

DYSFUNCTIONAL AUDIT BEHAVIORS: AN EXPLORATORY STUDY IN PAKISTAN

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ABSTRACT

Over the last three decades, interest in identifying what factors can lead dysfunctional audit behavior has proliferated. Notably, collapse of Enron (2001) and Arthur Andersen LLP, it has become common to criticize audit firms. Shockingly, recent Satyam (India's Enron, 2009) has amplified concerns by many researchers. This study aims to draw attention of Institute of Chartered Accountants of Pakistan towards occurrences of dysfunctional audit behaviors among auditors. This is a timely and important accounting text that provides its readers with an intelligent and comprehensible explanation of when, how and why auditors in Pakistan resort dysfunctional audit behavior. In this study, the organizational behavior and industrial psychology literatures provide the basis for developing and testing a model that identifies that emotional intelligence moderate the relationship between professional skepticism, time budget pressure, under reporting of time and premature sign off behaviors.

KEYWORDS: Professional Skepticism, Emotional Intelligence, Dysfunctional Audit Behaviors, Pakistan.

1. INTRODUCTION

Over the last three decades, interest in identifying what factors can lead to a quality audit has proliferated [1] including the United States [2, 3]; the United Kingdom [4]; France [5]; Australia [6]; Ireland [7, 8]; Malaysia [9]; and China [10]. Importantly, collapse of Enron in 2001 and the following demise of Arthur Andersen LLP, it has become common to criticize audit firms credibility, collectively the Big4 [1]. It is noted that despite the flowering research on audit quality, literature reveals that the quality of an audit can be harmed by dysfunctional audit behaviors [11]. Typically, these dysfunctional audit behaviors take the form of actions on the part of an auditor during the audit that compromises the reliability of evidence [12]. Often produce catastrophic outcomes at all levels; individuals, organizations, and society [9]. In most of the studies these behaviors have been investigated either through survey or experiment [1]. However, over time, these incidents will damage the reputation of the individual auditors and the firm [13].

2. RESEARCH FOCUS

Majority of the literature has focused on investigating the financial and regulatory consequences of dysfunctional audit behaviors [14, 15]. However, researchers are still struggling to dig out the factors that identify ways to reduce occurrences of dysfunctional audit behaviors. This study is an effort to fill this gap. In the present study, two widely researched dysfunctional audit behaviors are taken as a research topic. These are premature sign-off [1, 16, 17] and underreporting of time [18]. Both behaviors involve falsifying reports and disregarding auditing standards and the professional policies of the accounting firm [11]. Firstly, the study sets out to examine these behaviors in Pakistani context.

Secondly, this study will examine the relationship between professional skepticism, emotional intelligence, under reporting of time and premature sign-off behaviors among auditors in Pakistan. Notably, this research proposes the concept of emotional intelligence as moderator in the proposed framework (Figure 1). The studies of emotional intelligence in multidisciplinary settings have shown outstanding results either theoretical or empirical to understand the construct and its work-related outcomes. In auditing context, few attempts have been made to understand the relationship between emotional intelligence and auditor's performance [19-23] especially in terms of empirical findings, with the exception of a couple of studies that looked at the university students [23]. Another study conducted by [78] that focused on the development of emotional intelligence in business alumnae. Yet much is to be explored. [83] raised the call for study the role of emotional intelligence with the performance of auditors. Akerjordet and Severinsson [24] stressed that despite of several empirical findings; different approaches are still required in order to further expand the theoretical, empirical and philosophical basis of emotional intelligence. Emotional intelligence is not limited to being professional behavior at workplace rather it can also be seen as application of empathy during the performance review process. Rather, this concept can fabricate more positive outcomes [25]. It is noted that the results of past studies on dysfunctional audit behavior either lacking in highlighting the importance of behavioral skill (e.g., emotional intelligence) or not strongly supported. On a similar note, the lack of a consistent definition of professional skepticism and the need for more guidance indicates that more research is needed [28]. International regulator has agreed that auditors' must exercise professional judgment or skepticism; however, they could not educate nor guide the auditor about how to decrease judgment errors during audit evidence testing [26]. Researchers suggested that auditing standards must provide better guidance on how to implement professional skepticism [27]. The purpose of this paper is to review relevant emotional intelligence and Professional Skepticism (PS) literature to identify practical approaches to the application of these two concepts to reduce dysfunctional audit behaviors.

3. LITERATURE REVIEW AND RESEARCH QUESTIONS

3.1 Dysfunctional Audit Behavior (DAB)

These behaviors often termed as "Quality Threatening Behaviors (QTB)" [12]. [12], defined these behaviors as an intentional action taken by an auditor during an audit that brings negative consequences for the firm, individual auditor and the entire profession [12]. Bedard, [37] classified these behaviors as anti-social behaviors in accounting and auditing profession and viewed Paul *et al.*, [38], classified the term dysfunctional audit behaviors as the improper verification of items in a sample and the auditors' acceptance of questionable evidence at face value. When evidence is not diligently gathered and examined, errors maybe missed that would otherwise be picked up by an extensive review of the evidence. Paul *et al.*, [38], further states that typically, this type of dysfunctional audit behavior occurs in firms with complex hierarchies (Big4) with complex time budgets, procedures and with supervision that is more stringent.

These efforts at domain definition generally involve a focus on auditors' intentional behavior to perform. Many researchers agreed that if an auditor engages in either under reporting time or premature sign-off behaviors, they are more likely to engage in further dysfunctional behaviors [9, 39]. Commonly, while conducting audit tests, staff auditors agreed with doubtful audit evidence; slipping off information that should have been gathered; execute only a superficial review of documentation; and select the wrong sample to test because the right sample might indicate difficulties of inspection [40]. According to [41] these two contradict the policies of auditing firms and professional codes of conduct and allow auditors to manipulate procedures to cover up wrong doing on the part of an organization. These behaviors can be the complete disregard of auditing rules or they may simply be

innocent mistakes made by auditors who do not understand their work related demands, or are beyond their abilities or level of competence.

3.2 Under Reporting Of Time (URT)

Under reporting of time is motivated by a desire to avoid or minimize budget over-runs, it can seriously and negatively affect the audit firm [7]. In accounting firms, chargeable hours are used to invoice clients for the work done, set time budgets, and evaluate employee performance [3]. When auditors charge-hours report incorrectly, the profitability of a firm is compromised [42]. If time budget is not revised, it increases the possibility that insufficient time will be allotted for future audits [43]. Under reporting of time has the potential to put senior auditing staff in a position where they might manipulate evidence and produce an audit of poor quality, which could lead to a compromised audit environment and even an auditing disaster [4, 7, 8, 12, 44, 45]. Otley and Pierce [7], noted that under high level of time budget pressure feelings of disillusionment and indifference occurs, and the quality of work carried out might be suffered or suspect. Cook and Kelley [46], found that over half of New Zealand's senior and junior auditors under report their time, at least occasionally. Otley and Pierce [7] and Coram *et al.*, [39] found similar levels of results in Ireland and in Australian context. Dirsmith and Covaleski [47], viewed underreporting time as a way to prove one's loyalty to the firm [8, 48]. [49], stated that auditors did not willingly engage in underreporting time when tighter supervision was in place. Under tight supervision, auditors reported inappropriate behavior to their supervisor. Implicit or explicit requests were not the only factors related to increased incidents of under reporting time but lack of oversight and level of moral reasoning were other factor that caused auditors to under report time. However, in any case, this behavior is prohibited in professional standards and it is against the firm policy. The specific question addressed in this study on URT is:

RQ1: Do auditors in Pakistan under report their time?

3.3 Premature Sign-Off Behaviors (PMSO)

Premature sign-off has been explained as occurring, "when an auditor actually sign-off on required audit procedures without going through complete and required audit procedure" [12]. These behaviors highlighted first time in a survey conducted by [2]; the 60% of respondents admitted to premature sign-off (PMSO) behaviors provided the reasons such that deadline pressure, did not recognize the importance of the audit step, did not understand the audit step, the client had imposed a tight deadline, laziness and boredom, lack of training and experience. [2] initial study was followed by several others researchers. Poor staff evaluation and unfeasible future budgets were the most studied factors [3-5, 7, 12, 39, 50-57].

Qianhua and Akers [58], states that premature sign-offs behaviors affect not only the quality of internal audits but they also affects any subsequent external audits that rely on the quality of internal audits. However, external auditors are also respected to the same types of dysfunctional audit behaviors as internal auditors. Qianhua and Akers [58] and Azad (1994) further provided reasons that included; accepting the explanations provided by the client, belief that the auditing step is not relevant, lack of instruction, lack of communication with supervisors, lack of experience in technical matters, unrealistic or challenging deadlines. [1], asked senior auditors, managers and partners to report how many times they had detected premature sign-off behaviors under supervision. Many participants reported that they had discovered intentional false sign-offs, but many more reported that they had uncovered unintentional false sign-offs. Back in 1995, [52] investigated how firms dealt with premature signoff (PMSO) behavior that was thought to have occurred because prior instances had not been sufficiently

discouraged. He found that audit supervisors who discover premature sign-off did not always report the behavior as required by firm policy if the employee had a good work history or if the audit step was deemed unnecessary.

Based on discussion next research question is:

RQ2: Do auditors in Pakistan engage in PMSO behaviors?

3.4 Professional Skepticism (PS) and Dysfunctional Audit Behavior (DAB)

Professional skepticism is perceived as an important audit trait that is intrinsic to the audit process and provides the foundation to detecting fraud [30]. SEC enforcement actions highlighted that lack of skepticism a prime cause of audit failure [32]. More than half (60%) of enforcement actions by the Securities and Exchange Commission (SEC) between 1987 and 1997 involved auditors who did not use Professional Skepticism (PS) [32]. PCAOB report revealed that most of the deficiencies from 2004 to 2007 for domestic audit firms were caused by a lack of auditor skepticism (PCAOB Release No. 2008-008, 2008). The PCAOB [33] found that several audit firms failed to collect, test, investigate, evaluate, challenge, and examine evidence and thus could not claim that their opinions rested on reliable evidence [33]. Majority of the studies are looking at the relationship between professional skepticism and auditor behavior [31, 32, 34]. Asare and Wright [35], found that auditors might under emphasized or even overlook fraud risks as a way to avoid missing deadlines.

According to auditing standard and regulation, an auditor should plan and perform the audit with an attitude of professional skepticism (SAS: 99). Importance of professional skepticism is further can be seen in International Auditing Standard IAS-240 that defines professional skepticism as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence” and it can be used as a tool for detecting fraud. While the existing professional skepticism research includes differing definitions and implication of the professional skepticism construct [29]. Professional skepticism is often illustrated as “having a reasoning of mind to ask what has been presented for evaluative purposes—to look beyond the obvious in the search for revealing information and relationships”[59].

Nolder [29], pointed out that professional skepticism is related to the beliefs and attitudes of the auditors, his team and the firm. Professional skepticism allows an auditor to recognize fraud even when it is well hidden [60]. According to [61] skeptic mind enable an auditor to spot and respond to circumstances that may indicate misstatement in clients statement. In fact, skeptic is an individual who enjoy the learning process, keeps an open and speculative mind and seek knowledge for knowledge’s sake [62]. Martin *et al.*, [63] has indicated that the wording used in standards may contribute to a lack of professional skepticism. Example can be seen in AU Sec. 332.35, Auditing Derivative Instruments, Hedging Activities, and Investment in Securities states that, “the auditor should obtain evidence supporting management’s assertions about the fair value of derivatives and securities measured or disclosed at fair value”[64]. This instruction could lead to confirmation bias because it encourages an auditor to search out and give more credence to evidence that confirm the assertions made by management. Christensen *et al.*, [65], warned that when auditing standards increase the ambiguity of an already complex and unstructured task they increases processing demands. Increasing processing demands encourages auditors to adopt simplifying decision strategies that make them less skeptical. According to Hammersley and Hall [66] increased level of Professional Skepticism (PS) among accounting professionals has been recommended as a way of improved auditors’ performance. They further states that “ We currently know little about how auditors’ levels of trait or state skepticism affects, how they process information or make decisions and how these measures interact with other environmental variables in fraud planning tasks” (p.17). This discussion leads to two research

questions:

RQ3: Does Professional Skepticism (PS) is significantly related to Underreporting of Time (URT)?

RQ4: Does Professional Skepticism (PS) is significantly related to Premature Sign-Off Behavior (PMSO)?

3.5 Emotional Intelligence (EI), Professional Skepticism (PS) and Dysfunctional Audit Behavior (DAB)

Unsurprisingly, in the academic arena interest has grown in the emotional intelligence domain; how it can be used to benefit organizations [67, 68]. Salovey and Mayer [69] were two of the first researchers who attempted to explain how individuals handle emotion using a hierarchical psychometric model of intelligence [70]. Emotional intelligence refers to each individual's capacity to observe, assess and express emotions in appropriate ways [71]. According to [72] emotional intelligence refers to the positive emotions that create and sustain change for individuals, groups of people (teams and communities) and organizations. An individual's level of emotional intelligence influences several work related behaviors such as how they deal with conflict, ambiguity, and demanding jobs. Individuals with high levels of emotional intelligence have careers that are more successful, stronger personal relationship, enjoyable personal lives and better health than those with low levels of emotional intelligence [73]. It also helps individual to motivate personal intellectual and emotional growth [71]. In fact, the demand for emotional intelligence is twice that of technical skills [74, 75]. Goleman [74], have suggested that 20% of professional success depends on the intelligence of the individual and the other 80% depends on the ability to understand oneself and interact with others in a network. The behaviors most often identified with emotional intelligence may be learned and applied in a practical manner to improve the overall quality of decisions and decision-making processes [76].

Few preliminary findings suggest that lower emotional intelligence levels are related to self-destructive and deviant behaviors [84]. Socially deviant behavior can be measured by markers such as the number of physical fights the individual has been involved in or the number of times they have vandalized public property in the last year. Questions such as these are correlated to emotional intelligence with ranges from $r = -.27$ to $r = -.20$ when the effects of SAT scores and Big Five personality attributes are factored out by [85]. Similarly, [86] examined the emotional intelligence of 59 participants in court mandated violence prevention programs. [86], discovered that there was a negative relationship between perceiving emotions and psychological aggression such as insults and emotional torture. He also found a positive relationship between psychological aggression and high scores for the ability to manage emotions. This was an unexpected discovery.

Looking into literature, it is noted that emotional intelligence as moderator has work well in different domains successfully. For example, in relationship between stress and mental health [89]; emotional and behavioral reactions to job insecurity [90]; job stress and job performance [91]. Zeidner *et al.*, [87] and [88] affirmed that it is quite justifying that investigating a direct effect of emotional intelligence with varied work related activities will be less worthy. Rather, it will be fruitful if emotional intelligence is investigated in relation to other variables or look at a moderating effect of emotional intelligence in already conventional relationships. The influence of emotional intelligence as a moderating variable is based on its varied benefits. In the light of literature reviewed, author can assume here that highly emotional intelligent auditors can be more responsive in sample testing. Thus, this sensitivity will enable them to test each of the samples carefully. Furthermore, this sensitivity of the work will enable them to deal with emotion invoking encounters. They will be likely to control their emotions in stressful audit environment. Thus, the detrimental effects of under reporting of time, premature sign off behaviors are likely to be moderated. The next research question addressed in this study is:

RQ5: Does emotional intelligence moderate the relationship between professional skepticism underreporting of time and premature sign-off behavior?

This study will also test the dimension of emotional intelligence proposed by [82]. To examine at what extent each of four dimensions moderate the relationship of professional skepticism, underreporting of time and premature sign-off behaviors. Devonish and Greenidge [80], tested emotional intelligence and its sub dimensions with the relationship with justice- contextual performance and found significant results. According to [92] if a person is able to manage his or her own behavior, he may resist to accept ethical violations. On the opposite, an individual without emotional intelligence is likely to have poor decision making ability and often gather less or insufficient information for decision-making [25]. According to [66] auditors who lack in knowledge will be less likely to perform necessary audit test; thus fail to identify falsifying transaction. Emotional intelligence is the skill that could allow auditors with sufficient knowledge, problem solving ability, and epistemic motivation during audit. Next research questions are:

RQ5a: Does perception of emotion in self moderate the relationship between professional skepticism, underreporting of time and premature sign-off?

RQ5b: Does perception of emotion in others moderate the relationship between professional skepticism, underreporting of time and premature sign-off?

RQ5c: Does recognition of emotion moderate the relationship between professional skepticism, underreporting of time and premature sign-off?

RQ5c: Does regulation of emotion moderate the relationship between professional skepticism, underreporting of time and premature signs-off?

3.6 METHODOLOGY

Deductive approach is selected as research methodology. The main research instrument is self-administered questionnaire, reasoning that, data is known, specific, and measurable. The population of this study is consisting of 7000 senior and junior level of auditors from the Big4 firms and Non-Big4 firms in Pakistan according to Institute of Chartered Accountants of Pakistan (ICAP) directory. The Big4 firms are Deloitte and Touche LLP, Ernst and Young LLP, KPMG LLP, and Price Waterhouse Coopers LLP. The Non-Big4 or medium and smaller firms are those firms which are registered with the ICAP. This study follows stratified sampling method. Sampling process will be done in two stages. In the first stage, entire population “audit firms” will be divided into two strata ‘Big4’ and ‘Non-big4’. These Strata’s will further be divided into two namely “senior” and “junior”. The strata will be formed on the basis of specified characteristics and the auditors’ level of work. In the second sampling stage, simple random sampling will be applied in each of the selected strata. Total 364 will be an adequate sample size according to the formula developed by [93]. For segregation among senior and junior 2:1 ratio will be used. Ratio 2:1 explains that on average with every two senior one junior works in a team during the audit engagement. For geographical representation of the population largest city Karachi is selected. In regards to data collection, a survey instrument will be distributed to each participant through office in-charge and will be returned directly to the author through self addressed stamped envelope to ensure confidentiality. There are two-parts in questionnaire. The part A is consist of participant demographic, Part B is consist of professional skepticism, emotional intelligence, under

reporting of time, premature sign- off behaviors. A five point scale, ranging from 1 (strongly disagree) to 5 (strongly agree) will be used to record the responses. The next section will conclude this paper and propose the framework on dysfunctional audit behavior.

3.7 CONCLUSION

In light of the previous work done on under reporting of time and premature sign off behaviors, this study came at a good time; offering several new insights and significant contributions to research and practice. This study will contribute in different way. Firstly, this study describes the relationship between *Emotional Intelligence (EI)*, *Professional Skepticism (PS)*, *Under Reporting Of Time (URT)* and *Premature Sign- Off Behaviors (PMSO)* and by doing so, it adds to the body of knowledge in these three areas. Secondly, this study emphasizes the important role of emotional intelligence as a moderator in the proposed framework (Figure 1) as the primary focus of this study. Thirdly, this study looks at the practical ways on how *Professional Skepticism (PS)* can be used to lessen the frequency of *Under Reporting Of Time (URT)* and *Premature Sign- Off (PMSO)*. The practical implication of *Professional Skepticism (PS)* attitude with respect to *Under Reporting Of Time (URT)* and *Premature Sign- Off (PMSO)* will open numerous ways of concerns for the policy maker i.e., Institute of Chartered Accountant of Pakistan (*ICAP*). *ICAP* has the authority to investigate any of its members and can advise its members, including the Big4 and Non-Big4 auditing firms on the importance of audit quality. The *ICAP* can also investigate members who may not adhere to international auditing standards that delineate to maintain professional and ethical guidelines. *ICAP* would try to search answer of the question; are dysfunctional audit behaviors occurring in Pakistani context? What strategies could opt for prevention and detection of *Under Reporting Of Time (URT)* and *Premature Sign- Off (PMSO)*? Has professional skepticism been important to auditors? If it is true, then what actions or strategies should be place to include as a predictor of *Professional Skepticism (PS)* attitude? At last, as argued, Is *Emotional Intelligence (EI)* could be helpful to enhance the ability of professional skepticism among auditors? Another way to deal with dysfunctional audit behaviors is through education [94]. The institution of educational programs directed at all levels of auditors can help lessen the frequency of dysfunctional audit behavior, especially when the standards of professional conduct are well communicated. One of the goals of this study is to encourage accounting firms to help their employees complete their professional education and obtain professional certification. This will result in auditors with a complete range of knowledge who are capable of making qualified and educated decisions while improving their judgment [95]. A well-educated auditor is more likely to rely on their judgment and develop their professional skepticism, which will subsequently improve audit quality [61].

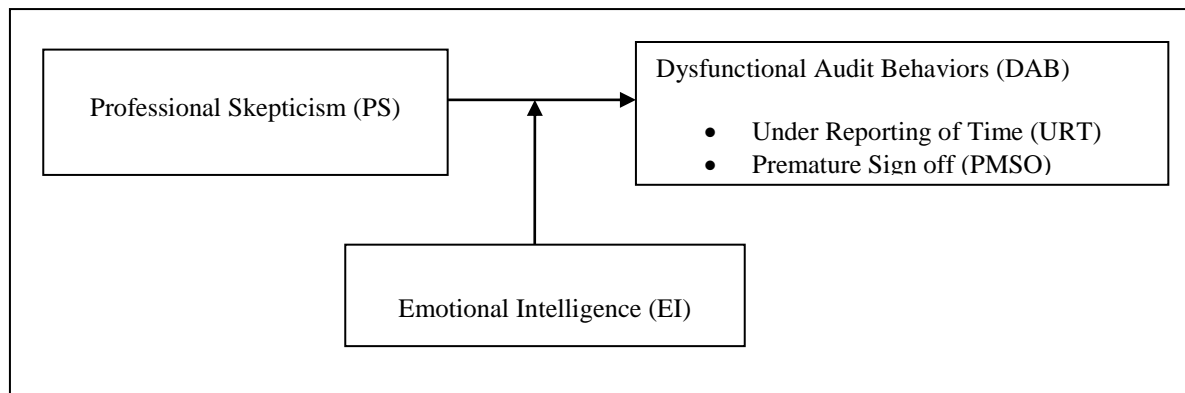


Figure 1: Conceptual Framework

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