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Research Article

Who is responsible for ensuring a high-quality audit that achieves accurate financial reporting?

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1. Introduction

Who is responsible for ensuring a high-quality audit that achieves accurate financial reporting? That is an important question because financial reporting quality is at least a joint effort of the auditor and auditee as 'financial reporting quality and audit quality are often inseparable in terms of observable financial reporting outcomes' (Gaynor et al. 2016). Also, the DeFond and Zhang (2014) perspective on audit quality 'encompasses the auditor's broad responsibilities and recognizes audit quality as a component of financial reporting quality that is bounded by the firm's reporting system and innate characteristics.' In her presentation at the FAR-conference, Preeti Choudhary presented results concerning the mutual and 'interlaced' responsibility of auditors and their clients and related market outcomes.

2. The aftermath of the financial reporting crises

Following substantial financial reporting crises in both number and magnitude, faith in US capital markets was rapidly subsiding. US congress stepped in, to improve investor confidence particularly through changes in governance. They created a new regulator called the PCAOB whose mission is to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Previously the audit industry was subject only to peer review. Congress also passed legislation referred to as the Sarbanes Oxley Act of 2002 (SOX) by overwhelming majority. This legislation did many things, including:

Requiring management to assert responsibility of financial statements formally, with increases in legal liability for failing to fulfill these responsibilities.
Increasing the role of audit committees in overseeing financial reporting.
Increasing the auditor's role in financial reporting. In particular, SOX expanded the auditor's role to form a separate opinion on the internal controls over financial reporting of companies, not just financial statements.

There are at least four parties that play an important role in ensuring high-quality audits and that make financial statements reliable to the investing public. The focus of the presentation is on management and the auditor's role, with less emphasis placed on the regulator and audit committee.

3. Management's responsibilities

Per US regulations, management is responsible for adopting sound accounting policies and for establishing and maintaining internal controls that will among other things, initiate, record, process, and report transactions consistent with management's assertions embodied in the financial statements. Despite management's explicit responsibilities to have accurate financial reporting and good internal controls, a principal-agent conflict exists when reporting to shareholders. Generally, management (the agent), must report to the shareholders (the principal) financial performance via financial statements. Conflicts of interest and incentives may arise, complicating truthful reporting (e.g. Lambert 2001). Prior research extensively shows evidence of cases where managers manage reported earnings, sometimes exploiting gray areas in GAAP other times rising to the level of fraud when reporting to the public.

4. Auditor's responsibilities

Given this principal-agent conflict that exists, the auditor is enrolled to provide some assurance that management has reported financial information truthfully in accordance with GAAP (e.g. Lambert 2001). The auditor should

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plan and perform the audit in accordance with regulations to achieve reasonable assurance that financial statements are free of material misstatements. However, the auditor's incentives may not be perfectly aligned with shareholder incentives (e.g. Antle 1982; Baiman et al. 1987; Baiman et al. 1991). For example, auditors are selected and paid by the company, which is run by management. It is unclear whether auditors may act upon incentives that align with management rather than shareholders.

5. How does the auditor achieve this role of providing reasonable assurance?

The auditor is supposed to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. The auditor must collect evidence to ensure financial statements are not materially misstated by designing a variety of tests. These tests can sometimes indicate that pre-audited financial statements have misstatement, which is referred to as an audit adjustment. The auditor will present these misstatements to management, who will decide whether to record or waive the audit adjustments. In the US, the audit committee reviews disposition decisions, recorded adjustments, and materiality assessments. The auditor must determine that waived adjustments do not indicate the financial statement are materially misstated (in the case of an unqualified opinion).

We know that management may face disincentives to reporting financial statements accurately. In addition, evidence suggests that auditors are able to improve the reliability of financial reporting (e.g. Lennox et al. 2014; Lennox et al. 2016). Despite auditors' ability to make such improvements in financial statements, still cases are observed where the auditors missed material errors, so let's consider what could have gone wrong.

6. Why do we observe audit failures?

It is possible that the client has poor quality internal controls, but the auditor is not able to detect this because of some deficiency in conducting the audit. This could be due to insufficient identification of control deficiencies or due to insufficient testing of control deficiencies. Finally, it is possible the auditor conducted the audit appropriately, but simply fails to report internal control problems due to disincentives. Rice and Weber (2012) provide evidence consistent with the latter explanation, however do not explore the first two reasons due to lack of data. More evidence on what may be driving the auditor's inability to identify material weaknesses in issuer internal controls is needed.

Another potential reason material errors that require ex post correction is that auditors detect misstatements, but management does not correct them. That is, management waives identified audit adjustments. In the US, such decisions to waive are made by management and reviewed by the board of directors, highlighting both parties' role in high-quality audits. Prior research on audit adjustments for US clients consists mostly of two broad streams: (1) descriptive evidence on audit adjustments (e.g. Bell and Knechel 1994; Kinney and Martin 1994; Icerman and Hillison 1991) and (2) analysis of factors related to variation in waived audit adjustments (e.g. Brown-Liburd and Wright 2011; Nelson et al. 2002; Joe et al. 2011). A few studies using Chinese data on audit adjustments (e.g. Lennox et al. 2014; Lennox et al. 2016) suggest managers ascribe value to audits, including adjusting financial statement amounts during the audit process. However, what remains unknown is to what extent auditor identified adjustments have not been corrected by management in the current post-SOX era; more importantly, are there any implications for financial reporting reliability for waiving audit adjustments. More evidence here would be useful.

7. Conclusions

Both managers and auditors play important roles in ensuring high-quality audits that achieve reliable financial reporting. Managers are tasked with the responsibility of reporting financial statements accurately but face a principal-agent conflict that may limit their ability to achieve the best possible outcome. Auditors aid in ensuring the accuracy of financial statements, often improving reliability. However, audit failures still occur. More evidence on the role of identifying and testing internal controls as well as evidence on management's disposition decision could possibly shed light on such audit failures.

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