

Culture Controls in Audit Firms

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Culture Controls in Audit Firms



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Background

- The mission of FAR is to improve audit quality
- Inherent incentive conflicts between auditors, client management, and society at large reduce the potential for explicit incentives alone to ensure high audit quality
- Audit firms have shown interest in ‘soft’ cultural controls
- ***To what extent has the audit profession implemented an organizational culture that ensures high audit quality?***

Research set-up

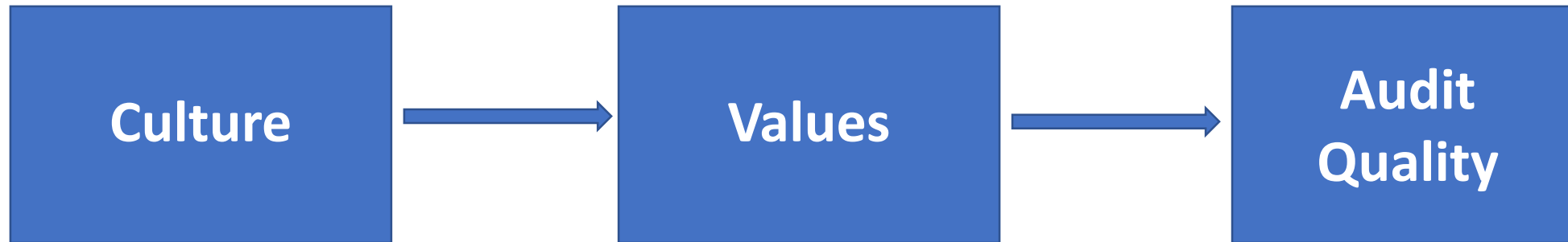
Organizational culture: The organizational purpose and values that the organization and employees share and that *guide decision-making and actions in domains where explicit rules and policies are difficult to define*

- Culture helps internalize values



Research set-up

- Culture helps internalize values



Research Questions

Part 1:

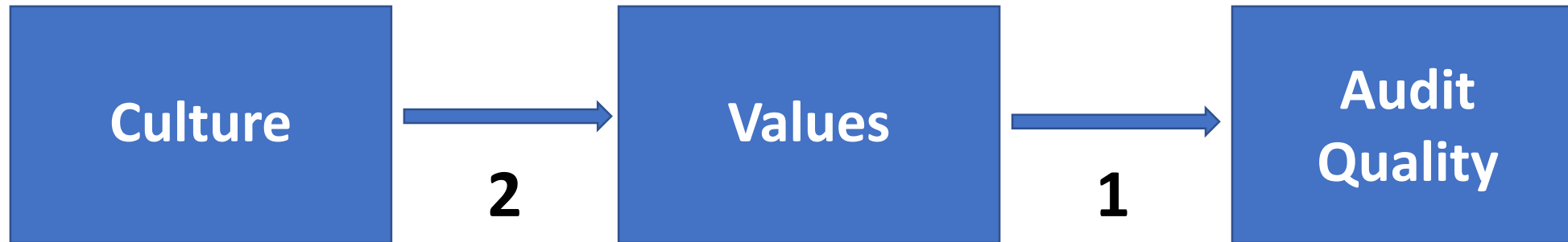
- Which cultural values can lead to better professional judgment when **assessing the risk** of material misstatement in management's accounting estimates **and** in **planning actions** that better address this more appropriately assessed risk?

Part 2:

- What are the determinants of those values that improve professional judgment?

Research set-up

- Culture helps internalize values



Research set-up



- Action oriented
 - Prior research show skeptical beliefs often do not translate into skeptical actions
 - Prior research shows that skeptical beliefs often are **not** calibrated to evidence of misstatement

Part 1: Values – Calibrated Skeptics

- Auditors who value **well-calibrated professional skepticism**
 - Questioning mind and critical assessment of and response to evidence
- Not just being more skeptical or conservative all around
 - Calibrate how much to push for more reasonable estimates only when called for
 - In line with evidence as well as incentives and (often subconscious) biases of client management

Part 1: Values - Auditor Pride

- Auditors who value **taking pride** in their profession
- Substantial investment of financial and human resources in the Auditor Proud theme
- Auditorproud# videos and campaigns in the USA, The Netherlands, and globally
 - Google search on 1 June 2022 on **Auditor Proud** returns > 31 million web page results and over 600.000 videos

Part 1: Values - Auditor Pride

- To date, no empirical investigation on the impact of higher levels of auditor pride on auditors' professional judgment quality or on other measures of audit quality
- **Enduring latent pride:** Engrained value
- **Primed pride:** An 'in the moment' emotional state that affects auditors' judgment and actions

Part 1: Values

- We examine whether auditors who...
 - perceive themselves as **calibrated skeptics**
 - indicate high levels of **latent pride** in the profession
 - are **primed to experience pride** in the profession
 - ... think critically about audit evidence while **assessing the risk of material misstatement** and while **planning actions** to address this risk

Part 1: Data Collection

- Interviews – April to June 2019
 - 34 interviews in total
 - 3 audit firms
 - 3 partners, 16 seniors, 14 juniors, and 1 HR manager
- Experiment and Survey – August & September 2019
 - 409 participants in total
 - 5 audit firms
 - 2 Big 4 and 3 Non Big 4
 - 49 partners, 221 seniors, and 139 juniors

Part 1: Data from Survey

Perceived Skeptical Calibration

- How often do you ensure high audit quality by...
 - Pushing **back** to e.g., colleagues, your supervisor, the client
 - Following up with the client **when appropriate**
 - Being vigilant about things that are **in the grey zone**
 - Getting expert help **if necessary**

Part 1: Data from Survey

Measured Pride

- I am proud to be an auditor
- I am especially proud to work for {audit firm}
- I care deeply about the future of the audit profession
- I am proud to tell my friends that I am an auditor
- I am extremely happy that I chose the audit profession over others I was considering at the time I joined
- I consider being an independent auditor a significant professional accomplishment

Part 1: Experiment

- Experimental task:
 - Participants are **part of the audit engagement team** of Heerlijke Kaas, one of the largest cheese companies in the Netherlands
 - They **assess the reasonableness of management's assumption** about future revenue growth for its flagship cheese, Glorious Gouda

Part 1: Experiment

- Participants are divided into two groups:
 1. Management's forecasted revenue is reasonable (neutral)
 2. Management's forecasted revenue is unreasonable (aggressive)
- Design distinguishes overall conservativeness from calibrated skepticism
 - When the growth rate is *reasonable*, pushing back will likely **decrease audit quality**
 - When the growth rates is *unreasonable*, pushing back will likely **increase audit quality**

Part 1: Experiment

- Participants are again divided into two groups:
 - One group is primed to feel pride, the other is not
- **Prime**
 - Text about pioneers who helped establish the modern audit profession
 - Text exemplified how the auditing profession can create tremendous value for society by being a courageous champion of integrity, objectivity, and honesty
 - At the end of the text, participants describe their key takeaways

Part 1: Experiment

Judge

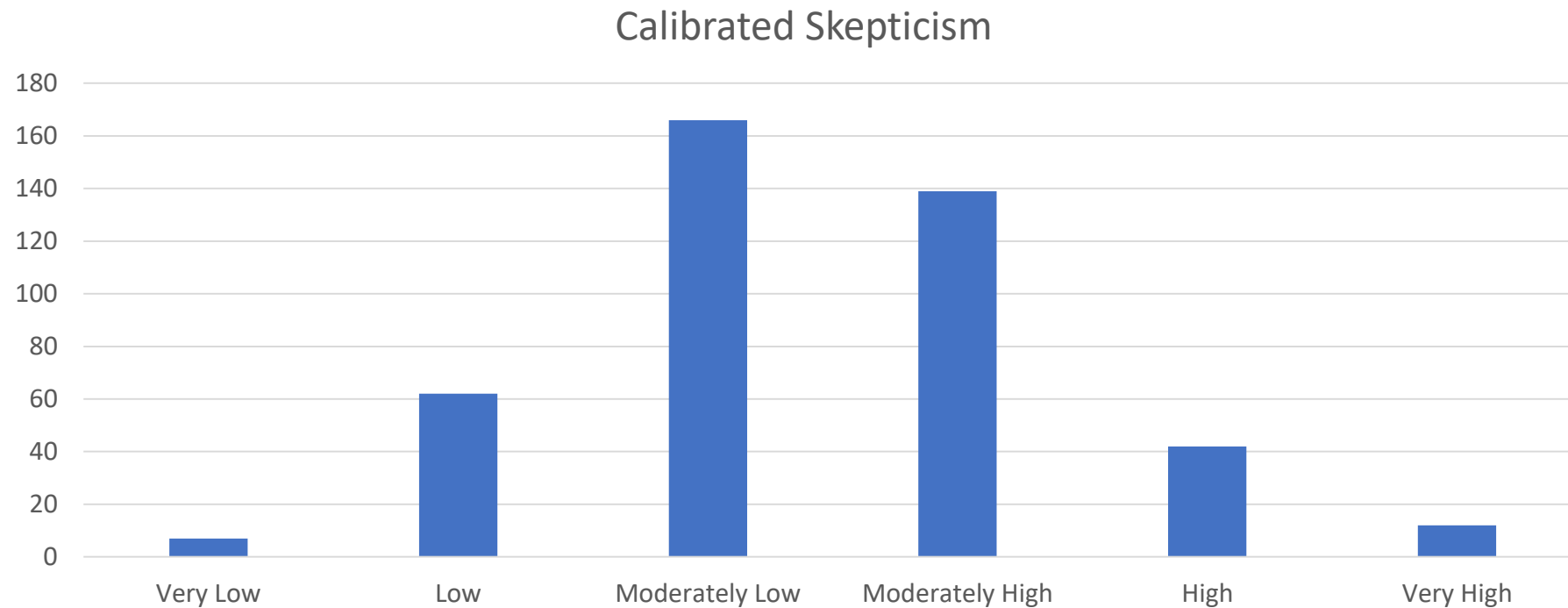
- How comfortable are you with management's assumed revenue growth rate of X%?
- Do you believe that management's X% growth assumption is biased?
- How reasonable is management's X% revenue growth assumption?

Action

- In this situation, should the audit partner “sign off” and grant a clean audit opinion on HK's financial statements?

Part 1: Calibrated Skeptics

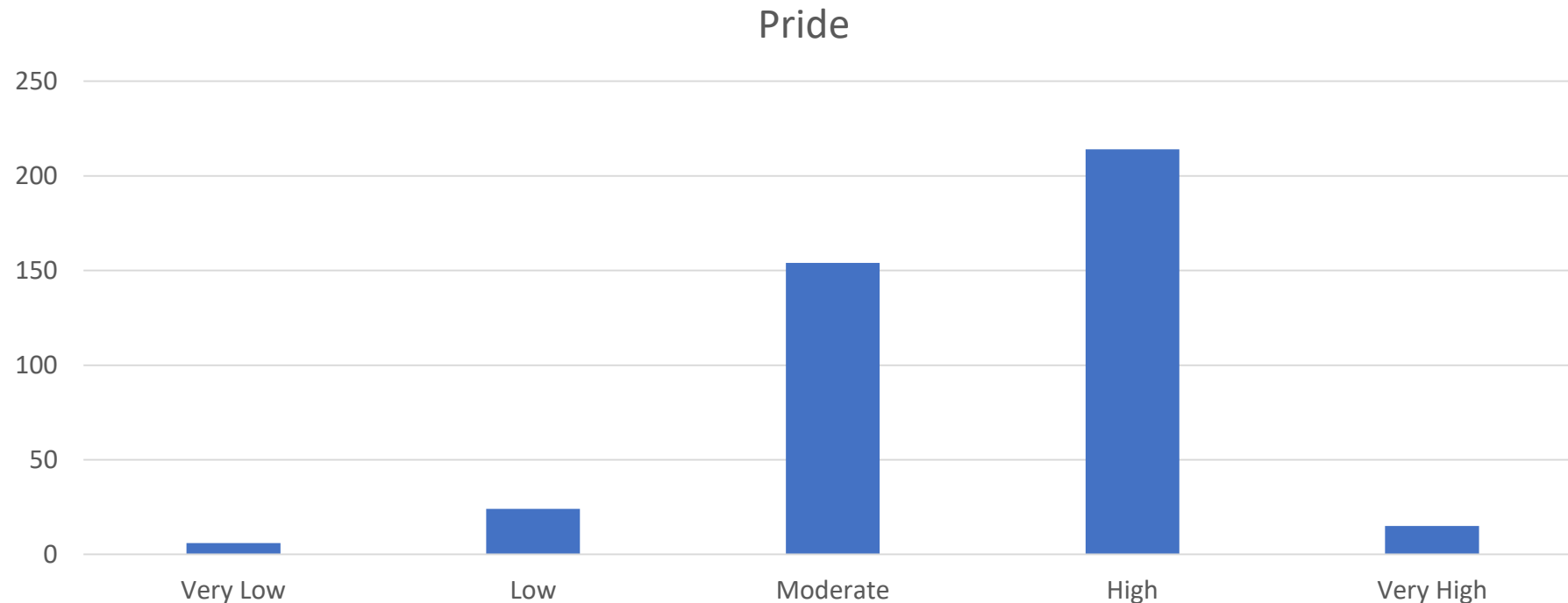
- Prior studies suggest auditors have trouble applying calibrated skepticism



- Significant variation in how auditors perceive themselves

Part 1: Auditor Pride

- No a priori expectations on auditor pride



- Significant variation across auditors' enduring latent pride.

Part 1: Results of experiment

VARIABLES	Neutral Growth Rate Judge	Aggressive Growth Rate Judge	Neutral Growth Rate Actions	Aggressive Growth Rate Actions
Perceived Skeptical Calibration	-0.0778 (0.0893)	-0.225*** (0.0795)	-0.0102 (0.0986)	-0.241*** (0.0740)
Measured Pride	0.0351 (0.0861)	0.0243 (0.0794)	-0.0808 (0.0951)	0.0635 (0.0739)
Primed Pride	0.0188 (0.140)	-0.0106 (0.131)	-0.0392 (0.155)	-0.128 (0.122)
Controls				
Observations	195	204	195	204
R-squared	0.125	0.181	0.149	0.152

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Controls				
Observations	195			
R-squared	0.125			

Auditors who perceived themselves to be calibrated skeptics indeed show well-calibrated professional skepticism

- The experimental results validate our calibrated skepticism measure

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Observations	195	204	195	204
R-squared	0.125	0.141	0.149	0.152

No evidence that higher pride drives better professional judgment

Part 1: Implications for Audit Profession

To enhance audit quality:

- Investments in increasing the levels of **calibrated skepticism** is **promising**, as that drives better professional judgment in our experiment
- Investing in increased levels of **auditor pride** is **not promising**: We observe no evidence that it drives better professional judgment in our experiment

Future research:

- Do higher pride have other beneficial outcomes? Recruitment? Retention?

Part 1: Implications for Audit Profession

- But how can audit firms increase calibrated skepticism?

Part 2

- We examine the determinants of auditors' well-calibrated professional skepticism
 - What makes calibrated skeptics?

Part 2: Determinants of Calibrated Skeptics

- We examine how the management control system, specifically the **organizational culture**, promotes and engrains the value of calibrated skepticism
 - **Management controls:** Organizations' actions undertaken to increase the probability that employees will behave in ways leading to the attainment of organizational objectives
 - **Organizational culture:** The organizational purpose and values that the organization and employees share and that guide decision-making in domains where explicit rules and policies are difficult to define

Part 2: Organizational Cultural Content

Cultural content that likely promotes calibrated skepticism:

- An organizational culture where auditors **perceive** that audit firm leadership truly values auditors getting a deep understanding of the client's financial statements
 - Includes the facilitation of learning, openness, and the provision of sufficient resources and attention
- We call this **Facilitating Culture**

Part 2: Organizational Cultural Content

Cultural content that likely promotes calibrated skepticism:

- An organizational culture where auditors **perceive** that audit firm leadership truly values being independent from clients
- We call this **Independence Culture**

Part 2: Auditors' Personal Values

Personal values that are likely associated with being a calibrated skeptic:

- Auditors who truly value contributing to society's best interest
- Auditors who value getting to the bottom of things

Part 2: Data from survey

Facilitating culture 1

- I feel like my supervisors, including the audit partner, truly appreciate learning when I have serious concerns about the quality of management's accounting estimates or disclosures
- There are many resources (like the partner, the specialists, etc.) to help when I have questions
- Through tone at the top, open communication is promoted
- [Company name]'s culture gives me the feeling that I do not have to hide my mistakes

Part 2: Data from survey

Facilitating culture 2 - Budget pressure

- Please think about all audit engagements you have worked on in the busy season
- On what percentage of these engagements would each of the following statements apply:
 - The budget allows for sufficient time for our audit team members and I to **think critically about the information provided** by the client
 - The budget allows for sufficient time for our audit team members and I **to be critical about client management's estimates** that are in the grey zone
 - The budget allows for sufficient time to **involve experts** if it is beneficial to audit quality

Part 2: Data from survey

Independence culture

- I feel like the partners would fire a client when its deliverables threaten audit quality
- [Company name] ensures that we do not have clients from whom we cannot be independent
- I feel like the partners do not distinguish between strategic and non-strategic clients in the services that they offer
- I feel like the partners take on too many clients

Part 2: Data from survey

Importance society

- Contributing to society is very important to me

Bottom of things

- I really like to get to the bottom of things
- I cannot stand it when something is not exactly correct

Part 2: Data

- Controls
 - Auditor competence
 - Performance conflict
 - Competitive environment
 - Perception of the extent to which audit quality is promoted in company values, objectives, and priorities
 - Job tenure, ambition to become partner, intention to leave, big 4

Part 2: Results

Variables	Calibrated Skeptics
Facilitating culture - factor	0.117** (0.0492)
Facilitating culture – Budget pressure	-0.0117*** (0.00198)
Independence culture	-0.0745 (0.0469)
Importance society	0.0970*** (0.0330)
Bottom of things	0.124*** (0.0427)
Auditor competence	0.290*** (0.0435)
Performance conflict	0.00733 (0.0445)
Culture message	-0.0189*** (0.00707)
Competitive environment	-0.0217 (0.0248)
Long tenure	0.234*** (0.0879)
Leave	-0.0196 (0.100)
Aim partner	0.131 (0.101)
Big 4	0.399*** (0.0944)
Constant	-1.564*** (0.228)
Observations	399
R-squared	0.406

Part 2: Results

Variables	Calibrated Skeptics
Facilitating culture - factor	0.117** (0.0492)
Facilitating culture – budget pressure	-0.0117*** (0.00198)
Independence culture	-0.0745 (0.0469)
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An organizational culture where auditors perceive that audit firm leadership truly values auditors getting a deep understanding of the client's financial statements leads to more calibrated skeptics

Part 2: Results

Variables	Calibrated Skeptics
Facilitating culture - factor	0.117** (0.0492)
Facilitating culture – budget pressure	-0.0117*** (0.00198)
Independence culture	-0.0745 (0.0469)
Importance society	0.0970*** (0.0330)
Bottom of things	0.124*** (0.0427)
Controls	
Observations	399
R-squared	0.406

An organizational culture where auditors perceive that audit firm leadership truly values being independent from clients does not affect the levels of calibrated skepticism

Part 2: Results

Variables	Calibrated Skeptics
Facilitating culture - factor	0.117** (0.0492)
Facilitating culture – budget pressure	-0.0117*** (0.00198)
Independence culture	-0.0745 (0.0469)
Importance society	0.0970*** (0.0330)
Bottom of things	0.124*** (0.0427)
Controls	
Observations	399
R-squared	0.406

Auditors who personally place value on the importance of society are more likely to be calibrated skeptics

Auditors who personally value getting to the bottom of things are more likely to be calibrated skeptics

Part 2: Results

Variables	Calibrated Skeptics
Facilitating culture - factor	0.117** (0.0492)
Facilitating culture – budget pressure	-0.0117*** (0.00198)
Independence culture	-0.0745 (0.0469)
Importance society	0.0970*** (0.0330)
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An organizational culture where auditors perceive that audit firm leadership truly values being independent from clients does not affect the levels of calibrated skepticism

Part 2: Results

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Facilitating culture - factor	0.117** (0.0492)
Facilitating culture – Budget pressure	-0.0117*** (0.00198)
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Part 2: Results

Variables	Calibrated Skeptics
Auditor competence	0.290*** (0.0435)
Performance conflict	0.00733 (0.0445)
Culture message	-0.0189*** (0.00707)
Competitive environment	-0.0217 (0.0248)
Observations	399
R-squared	0.406

Auditors who feel more competent are more likely to be calibrated skeptics

Part 2: Results

Variables	Calibrated Skeptics
Auditor competence	0.290*** (0.0435)
Performance conflict	0.00733 (0.0445)
Culture message	-0.0189*** (0.00707)
Competitive environment	-0.0217 (0.0248)
Observations	399
R-squared	0.406

Performance conflict and competitive environment have no impact on calibrated skeptics

Part 2: Results

Variables	Calibrated Skeptics
Auditor competence	0.290*** (0.0435)
Performance conflict	0.00733 (0.0445)
Culture message	-0.0189*** (0.00707)
Competitive environment	-0.0217 (0.0248)
Observations	399
R-squared	0.406

The message of audit quality is not enough to increase calibrated skepticism

Part 2: Results

Variables	Calibrated Skeptics
Long tenure	0.234*** (0.0879)
Leave	-0.0196 (0.100)
Aim partner	0.131 (0.101)
Big 4	0.399*** (0.0944)
Constant	-1.564*** (0.228)
Observations	399
R-squared	0.406

Auditors who have longer tenure are more likely to be calibrated skeptics

Part 2: Results

Variables	Calibrated Skeptics
Long tenure	0.234*** (0.0879)
Leave	-0.0196 (0.100)
Aim partner	0.131 (0.101)
Big 4	0.399*** (0.0944)
Constant	-1.564*** (0.228)
Observations	399
R-squared	0.406

Intentions to leave do not leave to higher levels of calibrated skepticism
Auditors who have the ambition to become partners are no more likely to be calibrated skeptics

Part 2: Results

Variables	Calibrated Skeptics
Long tenure	0.234*** (0.0879)
Leave	-0.0196 (0.100)
Aim partner	0.131 (0.101)
Big 4	0.399*** (0.0944)
Constant	-1.564*** (0.228)
Observations	399
R-squared	0.406

Auditors at the big 4 are more likely to be calibrated skeptics

Part 2: Implications for Audit Profession

- Enhance audit quality by increasing the levels of calibrated professional skepticism of auditors
 - By building action-oriented culture that makes auditors feel that audit firm leadership truly values auditors getting a deep understanding of the client's financial statements
 - Go beyond commercial messaging, auditors need to perceive the importance

Part 2: Implications for Audit Profession

- Enhance audit quality by increasing the levels of calibrated professional skepticism of auditors
 - Through selection and promotion, focus on individuals that care about societal interests and want to get to the bottom of things
 - Ensure that auditors are and feel competent

Part 2: Future Research

- Organizational culture is a multi-faceted control that is constructed through the combination of four elements:
 - Selection of personnel
 - Reinforcement systems
 - Accountability and feedback systems
 - Training and coaching
- What **specific control elements** can be used to build a culture where auditors perceive that audit firm leadership truly values auditors getting a deep understanding of the client's financial statements?

THANK YOU

For questions please email me at jbol@tulane.edu

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