

Practice Note

The Effect of Audit Culture on Audit Quality

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Executive Summary

In this research note, we discuss why designing a management control system that directs effort towards audit quality is so tricky. We discuss the different ways that audit firms motivate effort and highlight “culture controls” where, through selection and socialization, audit firms create a workforce of auditors that value and, therefore, work hard to ensure audit quality. We also discuss the importance of directing auditors’ efforts towards audit quality and distinguish three critical elements. Auditors must: (1) understand the importance of audit quality, (2) possess the right tools and capabilities, and (3) prefer those tasks that lead to audit quality. We share some preliminary results of our research that examines how successful five Dutch audit firms are at this non-trivial task. This provides firms with the knowledge to critically examine and improve their own current management control system. Our study is relevant for Dutch audit firms as well as for auditors all over the world.

Introduction

In business, employees are one of the most important drivers of success. Audit firms, in particular, rely greatly on employee cooperation and knowhow to achieve organizational objectives. As a result, smart audit firms motivate and guide staff members to organizational goals. Without proper motivation and guidance, employees take actions that may not enhance organizational value or may even take actions that destroy value. Importantly, this does not necessarily suggest that they engage in fraud or intentional negative behavior, because value also evaporates, for example, when employees simply prioritize the wrong actions on a busy day. To mitigate these motivation and direction concerns, effective audit firms use a management control system (see Merchant and Van der Stede 2007; Flamholtz 1983; Otley and Berry 1980; Ouchi 1979). In our research study, we examine how Dutch audit firms use their management control system to motivate and direct auditors' efforts towards audit quality.

Influencing Behavior in the Audit Sector

Auditing offers a social public good, at least potentially, when auditors fully commit to ensuring that client management's financial statements not only contain no material misstatements but also provide a fair and true depiction of the company's financial position—results of operation and cash flows. However, since audit firms are for-profit businesses who are compensated by their clients, audit quality may not be their sole concern. Audit firms compete for pecuniary rewards and want to retain prestigious clients. Previous behavioral audit studies have shown how these alternative objectives (often subconsciously) decrease auditors' objectivity in evaluating management's

accounting choices and audit evidence. Instead of being objective, auditors may actively try to justify reaching management-preferred conclusions (see Kadous, Kennedy and Peecher 2003; Peecher, Piercey, Rich and Tubbs 2010; Altiero, Kang and Peecher 2018). Thus, developing a management control system to motivate a commitment to audit quality is not a straightforward task.

Effective Management Control Systems

Following Merchant and Van der Stede (2007) and Bol and Loftus (2019), we argue that an effective management control system must activate effort and direct it towards achieving organizational goals. For audit firms, this means the system should motivate auditors to work diligently to provide high audit quality. Traditionally, audit firms have used financial rewards as incentives to motivate employees. Good starting salaries, opportunities to develop valuable skills, and prospects to become a partner have resulted in the willingness of auditors to work hard. However, directing that effort towards audit quality is difficult. Audit firms conventionally have used pay-for-performance systems where high performance is rewarded with bonuses and promotions. Unfortunately, audit quality can be very hard to assess. Performance measures tend to focus on more quantifiable areas, like profitability, client acquisition, client satisfaction, and meeting the budget. However, research has shown that these measures likely do not capture, and may even destroy, audit quality. High audit quality demands keen professional judgment, which in turn requires both technical and tacit knowledge (i.e., emotional intelligence) throughout an engagement (Bol, Estep, Moers and Peecher 2018). To accomplish the challenging task of assessing audit quality on particular engagements, audit firms have also relied on

subjective performance evaluations about the quality of auditors' professional judgments and have linked these evaluations to financial rewards and promotions. But, because supervisors have similar conflicted incentives and time pressures as their subordinates, the success of this mechanism is limited.

Recent financial reporting scandals cast further doubt on the effectiveness of these mechanisms. And, as a result of these scandals and the subsequent pressure from regulators such as the AFM (Authority for the Financial Markets), audit firms have begun to increase their focus on audit quality by emphasizing "culture controls" in their management control systems. Culture controls are principles and actions that enhance the value alignment between organization and employee. These controls do not rely on an individual's desire for tangible reward but, instead, rely on their willingness to work hard for what they believe in (i.e., their values). Employees exert effort, because they care about their organization's values and objectives. Value alignment is created by employee selection and socialization. Through these mechanisms, audit firms try to create a workforce whose members are united by their shared commitment to audit quality. This motivates them to work hard to achieve what they care about—high audit quality.

Culture controls prompt a desire for audit quality that is held internally, which implies that the performance measurement and monitoring problems of audit quality are not as evident, resulting in less conflict with effort direction than other effort activating rewards. It is, however, not clear whether audit firms have been successful in creating a workforce that is internally and increasingly committed to audit quality. Moreover, even though internal commitment to audit quality can be an important driver of employee

behavior, it will unlikely be the only driving factor, as employees also care about salaries, bonuses, and promotions. No matter how much individuals care about the social public good of audit quality, value alignment alone in this area is unlikely enough motivation for auditors to put in the long hours and challenge management's assertions when required to ensure high quality, especially in the busy season. Thus, while firms may reduce the need for motivating and directing effort to audit quality by increasing the value alignment of their auditors through culture controls, the effort-directing challenge will still be significant.

As a result, we will also examine the controls that audit firms use to direct the motivation to work hard, created by financial and other tangible rewards, towards audit quality.

Focusing Effort on Audit Quality

We follow the framework developed by Bol and Loftus (2019) that explicitly separates controls that motivate effort from controls that direct effort towards the organizational goals. They argue that after the willingness to work hard is created, the management control system must provide three critical elements to direct effort toward organizational goals: understanding, capabilities, and preference.

Understanding

Do employees understand what the desired tasks are? Employees need to clearly comprehend what the strategy is and how to prioritize objectives in order to focus on

organizational goals. Auditors must understand what audit quality is and what actions will ensure/enhance excellence. They also must know how to prioritize actions related to audit quality compared to other company objectives, like winning clients and meeting budgets. Prioritizing the right tasks is not trivial, as audit quality is a complex construct which even scholars find difficult to define and explain.

Capabilities

Can employees perform the desired tasks? Employees need to have both the skills and the tools to accomplish any and all tasks. Auditors need to have the technical knowledge, problem-solving skills, and social emotional intelligence to perform their tasks proficiently. Auditors also must be provided with the necessary tools, such as data-analysis programs and expert assistance. Another critical factor is time, ensuring that auditors have enough time with the client to complete a high-quality audit.

Preference

Do the employees want to perform the desired tasks? Even if employees understand what they need to do to achieve organizational success, it does not necessarily mean that they intend to perform the tasks. Although organizations might communicate compelling strategic objectives, the business may unintentionally provide their employees with incentives to prefer other tasks. For example, auditors may be offered social affirmation or even a financial incentive, such as a yearly bonus, to meet the budget. Since auditors have stronger preferences to undertake tasks that lead to social and financial rewards than to undertake tasks that are being communicated as desirable but are not rewarded

as such, auditors will likely focus on meeting the budget even if that does not maximize audit quality. Thus, even employees who know the importance of audit quality, and who can actually provide it, might still choose to focus their attention elsewhere. Importantly, it is not only financial rewards that shift auditors' preferences, auditors may also focus on exciting tasks that only marginally contribute to audit quality at the expense of tedious tasks with meaningful impact.

Research Method

In our study, we are using a two-stage approach to answer our research question. The first stage is exploratory, and the second stage is focused on model/hypothesis testing. In our first stage, we have conducted explorative interviews to attain a deeper understanding of the different controls audit firms use to enhance audit quality, specifically the culture controls used for value alignment. In the second stage, we will collect survey data and experimental data to test whether the controls in place motivate effort and provide the understanding, capabilities, and preference necessary to direct efforts towards audit quality.

It is important here to recognize that not necessarily all auditors at the firm perceived the controls identified through the first-stage interviews to be present or as dominant as described. In our second stage, we therefore want to get a sense of what auditors, in general, think about their management control system and how it influences their choices. We also will perform tests to see if there are differences between audit firms, offices, hierarchical levels, and other demographic characteristics. Lastly, we will use experimentation to examine how auditors' commitment to and attainment of higher

audit quality systematically differs depending on how cultural commitment to audit quality is made salient.

Findings Stage One

Only the first stage of the research study has been conducted. Hence, the findings we can share are still limited. When it comes to motivating efforts, both audit firm management and auditors did not view motivation (i.e., hours, dedication and focus) as a problem for providing audit quality. Management indicated that their employees work hard, and auditors agreed. However, very few auditors indicated that their motivation to work hard was caused by a desire to provide high audit quality. Instead, they are being motivated by other factors, such as receiving a good evaluation or improving their probability of promotion. The culture controls that research has found to be effective in creating value alignment did not seem to be prominent in the firms' management control systems. For example, although a great deal of effort was focused on hiring employees that "fit" the organization, "fit" was not defined as individuals who inherently value the importance of audit quality but more as a personality and attitude match.

When it comes to controls that direct effort towards organizational goals (versus controls that motivate effort), we can conclude from our interviews that Dutch audit firms, in general, have controls that direct their auditors' efforts towards audit quality. Below are examples in each of the three categories identified. However, note that from our first stage interviews we cannot conclude efforts are effectively directed towards quality, as this will depend on whether the controls in each firm are perceived as dominant enough

by the employees to effectively create understanding, capabilities, and preference. We defer reaching this conclusion until after analysis of the survey and experimental results.

Controls Focused on Understanding

In general, audit firms have worked hard in the last couple of years on improving their auditors' understanding of the importance of audit quality. Some typical examples of controls introduced are: extensive dialogs about key values; storytelling about key values as lived out by members of top management; intense use of intranet or other electronic communication means to reinforce values and mission; increased time spent on strategy and values during training; and performance measures that communicate the importance of quality. The second stage of our research will provide further insights into the potential effectiveness of storytelling as a means of motivating auditor commitment to working hard and, as needed, challenging management's preferred financial reporting.

Controls Focused on Capabilities

In general, improving capabilities also has received much attention. Audit firms have ramped up mandatory technical training and have provided more soft-skills training. More help is offered to junior auditors, as firms try to remove the stigma from asking for help and admitting mistakes. The availability of expert advice on complicated audit matters also has increased. The budgeting process has been overhauled, allowing more time for audits and more opportunities to renegotiate the budget when client deliverables are not as expected. Finally, many initiatives have been introduced which are focused on

work-life balance to decrease stress. Our follow-up survey and experiment will examine auditors' propensity to use their capabilities to improve audit quality.

Controls Focused on Preference

Also, in general, audit firms are focused on increasing the preference for tasks that enhance audit quality, such as appropriately challenging management's accounting choices. For example, the weight and emphasis put on audit quality in annual evaluations of all level auditors, and the resulting rewards and promotion decisions, have increased significantly. The firms also have implemented negative consequences for audit teams whose audit reports do not meet the standard for internal or external testing. Our survey and experimentation will shed further light on the circumstances under which, and the extent to which, these controls enhance the likelihood that auditors undertake actions that improve audit quality.

Relevance

This study is relevant for all auditors, as it takes a critical look at audit firms' management control system design. It presents a theoretical standard of the elements needed to motivate and direct effort towards audit quality. This will provide firms with the knowledge to critically examine their own management control system.

The research is especially relevant for Dutch audit firms, as, in the second stage of our research, we will also examine how effective Dutch firms are at using the control elements necessary to motivate quality. Thus, this study will provide firms with insight into how effective their controls systems are and what factors determine that

effectiveness. Moreover, the study will give insights into best practices. By examining the way controls are approached by different firms, each firm also can learn from these best practices.

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