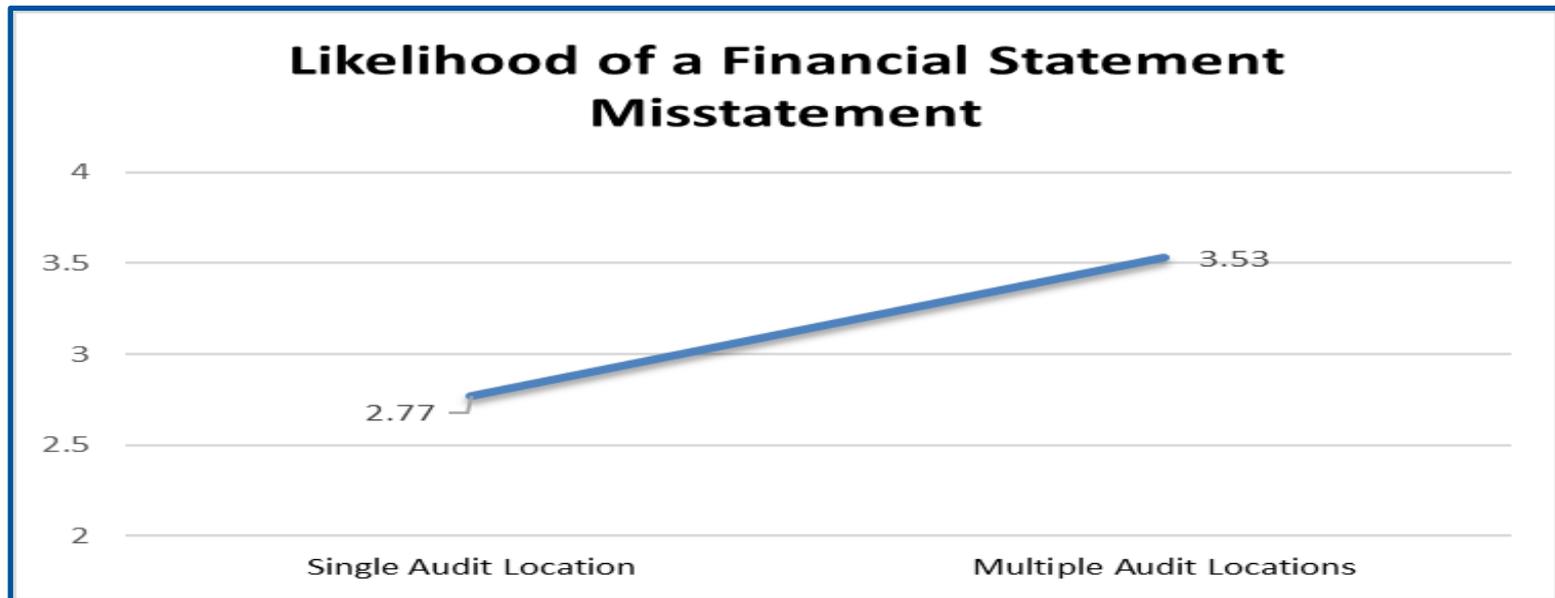
**5 out of 9 chance of
winning (55.56%)**

Will **numerosity heuristic processing** drive juror thinking about audit liability?



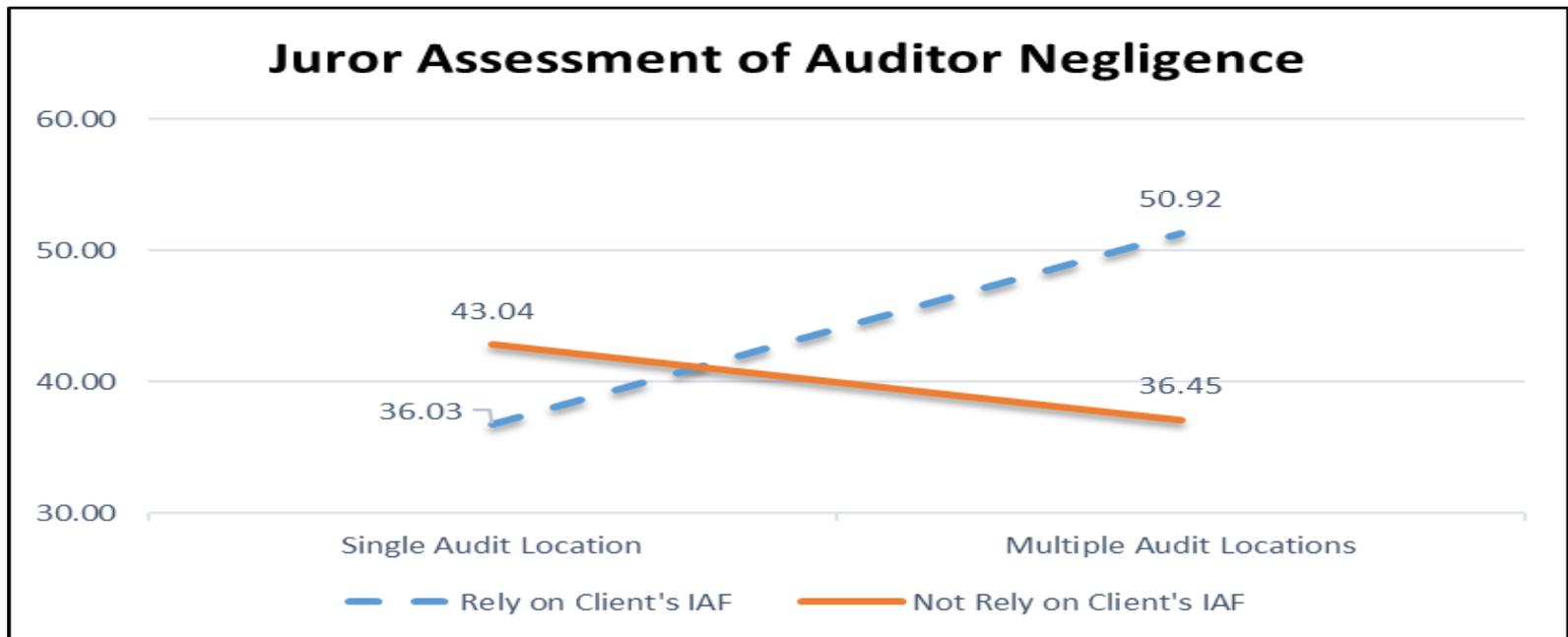
Results: Juror numerosity heuristic processing

- ✓ Jurors think in line with the numerosity heuristic – they recommended drawing from the **10 winning numbers in 1,000** lottery over the **1 out of 100 winning numbers** lottery
- ✓ Jurors judge the risk of misstatement to be **higher** when the client's inventory is stored at multiple locations versus at a single location even though controls and policies are equivalent across locations.



Results: Juror assessment of auditor liability

- ✓ Even though auditors tested the same proportion of the dollar amount of inventory, jurors were more likely to find auditors guilty when they relied on the Internal Audit Dept. in multi-location audits than single location audits



Thank you!

Questions?

