

## Do “Superstar” CEOs Impair Auditors’ Judgement and Reduce Fraud Detection Opportunities?

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### Introduction

Current auditing standards require firms to utilize a risk-based audit approach which involves conducting a strategic risk assessment of factors which may impact the achievement of the client’s strategies and objectives. Information gathered through the risk assessment process assist auditors in determining the nature, timing and extent of audit tests. Academic studies (O’Donnell and Schultz, 2005; Utami et al., 2014) have documented the potential for the results of the strategic risk assessment to distort the financial account level risk assessment. This potential distortion of account level risk assessment may have an adverse effect on the quality of the audit and prevent the auditor from adequately satisfying the requirements of the Statement of Auditing Standard 99 (SAS 99). SAS 99 requires that the auditor consider the potential existence of fraud during a financial statement audit (AICPA, 2020). Since the effectiveness of the client’s CEO is critical to the success of the company, the auditor’s perception of the CEO’s effectiveness has the potential to distort the auditor’s strategic risk assessment of the company which may in turn lower the quality of the audit. There is evidence that highly trained and skeptical individuals may be influenced by superstar personalities as in the case of a well-known CEO.

This article examines whether a firm’s CEO who has an extraordinary personal reputation or superstar status can have an adverse impact on the independence in fact of an auditor who is engaged in the audit of the firm’s financial statement.<sup>1</sup> Impairments to independence are measured by comparing the risk assessments of the participants. Independence in fact refers to auditors’ impartial mental attitude towards audit clients whereas independence in appearance refers to the perception of users of financial statements that the auditor is impartial. A superstar CEO is defined in the literature as someone who is compensated at a much higher level than other CEOs and receives an unusual amount of public attention (Rosen, 1981). The article is based in part on halo theory and thus superstar is defined only in terms of personal characteristics that are unrelated to business performance.

There is some anecdotal evidence that audit quality may decline in the presence of a superstar CEO. Examples include the frauds associated with Sunbeam’s “Chainsaw” Al Dunlap, ZZZZ Best “Boy Wonder” Barry Minikow, Lincoln Savings and Loan CEO Charles Keating, and Health South CEO Richard Scrushy. There are non-auditing examples where a superstar personality may bias the judgments of highly trained and skeptical people. The Bernie Madoff Ponzi scheme is one example where this appears to have happened.

Thorndike (1920) defines the halo effect as a “marked tendency to think of the person in general as rather good or rather inferior and to color the judgments of the qualities by this general feeling”. In essence, the halo effect occurs when a particular attribute of a person or thing is used to assess the characteristics of an unrelated attribute even though adequate information may exist to assess the unrelated attribute on its own merits. A simple example of the halo effect is demonstrated by Felton et al. (2008) which showed that students rated the quality of the course based on the physical attractiveness of the professor although adequate information existed to rate the course quality on its own merits.

The halo effect bias that may affect auditors’ judgment resulting from a superstar CEO is appropriately tested in an experimental setting where the information about the CEOs can be controlled. This setting affords an opportunity to objectively evaluate the impact of superstar CEOs on auditors which is the primarily objective of the study. In accordance

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<sup>1</sup> In this study, it is important to distinguish between a CEO’s personal and business reputation. This study specifically examined whether non-business characteristics of the CEO influences the auditors’ judgments.

with halo theory, auditors will be biased by factors associated with CEOs that would be unrelated to their business acumen such as physical attractiveness, athletic ability, and charitable contributions.

Another objective of this study is to determine if a debiasing technique can reduce the judgment distortions associated with the influence of a superstar CEO. In this study, the debiasing method utilized by Embu and Finley (1977) was tested to determine its effectiveness in mitigating the judgment distortions associated with a halo effect bias. Embu and Finley (1977) demonstrated that the rating of evidence by individuals prior to making a judgment was effective in reducing the distortions associated with a framing effect bias.

A 2x2 experimental design was utilized to examine the potential threat to an auditor's independence caused by a superstar CEO where the superstar status of the CEO is manipulated. The second manipulation is the presence or absence of a debiasing technique. A modified version of the O'Donnell and Schultz (2005) instrument is used as the context of the audit judgment.

This study investigates the potential direct impact that CEOs may have on auditors' judgment. Prior studies have primarily concentrated on the indirect effect of the CEO through his or her influence on the audit committee. The findings of this study will be of interest to academicians, practitioners and regulators who are concerned with factors that may have a negative impact on auditors' abilities to perform a high-quality independent audit of a firm's financial statements. First, the study provides insight into whether certain CEOs who possess extraordinary personal reputations can compromise the independence in fact of an auditor. Also, the findings of the study provide an evaluation of the effectiveness of the evidence rating debiasing method in the mitigation of the judgment distortions of a halo effect bias. The remaining sections of the study are organized into four sections. Section II provides a brief literature review. Section III provides a theoretical foundation for the hypotheses. Section IV describes the experimental method that was utilized. Finally, the results, conclusions and limitations are discussed.

## **Literature Review**

### ***Superstar CEO***

Rosen (1981) describes a superstar CEO as an individual that is compensated at a level that is much higher than other CEOs and receives an unusual amount of attention from the public. Mark Cuban and former CEO, Bill Gates, are good examples of superstar CEOs who were highly compensated and received extraordinary amounts of attention from the media and even the entertainment industry. The characteristics that make an athlete and a comedian a superstar are similar to that which makes a CEO a superstar; all are viewed as being more talented than their peers (Rosen, 1981). Although superstar CEOs are viewed as being more talented than their peers, their superstar status does not always benefit the shareholders of the corporation. The literature review pertaining to superstar CEOs will focus on their impact on an organization's performance, power within the organization and their tendency to engage in deviant behavior.

Khurana (2002) examined the tendency of corporations to hire superstar CEOs based on their perceived charisma rather than the professional skills and experiences that they possess.

The charisma of CEOs have been shown to impact the behavior of individuals and organizations that are external stakeholders of the organization that employ the CEO (Fanelli and Misangyi, 2006). This influence and goodwill bestowed on the CEO by his or her charisma can elevate the individual to celebrity status and provide opportunities for success that are not available to other less celebrated CEOs (Treadway et al., 2009). Because of their celebrity status, superstar CEOs are often viewed in an overly favorable manner by individuals inside and outside the organization. In essence, a CEO's celebrity status can create a "halo effect" on others that are evaluating their performance in the operation of the organization. Success of an organization is often unduly attributed to the actions of a superstar CEO which can create a sense of overconfidence that leads to detrimental business actions being taken by the individual (Hayward et al., 2004).

As indicated above, a superstar CEO can have an influence on individuals inside and outside the organization. Audit committees are not exempt from the impact of an influential CEO. Lisic (2015) demonstrated that an audit committee that appears effective in form can be rendered ineffective in substance by high influential CEO. Results of the study illustrates the power that an influential CEO can have in an organization which would reasonably be expected to increase if the individual possesses the celebrity status of a superstar CEO. CEOs with celebrity status appears to be granted a certain degree of protection against being terminated even when the performance of the organization is in decline (Flickinger et.

al., 2016). This protection against dismissal seems to be created by the high social status that is bestowed on superstar CEOs which is not possessed by other CEOs that are more likely to be dismissed from their position during periods of declining performance.

Even though the superstar status of a CEO can potentially benefit the profitability of a corporation, his or her high social status can pose risks to the organizations. CEOs that are revered by those inside and outside the organization have more opportunities and instances of committing financial frauds, especially financial statement fraud than other CEOs (Arnulf and Gottschalk, 2013). Malmendier and Tate (2008) demonstrated that earnings management tends to increase after a CEO obtains superstar status. A possible explanation why superstar CEOs are more likely to engage in financial statement fraud is that they feel pressured to live up to the expectations of their admirers. The close relations that a CEO develops with top executives and potentially the auditor enhances the possibility that any fraudulent transactions engaged in could be concealed (Khanna et al., 2015).

Charisma as well as a good sense of humor is typically associated with CEOs that have achieved celebrity status. Although a good sense of humor can potentially enhance a CEO's leadership effectiveness, frequent use of humor by leaders has been shown to increase the likelihood that followers or subordinates will engage in deviant behavior that is against the organization's norms (Yam et al., 2018). The association of the use of humor by leaders and the deviant behavior of authorities is explained by the fact that what often makes a statement funny is that it involves some perceived benign violation of an established rule or law that minimizes the seriousness of violations (McGraw and Warren, 2010).

Academic research other than this study has essentially ignored the potential direct impact that a CEO's reputation can have on an auditor's judgment. Studies have instead concentrated on the indirect influence that a CEO can have on audit quality. These studies have almost exclusively focused on the CEO's influence on the audit committee and audit fees.

### ***Professional Skepticism***

Unlike the general use of the term "skepticism", professional skepticism is not as easily defined. Various definitions of professional skepticism have been provided by academicians and practitioners. However, the definitions can be broadly classified into two categories. The first category views the term from the perspective of an auditor that possesses a doubting attitude while the other describes it as an auditor that possess a neutral attitude towards management. Proponents of the first category definition of professional skepticism describe a skeptical auditor as one that assumes material financial misstatements are present during an audit engagement until the evidence gathered disapproves this assumption. Studies such as Shaub (1996) view skepticism as the total opposite of trust in which a firm's management is expected to behave unethically. McMillian and White (1993) described a skeptical auditor as one that reacts more to negative rather than positive information. This perspective of professional skepticism could result in a more effective audit but the increase in audit fees may outweigh the benefit.

In this study, the second definition category of professional skepticism will be used in which it is assumed that the auditor maintains a neutral attitude pertaining to the adequacy of the client's financial statements. Hurr (2010) views a skeptical auditor as one who possesses characteristics such as a questioning mind and suspension of judgment which indicates neither a trust nor distrust of management. A skeptical auditor is seen by Bamber et al., (1997) as an individual who objectively evaluates information pertaining to management assertions.

Nelson (2009) provides a comprehensive model of the factors that are instrumental in determining the skeptical behavior of auditors. Recognizing that professional skepticism is a multi-dimensional process, Nelson (2009) categorizes the factors that affect auditors' professional skepticism levels into four categories. These four categories include the following: (1) incentives, (2) knowledge, (3) audit experience and training and (4) traits.

### ***Source Reliability***

Halo theory which is used in this study is very different from the concept of source reliability proposed in Schum and Du Charmé (1971). Source reliability addresses the logical basis for a decision maker relying more on information from one source than another. Bamber (1983) used the source reliability approach to examine the process that an audit manager uses to determine the reliability of the information provided by an audit senior. Unlike source reliability, halo theory relates to cognitive biases of the decision maker which causes an individual to use general feelings towards an individual or thing to make judgments about specific attributes although more appropriate information may be available. An example of this

inappropriate use of information is illustrated by Felton et al. (2008) which illustrated how general feelings caused by the physical attractiveness of the professors were used to assess the quality of the course. Only the personal reputation (i.e., non-professional) of the CEO was addressed here to minimize any confusion between elements of halo theory and source reliability.

### ***Halo Theory***

Halo theory originated with the work of Thorndike (1920) in which an error in psychological ratings of military officers was documented through the examination of performance ratings of the officers. Officers were rated independently based on intelligence, physique, leadership and character. Although the ratings of the characteristics were supposed to be rated independently, it was found that an officer's intelligence rating had an unreasonably high correlation with the other characteristics. This tendency to erroneously use a general assessment of a person or thing to evaluate individual attributes was coined the "halo effect".

A very troubling aspect of the halo effect is that individuals who are under the influence of this bias are entirely convinced that their judgment about a particular attribute of an individual or thing is logical based on the available information (Nesbit and Wilson, 1977). Nisbett and Wilson (1977) presented a videotaped interview of a college professor who spoke English with an accent to college students. The college professor was friendly in one of the videotaped interviews and unfriendly in the other interview. Students who saw the friendly college professor indicated that his appearance, mannerisms, and accent was appealing while those that saw the unfriendly professor indicated these attributes were irritating. When questioned whether the friendly or unfriendly nature of the college professor had any effect on the rating of his other attributes, the students insisted that their ratings were totally unaffected by the professor's friendliness or unfriendliness. Nisbett and Wilson (1977) illustrate how a general assessment of an individual or thing can drastically impact the assessment of individual attributes although sufficient information is available to independently assess the attribute.

Professional training may not be sufficient to allow an individual to resist the distortion influence of the halo effect as implied by the results of Smith (1986) and Hong and Liskovich (2014). Smith (1986) showed that suspects encountered in lower-status neighborhoods by police officers were three times as likely to be arrested than suspects encountered in more affluent neighborhoods regardless of the types of crime, race of the suspect, suspect's demeanor or the victim's preference that an arrest occur. Results of Hong and Liskovich (2014) found that firms who are viewed as more socially responsible are assessed fines of approximately forty percent less than firms perceived as less socially responsible when charged with violations of the Foreign Corrupt Practice Act. Law enforcement personnel are trained to be impartial but yet the halo effect caused by the status level of a neighborhood or the socially responsible perception of a firm appears to cause a differential weighing of information depending on a general assessment of the individual or entity.

Prior auditing literature findings suggest that the existence of a halo effect on auditors performing audit tasks has become more prevalent as accounting firms have transitioned from a transactional analysis approach to a business risk audit approach (O'Donnell and Schultz, 2005). This possible increase in the influence of the halo effect on auditors' judgment and behavior may be attributable to the top-down approach utilized by the business risk audit approach in which an auditor receives general information about a client's firm prior to evaluating specific account information. Academic studies performed by psychology researchers have shown that the occurrence of judgment distortions caused by the halo effect is more likely when an evaluator receives information using a top-down task structure (Murphy, Jako, and Anhalt, 1993; Lance and Woehr, 1986).

In addition to O'Donnell and Schultz (2005), other academic auditing studies have illustrated how this top-down approach utilized by the business risk audit approach can create a halo effect on auditors' judgment. Utami, et. al. (2014) demonstrated in an experiment that general analytical procedures utilized by accounting firms during the planning stage of an audit has the potential to create a halo effect on auditors' evaluation of specific account information as a result of the general information obtained during the analyses. Ballou, Earley, and Rich (2004) suggest that when an auditor receives information at the beginning of an audit that the client's firm is typical or atypical compared to the other firms in the industry, this general information causes a differential weighing of information pertaining to the client's firm.

There also exists the potential that a halo effect can be generated when an auditor becomes aware of the assessments of others such as his or her supervisor and even the management of the client's firm at the early stages of an audit. Wilks (2002) showed that an auditor's going concern opinion assessment is more consistent with the audit supervisor's general

assessment if he or she becomes aware of the supervisor's assessment prior to examining specific account information than after examining specific account information. Arel, Kaplan, and O'Donnell (2005) showed that knowledge of a firm's management reliability assessments of its internal controls can have a positive influence on an auditor's independent assessment of the firm's internal controls.

### ***Debiasing Cognitive Biases***

It is reasonable to believe that unconscious cognitive biases of auditors contribute more to audit failures than corruption on the part of auditors (Bazerman et. al., 2002). If this is true, it would be prudent for academicians and practitioners to develop techniques for mitigating these biases. Kennedy (1993) categorizes the causes of cognitive biases that affect auditor performance as either effort or data related issues. Debiasing techniques designed to mitigate effort related biases should include strong effort inducing incentives such as accountability to counter the judgment distortion effects of this type of bias (Kennedy, 1993). The second type of bias, data related, is not caused by insufficient effort but is the result of distortions in the manner in which the auditor views the relevant data or evidence (Emby and Finley, 1997). In order to mitigate the judgment distortions caused by a data related bias, the debiasing technique must motivate the auditor to consider various explanations or perspectives pertaining to a particular issue (Anderson et. al., 1997).

As indicated above, debiasing techniques that induce the auditor to increase task effort are expected to be more successful in mitigating the judgment distortion influence of the effort related type of bias. Biases included in this category are viewed from the perspective of being caused by insufficient effort being exerted by an individual during the process of making a judgment pertaining to an issue. A good example of biases that are included in this category is the recency bias (Kennedy, 1993). This type of bias essentially occurs when an auditor assigns more importance to items that were examined at the end of an audit than those that were examined earlier regardless of the actual importance of the items (Cushing et. al., 1996). Recency is more of an effort related bias than an explanation related bias because additional effort is required of the auditor to evaluate the importance of earlier examined items in comparison to those examined at the end of the audit. Several debiasing techniques have been shown to be successful in mitigating the influences of a recency bias.

Kennedy (1993) tested two debiasing techniques designed to increase audit effort and thereby mitigating the recency bias. The first technique provided an expectation of accountability (explanation of judgment may be required) to the participants prior to the beginning of the task and the other technique provided accountability after completion of the review task but prior to participants providing their judgment assessments. Only the technique in which an expectation of accountability was established prior to the beginning of the task was successful in mitigating the recency bias. It appears that the second technique introduced the expectation of accountability too late in the process to induce the desired amount of effort. Another study (Ashton and Kennedy, 2002) was able to mitigate the recency bias by requiring participants to self-review their judgment which appears to have increased their accountability and induced more effort.

Cushing et. al. (1996) was successful in mitigating the recency bias by requiring that participants document the reasons for their audit judgment prior to providing their final judgment. "It is hypothesized that the documentation task stimulates greater effort, attention, comprehension and recall of information relevant to the formation of audit judgments, causing those judgments to be less subject to a recency bias" (Cushing et. al., 1996). The study supports prior studies that effort inducing techniques are effective in mitigating biases in this category.

Unlike effort related biases which can be mitigated with additional effort, data related biases must be mitigated by motivating the auditor to consider various explanations or perspectives pertaining to a particular issue (Anderson et. al., 1997). Biases included in this category include biases such as hindsight bias, outcome effect and the framing effect. Hindsight bias occurs when knowledge of an outcome causes individuals to overstate their ability to have predicted the outcome prior to its occurrence (Clarkson et. al., 2002). Outcome bias pertains to evaluation of an individual judgment based on the known outcome as opposed to what was known at the time that the decision was made (Clarkson et. al., 2002). The framing effect occurs when data is obscured by irrelevant data or presented in a form which distorts the meaning of the data (Emby and Finley, 1997). Several debiasing techniques have been shown to be successful in mitigating the influences of biases included in this category.

An experiment was conducted by Anderson et. al. (1997) which showed that judges' hindsight bias in an auditor liability case could be mitigated by encouraging them to consider alternative stakeholders (other than the plaintiff). The consideration of alternative stakeholders in the case apparently allowed the judges to consider the facts from a perspective

other than just the plaintiff's perspective. Hindsight bias is able to be successfully mitigated in this manner because the debiasing technique forces individuals to consider other possibilities as to why an event occurred.

Outcome effect bias was successfully mitigated by Lowe and Reckers (1994) and Clarkson et. al. (2002). Lowe and Reckers (1994) mitigated the bias by having jurors generate a list of reasons why alternative outcomes could have occurred in an auditor liability case. Clarkson et. al. (2002) provided instructions to the participants that either emphasized the normativeness of the outcome effect or the seriousness and gravity of the evaluation. Both techniques used by Clarkson et. al. (2002) were successful in mitigating the outcome bias. The documentation technique of Lowe and Reckers (1994) and instruction technique of Clarkson et. al. (2002) appeared to have allowed the participants to consider the possibility that a different outcome could have resulted from the situation.

Embu and Finley (1997) demonstrated that the judgment distorting influence of a framing effect could be successfully mitigated by having participants rate the evidence involved in a fictitious audit client. A framing effect bias causes an individual to frame or view information pertaining to a situation in a particular manner regardless of how illogical this evaluation of the information may be. "Because framing effects are caused by inducing different internal representations of the components of the decision problem, procedures that encourage standard forms of problem representation should mitigate framing effects" (Embu and Finley, 1997). The debiasing technique required the participants to rate the impact and relevance of the evidence. It appears that the technique was successful in mitigating the framing effect because it forced the participants in the experiment to focus on relevant rather than irrelevant factors. Apparently, the individual rating of each item of evidence allows the evaluation to occur without the distorting influence of the framing effect.

## **Hypotheses Development**

### ***Hypothesis 1a***

Auditors are required to exercise professional skepticism during the performance of an independent audit of a client's financial statements (PCAOB, 2020). The risk assessments made by an auditor during the early stages of an audit is an indication of the extent that he or she believes the assertions made by a firm's management can be relied upon. O'Donnell and Schiltz (2005) and Utami et. al. (2014) demonstrated that the business audit risk approach currently used by auditors has the potential to create a halo effect on the judgment of auditors.

The results of Fanelli and Misangyi (2006) and Treadway et. al. (2009) demonstrated how a superstar CEO can have an unduly influence on the impression that individuals inside and outside a corporation have of the organization's financial performance. It was further shown by Lisic (2015) that an influential CEO can minimize the monitoring effectiveness of a corporation's audit committee. Septian and Astika (2019) provided evidence that a halo effect lessens the impact of auditor professional skepticism on auditor performance. Therefore, it is reasonable that the influence of a superstar CEO along with a business audit risk approach can distort the judgment of auditors in a similar manner as indicated in hypothesis 1a.

H1a: Auditors assess the strategic risk at a lower risk level for firms that employ a superstar CEO than those who employ a non-superstar CEO.

### ***Hypothesis 1b***

The halo effect occurs when a decision maker uses general feelings towards an individual or thing to make judgments about specific attributes although more appropriate information may be available (Thorndike, 1920). A halo effect would appear to be a data related type of bias as described by Kennedy (1993) because the distortion is the result of the manner in which the individual views the relevant data or evidence. Therefore, any debiasing technique should be designed to motivate the auditor to consider other perspectives that are different from the general favorable or unfavorable general feelings that have been imposed by the induced halo effect. Embu and Finley (1997) was successful in mitigating the judgment distortions of a framing effect which is also a data related bias by having participants rate the relevancy and importance of the evidence in a fictitious audit. Because of the similarities between a framing effect and a halo effect, it is reasonable to anticipate that the evidence rating debiasing technique will also be successful in mitigating the judgment distortions caused by a halo effect. As in the Embu and Finley (1997) experiment, the debiasing technique is expected to motivate the participants to focus on relevant rather than irrelevant factors. The hypothesis stated below reflects the expectation that the debiasing technique will significantly mitigate the judgment distortions caused by a halo effect.

H1b: When auditors formally rate evidence, the difference in auditors' strategic risk assessment level for firms that employ a superstar CEO and those who employ a non-superstar CEO will be less than when auditors do not formally rate evidence.

## **Research Design**

An experiment was conducted to test the hypotheses of the study. The manipulated variables of the study are the status of the CEO (superstar or non-superstar) and whether participants are instructed to formally rate the evidence provided in the scenario (evidence rating task or no evidence rating task). Research procedures and instruments used by O'Donnell and Schultz (2005) were modified to test the hypotheses pertaining to the impact of a halo effect on the judgment and behavior of auditors during the performance of a financial audit. The procedures used by O'Donnell and Schultz (2005) were shown to be effective in inducing a halo effect in their experiments. The procedures used in Embu and Finley (1997) will be used in the debiasing portion of the experiment.

## **Participants**

Participants initially consisted of 120 professional auditors involved in public accounting from various locations in the United States. All participants that adequately completed the experiment were financially compensated. Participants consisted of individuals that possess substantial audit experience and those that possessed minimal audit experience.

However, an analysis of the information provided by the participants resulted in 40 of the 120 participants being removed from the study because of concerns pertaining to the validity of the data obtained from these participants. Eighteen participants were removed from the study because it appears that these participants incorrectly reported their audit position as either a director or partner. Twenty-two participants were removed from the study because it was determined that the amount of time that these participants spent completing the experiment task was not adequate to make an informed judgment. Removal of the participants indicated above resulted in the experiment sample being reduced to 80 participants.

An unusual number of participants identified themselves as being employed by a public accounting firm as either a director or partner. These participants were scrutinized in the manner indicated below which resulted in 18 participants being removed from the study. First, participants with less than ten years of public audit experience and identified as either a director or partner were removed. It is highly unlikely that individuals with less than ten years of experience would be employed in these positions. Next, participants identified as participants in these position categories were removed if their years of professional experience was inconsistent with their age.

After participants that identified themselves as either a director or partner were scrutinized, an analysis of the remaining participants was performed to evaluate the adequacy of the amount of time spent completing the experimental tasks. It was expected that participants would complete the experimental tasks within 25 minutes. A very conservative minimum completion time of 5.60 minutes was used to remove all participants that completed the tasks in less than this minimum time. This procedure resulted in 22 participants being removed from the study.

## **Task**

Utilizing a modified version of the case obtained from O'Donnell and Schultz (2005), the impact of a firm's CEO's status (superstar or non-superstar) on the strategic risk assessment and planned audit effort was examined. The premise of the study is that superstar CEOs pose a potential threat to the independence in fact of auditors. Hypotheses were tested by manipulating the reputation of the firm's CEO. Manipulation of the CEOs' reputation created two independent variables (superstar and non-superstar CEO). A detail description of what constitutes a superstar and non-superstar CEO can be found in Appendix B. Two additional independent variables were created based on whether the participants are requested to perform a formal rating of the evidence in the fictitious audit (evidence rating task or no evidence rating task) as a means to minimize the halo effect. Similar to O'Donnell and Schultz (2005), the experiment was conducted in two phrases. Participants completed all phases of the experiment using a national online survey service.

Phase one consisted of providing general information pertaining to the fictitious accounting firm and audit client. In this phase, no information was provided pertaining to the reputation of the firm's CEO. All conditions that existed in prior audit years when the audit client received unqualified audit opinions still existed and therefore participants would be expected to view the strategic risk to be at a moderate level. Based on the information provided, the participants were

requested to assess the strategic risk of the fictitious audit client. Assessments range from 0 which indicates very low risk to 100 which indicates very high risk. After phase one was completed, participants were prompted to continue to phase two of the experiment. Once phase one was completed, participants were not allowed to refer back to this information.

Phase two consisted of participants auditing the same client for the following year. Participants were told that the audit for the previous year went well with no proposed adjusting entries and the client received an unqualified opinion. Similar to phase one, participants were provided general information pertaining to the audit client. This information included a description of the client's new business strategy that is designed to increase its market share as a means to make the firm a more attractive merger partner with a larger company. Participants were also introduced to a new CEO who was hired at the beginning of the year to replace the prior CEO who retired. The participants of the experiment were randomly assigned to a second-year audit scenario in which the CEO of the audit client was either a superstar or a non-superstar CEO and requested to perform either a formal evidence rating task or not requested to perform the task. In both scenarios, the new business strategy which is designed to increase market share by reducing prices on key products of the audit client should logically increase the strategic risk of the audit client because of the more aggressive business goals which may not be achieved. Participants were asked to assess the strategic risk of the fictitious audit client. Assessments range from 0 which indicates very low risk to 100 which indicates very high risk.

### **Sample Selection and Descriptive Statistics**

#### ***Participants***

All experiment participants were secured by a national online survey service. A total of 80 professional auditors involved in public accounting were used as participants in the study. Descriptive statistics pertaining to the experiment participants are presented in Appendix D. Appendix D presents the descriptive statistics pertaining to the participants' professional characteristics. Participants consisted of 23 staff auditors (28.8%), 29 audit managers (36.2%), five directors (6.2%), 20 partners (25.0%), and three other (3.8%). The majority of participants (61.2%) possess professional public auditing experience between one and 10 years. Almost 20 percent (18.8%) of the participants were employed by a Big 4 accounting firm.

Appendix D presents the descriptive statistics pertaining to the participants' personal characteristics. The majority of the participants were male auditors (71.2%) while less than a third (28.8%) were female auditors. Participants were highly educated with over 60 percent (61.2%) possessing a master or doctorate college degree.

### **Experimental Results**

#### ***Hypothesis 1a***

Hypothesis 1a states that auditors assess the strategic audit risk at a lower risk level for firms that employ a superstar CEO than those who employ a non-superstar CEO. This hypothesis was tested in the experiment by having participants randomly placed in a scenario that involved either a fictitious superstar or non-superstar CEO and instructed to perform an audit risk assessment task under conditions which would suggest that there was potentially a high audit risk involved in the audit. In the scenario, the fictitious client had hired a new CEO during the audit year to replace the prior CEO who retired at the end of the prior year. During the audit year, the audit client under the leadership of the new CEO, embarked on an aggressive new business strategy to increase the company's profits and market share in anticipation of merging with a competitor in the future. The uncertainty caused by the hiring of a new CEO and adoption of a new business strategy would be expected to be viewed from the perspective of an auditor that the client's audit risk had substantially increased from the previous audit years.

An analysis of variance was utilized to test whether there was a differential treatment of the audit risk by the superstar and non-superstar CEO participant groups as reflected by their audit risk assessments. The results of the experiment support the hypothesis that a superstar CEO distorts the judgment of auditors as reflected by the significant p-value of .081 pertaining to the mean difference (9.59) of the superstar and non-superstar participant groups' risk assessments in Table 1. Experimental results reflected a mean risk assessment for the non-superstar CEO of 67.00 and a risk assessment of 57.41 for the superstar CEO/no debiasing group on a scale of 1–100 with 100 indicating the highest risk level. Covariates that were tested during the experiment included the following participants' characteristics: (1) educational level, (2) firm



type. (3) audit position, (4) age, and (5) gender. All covariates were determined to have an insignificant differential impact on participants' risk assessment whether it pertained to the superstar or non-superstar CEO group.

**Hypothesis 1b**

Hypothesis 1b states that when auditors formally rate evidence, the differences in auditors' strategic risk assessment level for firms that employ a superstar CEO and those who employ a non-superstar CEO will be less than when auditors do not formally rate evidence. The debiasing technique used by Embu and Finley (1997) to successfully mitigate the framing effect was tested to assess its ability to mitigate the halo effect bias. Embu and Finley (1997) debiasing technique requires participants to rate the relevancy and importance of the evidence. This hypothesis was tested in the experiment by having participants who were randomly placed in a scenario that involved either a fictitious superstar or non-superstar CEO and were either requested or not requested to complete Embu and Finley (1997) debiasing technique prior to rendering an audit risk assessment. The audit risk assessment in the scenario was made during a period of uncertainty due to the hiring of a new CEO and the aggressive business strategy that was implemented.

An analysis of variance with the addition of a Tukey post hoc test was utilized to assess the potential mitigating effect of the debiasing technique on the potential judgment distortions caused by a halo effect. The results of the experiment support hypothesis 1b as reflected by the insignificant p-value of 0.203 pertaining to the mean differences (5.38) of the risk assessments between the non-superstar CEO/no debiasing vs. superstar CEO/debiasing technique as shown in Table 1. Experimental results reflected a mean risk assessment for the non-superstar CEO of 67.00 and a risk assessment of 61.62 for the superstar CEO/debiasing technique group. As indicated by the statistical insignificant mean risk assessment difference between non-superstar CEO/no debiasing vs. superstar CEO/debiasing technique, the study demonstrates that the debiasing technique was effective in mitigating the potential judgment impairment caused by a super-star CEO. Covariates that were tested during the experiment included the following participants' characteristics: (1) educational level, (2) firm type. (3) audit position, (4) age, and (5) gender. All covariates were determined to have an insignificant differential impact on participants' risk assessment whether or not it pertained to either of the three groups.

**Table 1: Analysis of Variance—Hypothesis**

<b>Main Effect on Risk Assessment</b>			
<b><u>DEPENDENT VARIABLE</u></b>	<b><u>INDEPENDENT VARIABLE</u></b>	<b><u>MEAN DIFFERENCE</u></b>	<b><u>P-VALUE</u></b>
Strategic audit risk assessment	<b>Non-Superstar CEO/No Debiasing vs. Superstar CEO/ No Debiasing</b>	9.588	0.081
Strategic audit risk assessment	<b>Non-Superstar CEO/No Debiasing vs. Superstar CEO/ Debiasing</b>	5.381	0.203

**Table 1: Analysis of Variance—Panel B**

<b>Panel B: Risk Assessment Estimates</b>		
<b><u>Group</u></b>	<b><u>No Debiasing</u></b>	<b><u>Debiasing</u></b>
<b><u>Non- Superstar CEO</u></b>	67.00	67.29
<b><u>Superstar CEO</u></b>	57.41	61.62

**Conclusions and Limitations**

The primary purpose of the study was to examine the potential impact that a superstar CEO may have on the judgment of auditors pertaining to the strategic risk assessment of an audit client. O'Donnell (2005) demonstrated how a strategic risk assessment has the potential to distort the financial account level risk assessment and therefore have a negative

impact on the quality of an audit. Since it has been demonstrated that a strategic risk assessment may have a substantial impact of an audit, it would be beneficial for practitioners as well as regulators to understand the potential biased impact that superstar CEOs may have on auditors' risk assessment. A secondary goal of the study was to test whether the evidence rating debiasing technique used by Embu and Finley (1997) to mitigate the judgment distortion influence of a framing effect could also be successful in mitigating the impact of a halo effect bias.

As indicated in the experiment that was conducted in the study, the superstar status of a CEO of a firm being audited appears to have the potential to have a negative impact of the strategic risk assessment of an auditor's overall risk assessment of an audit during the planning stage of an audit. It would be very troublesome if an auditor unwittingly or consciously lowered the strategic risk assessment as a result of the CEO's superstar status. The strategic risk assessment of an audit determines the level of substantive audit tests that are performed as well as the amount of audit time that is devoted to the completion of the audit. Therefore, it is essential that an unbiased strategic risk assessment be performed by the auditor. If the presence of a superstar CEO causes audit risk to be understated, audit quality may be sacrificed and there will likely be less opportunities for the auditor to consider fraud as required by SAS 99 (AICPA, 2020).

Fortunately, the study demonstrates that the potential negative impact on an auditor's judgment caused by the superstar status of a CEO can potentially be minimized by utilizing debiasing techniques. As demonstrated in the study, the evidence rating debiasing technique used by Embu and Finley (1997) demonstrates that the judgment distortion of a halo effect caused by the impact of a superstar CEO on an auditor can potentially be minimized. It is imperative that auditors are vigilant when conducting an audit and employ techniques to minimize the impact of biases during the performance of an audit and consider the possibility that an element of fraud may exist in the financial statements.

As in all experiments, the model of the strategic risk assessment task that is used does not include all the factors that are involved in the performance of the task during an actual financial audit. Although the participants were instructed to perform a detail comprehensive analysis of the information, it is unlikely that the task was performed with the same level of due professional care that would be expected during an actual audit. Also, conclusions reached by auditors during an actual audit are typically reviewed by managers which may lessen the distortions that may occur as a result of a halo effect.

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### Appendix A: Screening of Participants

Are you currently employed by a public accounting firm? Yes, or No. If no, participant will not be allowed to complete the survey.

What is your current position? Indicate one of the following:

- A. Tax professional
- B. Audit professional
- C. Administrative support
- D. IT professional
- E. Other

Any answer other than an audit professional will result in the participant not being allowed to continue the survey.

Indicate your number of months of experience as an audit professional with a public accounting firm?

- A. 0–11 months
- B. 12–60 months
- C. 61 or over

The participant will not be allowed to continue the survey if he or she answers 0–11 months.

### Appendix B: Non-Superstar/Superstar CEO Description

#### *Non-superstar CEO*

The new CEO, John Doe, was hired in January 2015. John has ten years of experience performing the duties of a CEO which was obtained during his tenure with a grocery company that is similar in size and complexity of ABC Grocery Stores. Prior to his employment in the grocery store business, John was a member of his high school golf team and still plays golf recreationally on the weekend. He has occasionally portrayed a businessman character in a local play that is performed annually in his small town and has once been a guest on a local radio show. He is a well-liked member of his neighborhood and has been recognized by his homeowner's association for his service to the neighborhood. John is 5 feet 6 inches tall and is slightly overweight for his height.

#### *Superstar CEO*

The new CEO, John Doe, was hired in January 2015. John has ten years of experience performing the duties of a CEO which was obtained during his tenure with a grocery company that is similar in size and complexity of ABC Grocery Stores. Prior to his employment in the grocery store business, John was a professional golfer who won several PGA major golf tournaments. He has occasionally portrayed a successful CEO character on a nationally broadcasted television show and appeared on various talk shows. He is a prominent member of the community and has received prestigious awards such as "Man of the Year" awarded by the state's Governor. John is 6 feet 4 inches tall and was recently awarded the title of sexiest CEO alive by a national magazine.

### Appendix C: Participant Demographics

What is your highest level of education?

- A. Bachelor
- B. Master
- C. Doctorate
- D. Other

Indicate which accounting certifications you have obtained? Indicate all that apply.

- A. CPA.
- B. CIA.
- C. CMA
- D. CFE

- E. Other
- F. None

Are you employed by a Big 4 accounting firm?

- A. Yes
- B. No

Choose the audit position which best describes your audit position.

- A. Staff Auditor
- B. Audit Manger
- C. Director
- D. Partner
- E. Other

Indicate your total years of public accounting auditing experience.

Indicate your total years of public accounting experience which was not audit related.

Indicate your total years of accounting experience which was not in public accounting.

What is your age?

What is your sex?

- A. Male
- B. Female

**Appendix D: Tables and Figures**

**Panel A: Participants by Audit Firm Position**

	f	%
Staff	23	28.8
Manager	29	36.2
Director	5	6.2
Partner	20	25.0
Other	<u>3</u>	<u>3.8</u>
Total	<u>80</u>	<u>100%</u>

**Panel B: Participants by Years of Public Accounting Audit Experience**

	f	%
0–10 Years	49	61.2
11–20 Years	13	16.2
21–30 Years	11	13.8
31–40 Years	7	8.8
Over 40 Years	<u>0</u>	<u>.0</u>
Total	<u>80</u>	<u>100%</u>

**Panel C: Participants by Years of Public Accounting Non-Audit Experience**

	f	%
0–10 Years	77	96.2
11–20 Years	1	1.2
21–30 Years	1	1.3
31–40 Years	1	1.3
Over 40 Years	<u>0</u>	<u>0</u>
Total	<u>80</u>	<u>100%</u>

**Panel D: Participants by Years of Non-Public Accounting Audit Experience**

	f	%
0–10 Years	80	100
11–20 Years	0	0
21–30 Years	0	0
31–40 Years	0	0
Over 40 Years	<u>0</u>	<u>0</u>
Total	<u>80</u>	<u>100%</u>

**Panel E: Participants by Years of Non-Public Accounting Non-Audit Experience**

	f	%
0–10 Years	80	100
11–20 Years	0	0
21–30 Years	0	0
31–40 Years	0	0
Over 40 Years	<u>0</u>	<u>0</u>
Total	<u>80</u>	<u>100%</u>

**Panel F: Participants by Type of Accounting Firm**

	f	%
Big 4	15	18.8
Non-Big 4	<u>65</u>	<u>81.2</u>
Total	<u>80</u>	<u>100%</u>

**Panel G: Participants by Educational Level**

	f	%
Bachelor	31	38.8
Master	47	58.8
Doctorate	2	2.4
Other	<u>0</u>	<u>0</u>
Total	<u>80</u>	<u>100%</u>

**Panel H: Participants by Gender**

	f	%
Male	57	71.2
Female	<u>23</u>	<u>28.8</u>
Total	<u>80</u>	<u>100%</u>

**Panel I: Participants by Age**

	f	%
19–29 Years Old	26	32.5
20–39 Years Old	22	27.5
40–49 Years Old	16	20.0
50–59 Years Old	8	10.0
60–69 Years Old	7	8.8
70 and over	<u>1</u>	<u>1.2</u>
Total	<u>80</u>	<u>100%</u>