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Nationality and differences in auditor risk assessment: A research note with experimental evidence

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A B S T R A C T

This study examines whether auditors from different countries come to different conclusions when they perform analytical procedures to assess the risk of misstatement in accounts. During a laboratory experiment, auditors who worked for the same firm in the United Kingdom, France, and the United States performed analytical procedures on identical case materials. Although auditors from all three countries came to similar conclusions about the overall risk of misstatement, they attributed risk differently across the individual financial statement accounts they evaluated.

Introduction

People of different nationalities develop different "software of the mind" for decision making and, as a result, often come to different conclusions after evaluating the same information (Hofstede, 2001). Professional standards describe the types of information that auditors should evaluate when they form conclusions about risk, and auditors rely on their risk assessments when planning the auditing procedures they will perform to test financial statement accounts (IFAC, 2008, ISA 315). If nationality changes conclusions about risk that auditors develop when evaluating a common set of information, then programs of audit tests may not be consistent from one country to the next, even when those programs have been developed by auditors from the same firm.

Differences in the way that auditors evaluate patterns of fluctuations in accounts explain a significant portion of variations in the way auditors attribute risk to individual accounts (Bedard & Biggs, 1991). Auditors' predisposition for grouping information into causal patterns influences the way they attribute misstatement risk to related accounts (Hammersley, 2006). Because research suggests that nationality fosters a predisposition for evaluating accounting information in ways that often differ between countries (Chanchani & MacGregor, 1999; Doupnik & Tsakumis, 2004), we suggest that nationality could influence auditor judgment about the likelihood of misstatement for individual accounts by changing the strategy auditors use to assess risks.

This study examines whether auditors from different countries respond differently to a pattern of inconsistent fluctuations in accounts when they assess misstatement risk during the planning phase of an assurance engagement. Audit firms have developed uniform audit methodologies intended to produce consistent conclusions about audit evidence regardless of nationality (Allen, Hermanson, Kozloski, & Ramsay, 2006; Bell, Peecher, & Solomon, 2005; Knechel, 2007). If nationality alters decisions based on the same accounting information, then mandating uniform audit methodologies may not lead to consistent conclusions about audit evidence across national boundaries. If so, audit firms may want to re-evaluate whether uniform audit methodologies encourage global consistency in auditor judgment. In the following paragraphs we explain why we expect to find an association between nationality and the way auditors reach conclusions based on audit evidence.

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Nationality affects diagnostic conclusions by changing the way people analyze patterns of causal attributes (Triandis, 2007). Research shows that there are differences by nationality in how patterns of information cues are evaluated when individuals determine the cause of an unexpected event (Kitayama, Duffy, & Uchida, 2007). For example, nationality influences whether individuals focus on the independence or interdependence of information during causal reasoning about risk. Unsworth, Sears, and Pexman (2005) found that nationality affected whether students tended to categorize stimuli based on perceived similarities among independent attributes or based on the perceived strength of interdependent relations.

Nationality also affects whether pieces of information are evaluated separately or jointly when assessing risk. Chu, Spires, Farn, and Sueyoshi (2005) found that nationality influenced whether students integrated decision cues by: (a) weighting the attributes of each cue then aggregating weights by cue to make a choice versus (b) evaluating how common attributes co-varied across decision cues based on interdependent trade-offs. In other words, nationality influences the way that people evaluate patterns of information and distribute causality across decision cues (Oyserman & Lee, 2008).

In this study, we compare risk assessments developed by auditors from the United Kingdom (UK), France (FR), and the United States (US). We selected these particular countries because they represent three of the most significant economic and political powers in the Western world, and because the firm that provided participants for our study uses the same audit methodology in all three countries, which provides participants with the same training and requires them to use the same auditing procedures. However, while the UK and the US share a common heritage and language, the UK and FR share a common currency and economic union. If nationality influences the way auditors evaluate evidence, we speculate that nationality should alter auditor conclusions about risk. We base this prediction on conclusions about national differences reached by other accounting researchers.

Gernon and Wallace (1996) suggest that, when examining national differences in accounting practices, one must consider a country's accounting ecology as a multidimensional system where no single variable is likely to account for differences in the development and use of accounting information. Both environmental variables (e.g. political constraints and economic factors) and social differences (e.g. cultural peculiarities and behavioral norms) exert influence on accounting practices, and to the extent that those factors differ between countries, the use of accounting information is likely to differ between those countries as well (Saudagaran & Diga, 1999). Researchers who examined national differences across both environmental and social dimensions have come to different conclusions about how to group countries when describing similarities in accounting practices (see d'Arcy (2001) for a review, synthesis and discussion).

Alternative theoretical frameworks for describing the influence of nationality on accounting practices have not reached a consensus with respect to differences and similarities across the UK, FR and the US. With regard to environmental factors, Nobes (1998) proposes that characteristics of the financing systems developed for capitalizing business ventures will influence the use of accounting information differently in the UK and the US than in FR. On the other hand, because the legal system in the UK and FR originated from code-law while the legal system in the US originated from common-law, finance and accounting practices in the UK and FR have evolved differently than practices in the US (Francis, Khurana, & Pereira, 2005; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; Reynolds & Flores, 1989). With regard to social factors, Gray (1988) suggests that individual-level differences in culture-specific values should have a different influence on decisions made with accounting information in the UK and FR than in the US. On the other hand, Ramirez (2001) argues that social constraints caused the auditing profession in FR to evolve separately and distinct from the accounting profession, and very likely in ways that differ significantly from the evolution of the auditing professions in Anglo-Saxon systems (e.g. UK and US).

In summary, we believe it is likely that nationality will influence auditor risk assessments because research has shown that nationality changes the way the people use accounting information to make decisions. However, due to the lack of consensus on how and why accounting practices differ across the UK, FR and the US, we can only hypothesize that patterns of risk assessments will not be consistent among auditors from these three countries. The next section explains how we examined this research question.

Method

Auditors domiciled in UK, FR, and US participated in a laboratory experiment at firm training sessions in their respective countries. Participants performed analytical procedures to assess misstatement risk for a retail grocery company across two successive years. All participants were trained by and worked for the same international auditing firm, held the rank of senior in their firm, and used the same accounting information to assess risk. Case materials were written in English and organized in a manner consistent with the audit support software used by the participants' firm in all three countries, which presents information in English and requires auditors to document their conclusions in English. Firm partners in all three countries assured us that auditors in their country would have no problem understanding or responding to the case in English. Those same partners reviewed the case materials to ensure that seniors would be able to understand the client's business, and would be familiar with the type of questions they were required to answer. We have provided the case materials as an Appendix.

The experiment was designed to examine how auditors from countries, where people are likely to evaluate accounting metrics differently, will attribute misstatement risk across related accounts with an inconsistent pattern of fluctuations. Participants performed analytical procedures for two successive years on a continuing client. Case materials for year one suggested that misstatement risk was

minimal, but information provided for year two suggested an increase in misstatement risk. During year two, case materials indicated that there had been no significant change in unit sales prices, inventory costs, or product mix and that sales had increased 3.2% from the previous year. Under these conditions, the increase in cost of sales should be proportional to the increase in sales, but case materials indicated that cost of sales increased by only 1.9%. This inconsistency increases the likelihood that cost of sales could be misstated because inventory costs had not properly been removed from inventory (see O'Donnell and Schultz (2005) for further discussion of the materials, which we adapted from the case used in their study).

During each year, participants assessed misstatement risk for inventory, sales, cost of sales, and store expenses on a scale from 0 (low) to 100 (high), then they assessed the overall risk of material misstatement on a scale from 1 (low) to 7 (high). The change in risk assessments from year one to year two provided a metric for examining auditor attribution of misstatement risk when conditions suggest that the potential for misstatement has increased (during year two). Using a change score also controls for differences in between-subjects predispositions for risk attributions.

Findings

A total of 77 auditors from the UK (28 auditors), FR (28 auditors), and the US (21 auditors) participated in our experiment. Participants had an average of 35.5 months of audit experience (standard deviation was 19.0 months) and had held the rank of senior for an average of 12.5 months (standard deviation was 11.9 months).

Before evaluating national differences in risk assessments, we gathered evidence to check our risk manipulation. Recall that case materials for year one were designed to suggest relatively low risk but materials for year two were intended to suggest that the risk of misstatement had increased from year one. During year one, participants across all nationalities rated the overall risk of misstatement at an average of 2.9 compared with an average of 3.9 for year two. Across the entire sample, average ratings for year two are significantly larger than average ratings for year one (within-subjects $t = 4.74$; $p < .01$). We also replicated this analysis by country (not tabulated). Across all nationalities, average overall risk assessments for year two were significantly greater ($p < 0.01$) than average overall risk assessments for year one. We present descriptive statistics by nationality in Table 1.

Our research question is whether auditor nationality influences judgment about the risk of misstatement in accounts. If so, nationality should alter the pattern of risk assessments for inventory, sales, cost of sales, and store expenses. In other words, participants from different countries should increase risk for year two by different amounts for at least one of the four accounts they analyzed. We used multiple analyses of variance to test whether differences in mean risk assessments across the four accounts were influenced by participant nationality. Results are presented in Table 2.

Findings presented in panel A of Table 2 indicate that nationality altered the pattern of average risk assessments for inventory, sales, cost of sales, and store expenses, as evidenced by the significant, within-subjects interaction between account risk assessments and nationality. Between-subjects results presented in panel B of Table 2 show that national differences revealed in panel A were attributable to differences in risk assessments for cost of sales. These findings provide evidence that nationality can cause auditors from different countries to reach different conclusions about the risk of misstatement in accounts even though they evaluate the same evidence, hold the same rank, and were trained by the same firm.

Additional analyses

As noted by the descriptive statistics presented in Table 1, participants from the UK had an average of 21.4 months

Table 1
Descriptive statistics for measured variables by nationality.

	United Kingdom		France		United States	
	Mean	SD	Mean	SD	Mean	SD
Months as an auditor	51.1	19.2	27.1	12.4	26.1	11.9
Months at senior rank	21.4	10.8	6.5	5.2	8.8	12.8
Overall risk of misstatement elicited on a scale from 1 (low) to 7 (high)						
Year one	3.1	0.8	3.0	0.9	2.7	1.0
Year two	4.0	0.9	3.9	1.0	3.7	1.1
Assessments for year one elicited on a scale from 0 (low) to 100 (high)						
Inventory	39.2	19.9	27.2	13.4	32.8	16.3
Sales	38.3	19.5	28.7	11.1	35.2	14.9
Cost of sales	31.3	13.3	35.5	16.7	31.1	13.2
Store expenses	25.4	10.8	26.0	11.9	25.2	8.5
Assessments for year two elicited on a scale from 0 (low) to 100 (high)						
Inventory	42.8	17.0	35.3	14.7	36.9	16.9
Sales	42.8	16.5	30.2	11.3	37.4	14.1
Cost of sales	37.6	13.7	34.3	14.7	39.1	18.4
Store expenses	29.8	13.3	29.2	14.0	28.5	13.5

Table 2
Test for difference in account risk assessments across nationalities.

Dependent variables: change in risk assessment from year one to year two for inventory, sales, cost of sales, and store expenses elicited on a scale from 0 (low) to 100 (high)

	Degrees of freedom	Sum of squares	*F*-statistic	*p*-value
Panel A: within-subjects results for multiple analysis of variance				
Account risk assessments	3	265.3	0.97	0.4046
Account risk assessments × nationality	6	1492.2	2.74	0.0142
Error for account risk assessments	222	20142.7		

	Change in risk between year one and year two			Test for differences	
	United Kingdom	France	United States	*F*-statistic	*p*-value
Panel B: difference in mean risk assessments by nationality					
Inventory	3.4	8.1	4.0	1.32	0.2727
Sales	4.5	1.5	2.2	0.56	0.5716
Cost of sales	6.2	−0.9	8.0	3.64	0.0310
Store expenses	4.3	3.1	3.3	0.14	0.8726

(standard deviation = 10.8 months) experience at the senior rank compared with an average of 6.5 months (standard deviation = 5.2 months) for FR auditors and 8.8 months (standard deviation = 12.8 months) for US auditors. Average experience as a senior for UK auditors was significantly greater than for either FR or US auditors ($p < 0.01$). We do not believe that differences in experience threaten the reliability of evidence that nationality influenced risk assessments for three reasons.

First, we replicated the analyses presented in Table 2 using both months at the senior rank and months of audit experience as covariates (not tabulated). The results did not change substantively. Second, we used ordinary least-squares regression (not tabulated) to conduct exhaustive tests for the influence of both months at the senior rank and months of audit experience on average risk assessments for UK, FR, and US auditors. Our tests accounted for all possible main effects and all potential interactions. We found no evidence that differences in experience accounted for any of the differences (or similarities) in patterns of risk assessments. Third, *t*-tests (not tabulated) indicated that neither months at the rank of senior nor months as an auditor differ significantly between FR and US participants (at the $p < 0.10$ level). We removed UK participants from the sample and recalculated the MANOVA reported in panel A of Table 2. The results did not change. Even if UK participants performed differently because they had more experience, findings suggest that there were significant differences between patterns of risk attributions by FR and US auditors, who had equivalent experience.

The analyses we used to evaluate our research question focused on national differences in risk assessments under conditions that increase the likelihood of misstatement. However, it is also possible that nationality could influence risk assessments when evidence suggests that the likelihood of misstatement is relatively low (e.g. during year one of our case). To examine this possibility, we used *t*-tests to search for national differences in mean risk assessments for year one. Of all possible comparisons for inventory, sales, cost of sales, and store expenses across the three nationalities in our study, the only significant differences in mean risk assessments during year one were between UK and FR for inventory ($p < 0.01$) and sales ($p < 0.05$). These findings provide little evidence that nationality altered the pattern of first-year risk attributions across the four accounts, and no compelling reason to be concerned that differences in year-one risk assessments created a baseline effect that drove differences in the change in risk assessments between year one and year two.

Summary

This study used a laboratory experiment to examine whether nationality influences auditor judgment about how the likelihood of misstatement should be attributed to individual financial statement accounts. We examined patterns of misstatement risk assessments developed by auditors from the United Kingdom (UK), France (FR), and the United Stated (US) because research suggests that differences in cultural and environmental factors may cause people in these countries to make accounting-related decisions differently. Auditors who worked for the same firm but were domiciled in different countries performed analytical procedures to assess misstatement risk for two consecutive years for the same client. Case materials described conditions that increased risk for the second year. While assessments of overall misstatement risk did not differ across the three countries, attributions of risk to individual accounts differed depending on auditor nationality.

Findings suggest that nationality influences the risk assessments auditors develop when they encounter conditions that increase the likelihood of misstatement in accounts. In our experiment, French auditors responded differently to an inconsistent fluctuation in cost of sales that we seeded to the case materials. To help audit practitioners and researchers understand the association between national differences and professional judgment, future research should explore how, why, and under what circumstances nationality can influence auditor judgment. Results from this study should motivate research designed to identify and categorize differences in the way that

professionals from countries with different national cultures will interpret and respond to accounting information.

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Appendix. Experimental instrument

Instructions and background

Assume that you are the in-charge accountant on the annual audit of ABC grocery stores for the fiscal year ended December 31, 2004. Your task will be to perform analytical procedures and assess misstatement risk for selected accounts. ABC is a publicly-owned company that has been a client of your firm for 6 years and has always received unqualified opinions.

The key strategic management issue for ABC is differentiating its stores from competitors. The grocery industry is characterized by intense competition, limited potential for growth, and thin margins. ABC has focused exclusively on the high-end grocery market by locating its stores in upper-middle-class neighborhoods. In the past, ABC differentiated its stores by offering services and products that provided customers with a unique shopping experience. However, competitors have copied ABC's format and now provide a comparable shopping experience. In an effort to regain competitive advantage through differentiation, ABC has adopted a "best for less" strategy, whereby they provide the same premium shopping experience, but with lower prices. The goal is to draw more customers into ABC stores by cutting prices on key product lines.

The audit team has identified two strategic business processes: (1) category management, which involves deciding what to sell and how much to sell it for, and (2) supply chain management, which involves purchasing and distributing goods to individual stores at the lowest possible cost. Core processes in category management include advertising, determining product mix, establishing unit sales prices, and in-store customer service. Core processes in supply chain management include demand planning, procurement, distribution center logistics, and product deliveries to individual stores. ABC implemented a comprehensive enterprise system three years ago, which has allowed them to streamline their supply chain management functions.

During the 2004 client continuation review, the audit team assessed overall engagement risk at 25 on a 100-point scale where 0 represents very low risk and 100 represents very high risk. The assessment for 2004 was consistent with engagement risk assessments for the past several years and represents one of the lowest risk ratings in the firm's client portfolio. ABC enjoys a strong financial position and has the lowest debt-to-equity ratio in the industry. During their interim review, the audit team assessed control risk at 20 on a 100-point scale where 0 represents very low and 100 represents very high. ABC also has one of the lowest control risk assessments in your firm's client portfolio.

Strategic analysis

ABC phased in their new "best for less" strategy during 2004 by experimenting with price reductions in different product categories and evaluating the impact on customer value perceptions. After reviewing key performance indicators with ABC management, the engagement partner has concluded that it is still too early to develop any meaningful assessment of the viability of the new business strategy. ABC's sales revenue and market share have not changed significantly but net income has remained relatively stable because a small increase in sales has offset the lower gross profit margin caused by the price reductions. The engagement partner believes that next year will be the real test for the viability of the "best for less" strategy.

Process analysis

Category management processes did not change from 2003 to 2004. The product mix remained virtually the same as 2003. Although unit sales prices were reduced on selected items, the reductions produced an increase in sales volume that largely offset reductions in gross margin.

	Industry best	Current (2004)	Previous (2003)	Change	Percent
Sales revenue (in $ thousands)		28,859	28,349	510	1.8
Store operating expense (in $ thousands)		5244	5181	63	1.2
Sales per square foot	$10.21	$9.94	$9.81	$0.13	1.3
Average customer transaction	$23.91	$22.05	$22.64	$⟨0.59⟩	⟨2.6⟩
Operating expenses to sales (%)	17.4	18.2	18.3	⟨0.1⟩	⟨0.5⟩

Supply chain management processes did not change significantly from 2003 to 2004. There have been no significant changes in unit costs for inventory. During 2004, ABC opened six new stores and closed five stores that were not meeting performance expectations. There were no significant changes in the management team.

	Industry best	Current (2004)	Previous (2003)	Change	Percent
Merchandise inventory (in $ thousands)		2736	2760	⟨24⟩	⟨0.9⟩
Cost of goods sold (in $ thousands)		20,349	19,891	458	2.3
Average inventory turnover	10.4	10.1	9.9	0.2	2.0
Average distribution costs per case	$16.60	$16.62	$16.74	$⟨0.12⟩	⟨0.7⟩
On-time deliveries from warehouse (%)	95.7	95.7	94.3	1.4	1.5

Misstatement risk analysis

Document your 2004 misstatement risk assessment for each of the following accounts on a 100-point scale where 0 represents very low risk and 100 represents very high risk.

Merchandise inventory: _____
Sales revenue: _____
Cost of goods sold: _____
Operating expenses: _____

Rate the overall risk of significant misstatement at ABC for 2004 on a scale from 1 (very low) to 7 (very high).

1	2	3	4	5	6	7
Very low			Moderate			Very high

Assume that the audit for 2004 went smoothly and that you completed the engagement within the budgeted time. The audit team proposed no adjusting entries and ABC received an unqualified opinion. It is now 1 year later and you have begun year-end field work for the 2005 audit. Use the information provided on this page to perform analytical procedures and assess misstatement risk for the accounts listed below.

During 2005: (a) the company did not close any existing stores or open any new stores, (b) there have been no significant changes in category management processes, (c) unit sales prices have not changed significantly, (d) there have been no significant changes in the product mix, (e) there have been no significant changes in supply chain management processes, and (f) there have been no significant changes in unit costs for inventory, and (g) there has been no turnover on ABC's management team. However, during the 2005 client continuation review the audit team increased overall engagement risk from 25 to 35 (on a 100-point scale) because ABC has recently entered into negotiations with a larger competitor about a potential merger.

Strategic analysis

ABC has continued to pursue its "best for less" strategy during 2005. After reviewing key performance indicators with ABC management, the engagement partner believes that the new strategy may achieve the results that ABC had hoped for. Sales growth during 2005 was 3.2% while the average sales growth in ABC's market was only 1.9%. ABC's numbers show a gain in market share during 2005 and an increase in net income of 1.8%.

Process analysis

There have been no significant changes in category management processes during 2005, unit sales prices have not changed significantly since the end of 2004, and there have been no major changes in the product mix.

	Industry best	Current (2005)	Previous (2004)	Change	Percent (%)
Sales revenue (in $ thousands)		29,782	28,859	923	3.2
Store operating expense (in $ thousands)		5386	5244	142	2.7
Sales per square foot	$10.82	$10.25	$9.94	$0.31	3.1
Average customer transaction	$23.67	$21.63	$22.05	$⟨0.42⟩	⟨1.9⟩
Operating expenses to sales (%)	17.6	18.1	18.2	⟨0.1⟩	⟨0.5⟩

There have been no significant changes in supply chain management processes during 2005 and there have been no significant changes in unit costs for inventory. During 2005, ABC installed a significant upgrade to their supply chain management software. The computer risk management group has evaluated ABC's enterprise system for 2005 and is comfortable that the new software is functioning effectively. However, because the new system has altered a number of inventory management procedures, the audit team has increased control risk for 2005 from 20 to 25 (on a 100-point scale).

	Industry best	Current (2005)	Previous (2004)	Change	Percent
Merchandise inventory (in $ thousands)		2785	2736	49	1.8
Cost of goods sold (in $ thousands)		20,532	20,349	183	0.9
Average inventory turnover	10.5	10.3	10.1	0.2	2.0
Average distribution costs per case	$16.44	$16.44	$16.62	$⟨0.18⟩	⟨1.1⟩
On-time deliveries from warehouse (%)	95.5	95.5	95.7	⟨0.2⟩	⟨0.2⟩

Misstatement risk analysis

Document your 2004 misstatement risk assessment for each of the following accounts on a 100-point scale where 0 represents very low risk and 100 represents very high risk.

Merchandise inventory: _____
Sales revenue: _____
Cost of goods sold: _____
Operating expenses: _____

Rate the overall risk of significant misstatement at ABC for 2005 on a scale from 1 (very low) to 7 (very high).

1	2	3	4	5	6	7
Very low			Moderate			Very high

Please provide us with the following information:

1. How many months have you been employed as anauditor on a full-time basis?
2. How many months have you worked as an in-chargeauditor who supervises field work?

Thank you for participating in this study.

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