Experienced auditors better at fraud detection after a simple cue: study

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A simple cue can trigger a marked increase in fraud detection among veteran auditors, says a new study co-written by business professors Jessen L. Hobson, right, and Mark Peecher. Credit: L. Brian Stauffer

A new study co-written by a pair of University of Illinois experts in audit

and financial accounting finds that a simple cue can trigger a sizable increase in fraud detection among experienced auditors.

Research from Mark Peecher and Jessen L. Hobson of the College of Business finds evidence that experienced auditors' judgments about deception are less accurate for companies later linked to fraud, regulator investigation or class-action litigation unless they are first instructed to look for signs of guilt in the CEO's voice.

"Deception detection is very difficult. Most people have trouble figuring out when someone is deceiving them," said Peecher, the Deloitte Professor of Accountancy and associate dean of faculty at the College of Business. "The good news here is that very experienced auditors, who are hired because they're supposed to be watchdogs for society, actually have the capacity to discern when upper management is being deceptive.

"The bad news is that they don't fully tap into that ability, and overlook fraud cues right before them, unless we make that task easier by prompting them with this cue."

The researchers compiled 124 judgments from 31 very experienced auditors from multiple accounting firms. Each participant provided deception judgments for four publicly traded companies, using excerpted CEO responses to analyst questions during quarterly conference calls. Software randomly drew excerpts from a population of five fraud and five nonfraud companies, with the expectation that participating auditors would spot fraud accurately 50 percent of the time by chance alone. For each company, auditors also received background information and financial statements.

While reviewing CEO answers to analyst questions, auditors decided whether they thought the financial results being discussed were fraudulent. Peecher and Hobson found that accuracy levels for

accurately spotting fraud improved from 43 percent to 70 percent when veteran auditors were given instructions to look for signs of "negative affect" during CEO narratives from conference calls.

The instruction had the effect of shattering the auditors' subconscious "illusion of objectivity" that otherwise enables them to downplay fraud cues, according to the paper.

"If you make it easier for auditors by saying 'One of the symptoms of fraud is cognitive dissonance, so keep that in mind as you listen to this real-world recording of an earnings call with an executive and when you assess if there's deception,' that's where they're able to perform substantially better than chance at predicting fraud," Peecher said. "And that's encouraging and something that audit firms may want to take a look at when they try to assess fraud risk of potential and current clients."

According to Peecher, auditors may be reluctant to see fraud or unequivocally declare fraud because "there are costs to false positives - to seeing fraud where there is none."

"No auditor wants to be seen as crying wolf - and there's also no clear reward for an auditor who finds fraud unless they bring the client in and find the fraud in the first quarter of them being a client," he said. "Because anytime beyond that, the counterargument will be 'You missed it.'"

"When you find fraud, it's not a great day for the firm," said Hobson, an associate professor of accountancy and a PricewaterhouseCoopers Faculty Fellow at the College of Business. "Because now you've got additional work, litigation risks, and you will probably lose the client anyway. You worry about if it's going to hurt your reputation. The auditor is doing their job, but there really are quite limited rewards for

suspecting or finding fraud."

Audit students doing the same experiment and prompted the same way are "still unable to find fraud and perform no better than chance. You see no improvement," Peecher said.

"You need experience and ability for the prompt to work," he said. "As a bright new audit pro, you tend to see fraud where it doesn't exist. Over time, you learn that you ought not to cry wolf. But the problem is, fraud is very costly. There's a danger in being so reluctant to cry wolf that you tend to see more innocence than there really is."

"For all those reasons, we think that very experienced auditors subconsciously try to avoid false positives, which is why they may need a little encouragement to detect deception," Hobson said.

Provided by University of Illinois at Urbana-Champaign

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