MAB MAANDBLAD VOOR ACCOUNTANCY EN BEDRIJFSECONOMIE

Maandblad voor Accountancy en Bedrijfseconomie 92(5/6) (2018): 187–191
DOI 10.5117/mab.92.28178

Editorial

Audit Research Summaries

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Received 4 July 2018 | **Accepted** 5 July 2018 | **Published** 23 July 2018

Ook deze maand presenteren wij weer enkele "Auditing Research Summaries" uit de database van de American Accounting Association (www.auditingresearchsummaries.org).

De eerste samenvatting betreft een onderzoek van Brazel, Jones en Pravitt (2014) naar *het gebruik van niet-financiële informatie (NFI) bij cijferanalyse in de jaarrekeningcontrole*. Zij onderzoeken wat de effecten zijn van het frauderisico en van een expliciete prikkel om van de beschikbare niet-financiële informatie gebruik te maken. De resultaten duiden erop dat NFI dikwijls niet bij het uitvoeren van cijferanalyse wordt betrokken. Zelfs niet als deze informatie op een verhoogd frauderisico duidt. De onderzoekers stellen dat slechts een simpele hint, dat NFI wel degelijk gebruik kan worden, leidt tot gebruik van NFI en een meer kritische houding.

De volgende samenvatting betreft een Amerikaans onderzoek van Kaplan en Williams (2013) naar *de vraag of een verplicht toelichtende paragraaf in geval van ernstige onzekerheid omtrent de continuïteit een bescherming biedt tegen claims.* De literatuur suggereert dat accountants terughoudend zijn met het afgeven van een dergelijke verklaring (een zogenaamde going concern opinion) onder andere omdat een 'self fulling prophecy' wordt verondersteld en de klant mogelijk op zoek zal gaan naar een andere accountant. De uitkomsten van dit onderzoek bieden echter een stimulans om een dergelijke verklaring weldegelijk af te geven. Gesuggereerd wordt namelijk dat de kans dat beleggers een rechtszaak tegen de accountant aanspannen significant lager is in het geval een going concern opinion is afgegeven vanwege een ernstige onzekerheid omtrent de continuïteit.

De derde samenvatting betreft een studie van Agoglia et al. (2010). Zij zijn nagegaan *hoe zowel het risico op een materiële afwijking als de ervaren werkdruk, de aanpak van reviewers van controledossiers beïnvloedt*. Uit het onderzoek blijkt dat respondenten van mening zijn dat persoonlijk contact (in-person) in het reviewproces meer effectief is. Respondenten vinden interactie die alleen elektronisch plaatsvindt, doelmatiger. Zowel de hoogte van het risico op een materiële fout als de hoogte van de werkdruk hebben invloed op de aanpak die wordt gekozen. Interessant is de bevinding dat een hoog risico op een materiële fout het effect van hoge werkdruk vrijwel teniet doet. De onderzoekers concluderen dat reviewers in geval het risico op een materiële fout hoog is, de effectiviteit belangrijker vinden dan doelmatigheid, en kiezen voor persoonlijk contact in plaats van dossiers elektronisch te reviewen.

In het vierde onderzoek van Chen et al. (2017) wordt nagegaan *in hoeverre de ondernemingsstrategie invloed heeft op de besluitvorming rondom materiële leemten in de interne beheersing en continuïteitvraagstukken.* Strategie wordt hiertoe onderscheiden in een 'prospector'- en een 'defender'-benadering. De eerste vindt zijn basis in innovatie en brengt zowel een relatief hoog risico als volatiliteit met zich mee zodat het moeilijk is de toekomstige uitkomsten te voorspellen. Een 'defender'-strategie legt daarentegen nadruk op kostenbesparing zoals investeren in automatisering van productie- en distributieprocessen.

Uit het onderzoek blijkt dat accountants eerder een type II-fout maken (ten onrechte geen 'going concern' verklaring afgeven) in geval van een 'prospector'-strategie. Zij zijn dus minder succesvol in het voorspellen van faillissementen voor ondernemingen met deze strategie.

De laatste samenvatting betreft een experiment uitgevoerd door Early et al. (2008) naar *de invloed die management heeft op de besluitvorming van accountants*. Hiertoe is gekeken naar de invloed dat een standpunt van het management inzake materiële leemten in de interne beheersing heeft op de besluitvorming van de accountant. Het onderzoek impliceert dat het vooraf beschikbaar zijn van het standpunt van het management, de classificatie van de leemten in de interne beheersing door de accountant beïnvloedt. De auteurs noemen dit fenomeen "knowledge bias". De besluitvorming van accountants wordt minder beïnvloed ingeval management spreekt van ernstige leemten (material weaknesses) dan ingeval van minder ernstige leemten (significant deficiencies). Relevant voor de praktijk is de constatering dat de "know-

ledge bias" kan worden verminderd indien accountants potentiële consequenties die de leemte kan hebben op de betrouwbaarheid van de jaarrekening expliciet moeten overwegen en documenteren.

1. Auditors' reactions to inconsistencies between financial and nonfinancial measures: the interactive effects of fraud risk assessment and a decision prompt

Practical Implications

The findings suggest that auditors need improvement in the use of Nonfinancial Measures (NFMs) when performing substantive analytical procedures. Also, the findings of this study suggest that a relatively simple and efficient prompt regarding the use of NFMs can improve auditor substantive testing in the important area of revenue recognition. The evidence suggests that auditors are more likely to respond appropriately to a prompt when fraud risk is assessed at high levels. This demonstrates that decision-makers should carefully assess the level of fraud risk that will result in the desired behavior from in-charge senior auditors.

Citation

Brazel JF, Jones KL, Prawitt DF (2014) Auditors' Reactions to Inconsistencies between Financial and Nonfinancial Measures: The Interactive Effects of Fraud Risk Assessment and a Decision Prompt. Behavioral Research in Accounting 26(1): 131–156.

Purpose of the Study

Professional standards, auditing texts, and prior research suggest that external auditors can use nonfinancial measures (NFMs) to verify their clients' reported financial information. These sources also suggest that an inconsistency between a company's financial performance and related NFMs represents a potential red flag for financial statement fraud. However, recent research indicates that auditors' attention to NFMs is insufficient to detect inconsistencies between financial data and NFMs. This paper addresses this concern by investigating factors that affect auditors' use of NFMs when auditing financial statement data. Specifically, the paper investigates whether auditors' reliance on NFMs and development of revenue expectations are affected by the following factors:

- The consistency/inconsistency of NFMs and related financial data
- The use of a prompt to encourage auditors to use NFM to calculate a revenue expectation
- The level of fraud risk assessed during planning

The authors motivate their hypotheses using the Heuristic-Systematic Model from the psychology literature. This model suggests that the contextual features of a judgment affect how an individual processes information. The authors use this theory to suggest that auditors who are prompted to use NFMs might be more likely to use NFMs to set revenue expectations under high fraud risk compared to low fraud risk.

Design/Method/Approach

The research evidence used in this study was gathered in 2009. In this study, the authors use in-charge senior auditors from a Big 4 firm to complete two experimental tasks. In both experiments, the participants were given access to client information and were asked to develop an expectation for a client's revenue balance. The second experiment introduces an NFM prompt and manipulates fraud risk.

Findings

- The authors find that a minority of auditors use NFMs as an information source for performing analytical procedures and report that auditors do not increase their reliance on NFMs when the NFMs point to a fraud red flag in revenue figures.
- The authors find that the presence of high fraud risk alone does not affect the auditors' NFM reliance or revenue expectations.
- The authors find that auditors are more likely to rely on NFMs and question the client's revenues balance when prompted about how NFMs can be used to develop a revenue expectation.
- The influence of the prompt on auditor reliance on NFMs and account balance expectations is stronger when fraud risk is assessed as high.

2. Do going concern audit reports protect auditors from litigation? A simultaneous equations approach

Practical Implications

The results should be of interest to auditing practitioners. Generally, managers of public companies prefer that the audit report does not contain a going concern paragraph. In this regard, researchers have found that issuing a going concern audit report increases the likelihood of management-initiated auditor switches. These results highlight the expected benefits to auditors from issuing a going concern report to their financially stressed clients. Specifically, better controlling for endogeneity, the evidence indicates that issuing a going concern report lowers the likelihood of investors naming the auditor in a class action lawsuit.

Citation

Kaplan SE, Williams DE (2013) Do Going Concern Audit Reports Protect Auditors from Litigation? A Simultaneous Equations Approach. Accounting Review 88(1): 199–232.

Purpose of the Study

An important aspect of the auditors' environment is state and federal laws that allow third parties such as investors to sue auditors in an effort to recover damages. Historically, these litigation-related costs have been substantial. Potentially, auditors may be able to reduce their exposure to litigation when auditing a financially stressed client by issuing a going concern report. Under current auditing standards, a going concern audit report is required when an auditor has substantial doubt about the client's ability to remain a going concern for a reasonable period of time. Whether a going concern report actually protects auditors against lawsuits is an open question.

The study applies a simultaneous equations approach to examine the relation between auditor going concern reporting and investors' decisions to sue auditors. Importantly, this approach takes into account the endogeneity between the auditor's going concern reporting decision and ex ante litigation risk. The authors explicitly recognize two separate aspects of the relation between going concern reporting and auditor litigation.

Design/Method/Approach

The sample consisted of 1,211 securities class action lawsuits filed against the auditors between 1986 and 2009. 147 firms comprise the final auditor litigation sample. The authors determined whether a securities class action lawsuit had been filed against the auditors by examining the databases constructed by Palmrose (1999), the Stanford Class Action Securities Clearinghouse, Audit Analytics, LexisNexis, Westlaw, CASEmaker, ISS Securities Class Action Services, and the popular press.

Findings

- The evidence indicates that for auditors' going concern reporting decisions as well as for investors' decisions to sue auditors, the results differ between the two methods.
- While the relation between the risk of an auditor lawsuit and going concern reporting decisions is consistently positive, the lawsuit coefficient is larger and significant using simultaneous equations but insignificant using probit analysis.
- The results also show that the relation between going concern reports and investors' lawsuit decisions is consistently negative.
- However, and perhaps more importantly, the going concern coefficient is larger and significant when using simultaneous equations but insignificant when using probit analysis. That is, the simultaneous equations results indicate that going concern reports significantly deter investors from suing auditors.
- The evidence showing that going concern reports deter investors from filing class action lawsuits against auditors is important, in that it suggests that going concern reports are useful to investors.
- When investors see a going concern report for financially stressed companies, they are less likely to sue the auditor for their investment losses.
- Issuing a going concern report offers the auditor protection against claims of negligence due to reporting, but not other claims of auditor negligence.

3. How do audit workpaper reviewers cope with the conflicting pressures of detecting misstatements and balancing client workloads?

Practical Implications

These findings have implications for both practice and future research. For example, the PCAOB has raised questions about (1) the thoroughness with which engagement managers and partners review audit documentation, and (2) the extent to which their attention to engagements reflects audit-related risks. Further, the IFAC has acknowledged that reviewers in today's audit environment have alternative ways in which to conduct their reviews, and prior research suggests that the choice of review format has implications for audit. The results presented here advance the understanding of the factors that influence this choice. The findings provide insight to firms, regulators, and inspectors regarding the impact of workload pressure and misstatement risk on how audit managers and partners conduct their reviews. These issues are increasingly relevant given recent changes to the regulatory environment.

Citation

Agoglia CP, Brazel JF, Hatfield RC, Jackson SB (2010) How Do Audit Workpaper Reviewers Cope with the Conflicting Pressures of Detecting Misstatements and Balancing Client Workloads? Auditing: A Journal of Practice & Theory 29(2): 27–43.

Purpose of the Study

This study examines how risk of misstatement and workload pressure affect audit workpaper reviewers' choice of review format. Recently, auditors have witnessed a number of changes in their regulatory environment that

have increased their workloads. The advent of electronic communication and electronic workpapers has provided auditors with the means to alleviate certain pressures on firm resources. Electronically reviewing workpapers and transmitting review notes can ease scheduling issues and reduce reviewer travel time as it permits reviewers to review multiple jobs concurrently and from a remote location. However, prior research suggests that face-to-face communication during review has the potential to improve audit quality. Concerns over the effectiveness of reviews are highlighted by recent PCAOB inspections which raise questions about how engagement risk impacts the thoroughness of the review process. Further, the International Federation of Accountants (IFAC) acknowledges current alternatives available to reviewers and advises that explicit consideration be given to the review format choice during the audit planning process. While prior research has concentrated on the impact and extent of review, the study contributes to the literature by focusing on the choice between alternative review formats.

Design/Method/Approach

The authors surveyed twenty-three practicing auditor managers and partners to learn their beliefs about in-person and electronic communication during review. Seventy-eight percent of survey participants were from international firms, while 22 percent were from large regional firms. For the authors' experiment participants were 60 practicing auditors from international, national, and large regional firms. They were primarily managers (43 percent) and partners (50 percent) with an average of 14.5 years of experience. Evidence was gathered prior to July 2009.

Findings

Results of the survey suggest that reviewers view in-person interaction during review as more effective and electronic interaction as more convenient. In addition, reviewers report that they use electronic and in-person communication for roughly an equal proportion of their reviews. Results of the experiment indicate that risk of misstatement and workload pressure interact to affect participants' review mode choices. Misstatement risk moderates the effect of workload pressure such that, when risk is high, the effect of workload pressure is effectively eliminated. These findings suggest that reviewers perceive reviews involving face-to-face interaction to be more appropriate when effectiveness of procedures is essential to ensure an acceptable level of audit quality and, when risk conditions allow, consider electronic review to be a practicable way to cope with workload pressures associated with a hectic client schedule.

Given the survey and experimental results, the authors conclude that reviewers will choose to sacrifice convenience when higher risk calls for employing a more effective review format. They document a relationship between risk and review format. Therefore, the authors are able to shed light on how auditors are concurrently reacting to the pressures of client risk and balancing a portfolio of clients while maintaining audit quality.

4. Business strategy and auditor reporting

Practical Implications

This study is informative for stakeholders when they are analyzing financial statements. It provides support that a going concern opinion for a prospector firm may not be as alarming as it appears. It also reveals that many influences are at play when auditors are determining which audit opinion is most appropriate for the situation.

Citation

Chen Yu, Eshleman JD, Soileau JS (2017) Business Strategy and Auditor Reporting. Auditing, A Journal of Practice and Theory 36(21): 63–86.

Purpose of the Study

This study examines the effects that a firm's business strategy, whether prospector or defender, has on an auditor's decision in areas requiring significant professional judgment. Specifically, the authors investigate areas involving material weakness and going concern opinions. Prospector business strategies focus on innovation and invest heavily in marketing and research and development. Alternatively, defender business strategies place a strong emphasis on cost efficiency and instead invest heavily in automated production and distribution processes. It is important to note the focus in the study is on business-level strategy, not corporate strategy. Business level-strategy is the way a firm competes within an industry, not what industries it competes in.

Design/Method/Approach

All firms in the study were placed into 3 categories: prospectors, analyzers, and defenders. The authors used 6 characteristics to measure strategy in order to categorize the firms. The final sample size was 4,332 firms from 2000-2013. Financial information was obtained about the firms from databases such as Compustat, Audit Analytics, and CRSP.

Findings

The authors find that a firm's decision to adopt a prospector versus defender strategy significantly increases the likelihood of an auditor issuing an unfavorable opinion.

The authors find the reasoning behind this to be comprised of the following:

- Prospector business strategies are rooted within innovation and therefore likely to take risks. Often times this leads to past performances being more volatile which reduces the auditor's ability to accurately predict future outcomes. This results in auditors choosing the most conservative choice, a going of concern opinion.
- Collectively, prospector strategy characteristics such as decentralized control, frequent product changes, and high executive turnover all lead to a higher probability of material weakness.

Overall, auditors are more prone to Type II errors regarding the issuant of going concern opinions to prospector firms. The evidence suggests that auditors are less successful in predicting bankruptcy for these firms and the going concern opinion is not always warranted.

5. Reducing management's influence on auditors' judgments: an experimental investigation of sox 404 assessments

Practical Implications

The results of this study are important for audit firms to consider in planning, implementing, and documenting their assessment of internal controls. Findings suggest that auditors are influenced by knowing management's classification of the ICFR issue before making their assessment. The authors suggest this "knowledge bias" impairs independence and could also reduce audit ef fectiveness, impact tests of controls, and the reliance of others' work (i.e., internal auditors). There are additional implications for other parts of the audit (e.g., auditing estimates) where the audit client presents information that may bias an "independent assessment" of the account(s) being audited. However, as findings in this study suggest, requiring auditors to consider and explicitly document the potential impact the deficiency may have on the financial statements may reduce the impact of such knowledge biases.

Citation

Earley CE, Hoffman VB, Joe JR (2008) Reducing Management's Influence on Auditors' Judgments: An Experimental Investigation of SOX 404 Assessments. The Accounting Review 83(6): 1461–1485.

Purpose of the Study

Under Section 404 of the Sarbanes-Oxley Act (SOX), both client management and the external auditors must evaluate the effectiveness of internal controls over financial reporting (ICFR). Since management has to test and evaluate its internal controls, the external auditors may be testing and evaluating internal controls after management. Knowledge of management's conclusions as to the effectiveness of internal controls may bias the auditors' judgment in evaluating the effectiveness of ICFR. This paper examines whether auditors are influenced by this knowledge bias in their assessment of ICFR. Also, the paper examines whether auditors' explicit documentation of potential financial statement impact helps reduce any effect of knowledge bias.

Design/Method/Approach

The authors collected their evidence via experimental cases administered to in-charge auditors from one of the Big 4 accounting firms. At the time of the experiment, the participants had completed at least one year of SOX 404 audit procedures for their clients. Data was collected prior to August 2007. Participants were provided several control deficiencies and asked to evaluate their significance. Participants were either provided management's assessment (either more or less severe) or not provided management's assessment at all. Additionally, some participants were asked to consider and explicitly document the potential impact the deficiency could have on the financial statements, if the deficiency was not corrected.

Findings

- The authors' find that when auditors are provided management's assessment of ICFR issues, their classifications of control deficiencies are different than when they are not provided management's assessments.
- Auditors are *more* influenced when management's classification was "less severe" and was more favorable to management (i.e., Significant Deficiency compared to a Material Weakness), suggesting that the auditors do not "discount" management's assessments that favor the client.
- Overall, auditors change their assessment of the control deficiency after having to consider and explicitly document the impact the control deficiencies may have on the financial statements. This suggests that such "knowledge biases" may be reduced by having auditors consider and explicitly document potential consequences.