



**Auditors' Evaluation of Subsequent Events:
The Effects of Prior Commitment, Risk Factors,
and Type of Accountability**

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Declaration of Originality

This thesis is an original written work that incorporates an account of research completed in the Doctor of Philosophy (Commerce) program. To the best of my knowledge, this thesis contains no material previously published or written by another person except where due reference is made.



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Abstract

Recent international inspection reports indicate that there are deficiencies in the audits of subsequent events. What is less well understood is why these deficiencies occur. As the evaluation of subsequent events generally occurs toward the end of the audit process, this thesis examines whether auditors will commit to an initial view formed during the audit, and are therefore more likely to propose smaller audit adjustments to management in response to subsequent events.

This thesis contains two studies. Study 1 examines the effects of prior commitment and risk of material misstatement on auditors' evaluation of subsequent events. The findings from an experiment involving 87 auditors indicate that auditors propose a significantly smaller audit adjustment on a subsequent event when the event becomes known to them, after they have provided an initial view to management on the fair presentation of the financial statements. However, auditors are expected to be more skeptical when risk factors are present, so that they are more likely to adjust for subsequent events when the risk of material misstatement is high. Study 1 finds that when risk of material misstatement is high, auditors are less influenced by prior commitment. Therefore, they will propose to management a significantly larger amount of audit adjustment.

Study 2 builds upon Study 1 by examining how accountability can mitigate auditors' escalation behavior in evaluating subsequent events. The study specifically examines the effectiveness of two types of accountability—process versus outcome accountability—on auditors' judgment decision-making. The results from an experiment involving 66 auditors demonstrate that auditors are more skeptical, by proposing a larger audit adjustment on a subsequent event when they are expected to justify their judgment

process, than those who are expected to justify their judgment outcome. Study 2 provides evidence that auditors' tendency to show escalation behavior is mitigated more by process accountability than by outcome accountability. That is, auditors' proposed adjustments on subsequent events are less influenced by prior commitment to an initial view when the auditors are expected to justify their judgment process, rather than their judgment outcome. This study suggests a benefit of employing process accountability documentation in the audits of subsequent events.

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List of Abbreviations

ANCOVA:	Analysis of Covariance
ANOVA:	Analysis of Variance
ANU:	The Australian National University
AOB:	Audit Oversight Board
ASIC:	Australian Securities and Investments Commission
CAQ:	Center for Audit Quality
CFO:	Chief Financial Officer
CIFR:	Centre for International Finance and Regulation
GAAP:	Generally Acceptable Accounting Principles
IAASB:	International Auditing and Assurance Standards Board
IAS:	International Accounting Standard
IASB:	International Accounting Standard Board
ICAEW:	Institute of Chartered Accountants in England and Wales
IFRS:	International Financial Reporting Standard
ISA:	International Standard on Auditing
MIA:	Malaysian Institute of Chartered Accountants
MICPA:	Malaysian Institutes of Certified Public Accountants
PCAOB:	Public Company Accounting Oversight Board
R&D:	Research and Development
RM:	Malaysian Ringgit
SEC:	Securities and Exchange Commission
SOX:	Sarbanes-Oxley
UK:	United Kingdom
US:	United States

Chapter 1: Introduction to Thesis

1.1 Introduction

Evidence from the Public Company Accounting Oversight Board (PCAOB) (Chung et al. 2013) and international audit regulators¹ indicates that there are deficiencies in the audit of subsequent events. The audit regulators highlight that properly identifying, evaluating, and resolving subsequent events can be problematic, both for management and auditors. Responding to a PCAOB call for research related to audit deficiencies (PCAOB 2011a), Chung et al. (2013) find that, of a sample of PCAOB inspection reports with deficiencies on annually inspected accounting firms, issued from January 2004 to March 2012—34% report potential deficiencies in the auditing of subsequent events. For example, California Micro Devices terminated a contract with distributors after a balance sheet date and some inventories returned by these distributors were obsolete or damaged. The auditor was aware of the subsequent event, but did not follow-up on the valuation of ending inventory (Securities and Exchange Commission [SEC] 2003). Another example is the failure to disclose the subsequent events in the financial statements. For example, Whitemark Homes had options that expired in January of the subsequent year, but the auditors failed to disclose the expiration of the options in the financial statements (SEC 2006).²

International audit regulators highlight the deficiencies in the audits of subsequent events. In Australia, the Australian Securities and Investments Commission (ASIC) audit inspection program report for 2011/2012 raised concerns that auditors did not obtain sufficient evidence to support their conclusions about subsequent events. Examples

¹ These include the Australian Securities and Investment Commission (ASIC) (2012) and the Audit Oversight Board (AOB) Malaysia (2013).

² See Chung et al. (2013) for more cases related to the deficiencies in the audits of subsequent events.

included the fact that there was no evidence in the audit files that subsequent event procedures were performed by the auditor; subsequent event procedures were performed but were not carried out until the date of signing the audit report; and a subsequent event was disclosed in a financial report but there was no evidence that the auditor had performed procedures on the item (ASIC 2012). In Malaysia, the Audit Oversight Board (AOB) annual report 2013 highlighted that auditors need to be more skeptical in complex areas, such as accounting estimates that include the allowances for inventory write-down and allowances for doubtful debts issues. These areas essentially refer to the audit of subsequent events (AOB 2013).

The evidence from inspection programs is supported by survey studies that indicate that auditors experience difficulties in auditing subsequent events (Janvrin and Jeffrey 2007; Herda and Lavelle 2014). Some factors that could make it difficult for auditors to successfully identify and evaluate subsequent events are: following recommended audit procedures but failing to discover subsequent events; having less time to search for and evaluate subsequent events that occur late; a tendency to search for subsequent-event evidence that is consistent with prior evidence more often; and encountering client issues (e.g., deals with uncooperative clients; client not identifying subsequent events; poor communication with client management). These difficulties can be attributed to subsequent events that occur late in the auditing process, as well as those arising from problems associated with auditors' judgments. These survey findings suggest that audit quality may be low in this area.

Given the deficiencies in the audits of subsequent events identified by regulators, both regulators and practitioners have a stake in understanding the underlying causes of these deficiencies, and the extent to which they can be mitigated. What is less understood is

why these deficiencies occur. This thesis contains two studies that examine the underlying causes affecting auditors' judgment and decision-making in the subsequent events task, and that investigate potential strategies to improve the audits of subsequent events in an experimental setting.

1.2 Research aims

The aims of this thesis are threefold. The first aim is to examine one of the judgment biases in the audit of subsequent events: escalation of commitment. Auditors are required to respond to subsequent events which normally come to their attention after a significant amount of audit work has been completed (PCAOB 2003; International Auditing and Assurance Standards Board [IAASB] 2011; Chung et al. 2013; Arens, Elder, Beasley, and Hogan 2014).³ Because subsequent events generally occur late in the audit process, and most of the subsequent events audit procedures are performed near the date of the auditor's report, this thesis focuses on the potential bias in auditor judgment that may arise due to over-commitment to an initial hypothesis or expectation formed during the audit process. Prior research on escalation of commitment in an audit context suggests that auditors can over-commit to an initial hypothesis formed during the auditing process (e.g., Church 1991; Jeffrey 1992; Ayer and Kaplan 1993; Brody and Kaplan 1996) or prior-year decisions or judgments (e.g., Tan 1995; Hatfield, Jackson, and Vandervelde 2011; Messier, Linda, and Vandervelde 2014). Drawing on this line of research, this thesis

³ The International Standard on Auditing (*ISA*) 560 *Subsequent Events* indicates the auditors' responsibilities for three phases of subsequent events: (1) events occurring between the date of the financial report and the date of the auditor's report; (2) facts that become known to the auditor after the date of the auditor's report but before the date of the financial report is issued; and (3) facts that become known to the auditor after the financial report has been issued. The majority of the subsequent events audit procedures are performed near the date of the auditor's report. Auditors are required to respond to subsequent events that may come to the auditors' attention after the completion of the audit procedures, such as after the issuance of the audit report or after the audited financial report has been issued to the public, even after the completion of the audit (IAASB 2011).

aims to examine whether auditors have escalation tendencies in evaluating subsequent events when the event becomes known to them after they have committed to their position on the fair presentation of the financial statements.

The second aim of this thesis is to examine the effect of risk of material misstatement on auditors' evaluation of subsequent events. According to the *ISA 560*, paragraph 7, auditors shall take into account their risk assessment in performing the audit procedures on subsequent events. Auditors are required to consider the nature of the various risk factors, relevant internal controls, and the required level of audit evidence in auditing subsequent events. Considerable auditing research finds that auditors recognize and respond to risk factors in audit practice (e.g., Bedard and Johnstone 2004; Bell, Peecher, and Solomon 2005; Schelleman and Knechel 2010; Ruhnke and Schmidt 2014). This thesis focuses on the risk of material misstatements, because auditors are required to respond to the risk of material misstatements in developing an overall audit strategy and in planning the nature, extent, and timing of audit procedures. Accordingly, this thesis predicts that auditors are more skeptical when high risk material misstatement factors are present, so are therefore more likely to adjust for subsequent events, even when an initial view has been previously reported.

The third aim of this thesis is to consider mitigating strategies to reduce auditors' escalation tendencies in evaluating subsequent events. Tan (1995) finds that awareness of audit review reduces the effects of escalation of commitment arising from prior involvement in the going-concern task. Because Tan (1995) focuses on the effect of accountability induced by the awareness of audit review, it is unclear how the type of accountability (process versus outcome) can affect auditors' bias arising from prior commitment, particularly in the subsequent event task. Prior psychology studies suggest

that process accountability is effective in reducing decision-makers' tendency to commit to losing courses of actions, relative to outcome accountability (e.g., Simonson and Staw 1992; Lerner and Tetlock 1999). Auditing studies find that process accountability can lead to higher-level audit judgment quality (Messier et al. 2014; Kim and Trotman 2015). Given this evidence, this thesis proposes that one way to reduce auditors' escalation tendencies in the audit of subsequent events is to impose process accountability requirement on auditors, instead of an outcome accountability requirement.

1.3 Preface of results

This thesis contains two studies that address the research aims.

Study 1 examines whether auditors—having developed an initial view during the audit—are more likely to propose smaller audit adjustments in response to subsequent events. In considering the audit of subsequent events, and based upon consultation with auditors, a key point of commitment is the reporting of the fair presentation of the audited financial statements to management. Drawing on the literature on escalation of commitment, Study 1 predicts that auditors will propose a smaller audit adjustment on a subsequent event when the event becomes known to them after they have committed to their position on the fair presentation of the financial statements to management.

Study 1 also examines whether risk of material misstatement can affect auditors' escalation tendencies in the subsequent events context. When risk of material misstatement is high, auditors are more likely to be skeptical and less susceptible to bias in the decision-making process (Coram, Ng, and Woodliff 2004; Bell et al. 2005; Nelson 2009; Hwang and Chang 2010). Therefore, Study 1 predicts that auditors are more likely

to commit to an initial position formed during the audit when risk of material misstatement is low, but not when risk of material misstatement is high.

Study 1 uses a 2 x 2 between-subjects experiment in which auditors are required to propose an audit adjustment to the client for a subsequent event. The first independent variable examined is the commitment to management, which is manipulated as either “prior commitment” or “no commitment.”⁴ The second independent variable is the level of risk of material misstatements, which is manipulated as either “high risk” or “low risk.” The results from an experiment involving 87 experienced auditors find that auditors propose a significantly smaller audit adjustment to management when the subsequent event becomes known to them after they have committed to their initial position on the fair presentation of the financial statements to management. The findings on the risk of material misstatements indicate that auditors are more likely to commit to an initial position formed during the audit by proposing a significantly smaller audit adjustment to management when the risk of material misstatement is low, but not when the risk of material misstatement is high.

As Study 1 provides evidence that auditors have a tendency to commit to their initial view on the fair presentation of the financial statements to management, Study 2 compares process and outcome accountability as mechanisms through which auditors’ escalation tendencies can be mitigated. Study 2 predicts that process accountability can mitigate auditors’ escalation tendencies in the audits of subsequent events, compared to outcome accountability. That is, the presence of process accountability mitigates auditors’ prior commitment to management on the fair presentation of the financial statements, such that

⁴ This thesis uses the word “commitment” when referring to auditors who are committed to the fair presentation of the financial statements after they have reported the audit findings and fair presentation of the financial statements to management. The terms “commitment to management” and “prior commitment” are used interchangeably in this thesis.

auditors will propose a larger audit adjustment on a subsequent event, than the presence of outcome accountability.

In this study, a 2 x 2 between-subjects experiment is used, in which auditors are required to propose an audit adjustment for a subsequent event. The first independent variable is similar to Study 1, that is, the commitment to management is manipulated as either “prior commitment” or “no commitment.” The second independent variable is the type of accountability, manipulated as either “process” or “outcome” accountability. Results of Study 2—involving 66 experienced auditors—indicate that auditors’ adjustments are less affected by prior commitment to an initial view provided to management when they are expected to justify their judgment process than by those who are expected to justify their judgment outcome. Overall, Study 2 suggests that process accountability can mitigate auditors’ escalation tendencies in the evaluation of subsequent events, relative to outcome accountability.

1.4 Contributions

1.4.1 Contributions to auditing literature

This thesis advances the auditing literature in several ways. First, it contributes to the literature on the effects of the escalation of commitment on auditors’ judgments, particularly whether auditors are susceptible to bias arising from escalation behavior in evaluating subsequent events. Prior auditing studies mainly examine the judgment bias of auditors’ involvement in the prior-year audit engagement or no audit rotation condition (e.g., Tan 1995; Hatfield et al. 2011; Messier et al. 2014). This thesis extends this line of escalation research by providing evidence that auditors can exhibit escalation behavior in

the current year audit engagement, especially when subsequent events become known to them after they have reported the fair presentation of the financial statements to management.

This thesis is different to the prior escalation research in that subsequent events occur in the current year audit, but occur late in the audit process. Several PCAOB audit inspection cases highlighted that auditors failed to respond to subsequent events that came to their attention after most or all of the audit fieldwork was completed, but before the date of the auditor's report (e.g., SEC 2003; PCAOB 2007).⁵ These audit inspection cases raise concerns that auditors are less likely to adjust or disclose subsequent events that occur during this period. The findings of this thesis demonstrate that auditors exhibit escalation tendencies after they have communicated their prior decisions to management during the current year audit. This thesis provides a better understanding of how auditors can escalate their commitment in the audit process.

Second, Study 1 contributes to the risk assessment literature by demonstrating that auditors are less influenced by escalation bias in high-risk situations. Auditors are more skeptical in the high-risk setting by proposing a larger audit adjustment on a subsequent event. Risk assessment procedures are recommended by the audit regulators to be applied from the audit planning stage until the final stage of the audit process (Bell et al. 2005). Also, proper understanding of the risk assessment is necessary, both to analyze results

⁵ For example, auditors for an audit engagement on Ligand Pharmaceutical failed to evaluate the subsequent events and signed the audit opinion. There were significant increases of inventory in the distribution channel due to product returns from three large whole-sellers. The audit plan for the evaluation of subsequent events was provided before the completion of the audit. However, the plan was not executed by auditors, and the estimate of inventory returns was not adequately reviewed by the audit partner before signing the audit opinion (PCAOB 2007). Another inspection case highlighted that California Micro Devices terminated relationships with distributors, and some of the inventories held by the distributors that returned were obsolete or damaged. The auditors were aware of the subsequent event before the issuance of the audit report, but they did not evaluate the inventory write-off estimation (SEC 2003).

from analytical procedures and to engage in effective professional skepticism for management's assertions (Nelson 2009; Glover and Prawitt 2013; Wright 2016). Importantly, auditors are required to describe the assessed risks of material misstatement in the expanded model of auditing report (IAASB 2013). The findings of Study 1 are consistent with archival research conducted by Ruhnke and Schmidt (2014), which indicates that the risk of material misstatement has a significant effect on the magnitude of the audit adjustments. In sum, escalation bias observed in low-risk settings does not generalize to high-risk settings, where it would be of most concern. The implication is that accurate assessment of the overall risk of material misstatement can improve the assessment of the importance of the subsequent event.

Third, Study 2 contributes to the accountability literature by providing evidence that auditors' tendency to show escalation behavior is mitigated more by process accountability than outcome accountability. Previous accountability research has focused on the outcome accountability, and this type of accountability may not improve judgment quality. In some cases, it can even lead to unanticipated consequences or biases (Peecher, Solomon and Trotman 2013). This study responds to calls made by Peecher et al. (2013) and Trotman, Bauer and Humphreys (2015) to examine how the type of accountability can affect the quality of auditors' judgment. The findings of Study 2 are consistent with previous psychology studies (Simonson and Staw 1992; Lerner and Tetlock 1999) indicating that the type of accountability (process and outcome) has different effects on the decision-makers' escalation behavior. The findings of Study 2 demonstrate that auditors who are expected to justify their judgment process are more likely to propose a larger audit adjustment on a subsequent event than auditors who are expected to justify their judgment outcome, even if they have committed to their previous decision or position. The results of this study complement those of Kim and Trotman (2015) and

Messier et al. (2014) by providing evidence that process accountability can mitigate auditors' bias arising from prior commitment in the subsequent event context.

Finally, this thesis contributes to the literature on subsequent events. Previous auditing studies have used subsequent events as an experimental task to examine the ability of auditors to resist client pressures (Knapp 1985), and the extent to which audit committee members will support auditors in an audit dispute (Knapp 1987; Dezoort, Hermanson and Houston 2003). This thesis extends these previous studies to directly examine judgment biases in the evaluation of subsequent events. Two studies use surveys to investigate auditors' perceptions about subsequent events (Janvrin and Jeffrey 2007; Herda and Lavelle 2014). Janvrin and Jeffrey (2007) observe that auditors tend to search for subsequent event evidence that is consistent with their initial expectations. This thesis adds to the existing evidence by examining how auditors evaluate subsequent event evidence in a controlled experiment.

1.4.2 Contributions to auditing practice

This thesis provides additional insights for audit regulators and practitioners on the potential deficiencies in the process for the audit of subsequent events. This thesis responds to Chung et al.'s (2013) call for research to focus on auditors' judgments on the audit of subsequent events. It also responds to Simnett, Carson and Vanstraelen's (2016) call for research to investigate the issues surrounding international auditing standards (ISAs), thus highlighting the implications of the findings of this thesis for both international auditing and assurance standard-setting and regulatory boards.

The results of the two experimental studies indicate that auditors tend to exhibit escalation behavior if subsequent events become known to them after they have reported the fair

presentation of the financial statements to management. Importantly, the findings infer that even when auditors perform the early phases of an audit well, if they conduct the audit completion phase (such as evaluation of subsequent events) poorly, the quality of the overall audit will be low. The inference for auditors is the need for unbiased assessment of subsequent events discovered late in the audit process, such as following the preliminary earnings announcement.

This thesis has implications for audit practice. The findings suggest that auditors show escalation behavior when subsequent events become known to them after they have reported the fair presentation of the financial statements to management. In essence, auditors are more likely to escalate their commitment to their decision after the audited financial statements are authorized by the audit committee, or after the issuance of an audit report to the public. This thesis suggests that auditors escalate their position in the early phase of the audit process; that is, after the reporting of the fair presentation of the audited financial statements to management. This has implications for the audit process. In practice, auditors are required to communicate frequently to management in the audit process in order to collect audit evidence or seek clarification to resolve auditing issues (Trompeter and Wright 2010). Accordingly, if auditors have reported their initial position to management, they may fail to consider disconfirming evidence identified late in the audit process, or they may be reluctant to modify their initial position, suggesting that the escalation bias in the completion phase of the audit found in this thesis could affect audit outcomes. Thus, it is important that audit firms have proper mechanisms to reduce auditors' escalation tendencies, such as performing an ongoing supervisory review process, or emphasizing the documentation requirements in the audit completion phase.

Enhancing accountability is important to auditors because it affects how favorably superior and peer reviewers, regulators, and judges evaluate their performance (Emby and Gibbins 1988; Kennedy, Kleinmuntz and Peecher 1997; Tan and Shankar 2010). This thesis has implications for the audit profession by demonstrating the benefits of employing process accountability documentation when enhancing audit judgment quality. This is important, given the considerable move toward documentation of the judgment process, about which little is known about important audit judgments.

The IAASB (2014) recently presented a framework for audit quality that requires auditors to document their rationale for significant audit judgment, and how they reach a justifiable conclusion. The SEC's Advisory Committee on Improvements to Financial Reporting recommends the adoption of a professional judgment framework, to encourage auditors to document the decision-making process they used to justify the conclusions reached (Centre for International Finance and Regulation [CIFR] 2008). Recent audit inspection processes increase auditors' accountability for the contents of their audit working papers, and justification for their documented conclusions (Lennox and Pittman 2010; Moroney, Dowling, and Knechel 2015; Dowling, Knechel, and Moroney 2015). Study 2 of this thesis demonstrates the importance of process accountability documentation in promoting auditor judgment quality. This study should be informative to both auditor regulators—who are contemplating issuing formal judgment guidance—and audit firms interested in developing their existing judgment frameworks.

1.5 Structure of the thesis

This thesis contains two studies. Study 1 examines the effects of prior commitment and risk of material misstatement on auditors' evaluation of subsequent events. Study 1 finds

that auditors have a tendency to commit to their initial view after reporting the fair presentation of the financial statements to management, and Study 2 extends Study 1 by examining whether the type of accountability (process versus outcome) can mitigate auditors' escalation tendencies in evaluating subsequent events.

Chapter 2 provides background and discusses the previous research on the audits of subsequent events. The background covers the requirements of the auditing standard on the audit of subsequent events, auditors' cognitive approach to subsequent events, past studies related to the audits of subsequent events and the scope of subsequent events covered in this thesis.

Chapter 3 reviews the previous literature that motivates the hypotheses and the research design of the two experiments. A review of the literature on the escalation of commitment, risk of material misstatements and accountability motivates the research questions proposed.

Study 1 is presented in Chapters 4 to 7. Chapter 4 introduces Study 1. The development of the hypotheses and research design are presented in Chapters 5 and 6, respectively. Chapter 7 presents the results and concludes Study 1.

Study 2 is presented in Chapters 8 to 11. Chapter 8 provides an overview of Study 2. The development of the hypotheses and research method are discussed in Chapters 9 and 10, respectively. Chapter 11 reports the results and concludes Study 2.

Chapter 12 concludes the thesis, summarizing the main findings of the two studies. The limitations of this research, and future research opportunities arising from it, are also presented in this chapter.

Chapter 2: Background

2.1 Introduction

This chapter provides background on the audits of subsequent events. It begins with an overview of the audit of subsequent events, followed by discussion of auditors' cognitive approaches to subsequent events, a review of previous studies related to the audits of subsequent events, and the scope of the subsequent events covered in this thesis.

2.2 Overview of the audit of subsequent events

Subsequent events are defined by the auditing standard *ISA 560 Subsequent Events* paragraph 5(e) as “events occurring between the date of the financial report and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report” (IAASB 2011).⁶ According to the *IAS 10 Events after the Reporting Period*, there are two types of subsequent events (International Accounting Standard Board [IASB] 2013). First, those events that provide evidence of conditions that existed at the end of the reporting period. This is typically an adjusting event after the financial reporting period that requires adjustment on the financial statements (Type I subsequent event). For example: the bankruptcy of a customer that occurs after the reporting period, for which adjustment is needed for the carrying amount of the trade receivable. Second, those events that provide evidence of indicative conditions that arose after the reporting period. This refers to the non-adjusting event after the reporting period that usually

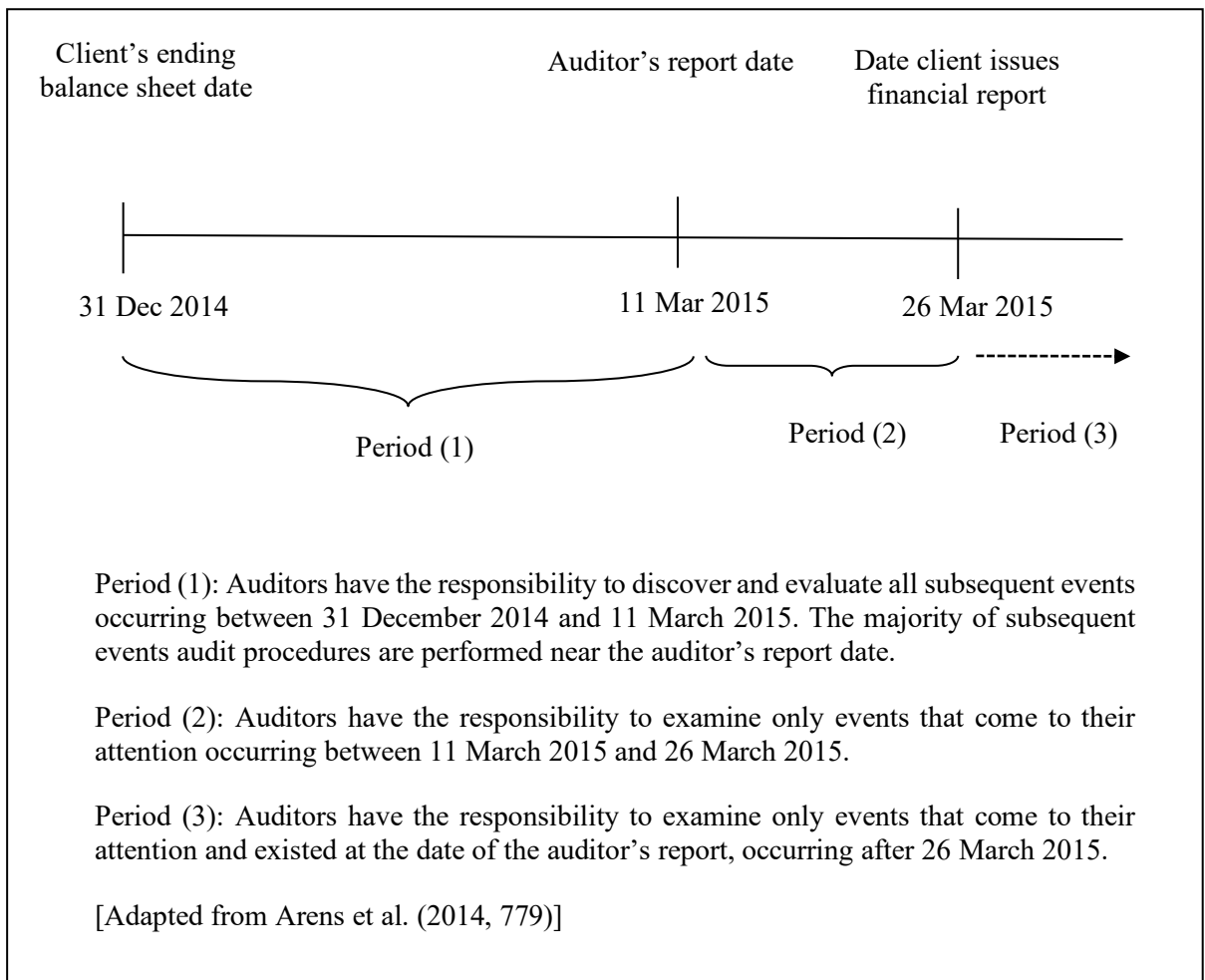
⁶ This definition is similar to the United States (US) auditing standard. The US auditing standard *AU560* defines subsequent events as: “events or transactions [that] sometimes occur subsequent to the balance-sheet date, but prior to the issuance of the financial statements, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements” (*AU 560*, paragraph 1).

requires disclosure in the notes to financial statements (Type II subsequent event).⁷ For example: major litigation arising solely out of events that occurred after the reporting period.

The *ISA 560* requires auditors to obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial report and the date of the audit report require adjustment or disclosure in the financial report. Auditors are further required to respond to facts that become known to them after the date of the auditor report that may result in the amendment of the audit report (IAASB 2011, *ISA 560* para. 4). The *ISA 560* outlines the requirements and audit procedures for three phases of subsequent events: (1) events occurring between the date of the financial report and the date of the auditor's report; (2) facts that become known to the auditor after the date of the auditor's report, but before the date of the financial report is issued; and (3) facts that become known to the auditor after the financial report has been issued (IAASB 2011). Although auditors have no obligation to conduct any audit procedures for phases (2) and (3) of subsequent events, facts may come to the auditor's attention after the issuance of the financial report that might affect the audited financial statements. This requires auditors to respond appropriately to the facts. Figure 2.1 illustrates the period covered by subsequent events review and the responsibility of auditors for subsequent events.

⁷ The Financial Accounting Standard Board's ASC 855-10-25-1 refers to Type I subsequent events as "recognized subsequent events" because the effects of these events are recognized in the financial statements. The International Financial Reporting Standard (IFRS) refers to these Type I events as "adjusting events" (*IAS 10* para. 8) because the financial statements are adjusted to reflect these events. Similarly, Type II subsequent events are called "non-recognized subsequent events" under the US Generally Acceptable Accounting Principles (GAAP) and "non-adjusting events" (*IAS 10* para. 10) under the IFRS.

Figure 2.1: Period covered by subsequent events review

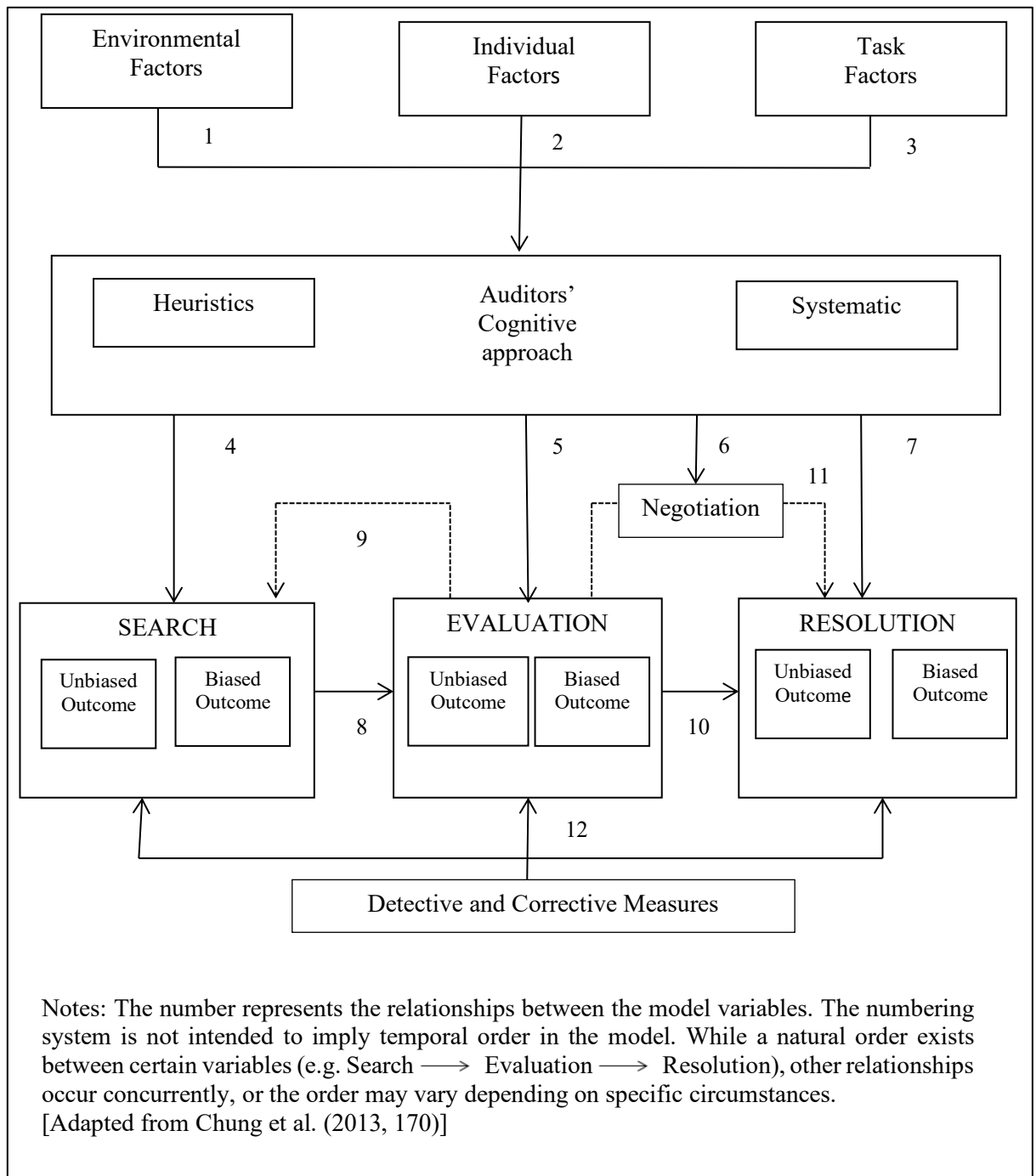


The audit of subsequent events is normally conducted in the completion stage of the auditing process. This completion stage includes, but is not limited to, final analytical review, final evaluation of audit evidence, review of contingent liabilities, going concern procedures and communications with audit committee and management. If the completion stage of the audit process is not adequately performed, there is a risk that an inappropriate opinion is given on the financial statements (Arens et al. 2014). Therefore, proper audit of the subsequent event is important in order to reach an appropriate audit opinion. In summary, the effectiveness of the audit of subsequent events can affect audit quality and the audit opinion decision.

2.3 Auditor's cognitive approach to subsequent events

The processes for auditing subsequent events are largely cognitive in nature, requiring auditors to exercise professional judgment to avoid biased outcomes and deficiencies. Chung et al. (2013) develop a model of auditors' cognitive approaches to the audit of subsequent events, which covers the search, evaluation, and resolution process. To ensure the effectiveness of the auditing of subsequent events, auditors must discover all relevant subsequent events during the search phase, evaluate the evidence correctly, and then ensure that each is resolved appropriately. The search, evaluation, and resolution processes can cascade during the process of auditing subsequent events. It is important that auditors exercise professional judgment throughout the audit of subsequent events. Figure 2.2 shows a model of the auditor's cognitive approach to the audit of subsequent events.

Figure 2.2: A model of the auditor's cognitive approach to the audit of subsequent events



Chung et al.'s (2013) model suggests that the effectiveness in the audit of subsequent events is largely driven by the auditor's cognitive processing mode, which is influenced by environmental, individual, and task-specific factors. Specifically, environmental factors that could affect the auditor's cognitive processing approach include: time pressure, accountability, client preferences, and client risk. Individual characteristics that affect the auditor's response to subsequent events include: knowledge and expertise, affect, professional skepticism, and culture. Finally, task-specific factors related to the audit of subsequent events include: task complexity, use of decision aids, and the nature of evidence. These combinations of factors can affect an auditor's cognitive approach (heuristic or systematic) during each step in the auditing process of subsequent events (search, evaluation, and resolution). Understanding these factors is important in identifying the causes of subsequent event audit deficiencies, and in developing potential mitigating strategies to improve subsequent event audit effectiveness.

In considering that there are deficiencies in the audit of subsequent events highlighted by audit inspection reports, Chung et al. (2013) propose potential mitigating strategies to improve the effectiveness of the audit of subsequent events. The potential mitigating strategies suggested include the use of decision aids, the audit firms' quality control processes associated with the audit of subsequent event, the review process on the documentation of the subsequent events, and the potential for group decision-making to minimize inappropriate biases in different stages of the audit of subsequent events.

This thesis responds to Chung et al.'s (2013) suggestion to examine one of the biases in the evaluation of subsequent events (Link 5, as shown in Figure 2.2), which is escalation of commitment. This thesis also examines the importance of identifying the level of risk of material misstatement in the evaluation of subsequent events, which is considered one

of the task characteristics (Link 3, as shown in Figure 2.2). Additionally, this thesis examines one of the environmental characteristics that can affect the auditor's cognitive processing approach (Link 1, as shown in Figure 2.2), which is accountability. Specifically, this thesis examines whether bias in auditors' judgments from the escalation of commitment can be mitigated by imposing a different type of accountability requirement on auditors' decision-making (Link 12, as shown in Figure 2.2).

2.4 Past studies on the audit of subsequent events

Previous auditing research used a subsequent event as an experimental task in the auditor-client negotiation context (Knapp 1985, 1987; DeZoort et al. 2003). Knapp (1985) examines factors that affect the perceived ability of senior loan officers to resist client pressures in the experiment task, related to the disclosure of the subsequent event on unrecorded liabilities consisting primarily of prior-year expenses that were neither paid nor recorded in accounting records. Knapp (1987) investigates factors that affect the likelihood that an audit committee will support auditors, rather than management, in audit disputes over the disclosures of the subsequent event related to material loss on account receivables. DeZoort et al. (2003) study the effects of the auditors' materiality justification, and the precision of the accounting issues that affect audit committee support for auditors in audit disputes related to the adjusting subsequent event (customer bankruptcy subsequent to year end). These early studies focus on the nature of negotiations, and they do not specifically examine the factors that affect auditors' decision-making in the audits of subsequent events.

Two studies survey the auditors' perception of subsequent events and factors influencing this audit area (Janvrin and Jeffrey 2007; Herda and Lavelle 2014). Janvrin and Jeffrey (2007) survey auditors' perceptions of subsequent events and examine factors affecting

auditors' search for subsequent event evidence. This survey evidence indicates that auditors follow audit procedures suggested in the audit standard to search for subsequent events. However, the use of any one recommended audit procedure does not increase the frequency with which they detect subsequent events. The survey findings further reveal that auditors are more likely to find subsequent event evidence when that evidence is perceived to be consistent with the initial evaluation made, and when the search period is relatively longer. In summary, the survey findings indicate that subsequent events evidence is important in the audit environment and various factors affect the effectiveness and efficiencies of the audits of subsequent events.

Herda and Lavelle (2014) survey practicing auditors to investigate why subsequent event audit deficiencies occur, and what might be done to improve this area of the audit. Seventy-six auditors at a large regional public accounting firm participated in this survey. The survey evidence reveals that various factors—such as uncooperative clients, client fraud, deadline pressures, and insufficient audit evidence—pose challenges for auditors in successfully identifying and evaluating subsequent events (Herda and Lavelle 2014). These challenges can be attributed to subsequent events that occur late in the auditing process, and problems associated with auditors' decision-making processes. These findings suggest that audit quality may be low in the audits of subsequent events.

Griffith, Hammersley and Kadous (2015) examine the process of auditing complex estimates, and the problems that auditors encounter in this area of auditing. The interview findings reveal that auditors tend to verify clients' model for generating the complex accounting estimate, instead of using subsequent events information to validate an estimate. These findings highlight that auditors rarely respond to or use subsequent events evidence to validate an accounting estimate.

In general, there has been little academic research investigating auditors' approach to the auditing of subsequent events. Chung et al. (2013) have noted the need for this type of research. This thesis adds to the subsequent event audit literature by examining auditors' judgment decision-making in the audits of subsequent events, using an experimental method.

2.5 Scope of subsequent events covered in this thesis

The audits of subsequent events cover many aspects and processes. This thesis extends previous survey studies by examining auditors' judgment of the evaluation of subsequent events using an experimental method. It focuses on the subsequent events that come to auditors' attention after most or all of the audit fieldwork is completed, but before the date of the auditor's report.⁸ This period is shown as a "Period (1)" and is illustrated in Figure 2.1. This is because auditors are required to respond to subsequent events that come to their attention after a significant amount of audit work has been completed, and most of the subsequent events procedures are performed near the date of the auditor's report (IAASB 2011; Chung et al. 2013; Arens et al. 2014).

This thesis focuses on the auditors' commitment to management. The audit negotiation literature recognizes that financial statements are materially affected by negotiations between the auditor and the management, and both parties typically arrive at some form of negotiated agreement before they report to the audit committee and sign the auditor's report (e.g., Cohen, Krishnamoorthy, and Wright 2010; Tan and Trotman 2010; Cohen,

⁸ According to the *ISA 560*, this is the first phase of the subsequent event; that is, the events occurring between the date of the financial report and the date of the auditor reports.

Hayes, Krishnamoorthy, Monroe, and Wright 2013). This line of research suggests that auditors and management need to arrive at an agreement on the fair presentation of the audited financial statements. Such agreements could potentially affect auditors' judgments on subsequent events. Therefore, this thesis focuses on judgment regarding a subsequent event that comes to the auditors' attention after they have communicated their decision to management but before the issuance of the auditor's report.

The process for auditing subsequent events is inherently complex. This process includes a search, evaluation and resolution process (Chung et al. 2013). First, auditors are required to search and discover subsequent events evidence. Then, they are required to evaluate the subsequent events evidence to determine the effects of the events on the financial statements. Finally, the subsequent events issues need to be resolved appropriately with the client. This thesis focuses on the evaluation of subsequent-event evidence. Chung et al. (2013, 171) highlight that 12 PCAOB inspection reports out of the sample of 20 inspection reports noted deficiencies in the evaluation of subsequent events. That is, auditors were aware of the subsequent events, but did not understand the implications of the subsequent events for their audit work, and/or responded appropriately to the subsequent events. In this regard, this thesis examines the narrow area of potential bias in auditor evaluation of subsequent event, given that an event has been identified.

The outcomes of the audits of subsequent events include adjusting events (Type I subsequent events) and non-adjusting events (Type II subsequent events). Early research on the audit adjustment decision raises concerns that many factors affect the auditors' decision to propose audit adjustments, and the improper audit adjustment can potentially lead to misleading financial statements (Wright and Wright 1997; Nelson and Tan 2005; Joe, Wright and Wright 2011). Chung et al. (2013, 171) report that the majority of the

subsequent events concerns expressed in the PCAOB's inspection reports involved Type I subsequent events (i.e., 18 of 20 reports). Specifically, the majority of deficiencies were noted in the evaluation of subsequent events. Therefore, this thesis focuses on the adjusting events (Type I subsequent event).

2.6 Summary

This chapter provides background to the audit of subsequent events. The *ISA 560* states that an auditor has a responsibility to perform audit procedures to determine whether all material adjusting and non-adjusting events have been appropriately adjusted for (Type I subsequent events) or disclosed (Type II subsequent events) in the financial statements, up until the date of the auditor's report.

Chung et al. (2013) develop a model of auditor's cognitive approach to the audit of subsequent events. The model suggests that the effectiveness of the audit of subsequent events is influenced by auditors' cognitive processing mode. Thus, the process of auditing subsequent events requires auditors to exercise significant professional judgment.

Several survey studies indicate that auditors face difficulties in the audits of subsequent events (Janvrin and Jeffrey 2007; Herda and Lavelle 2014). Given the difficulties and challenges faced by auditors in the audit of subsequent events, this thesis aims to examine the underlying causes of these deficiencies and the extent to which they can be diminished by specifically focusing on the audit judgment decision-making. This thesis focuses on the subsequent events that come to the auditors' attention after the financial year end, but before the date of the auditor's report. Additionally, this thesis focuses on the evaluation

of subsequent events, assuming that the events have been identified, and specifically on the adjusting events (Type I subsequent events).

Chapter 3: Literature Review

3.1 Introduction

This chapter reviews three topics: escalation of commitment, risk of material misstatement and accountability. This thesis examines one of the judgment biases in the audit of subsequent events, namely escalation of commitment. Previous research suggests that auditors can over-commit to their initial view or expectation formed during the audit process or prior-year decisions (Libby 1985; Church 1991; Tan 1995; Hatfield et al. 2011; Messier et al. 2014). This thesis draws on the literature on the escalation of commitment to explain auditors' escalation tendencies in the audits of the subsequent event context.

This chapter reviews the literature on the effects of the risk of material misstatement on auditors' judgments. Previous audit research studies suggest that auditors' judgment or professional skepticism is influenced by various risk factors, such as litigation risk, business risk and risk of material misstatement (Bedard and Johnstone 2004; Schelleman and Knechel 2010; Ruhnke and Schmidt 2014). Drawing on this line of literature, this thesis examines whether auditors respond to the high risk of material misstatement, thereby being less influenced by escalation tendencies in the audits of subsequent events.

This chapter subsequently discusses the literature on auditors' accountability. Accountability research provides mixed results on the impact of accountability on auditors' judgment quality. Recent accounting studies suggest that instructing auditors to be accountable for their judgment process can improve judgment quality and professional skepticism. Psychology studies indicate that process accountability is effective in reducing decision-makers' tendency to commit to losing courses of action, compared to

outcome accountability (Simonson and Staw 1992). Accordingly, this thesis aims to compare process and outcome accountability as mechanisms through which auditors' escalation tendencies can be reduced. This chapter briefly reviews relevant literature on process and outcome accountability.

This chapter is organized as follows: a review of the escalation of commitment literature in the next section is followed by the risk of material misstatement literature and the accountability literature, ending with a summary.

3.2 Escalation of commitment literature

This section explains the theory of escalation of commitment and the biases resulting from it. Previous literature on the effects of escalation of commitment on auditors' judgments is then reviewed.

3.2.1 Escalation of commitment

Escalation of commitment refers to the situation in which a decision maker is faced with negative feedback about a prior decision, but continues to commit resources to the choice despite negative consequences (Staw 1976). The auditing standard *ISA 560* requires auditors to respond to subsequent events that come to their attention after a significant amount of audit work has been completed. This suggests that auditors may have committed to an initial view and may be reluctant to update their priors in evaluating subsequent events evidence. The theory of the escalation of commitment provides a basis for considering potential bias in judgment arising in this context.

Escalation of commitment research is attributed to a psychology research paper by Staw (1976), who examined the process of escalation of commitment through the simulation of a business investment decision case in an experimental setting. In this experiment, 240 business school students participated in a role-playing exercise, in which personal responsibilities and decision consequences were the manipulated independent variables. Participants were asked to allocate research and development funds to one of the two operating divisions of a company. Experiment results indicate that decision-makers are more likely to commit the greatest amount of resources to a prior chosen course of action when they are personally responsible for negative consequences from their prior decision. From these findings, Staw (1976) interprets that the decision-makers will increase their total investment (i.e., commitment) in order to “self-justify” their prior decision when they face negative consequences about it. In general, escalation of commitment is expected when a decision-maker is held responsible for their prior decision, and encounters new or contradictory information.

Staw (1981) develops a theoretical model to explain escalation of commitment determinants and commitment process. This model indicates that commitment is a complex process dependent on forces for retrospective rationality, prospective rationality, and behavioral modeling. The important features of commitment decisions are determined by a given choice, the consequences of any single decision having implications for past as well as future events. In particular, norms for consistency (i.e., individuals seek cognitive consistency or socializations for consistency within the general society) override economic consideration or rational behavior. Therefore, escalation of commitment behavior is somehow determined by the behavior and personality of decision-makers. Staw and Ross (1987) further replicate the model that includes far greater detail and more determinants on escalation of commitment. The model includes

determinants as follows: project determinants, psychological determinants, social determinants, organizational or structural determinants, and contextual effects. This model motivates future research on escalation of commitment behavior in different research areas such as psychology, sociology, management, and accounting.

Escalation of commitment has been demonstrated to influence decision-making in a wide variety contexts, including information system projects (Pan, Pan, Newman, and Flynn 2006), project management (Harrell and Harrison 1994; Keil et al. 2000), new product development (He and Mittal 2007), capital investment decisions (Kadous and Sedor 2004; Denison 2009; Seybert 2010) and auditors' decision-making (Church 1991; Jeffrey 1992; Tan 1995; Brody and Kaplan 1996; Hatfield et al. 2011). For a review of research on escalation of commitment in the psychology and management literature, see Staw (1997) and Sleesman, Conlon, McNamara, and Miles (2012). This thesis draws on the escalation of commitment literature, with the intention of explaining auditors' escalation tendencies in the audits of a subsequent event context.

3.2.2 The effect of escalation of commitment on auditor judgments

In the auditing context, Bazerman, Loewenstein, and Moore (2002) explain that auditors are susceptible to escalation bias. This is because auditors tend to protect their self-identity, or maintain the perception that they have not made a mistake in the audits, by choosing not to correct previous misstatements even if there is negative or contradictory evidence. Nelson (2009) points out that auditors tend to commit to earlier decisions because they are concerned that changing them might indicate that they made a mistake, or cause a break in an agreement with a client. As explained by Bonner (2008), escalation of commitment has a negative effect on the quality of a judgment because auditors tend

to commit to their previous decisions without properly evaluating subsequent evidence or information in the auditing process.

Early auditing research studies explain that the auditing process can induce auditors' escalation behavior. Based on Kiesler's (1971) study on the psychological perspectives of the commitment, Jeffrey (1992) and Tan (1995) posit that audit practices can increase auditors' commitment. Kiesler (1971) explains that commitment is escalated with the explicitness of the act, the irrevocability of the act, the act's importance for the subject, the freedom of choice perceived by the decision-maker, and the number of acts performed. Applying these contributors to commitment to the current audit environment, Jeffrey (1992) and Tan (1995) explain that the documentation of audit evidence in the working papers is considered explicit and irrevocable. The audited financial statements are considered important to the auditor and client. Auditors use judgment in audit practice, so have the freedom of choice. Finally, the audit process consists of many stages, and audit engagement is normally repeated, so the number of acts performed is substantial. Kiesler (1971) indicates that one or more of the above conditions are sufficient to increase the degree of commitment. Therefore, audit practice has the possibility of inducing auditors' escalation tendencies.

Several auditing studies examine the direct effect of escalation of commitment on auditors' judgment. Church (1991) finds that auditors who committed to their initial hypotheses about the source of an error allocate more time to examining that source. Tan (1995) shows that prior involvement with a going-concern decision results in auditors paying more attention to evidence that is consistent with their initial judgments. Jeffrey (1992) demonstrates that auditors are susceptible to escalation behavior when they participate in sequential audits on bank loans. Brody and Kaplan (1996) report that

internal auditors who make an initial decision, and then a final decision, on risk assessment engage in escalation behavior in such a way that they tend not to change their initial decisions. Hatfield et al. (2011) find that auditors involved in waiving previous period audit adjustments propose smaller audit adjustments than auditors in the no-prior-involvement conditions. In Petycheva and Gillet's (2012) study, auditors perceived that prior involvement in the audit work is more likely to suppress discomforting audit evidence. Auditors believe that personal reputation threats induced by personal prior involvement contribute to this quality, threatening audit behavior. Using a *status quo* heuristic context, Messier et al. (2014) demonstrate that auditors stick with the *status quo* and tend to fixate on prior-year judgment decisions, even if current-year applicable accounting standards are changed from the US GAAP to the IFRS.

Overall, the above findings show that auditors with prior involvement in audit tasks are more likely to demonstrate escalation behavior. These findings suggest that escalation behavior will result in low judgment quality, such as bias in the search for audit evidence, and a decrease in audit effort (Tan 1995; Hatfield et al. 2011). These findings may be of concern to regulators and stakeholders because audit independence and professional skepticism will be eroded if auditors demonstrate escalation bias in the auditing task.

Previous studies mainly examine the judgment bias of auditors' involvement in the prior-year audit engagement (Tan 1995; Hatfield et al. 2011; Messier et al. 2014). However, studies have not investigated whether bias from escalation of commitment manifests in the evaluation of subsequent events. This thesis is different to these earlier studies in that the audit of subsequent events occurs in the current year audit, but occurs late in the auditing process. It is expected that auditors may commit to their initial view to management, even in the current year audit engagement, and they may ignore the

subsequent event evidence. Therefore, this thesis contributes to the auditors' escalation behavior literature by examining the effect of escalation of commitment on auditor judgments in the audit of the subsequent event context.

3.3 The effect of risk of material misstatement on auditor judgments

Risk is an important aspect of decision-making (Sitkin and Pablo 1992), and an important factor in the conduct of an audit. Previous research suggests that the auditor's evidence evaluation decisions benefit from early risk assessment (Hammersley, Bamber, and Carpenter 2010; Glover and Prawitt 2013). Incorporating risk assessment in the process of auditing subsequent events ensures that subsequent events are given more attention in the audit program. Auditors are more likely to relate their subsequent events findings to the risks identified during audit planning. Therefore, the risk assessment ensures that the identified subsequent events are investigated adequately, and that relevant findings are documented.

The *ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* and the *ISA 330 The Auditor's Responses to Assessed Risks* specifically set out a risk-based audit approach that requires the auditor to understand the entity and its environment in order to identify risks that may cause material misstatements of the financial statements. The auditor is expected to perform an assessment of those risks at both the financial statements and assertion levels. This risk assessment considers factors such as the nature of the various risk factors, relevant internal controls, and the required level of audit evidence. In practice, the audit risk model is utilized by auditors to indicate the amount of audit work that should be undertaken on

an audit (Houston 1999). When risk of material misstatement is high, detection risks will need to be set low, resulting in increased audit effort to maintain the level of audit risk.

Auditing research provides evidence that auditors recognize and respond to various risk factors in performing various auditing tasks (Shaub and Lawrence 1996; Coram et al. 2004; Moroney and Trotman 2015). Shaub and Lawrence (1996) find that auditors are more likely to be skeptical when various risk factors are present, such as related-party transaction, client financial stress, and previous client inaccuracies. Coram et al. (2004) find that auditors respond to the level of risks of misstatement by being more vigilant in the audit. Moroney and Trotman (2015) demonstrate that risk factors can affect auditors' materiality judgment on the financial statement audits and sustainability assurance engagements.

Several auditing studies also report that audit effort is responsive to the risk of material misstatement (Bell, Landsman, and Shackelford 2001; Bedard and Johnstone 2004; Bell, Doogar, and Solomon 2008; Schelleman and Knechel 2010; Kim and Fukukawa 2013). Bedard and Johnstone (2004) show that auditors extend evidence searches when corporate governance risk is higher. Bell et al. (2001) find that clients' higher business risk resulted in more allocation of audit hours. Bell et al. (2008) demonstrate that auditors who adopt a business risk audit approach allocate more audit resources in response to assessed auditor business risk. Schelleman and Knechel (2010) report that auditors allocate more audit effort (in terms of audit hours and mix of grade of labor) when a client has a higher level of short-term accruals (i.e., greater earnings management). Similarly, in the Japanese context, Kim and Fukukawa (2013) show that audit firms increase audit effort and charge a risk premium for audit engagements with higher business risks.

Glover and Prawitt (2013) propose a “professional skepticism continuum” that recognizes that the appropriate application of professional skepticism depends on the risk characteristics of the particular account and assertion being audited. Auditors are required to continue to reevaluate risk throughout the audit process to ensure that appropriate skepticism is applied to the collection and evaluation of audit evidence. This highlights that the level of professional skepticism exercised should always be determined by the level of risk of material misstatements.

Study 1 in this thesis is motivated by this line of research, with the focus on extending the assessment of the risk of material misstatement to the audit of subsequent event contexts. Specifically, this study predicts that when risks of material misstatements are high, auditors tend to scrutinize such risks, and more skeptical when proposing an audit adjustment on a subsequent event, even if they have committed to an initial view.

3.4 Accountability literature

This section reviews the literature on accountability effects on auditors’ judgments. Research suggests that process accountability alone, or in conjunction with outcome accountability, might improve auditors’ judgments more than outcome accountability alone (Peecher et al. 2013). This is because individuals who are accountable for the judgment process are more likely to use proper decision strategies and to thoroughly evaluate the available alternatives before making a decision, regardless of the decision outcomes. In contrast, individuals who are accountable for the judgment outcome are more likely to focus on the final judgment while compromising cognitive effort when processing underlying evidence. Considering that each type of accountability has unique effects on judgments and decision-making, the process accountability needs to be

distinguished from outcome accountability in examining accountability effects on auditor judgments. Previous literature on process and outcome accountability is then reviewed.

3.4.1 Accountability effects on auditor judgments

The social psychology theory of accountability concerns how individuals cope with different socio-economic pressures (Tetlock 1983, 1985; Tetlock, Skitka, and Boettger 1989; Lerner and Tetlock 1994). The theory explains that individuals attempt to develop different social and cognitive strategies for coping with different types of accountability pressures, in order to obtain acceptance from—or avoid conflict with—important interpersonal or institutional parties. Lerner and Tetlock (1999, p. 255) explain that accountability is “the implicit or explicit expectation that one may be called to justify one’s beliefs, feelings and actions to others.” Under the conditions of accountability, an individual is required to justify his or her judgments and decisions to others. Several accounting studies have examined the effects of accountability on a variety of judgment quality dimensions (see Bonner 2008; Trotman et al. 2015 for reviews). This section limits discussion to the positive and negative effects of accountability on auditor judgments.

Considerable research shows that accountability has positive effects on auditors’ judgments. It focuses on the importance of the review process in inducing accountability effects on audit preparers (Lord 1992; Kennedy 1993; Tan 1995; DeZoort, Harrison, and Taylor 2006). For example, Lord (1992) reports that auditors who are accountable for their decisions will act more conservatively, as they are less likely to give an unqualified audit opinion to a client with a questionable accounting choice. Kennedy (1993) finds that accountability can reduce the recency effect in the audit process. Tan (1995) indicates

that awareness of potential review motivates auditors' vigilance in the going-concern judgments, and auditors recall relatively more inconsistent information and make different judgments than control-group subjects. Tan and Kao (1999) report that accountability improves performance on high-complexity audit tasks. DeZoort et al. (2006) demonstrate that accountability pressure increases the time auditors spend on a task, explanation length, and consideration of qualitative material factors.

A number of studies examine the effect of justification on enhancing auditors' judgment quality. Justification is the process of providing an explanation in support of one's belief (Peecher 1996). Ashton (1992) finds that auditors who are required to justify their decisions are more likely to make more accurate and consistent judgments over time. Koonce, Anderson, and Marchant (1995) find that accountability increases the number of justifications. That is, the audit review and the availability of audit evidence increase the documentation of justifications. Peecher (1996) presents a cognitive model of how justification affects auditors' decisions, and an experiment focusing on how auditors' justification processes affect their analytical procedures performance. Asare, Trompeter, and Wright (2000) demonstrate that auditors who are asked to justify the causes of ratio fluctuation are more likely to conduct more tests and examine more hypotheses. Audsabumrungrat, Pornupatham, and Tan (2015) find that audit managers who are required to justify their materiality assessment are more likely to make appropriate planning materiality assessments in the presence of structured materiality guidance. In general, this body of research indicates that justification requirements improve auditors' performance in various auditing tasks.

Conversely, another strand of research indicates that increases in auditors' accountability may not improve judgment quality (Kennedy 1995; Glover 1997; Hoffman and Patton

1997; Bagley 2010; Piercey 2011). For example, Kennedy (1995) demonstrates that accountability is ineffective in mitigating the curse of knowledge (when individuals are unable to disregard information already processed). Glover (1997) finds that accountability has no significant effect on reducing the effect of non-diagnostic information (i.e., dilution effect) on auditor judgment. Similarly, Hoffman and Patton (1997) find that auditors' judgments show the dilution effect, even when held accountable. Piercey (2011) finds that documentation can make auditors more lenient with clients on a misstatement task if they document their risk assessments qualitatively rather than quantitatively. Bagley (2010) finds that auditors who are accountable to multiple parties will experience negative affect, which can harm low-complexity audit task performance. These studies suggest that increased auditor accountability may not be effective, or may lower judgment quality resulting from cognitive bias.

Accountability research also indicates that accountability to a party with a known view can generally lead to a negative effect on judgment quality. This line of research shows that auditors are likely to adopt a least effort (cognitive miser) solution and simply follow the supervisors' or reviewer's position (e.g., DeZoort and Lord 1994; Cohen and Trompeter 1998; Wilks 2002). For example, DeZoort and Lord (1994) find that auditors accountable to either managers or partners who wish to allow latitude to a client are more likely to indicate that they would allow clients to circumvent audit procedures than are subjects under no accountability. Cohen and Trompeter (1998) report that audit managers accountable to an aggressive partner are more likely to accept clients' proposed aggressive accounting treatment. Similarly, Wilks (2002) finds that audit managers given a partner's view on going-concern judgment are more likely to follow the partner's view than managers given the view after evidence evaluation.

In summary, accountability research provides mixed results on the effects of accountability on auditors' judgment quality. Research findings in a variety of auditing settings suggest that increased auditor accountability may not improve the judgment quality and, in some cases, can even lead to unanticipated consequences or biases. These accountability studies are closely related to the outcome accountability perspective. This is because participants in experimental studies are informed of the presence of audit review or justification requirements, compared to no information given about the audit review or justification requirement (Peecher et al. 2013; Trotman et al. 2015). This previous research suggests that adding a process accountability requirement to the current auditing setting that is dominated by outcome accountability is expected to enhance audit judgment quality.

3.4.2 The comparative effect of process and outcome accountability on auditor judgments

Peecher et al. (2013) propose an accountability framework for financial statement auditors with two main dimensions: rewards versus penalties, and process versus outcome accountability. The framework suggests that process accountability alone, or used in conjunction with outcome accountability, might improve auditor judgments more than outcome accountability alone. This thesis focuses on these two types of accountability, and compares the effects of process versus outcome accountability on the audit of the subsequent events context.

Lerner and Tetlock (1999) identify two distinct types of accountability: process accountability and outcome accountability. Outcome accountability focuses on the quality of the outcomes of an action. Process accountability focuses on the procedures used to arrive at a decision. Lerner and Tetlock (1999) highlight the fact that different

types of accountability affect cognitive effort in different ways. Numerous psychology studies have shown the benefits and risks of requiring decision-makers to be accountable for their judgment process, as opposed to just their judgment outcome (e.g., Simonson and Staw 1992; Siegel-Jacobs and Yates 1996; Brtek and Motowidlo 2002; Scholten, Knippenberg, Nijstad, and De Dreu 2007).

Psychology research has suggested that process accountability generally improves judgment quality more than outcome accountability (Peecher et al. 2013). Of these, Simonson and Staw (1992) note that process accountability is an effective de-escalation strategy. Using business students as subjects in a laboratory experiment, they find that decision-makers who are accountable for process judgment rather than outcome judgment are less likely to commit to losing courses of action. Siegel-Jacobs and Yates (1996) find that process accountability motivates decision-makers to take into account more available information in their judgment decision-making, leading to higher judgment accuracy. However, outcome accountability has detrimental effects, such as increasing decision-makers' stress levels and frustration. Similarly, Brterk and Motowidlo (2002) find that process accountability increases decision-makers' attentiveness, so improves consistency in interview judgments. Scholten et al. (2007) provide experimental evidence that process accountability motivates decision-makers to consider more relevant information and to choose the correct decision alternative. Thus, this combination of results support the notion that decision-makers who are accountable for process judgment will tend to make more accurate and high-quality judgments than those decision-makers who are accountable for outcome judgment.

Recent accounting studies also examine the comparative effects of process and outcome accountability on judgment decision-making in various contexts. Chang et al. (2013)

examine the effects of process-versus-outcome accountability on the customer-supplier negotiations. Experimental results reveal that negotiators who are required to document their judgment process are more likely to reduce their fixed-pie bias and obtain lower joint costs than those negotiators who are required to document their judgment outcome. Kim and Trotman (2015) compare the effect of process and outcome accountability in enhancing auditors' professional skepticism. The authors find that process accountability improves novice auditors' professional skepticism to a greater extent than that of more experienced auditors. However, auditors do not show greater professional skepticism when they are accountable for judgment outcome. Messier et al. (2014) find that auditors who are accountable for judgment process are less likely to follow prior-year US GAAP accounting treatment when the accounting standard has been changed from the US GAAP to the IFRS. Their findings reveal that process accountability improves judgment quality, compared to the no accountability condition.

In summary, only a few accounting studies examine the direct effects of the type of accountability on decision-makers' judgment. Beyond Kim and Trotman's (2015) study, little is known about the direct effects of process and outcome accountability in improving auditors' judgments in alternate-decision contexts.

Study 2 of this thesis complements the previous research by examining the direct effect of process and outcome accountability on auditors' evaluation of subsequent events. Specifically, this thesis examines how the process and outcome accountability can mitigate auditors' escalation behavior in the audits of subsequent events context.

3.5 Summary

Previous literature on the effect of escalation of commitment on auditors' judgments indicates that auditors have a tendency to commit to their initial expectation or decision in the auditing process. In the context of subsequent events, auditors have a responsibility to respond to the subsequent events that occur late in the audit process. The research on escalation of commitment in an audit context suggests that auditors can over-commit to their initial view or expectation formed during the process of auditing (Tan 1995; Messier et al. 2014; Hatfield et al. 2011). Escalation of commitment theory is therefore considered to explain the observed deficiencies in auditors' responses to subsequent events. Study 1 of this thesis examines whether auditors show escalation of commitment behavior when subsequent events become known to them after they have provided an initial view during the process of auditing.

Considering the fact that risk is an important consideration in the conduct of an audit, Study 1 examines whether the risk of material misstatement can affect an auditor's evaluation of subsequent events. The review of the literature on the risk of material misstatement highlights the importance of identifying and assessing the risk of material misstatement in the audits of financial statements. Findings from previous research suggest that appropriate application of the audit risk assessment is crucial in enhancing the overall audit quality. This strand of literature is discussed in this thesis in order to examine whether the risk of material misstatement can affect auditors' evaluation of subsequent event evidence, thus reducing auditors' escalation tendencies.

This chapter reviews the literature on the effect of accountability on auditors' judgments. Study 2 of this thesis examines the joint effects of prior commitment and the type of accountability on auditors' evaluation of subsequent events. Previous auditing research examining the effect of accountability on judgment decision-making indicates that increased auditor accountability may not improve the judgment quality and, in some

cases, can even lead to unanticipated consequences or biases. This strand of previous research focuses on the outcome accountability perspective. Recent auditing studies have suggested that process accountability is more effective in enhancing audit judgment quality than outcome accountability. In particular, psychology research notes that process accountability is an effective mechanism in mitigating decision-makers' escalation behavior. This thesis extends this line of research by examining how the type of accountability (process versus outcome accountability) can mitigate auditors' escalation behavior in evaluating subsequent events.

SECTION I

Study 1: The Effects of Prior Commitment and Risk of Material Misstatements on Auditors' Evaluation of Subsequent Events

Chapter 4: Introduction to Study 1

Recent PCAOB and international inspection reports indicate that there are deficiencies in the audits of subsequent events (ASIC 2012; Chung et al. 2013; AOB 2013). Given these deficiencies, both regulators and practitioners have a stake in understanding the underlying causes of these deficiencies, and the extent to which they can be mitigated.

Auditors are required to respond to subsequent events that may come to their attention after a significant amount of audit work has been completed (PCAOB 2003; IAASB 2011; Chung et al. 2013; Arens et al. 2014). According to the *ISA 560*, auditors are required to respond to subsequent events that may come to the auditor's attention even after the completion of the audit procedures, such as after the issuance of the auditor's report, or even after the audited financial report has been issued to the public (IAASB 2011). As subsequent events occur late in the process of auditing, and the majority of subsequent events audit procedures are performed near the auditor's report date, Study 1 focuses on the potential biases in auditor judgments that may arise from over-commitment to an initial hypothesis, or expectations formed prior to the subsequent events.

The research on escalation of commitment in an audit context suggests that auditors can over-commit to an initial expectation formed during the auditing process (Church 1991; Jeffrey 1992; Ayer and Kaplan 1993; Brody and Kaplan 1996), or during prior-year decisions (Tan 1995; Hatfield et al. 2011; Messier et al. 2014). Nelson (2009, p. 13) explains that "these effects could be driven by auditors' concerns over the potential for negative outcomes should they reverse a previous decision and appear to have admitted a mistake or broken an agreement with their client." Previous literature from a range of audit judgments suggests that auditors are more concerned that changes in opinion or

position may signal poor quality of their earlier audit work and lead to a bad reputation (Kanodia, Bushman, and Dickhaut 1989; Jeffrey 1992; Peytcheva and Gillett 2012). In the context of the audits of subsequent events, survey results from Janvrin and Jeffrey (2007) indicate that auditors tend to search for subsequent event evidence that is consistent with their initial expectation more often than they search for subsequent-event evidence that is inconsistent with their initial expectation. This body of research suggests that subsequent events that become known to auditors toward the completion of the auditing process can potentially lead to auditors' over-commitment to their initial expectations or previous decisions.

Discussion with audit practitioners suggests that a key point of "commitment" in the auditing process is the reporting of the fair presentation of the audited financial statements to management. Auditors are still required to communicate with the management (i.e., the Chief Financial Officer [CFO]) about audit findings and overall presentation of the financial statements before the audit committee meeting. The auditor-client management negotiation literature documents the fact that auditors and CFOs normally resolve accounting disputes and reach an agreed conclusion before auditors report their findings to the audit committee and sign the auditor's report (Cohen et al. 2010, 2013).

This thesis uses the word "commitment" to mean that auditors are committed to the fair presentation of the financial statements after they have reported the audit findings and fair presentation of the financial statements to management. Interestingly, preliminary discussions with a Big-4 audit partner and three audit senior managers suggested that reporting to management was considered more important than subsequent communication with the audit committee. Therefore, this thesis uses the reporting of the fair presentation of the audited financial statements to management as the key event.

Audit regulators highlight the fact that auditors fail to consider or evaluate the subsequent events that generally become known to them after most, or all, of the audit fieldwork is completed. The PCAOB provides an example that the auditor waived audit adjustments when the client had committed to a certain profit figure during an investor conference call. The auditor subsequently found a misstatement that would have caused the client's profit to be less than the previously announced result. The auditor waived the adjustment as being immaterial, allegedly because of subsequent client pressure (PCAOB 2008). The inference is that some level of commitment can arise as early as the preliminary earnings announcement. Therefore, Study 1 aims to examine whether auditors exhibit escalation tendencies in evaluating subsequent events when the event becomes known to them, after they have committed to their position on the fair presentation of the financial statements to management.

Considering that risk is an important aspect in the conduct of an audit, Study 1 examines whether the risk of material misstatement can affect the auditors' evaluation of subsequent events. When risk of material misstatement is high, auditors are more likely to be skeptical and less susceptible to bias (Nelson 2009). Previous research indicates that when auditors identify a higher risk of material misstatement in a financial report, they will be less susceptible to bias when they search for or evaluate audit evidence (Coram et al. 2004; Bell et al. 2005; Hwang and Chang 2010). The impact of the level of risk assessed on auditors' judgment is well-documented, so this thesis instead examines whether auditors respond to the high risk of material misstatement, and thus whether they are less likely to be affected by escalation of commitment in the subsequent events context.

Study 1 uses a 2 x 2 between-subjects experiment, in which auditors are required to propose an audit adjustment to the client for a subsequent event. The first independent variable examined is the commitment to management, which is manipulated as either “prior commitment” or “no commitment.” The second independent variable is the level of risk of material misstatements. The findings from an experiment involving 87 experienced auditors indicate that auditors exhibit escalation tendencies by proposing a significantly smaller audit adjustment to management when the subsequent event becomes known to them, after they have committed to their initial view on the fair presentation of the financial statements to management. The results of this study suggest that a high risk of material misstatement can reduce auditors’ escalation tendencies in the evaluation of subsequent events. Auditors exhibit escalation tendencies by proposing a significantly smaller audit adjustment to management when the subsequent event becomes known to them after they have committed to their initial position when the risk of material misstatement is low, but not when the risk of material misstatement is high.

The results of this study are of interest to both researchers and practitioners. First, this study provides additional insights for audit regulators and practitioners on potential deficiencies in the audit process for subsequent events. This study provides evidence that auditors tend to exhibit escalation behavior if subsequent events become known to them after they have reported the fair presentation of the financial statements to management. Even when auditors perform the early phases of an audit well, if they carry out the audit completion phase (such as evaluation of subsequent events) poorly, the quality of the overall audit will be low.

Second, Study 1 finds that auditors escalate their position after the reporting of the fair presentation of the audited financial statements to management. It is possible that other

information or subsequent events may arise during the course of auditing, or after the completion of the audit engagement (PCAOB 2003; IAASB 2011; Chung et al. 2013); for example, after the announcement of the profit figure during an investor conference call, or after the signing of the auditor's report. It is expected that auditors are more likely to escalate their commitment to the preliminary profit figure or the audit opinion issued. This is because they might be concerned about negative consequences, such as the potential for client or reputation loss, should they reverse a previous decision.

Third, this study contributes to the auditing literature on the effect of escalation of commitment on auditors' judgments. Previous studies mainly examine the judgment bias of auditors arising from involvement in the prior-year audit engagement (Hatfield et al. 2011; Messier et al. 2014). Study 1 extends the escalation research by providing evidence that auditors tend to exhibit escalation behavior in the current year audit engagement, or toward the end of the auditing process, when subsequent events become known to auditors after they have communicated and reported the fair presentation of the financial statements to management.

Finally, this study contributes to the risk assessment literature by examining whether risk of material misstatement reduces the effect of escalation of commitment in the audits of subsequent events. It is recommended that risk assessment procedures be applied from the audit planning stage until the final stage of the audit process (Bell et al. 2005). The results of this study are consistent with recent archival research by Ruhnke and Schmidt (2014), which indicates that the risk of material misstatement has a significant effect on the magnitude of the audit adjustments. The results of Study 1 demonstrate that when risk of material misstatement is high, auditors tend to be less affected by prior commitment to

an initial view provided to management, so that they will propose a significantly larger amount of audit adjustment to management.

Study 1 constitutes Section I of this thesis. The following chapters are structured as follows: Chapter 5 contains the development of hypotheses tested in this study, while Chapter 6 describes the research method. Chapter 7 discusses the results, as well as the conclusions and limitations of Study 1.

Chapter 5: Study 1 Development of Hypotheses

5.1 Introduction

Study 1 relies on research on decision-makers' tendency to commit to a chosen course of action, in order to predict that auditors are more likely to exhibit escalation tendencies in evaluating subsequent events when the event becomes known to them after they have committed to an initial expectation or decision formed during the process of auditing. This study also expects that risk of material misstatement interacts with auditors' escalation tendencies. Specifically, auditors are more skeptical when high-risk material misstatement factors are present. Therefore, they will adjust for subsequent events, even when a contrary view has been previously reported to management. In the following sections, three hypotheses are developed.

5.2 Prior commitment in the audit of subsequent events

According to the *ISA 560 Subsequent Events*, auditors are required to respond to subsequent events that normally come to their attention after a significant amount of audit work has been completed. This thesis focuses on subsequent events that come to the auditors' attention after most or all of the audit fieldwork has been completed, but before the date of the auditor's report. This suggests that auditors may have committed to an initial view, and may be reluctant to update their priors in the audit of subsequent events. To derive predictions on the manner in which auditors will commit to their initial view to management, this study relies on research on the escalation of commitment. As explained by Staw (1976), escalation of commitment refers to situations in which decision-makers

are faced with negative feedback about a prior decision, but continue to commit resources to the choice despite negative consequences.

The escalation effect on auditors' judgment has been explained by Jeffrey (1992), who has argued that auditors are susceptible to escalation behavior due to the nature of audit practice. Escalation of commitment is more likely to occur in the audit environment when (1) sequential evaluations about the course of action are made; (2) the decision-maker has personal responsibility for a previous favorable decision; and (3) the outcome is negative, and the results of the chosen course of action do not meet expectations. Drawing on Jeffrey's (1992) arguments, commitment could be increased or escalated in the audits of a subsequent events context because (1) subsequent events involve sequential evaluations about course of action or decisions to be made; (2) auditors bear responsibility for their prior decision made, on the overall presentation of financial statements after audit work has been completed; and (3) the outcome of subsequent events are unfavorable, or considered to disconfirm evidence that results from the chosen course of action, or if decisions are not consistent with expectations on the fair presentation of the financial statements. Therefore, it is plausible that escalation of commitment can affect auditors' responses to subsequent events.

The escalation effect may result from the negative consequences of previous decisions. Escalation of commitment typically refers to a situation in which resources continue to be committed to an initial course of action beyond a point where there is an indication of negative consequences (Staw 1976). It is possible that, when evidence from tests of subsequent events requires the amendment of the financial statements, the evidence is in the nature of negative feedback on the auditor's initial position. Church (1991) finds that auditors who are committed to their initial hypotheses will attach more importance to

confirming than disconfirming evidence. This result is consistent with Libby (1985), who posits that auditors' evaluation of audit evidence is affected by their formulated hypotheses. Survey evidence from Janvrin and Jeffrey (2007) regarding tests of subsequent events indicates that auditors do not search for evidence more often when the subsequent event evidence is perceived to be inconsistent with their initial judgment formed on or before the balance sheet date. These findings raise the concern that auditors may be reluctant to make a subsequent amendment of the financial statements when there is a level of commitment to the previous decision resulting in negative consequences to the auditor's initial position.

Prior auditing research on the effect of escalation of commitment on auditors' judgment indicates that auditors have a tendency to commit to their previous decisions if they have a prior involvement in the audit engagement (Tan 1995; Hatfield et al. 2011; Petycheva and Gillet 2012; Messier et al. 2014). Church (1991) argues that audit seniors think they would be less favorably evaluated if they were to go back and forth between different conclusions than if they were to stick with one conclusion. Nelson (2009) explains that auditors have a tendency to commit to their previous decision because of concerns over what changing a previous decision might indicate. Bazerman et al. (2002) point out that auditors are susceptible to escalation bias because they tend to protect their self-identity, or maintain the perception that they have not made a mistake in the audits by choosing not to correct previous misstatements, even if negative or contradictory evidence is available. Recent auditing research (Hatfield et al. 2011; Petycheva and Gillet 2012; Messier et al. 2014) documents that auditors who have previous involvement in the audit work are more likely to commit to their previous decisions or initial views, by accepting clients' aggressive accounting treatment or suppressing discomfiting audit evidence.

In considering the audit of subsequent events, a key point of commitment is the resolution of any proposed adjustments, and the reporting to management that the financial statements appear to be fairly presented. The commitment is expected to increase if decision-makers have communicated their initial position to others (Kiesler 1971; Staw and Ross 1987; Staw 1997). Having committed to their position on the fair presentation of the financial statements to management, the auditor may feel compelled to resist requesting a further adjustment, or propose a smaller audit adjustment, even when evidence from a subsequent event requires an alternative conclusion on the presentation of the financial statements.

Despite the growing role of the audit committees in resolving accounting disputes between auditors and management, auditors still interact with management to resolve accounting disputes before they report to the audit committee. Beasley, Carcello, Hermanson and Neal (2009) report evidence of audit committee governance being regarded as a symbolic endeavor. A survey by Cohen et al. (2010) finds that senior audit partners indicate that auditors and management resolve their accounting disputes before they report to the audit committee. The results suggest that interactions between auditor and management to resolve accounting disputes are still common in the post-Sarbanes-Oxley (SOX) environment. Interview findings from Cohen et al. (2013) reveal that directors' responses demonstrate some variation in the extent and nature of the role played by the audit committee in resolving accounting disputes, due to the ambiguity of the SOX regulation on the oversight role of the audit committee. The auditor client negotiation literature also documents the fact that auditors and CFOs normally resolve accounting disputes before auditors report their findings to the audit committee (e.g., Gibbins, Salterio and Webb 2001; Gibbins, McCrackens and Salterio 2005). In line with these findings and literature, this thesis focuses on auditors' commitment to the management

(i.e., the CFO) pertaining to the audit findings and overall presentation of the financial statements.

Study 1 predicts that auditors will propose a smaller audit adjustment when subsequent events occur after they have committed to their position on the fair presentation of the financial statements to management. In contrast, auditors will propose a larger audit adjustment to management when subsequent events occur before they communicate and report the fair presentation of the financial statements to management. This reasoning leads to the first hypothesis (in alternative form):

H1: *Auditors will propose a smaller (larger) audit adjustment relating to a subsequent event when the subsequent event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management.*

5.3 Risk of material misstatement

Audit researchers (e.g., Bell et al. 2005; Kachelmeier, Majors, and Williamson 2014) and regulators (e.g., PCAOB 2007) have embraced the concept of “risk-based auditing,” under which auditors should expend more resources or effort to address significant risks and fewer resources when risks are lower. In the context of subsequent events, the *ISA 560* (para. 7) requires auditors to take into account their risk assessment in auditing subsequent events. Auditors are required to respond to the risk of material misstatements in developing an audit strategy and in planning the nature, extent and timing of audit procedures in the process of auditing subsequent events. Considering the importance of the risk of material misstatement in auditing practice, this study aims to gain insight into

auditors' decision-making across a spectrum of misstatement risk in evaluating subsequent events.

Previous auditing research indicates that auditors recognize and respond to risk factors (e.g., Bedard and Johnstone 2004; Coram et al. 2004; Bell et al. 2008; Schelleman and Knechel 2010; Ruhnke and Schmidt 2014). Shaub and Lawrence (1996) find that auditors are more likely to be skeptical when various risk factors are present, such as related-party transaction, client financial stress and prior client inaccuracies. Similarly, Coram et al. (2004) find that auditors are responsive to the level of risk of misstatement by being more vigilant in the audit. Bedard and Johnstone (2004) show that auditors extend evidence searches when corporate governance risk is higher. Bell et al. (2008) demonstrate that auditors adopt a business risk audit approach and allocate more audit resources in response to assessed auditor business risk. Similarly, Schelleman and Knechel (2010) reveal that auditors allocate more audit effort—in terms of audit hours and mix of grade of labor—when a client has higher-level short-term accruals (i.e., greater earnings management).

Based on proprietary firm data from a large sample of audit adjustments detected in the financial statements audits of a German Big 4 audit firm's sample of clients, Ruhnke and Schmidt (2014) find that risk of material misstatement has a significant effect on the magnitude of audit adjustments. That is, a high risk of material misstatement significantly increases the magnitude of the audit adjustments. This strand of research is consistent with the appropriate application of the audit risk model. This audit risk model is used by auditors to indicate the amount of audit work that should be undertaken on an audit (Houston 1999). When risk of material misstatement is high, detection risks will need to be set low, resulting in increased audit effort to maintain the level of audit risk.

Given this previous research on the importance of risk to auditor decision making, it is necessary to consider how auditors assess evidence regarding a subsequent event in both low and high-risk conditions. With a focus on auditors' judgment of subsequent events, Study 1 expects that auditors will propose a smaller audit adjustment to management when the subsequent events become known to them in a condition of low risk of material misstatement. This reasoning leads to the second hypothesis:

H2: *Auditors will propose a smaller audit adjustment when the subsequent event becomes known to them in a condition of low risk of material misstatement, rather than that of high risk of material misstatement.*

5.4 Prior commitment and risk of material misstatement

Given the expectation that auditors respond to the risk of material misstatement, this study further explores whether risk of material misstatement interacts with auditors' prior commitment to management. Hackenbrack and Nelson (1996) find that auditors require more conservative reporting when engagement risk (litigation and reputation losses) is high. Phillips (1999) demonstrates that a high assessed level of risk for one account attracts auditors' attention to evidence of aggressive reporting in that account and directly increases their skepticism about the financial reporting in that account. Similarly, Hwang and Chang (2010) find that there is a significant interactive effect between litigation environment, client business risk, and client retention pressure on auditors' decisions to accept clients' aggressive reporting choices. In the tax practice context, Kadous, Magro, and Spilker (2008) report that a tax professional advising a client with high practice risks will perform a less biased search and make more objective and conservative recommendations. Cohen, Gaynor, Krishnamoorthy, and Wright (2011) find that auditors

waive the largest amount of the proposed adjustment—regardless of audit committee independence—when managers have low incentives to manage earnings, presumably because the risk of material misstatement is low. Quadackers, Groot and Wright (2014) examine the relationship between auditors’ skeptical perspective (neutrality and presumptive doubt) and auditors’ skeptical judgments across client risk settings (higher versus lower control environment risk). They find that auditors who possess presumptive doubt are more skeptical in the high-risk condition. Considering that this previous research suggests that auditors are less likely to be subject to bias in the presence of a high-risk condition, this study predicts that auditors are more skeptical when a high risk of material misstatement factors are present, and therefore they will adjust for subsequent events, even when a contrary view has been previously reported to management.

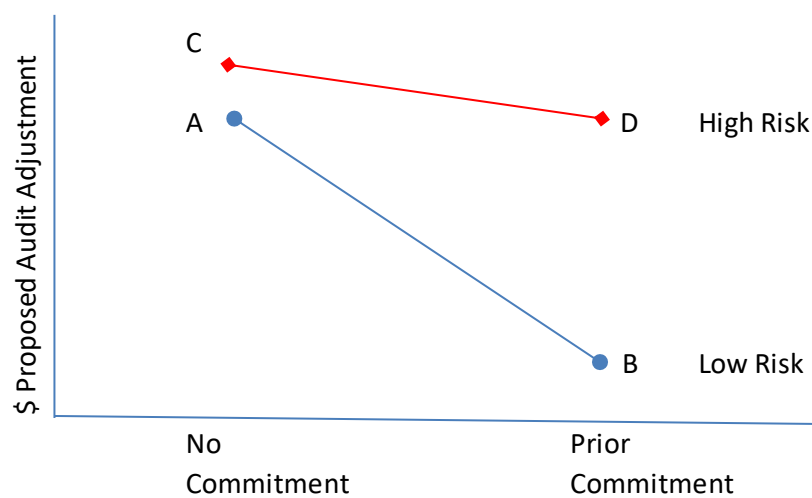
This study predicts that auditors who are in the presence of a high risk of material misstatement for the audit engagement will propose a significantly larger audit adjustment to management when subsequent events become known to them, even after they have made a prior commitment on the fair presentation of the financial statements to management. Conversely, auditors who are in the presence of a low risk of material misstatement for the audit engagement will propose a significantly smaller audit adjustment to management, even when subsequent events become known to them after they have escalated their position on the fair presentation of the financial statements to management. This prediction leads to the third hypothesis which is graphically depicted in Figure 5.1:

H3: *Auditors’ prior commitment to management on the fair presentation of the financial statements has a larger downward effect on the proposed audit adjustment in a low*

risk of material misstatement condition than a high risk of material misstatement condition.

Higher risk increases auditors' skepticism and reduces bias in performing auditing tasks, but demonstrating this with the context of the audit of subsequent events highlights the importance of identifying the level of risk prior to the evaluation of subsequent events. If auditors' escalation behavior is significantly affected by risk of material misstatement, this suggests an avenue for improving training or additional procedures to improve auditors' review of subsequent events.

Figure 5.1: Study 1- Graphical representation of the predicted interaction between commitment and risk of material misstatement on the lowest acceptable inventory write-down assessment



5.5 Conclusion

Study 1 examines whether prior commitment and risk of material misstatement affect auditors' evaluation of subsequent events. H1 is developed to answer the research question on whether prior commitment would affect auditors' evaluation of subsequent events. Drawing on the escalation of commitment literature, H1 predicts that auditors have escalation tendencies, by proposing a smaller audit adjustment on a subsequent event when the event becomes known to them after they have committed to their initial view on the fair presentation of the financial statements to management. H2 is developed to answer the research question about whether auditors respond to risk of material misstatement in evaluating subsequent events. The argument is that auditors will propose a smaller audit adjustment to management when subsequent events become known to them in the condition of low risk of material misstatement. H3 is developed to examine the interactive effects of prior commitment, and the risk of material misstatement. The argument is that auditors are sensitive to increased risk of material misstatement, so will adjust for subsequent events, even when a contrary view has previously reported to management.

Chapter 6: Study 1 Research Method

6.1 Introduction

This chapter explains the research method used to test the hypotheses developed in Chapter 5. Study 1 employs a 2 x 2 between-subject experimental design to examine the effects of prior commitment and risk of material misstatement on auditors' evaluation of subsequent events. Section 6.2 provides an overview of the experimental design, while Section 6.3 details the experimental task and the procedures of the experiment. Section 6.4 discusses the measurement of dependent variables, and Section 6.5 explains the manipulation of the two independent variables. Section 6.6 presents the details of participant recruitment and demographic information, and the final section concludes the chapter.

6.2 Overview of the experiment

An experiment was conducted to examine the causal relationship between prior commitment and risk of material misstatement on auditors' evaluation of subsequent events. Maines, Salamon and Sprinkle (2006, p. 99) explain that “the primary strength of experiments, compared to other empirical approaches, is the ability to infer the direction of causality between independent and dependent variables.” In an experimental setting, the researcher can manipulate one or more independent variables and hold all other variables constant. This mechanism disentangles the effects of variables that are confounded in the environment, therefore achieving strong causal inferences (Trotman 1996; Libby, Bloomfield, and Nelson 2002; Bloomfield, Nelson and Soltes 2016).

Additionally, experiment allows researchers to test things that do not exist in practice yet, such as proposed new standards and potential decision aids (Trotman 2014).

As outlined in Chapter 4, H1 predicts that auditors will propose a smaller (larger) audit adjustment on subsequent events when the event becomes known to them after (before) they have committed to their view on the fair presentation of the financial statements to management. H2 predicts that auditors will propose a smaller audit adjustment to management when subsequent events become known to them in the condition of low risk of material misstatement. H3 predicts interaction effects between prior commitment and risk of material misstatement. Specifically, auditors' prior commitment to management on the fair presentation of the financial statements has a larger downward effect on the proposed audit adjustment in a low risk of material misstatement condition than in a high risk of material misstatement condition. Figure 5.1 shows the predicted interaction between commitment and risk of material misstatement.

To test these hypotheses, this study uses a 2 x 2 between-subjects experimental design, in which auditors are required to propose an audit adjustment to the client for a subsequent event. The first independent variable examined is the commitment to management, which is manipulated as either "prior commitment" or "no commitment." The second independent variable is the level of risk of material misstatement, which is manipulated as either "high risk" or "low risk." Study 1 predicts an interaction between commitment to management and risk of material misstatements. A predicted interaction can help control for potential omitted variables, or rule out alternative explanations (Evans, Feng, Hoffman, Moser, and van der Stede 2015). The predicted interaction of commitment to management and risk of material misstatement is graphically depicted in Figure 5.1.

Manipulation of the two independent variables results in the experimental design of Study 1, as presented below.

Table 6.1: Design of Study 1

		Commitment to Management	
		Prior Commitment	No Commitment
Risk of Material	High risk	Adj ₁	Adj ₃
Misstatement	Low risk	Adj ₂	Adj ₄

Notes: Dependent variable is proposed audit adjustment. The measure used is: the lowest acceptable inventory write-down assessment that the auditor would be willing to accept being recorded in the financial statements. Adj: An assessment of the lowest inventory write-down amount, between zero and the total value of old inventory (in millions of dollars) that the auditor would be willing to accept being recorded in the financial statements.

The experiment was mainly conducted online, and participants were randomly allocated across treatments when logging on. A further 14 paper copies of the survey were completed and received from one of the Big-4 firms, because the contact person preferred a paper-based survey to an online survey. Any differences in responses in the two modes were tested and not significant.

Participants were primarily recruited from Malaysia. Using Malaysian auditors as participants may mean that the results are not generalizable to US auditors. This concern is mitigated by the fact that the participating auditors are from the Big-4 and mid-tier firms, all of which are also members of the global audit firm network and adopt consistent global practices. To further mitigate this concern, a smaller secondary group of auditors was recruited from Australia. This study reports the aggregate analyses from Malaysia and Australia auditors because results do not systematically vary between these two countries. Eighty-seven usable responses (61 responses from Malaysia and 26 responses from Australia) were used to test hypotheses. Auditing experience ranged from two to 35 years, with an average of 5.89 years of audit experience (standard deviation=5.18).

Ideally, experiments would be conducted under controlled conditions. However, the experiment in this study was not. Participants completed the instrument at their own convenience. However, additional controls were built into the instruments. For the online instrument, the program disallowed participants from changing their responses provided on an earlier screen. For the paper-based instrument, participants were instructed not to change the responses they had made. On average, participants took 25 to 35 minutes to complete the research instrument.

Individual differences among the participants were controlled by randomly assigning participants to one of the four treatment groups. Randomization ensures that other possible extraneous variables will not systematically bias the results (Trotman 1996, 2001; Libby et al. 2002), and therefore attains internal validity. Additional analyses were also performed to ensure that none of the demographics of participants affected the hypotheses tests.

6.3 Experimental task and procedures

6.3.1 Experimental task

This experiment adapts and modifies an inventory obsolescence task from Bauer (2015). Participants were provided with a case requiring an adjustment arising from a subsequent event related to an inventory obsolescence issue. This task was chosen because an inventory obsolescence issue after the balance sheet date is an example of a common subsequent event provided in *IAS 10 Events After the Reporting Date* (see *IAS 10*, para. 9). Auditors are more likely have the requisite knowledge and experience to evaluate the inventory obsolescence issue (Bhattacharjee, Moreno, and Riley 2012). The inventory

obsolescence case adopted in this thesis reflects a task performed by auditors on a regular basis. The inventory obsolescence task entails an estimate that is inherently subjective, and this leaves room for auditors to make judgments (Trotman, Wright, and Wright 2005). The results obtained—based on the inventory obsolescence task—may not generalize to all subsequent events, which may limit the generalization of the results.

Pilot testing is necessary to ensure that participants perceive the selected levels of independent variables as intended (Evans et al. 2015). The experimental instrument was pilot tested with three groups. First, the instrument was refined based on the comments and feedback received from 15 external auditors with different levels of experience in several audit firms. One audit partner and two senior managers from two Big-4 firms in Australia specifically reviewed the case materials for realism and accuracy. Second, four senior academics with more than 15 years of experience in accounting research and education in Australia helped refine the completeness and wording of the materials. Third, the experimental instrument was pilot tested with 10 Accounting PhD students in Australia, and two Accounting PhD students in Malaysia. The instrument was modified based on the feedback received from these groups.

Ethics approval was obtained prior to commencing data collection. The research was conducted in accordance with the approval received from the Human Research Ethics Committee of The Australian National University (ANU). No concerns relating to ethical conduct arose during the course of this research. The confidentiality and anonymity of data were maintained as far as the law permits. All data collected have been securely stored, and will be destroyed after the storage period.

6.3.2 Procedures for the experiment

The experiment consisted of four sections. The following sections describe each part of the experiment. The completed instrument is included as Appendix A.

Section 1: Introduction to the experimental task

At the start of the experiment, participants read the information sheet, which presented the following general information: (1) the research objectives; (2) the voluntary nature of participation in the research; (3) the incentive payment to participants; (4) the assurance of confidentiality; and (5) the contact details of the researcher and the Human Ethics Committee. Next, the general instructions to complete the task were presented to the participants.

Section 1 presented the background of a hypothetical company, management team and company's summarized financial information. All participants read the background information on the client, Johnson Products Inc. (Johnson), such as information on the client's business and industry; other information regarding the client's corporate governance (e.g., the structure of its board committee, and the frequency of its meetings); and the summary of financial information. The financial results presented were generally favorable. Participants were instructed to assume the role of an audit manager on an audit engagement of Johnson.

For the experimental instrument provided to the Malaysia participants, Johnson Products Inc. was translated to "Johnson Products Berhad," to be consistent with the Malay language, and all currency in the instrument was shown in Malaysian Ringgit (RM).

Section 2: Information on subsequent events and manipulation of independent variables

In Section 2, participants were provided with information on the subsequent event that leads to the adjustment of the inventory balance. Participants were informed by audit staff that the audit client, Johnson, had terminated a relationship with its distributors after the financial year end, June 30, 2014, and were holding high-tech inventory. Some of the inventory that was returned to Johnson's warehouse was obsolete or damaged. There were significant increases in excess levels of inventory in the distribution channel after the financial year end. Thus, concern arose over the adjustment on the closing balance of the inventory account because the condition of inventory in the warehouse indicated the need to provide an allowance for inventory obsolescence. This subsequent event scenario was adapted from one of the PCAOB inspections against auditors, who were involved in the audit of the California Micro Devices Corporation (SEC 2003).

In this experiment, the audit partner requested participants' assessment of the write-down that would be used in further discussions with Johnson's management. Participants were provided with summarized audit working papers on the audit issue. Johnson's total inventory was \$10.08 million. The audit team estimated a write-down of \$7.56 million based on unrecoverable value, and this proposed write-down amount resulted in a net loss position of \$2.69 million. However, Johnson's CFO believed a write-down of \$3.93 million was reasonable because Johnson would be more likely to transform the old product, and the inventory was too early in the life cycle to consider a write-down. Johnson's inventory write-down resulted in a net income position of \$940,000. Both

write-down amounts have a material impact on Johnson's financial statements.⁹ A summary of the financial statements, incorporating the two estimates were provided to participants.

In Section 2, participants were also provided with descriptions of the manipulated variables of the commitment to management, and the assessment of the risk of material misstatement. Participants read one of the four versions of the description on the commitment to management and risk of material misstatements. Four treatment conditions represented by four versions of the experimental task are presented in Table 6.2.

Table 6.2: Study 1- The four versions of the experimental task

	Commitment to Management	Risk of Material Misstatement
1	Prior commitment	High risk
2	Prior commitment	Low risk
3	No commitment	High risk
4	No commitment	Low risk

Finally, participants were required to decide upon the lowest acceptable inventory write-down, inventory write-down amount to be recommended to audit engagement partners, and the amount of audit adjustment that would ultimately be booked.

Section 3: Manipulation checks and debriefing questions

⁹ Materiality level can affect auditors' proposed audit adjustment (Chung, Cohen and Monroe 2008). This experiment informed participants that the auditor and management's proposed audit adjustments have material effects on the financial statements.

In Section 3, participants were required to answer manipulation checks and debriefing questions. The first two questions in Section 3 were manipulation check questions on the construct validity of the commitment to management and the risk of material misstatements.

The remaining four questions were a series of debriefing questions, to allow participants to reflect on what had occurred in the experimental task. The questions were provided to ensure that participants understood the experimental task intended. Participants were asked to indicate whether they thought the case materials were realistic. They were also asked to indicate their experience level, confidence level, and involvement level, to complete the experimental task.

Participants were also asked to complete an 18-item self-monitoring scale, developed by Snyder and Gangestad (1986). The purpose of these scale items is to capture whether individuals have a tendency to alter their attitudes, perspectives, or behaviors to adapt different situations in order to portray a better image of themselves (Snyder 1974).

Section 4: Demographic questions

Section 4 consisted of a number of demographic questions on participants' audit experience, experience in auditing subsequent events and inventory, the current position in the firm, work affiliation, professional background, and gender. These demographic questions were chosen because they are considered potential influential variables or extraneous variables, besides the independent variable that could affect the dependent variable. These extraneous variables affect conclusions about the causal relationships between the dependent and independent variables, and therefore need to be controlled to

attain internal validity (Libby et al. 2002; Evans et al. 2015). Sensitivity analyses were used to test for any potential effects on the dependent variable arising from these demographic variables. For example, background post-experimental data (e.g., years of experience, position) was used as a control variable to reduce the variability of responses. The list of demographic questions selected was kept small in considering that auditor time is valuable.

6.4 Dependent variables

The dependent variable is an assessment of the lowest inventory write-down amount, between zero and the total value of old inventory (in millions of dollars), which the auditor would be willing to accept being recorded in the financial statements. This measure was chosen because this thesis focuses on an adjusting event after the financial reporting period that requires adjustments on the financial statement (Type I subsequent event). The assessment of the lowest inventory write-down amount was essentially related to the evaluation of subsequent event evidence. In deciding an audit adjustment on a subsequent event, given that the event has been identified, auditors are required to evaluate the evidence of subsequent events (Janvrin and Jeffrey 2007; Chung et al 2013). Smaller audit adjustment proposed indicates greater agreement with the client. This may suggest less skepticism in auditor judgments (Chung et al. 2008; Bauer 2015).

Following Trotman, Wright, and Wright (2009), participants were also asked to assess the write-down amount they would recommend be recorded, and the amount they believed would ultimately be recorded. The difference between the two amounts is the amount of audit adjustment that would be waived. This study finds no significant differences across conditions for the amount of audit adjustment that would be waived.

Therefore, all data and statistics reported in this thesis are based on the assessment of the lowest inventory write-down amount.

Participants were also asked to provide one or two reasons for the proposed audit adjustment, as this is consistent with the practice of documenting reasoning in audit working papers for significant proposed adjustment and audit decisions (Hatfield et al. 2011).

6.5 Independent variables

As discussed above, Study 1 employs a 2 x 2 between-subjects experimental design. The first independent variable is the commitment to management (manipulated as “prior commitment” versus “no commitment”), and the second independent variable is the level of risk of material misstatement (manipulated as “high risk” versus “low risk”). The following sections discuss how these variables are manipulated in the experiment.

6.5.1 Commitment to management

Drawing on the escalation of commitment research, this thesis examines whether auditors exhibit escalation tendencies in evaluating subsequent events when the event becomes known to them after they have committed to their initial position. H1 predicts that auditors will propose a smaller (larger) audit adjustment relating to a subsequent event when the subsequent event becomes known to them after (before) they have committed to their initial view on the fair presentation of financial statements to management. That is auditors will propose a smaller audit adjustment when subsequent events occur after they

have committed to their initial position on the fair presentation of the financial statements to management.

In considering the audit of subsequent events, a key point of commitment used in this thesis is the resolution of any proposed adjustments and the reporting to management that the financial statements appear to be fairly presented. Prior auditing studies manipulate the escalation behavior based on the condition of auditors' "prior involvement" and "no prior involvement" in auditing tasks (e.g., Tan 1995; Brody and Kaplan 1996; Hatfield et al. 2011). Similarly, this study argues that subsequent events become known to auditors after they have communicated the fair presentation of the financial statements to management, which is similar to the "prior involvement" condition because they will commit to a previous decision made after communicating the audit findings to management. The commitment is expected to increase if they have communicated their position to others (Kiesler 1971). For example, Staw and Fox (1977) find that escalation is likely to occur when individuals are personally held responsible for previous decisions communicated to others.

In the "prior commitment" condition, subsequent events become known to auditors after auditors have reported the fair presentation of the financial statements to management. Participants in the "prior commitment" condition were told the following:

You have presented all the audit findings to Johnson's management and conclude that there are no material misstatements in the financial statements for the financial year ended 30 June 2014. You have confirmed the correctness of the presentation of financial statements and propose to issue a standard unmodified audit report. Management agrees with the presentation of the audited financial statements and

will organize an audit committee meeting to authorize the issuance of the audited financial statements. Johnson's management has expressed that they have strong reservations about any proposed audit adjustments that materially distort the financial performance of the company, especially after you have confirmed the correctness of audited financial statements, because they have a very short time period to issue the audited financial statements to shareholders.

After you have presented the audited financial statements and reported the fair presentation of the financial statements to Johnson's management, you are informed by your audit team members that there is a subsequent event regarding an issue of inventory obsolescence. Today's date is August 24, 2014.

In the “no commitment” condition, subsequent events become known to auditors before they report the fair presentation of the financial statements to management. Participants in the “no commitment” condition were told the following:

Before you present the audited financial statements and confirm the correctness of the presentation of financial statements to Johnson's management, Johnson's management has expressed that they have strong reservations about any proposed audit adjustments that materially distort the financial performance of the company, especially after you have confirmed the correctness of audited financial statements, because they have a very short time period to issue the audited financial statements to shareholders.

Before you present the audited financial statements and report the fair presentation of the financial statements to Johnson's management, you are informed by your audit

team members that there is a subsequent event regarding an issue of inventory obsolescence. Today's date is August 24, 2014.

For both conditions, participants were told that management has strong reservations about any proposed audit adjustments that materially distort the financial performance of the company, especially after they have reported the fair presentation of the audited financial statements. This is because the escalation of commitment research suggests that decision-makers will commit the greatest number of resources to a previously chosen course of action when they are personally responsible for negative consequences (Staw 1976; Staw and Ross 1989). The negative consequences for changing previous decisions in the experimental context are strong objections from management to the proposed audit adjustments after the presentation of the financial statements to management. Therefore, in these conditions, auditors are expected to be responsible for their initial decision, communicated to management.

6.5.2 Risk of material misstatement

Auditors are required to recognize and respond to risk factors in the audit process. With the focus on auditor adjustment decisions on subsequent events, H2 predicts that auditors will propose a smaller audit adjustment to management when subsequent events become known to them in the condition of low risk of material misstatement. This study also predicts an interaction effect between prior commitment and risk of material misstatements. H3 suggests that auditors' prior commitment to management on the fair presentation of the financial statements has a larger downward effect on the proposed audit adjustment in a low risk of material misstatement condition than in a high risk of material misstatement condition. That is, auditors will adjust for subsequent events when

high risks of material misstatement factors are present, even when a contrary view has been previously reported to management.

Auditors are responsible for identifying and assessing the risk of material misstatement in the financial reporting, through understanding the entity and its environment, including the entity's internal control. Accordingly, the manipulation of the level of risk of material misstatement includes the aspect of the level of internal control and an entity's business environment. One of the main indicators for the level of internal control is client's control environment. Previous studies show that auditors take into consideration the clients' control environment when, for example, audit planning, accepting clients, and assessing risk (Bernardi 1994; Beasley 1996; Cohen and Hanno 2000). Experimental studies indicate that auditors are more skeptical in higher control environment risk settings (Quadackers, Groot, and Wright 2014).

According to the Committee of Sponsoring Organizations of the Treadway Commission (2013), the control environment includes: integrity and ethical values, commitment to competence, participation by those charged by governance, management's philosophy and operating styles, organizational structure, assignment of authority and responsibility, and, human resource policies and practices. In designing the risk of material misstatement, the experiment combines these elements of the control environment. Participants in the "high risk" condition were informed that the client's control environment highlighted in the audit planning section was weak. In the "high risk" condition, participants were told the following:

In the audit planning section documented in the audit working paper, there were several aspects of control environment noted, and the preliminary assessment shows that the control environment was weak. The audit working papers show:

- 1) Johnson has policy statements and a code of conduct applies to all employees, including top management. Employees read the code of conduct on the first day of their employment and seldom review it afterward.*
- 2) Johnson has high turnover in the senior management positions. It is noticed that inexperienced staff held these management positions.*
- 3) Johnson does not have a well-specified organizational chart that indicates lines of authority and control-related responsibilities for management and supervisory personnel.*
- 4) Although there are a large number of internal-control procedures in place, they are sometimes less strictly applied.*

In contrast, participants in the “low risk” condition were informed that the client’s control environment, highlighted in the audit planning section, was strong. In the “low risk” condition, participants were told the following:

In the audit planning section documented in the audit working paper, there were several aspects of control environment noted, and the preliminary assessment shows that control environment was strong. The audit working papers show:

- 1) Johnson has policy statements and a code of conduct which explicitly communicated to all employees, including top management, and reinforced by day-to-day practice.*
- 2) Johnson has low turnover in the senior management positions, and high experienced staff held these senior management positions.*
- 3) Johnson has a well-specified organizational chart that indicates lines of authority and control-related responsibilities for management and supervisory personnel.*
- 4) There is a strict policy for following all established internal-control procedures.*

The manipulation of risk of material misstatement is designed to be relatively strong. While having such a strong manipulation helps maintain a high level of internal validity and makes strong casual inferences, such manipulation may make it harder to generalize and contextualize results (Bloomfield et al. 2016). The design of the manipulation in the current experiment may not capture the other aspects of the risk of material misstatement, including the assertion levels for classes of transactions or account balances (i.e., inventory balance), and control activities.

6.6 Participants

6.6.1 Recruitment procedures

Participants in this experiment were experienced auditors (partners, directors, senior managers, managers and seniors) because these people have practical knowledge and experience of the audit of subsequent events. Partners and managers at participating firms indicated that audit seniors and higher levels are appropriate participants because they have experience evaluating subsequent events. There is evidence that audit seniors routinely plan audit work and modify audit programs (Hammersley, Johnstone, and Kadous 2011). Audit partners' decisions are also affected by the direction of the seniors' decisions, documented in the audit working papers (Ricchiute 1999).

The experiment was conducted from September 2014 to November 2014. Contacts at audit firms were approached to secure the participation of auditors. Participants were mailed a web link by a contact person, which directed them to the online survey through a contact person in each participating firm. The online system automatically and randomly allocated participants to one of the four treatments. Additionally, 20 copies of a paper-

based instrument, with four different versions were mailed to one of the Big 4 firms, as the contact person at that firm preferred a paper-based survey to an online one. 14 paper-based surveys were completed and received.¹⁰ Participants were assured confidentiality, and that their participation in the experiment was voluntarily.

Participants were primarily recruited from Malaysia. Using Malaysian auditors means that the results may not be generalizable to US auditors. This concern was mitigated by the fact that the participating auditors were from Big 4 and mid-tier firms, all of which are members of the global audit firm network and adopt consistent global practices. Auditors in Malaysia comply with the ISA standards issued by the IAASB. As Big 4 firms and large international firms in Malaysia are also members of the global audit firm network, it is believed that the results obtained using Malaysian participants will not be significantly different from the results of studies that use auditors from other countries.

To further mitigate these concerns, a smaller secondary group of auditors was recruited from Australia. Both groups completed the instrument in English. For Malaysian participants, the currency used was RM, and the company name was kept consistent with that of a company within the auditing environment in Malaysia.¹¹

Malaysia participants who completed the experimental materials were remunerated with a gift voucher worth RM50 (approximately \$20). Australian participants received a donation of \$25 to a charity, for each completed experiment instrument. A gift voucher was provided to Malaysian participants because the Malaysian auditors indicated that they preferred a gift voucher. The donation to charity was the preferred method in

¹⁰ Any differences in responses in the two modes were tested and are not significant.

¹¹ This study reports the aggregate analyses from Malaysian and Australian auditors, because the results for the t-test reports that there are no significant differences in the dependent variable between these two countries ($p = 0.356$).

Australia. While this experiment would have preferred to use the same inducement method for both groups, after local advice it was determined that these respective inducements were the most appropriate to encourage auditors' participation in each location. The payment of an incentive to participants was a gesture of appreciation for their time and effort required to complete the research instrument. Auditing behavioral studies often pay incentives to participants (e.g., Chung et al. 2008; Kim and Trotman 2015; Moroney et al. 2015).

6.6.2 Demographics of the participants

Additional analyses were performed to test any potential effects on the dependent variable arising from the demographic variables. Detailed analyses and results are reported in Chapter 7.

A total of 105 auditors participated in this experiment.¹² The participants consisted of 78 auditors from three Big-4 firms and two mid-tier firms in Malaysia, and 27 auditors from two Big 4 firms and one regional firm in Australia. Among the sample, 17 responses were eliminated from the full sample due to failed manipulation checks, leaving 87 useful responses (61 from Malaysia and 26 from Australia) with which to test the hypotheses.¹³ All data and statistics reported were based on the remaining 87 participants. The results for manipulation checks are reported in Chapter 7.

Demographic information is presented in Table 6.3. The participants consisted of seven partners (8% of the sample), five directors (5% of sample), five senior managers (6% of

¹² As the audit firms helped to secure the participants, this study was not able to assess a response rate.

¹³ This experiment also excludes one incomplete response from the sample of Malaysian participants.

sample), 11 managers (13% of sample), 15 assistant managers (17% of sample), and 39 seniors (45% of sample).¹⁴ Their audit experience ranged from two to 35 years, with an average of 5.89 years audit experience (standard deviation=5.18). The reported experience with the audit of inventory was in the lowest category for some respondents, but this study did not find any systematic relation between experience measures and responses. In the sample, 87.8% of participants had professional qualifications, and 10.2% were still seeking them. Sixty-nine percent of the participants worked for a Big 4 firm, while the remaining 30% worked for mid-tier firms. There was a fairly even gender split (47.1% females).

¹⁴ Five respondents listed their current role as 'other'. These participants worked in service areas, but they had at least two years of audit-related experience. This study includes these five participants in the analyses, as they possessed the relevant years of audit experience. Excluding these responses yielded similar results to those reported.

Table 6.3: Study 1- Demographic information of participants

Current position in firm (Frequency and Percentage)	
Audit partner	7 (8.0)
Audit director	5 (5.7)
Audit senior manager	5 (5.7)
Audit manager	11 (12.6)
Audit assistant manager	15 (17.2)
Audit senior	39 (44.8)
Other	5 (5.7)
Total	87 (100)
Type of employer the participants currently work for (Frequency and Percentage)	
Big-4 accounting firms	60 (69)
Non-Big-4 accounting firms	27 (31)
Total	87 (100)
Audit experience (Mean and Standard deviation)	
Number of years of audit experience	5.89 (5.18)
Number of years in current position	2.57 (3.94)
Percentage of time spent performing each of the following tasks (Mean)	
Audit	84.24
Tax	3.75
Consulting	4.59
Other	7.42
Professional qualifications (Frequency and Percentage)*	
Chartered Accountant (CA) (Australia)	25 (25.51)
Certified Practising Accountant (CPA) (Australia)	16 (16.33)
ACCA (United Kingdom [UK])	20 (20.41)
Malaysian Institute of Chartered Accountants (MIA) (Malaysia)	12 (12.25)
Malaysian Institutes of Certified Public Accountants (MICPA) (Malaysia)	10 (10.20)
Institute of Chartered Accountants in England and Wales (ICAEW) (UK)	3 (3.06)
Still seeking professional qualification	10 (10.20)
Other	2 (2.04)
Number of times the participant has been involved in the audit of subsequent events (Frequency and Percentage)	
0–20	53 (60.9)
21–40	9 (10.3)
41–60	9 (10.3)
61–80	6 (6.9)
81–100	2 (2.3)
Above 100	8 (9.2)
Total	87 (100)
Number of times the participant has been involved in the audit of inventory (Frequency and Percentage)	
0–20	45 (51.7)
21–40	11 (12.6)
41–60	19 (21.8)
61–80	5 (5.7)
81–100	2 (2.3)
Above 100	5 (5.7)
Total	87 (100)

Notes: *Some participants hold two or more professional qualifications.

6.7 Conclusion

Study 1 examines the effects of prior commitment and risk of material misstatement on auditors' evaluation of subsequent events. This study examines whether auditors commit to an initial view formed during the audit, and therefore exhibit escalation tendencies by proposing a smaller audit adjustment to management. However, auditors are expected to be more skeptical when risk factors are present, so that they will adjust for subsequent events when the risk of material misstatement is high. Study 1 uses an experimental approach with a 2 x 2 factorial design, using an online instrument. An inventory obsolescence task is used in this thesis which requires auditors to propose an audit adjustment on a subsequent event. All data and statistics reported in this thesis are based on the usable 87 experienced auditors. The next chapter presents the results and the additional analyses of Study 1.

Chapter 7: Study 1 Results and Conclusions

7.1 Introduction

This chapter presents the results for Study 1. Section 7.2 reports the results for the manipulation checks and debriefing questions, while Section 7.3 provides the results for the hypotheses. Section 7.4 covers supplemental analyses and Section 7.5 reports the results for the additional analyses. Section 7.6 summarizes the results of Study 1, and Section 7.7 discusses and concludes Study 1.

7.2 Manipulation checks and debriefing questions

Manipulation checks were conducted to ensure that participants understood commitment to management and risk of material misstatement manipulations as intended. To verify that auditors attended to the manipulation of the commitment to management, participants were asked to choose either the subsequent event of inventory issues informed by audit team members after or before they reported the fair presentation of the financial statements to management. These options reflected the wording in the case materials regarding the “prior commitment” and “no commitment” conditions. Most participants correctly identified the treatment for commitment to management. Seventeen participants (16%) failed this manipulation check and their responses are not included in the data analyses. These responses were scattered across treatments. Including these responses in the analyses yielded similar significant results for H2 and interaction effects, but only a marginally significant result for H1 ($p=0.071$).

To verify that auditors attended to the manipulation of the risk of material misstatement, participants were required to rate the level of the risk of material misstatement described in the case materials, using an 11-point scale (0=“very low risk” to 10=“very high risk”). As expected, the mean ratings are 7.19 (standard deviation=1.63) for the high risk of material misstatement condition, and 5.04 (standard deviation=2.86) for the low risk of material misstatement condition. The results indicate that the manipulation of risk of material misstatement was successful ($t(85)=4.26, p<0.01$).

To evaluate whether various perceptions about the case materials or dispositional characteristics of participants affected the results, participants were asked to answer several debriefing questions related to their experience in the audit of subsequent events, realism of case materials, confidence completing the experimental task, and their involvement in completing the experimental task. Responses were collected using an 11-point Likert scale ranging from -5 (“strongly disagree”) to +5 (“strongly agree”). The mean ratings and standard deviations for these debriefing questions are reported in Table 7.1. Participants found the case materials to be realistic (mean=2.05, standard deviation=1.96), suggesting a relatively high experimental realism. Participants were confident in their ability to complete the task (mean=2.33, standard deviation=1.86), and they felt involved in completing the task (mean=1.86, standard deviation=1.93). Finally, participants also indicated that they had sufficient experience in the audit of inventory or inventory obsolescence (mean=2.18, standard deviation=2.06).

To examine whether these debriefing questions would affect hypotheses tests, this study includes these four measures as covariates in a 2 x 2 analysis of covariance (ANCOVA), with the auditor’s lowest acceptable inventory write-down assessment (in millions of dollars) as the dependent variable. The un-tabulated ANCOVA analyses show that none

of these measures are significant at the 5% level (all $p > 0.70$). The results for the hypotheses are not qualitatively affected by the inclusion of these measures in the ANCOVA, so are not included in hypotheses tests. The results for the debriefing questions reveal that the experimental instrument was considered realistic, and participants possessed sufficient experience to complete the task.

Table 7.1: Study 1- Debriefing questions

	Mean	Std. Dev.
1. Experience in the audit of inventory	2.18	2.06
2. Realism of case materials	2.05	1.96
3. Confidence in ability to complete task	2.33	1.86
4. Felt involved to complete task	1.86	1.93

Notes: Responses were collected using a scale ranging from -5 (Strongly disagree) to +5 (Strongly agree).

7.3 Tests of hypotheses

This section presents the results of auditors' assessment of the lowest inventory write-down amount. The commitment to management (prior commitment versus no commitment) and the risk of material misstatements (high risk versus low risk) are two between-subject factors.

This section first reports the descriptive statistics of the cell means across all experimental conditions and the results for the t-tests that show the mean differences between the treatment groups. Second, the results for multivariate analysis are reported. Lastly, the tests of predicted interaction are presented.

7.3.1 Descriptive analyses

Descriptive analyses of the lowest acceptable inventory write-down assessment are reported in Table 7.2, Panel A. The pattern of means in Table 7.2, Panel A shows the main effects of the commitment and risk of material misstatements. Participants in the no commitment condition accept a larger audit adjustment (mean=\$6.24 million) than the participants in the prior commitment condition (mean=\$5.42 million). Table 7.2, Panel B provides the results for the t-test between the treatment groups. The mean difference on the lowest acceptable inventory write-down assessment is marginally significant ($t(85)=1.98$, $p=0.051$). Consistent with H1, the results suggest that auditors will propose a smaller (larger) audit adjustment on a subsequent event when the event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management.

Table 7.2, Panel A also reports the results for the risk of material misstatement conditions. Participants in the low risk of material misstatement condition accept a smaller audit adjustment (mean=\$5.39 million) than the participants in the high risk of material misstatement condition (mean=\$6.33 million). The mean difference on the lowest acceptable inventory write-down assessment is statistically significant between the two conditions ($t(85)=-2.33$; $p=0.022$). This finding supports H2, which predicts that auditors will propose a smaller audit adjustment when the subsequent event becomes known to them in a condition of low risk of material misstatement, than if it becomes known in high risk of material misstatement.

Table 7.2: Study 1- Auditors' assessment of the lowest acceptable inventory write-Down

Panel A: Descriptive statistics: Mean, (Standard deviations), and Number of observations

	Risk			
	Low Risk		High Risk	Overall
Commitment				
No Commitment	[A]	6.09 (2.02) n=24	[C]	6.40 (1.59) n=21
Prior Commitment	[B]	4.59 (1.86) n=21	[D]	6.26 (1.81) n=21
Overall		5.39 (2.07) n=45		5.84 (1.94) n=87

Panel B: Differences in mean of the lowest acceptable inventory write-down assessment by treatment conditions

	Commitment		Risk	
	No	Prior	Low	High
Mean of the lowest acceptable inventory write-down assessment (Standard deviation)	6.24 (1.82)	5.42 (2.00)	5.39 (2.07)	6.33 (1.68)
Difference (standard error)	0.81 (0.41)		-0.95 (0.41)	
T-statistic (p-value)	1.98 (0.051)*		-2.33 (0.022)**	

Panel C: Analysis of Variance (ANOVA) results

Source	Type III sum of squares	df	Mean square	F-value	p-value	
Corrected model	45,000,745	3	15,000,248	4.460	0.006	
Commitment	14,632,039	1	14,632,039	4.351	0.040	**
Risk	21,512,508	1	21,512,508	6.397	0.013	**
Commitment * Risk	10,114,578	1	10,114,578	3.008	0.087	*
Error	279,137,433	83	3,363,102			
Corrected total	324,138,178	86				

Notes: Dependent variable: the lowest inventory write-down amount that auditors would accept (in millions of dollars). *Independent variables:* Commitment: the commitment to management is manipulated at two levels: prior commitment versus no commitment. Risk: the risk of material misstatement is manipulated at two levels: high risk versus low risk.

*, **, *** indicate significance at the 10, 5, and 1% levels (one-tailed), respectively.

7.3.2 Multivariate analysis

A two-way ANOVA was used to test hypotheses concerning the variance of groups created by combining the levels of two factors (Hair, Black, Babin and Anderson 2010). Table 7.2, Panel C reports the results for the two-way ANOVA. H1 predicts that auditors will propose a smaller (larger) audit adjustment relating to a subsequent event when the event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management. As described in the descriptive analyses section, the mean lowest acceptable audit adjustment in the no commitment condition is \$6.24 million, while the mean lowest acceptable audit adjustment in the prior commitment condition is \$5.42 million. The direction of the difference between conditions is consistent with H1. Table 7.2, Panel C reports a significant main effect for commitment ($f(1,83)=4.351$; $p=0.040$), providing support for H1.

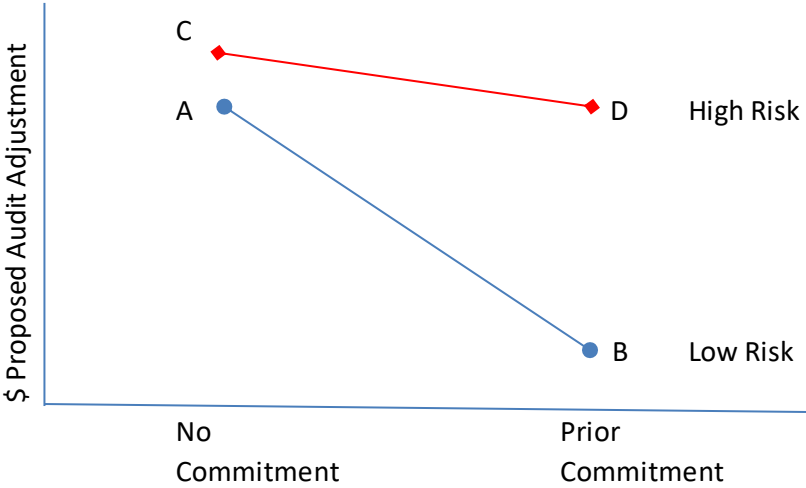
H2 posits that auditors will propose a smaller audit adjustment on a subsequent event when the event becomes known to them in a condition of low risk of material misstatement, rather than of high risk of material misstatement. Table 7.2, Panel A reports that the mean lowest acceptable audit adjustment in the high risk condition is \$6.33 million, while the mean lowest acceptable audit adjustment in the low risk condition is \$5.39 million. The direction of difference between conditions is consistent with H2. The ANOVA results shown in Table 7.2, Panel C indicate that the difference is significant ($f(1,83)=6.397$; $p=0.013$). Consistent with H2, the finding indicates that auditors are responsive to the risk of material misstatement when they propose an audit adjustment to management. As would be expected, auditors will propose a significantly smaller audit

adjustment to management in the presence of low risk of material misstatement, compared to the presence of high risk of material misstatement.

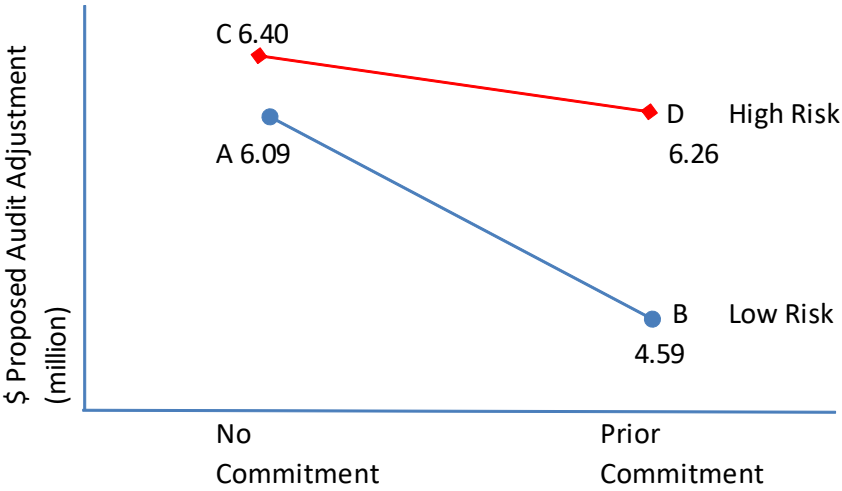
H3 predicts that auditors' prior commitment to management on the fair presentation of the financial statements has larger downward effects on the proposed audit adjustment in the condition of low risk of material misstatement than in the condition of high risk of material misstatement. The ANOVA in Table 7.2, Panel C shows that there is a marginally significant interaction between commitment and risks of material misstatement ($f(1,83)=3.008$; $p=0.087$). The predicted and actual interaction between commitment and risks of material misstatement are plotted in Figure 7.1. Figure 7.1, Panel B indicates that the difference in the mean on the proposed audit adjustment across the risk of material misstatement conditions is larger in the condition of prior commitment, compared to the condition of no commitment. The graphical representation of actual interaction is consistent with the graphical representation of predicted interaction as shown in Figure 7.1, Panel A. As Study 1 predicts an ordinal interaction effect between commitment and risk of material misstatements, H3 is further tested using the planned-contrast testing.

Figure 7.1: Study 1- Graphical representation of the interaction between commitment and risk of material misstatement on the lowest acceptable inventory write-down assessment

Panel A: Predicted results



Panel B: Actual results



7.3.3 Tests of predicted interaction using planned contrasts

Table 7.3 reports the results of planned-contrast testing and simple-effect comparison. The difference in the mean on the proposed audit adjustment across the risk of material misstatement conditions is larger in the condition of prior commitment than, the condition of no commitment. This shows a predicted ordinal interaction effect between commitment and risk of material misstatement. Accordingly, this study tests this predicted interaction using planned contrasts.

Contrast coding and testing follow the methods outlined by Buckless and Ravenscroft (1990), Rosnow and Rosenthal (1995), and Keppel and Wickens (2004), maximizing the power of hypothesis tests given a specific predicted pattern of results. For recent examples of the application of planned contrast testing to test experimental hypotheses, see Kadous, Leiby and Peecher (2013), Bauer (2015), and Moroney et al. (2015).

Planned-contrast testing is used to test a specific comparison of group mean differences. The test provides greater statistical power than the conventional ANOVA when examining predicted ordinal interactions (Buckless and Ravenscroft 1990). The test is performed in conjunction with the tests for main and interaction effects by using a weight contrast. Planned-contrast testing requires an assumption regarding the weights for each group mean (Buckless and Ravenscroft 1990; Hair et al. 2010). For Study 1, planned-contrast testing is conducted using the following weights: no commitment/low risk [A] -1; prior commitment/low risk [B] -3; no commitment/high risk [C] +2; prior commitment/high risk [D] +2. The weights assigned to the conditions are consistent with the predictions depicted in Figure 7.1, Panel A. The weights are positive for high risk and negative for low risk, reflecting the expectation that auditors who are assessing high risk

of material misstatement for the audit engagement will propose a significantly larger audit adjustment, even when they have escalated their position on the fair presentation of the financial statements to management.

As Study 1 also expects that the auditors' proposed audit adjustment will not differ significantly under high risk conditions by having commitment to management, this study assigns the same weight to the two means of auditors' proposed audit adjustments under the conditions of high risk. Thus, the weights assigned for both conditions of high risk (i.e., no commitment/high risk [C], and prior commitment/high risk [D]) are +2. On the other hand, in the condition of low risk, this study expects that auditors with prior commitment will propose a smaller audit adjustment to management compared to the auditors with no commitment. Thus, under the conditions of low risk, the weight assigned for the condition of prior commitment/low risk [B] is lower (i.e., -3) than the condition of no commitment/low risk [A] (i.e., -1). Using the assigned weights (-1, -3, +2, +2), planned interaction contrast is significant ($t(1)=3.24, p<0.01$) as shown in Table 7.3, thus supporting H3. In addition, the semi-omnibus F-test (not tabulated) indicates that cells A, C, and D (see Figure 7.1, Panel A) are not significantly different from each other ($F(1,83)=0.06, p=0.807$, two-tailed). As the residual between-cells variation is insignificant, this supports the first contrast specification.¹⁵

As the means of the lowest acceptable audit adjustment are relatively similar for the conditions A, C, and D (i.e., about \$6 million as plotted in Figure 7.1, Panel B), this study also tests the planned interaction contrast using the weights: +1 (Condition A), -3 (Condition B), +1 (Condition C), and +1 (Condition D). The weight given for prior

¹⁵ The semi-omnibus F statistic tests the significance of the variation caused by the independent variables that is not explained by the hypothesized contrast; a p-value greater than 0.05 indicates that the remaining variation is insignificant (Keppel and Wickens 2004). The semi-omnibus F test is computed using the sums of squares from an ANOVA model testing the dependent variable.

commitment/low risk [B] is negative (i.e., -3), reflecting the expectation that auditors who have escalated their position on the fair presentation of the financial statements to management in the low risk of material misstatements condition will propose a significantly lower audit adjustment. Similarly, the un-tabulated planned interaction contrast results using the assigned weights (+1, -3, +1, +1) show a significant planned interaction contrast ($t(1)=3.63$; $p<0.01$). The semi-omnibus F-test (not tabulated) indicates the hypothesized contrast explains the data well ($F(1,83)=0.326$, $p=0.569$, two-tailed).

The simple-effect analysis is used to explore the nature of the interaction by examining the difference between groups within one level of one of the independent variables (Hair et al. 2010). As reported in Table 7.3, follow-up simple effects analyses show that the mean of the lowest acceptable audit adjustment is significantly larger for no commitment versus prior commitment in the condition of low risk of material misstatement (no commitment=6.09; prior commitment=4.59; $t(1)=2.75$; $p<0.01$), but not in the condition of high risk of material misstatement (no commitment=6.40; prior commitment=6.26; $t(1)=0.24$; $p=0.404$). Further, the mean of lowest acceptable audit adjustment is significantly smaller for auditors with prior commitment in the condition of low versus high risk of material misstatement (low risk=4.59; high risk=6.26; $t(1)=-2.97$; $p<0.01$). The results for simple-effect analysis support H3.

In summary, the testing using planned contrasts supports H3. This finding indicates that auditors are subject to escalation behavior, by proposing a significantly smaller audit adjustment to management when the subsequent event becomes known to them after they have committed to their initial view on the fair presentation of the financial statements to management, specifically in the low risk of material misstatement condition. In contrast,

auditors will propose a significantly larger audit adjustment to management, even though the subsequent event becomes known to them after they have committed to their prior view on the fair presentation of the financial statements to management, specifically in the high risk of material misstatement condition.

The findings suggest that escalation bias observed in low-risk settings does not generalize to high-risk settings. The implication is that accurate assessment of the overall risk of material misstatement can improve auditors' evaluation of subsequent event evidence.

Table 7.3: Study 1- Planned-Contrast and Simple-Effect comparisons on auditors' assessment of the lowest acceptable inventory write-down assessment

Planned-Contrast and Simple-Effect comparisons

Source	df	t-stat	p-value	
Planned-contrast †	1	3.24	< 0.01	***
Simple-Effect comparisons of:				
No/prior commitment, low risk [B-A]	1	2.75	< 0.01	***
No/prior commitment, high risk [D-C]	1	0.24	0.404	
Low/high risk, prior commitment [B-D]	1	-2.97	< 0.01	***
Low/high risk, no commitment [A-C]	1	-0.57	0.285	

Notes: Dependent variable: the lowest inventory write-down amount that auditors would accept (in millions of dollars). *Independent variables:* Commitment: the commitment to management is manipulated at two levels: prior commitment versus no commitment. Risk: the risk of material misstatement is manipulated at two levels: high risk versus low risk.

*, **, *** indicate significance at the 10, 5, and 1% levels (one-tailed), respectively.

† Contrast weights are -1 for no commitment/low risk [A]; -3 for prior commitment/low risk [B]; +2 for no commitment/high risk [C]; and +2 for prior commitment/high risk [D].

7.4 Supplemental analyses

Supplemental analyses were conducted to examine the potential effect of self-monitoring on auditors' escalation tendencies. Supplemental analyses were then performed, to examine the effects of prior commitment and risk of material misstatements on the alternate measures of dependent variables.

7.4.1 The effect of self-monitoring

Because early research indicates that self-monitoring can affect decision-makers' escalation tendencies (Kadous and Sedor 2004; Seybert 2010), a supplemental test was performed to explore whether auditors with a high propensity to self-monitor have a tendency to escalate their commitment by proposing a smaller audit adjustment. This study used the revised self-monitoring scale refined by Snyder and Gangestad (1986) to capture an individual's tendency to alter their behavior to convey a positive image. The self-monitoring scale is widely used in psychology studies to measure the extent to which individuals will act on social cues when managing their self-presentational behavior (e.g., Snyder 1974; Snyder and Gangestad 1986).

Several accounting studies examine the effect of self-monitoring on judgment decision making (e.g., Kadous and Sedor 2004; Seybert 2010). Kadous and Sedor (2004) perform experiments to examine the efficacy of a potential control mechanism (third-party consultation) in preventing managerial escalation of commitment in project investment. They find that consultants assigned to a specific role in evaluating a failing project for continuation are less likely to continue the project than participants assigned a general role or specific unrelated role in the firm, and that high self-monitors (those most likely to alter their behavior to convey a positive image) are more likely to continue a failing

project. Seybert (2010) examines the issues of capitalization of research and development (R&D) investment from an escalation of commitment perspective. Findings show that managers responsible for initiating an R&D project are more likely to overinvest when R&D is capitalized. High self-monitors have a tendency to overinvest, suggesting that reputation concerns contribute to this escalation behavior. In the auditing context, self-reputation affects auditors' behavior, especially when auditors perceived themselves to be accountable for their earlier actions (Gibbins and Newton 1994). Auditors have a tendency to commit to their previous decisions because they are concerned that changing previous decisions might indicate that they made a mistake, or that it may lead to breaking an agreement with a client (Bazerman et al. 2002; Nelson 2009). Therefore, in the context of judgment regarding subsequent events that become known to auditors after they have made a prior commitment to management, it is plausible that auditors may be reluctant to change their position because they are concerned about their reputation.

This study collected participants' self-monitoring scores using Snyder and Gangestad's (1986) revised self-monitoring scale as a potential covariate, in order to demonstrate that the effects of prior commitment to management are stronger for those who are more likely to change their behaviors to present a positive image.¹⁶ Following Kadous and Sedor (2004) and Seybert (2010), a standard three-way interaction using the dichotomous self-monitoring measure as a factor in a full 2 x 2 x 2 traditional ANOVA is performed. Self-monitoring reflects a median split on Snyder and Gangestad's (1986) self-monitoring scale. This measure is insignificant as a main ($p=0.552$) or interaction effect ($p=0.453$) in the ANOVA analyses (un-tabulated). Further, the inclusion of this measure as a covariate in the ANCOVA does not qualitatively alter any of the inferences or conclusions of this

¹⁶ Compared to the original self-monitoring scale developed by Snyder (1974), Snyder and Gangestad's (1986) revised self-monitoring scale excludes seven items that were deemed poor at differentiating between high and low self-monitors. The revised self-monitoring scale provides a higher coefficient alpha than that the original 25-item scale (Snyder and Gangestad 1986).

study (un-tabulated). Finally, this measure is also treated as a mediator between commitment and the dependent variable. Mediation analyses that use Baron and Kenny's (1986) approach demonstrate that the mediation effect is insignificant (un-tabulated). Overall, self-monitoring has an insignificant effect on auditors' escalation tendencies in evaluating subsequent events.

This study also measures the extent of participants' concern that bringing-up an additional audit adjustment to management after the presentation of the fair presentation of the audited financial statement would damage their personal reputation. Responses were collected using an 11-point Likert scale ranging from -5 ("strongly disagree") to +5 ("strongly agree"). The mean rating of this measure is 0.23, and standard deviation is 3.08. A standard three-way interaction including this measure in a full 2 x 2 x 2 traditional un-tabulated ANOVA reported no other main or interaction effect ($p > 0.195$). Taken together, this measure of reputation concern does not qualitatively change any of the inferences or conclusions of this study.

The insignificance of self-monitoring is not much of a concern for this study. This study predicts a two-way interaction between commitment and risk of material misstatements. Libby et al. (2015, 38) and Evans et al. (2015, 1177) explain that experimental studies showing a two-way predicted interaction can control potential omitted variables, or rule out alternative explanations. Although many alternatives can explain the observed main effect of the independent variables in this study, it is much less likely that alternatives can always explain the observed two-way interaction. Thus, this thesis does not discuss this measure further.

7.4.2 Alternate measures of dependent variables

The dependent variable in this study is the assessment of the lowest acceptable inventory write-down assessment. Following Trotman et al. (2009), participants were asked to provide the write-down amount they would recommend to an audit partner to be recorded, and the amount they believed would ultimately be recorded. The difference between the two amounts is the amount of audit adjustment that will be waived. Two-way ANOVAs are conducted on these dependent variables separately: (1) the write-down amount they would recommend to an audit partner to be recorded; (2) the amount they believed would ultimately be recorded; and (3) the amount of audit adjustment that would be waived. This study finds no significant differences across conditions for these three dependent variables (un-tabulated). Therefore, this thesis uses the dependent variable of the lowest inventory write-down amount that auditors would be willing to record on the financial statements. These results are consistent with those of Bauer (2015) and Hatfield et al. (2011), which use the dependent variable of the lowest inventory write-down that auditors would be willing to accept. According to Bauer (2015), the waived audit adjustments are likely subject to other factors, such as the real or perceived actions of the partner or client. All data and statistics reported in Study 1 are based on the lowest acceptable inventory write-down assessment.

7.5 Additional analyses

This section reports the results for several additional analyses. The first analyses examine the robustness of the results for hypotheses, by including responses that failed a manipulation check. A second group of analyses are conducted to analyze responses from different countries and survey delivery modes. A third group of analyses are conducted

to examine whether any participants' demographic variables affect auditors' assessment of the lowest acceptable inventory write-down assessment.

7.5.1 Analyses including responses that failed a manipulation check

Additional analyses are conducted to examine the robustness of the results to the full sample, by including responses that failed a manipulation check question. A total of 17 participants failed a manipulation check question on the independent variable of commitment, leaving a total of 87 usable responses. Study 1 excludes these participants in the testing of hypotheses. To test the robustness of the results to the exclusion of the responses that failed the manipulation check, two-way ANOVAs are conducted, by including the full sample of participants (N=104).¹⁷ Including these responses in the untabulated two-way ANOVA analyses yields similar significant results for H2 and H3, but only a marginally significant result for H1 ($p=0.071$). Taken together, there is no significant difference in the statistical conclusions if the 17 participants who failed the manipulation check question are included.

7.5.2 Analyses of responses from different countries and survey delivery modes

Study 1 included responses from Malaysia and Australia. A total of 87 auditors participated in Study 1 (61 auditors/70% from Malaysia and 26 auditors/30% from Australia), after the exclusion of the failed manipulation checks and incomplete responses. To examine whether the country affects the results of the hypotheses, independent-sample t-tests are performed to examine whether the participants from different countries evaluated subsequent events differently. The results demonstrate that

¹⁷ The analysis excludes one incomplete response.

there are no significant differences on the participants' lowest acceptable inventory write-down assessment ($t(85)=0.929$; $p=0.356$). Additionally, the inclusion of the country factor as a covariate in a 2 x 2 ANCOVA shows that this factor is insignificant ($p=0.697$), and there is no significant change in the results for the hypotheses testing (un-tabulated). Therefore, Study 1 reports the aggregate analyses from Malaysian and Australian auditors because the results do not systematically vary between the two countries.

The experiment included a paper-based and an online survey. Of the 87 usable responses, 74 (85%) were collected via the online survey, and the 13 (15%) via paper-based survey. T-tests are conducted to examine whether participants in different survey delivery modes evaluated subsequent events differently. The results for the t-tests demonstrate that there are no significant differences between the survey delivery modes of the participants' lowest acceptable inventory write-down assessment ($t(85)=1.498$; $p=0.138$).

7.5.3 Analyses including demographic variables and debriefing questions

Additional analyses were performed to examine whether the demographic variables as shown in Table 6.3 from Chapter 6, including position level, professional qualifications, firm size (Big 4 and non-Big 4), and gender—differ across experimental conditions. The inclusion of demographic variables as covariates in the ANCOVA analyses does not alter any of the inferences or conclusions of this study qualitatively, and none of these variables are significant.

Jeffrey (1992) finds that experience significantly affects auditors' tendency to escalate their commitment to a chosen course of action. Knowledge and experience can also influence auditors' risk identification and evaluation (Moroney and Simnett 2009).

Concerning this previous research, Study 1 conducts three-way ANOVAs to examine whether the measures of the auditors' level of experience—including years of audit experience, current position, number of times participants had been involved in the audit of subsequent events, and the audit of inventory—can affect results for all hypotheses.

To examine whether any of the measures of the auditors' level of experience affect the testing of hypotheses, each of the measure of the auditors' level of experience is individually included as an independent variable together with commitment to management and risk of material misstatements in separate three-way ANOVAs. The dependent variable is the lowest acceptable inventory write-down assessment. The results from three-way ANOVAs show that these variables are not significant alone, or when interacting with treatment variables. The results from the hypothesis testing remain unchanged. This study also includes the measures of the auditors' level of experience in the ANCOVA model. The results for the ANCOVA analysis show that none of the demographic variables are significant in influencing auditors' evaluation of subsequent events. These findings suggest that the testing of the hypotheses is robust to auditors' level of experience.

Of the total 87 participants, five listed their current role as 'other'. These participants work in service areas in audit firms but they have at least two years of audit-related experience. This study includes these five participants in the testing of the hypotheses because they possess the relevant years of audit experience. The results of hypotheses testing excluding these five participants remain unchanged for the dependent variable (un-tabulated).

Participants answered four additional questions related to the task, including experience level, realism of task, confidence level, and involvement level on a scale of -5 (“strongly disagree”) to +5 (“strongly agree”). This study includes these four measures as covariates in a 2 x 2 ANCOVA, with the auditor’s lowest acceptable inventory write-down assessment, in millions of dollars, as the dependent variable. None of these measures are sufficiently significant to affect the results for the hypotheses (all $p > 0.70$) (un-tabulated), so are not included in the testing of the hypotheses.

7.6 Summary of the results for testing of hypotheses

This chapter reports the results of the testing of hypotheses, and the results from additional analyses. Overall, the findings support H1, predicting that auditors will propose a smaller (larger) audit adjustment on a subsequent event when the event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management. Results on the material misstatement indicate that auditors are more skeptical when risk factors are present, so they will adjust for subsequent events when the risk of material misstatement is high, thus supporting H2. The findings of a significant interaction of prior commitment and risk of material misstatement support H3. The results suggest that auditors are more likely to commit to an initial position formed during the audit when the risk of material misstatement is low, but not when risk of material misstatement is high. Supplemental analysis shows that self-monitoring does not have a significant effect on the auditors’ escalation tendencies. The findings from the additional analyses indicate that the results for all hypotheses are robust to the exclusion of the responses that failed a manipulation check, and to different countries and experimental modes.

7.7 Conclusions and limitations of Study 1

Study 1 investigates deficiencies in the audit of subsequent events by focusing on the effect of prior commitment on auditor judgments. Drawing on the escalation of commitment research, this study examines whether auditors will propose a significantly smaller audit adjustment when a subsequent event becomes known to them after they have committed to their initial view on the fair presentation of the financial statements to management. This thesis provides the first empirical evidence that auditors propose a significantly smaller audit adjustment when a subsequent event becomes known to them after they have communicated the fair presentation of the financial statements to management. That is, auditors systematically reduce their estimate of minimum adjustments required on the subsequent events after they have committed to their initial view formed during the audit.

Study 1 also examines whether the risk of material misstatement can affect auditors' judgment of subsequent event evidence. This study reveals that a high risk of material misstatement significantly reduces auditors' proposed audit adjustment to management. This indicates that auditors consider risk of material misstatement in the audit of subsequent events. The significant interaction effect between prior commitment and risk of material misstatement indicates that auditors exhibit escalation tendencies by proposing a significantly smaller audit adjustment to management when the subsequent event becomes known to them after they have committed to their initial position when the risk of material misstatement is low, but not when the risk of material misstatement is high.

The results should be considered in light of a number of limitations, which provide opportunities for future research. First, this study does not cover the subsequent events that occur after the issuance of the audit report because the issuance of new audit report on the amended financial statements may not be common in audit practice. Additionally, the results of Study 1 suggest that auditors have a tendency to escalate after auditors commit their initial view to management. Auditors of the public entities are now required to report to the audit committee on the authorization of the issuance of the audited financial statements (Cohen et al. 2010). Future research might consider how commitment to a position develops over the course of the audit by investigating how communication with the audit committee can contribute to a possible escalation of commitment to an initial view or decision.

Second, the process for auditing subsequent events is relatively complex. Study 1 focuses on auditors' evaluation of subsequent events after the subsequent events have been identified. This study does not capture the auditors' search and identification of the subsequent events, which is an avenue for future research. Study 1 focuses on the adjustment type of subsequent events. Future research could also extend this study to the Type II subsequent events that require disclosure of the financial statements. Additionally, both auditors and clients are often involved in a negotiation process to waive or agree with proposed audit adjustments (Salterio 2012). This study does not capture the negotiation process between auditor and client in resolving the disputes arising from subsequent events. Future research is needed to consider the complex context around the process of auditing subsequent events.

Third, regarding the experimental task, this study uses an inventory obsolescence task. The results of this experiment may not be generalizable to all types of subsequent events.

This thesis uses a subsequent event representative of a case from one PCAOB inspection against auditors involved in the audit of the California Micro Devices Corporation (SEC 2003). Future research is encouraged, to explore whether the results from the current study are generalizable to other subsequent event tasks, such as those resulting from pending litigation or doubtful debt issues.

Finally, auditors from Malaysia and Australia participated in Study 1. The results from the experiment may not be generalizable to US auditors, because prior research indicates that differences in national culture may affect the decision-makers' escalation behavior and judgment decision making. For example, Keil et al. (2000) find that escalation of commitment behavior in software project development is attributed to cross-cultural differences, such as decision-makers' attitudes and perceptions toward risk. This concern is mitigated by the fact that participating auditors in this study are from the Big 4 and mid-tier firms, where training and audit practices are relatively similar worldwide. Future research could examine how cultural differences affect auditors' escalation behavior on the search for, evaluation of, and resolution of subsequent events.

SECTION II

Study 2: The Effects of Prior Commitment and Type of Accountability on Auditors' Evaluation of Subsequent Events

Study 1 provides evidence that auditors propose a significantly smaller audit adjustment on a subsequent event when the event becomes known to them after the reporting of the fair presentation of the financial statements to management. Auditors systematically reduce their estimate of minimum adjustments required on a subsequent event when the event becomes known to them after they have committed to their initial views formed during the audit. As auditors have a tendency to commit to their initial position, Study 2 considers methods to reduce auditors' bias, which arises from their prior commitment or escalation tendencies in the evaluation of subsequent events. Study 2 extends Study 1 by examining whether accountability (process versus outcome accountability) can mitigate auditors' bias, which arises from their prior commitment to evaluating subsequent events.

Previous research suggests that instructing auditors to be accountable for their judgment process is a likely mechanism for mitigating auditors' escalation bias. This is because previous psychology studies indicate that process accountability is effective in reducing decision-makers' tendency to commit to losing courses of actions, compared to outcome accountability (Simonson and Staw 1992). Additionally, process accountability can lead to higher levels of professional skepticism. Kim and Trotman (2015) find that process accountability enhances novice auditors' professional skepticism more than outcome accountability. Thus, process accountability is expected to improve auditors' judgment in the audits of subsequent events.

Given these considerations, Study 2 aims to compare process and outcome accountability as mechanisms through which auditors' biases from their prior commitment in the evaluation of subsequent events can be mitigated. Study 2 predicts that process accountability is more effective at mitigating auditors' biases arising from prior commitment than to outcome accountability. That is, auditors who are expected to justify their judgment process will propose a larger audit adjustment on a subsequent event than auditors who are expected to justify their judgment outcome, even if they have committed to their initial position.

Chapter 8: Introduction to Study 2

Study 1 finds that auditors propose a significantly smaller audit adjustment on a subsequent event when the event becomes known to them after they have reported the fair presentation of the financial statements to management. This finding is consistent with previous auditing research, which indicates that auditors can over-commit to an initial hypothesis (Church 1991; Jeffrey 1992; Ayer and Kaplan 1993; Brody and Kaplan 1996) or prior-year judgments (Tan 1995; Hatfield et al. 2011; Messier et al. 2014). Study 2 considers methods to reduce auditors' bias from their prior commitment in the evaluation of subsequent events.

Peecher et al. (2013) propose an accountability framework to motivate auditors to improve audit quality. They suggest that process accountability enhances the quality of judgment decision making in the audits of financial statements. For example, Kim and Trotman (2015) find that process accountability enhances novice auditors' professional skepticism, compared to outcome accountability. Prior psychology studies document the fact that process accountability, relative to outcome accountability, is effective in reducing decision-makers' tendency to commit to their previous decisions (Simonson and Staw 1992; Lerner and Tetlock 1999). Evidence indicates that decision-makers who are accountable for process judgments tend to make more accurate and high-quality judgments than those decision-makers who are accountable for outcome judgments. In particular, process accountability is an effective way of reducing decision-makers' escalation tendencies in judgment decision-making.

Recent audit regulations also demand that auditors document the decision processes used to reach a conclusion. The IAASB (2014) recently produced a framework for audit quality

that encourages auditors to document their rationales for significant audit judgments, and how they reached a justifiable conclusion. The SEC's Advisory Committee on Improvements to Financial Reporting recommends the adoption of a professional judgment framework to encourage auditors to document the decision process used to justify their conclusions (CIFR 2008). Recent audit inspection processes increasingly demand that auditors document their justifications for their conclusions in the audit working papers (Lennox and Pittman 2010; Moroney et al. 2015). In sum, recent audit regulations indicate that properly documenting and articulating the rationales for auditors' judgments is important to enhancing audit quality. This is because documentation of the judgment process provides the auditor the opportunity to carefully reconsider the preceding steps in the decision-making process, as well as the possibility that judgment traps or biases may affect the final conclusion (KPMG 2011; Center for Audit Quality [CAQ] 2014).

Motivated by this previous research and regulatory concerns, Study 2 proposes that one way of mitigating auditors' escalation tendencies in the audit of subsequent events is to impose accountability requirement on auditors. In particular, Study 2 expects that process accountability is more effective in mitigating auditors' escalation tendencies than outcome accountability. Auditors who are expected to justify their judgment processes are more likely to propose a larger audit adjustment on subsequent events to management than the auditors who are expected to justify their judgment outcome, even though they have committed to their previous position.

Accordingly, Study 2 develops three hypotheses. Study 2 retests the first hypothesis of Study 1, which predicts that auditors will propose a smaller (larger) audit adjustment relating to a subsequent event when the event becomes known to them after (before) they

have committed to their initial view on the fair presentation of the financial statements to management. The second hypothesis is developed to examine the influence of the type of accountability on auditors' evaluation of subsequent events. The second hypothesis predicts that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome. The third hypothesis is developed to examine the likelihood of process versus outcome accountability in reducing auditors' bias arising from their prior commitment in the evaluation of subsequent events. Specifically, the third hypothesis predicts that the presence of process accountability will mitigate auditors' prior commitment to management on the fair presentation of the financial statements such that auditors will propose a larger audit adjustment on a subsequent event, more so than the presence of outcome accountability.

To test the hypotheses, Study 2 uses a 2 x 2 between-subjects experiment in which auditors are required to propose an audit adjustment for a subsequent event. The first independent variable is the commitment to management. The manipulation of this independent variable is similar to Study 1; that is, "prior commitment" and "no commitment." The second independent variable is the type of accountability, which is manipulated as either "process accountability" or "outcome accountability." Study 2 finds that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome. The significant interaction effect between prior commitment and type of accountability reveals that auditors' adjustments are less affected by their prior commitment to an initial view provided to management when they are required to justify their judgment process, than those who are required to justify their judgment outcome.

Study 2 makes the following contributions. First, this study is important because of the considerable move toward the documentation of judgment process, an area in which little is known about important audit judgments. Recent audit regulations and the IAASB's audit quality framework demand that auditors document their decision-making processes and rationales for significant audit judgment in the audit working papers (CIFR 2008; IAASB 2014; Moroney et al. 2015; Dowling et al. 2015). Although the audit regulators have yet to issue any judgment guidance, audit firms have attempted to develop their own judgment frameworks (e.g., Deloitte 2009; KPMG 2011). Study 2 provides evidence that the documentation of process accountability leads to better evaluation of subsequent events. This study should be informative to both auditor regulators who are contemplating issuing formal judgment guidance, and to audit firms who are interested in improving their existing judgment frameworks.

Second, this study answers calls by Peecher et al. (2013) and Trotman et al. (2015) to investigate the comparative effects of process versus outcome accountability on auditors' judgments. This is because prior auditing studies focus on the benefits of outcome accountability induced by the audit review process. Kim and Trotman (2015) examine the comparative effect of process and outcome accountability in enhancing auditors' professional skepticism. Beyond the study by Kim and Trotman (2015), little is known about the direct effects of process and outcome accountability in improving auditors' judgments in alternate decision contexts. This study extends Kim and Trotman's (2015) study of the comparative effect of process and outcome accountability to the audit of subsequent events context. Study 2 provides evidence that auditors propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process, compared to when they are expected to justify their judgment outcome. Based

on this evidence, Study 2 demonstrates that process accountability improves judgment quality more than outcome accountability.

Third, Study 2 provides evidence that process accountability mitigates auditors' escalation tendencies relative to outcome accountability in the subsequent event task. Tan (1995) finds that accountability mitigates the effects of prior involvement in the going-concern task. However, it is unclear how the type of accountability (process versus outcome) can mitigate the auditors' bias arising from their prior commitment to management in the subsequent event task. Study 2 complements previous research by providing evidence that increasing accountability for judgment process is an effective mechanism in reducing auditors' escalation tendencies, compared to accountability for judgment outcome.

The remainder of the presentation of Study 2 is structured as follows. Chapter 8 presents the development of the hypotheses. Chapter 9 outlines the research method. Chapter 10 presents the results and concludes Study 2.

Chapter 9: Study 2 Development of Hypotheses

9.1 Introduction

This chapter develops three hypotheses to examine whether the type of accountability (process versus outcome) can mitigate auditors' bias arising from prior commitment in evaluating subsequent events.

9.2 Prior commitment in the audit of subsequent events

Study 2 initially tested the hypothesis from Study 1, which stated that auditors will propose a significantly smaller audit adjustment on a subsequent event when the event becomes known to them after they have reported the fair presentation of the financial statements to management. That is, bias from prior commitment is a maintained hypothesis for Study 2. Testing this hypothesis is necessary to provide evidence for Study 1's support for H1, and for finding ways of reducing auditors' bias arising from their prior commitment in the evaluation of subsequent events. The fourth hypothesis is:

H4: *Auditors will propose a smaller (larger) audit adjustment relating to a subsequent event when the subsequent event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management.*

9.3 Process and outcome accountability

Study 2 focuses on whether imposing accountability requirements on auditors can improve auditors' judgment in evaluating subsequent events. Study 2 predicts that auditors will be skeptical by proposing a larger audit adjustment on a subsequent event when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome.

Lerner and Tetlock (1999) propose two distinct types of accountability: process accountability and outcome accountability. Process accountability focuses on the procedures used to arrive at a decision or conclusion. Outcome accountability focuses on the quality of the outcomes of an action or decision. Psychology research indicates that individuals who are accountable for their judgment processes are more likely to consider more complex information processing (Tetlock et al. 1989), increase attentiveness throughout information processing (Brtek and Motowidlo 2002; Scholten et al. 2007), take more available information into account, make more accurate judgments (Siegel-Jacobs and Yates 1996), and reduce escalation commitment to losing courses of action (Simonson and Staw 1992). Conversely, psychology research on the effects of outcome accountability indicates that those who are accountable for their judgment outcomes tend to focus on the final judgment while compromising cognitive efforts when processing underlying evidence. For example, they will direct their efforts toward making more justifiable and defensible final judgments (Simonson and Staw 1992), and reach final conclusions early in the judgment process (De Dreu, Koole, and Steinel 2000). These psychology studies suggest that process accountability is more desirable and uniformly superior to outcome accountability in improving decision-makers' judgments and decisions.

Accountability has been studied in earlier auditing literature, with research findings suggesting that accountability has positive effects on the performance of various audit tasks (e.g., Kennedy 1993; Tan 1995; Koonce et al. 1995; Tan and Kao 1999). However, recent literature indicates that increasing auditors' accountability may not improve judgment quality (e.g., Bagley 2010; Piercey 2011; Libby, Rennekamp and Seybert 2015). Peecher et al. (2013) propose an accountability framework for financial statement auditors, and suggest that process accountability alone, or in conjunction with outcome accountability, might improve auditor judgments more than outcome accountability alone. They explain that having to document the process that an auditor went through in arriving at a judgment might encourage auditors to thoroughly evaluate and consider the available alternatives before making a decision.

In a management accounting context, Chang, Cheng, and Trotman (2013) find that negotiators who are held accountable for their negotiation processes are more likely to make better decisions (i.e., reduce their fixed-pie biases and achieve lower costs) than those who are held accountable for their negotiation outcomes on a customer-supplier negotiation setting. In the auditing literature, Kim and Trotman (2015) examine the comparative effect of process and outcome accountability in motivating auditors' professional skepticism. They find that novice auditors show greater professional skepticism than more experienced auditors, when novice auditors are accountable for their judgment process, compared to when they are accountable for their judgment outcome. Given this evidence, Study 2 aims to examine the comparative effect of process and outcome accountability in enhancing judgment quality in the audits of subsequent events.

Imposing accountability requirements on auditors is important in the process of auditing subsequent events. Recent audit regulation demands that auditors document the decision processes used to reach a conclusion (CIFR 2008; IAASB 2014). Documentation of the judgment process can motivate auditors to carefully consider the preceding steps in the decision-making process as well as the possibility that judgment traps or biases may have affected the final conclusion (KPMG 2011; CAQ 2014). As auditors do not respond to subsequent events that occur late in the audit process, this study expects that auditors who anticipate being accountable will tend to provide more justifiable explanations, and this accountability motivates them to thoroughly evaluate subsequent events. Specifically, auditors who are asked to focus on the judgment process will make better judgments while processing each piece of subsequent event evidence.

In this study, the type of accountability (process versus outcome) is manipulated by informing the participants that they are required to justify their judgment process or judgment outcome to the audit engagement partner.¹⁸ This is because process and outcome accountability typically require different types of justification or explanation.¹⁹ Messier et al. (2014) explain that similar accountability could be experienced by auditors in practice if the process or outcome accountability request of the partner is to document a description of the process or outcome used to arrive at the final decision in a memo.

¹⁸ As discussed in the Chapter 3, the notion of accountability is similar to that of justification, with considerable overlap between the two (Johnson and Kaplan 1991; Bonner 2008). Accountability is “the implicit or explicit expectation that one may be called on to justify one’s belief, feelings, and actions to others” (Lerner and Tetlock 1999, p. 255). Justification is the process of providing explanation to support one’s belief (Koonce et al. 1995; Peecher 1996). Justification normally refers to the documented output of this process of justifying.

¹⁹ Participants’ justification could involve an explanation of their decision outcomes, or their decision processes, or both. For example, Messier et al. (2014) operationalized process accountability by telling participants that “the partner is specifically interested in the process you used to come to a conclusion regarding the appropriate treatment of this transaction. Please explain the process you went through.” Chang et al. (2013) operationalized process accountability by telling participants to “write a report based on your negotiation processes,” and outcome accountability by telling participants to “write a report to justify their negotiation outcomes.” Kadous and Sedor (2004) operationalized accountability by telling participants that “the Board will require you to justify your recommendations in a convincing manner.” This manipulation of the type of accountability did not include participant communication with a supervisor or researcher.

Study 2 hypothesizes that auditors who are expected to justify their judgment process will propose a larger audit adjustment on a subsequent event than those who are expected to justify their judgment outcome. This leads to the fifth hypothesis:

H5: *Auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process than those who are expected to justify their judgment outcome.*

9.4 Prior commitment and type of accountability

As discussed above, psychology literature indicates that decision-makers who are accountable for process judgment tend to make more accurate and high-quality judgments than those decision-makers who are accountable for outcome judgment (e.g., Simonson and Staw 1992; Siegel-Jacobs and Yates 1996; Brtek and Motowidlo 2002; Scholten et al. 2007). In particular, process accountability is an effective mechanism for reducing decision-makers' escalation tendencies in judgment decision making (Simonson and Staw 1992). Study 2 is motivated by this line of research, and examines the likelihood of process versus outcome accountability in mitigating auditors' bias arising from their prior commitment in the evaluation of subsequent events. Specifically, this study predicts that the presence of process accountability can mitigate auditors' bias arising from their prior commitment in the evaluation of subsequent events, rather than the presence of outcome accountability.

Psychology research suggests that accountability leads decision makers to make better judgments, be less affected by prior beliefs, and be more driven by available evidence (see Tetlock 1983; Tetlock et al. 1989 for reviews). However, some studies suggest that

accountability may invoke justification motives and lead decision-makers to escalate their commitment to their prior decision (Fox and Staw 1979; Simonson and Staw 1992; Lerner and Tetlock 1999). For example, Fox and Staw (1979) demonstrate that evaluation apprehension that creates forces for justification can lead to commitment to losing courses of action.

Simonson and Staw (1992) propose that one way to reduce the dual or conflicting effects of accountability is to separate accountability for outcomes from accountability for process. Experimental results from Simonson and Staw (1992) indicate that decision makers who are evaluated on the basis of their judgment process rather than judgment outcome are less likely to commit to their previous actions. Process accountability is a more effective mechanism for reducing decision-makers' escalation tendency, compared to outcome accountability. Simonson and Staw (1992) suggest that the type rather than the degree of accountability must be considered in any effort to reduce commitment to a failing course of action. Thus, process accountability needs to be distinguished from outcome accountability in examining accountability effects on decision-makers' judgments

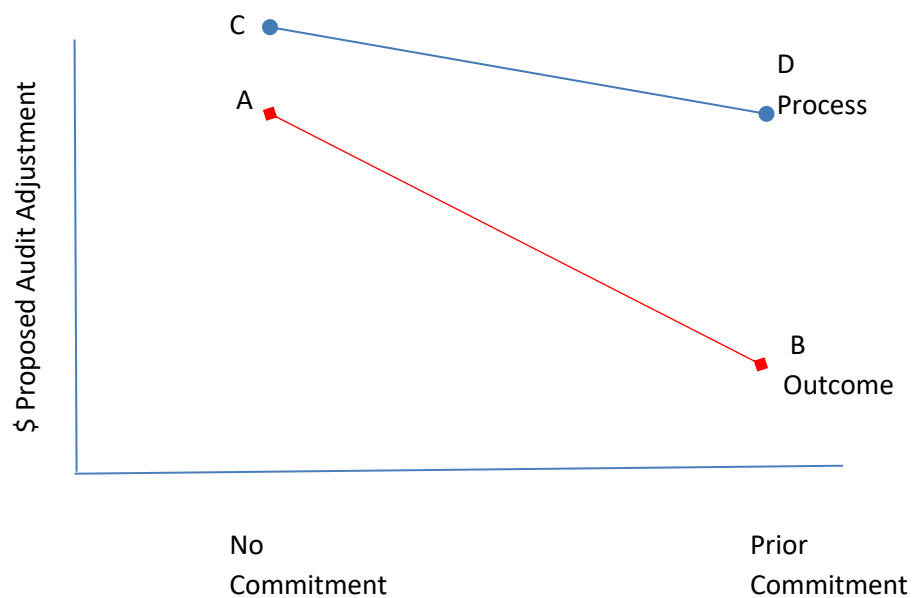
As process accountability is more likely to reduce decision-makers' escalation of commitment than outcome accountability, Study 2 predicts that process accountability, rather than outcome accountability, can mitigate auditors' escalation behavior in the audits of subsequent events. This is because auditors who are accountable for judgment processes are more likely to use proper decision strategies and thoroughly evaluate the available evidence before making a decision, regardless of the decision outcomes. In contrast, auditors who are accountable for judgment outcomes are more likely to defend

their final judgments while compromising cognitive effort when processing underlying evidence (Peecher et al. 2013; Kim and Trotman 2015).

Study 2 hypothesizes that auditors who are required to justify their judgment process will propose a significantly larger audit adjustment to management when subsequent events become known to them after they have made a prior commitment on the fair presentation of the financial statements to management. Auditors who are required to justify their judgment outcome will propose a significantly smaller audit adjustment to management especially when subsequent events become known to them after they have escalated their position on the fair presentation of the financial statements to management. That is, auditors' proposed adjustments on subsequent events are less affected by prior commitment to an initial view when the auditors are expected to justify their judgment process, rather than their judgment outcome. This leads to the sixth hypothesis which is graphically depicted in Figure 9.1:

H6: *The presence of process accountability will mitigate auditors' prior commitment to management on the fair presentation of the financial statements, such that auditors will propose a larger audit adjustment on a subsequent event, than the presence of outcome accountability.*

Figure 9.1: Study 2- Graphical representation of the predicted interaction between commitment and type of accountability on the lowest acceptable inventory write-down assessment



9.5 Conclusion

This chapter examines the joint effects of prior commitment and type of accountability on auditors' evaluation of subsequent events. H4 is proposed to test the maintained hypothesis about whether prior commitment to management would affect auditors' evaluation of subsequent events, as documented in Study 1. The argument is that auditors exhibit escalation tendencies by proposing a smaller audit adjustment on a subsequent event when the event becomes known to them after they have committed to their initial position.

H5 examines the effects of the type of accountability (process versus outcome) on auditors' evaluation of subsequent events. The argument is that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome. H6 is developed to test the likelihood of process versus outcome accountability in mitigating auditors' bias arising from prior commitment in the evaluation of subsequent events. It is predicted that process accountability can mitigate auditors' escalation behavior in the audits of subsequent events, relative to outcome accountability condition. The next chapter presents the research method used to evaluate these hypotheses.

Chapter 10: Study 2 Research Method

10.1 Introduction

This chapter explains the research method used in Study 2. This study uses a 2 x 2 between-subject experimental design to examine the joint effects of prior commitment and type of accountability on auditors' evaluation of subsequent events. Section 10.2 provides an overview of the experiment. Section 10.3 explains the experimental task and procedures. Sections 10.4 and 10.5 describe the dependent and independent variables, respectively. Section 10.6 presents the participants' demographic information. Section 10.7 concludes this chapter.

10.2 Overview of the experiment

An experiment was used to examine the casual relationship between prior commitment and type of accountability on auditors' evaluation of subsequent events. Study 2 uses a 2 x 2 between-subject experimental design in which auditors were required to propose an audit adjustment to the client for a subsequent event. Experiment enables researchers to make strong attributions about causal relations within a theory. This is because manipulated independent variables preclude reverse causality, and elicited dependent variables allow tests of theoretical constructs that would not be observable otherwise (Libby et al. 2002; Bloomfield et al. 2016). A between-subject factorial design is used in this thesis to control any potential confounding variables by holding one independent variable constant at different levels, when one independent variable is being manipulated (Trotman 1996, 2001).

As stated in Chapter 9, H4 predicts that auditors will propose a smaller (larger) audit adjustment on a subsequent event when the event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management. H5 predicts that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome. H6 predicts that process accountability mitigates auditors' escalation tendencies, compared to outcome accountability. It is expected that the presence of process accountability will mitigate auditors' prior commitment to management on the fair presentation of the financial statements such that auditors will propose a larger audit adjustment on a subsequent event, than the presence of outcome accountability.

The first independent variable examined is the commitment to management, which is manipulated as either "prior commitment" or "no commitment." The second independent variable is the type of accountability, which is manipulated as either "process accountability" or "outcome accountability." Study 2 predicts an interaction between commitment to management and type of accountability. The design of this experiment is summarized and presented in Table 10.1.

Table 10.1: Design of Study 2

		Commitment to Management	
		Prior Commitment	No Commitment
		Adj1	Adj3
Type of	Process	Adj1	Adj3
Accountability	Outcome	Adj2	Adj4

Notes: Dependent variable is proposed audit adjustment (Adj). The measure used is: the lowest acceptable inventory write-down assessment that the auditor would be willing to accept being recorded in the financial statements. Adj: An assessment of the lowest inventory write-down amount, between zero and the total value of old inventory (in millions of dollars) that the auditor would be willing to accept being recorded in the financial statements.

The experiment was conducted online. Participants were randomly assigned to one of the four treatment groups when logging on. The online instrument was distributed via email accompanied by an online survey link to participants by contact persons from participating firms. Participants completed the instrument at their own convenience. The online instrument did not allow participants to change the responses they provided on an earlier screen.

Individual differences among the participants were controlled by randomly assigning participants into one of four treatment groups. The online system automatically allocated participants randomly into different groups to provide them with one of the four versions of the instrument. Randomization helps to rule out other possible extraneous variables that would systematically bias the results of the experiment, thus achieving strong internal validity (Trotman 1996, 2001). Sensitivity analyses were also performed to ensure that none of the participant demographics would significantly affect the results of all hypotheses. The details of these analyses are presented in Chapter 11.

10.3 Experimental task and procedures

The experimental materials used in Study 2 are generally identical to those used in the Study 1. Participants were provided with a case requiring an adjustment arising from a subsequent event related to an inventory obsolescence issue.

The experimental instrument was pilot tested with five accounting PhD students and 10 external auditors with differing levels of experience in several audit firms. The instrument was revised accordingly, based on the comments and feedback received from these groups of people. The completed instrument is included as Appendix B. The research was conducted in accordance with the ethics approval received from the Human Research Ethics Committee at the ANU. No issues or problems relating to ethical conduct arose during the course of the research. Consistent with Study 1, the experiment included four sections.

Section 1: Introduction to the experimental task

Section 1 provided the background of a hypothetical company (Johnson), management team, and the company's summarized financial information. The background provided for Johnson includes information on clients' business and industry, other information regarding clients' corporate governance, and a summary of financial information. The financial results presented were generally favorable. Participants were instructed to assume the role of an audit manager on an audit engagement at Johnson Products. Study 2 holds the risk of material misstatement as low across all treatments. Participants were informed that the risk of material misstatement in the audit planning section was relatively low.

Section 2: Information on subsequent events and manipulation of independent variables

The information on subsequent events is similar to those in Study 1. The subsequent event is related to the inventory obsolescence issue after the balance sheet date. As described in Chapter 6, this study uses a subsequent-event representative of a case from the PCAOB inspections against auditors involved in the audit of the California Micro Devices Corporation (SEC 2003).

In Section 2, participants were also provided with descriptions of the manipulated variables of the commitment to management and type of accountability. Participants read one of the four versions of the description on the commitment to management and type of accountability. For the type of accountability conditions, they were required to document either process or outcome justifications on the proposed audit adjustment, depending on their assigned conditions, before they answered the question on the proposed audit adjustment. Participants were asked to provide two to three justifications across the treatments to ensure that the experimental results were not driven by differences in effort in providing process and outcome justifications. Four treatment conditions, represented by the four versions of the experimental task, are discussed in Section 10.2.

There are four treatment conditions represented by the four versions of the experimental task presented in Table 10.2:

Table 10.2: Study 2- The four versions of the experimental task

	Commitment to Management	Type of Accountability
1	Prior commitment	Process accountability
2	Prior commitment	Outcome accountability
3	No commitment	Process accountability
4	No commitment	Outcome accountability

Section 3 and Section 4: Manipulation checks and demographic questions

In Section 3, participants were required to answer manipulation check questions on the construct validity of the commitment and the type of accountability. Related to the manipulation check question on the type of accountability, participants were also asked to what extent they felt accountable for an engagement partner.

In Section 4, participants were required to answer a number of demographic questions including on audit experience, current position in the firm, work affiliation, professional background, and gender. These demographic variables were chosen because they were considered extraneous variables that could affect the dependent variable. Sensitivity analyses were performed to test for any potential effects on the dependent variable arising from these demographic variables.

10.4 Dependent variable

The dependent variable is an assessment of the lowest inventory write-down amount, between zero and the total value of old inventory (in millions of dollars) that the auditor would be willing to accept being recorded in the financial statements. This measure was

chosen because this study focuses on an adjusting event after the financial reporting period, which requires adjustment on the financial statement (Type I subsequent events).

Study 2 removes the two measures that related to the proposed audit adjustment used in Study 1: (1) the write-down amount they would recommend to partner to be recorded; and (2) the amount they believe will ultimately be recorded. Study 1 finds no significant differences across conditions for these two measures. Additionally, several participants in Study 1 commented that these two questions were relatively similar to the question related to the lowest inventory write-down amount that they would be willing to accept. Therefore, Study 2 removes these two measures of the proposed audit adjustment.

10.5 Independent variables

As discussed above, Study 2 employs a 2 x 2 between-subjects experimental design. The first independent variable is the commitment to management (manipulated as “prior commitment” versus “no commitment”); the second is the type of accountability (manipulated as “process accountability” versus “outcome accountability”).

10.5.1 Commitment to management

The main purpose of Study 2 is to test the likelihood of process versus outcome accountability in mitigating auditors’ bias arising from prior commitment in the evaluation of subsequent events. Consistent with Study 1, in considering the audit of subsequent events, a key point of commitment used in this thesis is the reporting to management that the financial statements appear to be fairly presented.

In the “prior commitment” condition, a subsequent event becomes known to auditors after they have reported the fair presentation of the financial statements to management. Participants in the “prior commitment” condition were told the following:

You have presented all the audit findings and reported the fair presentation of the financial statements to Johnson’s management for the financial year ended June 30, 2015. Johnson’s management has expressed that they have strong reservations about any proposed audit adjustments that materially distort the financial performance of the company, especially after you have confirmed the fair presentation of the audited financial statements, because they have a very short time period to issue the audited financial statements to shareholders.

After you have presented the audited financial statements and reported the fair presentation of the financial statements to Johnson’s management, you are informed by your audit team members that there is a subsequent event regarding an issue of inventory obsolescence. Today’s date is August 24, 2015.

In the “no commitment” condition, a subsequent event becomes known to auditors before they report the fair presentation of the financial statements to management. Participants in the “no commitment” condition were told the following:

Before you present all the audit findings and report the fair presentation of the financial statements to Johnson’s management for the financial year ended June 30, 2015, Johnson’s management has expressed that they have strong reservations about any proposed audit adjustments that materially distort the financial performance of the company, especially after you have confirmed the fair presentation of the audited

financial statements, because they have a very short time period to issue the audited financial statements to shareholders.

Before you present the audited financial statements and report the fair presentation of the financial statements to Johnson's management, you are informed by your audit team members that there is a subsequent event regarding an issue of inventory obsolescence. Today's date is August 24, 2015.

Study 2 slightly revised the wording of the manipulation of commitment to management conditions based on several participants' feedback from Study 1. In comparison to Study 1, this study removed the sentences:

You are satisfied with the fair presentation of financial statements and propose to issue a standard unmodified audit report. Management agrees with the presentation of the audited financial statements and will organize an audit committee meeting to authorize the issuance of the audited financial statements within one week.

This revision ensures that the length of the wording for both "prior commitment" and "no commitment" conditions is similar, and possibly eliminates unnecessary confounding factors that can affect the dependent variable.

10.5.2 Type of accountability

Study 2 examines whether imposing accountability requirements on auditors can improve auditors' judgment in evaluating subsequent events. Study 2 expects that auditors will be more skeptical by proposing a larger audit adjustment on a subsequent event when they

are expected to justify their judgment process, than those who are expected to justify their judgment outcome.

Lerner and Tetlock (1999) have explained two types of accountability: process accountability and outcome accountability. Process accountability focuses on the procedures used to arrive at a decision. In contrast, outcome accountability focuses on the quality of the outcomes of an action. Psychology studies that have examined the comparative effects of process and outcome accountability suggest that process accountability generally improves judgment quality, compared to outcome accountability (Simonson and Staw 1992; Siegel-Jacobs and Yates 1996; Brtek and Motowidlo 2002; Scholten et al. 2007). Therefore, this study focuses on these two types of accountability on auditors' judgments.

Following Kim and Trotman (2015) and Messier et al. (2014), in the “process accountability” condition, participants were asked to justify and provide two or three explanations for the judgment process that they used leading up to the final judgment on the proposed audit adjustment to an audit engagement partner. Participants were also asked to justify how they considered each piece of evidence item and how they reached their conclusions about the proposed audit adjustment on the inventory written-down amount. Specifically, participants in the “process accountability” condition were told:

Your engagement partner is interested in the process you will use to reach your conclusion regarding the inventory written-down amount.

Please justify your judgment process by documenting how you have considered each piece of evidence item and how you consolidated this information to reach your

conclusion about the proposed audit adjustment on the inventory written-down amount.

For the outcome accountability condition, participants were asked to justify and provide two or three explanations or reasons for their judgment outcome or final decision on the proposed audit adjustment to an audit engagement partner. Specifically, participants in the "outcome accountability" condition were told:

Your engagement partner is interested in your judgment outcome or final decision on the inventory written-down amount.

Please justify your judgment outcome or final decision by documenting your explanations and reasons for the proposed audit adjustment on the inventory written-down amount.

After participants provided the justification in writing, they were asked to provide an assessment of the lowest inventory write-down amount. This is consistent with audit practice, in that auditors are normally required to document the reasoning in the audit working papers for significant proposed adjustments before they propose audit adjustments to clients (Ashton 1990; Hatfield et al. 2011). The use of “report writing” to manipulate accountability is consistent with a number of accounting studies, including Kadous and Sedor (2004), Chang et al. (2013), and Messier et al. (2014). However, the lack of a face-to-face interaction in this study may have caused the participants to not feel accountable for their decisions, and this may bias the results.

10.6 Participants

10.6.1 Recruitment procedures

Participants were experienced auditors (partners, directors, senior managers, managers, and seniors) because partners and managers from the participating firms indicated that these people have sufficient experience evaluating subsequent events. The experiment was conducted in August and September 2015. Contacts at audit firms were approached to secure the participation of auditors from their firm. Participants were mailed a web link by a contact person, which directed them to the online survey through a contact person in each participating firm. Participants were randomly assigned across treatments when logging on.

Participants who completed the experimental materials were remunerated with a gift voucher worth RM50 (approximately \$20). The payment of an incentive was to recognize their time and effort.

10.6.2 Demographics of the participants

A total of 77 experienced auditors from the Big 4 firms and two mid-tier firms in Malaysia participated in the experiment. After excluding nine participants who failed manipulation check questions and two incomplete responses, Study 2 had 66 usable responses.²⁰ All data and statistics reported are based on the 66 participants.

²⁰ The analysis results excluding these nine participants are not significantly different from the results including all 75 participants (after excluding the two incomplete responses).

Demographic information is presented in Table 10.3. The participants consisted of two partners (3% of the sample), four directors (6% of sample), three senior managers (5% of sample), four managers (6% of sample), 22 assistant managers (33% of sample), and 31 seniors (47% of sample). The participants had an average of 4.09 years of audit experience, ranging from two to 13 years (standard deviation=2.40). On average, participants had been involved in the audits of subsequent events (mean=9.56 engagements, standard deviation=12.08) and the audits of inventory (mean=8.86 engagements, standard deviation=10.78), indicating that they had had significant involvement in auditing subsequent events. 80% of participants worked for a Big-4 firm, while the remaining 20% worked for mid-tier firms. In the sample, 88.7% of participants had professional qualifications, and 11.3% were still seeking professional qualifications. Sixty-one percent of participants were male. Sensitivity analyses were performed to test any potential effects on the dependent variable arising from these demographic variables. Detailed analyses and results for sensitivity analyses are discussed further in Chapter 11.

Table 10.3: Study 2- Demographic information of participants

Current position in firm (Frequency and Percentage)	
Audit partner	2 (3.0)
Audit director	4 (6.1)
Audit senior manager	3 (4.5)
Audit manager	4 (6.1)
Audit assistant manager	22 (33.3)
Audit senior	31 (47.0)
Total	66 (100)
Type of employer the participants currently work for (Frequency and Percentage)	
Big-4 accounting firms	53 (80)
Non-Big 4 accounting firms	13 (20)
Total	66 (100)
Audit experience (Mean and Standard deviation)	
Number of years of audit experience	4.09 (2.40)
Percentage of time spent performing each of the following tasks (Mean)	
Audit	85.82
Tax	3.86
Consulting	5.66
Other	4.66
Professional qualifications (Frequency and Percentage)*	
ACCA (UK)	25 (31.25)
MICPA (Malaysia)	14 (17.50)
CA (Australia)	14 (17.50)
CPA (Australia)	8 (10.00)
ICAEW (UK)	8 (10.00)
MIA (Malaysia)	2 (2.50)
Still seeking professional qualification	9 (11.25)
Number of times participants had been involved in auditing subsequent events (Mean and Standard deviation)	9.56 (12.08)
Number of times participants had been involved in auditing inventory	8.86 (10.78)
(Mean and Standard deviation)	

Notes: Some participants hold two or more professional qualifications.

10.7 Conclusion

Study 2 examines the effects of prior commitment and type of accountability on auditors' evaluation of subsequent events. Study 2 predicts that process accountability mitigates auditors' escalation behavior in the audits of subsequent events, compared to outcome accountability. This chapter explains the research method used for Study 2. A 2 x 2 between-subject experimental design is employed to test the proposed hypotheses. The experimental materials used in Study 2 are generally identical to those used in Study 1. This chapter also reports the demographic information of the 66 usable experienced auditors. The next chapter presents the results and the additional analyses for Study 2.

Chapter 11: Study 2 Results and Conclusions

11.1 Introduction

This chapter presents the results of Study 2. Section 11.2 discusses the results of the manipulation checks. Section 11.3 reports the tests of hypotheses. Taking into consideration the prediction that type of accountability interacts with auditors' prior commitment to management, planned-contrast testing was also conducted accordingly. Section 11.4 provides the results from the additional analyses. Section 11.5 summarizes the main findings, and Section 11.6 concludes Study 2.

11.2 Manipulation checks and debriefing questions

Similar to Study 1, the effectiveness of the manipulation for commitment to management was assessed by asking participants to choose the option of either whether the subsequent event of inventory issues were informed by audit team members after or before they had reported the fair presentation of the financial statements to management. The effectiveness of the manipulation for the type of accountability was assessed by asking participants to identify which they felt accountable for, either the process they used leading up to a conclusion, or the final decision on the proposed audit adjustment on the inventory written-down amount. Four participants (5.2%) failed the manipulation check on the commitment to management and two participants (2.6%) failed the manipulation check on the type of accountability. Three participants (3.9%) answered both questions incorrectly. These nine participants and two incomplete responses were excluded from the remaining statistical analyses.

For the type of accountability manipulation, this study also asked participants to indicate the extent to which they felt accountable for the engagement partner on a scale ranging from -5 (not accountable at all) to 5 (extremely accountable). The mean response is 2.73 (standard deviation=1.66). This finding indicates that participants generally felt accountable to the engagement partner when they were told to justify or explain the proposed audit adjustment in writing. This study also compared scores on the extent to which participants felt accountable for the engagement partner, between the process accountability and outcome accountability conditions. This study finds a statistical difference between the level of accountability auditors felt toward the process accountability (mean=3.51, $t(64)=4.71$, $p<0.01$) and the outcome accountability (mean=1.84). The results suggest that auditors who are required to justify their judgment process feel more accountable to the engagement partner, compared to those who are required to justify their judgment outcome.

The results of the manipulation checks indicate that most participants understood the manipulated conditions. Nine participants failed the manipulation check questions, and their responses were excluded from the testing of the hypotheses. The robustness of the results to the exclusion of responses that failed manipulation checks is discussed further later in the chapter.

Participants also answered debriefing questions related to the task, on a scale from -5 (“strongly disagree”) to +5 (“strongly agree”). The mean ratings and standard deviations of these questions are reported in Table 11.1. Participants found the case materials to be realistic (mean=2.80, standard deviation=1.70), suggesting a relatively high experimental realism. Participants were confident in their ability to complete the task (mean=2.61,

standard deviation=1.65), and they felt involved to do so (mean=2.45, standard deviation=2.05).

Table 11.1: Study 2- Debriefing questions

	Mean	Std. Dev.
1. Realism of case materials	2.80	1.70
2. Confidence in ability to complete task	2.61	1.65
3. Felt involved to complete task	2.45	2.05

Notes: Responses are collected using a scale ranging from -5 (Strongly disagree) to +5 (Strongly agree).

11.3 Test of hypotheses

This section presents the results for auditors' assessment of the lowest inventory write-down amount. The commitment to management (prior commitment versus no commitment) and the type of accountability (process versus outcome) are two between-subject factors. Study 2 examines how the type of accountability can mitigate auditors' escalation behavior in evaluating subsequent events.

This section first provides the descriptive statistics of the cell means across all experimental conditions. Second, the results for the multivariate analysis are presented. Lastly, the tests of predicted interaction are reported.

11.3.1 Descriptive analyses

Descriptive analyses of the lowest acceptable inventory write-down assessment are reported in Table 11.2, Panels A and B. Panel A presents the cell means, standard

deviations, and sample sizes for each treatment group. Panel B presents the results for t-tests, which show the differences in means between the treatment groups.

The pattern of means in Table 11.2, Panel A shows the main effects of the commitment and type of accountability. Participants in the no commitment condition accept a larger audit adjustment (mean=\$6.34 million) than the participants in the prior commitment condition (mean=\$5.46 million). Table 11.2, Panel B reports the results for the independent t-test between treatment groups. The mean difference on the lowest acceptable inventory write-down assessment is marginally significant ($t(64)=1.93$, $p=0.058$). Consistent with H4, the results suggest that auditors will propose a smaller (larger) audit adjustment when the subsequent event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management.

Table 11.2, Panel A also reports the results for the type of accountability conditions. Participants in the outcome accountability condition accept a smaller audit adjustment (mean=\$5.26 million) than the participants in the process accountability condition (mean=\$6.44 million). The mean difference on the lowest acceptable inventory write-down assessment is statistically significant between the two conditions ($t(64)=-2.64$; $p=0.011$). This finding supports H5, which predicts that auditors will propose a larger audit adjustment on subsequent events when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome.

Table 11.2: Study 2- Auditors' assessment of the lowest acceptable inventory write-down

Panel A: Means (Standard deviations) and Number of observations

		Type of Accountability		Average
		Outcome	Process	
Commitment				
No Commitment	[A]	6.28 (1.60) n=15	[C] 6.39 (1.90) n=17	6.34 (1.74) n=32
Prior Commitment	[B]	4.31 (1.70) n=16	[D] 6.48 (1.57) n=18	5.46 (1.95) n=34
Average		5.26 (1.91) n=31	6.44 (1.71) n=35	5.88 (1.89) n=66

Panel B: Differences in mean of the lowest acceptable inventory write-down assessment by treatment conditions

	Commitment		Accountability	
	No	Prior	Outcome	Process
Mean of the lowest acceptable inventory write-down assessment (Standard deviation)	6.34 (1.74)	5.46 (1.95)	5.26 (1.91)	6.44 (1.71)
Difference (standard error)	0.88 (0.45)		-1.17 (0.45)	
T-statistic (p-value)	1.93 (0.058)*		-2.64 (0.011)**	

Panel C: ANOVA results

Source	Type III sum of squares	df	Mean square	F-value	p-value	
Corrected model	52,747,123	3	17,582,374	6.103	0.001	
Commitment	14,442,779	1	14,442,779	5.013	0.029	**
Accountability	21,375,342	1	21,375,342	7.420	0.008	***
Commitment * Accountability	17,467,508	1	17,467,508	6.603	0.017	**
Error	178,610,667	62	2,880,817			
Corrected total	231,357,790	65				

Notes: Dependent variable: the lowest inventory write-down amount that auditors would accept (in millions of dollars). *Independent variables:* Commitment: the commitment to management is manipulated at two levels: prior commitment versus no commitment. Type of accountability: the type of accountability is manipulated at two levels: process-versus-outcome.

*, **, *** indicate significance at the 10, 5, and 1% levels (one-tailed), respectively.

11.3.2 Multivariate analysis

Table 11.2, Panel C reports the results for a two-way ANOVA. H4 predicts that auditors will propose a smaller (larger) audit adjustment when the subsequent event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management. The mean lowest acceptable audit adjustment is higher in the no commitment condition than the prior commitment condition (means=6.34 versus 5.46). The ANOVA results shown in Table 11.2, Panel C indicate that this difference is statistically significant ($f(1,62)=5.013$, $p=0.029$), thus supporting H4. This finding suggests that auditors show escalation tendencies by proposing a significantly smaller audit adjustment when a subsequent event becomes known to them after they have provided an initial view to management. The result is consistent with Study 1.

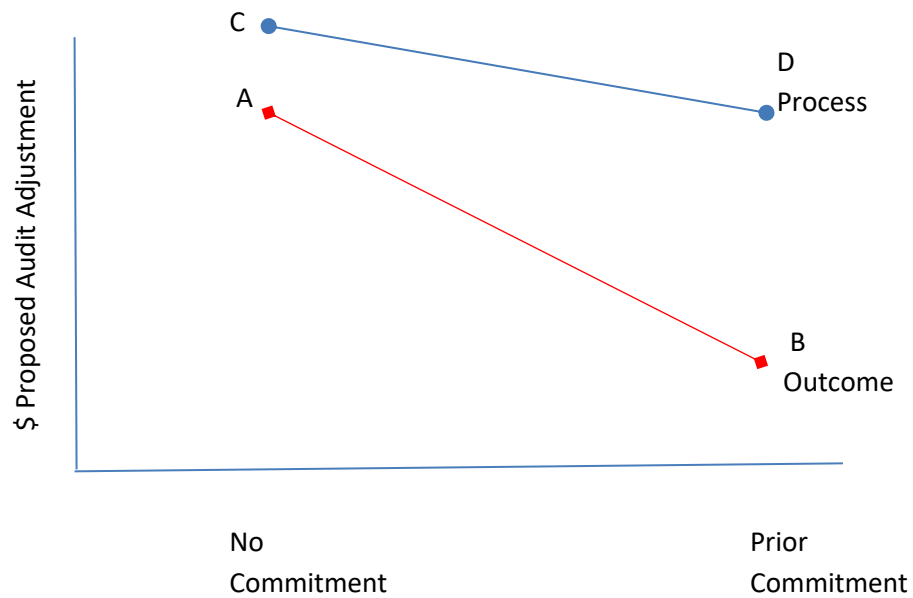
H5 predicts that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process than those who are expected to justify their judgment outcome. Table 11.2, Panel A reports that the mean of the lowest acceptable audit adjustment indicates that auditors tend to propose a larger audit adjustment when they are expected to justify their judgment process (mean=6.44) compared to when they are expected to justify their judgment outcome (mean=5.26). The results for the type of accountability from Table 11.2, Panel C show that the type of accountability has a significant effect on auditors' assessment of the lowest acceptable inventory write-down ($f(1,62)=7.420$, $p=0.008$), thus supporting H5. This finding suggests that auditors who are expected to justify their judgment processes will propose a larger audit adjustment to management than those who are expected to justify their judgment outcome.

H6 proposes that the presence of process accountability mitigates auditors' prior commitment to management on the fair presentation of the financial statements such that auditors will propose a larger audit adjustment on subsequent events than the presence of outcome accountability. The ANOVA results show that there is a significant interaction between commitment and type of accountability ($f(1,62)=6.603$; $p=0.017$). The predicted and actual interaction between commitment and type of accountability are plotted in Figure 11.1, Panels A and B, respectively. Figure 11.1 shows an ordinal interaction, of which the effects of type of accountability are in the same direction at each level of the commitment, but the effects differ in size. As plotted in the Figure 11.1, Panel B, the difference in the mean on the proposed audit adjustment across the type of accountability is larger in the condition of prior commitment than in the condition of no commitment. The graphical representation of actual interaction is consistent with that of predicted interaction as shown in Figure 11.1, Panel A.

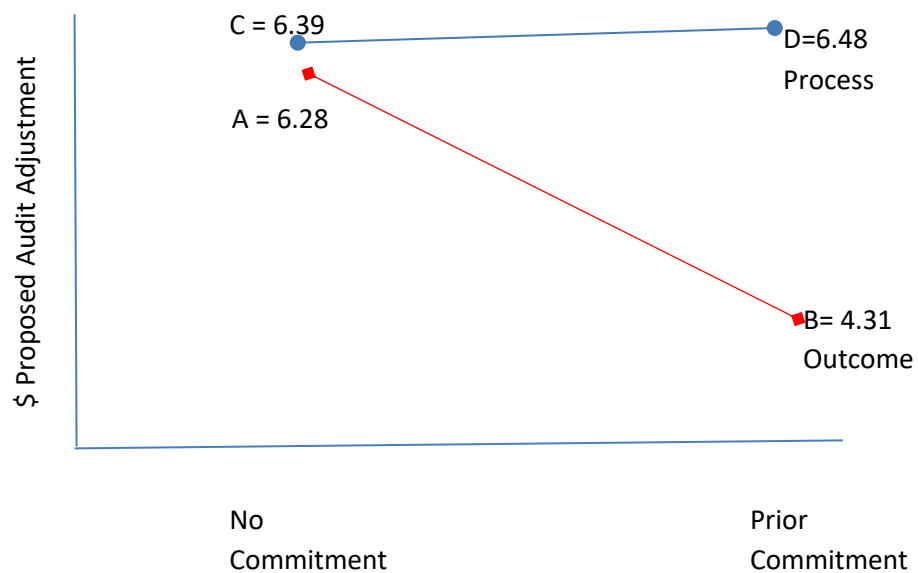
The findings reveal that the type of accountability has a greater downward effect on auditors' assessment of the lowest acceptable inventory write-down in the condition of prior commitment than on the condition of no commitment. This suggests that process accountability, relative to outcome accountability, can mitigate auditors' biases arising from prior commitment in evaluating subsequent events. In view of the fact that Study 2 predicts an interaction between commitment and type of accountability, H6 is further tested using the planned-contrast testing.

Figure 11.1: Study 2- Graphical representation of the interaction between commitment and type of accountability on the lowest acceptable inventory write-down assessment

Panel A: Predicted results



Panel B: Actual results



11.3.3 Tests of predicted interaction using planned contrasts

As Study 2 predicts an ordinal interaction effect in H6, planned-contrast coding is performed to further examine this predicted interaction effect. Buckless and Ravenscroft (1990) explain that contrast coding provides greater statistical power than the conventional ANOVA when examining ordinal interactions. Table 11.3 reports the results for planned contrast testing and simple-effect comparison. The predicted interaction between commitment and type of accountability is demonstrated in Figure 11.1, Panel A. That is the difference in the mean on the proposed audit adjustment across the type of accountability is larger in the condition of prior commitment than the condition of no commitment. Study 2 tests this prediction with planned-contrast testing. Contrast coding and testing follow the methods outlined by Buckless and Ravenscroft (1990) and Rosnow and Rosenthal (1995).

Planned contrast testing is initially conducted using the following weights: -1 for no commitment/outcome [A]; -3 for prior commitment/outcome [B]; +2 for no commitment/process [C]; and +2 for prior commitment/process [D]. The weights assigned for the conditions are consistent with the predictions depicted in Figure 11.1, Panel A. The weights are positive for process accountability and negative for outcome accountability reflecting the expectation that auditors who are required to document the judgment process are more likely to propose a larger audit adjustment, even though they have made a prior commitment to management, compared to those who are required to document their judgment outcome. Thus, the weights assigned for both conditions of no commitment/process [C] and prior commitment/process [D] are +2. In contrast, in the condition of outcome accountability, auditors with prior commitment are more likely to propose a smaller audit adjustment to management than the auditors with no commitment.

Thus, the weight assigned for the condition of prior commitment/outcome [B] is lower (i.e., -3) than the condition of no commitment/outcome [A] (i.e., -1). An ordinal interaction contrast coding that reflects the specific directional predictions show a statistically significant result, supporting H6 ($t(1)=3.69$, $p<0.01$). A test of the residual between-cells variation (not tabulated) indicates the hypothesized contrast explains the data well ($F(1,62)=0.027$, $p=0.871$, two-tailed).

This study also tests the planned interaction contrast using the weights: +1 for [A], -3 for [B], +1 for [C], +1 for [D]. This is because the means of the lowest acceptable audit adjustment are relatively higher for the conditions of A, C, and D than the condition of B, as shown in Figure 11.1, Panel B. Similarly, the un-tabulated planned interaction contrast results show a significant result ($t(1)=4.25$; $p<0.01$). A test of the residual between-cells variation (not tabulated) indicates the hypothesized contrast explains the data well ($F(1,62)=0.001$, $p=0.998$, two-tailed).

Follow-up simple effects analyses reported in Table 11.3 further support H6. The results indicate that the mean of the lowest acceptable audit adjustment is significantly larger for no commitment versus prior commitment in the presence of outcome accountability (no commitment=6.28; prior commitment=4.31; $t(1)=3.23$; $p<0.01$), but not in the presence of process accountability (no commitment=6.39; prior commitment=6.48; $t(1)=0.16$; $p=0.436$).

Together, the planned-contrast testing and follow-up simple effects analyses support H6. The findings suggest that process accountability is an effective mechanism for mitigating auditors' escalation behavior in evaluating subsequent events, relative to the outcome accountability. That is, auditors who are required to document the judgment process tend

to propose a larger audit adjustment on subsequent events, even though they have made a prior commitment to management.

Table 11.3: Study 2- Planned-Contrast and Simple-Effect comparisons on auditors' assessment of the lowest acceptable inventory write-down

Planned-Contrast and Simple-Effect comparisons

Source	df	t-stat	p-value	
Planned-contrast †	1	4.25	< 0.01	***
Simple-Effect comparisons of:				
No/prior commitment, outcome [B-A]	1	3.23	< 0.01	***
No/prior commitment, process [D-C]	1	0.16	0.436	
Outcome/process, prior commitment [B-D]	1	-3.72	< 0.01	***
Outcome/process, no commitment [A-C]	1	-0.18	0.428	

Notes: The main dependent variable is the lowest inventory write-down amount that auditors would accept (in millions of dollars). Commitment: the commitment to management is manipulated at two levels: prior commitment versus no commitment. Type of accountability: the type of accountability is manipulated at two levels: process-versus-outcome.

*, **, *** indicate significance at the 10, 5, and 1% levels (one-tailed), respectively.

† Contrast weights are -1 for no commitment/outcome [A]; -3 for prior commitment/outcome [B]; +2 for no commitment/process [C]; and +2 for prior commitment/process [D].

11.4 Additional analyses

Nine participants failed the manipulation check questions, and there were two incomplete responses, leaving a total of 66 usable responses. Study 2 excludes these participants in the testing of the hypotheses. To test the robustness of the results to the exclusion of the responses that failed manipulation checks, two-way ANOVA are conducted by including the full sample of participants ($N=75$).²¹ The un-tabulated two-way ANOVA results consistently show significant main effects of the commitment and type of accountability on auditors' assessment of the lowest acceptable inventory write-down, but only a marginally significant result for the interaction between commitment and type of accountability ($p=0.086$). Given the predicted interaction between prior commitment and type of accountability, planned-contrast testing is conducted accordingly. The un-tabulated planned-contrast testing analyses using the assigned weights (-1, -3, +2, +2) or (+1, -3, +1, +1) on the full sample of participants show a statistically significant interaction between prior commitment and type of accountability. Together, there is no significant difference in the statistical conclusions if the nine participants who failed the manipulation check question are included in the testing of hypotheses.

Previous research indicates that experience can affect auditors' tendency to escalate their commitment to a chosen course of action (Jeffrey 1992). Kim and Trotman (2015) demonstrate that novice auditors show greater levels of professional skepticism when they are accountable for their judgment process compared to their judgment outcome. Regarding the direct effect of the experience level on auditors' judgments, ANCOVA was conducted to determine whether auditors' level of experience would affect the testing of hypotheses. Covariates were included in the ANCOVA for participants' years of audit

²¹ The analysis excludes two incomplete responses.

experience, numbers of engagements in the audit of subsequent events and the audit of inventory. The results for all hypotheses are unchanged after controlling for auditors' level of experience (un-tabulated).

A separate three-way ANOVA analysis was conducted, to determine whether any categorical demographic variables would affect the hypotheses tests. The demographic variables included are: participants' professional qualifications, firm level, and current position. The un-tabulated ANOVA analyses indicate that none of these demographic variables significantly affect the hypotheses tests.

Participants answered three debriefing questions related to the task, such as realism of task, confidence level, involvement level on a scale from -5 ("strongly disagree") to +5 ("strongly agree"). This study includes these three measures as covariates in the ANCOVA analyses (un-tabulated), with the auditor's lowest acceptable inventory write-down assessment as the dependent variable. None of these measures are significant in explaining the results for all hypotheses (all $p > 0.20$), so are not included in the testing of hypotheses.

11.5 Summary of the results for hypotheses testing

The findings support H4, which predicts that auditors will propose a smaller (larger) audit adjustment on a subsequent event when the event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management. This finding is consistent with Study 1. The results on the type of accountability support H5, indicating that auditors will be more skeptical by proposing a larger audit adjustment on a subsequent event when they are expected to

justify their judgment process, than those who are expected to justify their judgment outcome. Instructing auditors to justify their judgment process can be considered an effective mitigating mechanism, to reduce auditors' bias arising from their prior commitment. The results support H6, suggesting that auditors' bias arising from their prior commitment in evaluating subsequent events can be mitigated by the presence of process accountability, relative to the presence of outcome accountability. Additional analyses are conducted to ensure that the results for all hypotheses are robust, to the exclusion of the responses that failed a manipulation check, and to different demographic variables.

11.6 Conclusions and limitations of Study 2

As Study 1 finds that auditors commit to their initial view after the reporting of the fair presentation of financial statements to management, Study 2 compares process and outcome accountability as mechanisms through which auditors' escalation tendencies can be mitigated.

The results from an experiment involving 66 experienced auditors indicate that auditors propose significantly smaller audit adjustments when subsequent events become known to them after they have communicated the fair presentation of the financial statements to management. This finding indicates that auditors propose a smaller audit adjustment on a subsequent event when the event becomes known to them after they have reported a view on the fair presentation of the financial statement to management. This finding is consistent with Study 1.

Drawing on psychology studies that suggest that process accountability is more desirable and uniformly superior to outcome accountability in improving decision-makers' judgments and decisions, Study 2 investigates the likelihood of process versus outcome accountability in mitigating auditors' bias arising from their prior commitment in the evaluation of subsequent events. Study 2 finds that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome. The finding of a significant ordinal interaction effect between prior commitment and type of accountability demonstrates that process accountability can reduce the effect of prior commitment in the audits of subsequent events, relative to outcome accountability. This finding suggests a benefit of employing process accountability documentation in the audits of subsequent events. Overall, this study provides practitioners, academics, and regulators with evidence that instructing auditors to document their judgment process used to reach a justifiable conclusion has the potential to improve the effectiveness of the audits of subsequent events.

Study 2 is subject to several limitations, and there are a few possible directions for future research. The first limitation concerns the manipulation of the type of accountability. Study 2 asked participants to type an explanation of the process they went through to arrive at the judgment, or the reasons for their final outcome. Previous accountability studies manipulate accountability by informing participants that they might be later contacted by researchers, and they were asked to justify and provide explanations for their judgment to the researchers. The lack of face-to-face interaction in this study may have caused participants to not feel accountable for their decisions, and this may have biased the results. To mitigate this concern, Study 2 included a manipulation check question for accountability, asking participants how accountable they felt to the hypothetical partner.

The results for the manipulation check indicated that participants generally felt accountable when they were required to justify their decision.

Second, participants were required to justify their decision-making to an audit partner. Future research can consider whether auditors exhibit escalation tendencies when they are held accountable for their decision to multiple parties, for example, having to explain their judgment to clients, audit committee members, or audit inspectors. Additionally, this study did not capture the negotiation process between auditors and clients in resolving disputes arising from subsequent events. Future research can investigate whether process accountability continues to have a positive effect on auditors' judgments in a more complex negotiation process.

Third, although the findings of this study demonstrate the benefits of process accountability in mitigating auditors' escalation bias, future research could consider other factors that enhance or reduce the benefits of both outcome accountability and process accountability, and the situations under which these factors are important. This is because process accountability may not always produce better judgment quality than outcome accountability. For example, auditors may adjust their judgment process to align with supervisors' or regulators' preferences (Peecher et al. 2013). Backof (2015) suggests that performing and documenting more audit work can increase jurors' perceptions of the foreseeability of the audit misstatement, increasing the likelihood that auditors are found negligent. Auditors may have incentives or biases in documenting their justification for their final decisions, to defend their work to evaluators.

Chapter 12: Conclusions of the Thesis

12.1 Introduction

The overarching aim of this thesis is to examine the underlying causes that can affect auditors' judgment in the subsequent events task, and to investigate potential strategies to improve the audits of subsequent events. This thesis comprises two studies. Study 1 examines the effects of prior commitment and risk of material misstatement on auditors' evaluation of subsequent events. Study 2 extends Study 1 by examining whether the type of accountability (process versus outcome) can mitigate auditors' bias arising from prior commitment in evaluating subsequent events. Sections 12.2 and 12.3 summarize each of these studies. Section 12.4 summarizes the general limitations of this thesis, together with suggestions for future research, and conclusions are drawn in Section 12.5.

12.2 Study 1: The Effects of Prior Commitment and Risk of Material Misstatements on Auditors' Evaluation of Subsequent Events

Study 1 examines the interactive effects of prior commitment and risk of material misstatement on auditors' evaluation of subsequent events. Because auditors are required to respond to subsequent events that come to their attention after a significant amount of audit work has been completed (PCAOB 2003; IAASB 2011), this study focuses on the potential bias in auditor judgment that may arise due to over-commitment to an initial decision or position. Study 1 predicts that auditors will propose a smaller audit adjustment on a subsequent event when the event occurs after they have committed to their initial view on the fair presentation of the financial statements to management.

Study 1 examines the effect of risk of material misstatement on auditors' evaluation of subsequent events, because auditors shall take into account their risk assessment in performing the audit procedures on subsequent events (IAASB 2013). Research indicates that auditors respond to the level of risk of material misstatement by being more skeptical in the audit (e.g., Coram et al. 2004; Hwang and Chang 2010; Quadackers et al. 2014), and that areas of higher risk receive more audit effort (e.g., Bell et al. 2001; Schelleman and Knechel 2010). With the focus on auditors' judgment on subsequent events, Study 1 predicts that auditors will be more likely to propose a smaller audit adjustment to management when subsequent events become known to them in the condition of low risk of material misstatement than in the condition of high risk of material misstatement.

Given the expectation that auditors respond to the risk of material misstatement, this study further explores whether risk of material misstatement interacts with auditors' prior commitment to management. Study 1 predicts that auditors will be more skeptical when high risk of material misstatement factors are present, and therefore they will adjust for subsequent events, even when an initial view has been previously reported to management.

To test these predictions, a 2 x 2 between-subjects experiment was conducted. The first independent variable is the commitment to management (manipulated as "prior commitment" versus "no commitment"), and the second independent variable is the level of risk of material misstatement (manipulated as "high risk" versus "low risk"). The results from an experiment involving 87 experienced auditors indicate that auditors propose significantly smaller audit adjustments when subsequent events become known to them after they have communicated the fair presentation of the financial statements to management. That is, auditors systematically reduce their estimate of minimum

adjustments required on the subsequent events after they have committed to their initial view formed during the audit. Escalation of commitment is most likely to have an effect when the auditor feels personally responsible and there are strong objections from management to change.

Auditors are expected to be more skeptical in proposing audit adjustments on subsequent events when risk factors are present. As would be expected, experimental results reveal that a high risk of material misstatement significantly increases auditors' proposed audit adjustment to management.

The significant interaction effects between prior commitment and risk of material misstatement indicate that when risk of material misstatement is high, auditors are less affected by prior commitment to an initial view provided to management, so that they will propose a significantly larger amount of audit adjustment to management. This combination of results suggests that auditors tend to propose a significantly smaller amount of audit adjustment on a subsequent event when the event becomes known to them after they have committed to their initial position in the low risk condition. Study 1 extends the escalation of commitment literature by demonstrating that escalation bias observed in low-risk settings does not generalize to high-risk settings in the context of auditing.

Overall, Study 1 provides a better understanding of factors that could potentially affect auditors' judgments in evaluating subsequent events. Specifically, auditors' adjustments on subsequent events are less affected by prior commitment to an initial position when the risk of material misstatement is high. This study suggests that proper assessment of

the overall risk of material misstatement can improve the assessment of the importance of the subsequent event.

12.3 Study 2: The Effects of Prior Commitment and Type of Accountability on Auditors' Evaluation of Subsequent Events

Study 1 provides evidence that auditors will propose a significantly smaller audit adjustment on a subsequent event when the event becomes known to them after the reporting of the fair presentation of the financial statements to management. As auditors have a tendency to commit to their initial view, this leads to Study 2, which considers methods to reduce auditors' bias arising from their prior commitment in the evaluation of subsequent events. Prior psychology studies document that process accountability, relative to outcome accountability, is effective in reducing decision-makers' tendency to commit to their previous decisions (Simonson and Staw 1992; Lerner and Tetlock 1999). Given these findings, Study 2 examines whether accountability (process versus outcome accountability) has the potential to mitigate auditors' bias arising from their prior commitment to evaluating subsequent events.

Study 2 employs a 2 x 2 between-subjects experimental design. The first independent variable is the commitment to management (manipulated as "prior commitment" versus "no commitment") and the second independent variable is the type of accountability (manipulated as "process accountability" versus "outcome accountability"). Study 2 retests the prediction hypothesized in Study 1 that auditors will propose a smaller (larger) audit adjustment when the subsequent event becomes known to them after (before) they have committed to their initial view on the fair presentation of the financial statements to management. The results from an experiment involving 66 experienced auditors confirm

that auditors exhibit escalation tendencies by proposing a smaller audit adjustment on a subsequent event when the event becomes known to them after they have committed to their initial view on the fair presentation of the financial statements. This finding is consistent with Study 1.

Study 2 predicts that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process than those who are expected to justify their judgment outcome. The results on type of accountability support the prediction that auditors will propose a larger audit adjustment on a subsequent event when they are expected to justify their judgment process than those who are expected to justify their judgment outcome.

Study 2 proposes that the presence of process accountability will mitigate auditors' prior commitment to management on the fair presentation of the financial statements, such that auditors will propose a larger audit adjustment on a subsequent event, than the presence of outcome accountability. The finding of a significant ordinal interaction effect between commitment and type of accountability indicates that process accountability can mitigate auditors' escalation behavior in the audits of subsequent events relative to outcome accountability. That is, auditors who are required to document their judgment process will propose a larger audit adjustment, even though they have committed to their initial view.

The findings from Study 2 are consistent with Simonson and Staw's (1992) notion that individuals who are accountable for the judgment process are more likely to use proper decision strategies, and to carefully evaluate the available alternatives before making a decision regardless of the previous decision outcomes. In contrast, individuals who are accountable for the judgment outcome are more likely to defend or commit to their

previous decision. Taken together, the findings of Study 2 suggest that process accountability is a more effective mechanism for reducing auditors' escalation tendency in evaluating subsequent events.

12.4 Limitations and suggestions for future research

This thesis is subject to several limitations. First, considering the fact that the process for auditing subsequent events is relatively complex, this thesis focuses on auditors' evaluation of subsequent events after the events have been identified. It does not cover the auditors search and identification of subsequent events, which is an avenue for future research. Further, this thesis focuses on auditors' escalation behavior when subsequent events come to the auditors' attention after most or all of the audit fieldwork is completed, but before the date of the auditor's report. An avenue for future research is to examine how auditors develop their commitment in the different stages of the audit of subsequent events, such as after the client's announcement of profit figures or after the signing of the auditor's report. Additionally, this thesis focuses on the adjusting events. Future research could also extend this research to the Type II subsequent events that require disclosure on the financial statements. Finally, this thesis does not capture the negotiation process between auditor and client, in resolving disputes arising from subsequent events. Both auditors and clients are normally involved in the negotiation process to waive or agree to proposed audit adjustments (Salterio 2012). Future research is needed to consider the complex context around the process of auditing subsequent events.

Second, this thesis does not measure auditors' prior beliefs. Without measurement of prior commitment, it is difficult to characterize the lower audit adjustments as a case of escalation bias. Additional experiments could be conducted to measure participants'

beliefs about the likelihood of material misstatement conditional on the prior commitment and risk of material misstatement conditions. This would help isolate the degree to which the different audit adjustments are stemming from Bayesian or non-Bayesian forms of belief revision.

Third, this thesis focuses on auditors' escalation of commitment to management in the auditing process. This design decision was based upon scoping discussions with audit practitioners, who suggested that reporting to management was considered more important than subsequent communication with the audit committee. It is important to note that auditors of the public entities are now required to report to the audit committee for the authorization of the issuance of the audited financial statements (Cohen et al. 2010). An avenue for future research would be to consider how auditors' commitment to a position develops over the course of the audit, by investigating how communication with the audit committee contributes to a possible escalation of commitment to an initial view or decision. Cohen et al. (2011) find auditors are less likely to waive an adjustment when management's incentives for earnings management are low, and the CEO has less influence over the audit committee's independence. Considering Cohen et al.'s (2011) findings, it is possible that the quality of the audit committee (such as the strength of audit committee independence) may cause auditors to be more skeptical and hence less likely to commit to their initial view formed during the audit process. Future research could test the extent to which those insights can be generalized to the reporting to the audit committee.

Fourth, this thesis uses an inventory obsolescence task. The results of this thesis may not generalize to all types of subsequent events. Future research could examine the robustness of the findings across various types of subsequent events with a range of severity, such

as subsequent events arising from pending litigation, doubtful debt issues or accounting estimates and fair-value measurements.²²

Fifth, with respect to the manipulation of the type of accountability, this thesis asked participants to write their justification for their judgment process or judgment outcome. Participants did not explicitly report their decision to a supervisor. The lack of a face-to-face interaction may cause the participants to not feel accountable for their decision, and the results must be interpreted with respect to this potential source of bias. Additionally, this thesis asked participants to provide their justifications to an engagement partner. In practice, auditors are held accountable to multiple parties simultaneously, such as audit client, audit committee members, or audit inspectors (Gibbins and Newton 1994; Bagley 2010). Future research could consider whether auditors exhibit escalation tendencies in the auditing process when they are held accountable to multiple parties.

Sixth, this thesis collected evidence on whether auditors' escalation behavior is driven by a reputation concern. However, supplemental analyses show that this personality characteristic does not affect auditors' escalation behavior. Future research could further explore the underlying reasons or personality characteristics that contribute to auditors' escalation tendencies in the auditing process, including risk attitude, extroversion, or directedness characteristics.

Seventh, this thesis only examines one of the judgment biases in the audit of subsequent events: escalation of commitment. Survey studies on the audit of subsequent events reveal

²² For example, the auditing standard *ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* requires auditors to review subsequent events or transactions that are related to accounting estimates. Griffith et al. (2015) find that auditors overwhelmingly reported testing management's process for generating complex estimates, rather than developing independent expectations or reviewing subsequent events data.

that many factors can affect auditors' evaluation or search for subsequent events evidence, such as time pressures, materiality level, client preference, and nature of audit evidence (Herda and Lavelle 2014). Chung et al. (2013) propose various mitigating strategies to improve the effectiveness of the audit of subsequent events, such as the use of decision aids, framing of the audit procedures and use of different types of audit review strategies. Future research could investigate these possible factors and the mitigating strategies that influence the effectiveness of the audit of subsequent events.

Finally, the results from the experiment may not be generalizable to US auditors, because the participants in these experiments were Malaysian and Australian auditors. It is possible that cultural differences may affect decision-makers (Keil et al. 2000; Nolder and Riley 2014). Cultural variables such as assertiveness or performance orientation may affect decision-makers across countries (House et al. 2004). However, this thesis does not expect that culture interacted with the variables of interest here, because participating auditors were from the Big 4 and mid-tier firms, all of which are members of a global audit firm network, and adopt consistent audit practices and procedures. Future research might provide more evidence of the impact of national culture on auditors' escalation tendencies.

12.5 Conclusion

This thesis contributes toward understanding the underlying causes that can affect auditors' evaluation of subsequent events, and the potential strategies that could be employed to improve the audits of subsequent events. Evidence from the PCAOB (PCAOB 2010; Chung et al. 2013) and international audit regulators (ASIC 2012; AOB

2013) indicates that there are deficiencies in the audit of subsequent events. A major issue raised by the PCAOB was that auditors do not adequately respond to subsequent events before the date of the auditor's report (e.g., SEC 2003; PCAOB 2007). This thesis provides insight into how auditors respond to subsequent events and specifically the bias to over-commit to an initial view formed during the audit process. The first study provides the insight that auditors tend to propose a significantly smaller amount of audit adjustment on a subsequent event when the event becomes known to them after they have committed to their initial position in the low-risk condition. Following the finding that auditors tend to over-commit to an initial position, the second study suggests a benefit of employing process accountability documentation in the audits of subsequent events. Specifically, auditors are less influenced by their prior commitment in proposing an audit adjustment on a subsequent event when they are expected to justify their judgment process, than those who are expected to justify their judgment outcome. Much future research, using a variety of methodologies, is still needed to fully understand the audit issues surrounding subsequent events.

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Appendices

Appendix A: Case Instrument for Study 1

Dear Sir/Madam,

INVITATION TO PARTICIPATE IN A SURVEY OF AUDITORS' EVALUATION OF SUBSEQUENT EVENTS

I am writing to you in relation to a research project that examines how auditors make judgments in the audit of subsequent events. This project is part of a doctoral thesis that I am undertaking at the Australian National University (ANU). This project aims to assist the auditing profession in obtaining a better understanding of auditors' judgments in the audit of subsequent events.

You are invited to participate in this survey if you are currently at the position of audit senior level (or at least 2 years audit experience) or above in the assurance department. This survey will take approximately 25 minutes to complete. A number of auditors from various audit firms have been invited to participate in this study. Your name or identity will not be linked in any way to the research data. No reference will be made to any individual or firm and no one will be able to trace the results back to the individual or firm involved in this study.

Your participation in this survey is important for the success of this project. I recognize that your time is valuable and I sincerely appreciate your assistance in participating in this project. In appreciation of your valuable time spent in participating in this study, you will receive AEON shopping vouchers valued at RM50 if you complete and return the questionnaire to the researcher.

Should you have any questions about the research project please contact me at soon-yeow.phang@anu.edu.au or on +614-34641007. In Malaysia, you may contact Ms. Penny Lim at poayne82@gmail.com or on 012-5349101.

Thank you for participating in this study. Your contribution is very much appreciated.

Yours sincerely,

Phang Soon Yeow

Research School of Accounting and Business Information Systems
College of Business and Economics
The Australian National University
Telephone: +612-6125 7328 (office) / +614-3464 1007 (mobile)
Email: soon-yeow.phang@anu.edu.au

Participant Information Sheet

Researcher:

Mr. Soon-Yeow Phang is a doctoral student in the Research School of Accounting and Business Information Systems at the Australian National University (ANU).

Project Title: Auditors' Evaluation of Subsequent Events

General Outline of the Project:

- The purpose of this project is to better understand how auditors make judgments in the audit of subsequent events. Auditing standard *ISA 560 Subsequent Events* defines subsequent events as “events occurring between the date of the financial report and the date of the auditors’ report, and facts that become known to the auditor after the date of the auditors’ report.” The effectiveness of the audit of subsequent events is important because this can influence audit quality. Your response to this project is important in assisting the auditing profession to obtain a better understanding of auditors’ judgments in the audit of subsequent events.
- The questionnaire takes approximately 25 minutes to complete.
- The data is being collected for a PhD thesis that will result in summary information for one or more papers to be published in peer reviewed academic journals.
- This project is funded by the Research School of Accounting and Business Information Systems at the ANU.

Participant Involvement:

Your participation in this research is voluntary. You may, without any penalty, decline to take part or withdraw from this project at any time without providing an explanation, or refuse to answer a question. To withdraw after completion of the survey, please email your request to the researcher at soon-yeow.phang@anu.edu.au. In the event of withdrawal, any data collected from the participant will not be used and will be destroyed.

In appreciation of your valuable time spent in participating in the study, you will receive shopping vouchers valued at RM50 if the questionnaire is returned to the researcher.

The researcher does not believe there are any risks, discomforts, hazards or side effects arising from participation in this project. Please be aware that your participation is voluntary with respect to all questions of the survey.

Confidentiality:

The confidentiality of individual responses will be protected as far as the law allows. Any publications will report aggregate results only and will not identify participants or their organizations. Only the researcher and supervisors of this project will have access to the data collected from the survey.

Data Storage:

All data collected will be held only by the researcher or his supervisors. It will be held on University computer hard drives requiring password access. It is anticipated that data will be held for at least 5 years after publication.

Queries and Concerns:

For any additional information or to have any questions answered, please contact Mr. Phang Soon Yeow (Primary Investigator) at soon-yeow.phang@anu.edu.au or on +612 6125 7328 or Professor Neil Fargher (Supervisor) at neil.fargher@anu.edu.au or on +612 6125 0541. In Malaysia, you may contact Ms. Penny Lim at poayne82@gmail.com or on 012-5349101.

Ethics Committee Clearance:

The ethical aspects of this research have been approved by the ANU Human Research Ethics Committee. If you have any concerns or complaints about how this research has been conducted, please contact:

Ethics Manager
The ANU Human Research Ethics Committee
The Australian National University
Telephone: +61 2 6125 3427
Email: Human.Ethics.Officer@anu.edu.au

General Instructions

Thank you in advance for your participation in this research project. Please read the following instructions before you proceed with this survey.

- This survey instrument consists of four sections as follows:
 - Section 1: Background information of the audit client.
 - Section 2: Additional information and audit evidence on subsequent event.
 - Section 3: Additional questions based on the background information.
 - Section 4: Demographic questions.
- You will be provided with case materials regarding a hypothetical audit engagement of a hypothetical company. The materials have been simplified to fit the time allowed. However, please base your responses solely on the materials provided.
- Please follow the instructions provided when recording your answers. There is no correct or incorrect response for each of the questions.

Please proceed with the survey.

SECTION 1: BACKGROUND INFORMATION AND CASE FACTS

COMPANY AND INDUSTRY BACKGROUND

Johnson Products Berhad (Johnson) is an optical equipment producer. Its made-to-order optical equipment is distributed in Malaysia and countries in South East Asia. The industry is very competitive, and product performance, reliability, price, and customer service are the primary competitive forces. Johnson is a public listed company in Malaysia. The company has a 30 June financial year end.

MANAGEMENT TEAM

The Board of Directors comprises ten people, two of whom are executive directors and the rest are non-executive directors. The audit and compensation committee are comprised entirely of non-executive directors. Board meetings are scheduled at regular intervals and the meetings typically are characterized by frank and harmonious discussions.

FINANCIAL REPORTING SUMMARY

The results of operations for 2014 and 2013 were very positive with net earnings totaling 7% and 3% of sales in the respective years. The current ratio for 2014 and 2013 is 1.45:1 and 1.30:1, respectively. Johnson has no long term debt. The company has maintained fairly steady revenue growth of 4-5% in each of the last five years. The previous three years' audits have resulted in standard, unmodified (i.e. clean) audit reports. Because of your experience with similar clients in the past, you have been asked to serve as audit manager on Johnson's audit for the financial year 2014.

SECTION 2: ADDITIONAL INFORMATION

CONFIRMATION OF THE AUDITED FINANCIAL STATEMENTS

You have presented all the audit findings to Johnson's management and conclude that there are no material misstatements in the financial statements for the financial year ended 30 June 2014. You are satisfied with the fair presentation of financial statements and propose to issue a standard unmodified audit report. Management agrees with the presentation of the audited financial statements and will organize an audit committee meeting to authorize the issuance of the audited financial statements within one week.

Johnson's management has expressed that they have strong reservations about any proposed audit adjustments that materially distort the financial performance of the company, especially after you have confirmed the fair presentation of the audited financial statements, because they have a very short time period to issue the audited financial statements to shareholders.

SUBSEQUENT EVENT

After you have confirmed the fair presentation of the financial statements to Johnson's management, you are informed by your audit team members that there is a subsequent event regarding an issue of inventory obsolescence. Today's date is August 24, 2014. Shortly you will be provided with working papers summarizing the subsequent event on an inventory obsolescence issue.

AUDIT ISSUE AND INVENTORY WRITE-DOWN ASSESSMENTS

SUMMARY OF INVENTORY OBSOLESCENCE ISSUE

The latest Board of Directors minutes have just been released. Your audit team reviewed these minutes and noted that Johnson had terminated the relationship with its major distributor after 30 June, 2014 which were holding relatively old products. Further enquiries with the production manager of Johnson revealed that some of its inventories sold before 30 June, 2014 had been returned to Johnson's warehouse because these were obsolete or damaged. A reliable industry publication recently suggested that this type of product may become obsolete very soon. There were significant increases in or excess levels of inventory in the distribution channel after the financial year ended 30 June, 2014.

ADJUSTMENTS TO WRITE-DOWN INVENTORY TO NET REALIZABLE VALUE

You and your engagement partner discussed with management a potential adjustment to write down inventory to its estimated net realizable value. This write-down could have a material impact on Johnson's financial statements.

Your partner has asked you to summarize all relevant information and provide him with your assessment of the write-down required for Johnson's inventory. He will take this into account in making his conclusions.

Excerpts from your audit team's working papers are provided on the next page.

EXCERPTS FROM WORKING PAPERS

The reported inventory in the statement of financial position as at 30 June, 2014 is RM24,000,000. Approximately RM10,080,000 (42 percent) of the ending inventory relates to the old product line marketed by the terminated major distributor, while RM13,920,000 (58 percent) relates to other types of product marketed by other distributors.

During discussions with Johnson's management, it was noted that old products would require additional investment to either negotiate contracts with new distributors or transform the old product line inventories into saleable products. Management had few plans in place to make either of these investments.

We developed the following estimates based on our knowledge of the industry and current market conditions:

Old Product Line Inventory	RM10,080,000
Percentage that could be Sold as Scrap	25%
Estimated Salvage Value of Inventory	<u>RM 2,520,000</u>
Percentage that could not be Recovered	75%
Estimated Obsolete Inventory	<u>RM 7,560,000</u>

We asked management for a report showing the breakdown of the slow-moving inventory. Johnson's accounting system cannot track inventory in real-time, so we cannot pull an aging analysis on slow-moving goods from the system. Management informed us that due to time constraints they would not be able to develop a new inventory system to track and value the existing inventory after the financial year end.

As a compensating control, the CFO had non-sales personnel conduct a physical inspection of the inventory warehouses. This process led Johnson's management to propose a considerably smaller estimate of RM3,930,000 in obsolete inventory.

Summary of the financial statements incorporating the two estimates are shown in **TABLE 1**.

The inventory write-down proposed by Johnson is based on the following assumptions made by the CFO:

1. The high inventory levels are due to Johnson's intense focus on its new marketing strategy rather than problems with selling old product line of inventory.
2. This inventory is too early in the life cycle to consider a write-down of the inventory.
3. This inventory can be written down in future periods if the products truly become unsaleable.

TABLE 1
EFFECTS OF ALTERNATIVE INVENTORY WRITE-DOWN ESTIMATES ON SELECT
FINANCIAL STATEMENT ITEMS
JOHNSON PRODUCTS

Selected Income Statement Items for the Financial Year Ended June 30, 2014
(unaudited)

	With Audit Team's Initial Estimate	With Johnson's Proposed Estimate
	RM	RM
Sales	41,610,000	41,610,000
Cost of Sales	(34,630,000)	(34,630,000)
Gross Margin	6,980,000	6,980,000
Operating Expenses	(2,110,000)	(2,110,000)
Other Expense		
Write-down of inventory to net realizable value	(7,560,000)	(3,930,000)
Net Income (Loss)	(2,690,000)	940,000

Selected Balance Sheet Items as at June 30, 2014 (unaudited)

	With Audit Team's Initial Estimate	With Johnson's Proposed Estimate
	RM	RM
Inventory	24,000,000	24,000,000
Less: Allowance to reduce inventory to net realizable value	(7,560,000)	(3,930,000)
Net Inventory	16,440,000	20,070,000
Current Assets	20,940,000	24,570,000
Current Liabilities	13,160,000	13,160,000

ASSESSMENT OF RISK OF MATERIAL MISSTATEMENT

In the audit planning section documented in the audit working papers, you noticed that there were several aspects of the control environment noted, and the preliminary assessment shows that the control environment was weak. The audit working papers show:

- 1) Johnson has a code of conduct that applies to all employees, including top management. Employees read the code of conduct on the first day of their employment and seldom review it afterwards.
- 2) The Board of Directors and the audit committee do not actively oversee Johnson's accounting and reporting policies and procedures.
- 3) Johnson has high turnover in senior management positions. It is noted that inexperienced staff hold these management positions.
- 4) Johnson does not have a well-specified organizational chart that indicates lines of authority and control-related responsibilities for management and supervisory personnel.
- 5) Although there are a large number of internal control procedures in place, they are sometimes less strictly applied.

A Few Questions Related to the Inventory Write-down Matter

INSTRUCTIONS: Please respond to the questions below. It is important that you think about what you would actually do under the circumstances. There are no “correct” answers, so respond to the questions in a manner consistent with your professional judgment. **Feel free to refer to the previous pages as you respond to these questions.**

Summary of Inventory Obsolescence Issue:

Total value of old product line inventory:	RM10,080,000
Audit team’s estimate of inventory write-down:	RM 7,560,000
Johnson’s proposed inventory write-down:	RM 3,930,000

1. What inventory write-down amount (between RM0 and RM10,080,000) is the lowest you would be willing to accept being recorded?

Lowest acceptable inventory write-down (indicate an amount in the box): RM

2. What inventory write-down amount (between RM0 and RM10,080,000) would you initially recommend to your partner to be recorded?

Inventory write-down to recommend to partner (indicate an amount in the box): RM

3. What inventory write-down amount (between RM0 and RM10,080,000) do you believe will ultimately be recorded?

Inventory write-down will ultimately be (indicate an amount in the box): RM

4. Please provide **one or two** reasons for your answers to **Questions 1 to 3:**

1. _____

2. _____

SECTION 3: ADDITIONAL QUESTIONS

INSTRUCTIONS: Please answer the following questions. Please do not turn back to any prior page. Also, please do not change any of the responses that you have already provided.

1. Which of the following item correctly states the information indicated in the situation presented in the Johnson case? Please tick ONE box only.

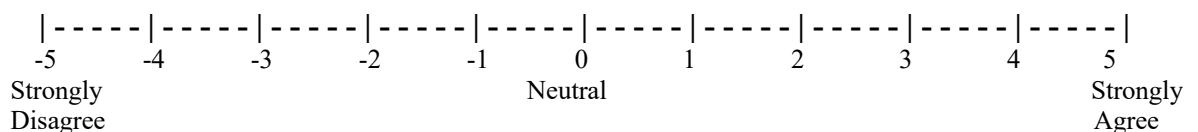
- ☐ The subsequent event of inventory valuation issues are informed by your audit team members **after** you have confirmed the fair presentation of the financial statements to Johnson's management.
- ☐ The subsequent event of inventory valuation issues are informed by your audit team members **before** you have confirmed the fair presentation of the financial statements to Johnson's management.

2. In the case you read, what is your assessment of Johnson's risk of material misstatement? Please circle a number.

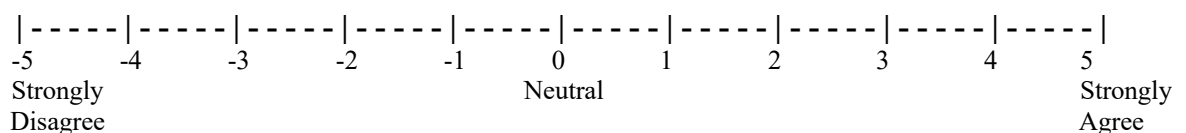


3. Do you agree to the following statements? Please circle a number.

- 3a. I was concerned that bringing-up additional audit adjustment to management after the confirmation of the fair presentation of the audited financial statement would damage my personal reputation in front of management.

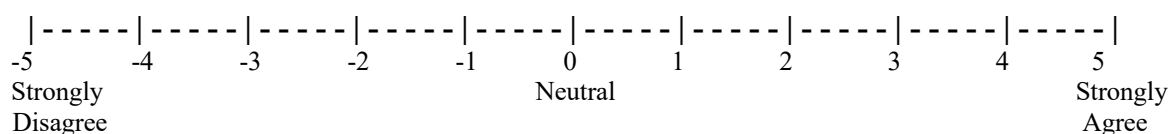


- 3b. I feel I have sufficient experience in the audit of inventory or inventory obsolescence.

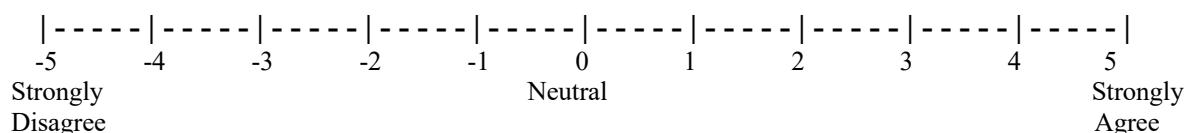


Please respond to the following three questions. Please circle a number.

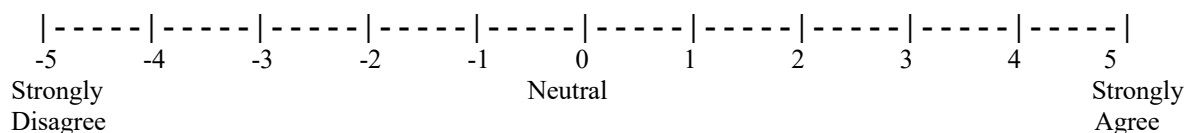
1. The experimental task was realistic to the audit duties I perform on a regular basis.



2. I felt confident to complete the experimental audit task and provide an appropriate assessment.



3. While completing the experimental task, I felt like I was involved in developing the audit team's estimate of the inventory write-down.



STATEMENTS DESCRIBING YOURSELF

INSTRUCTIONS: The statements below concern your **personal reactions** to a number of situations. No two statements are exactly alike, so consider each statement carefully before answering. If a statement is true or mostly true as applied to you, record **T** as your answer. If a statement is false or not usually true as applied to you, record **F** as your answer. It is important that you answer as frankly and as honestly as you can. Record your responses in the spaces provided on the left.

THE STATEMENTS (please record T or F)

- _____ 1. I find it hard to imitate the behavior of other people.
- _____ 2. At parties and social gatherings, I do not attempt to do or say things that others will like.
- _____ 3. I can only argue for ideas I already believe.
- _____ 4. I can make impromptu speeches even on topics about which I have almost no information.
- _____ 5. I guess I put on a show to impress or entertain people.
- _____ 6. I would probably make a good actor.
- _____ 7. In a group of people I am rarely the centre of attention.
- _____ 8. In different situations and with different people, I often act like very different person.
- _____ 9. I am not particularly good at making other people like me.
- _____ 10. I am not always the person I appear to be.
- _____ 11. I would not change my opinions (or the way I do things) in order to please someone else or win their favor.
- _____ 12. I have considered being an entertainer.
- _____ 13. I have never been good at games like charades or improvisational acting.
- _____ 14. I have trouble changing my behavior to suit different people and different situations.
- _____ 15. At a party, I let others keep the jokes and stories going.
- _____ 16. I feel a bit awkward in company and do not show up quite so well as I should.
- _____ 17. I can look anyone in the eye and tell a lie with a straight face (if for a right end).
- _____ 18. I may deceive people by being friendly when I really dislike them.

SECTION 4: DEMOGRAPHIC QUESTIONS

INSTRUCTIONS: Please provide the following information on yourself.

1. What is your **current position** at your firm? Please tick ONE box only.

☐ Audit Partner

☐ Audit Manager

☐ Audit Director

☐ Audit Assistant Manager

☐ Audit Senior Manager

☐ Audit Senior

☐ Other (Please specify): _____

2. For what **type of employer** do you currently work? Please tick ONE box only.

☐ Big-4 accounting firm

☐ Small accounting firm

☐ Medium size accounting firm

☐ Other (Please specify): _____

3. How many years have you been in your **current position**? _____ years

4. How many years of **audit-related** experience do you have? _____ years

5. What percentage of your **time is spent** performing each of the following types of tasks?

Audit= _____ %

Tax= _____ %

Consulting= _____ %

Other= _____ % (Please specify _____)

Total= _____ **100** %

6. Which **professional qualifications** do you have? Please tick the relevant box(es).

☐ MIA

☐ CIMA

☐ MICPA

☐ CPA (Australia)

☐ ACCA

☐ ICAA (Australia)

☐ ICAEW

☐ Still Seeking Professional Qualification

☐ Other (Please specify): _____

7. In approximately how many engagements have you been involved with a situation where there was a **difference in opinion between the auditor and client** on a significant accounting or auditing matter requiring resolution? Please tick ONE box only.

☐0-20

☐61-80

☐21-40

☐81-100

☐41-60

☐above 100

8. In approximately how many engagements have you been involved in the **audit of subsequent events**? Please tick ONE box only.

☐0-20

☐61-80

☐21-40

☐81-100

☐41-60

☐above 100

9. In approximately how many engagements have you been involved in the **audit of inventory**? Please tick ONE box only.

☐0-20

☐61-80

☐21-40

☐81-100

☐41-60

☐above 100

10. In approximately how many engagements have you been involved in the audit of a **public listed** company? Please tick ONE box only.

☐0-20

☐61-80

☐21-40

☐81-100

☐41-60

☐above 100

11. What is your gender?

☐Male

☐Female

**You have completed this study.
Thank you for your participation!**

Voucher Payment

Dear Participant,

In order to facilitate the payment of incentive (shopping vouchers valued at RM50), once you have completed the questionnaire, please complete this form.

Please be assured that all responses will be strictly kept confidential. Any publications will report aggregate results only and will not identify participants or their organizations.

Please return this form with the completed questionnaire to the researcher.

Name : _____

Address : _____

Email : _____

Thank you for your assistance.

Appendix B: Case Instrument for Study 2

Dear Sir/Madam,

INVITATION TO PARTICIPATE IN A SURVEY OF AUDITORS' EVALUATION OF SUBSEQUENT EVENTS

I am writing to you in relation to a research project that examines how auditors make judgments in the audits of subsequent events. This project is part of a doctoral thesis that I am undertaking at The Australian National University (ANU). This project aims to assist the auditing profession in obtaining a better understanding of auditors' judgment in the audits of subsequent events.

You are invited to participate in this survey if you are currently at the level of audit senior (or at least 2 years audit experience) or above in the assurance department. This survey will take approximately 25 minutes to complete. A number of auditors from various audit firms have been invited to participate in this study. Your name or identity will not be disclosed or linked in any way to the research data.

Your participation in this survey is important for the success of this project. I recognize that your time is valuable and I sincerely appreciate your assistance in participating in this project. In appreciation of your valuable time spent in participating in this study, you will receive a shopping voucher valued at RM50 if you complete and return the questionnaire to the researcher.

Should you have any questions about the research project please contact me at soon-yeow.phang@anu.edu.au or on +614-34641007. In Malaysia, you may contact Ms. Komala Veeriah at komala.veeriah@gmail.com or on 012-5868511.

Thank you for participating in this study. Your contribution is very much appreciated.

Yours sincerely,

Soon-Yeow Phang

Research School of Accounting
ANU College of Business and Economics
The Australian National University
ACT 2601, Australia
Telephone: +612-6125 7328 (office) / +614-3464 1007 (mobile)
Email: soon-yeow.phang@anu.edu.au

Participant Information Sheet

Mr. Soon-Yeow Phang is a doctoral student in the Research School of Accounting and Business Information Systems at the Australian National University (ANU).

Project Title: Auditors' Evaluation of Subsequent Events

General Outline of the Project:

- The purpose of this project is to better understand how auditors make judgements in the audit of subsequent events. Auditing standard *ISA 560 Subsequent Events* defines subsequent events as “events occurring between the date of the financial report and the date of the auditors’ report, and facts that become known to the auditor after the date of the auditors’ report”. Your response to this project is important in assisting the auditing profession to obtain a better understanding of auditors’ judgment in the audits of subsequent events.
- You will be given a set of materials pertaining to an inventory account for a hypothetical public client. You will be asked to evaluate the subsequent event issue after reading the materials. The materials have been simplified to fit the time allowed but I would greatly appreciate your opinion on this case. The responses you give should represent your individual judgment.
- The survey takes approximately 25 minutes to complete.
- You are invited to participate in this survey if you are currently at the level of audit senior or above in the assurance department.
- The data is being collected for a PhD thesis that will result in summary information for one or more papers to be published in peer reviewed academic journals.

Participant Involvement:

Your participation in this research is voluntary. You may, without any penalty, decline to take part or withdraw from this project without providing an explanation, or refuse to answer a question until the work is prepared for publication. To withdraw after completion of the survey, please email your request to the researcher at soon-yeow.phang@anu.edu.au. In the event of withdrawal, any data collected from the participant will not be used and will be destroyed.

It is unlikely that you will personally benefit from participating in this research, but we expect that this research will improve the understanding of the audits of subsequent events and we hope that our research findings contribute to audit practice and regulation by considering underlying causes that can influence auditors’ judgment on decisions relating to subsequent events.

In appreciation of your valuable time spent in participating in this study, you will receive shopping vouchers valued at RM50 if you submit the questionnaire to the researcher.

The researcher does not believe there are any risks, discomforts, hazards or side effects arising from participation in this project. Please be aware that your participation is voluntary with respect to all questions of the survey.

Confidentiality:

Responses will be held confidential as far as allowed by law. Any publications will report aggregate results only and will not identify participants or their organizations. Only the researcher and supervisor of this project will have access to the data collected from the survey.

Data Storage:

All data collected will be held only by the researcher or his supervisor. It will be held on University computer hard drives requiring password access. It is anticipated that data will be held for at least 5 years after publication. The data will be destroyed after the storage period. Identity records will be filed separately from the survey data.

Queries and Concerns:

For any additional information or to have any questions answered, please contact Mr. Soon-Yeow Phang (Primary Investigator) at soon-yeow.phang@anu.edu.au or on +61 2 6125 7328 or Professor Neil Fargher (Supervisor) at neil.fargher@anu.edu.au or on +61 2 6125 0541. In Malaysia, you may contact Ms. Komala Veeriah at komala.veeriah@gmail.com or on 012-5868511.

Ethics Committee Clearance:

The ethical aspects of this research have been approved by the ANU Human Research Ethics Committee. If you have any concerns or complaints about how this research has been conducted, please contact:

Ethics Manager
The ANU Human Research Ethics Committee
The Australian National University
Telephone: +61 2 6125 3427
Email: Human.Ethics.Officer@anu.edu.au

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 - Section 3: Additional questions based on the background information.
 - Section 4: Demographic questions.
- You will be provided with case materials regarding a hypothetical audit engagement of a hypothetical company. The materials have been simplified to fit the time allowed. However, please base your responses solely on the materials provided.
- It is important that you work independently of other members from your firm who are participating in this survey. Please do not discuss the contents of this study with anyone else.
- Please follow the instructions provided when recording your answers. There is no correct or incorrect response for each of the questions.

Please proceed with the survey.

SECTION 1: BACKGROUND INFORMATION AND CASE FACTS

COMPANY AND INDUSTRY BACKGROUND

Johnson Products Berhad (Johnson) is an optical equipment producer. Its made-to-order optical equipment is distributed in Malaysia and countries in South East Asia. The industry is very competitive, and product performance, reliability, price, and customer service are the primary competitive forces. Johnson is a public listed company in Malaysia. The company has a June 30 financial year end.

MANAGEMENT TEAM

The Board of Directors comprises ten people, two of whom are executive directors and the rest are non-executive directors. The audit and compensation committee are comprised entirely of non-executive directors. Board meetings are scheduled at regular intervals and the meetings typically are characterized by frank and harmonious discussions.

FINANCIAL REPORTING SUMMARY

The results of operations for 2015 and 2014 were very positive with net earnings totaling 7% and 3% of sales in the respective years. The current ratio for 2015 and 2014 is 1.45:1 and 1.30:1, respectively. Johnson has no long term debt. The company has maintained fairly steady revenue growth of 4-5% in each of the last five years. The previous three years' audits have resulted in standard, unmodified (i.e. clean) audit reports. The risk of material misstatement for 2015 audit is assessed as low in the audit planning section.

Because of your experience with similar clients in the past, you have been asked to serve as audit manager on Johnson's audit for the financial year 2015.

SECTION 2: ADDITIONAL INFORMATION

PRESENTATION OF THE AUDITED FINANCIAL STATEMENTS

You have presented all the audit findings and reported the fair presentation of the financial statements to Johnson's management for the financial year ended June 30, 2015. Johnson's management has expressed that they have strong reservations about any proposed audit adjustments that materially distort the financial performance of the company, especially after you have confirmed the fair presentation of the audited financial statements, because they have a very short time period to issue the audited financial statements to shareholders.

SUBSEQUENT EVENT

After you have presented the audited financial statements and reported the fair presentation of the financial statements to Johnson's management, you are informed by your audit team members that there is a subsequent event regarding an issue of inventory obsolescence. Today's date is August 24, 2015.

Shortly you will be provided with working papers summarizing the subsequent event on an inventory obsolescence issue.

AUDIT ISSUE AND INVENTORY WRITE-DOWN ASSESSMENTS

SUMMARY OF INVENTORY OBSOLESCENCE ISSUE

The latest Board of Directors minutes have just been released. Your audit team reviewed these minutes and noted that Johnson had terminated the relationship with its major distributor after June 30, 2015 whose was holding relatively old products. Further enquiries with Johnson's production manager revealed that some of its inventories sold before June 30, 2015 had been returned to Johnson's warehouse because these were obsolete or damaged. A reliable industry publication recently suggested that this type of product may become obsolete very soon. There were significant increases in, or excess levels of, inventory in the distribution channel after the financial year ended June 30, 2015.

ADJUSTMENTS TO WRITE-DOWN INVENTORY TO NET REALIZABLE VALUE

You and your engagement partner discussed with Johnson's management a potential adjustment to write down inventory to its estimated net realizable value. This write-down could have a material impact on Johnson's financial statements.

Excerpts from your audit team's working papers are provided on the next page.

EXCERPTS FROM WORKING PAPERS

The reported inventory in the statement of financial position as at June 30, 2015 is RM24,000,000. Approximately RM10,080,000 (42 percent) of the ending inventory relates to the old product line marketed by the terminated major distributor, while RM13,920,000 (58 percent) relates to other types of product marketed by other distributors.

During discussions with Johnson's management, it was noted that old products would require additional investment to either negotiate contracts with new distributors or transform the old product line inventories into saleable products. Management had few plans in place to make either of these investments.

We developed the following estimates based on our knowledge of the industry and current market conditions:

Old Product Line Inventory	RM10,080,000
Percentage that could be Sold as Scrap	25%
Estimated Salvage Value of Inventory	<u>RM 2,520,000</u>
Percentage that could not be Recovered	75%
Estimated Obsolete Inventory	<u>RM 7,560,000</u>

We asked management for a report showing the breakdown of the slow-moving inventory. Johnson's accounting system cannot track inventory in real-time, so we cannot pull an aging analysis on slow-moving goods from the system. Management informed us that due to time constraints they would not be able to develop a new inventory system to track and value the existing inventory after the financial year end.

As a compensating control, the CFO had non-sales personnel conduct a physical inspection of the inventory warehouses. This process led Johnson's management to propose a considerably smaller estimate of RM3,930,000 in obsolete inventory.

The inventory write-down proposed by Johnson is based on the following assumptions made by the CFO:

1. The high inventory levels are due to Johnson's intense focus on its new marketing strategy rather than problems with selling their old product line of inventory.
2. This inventory is too early in the product life cycle to consider a write-down of the inventory.
3. This inventory can be written down in future periods if the products truly become unsaleable.

A summary of the financial statements incorporating the two estimates are shown in **TABLE 1**.

TABLE 1
EFFECTS OF ALTERNATIVE INVENTORY WRITE-DOWN ESTIMATES ON SELECT
FINANCIAL STATEMENT ITEMS
JOHNSON PRODUCTS

Selected Income Statement Items for the Financial Year Ended June 30, 2015 (unaudited)

	With Audit Team's Initial Estimate	With Johnson's Proposed Estimate
	RM	RM
Sales	41,610,000	41,610,000
Cost of Sales	(34,630,000)	(34,630,000)
Gross Margin	6,980,000	6,980,000
Operating Expenses	(2,110,000)	(2,110,000)
Other Expense		
Write-down of inventory to net realizable value	(7,560,000)	(3,930,000)
Net Income (Loss)	(2,690,000)	940,000

Selected Balance Sheet Items as at June 30, 2015 (unaudited)

	With Audit Team's Initial Estimate	With Johnson's Proposed Estimate
	RM	RM
Inventory	24,000,000	24,000,000
Less: Allowance to reduce inventory to net realizable value	(7,560,000)	(3,930,000)
Net Inventory	16,440,000	20,070,000
Current Assets	20,940,000	24,570,000
Current Liabilities	13,160,000	13,160,000

DOCUMENTATION REQUIREMENTS

Your engagement partner is interested in the process you will use to reach your conclusion regarding the inventory written-down amount.

Please justify your judgment process by documenting how you have considered each piece of evidence item and how you consolidated this information to reach your conclusion about the proposed audit adjustment on the inventory written-down amount. It is important to this research that some documentation is included in the space provided (Please provide two or three justifications):

Question Related to the Inventory Write-down Matter

INSTRUCTIONS: Please respond to the question below. It is important that you think about what you would actually do under the circumstances. There are no “correct” answers, so respond to the question in a manner consistent with your professional judgment. Feel free to refer to the previous pages as you respond to the question.

Summary of Inventory Obsolescence Issue:

Total value of old product line inventory:	RM10,080,000
Audit team’s estimate of inventory write-down:	RM 7,560,000
Johnson’s proposed inventory write-down:	RM 3,930,000

Question

Based on your documentation, what inventory write-down amount (between RM0 and RM10,080,000) is the lowest you would be willing to accept being recorded?

Lowest acceptable inventory write-down (indicate an amount in the box): RM

SECTION 3: ADDITIONAL QUESTIONS

INSTRUCTIONS: Please answer the following questions. Please do not turn back to any prior page. Also, please do not change any of the responses that you have already provided.

1. **In the case you read**, which of the following items most appropriately describe the situation presented in the Johnson case? Please tick ONE box only.

☐ After you have reported the fair presentation of the financial statements to the Johnson's management, you are informed by your audit team members that there is a subsequent event regarding an issue of inventory obsolescence.

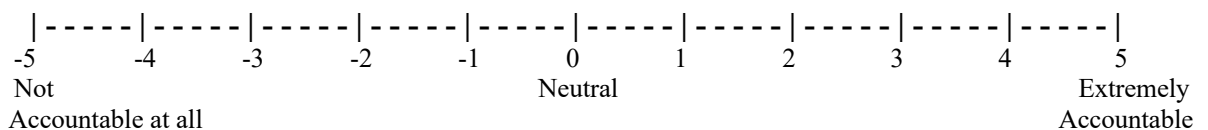
☐ Before you report the fair presentation of the financial statements to the Johnson's management, you are informed by your audit team members that there is a subsequent event regarding an issue of inventory obsolescence.

2. **In the case you read**, which of the following do you feel more accountable for?
Please tick ONE box only.

☐ The process you used leading up to a conclusion regarding the proposed audit adjustment on the inventory written-down amount.

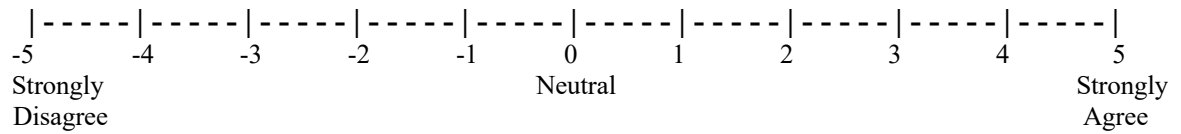
☐ The final decision on the proposed audit adjustment on the inventory written-down amount.

3. **In the case you read**, to what extent did you feel accountable to the engagement partner?

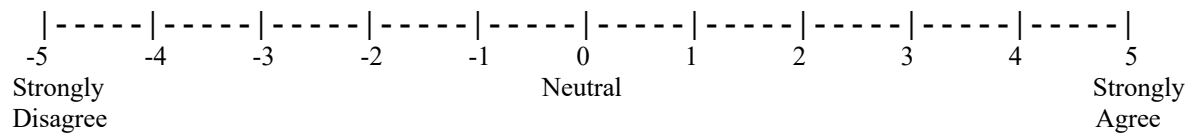


4. Please respond to the following three questions. Please circle a number.

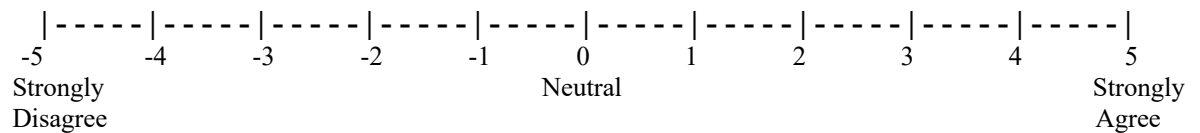
a. The experimental task was realistic to the audit duties I perform on a regular basis.



b. I felt confident to complete the experimental audit task and provide an appropriate assessment.



c. While completing the experimental task, I felt like I was involved in developing the audit team's estimate of the inventory write-down.



SECTION 4: DEMOGRAPHIC QUESTIONS

INSTRUCTIONS: Please provide the following information on yourself.

1. What is your **current role** at your firm? Please tick ONE box only.

- | | |
|--|--|
| ☐ Audit Partner | ☐ Audit Manager |
| ☐ Audit Director | ☐ Audit Assistant Manager |
| ☐ Audit Senior Manager | ☐ Audit Senior |
| ☐ Other (Please specify): _____ | |

2. For what **type of employer** do you currently work? Please tick ONE box only.

- | | |
|--|--|
| ☐ Big-4 accounting firm | ☐ Small accounting firm |
| ☐ Medium size accounting firm | ☐ Other (Please specify: _____) |

3. How many years of **audit-related** experience do you have? _____ years

4. What percentage of your **time is spent** performing each of the following types of tasks?

Audit =	_____ %
Tax =	_____ %
Consulting =	_____ %
Other =	_____ % (Please specify): _____
Total=	100 %

5. Which **professional qualifications** do you have? Please tick the relevant box(es).

- | | |
|--|---|
| ☐ MIA | ☐ CPA (Australia) |
| ☐ MICPA | ☐ ICAA (Australia) |
| ☐ ACCA | ☐ Still Seeking Professional |
| ☐ ICAEW | Qualification |
| ☐ Other (Please specify): _____ | |

6. In approximately how many engagements have you been involved with a situation where there was a **difference in opinion between the auditor and client** on a significant accounting or auditing matter requiring resolution?

7. In approximately how many engagements have you been involved in the **audit of subsequent events**?

8. In approximately how many engagements have you been involved in the **audit of inventory**?

9. In approximately how many engagements have you been involved in the audit of a **public listed** company?

10. What is your gender?

☐ Male

☐ Female

☐ Other

**You have completed this study.
Thank you for your participation!**

Voucher Payment

Dear Participant,

In order to facilitate the payment (a shopping voucher valued at RM50), once you have completed the questionnaire, please complete this form.

For this survey to be more useful, please ensure that you have completed the section on the documentation requirements. Thank you.

Please be assured that all responses will be strictly kept confidential. Any publications will report aggregate results only and will not identify participants or their organizations.

Please return this form with the completed questionnaire to the researcher.

Name : _____
Address : _____

Email : _____

Thank you for your assistance.