Practice Note: How is auditor commercialism related to audit quality?

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Executive Summary

It is taken for granted that a fundamental conflict exists between auditors’ professional responsibilities and their commercial interests. While there is no direct evidence to support this widely held belief, it nonetheless fuels extensive, costly regulatory and standard-setting activities. We propose to examine whether auditors’ commercial and professional motivations actually conflict. Moreover, we argue that quality control mechanisms in audit firms—e.g., performance evaluation and technical consultation procedures—create conditions in which the two sets of motivations are likely mutually reinforcing.

To test our research question, we will examine whether auditors’ commercial activity is related to indicators of audit quality such as individual performance evaluations and engagement quality reviews. We expect to find that firms reward auditors’ commercial activity. However, contrary to critics’ concerns, we also hypothesize that auditors’ commercial activity will be positively related to audit quality. For reasons discussed in this note, we argue that auditors who base their professional identity more on being successful at commercial endeavors will be more willing to access quality control mechanisms (e.g., ask for help from consultations). As far as we are aware, our examination will provide the first direct evidence on the beneficial effects of commercial motivations for auditors.
Research Synthesis

I. The Issue

Our study examines whether there is a tradeoff between an auditor’s commercial and professional interests. Audit firms’ business models have gradually changed over the last several decades to focus increasingly on commercial activities. This has led regulators and scholars to express concern that an increased focus on commercial interests necessarily conflicts with auditors’ professional obligations. There have also been claims that incentive systems within audit firms may not properly motivate auditors to fulfill their professional obligations. There is little, if any, direct evidence to validate these claims.

Our study examines these issues in order to inform regulators and practitioners, to ensure that regulations, standards, and quality controls on this issue are based on evidence. This includes evidence on the relation between auditors’ commercial and professional investments and key audit outcomes. In particular, we will provide insights into:

1) the drivers (or inhibitors) of audit quality, specifically focusing on auditors’ commercial activity;
2) the impact of audit firm incentive systems on key audit outcomes such as audit quality and efficiency;
3) the use and effectiveness of audit firm quality control mechanisms, especially when commercial activity is relatively higher;
4) how the audit firms’ business model influences audit production; and
5) the determinants of client satisfaction for audit clients.

II. Relevance to Practitioners and Regulators

This examination is timely and should be of interest to the auditing profession, given the current state of regulatory scrutiny in the Netherlands and in other developed audit markets. We contribute to auditing practice by examining costs and benefits of commercial activity by auditors. We will consider whether pursuing individual commercial interests comes at the expense of professionalism by examining auditor and audit engagement quality. At the firm level, we will examine whether the potential benefits of commercial motivations come at the cost of overall firm audit quality or will increase risk to the firm. Lastly, we will inform firms about the potential benefits and costs of quality control mechanisms. Specifically, we will explore how they might serve to enhance the benefits from commercial activity while safeguarding audit quality.

Our study is relevant to regulators as well. For example, the IAASB continues to seek out research that will help it set standards to improve audit quality (IAASB 2017). Concerns about audit quality also continue to be expressed by the European Commission which undertook its own initiative to improve audit quality. Our
study will respond to two items that the European Commission noted were important to multiple stakeholder when it summarized the responses it received to its Green Paper issued in October of 2010. These two issues were: (i) clearer incentives to individual auditors to provide a high-quality audit and (ii) mechanisms to instill a more professional orientation among auditors. Concerns about auditor incentives have been expressed by the Dutch Authority for the Financial Markets (AFM) as well. In its 2018 discussion of vulnerabilities in the audit sector, the regulator explicitly noted that it is concerned about audit firms placing their commercial interests ahead of their professional obligations (AFM 2018). Likewise, in the UK the CMA expressed serious concerns about audit quality and proposed a number of new regulations (CMA 2018).

III. Hypothesis Development

While auditors are charged with serving important societal functions, they are also engaged in for-profit enterprises. If auditors adhere to putting others first then they would not take advantage of their position to inflate their revenues or profits. However, auditors are often under considerable pressure to increase sales and to cater to their clients. This is why commercialism and professionalism are theorized to be fundamentally opposed and that emphasizing one will necessarily lead to a reduction in the other (Suddaby and Greenwood 2005).

The tradeoff between commercial and professional focus will have important implications for audit quality and efficiency. If auditors invest more time and effort in practice development, all else equal, there is less time available for them to audit their existing clients. Auditors may also perceive that investments in professional development through learning and education are less important relative to investments in growing business. These two points would suggest that practice development will be negatively related to audit quality. However, there are many possible reasons why higher levels of practice development will not be negatively related and may be even be positively related to auditor and audit engagement quality. First, it is likely that commercialism and professionalism both must exist in audit firms and the audit firm can actually be better served if the decision-making process allows the two to co-exist (Malsch and Gendron 2013). This reinforcement can occur through various mechanisms such as performance-based targets or evaluation systems (Faulconbridge and Muzio 2008). Second, auditors that invest more in practice development may simply exert more overall effort (i.e. drawing time from other activities such as leisure time to pursue practice development rather than taking time away from their audit work). Third, audits are conducted in teams and hence an individual audit partner may be able to leverage the abilities of team members to maintain quality when deciding to invest more time in practice development. Fourth, the audit firm itself may implement quality control measures that ensure consistent audit quality.

With respect to quality control serving to moderate the friction between commercialism and professionalism, we note that the effectiveness of quality control within an accounting firm is not clear. Professionals are accustomed to autonomy and historically socialization serves to instill self-control (Abernathy and Stoelwinder 1995). Auditors may not adhere to quality control policies requiring things such
as consulting with subject matter experts on highly complex or risky issues. If auditors believe that asking for help will negatively reflect upon their technical ability, they will be more likely to forego making such requests. However, if auditors are rewarded for their commercial efforts and they maintain their identity at least in part through their commercial focus rather than their professional focus then they would be more likely to ask for assistance. Given our prior expectation that auditors are rewarded for their commercial activity and our expectation that they will identify their value through success in their commercial efforts, we expect that quality control mechanisms will be used and will have a positive impact on audit quality.

IV. Methodology

We will conduct archival empirical analysis using a large sample data set provided by participating audit firms. Individual auditor performance will be estimated as a function of our commercialism measure for individual auditors, quality control measure for individual auditors, and appropriate controls. When examining the quality or efficiency of the audit itself, we will estimate a model of audit engagement quality (efficiency) as a function of our commercialism measure for audit partners, client importance, quality control measures for the audit engagement, and appropriate controls.

V. Empirical Expectations and Concluding Comments

While we acknowledge that many academics and regulators subscribe to the trade-off theory of commercialism and professionalism, we do not expect to find empirical support for this theory. Instead, we expect to find that an auditor’s commercial effort is rewarded within audit firms and that auditor commercialism is not negatively related to an assessment of an individual auditor’s quality, nor do we expect it to be negatively related to audit engagement quality. In fact, we expect that auditors with greater commercial orientation will be more likely to utilize quality control mechanisms and that these auditors could achieve audits of higher quality than auditors with less commercialism.

Our research project will make important contributions to auditing practice. For firms and practitioners, our research will provide insights into the impact of firms’ controls and the conditions in which these controls are effective in encouraging professionalism and the delivery of high-quality audits. For standard setters, our research will provide insights into factors that may compromise audit quality and into areas in which additional regulatory guidance may be necessary. In particular, we believe that our research will be relevant to several aspects of audit practice.
References


