

AUDITOR PROFESSIONAL SCEPTICISM: IMPACT OF TRUST AND DISTRUST

A SYNTHESIS OF RESEARCH FINDINGS

BE HEARD.
BE RECOGNISED.



CONTENTS

INTRODUCTION	3
IMPLICATIONS OF REDUCED TRUST AND INCREASED DISTRUST	4
DIMENSIONS OF TRUST AND DISTRUST	4
– Dispositional Trust and Distrust	4
– Situational Trust and Distrust	5
CHALLENGES IN MODIFYING DISPOSITIONAL TRUST AND DISTRUST	6
APPLYING SITUATIONAL TRUST AND DISTRUST	7
CONCLUDING COMMENTS	8

AUTHORS

Noel Harding PhD CPA, Business School – UNSW Australia

Mohammad I. Azim PhD CPA, Swinburne Business School – Swinburne University of Technology

Radzi Jidin PhD CPA, Tasmanian School of Business and Economics – University of Tasmania

Janine P. Muir PhD CPA, Swinburne Business School – Swinburne University of Technology

CPA Australia would like to thank for their ongoing support:

The Auditing and Assurance Special Interest Group of the Accounting and Finance Association of Australia and New Zealand (AFAANZ)

Claire Grayston, CPA Australia

CPA Australia Ltd ('CPA Australia') is one of the world's largest accounting bodies representing more than 155,000 members of the financial, accounting and business profession in 118 countries. For information about CPA Australia, visit our website cpaaustralia.com.au

First published July 2016

CPA Australia Ltd

ACN 008 392 452

Level 20, 28 Freshwater Place

SOUTHBANK VIC 3006

Australia

Copyright © CPA Australia Ltd ("CPA Australia") (ABN 64 008 392 452), 2016. All rights reserved. All trademarks and trade names are proprietary to CPA Australia and must not be downloaded, reproduced or otherwise used without the express consent of CPA Australia. You may access and display these materials on your computer, monitor or other video display device and make one printed copy of any whole page or pages for your personal use only. Other than for the purposes of and subject to the conditions prescribed under the Copyright Act 1968 (Cth) (or any other applicable legislation throughout the world), or as otherwise provided for herein, you may not use these materials in any manner without the prior written permission of the copyright owner.

CPA Australia and the authors have used reasonable care and skill in compiling the content of these materials. However, CPA Australia makes no warranty as to the accuracy or completeness of any information contained therein nor does CPA Australia accept responsibility for any acts or omissions in reliance upon these materials. These materials are intended to be a guide only and no part is intended to be advice, whether legal or professional. All persons are advised to seek professional advice to keep abreast of any legal or other reforms and developments. To the extent permitted by applicable law, CPA Australia, its employees, agents and consultants exclude all liability for any loss or damage claims and expenses including but not limited to legal costs, indirect special or consequential loss or damage (including but not limited to, negligence) arising out of the information in the materials. Where any law prohibits the exclusion of such liability, CPA Australia limits its liability to the resupply of the information.

INTRODUCTION

While professional scepticism has long been recognised as an important contributor to audit quality, the exercise of an appropriate level of professional scepticism continues to challenge the audit profession. Although improvements have been acknowledged, global professional accounting bodies (including CPA Australia) and global regulators / inspectors (including the Australian Securities and Investments Commission) continue to express concerns with regard to the application of insufficient levels of professional scepticism in the conduct of an audit. Often this is discussed in terms of auditors being too trusting of client management.

This publication is a summary of a synthesis on research examining trust and distrust with regard to the exercise of professional scepticism in an audit setting.

Trust and distrust are emphasised as distinct dimensions, and not, as they have traditionally been viewed, extremes on a single continuum. Recognising this allows for a realisation that low levels of professional scepticism may be as much about auditors being insufficiently distrusting of management as they are about auditors being overly trusting of management. Accordingly, the opportunities and challenges in elevating professional scepticism should be considered with reference to both tempering trust and elevating distrust. It is important to emphasise, however, comments and suggestions in this publication are based on inferences drawn from research often undertaken in domains other than auditing.

While these inferences point towards potentially productive ways in which auditors may be helped to exercise an appropriate level of professional scepticism, it is recognised that auditing is a unique discipline, and it is important to first subject the suggestions put forward to rigorous empirical investigation in an audit setting prior to their implementation in practice.

For a more detailed discussion about trust and distrust as they relate to professional scepticism in an audit setting, refer to the full research paper in the *Australian Accounting Review*¹.

1. The unabridged academic paper, which references the research on which this paper is based, is available online at the *Australian Accounting Review*: <http://onlinelibrary.wiley.com/doi/10.1111/auar.12126/full>
It has also been accepted for publication in a forthcoming printed issue.

IMPLICATIONS OF REDUCED TRUST AND INCREASED DISTRUST

While a tempering of trust and / or an increase in distrust are promising means by which auditors may be helped to exercise an elevated level of professional scepticism, trust has long been recognised as a fundamental and essential element of a successful audit. Lower levels of trust may be reciprocated with less compliance from management as the adversarial atmosphere intensifies. This then creates a number of concerns about the effective and efficient conduct of an audit. Recognising the challenges that auditors face in tempering trust and elevating distrust (issues which are discussed in this summary), attention should also be directed to means by which auditors may be encouraged to exercise an elevated level of professional scepticism that are independent of trust and distrust.

DIMENSIONS OF TRUST AND DISTRUST

Trust and distrust exist along different dimensions, initiate different responses and, importantly, can concurrently exist. That is, individuals can concurrently hold feelings of trust, which is confidence in the potential positive implications of another's actions, and distrust, which is concern for the potential negative implications of those actions. Higher levels of distrust encourage greater questioning and critical assessment. Importantly, both trust and distrust have dispositional (trait) and situational (state) dimensions.

DISPOSITIONAL TRUST AND DISTRUST

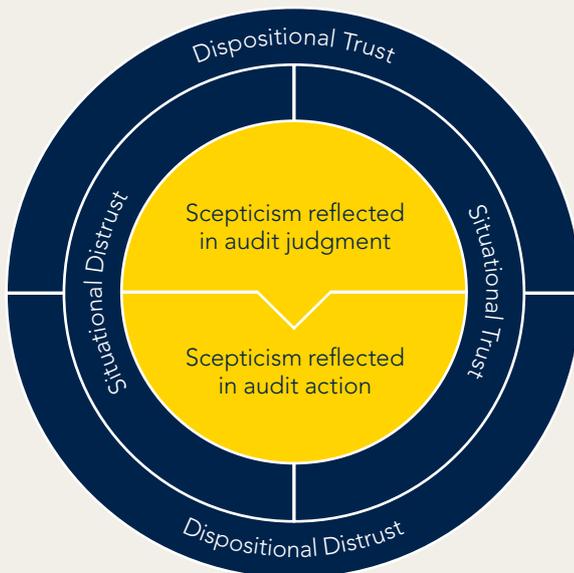
Individuals vary in the extent to which their personality predisposes them to be trusting and distrusting. That is, irrespective of the specific circumstances in each setting, some people will be more or less trusting and distrusting than others. This is referred to as dispositional trust and dispositional distrust.

Dispositional characteristics develop over a lifetime as interpersonal expectations are realised or violated. Repeated instances in which the vulnerability associated with the extension of trust has been honoured without abuse encourages the development of a disposition towards trust. In circumstances where the extension of trust is repeatedly violated and beliefs in the need to look after oneself as no one else will are reinforced, a disposition towards distrust develops. In general, life experiences encourage a disposition towards trust and discourage a disposition towards distrust, so much so that a disposition towards trust has been noted as one of the most basic human motivations. Existing research reveals that auditors with lower levels of dispositional trust make more sceptical judgements and are more focussed on evidence indicating potential financial statement fraud.

SITUATIONAL TRUST AND DISTRUST

The circumstances in each unique setting (for example, a manager’s reputation) are perceived through the underlying disposition towards trust and distrust so as to determine the level of trust and distrust exercised when making specific judgments and decisions (for example, the extent to which the manager’s representation is to be believed). This is referred to as situational trust and situational distrust, and is likely to be an important contributor to the level of professional scepticism being exercised. While the particular circumstances in each setting are important in determining the level of situational trust and situational distrust, the fact that these circumstances are perceived through underlying dispositions highlights the significance of dispositional trust and disposition distrust in determining the level of situational trust and distrust, and most likely the level of professional scepticism exercised when making judgments and decisions.

Although the precise nature of the way in which dispositional and situational trust and distrust impacts on sceptical judgements and sceptical actions is far from clear, research to date suggests that, while both are important, dispositional characteristics may play a more significant role than situational characteristics. Dispositional trust and distrust influence not only the way circumstances are perceived, thereby impacting on the level of situational trust and distrust, but also the extent to which these situational characteristics impact on audit judgments and audit actions.



Relationship between Dispositional and Situational Trust and Distrust and the Level of Scepticism Reflected in Audit Judgments and Audit Actions

CHALLENGES IN MODIFYING DISPOSITIONAL TRUST AND DISTRUST

Given the pervasive influence of dispositional characteristics on the level of trust and distrust being exercised in a given setting, and the fact that auditors, consistent with the general population, are likely to be more trusting than distrusting, there are challenges associated with encouraging greater levels of professional scepticism by way of increased distrust and lower levels of trust.

Attempts to elevate the level of professional scepticism being exercised by increasing an auditor's dispositional distrust or decreasing their dispositional trust are discouraged. Not only would this be extremely difficult, but such a change in underlying dispositions would pervade all aspects of the auditor's life, and not be restricted to an audit setting. Rather, it is suggested that attempts be made to quarantine increased levels of distrust and decreased levels of trust to audit settings by focussing on the salience of relevant situational characteristics.

Note that a given level of dispositional trust and a given level of dispositional distrust are more likely to be activated, respectively, in low risk and high risk settings. Making the risks inherent in the audit function more salient, including personal risks to lower level audit staff (for example, loss of employment) may discourage the application of a given level of trust and encourage the application of a given level of distrust. In doing so, this may increase the audit wide level of professional scepticism being exercised by the audit team.

The concern here is that while senior members of the audit team are likely to be acutely aware of what is at stake when making audit judgments and decisions, auditors at lower hierarchical levels may not have internalised the risks of, for example, not identifying and documenting an internal control exception. Recognising the high risks inherent in all aspects of audit work may encourage, more than would otherwise be the case, auditors to filter the circumstances in each setting through underlying dispositions towards distrust.

While there are challenges in modifying underlying dispositions, highlighting characteristics of the decision setting which are pertinent to an assessment of the amount of trust and distrust that should be extended may be beneficial in helping auditors exercise an appropriate level of professional scepticism. Those with lower levels of dispositional trust and / or higher levels of dispositional distrust are, for a given portfolio of circumstances, likely to exercise greater levels of professional scepticism than those with higher levels of dispositional trust and / or lower levels of dispositional distrust. Emphasising characteristics of the decision setting that point to the appropriateness of more distrust, however, will likely increase professional scepticism, irrespective of the underlying dispositions. This might be achieved by identifying which characteristics are relevant to a determination of an appropriate level of distrust, and prompting auditors to be vigilant for the presence of these characteristics.

APPLYING SITUATIONAL TRUST AND DISTRUST

Two types of situational trust / distrust, identification based and calculus based can be identified.

Identification based trust and distrust are functions of deep personal interaction. Identification based trust develops when one identifies with the values of the other such that they may act as their agent. It is normally present in close personal relationships that develop over time, but can also arise in business relationships. Issues of independence, including partner and firm rotation, address, among other issues, the potential for excessive levels of identification based trust to negatively impact on professional scepticism, and efforts should continue to limit the extent to which auditors identify with their clients.

Identification based distrust arises from a perceived lack of common values and goals. Instances of cross nation distrust, as an example, primarily have their origins from this source. Interactions characterised by identification based distrust are normally not continued and where interaction does continue, it is normally characterised by ineffective actions and outcomes. While there may be some merit in increasing professional scepticism by focusing on identification based trust, caution is warranted when attempting to increase professional scepticism with a focus on identification based distrust. A broad distrust of management, without discrimination, is not only unjustified, but would also most likely be counterproductive.

Calculus based trust and distrust, however, provide fertile ground within which to consider avenues to elevate professional scepticism. Calculus based trust and distrust is a function of the perceived rewards and consequences of behaviour. Trust is engendered in circumstances where the individual perceives significant sanctions imposed on the other person for inappropriate behaviour, but is inhibited by the realisation that the other person benefits from inappropriate behaviour.

Distrust is engendered when the individual realises that the cost of extending trust (for example, that actions taken on the basis of that trust may lead to personally detrimental outcomes) exceed the benefits of doing so (for example, that there may be some personally favourable outcome derived from the extension of trust). Note that trust is a function of the way in which an individual perceives implications for the other person whereas distrust is a function of the way in which the individual perceives implications for themselves.

To illustrate, consider a situation where client personnel are arguing for the collectability of a long-outstanding debtor balance. In this situation, trust is impacted by the perceived benefits that client personnel derive from not exercising the effort necessary to accurately make the assessment (for example, being able to focus on other more important aspects of their work) compared to the perceived sanctions imposed on client personnel for not accurately assessing the likelihood of being able to collect the balance. These may be external sanctions such as censure by their superiors and / or internal sanctions such as feelings of shame and regret. Distrust is engendered to the extent that the auditor perceives that the potential costs associated with extending trust (for example, a poor evaluation from superiors should the debtor balance prove to be uncollectible) exceed the benefits of not fully completing the work (for example, submitting incomplete work in order to meet the budget).

Most of the focus in the auditing literature has been on calculus based trust, in particular management integrity or a lack thereof. Almost no attention has been focused on calculus based distrust. Consideration of the various dimensions of calculus based trust and distrust will help to highlight new and potentially productive ways in which to encourage auditors to exercise an elevated level of professional scepticism.

CONCLUDING COMMENTS

Whilst the application of lower levels of trust and higher levels of distrust in client management by auditors will most likely elevate the level of professional scepticism auditors exercise, this research synthesis highlights the challenges in achieving this. Dispositional (trait) trust and distrust, which have developed over a lifetime of experiences, are relatively immutable. Decreases in identification based situational trust and increases in identification based situational distrust, while possible, must be considered with reference to the implications this will have on the overall conduct of an audit, in particular, the challenges this will create with regard to working with less compliant and less cooperative management following the expression of greater levels of distrust.

Elevating professional scepticism by way of tempering calculus based trust and increasing calculus based distrust, however, show potential. Auditors could be directed towards a consideration of the implications for client personnel of being diligent versus negligent, or honest versus deceptive. Auditors recognising that there are few sanctions on management for making incorrect judgments, and that management may benefit from misrepresentations, may temper levels of situational trust, thereby elevating professional scepticism. Auditors could also be mindful of the potential personally detrimental outcomes associated with relying on management's representations and the limited benefits of doing so. This may increase the level of distrust, thereby increasing the level of professional scepticism being exercised.

In conclusion, while a focus on distrust, in addition to trust, has the potential to elevate professional scepticism beyond that which has traditionally been the case, the dominance of dispositional dimensions of trust and distrust (which are relatively immutable) likely means that changes will be at the margin. Given the challenges of encouraging auditors to counter strong underlying dispositions favouring trust and discouraging distrust, in addition to examining ways to elevate professional scepticism by tempering trust and increasing distrust, there is a need to consider avenues independent of trust and distrust through which professional scepticism may be increased. For example, research on encouraging auditors to approach the problem in a particular manner (such as thinking more broadly and to consider all sides of an argument) are showing promise. Nevertheless, the perceived rewards and consequences of behaviour which drive calculus based trust and distrust is noted as an area of considerable potential to elevate professional scepticism and is worthy of further exploration.

Auditors face considerable challenges in elevating professional scepticism. A recognition that a low level of professional scepticism may be as much about insufficient levels of distrust as it is about excessive levels of trust, has potential benefits to auditors in helping them meet society's expectations for seemingly ever increasing levels of professional scepticism. Leveraging off the insights summarised here, the authors are currently investigating the merit of some of the suggested avenues by which professional scepticism may be increased.