

How is auditor commercialism related to audit quality (and efficiency)

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FAR Plenary 3 Presentation

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Agenda

- Why is this important?
- Research Question(s)
- Expected Relationships (Results)
- Data
- Data analysis
- Discussion of results
- Contribution to academic knowledge
- Contribution to audit quality
- Knowledge sharing plan

Why is this important?

Commercial motivations



Professional motivations

Maximize auditor wealth

Act in society's interest by
exercising skepticism,
independence, due care

e.g. Entertaining clients, developing sales proposals

e.g. Performing audit tasks, CPE, mentoring staff

Taken for granted assumption!

Why is this important?

“It is important that an audit firm has robust internal governance arrangements to safeguard the public interest nature of the audit function and to **avoid the firm’s commercial interests adversely affecting audit quality**, for example, by inappropriately promoting other practice areas (such as tax, corporate finance and consultancy) to the detriment of audit quality.”
- *International Federation of Accountants 2014*

“**Audit firms are organisations with commercial interests.** They are paid by the organisations being audited, i.e. their audit clients, and they compete with each other to win and retain audit business. This set-up creates inherent tension for auditors. On the one hand, the external auditor has to adopt an objective and sceptical attitude towards his audit client in order to perform a high-quality audit. On the other hand, the **auditor aims to provide the best possible service to his audit client in order to win or retain the business of that client.**”

– *AFM, 2011*

Why is this important?

“You know, a manager cannot be promoted if he is only a good auditor, sitting most of the time in his office. The firm wants its partners capable of recruiting new clients and selling a variety of services to existing clients” – Audit partner, Gendron (2002)

“...the tension between maintaining a high quality audit and succumbing to the commercial interests of an audit firm..” – J. Robert Brown, PCAOB Board Member, 2021

Why is this important?

- Theory and evidence also seems to suggest that allocating more time to commercial activities increases auditors' beliefs about the importance of those activities and ultimately their motivations to perform those activities well (Coffey 1994; Anderson-Gough et al. 2001; Suddaby et al. 2009; Bergeron et al. 2013)
- Commercial motivations may lead auditors to budget less time to complete audit engagements or unconsciously impair judgments as they conduct audit tasks (e.g. Bazerman et al. 1997; Moore et al. 2006; Nelson 2006; Guo 2016)

Research questions

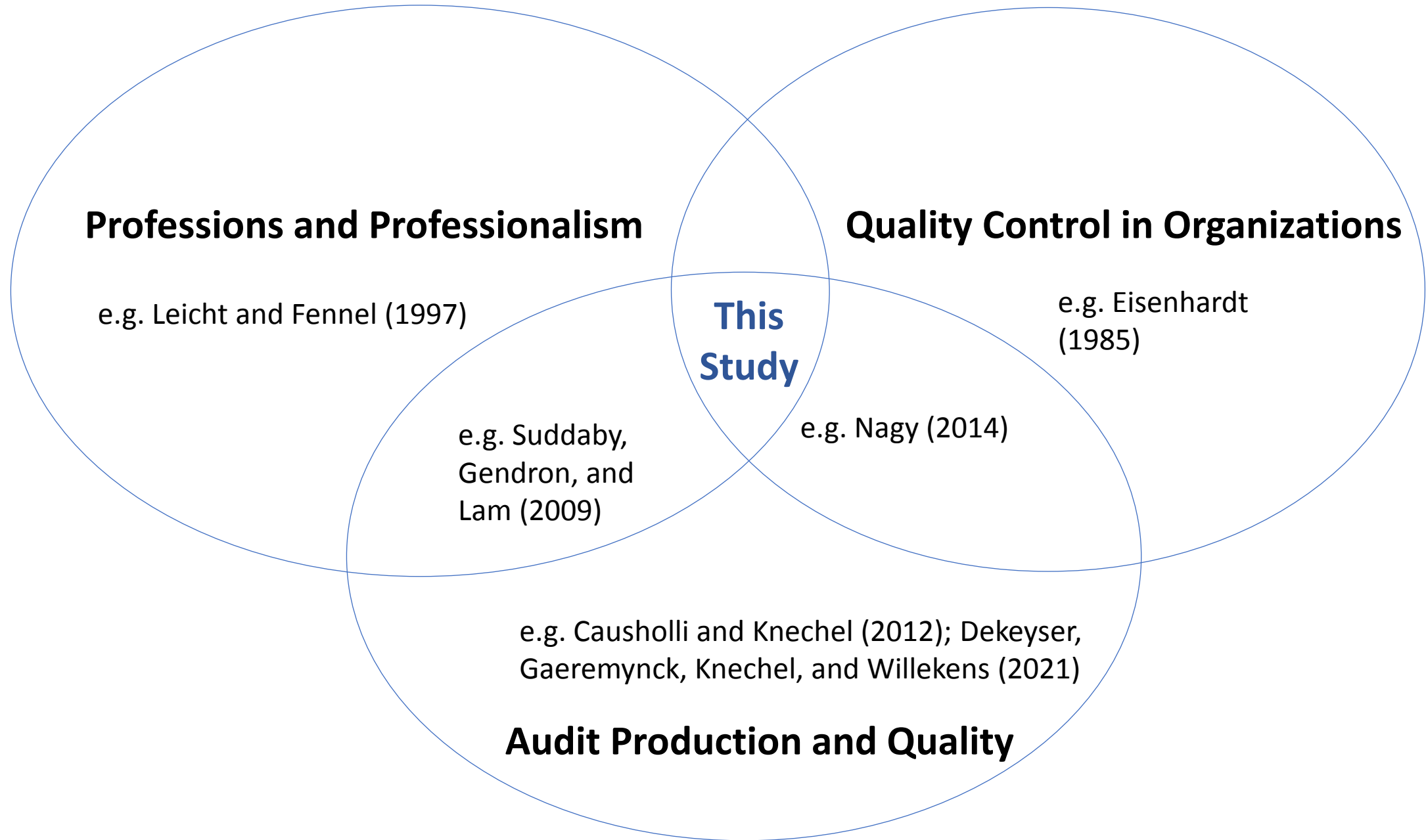
- Main research question:

Does auditors' commercial effort decrease audit quality?

- Two additional research questions addressed in our study:

Does auditors' commercial effort affect auditor compensation?

Does auditors' commercial effort affect audit engagement effort?



Professions and Professionalism

e.g. Leicht and Fennel (1997)

Quality Control in Organizations

e.g. Eisenhardt (1985)

This Study

e.g. Suddaby, Gendron, and Lam (2009)

e.g. Nagy (2014)

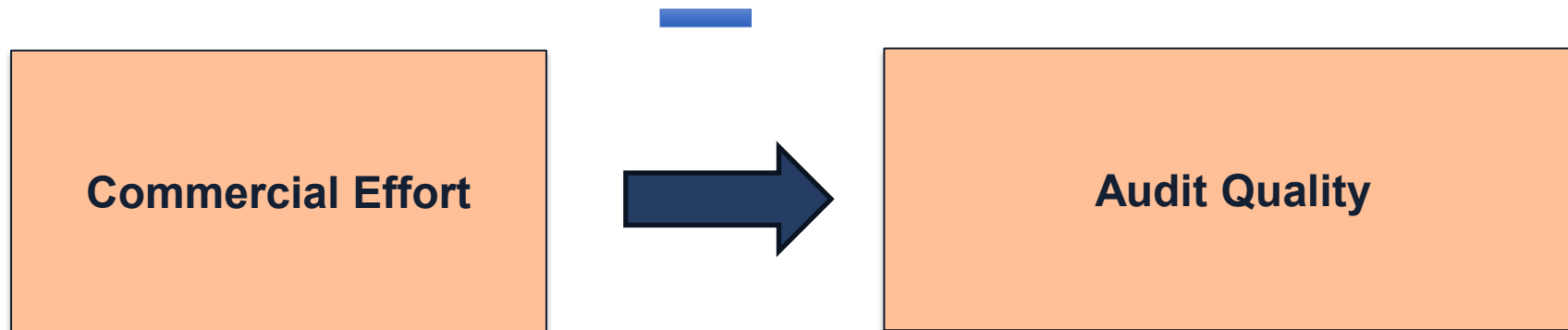
e.g. Causholli and Knechel (2012); Dekeyser, Gaeremynck, Knechel, and Willekens (2021)

Audit Production and Quality

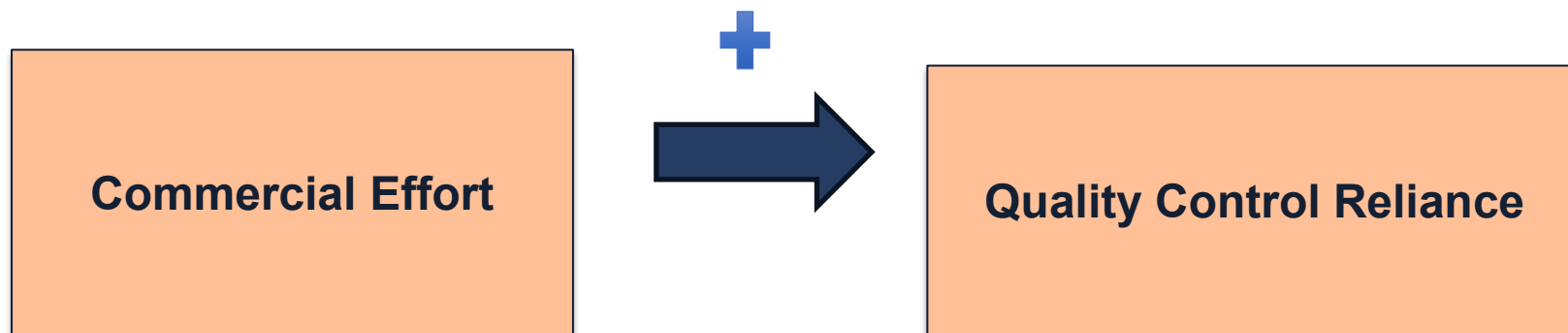
Research questions relevant for practice?

- Is commercial effort associated with lower audit quality?
- Is commercial effort associated with more access of quality control?
- Does quality control mitigate the negative impact of commercial effort on audit quality?
- Should regulators seek to directly curtail commercial effort?
- Should regulators focus instead on promoting stronger quality controls?

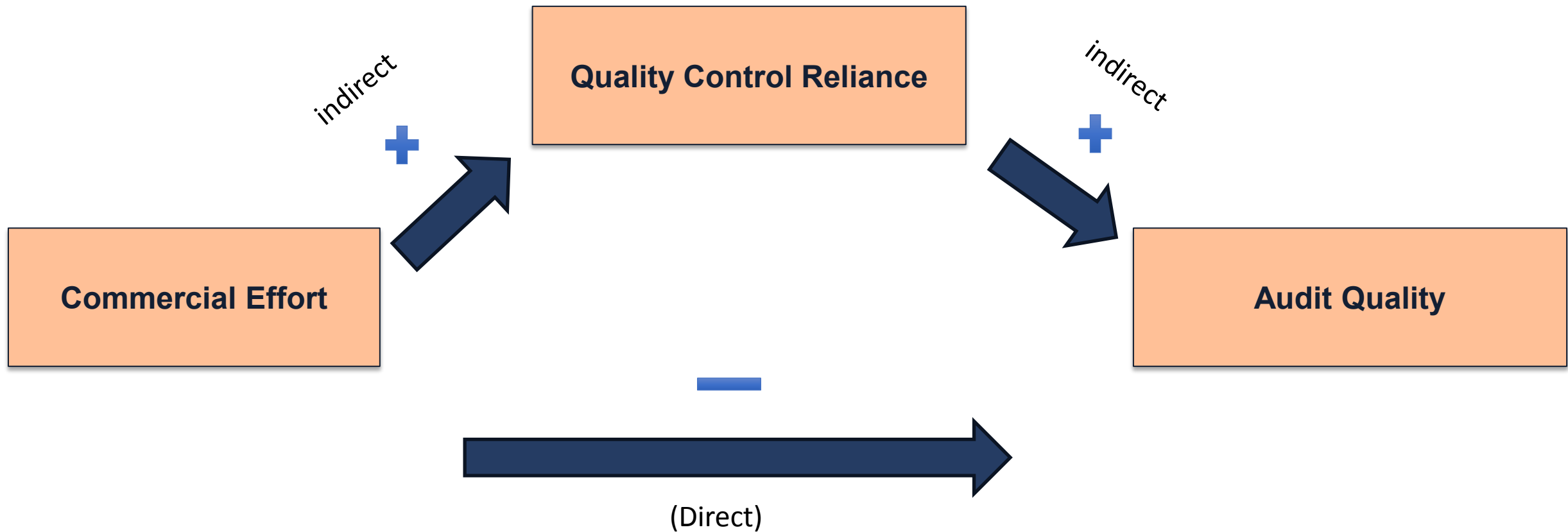
Expected relationships (results)



Expected relationships (results)



Expected relationships (results) summarized: Two competing paths



Data

- **Unit of analysis?**
 - Test variable, **Commercial Effort**: Partner/Director level
 - Dependent variable 1, **Audit Quality**: Partner/Director portfolio level
 - Dependent variable 2, **Quality Control**: Partner/Director portfolio level

Data – Commercial Effort

- **Auditor/Director Commercial time allocation (in hours)**
- Commercial effort measured as the total number of hours a given auditor spends on practice development

Data – Audit Quality

- **Audit Quality**
- Average engagement quality score for an auditor averaging all internal and external review scores
- The total number of modified opinions issued by the auditor
- Other: Restatements and possibly Abnormal Accruals

Data - Quality Control

- Total hours incurred by technical consultants for a given auditor's client portfolio
- Total hours for mandatory consultations incurred by technical consultants for a given auditor's client portfolio
- Total hours for voluntary consultations incurred by technical consultants for a given auditor's client portfolio
- Engagement leverage which is the ratio of the aggregate number of partner/director/senior manager hours on all audit engagements for the auditor divided by the aggregate number of hours by all other personnel working on audit engagements for the auditor

Data – control variables

- Professional Effort
 - Total hours spent on learning and education for a given auditor
 - Total hours spent on quality control reviews for other auditors' engagements for a given auditor
 - Total hours spent on audit work for a given auditor
 - Total hours spent recruiting for a given auditor
- Portfolio Characteristics
 - Portfolio size measured as total audit fees for the auditor's portfolio
 - Knowledge spillover measured as total non-audit fees for the auditor's portfolio
 - Client complexity measured as the number of listed companies for an auditor's portfolio
 - Client riskiness for an auditor's portfolio
 - Industry focus measured as the client industry that comprises the largest share of the auditor's client portfolio
- Auditor Characteristics
 - Auditor compliance measured as a dichotomous variable taking a value of one if the auditor has an independence or internal policy violation; 0 otherwise.
 - Auditor quality measured using the auditor's performance evaluation score
 - Auditor experience measured as either:
 - The auditor's rank (i.e. Partner, directors, or senior manager)
 - The auditor's tenure measured as the total number of years the auditor has been in practice
- Audit office measured using total audit fees for a given audit office

Data

- Data collection:
 - Process:
 - Primary data collected from firms' management accounting information systems
 - Supplemental audit quality data to be collected by the FAR
 - Timing:
 - Data collection in final stage but not yet complete
 - Finalizing data sets and analysis this summer

Data analysis

- We will estimate the following set of generalized regressions
 - Quality Control = $f(\text{Commercial Effort}; \text{Control Variables})$
 - Audit Quality = $f(\text{Commercial Effort}; \text{Quality Control}; \text{Control Variables})$

Discussion of results

- Caveats
 - Possible correlated omitted variables
 - Non-representative sample
 - Statistical power
- How certain can we be?
 - Reasonably confident because
 - Econometric techniques to address correlated omitted variable concerns
 - Obtain archival data from two firms
 - Only include partners, senior managers, and managers in sample
 - Power unlikely to be a problem
 - Power greater than 0.99 for our expected analysis

Contribution to academic knowledge

- New insights
 - Is commercial effort actually negatively related to audit quality?
 - Are auditors more/less likely to access quality control given their degree of commercial focus?
 - Does quality control mitigate the negative impact of commercial effort on audit quality?
- New questions
 - Are there more effective/efficient ways to design teams to balance commercial and professional interests?
 - What other quality controls can firms put in place to safeguard audit quality?
 - Could a similar emphasis on quality control mitigate the perceived negative impact of the joint provision of audit and non-audit services?

Contribution to audit quality

- Implications for practitioners
 - Commercial effort does not necessarily mean audit quality has to be lower
 - Quality control is critical to delivering and preserving audit quality
- Implementation in practice
 - Understand the audit partners/senior managers/managers in your firm
 - Look at how they allocate their time
 - What are their skillsets? What roles are they most comfortable performing?
 - Maintain and promote use of quality control mechanisms
 - Strong technical expertise for consultation
 - Careful structuring of engagement teams to have sufficient blend of technical skills

Knowledge sharing plan

- Academic Presentations
 - *Journal of Accounting Research* 2021 Second Registered Reports Conference
- Academic Journal Submission
 - Invited to resubmit registered report to *Journal of Accounting Research*
- Publication for wider audience
 - Foundation for Auditing Research Practice Note

THANK YOU

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