

Audit Research Summaries

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

In het themanummer van het MAB “What do we know about audit quality” (september 2016) werd aandacht besteed aan de eerste International Conference georganiseerd door de Foundation for Auditing Research (FAR) die op 9 en 10 mei jongstleden plaatsvond. De doelstelling van FAR is onder andere academisch onderzoek op het terrein van Auditing te stimuleren en zodoende de afstand tussen wetenschap en praktijk te verkleinen. Ondanks dat er al veel onderzoek naar “au-

dit quaality” is gedaan, blijkt het eenduidig definiëren en meten van de kwaliteit van de jaarrekeningcontrole nog in volle gang te zijn. Verdergaand onderzoek naar dit fenomeen is daarom ook noodzakelijk.

In de eerste twee samenvattingen van onderzoek wordt audit quality als een variabele gehanteerd. De derde samenvatting spreekt niet expliciet over audit quality maar “Organizational Learning and Organizational Forgetting” zal de kwaliteit ongetwijfeld beïnvloeden. De laatste samenvatting betreft een literatuuronderzoek naar mogelijke verbeteringen in de informatiewaarde als gevolg van wijzigingen in de controleverklaring. Een zeer actueel thema. ■

research summary

Title:	Audit Market Concentration, Audit Fees, and Audit Quality: Evidence from China
Practical Implications:	This study is important given the continued concerns expressed by global regulators about the potential harm to audit quality caused by concentrated audit markets. The separation of offsetting direct and indirect effects of concentration on audit quality enhances the understanding of how concentration influences audit quality and could explain why the previous studies document mixed evidences. The study also provides evidence on how audit fees play an important role in the association between concentration and audit quality and that regulatory interventions changing one of the offsetting effects could produce potential unintended consequences.
Citation:	Huang, T., Chang, H., and Chiou, J. 2016. Audit Market Concentration, Audit Fees, and Audit Quality: Evidence from China. <i>Auditing: A Journal of Practice and Theory</i> 35 (2): 121-145.
Keywords:	audit market concentration, audit fees, audit quality, and China
Purpose of the Study:	The potential effects of recent audit market concentration on audit fees and audit quality have been a point of concern for policy makers. The primary concern is that this concentration reduces clients' choice of audit service suppliers, strengthens auditor's market power, and encourages complacency among auditors, resulting in higher audit fees but lower audit quality. Despite the concern, the extant literature provides mixed evidence on the consequences of audit market concentration. The situation between developed countries where audit markets are dominated by the Big 4 audit firms, and the Chinese Ministry of Finance (MOF) is starkly different. As a result, the MOF has expressed concern about the competitive and immature Chinese audit market characterized by many small-seized audit firms, which increases auditors; incentives to compete for clients by providing fee discounts, resulting in low audit quality. The difference in attitudes toward concentration between the developed countries and China as well as the fact that China is a setting where competition is thriving, while most of the developed countries are more concerned about lack of competition is the primary motivation behind the authors examination of the Chinese audit market. The objective of the paper is to investigate the effect of concentration on audit quality in a setting with significant competition a relatively weak legal environment.
Design/Method/ Approach:	The authors employ path analysis to further examine the indirect effects of concentration on audit quality through audit fees. The sample consists of 12,334 Chinese firm-year observations from 2001-2011. Audit market concentration is measured at the city level as the market shares of the local top 4 audit firms and two Herfindahl indexes of audit fees earned from listed clients of the local top 4 and all audit firms in a city-year grouping, respectively.
Findings:	<ul style="list-style-type: none"> • The authors' findings support the claim that concentration influences audit fees; furthermore, the positive effects of concentration on audit fees is consistent with clients having a limited choice of audit service suppliers and audit firms having greater market power in concentrated audit markets. The increased market power reduces auditors' fear of client loss and allows them to charge higher fees. • The authors' findings suggest that audit market concentration has no significant overall effect on client earnings quality. • The authors' findings support the notion that concentration results in poor audit quality through auditor overconfidence and complacency. • The authors find that concentration increases audit fees and such increases in turn improve earnings quality, suggesting that when the audit market becomes more concentrated, auditors with increased market power become less lenient with clients and charge higher fees to devote more resources and effort to audit tasks, leading to higher audit quality. • The authors' findings suggest that auditors are less likely to issue modified audit opinions when the market becomes more concentrated. • The authors find that in concentrated audit markets auditors have greater market power and lower cost of tell the truth and can charge higher audit fees to devote more resources and efforts to the audits that they carry out.

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research summary

Title:	Audit Quality and Analyst Forecast Accuracy: The Impact of Forecast Horizon and Other Modeling Choices
Practical Implications:	This paper contributes to research examining the determinants and impacts of audit quality by identifying the limitations of aspects of metrics employed in recent research that could have been utilized by practitioners and suggesting useful alternate metrics for investigating the impact of audit quality on the properties of analysts' forecasts, including the usefulness of audited financial information and the prediction of future performance.
Citation:	Wu, Y. and Wilson, M. 2016. Audit Quality and Analyst Forecast Accuracy: The Impact of Forecast Horizon and Other Modeling Choices. <i>Auditing: A Journal of Practice and Theory</i> 35 (2): 167-185.
Keywords:	audit quality, auditor industry specialization and analyst forecast accuracy
Purpose of the Study:	Many studies examine the influence of auditor characteristics on the properties of analyst forecasts of client firms' earnings. A common argument is that audit quality affects the accuracy of analyst forecasts or closely associated metrics. However, there is considerable divergence in the posited theoretical association between audit quality and forecast accuracy and in the empirical associations reported. The majority of these studies rely exclusively on measures of forecast accuracy based on analysts' end-of-year forecasts. The authors argue that metrics drawn from these forecasts are noisy indicators of the impact of audit quality because there are convincing reasons why superior audit quality may affect the accuracy of the metrics in either direction. Financial reports of clients of higher quality auditors may be more useful for forecasting future earnings which in turn may increase forecast accuracy; however, higher quality auditors may be more effective in disallowing client attempts to manage earnings. Thus, if an auditor provides superior quality services to their client, then it is conceivable that these competing effects will offset each other, resulting in no net impact on forecast accuracy. As a result, the authors argue that the properties of analysts' beginning-of-year forecasts provide superior measures of any of the impacts of auditor characteristics because these forecasts are less likely to induce benchmark-beating incentives for earnings manipulation and because audited financial information has a greater relative impact on analysts' information set at the beginning-of-year than at the end-of-year.
Design/Method/ Approach:	Focusing on measures of audit firm industry specialization common to papers with competing predictions and results, the authors demonstrate the noisiness and sensitivity to model specification of test based on end-of-year forecast accuracy and show that similar tests based on beginning-of-year forecast accuracy generate predicted results that are consistent over a range of modeling approaches.
Findings:	<ul style="list-style-type: none"> • The authors find that analysts' beginning-of-year forecasts are a potentially superior proxy for auditors' impact on the properties of analyst forecasts because the "decision usefulness" impact of an audit is at its strongest soon after those reports are released and is likely to dominate any effect on audit quality on client benchmark-beating behavior. • The authors also identify the importance of other modeling choices facing researchers, such as the deflation of forecast errors and controls for the endogenous selection of industry specialist auditors.

research summary

Title:	Evidence of Organizational Learning and Organizational Forgetting from Financial Statement Audits
Practical Implications:	Organizational learning and knowledge depreciation play a significant role in a firm's audit strategy, pricing strategy, budgeting and forecasting. Failing to account for knowledge dissipation and differences in learning across personnel may lead to costly errors in the budgeting process. Furthermore, finding that there is little or no learning among lower-level staff provides empirical support for the concern of the effects of high turnover rates among lower-level staff in public accounting. This suggests that targeting retention at this level might reduce costs, including the costs of continuously having to train new personnel.
Citation:	Causholli, M. 2016. Evidence of Organizational Learning and Organizational Forgetting from Financial Statement Audits. <i>Auditing: A Journal of Practice and Theory</i> 35 (2): 53-72.
Keywords:	audit efficiency, organizational learning, and audit production
Purpose of the Study:	Organizational learning occurs when an organization gains knowledge from the repetition of producing a product or providing a service and uses this knowledge to operate more efficiently and at a lower cost. Organizational forgetting is when this knowledge is lost over time and results in losses in productivity and increases in the cost of production. A good amount of research exists on these topics as they relate to production, but the research on the correlation between these topics and professional services is underserved. Causholli investigates the nature of learning in the production of financial statement audits in this paper. This investigation comes at a good time due to the increasing debate surrounding whether mandatory audit firm rotation should be enforced. In 2013, the U.S. House of Representatives prohibited the PCAOB from mandating audit firm rotation, but in 2014 the European Parliament passed new regulation that requires audit firm rotation after a maximum of ten years. Because of these differing viewpoints, Causholli hopes to shed light on the discussion by showing how audit production costs vary with audit firm tenure.
Design/Method/ Approach:	Two equations were used to provide empirical specifications and test the hypotheses. Engagements were divided into three groups based on the number of years with a client, the short-tenure group, the medium-tenure group, and the long-tenure group. The audit production data are provided by a large international accounting firm and were collected as part of the annual internal quality reviews performed in late spring through early fall 2003.
Findings:	<ul style="list-style-type: none"> • The author's findings show that an increase in audit experience leads to an initial reduction in total labor hours. • The author finds that when labor hours are disaggregated, learning effects are not homogenous across different ranks of labor; specifically, learning is significant among higher labor ranks (partners, managers, and in-charge) and is not significant for the lower ranks (staff). • The author finds some evidence of knowledge depreciation; specifically, an increase in experience beyond the learning period negatively affects productivity. This leads to an increase in production costs for partners and in-charge, but not for managers. • Overall, the author's findings suggest that learning by doing as well as knowledge depreciation occur in a professional service industry.

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research summary

Title:	Does Recent Academic Research Support Changes to Audit Reporting Standards?
Practical Implications:	This study reviews academic literature to not only offer insights into how well recent audit reporting initiatives gives users the information they need to understand the audit, but also suggest future research that academics can perform to help standard setters improve the auditor's report. The authors argue that (1) disclosure of the audit partner's name does close the information gap, (2) disclosures related to auditor independence and tenure only partially closes the information gap, and (3) auditor commentary on going concerns does not close the information gap; however, not enough is known about how well either (4) disclosure of critical or key audit matters or (5) assurance on other information in the audit report closes the information gap. These insights may be of interest to stakeholders in the standard setting process who wish to evaluate the success of currently enacted audit reporting initiatives and the potential costs and benefits of proposed audit reporting initiatives.
Citation:	Bédard, J., P. Coram, R. Espahbodi, and T.J. Mock. 2016. Does Recent Academic Research Support Changes to Audit Reporting Standards?. <i>Accounting Horizons</i> 30 (2): 255-275.
Keywords:	audit reporting model, audit report, auditing, information gap.
Purpose of the Study:	Regulators interested in improving the informativeness of the auditor's report have recently proposed/required new disclosures to be made by the auditor to help information users better understand the audit. Academic researchers studied whether these new disclosures fulfill their intended purpose and/or have unintended consequences. The purpose of this study is to synthesize the academic literature related to the new disclosures in order to identify (1) whether the benefits of specific new disclosures outweigh the costs, (2) whether further changes to the auditor's report are needed, and (3) where more research is needed to better understand the effects of the new disclosures. Thus, this study serves as a means of communicating the findings of academic research to standard setters in order to enable academics to better fulfill their information-gathering role in the standard setting process.
Design/Method/ Approach:	The author perform a review of the academic literature relevant to PCAOB, IAASB, and U.K. FRC audit reporting initiatives, specifically focusing on (1) disclosure of critical or key audit matters, (2) assurance on other information in the audit report, (3) auditor commentary on going concerns, (4) disclosure of audit partner name, and (5) disclosures related to auditor independence and tenure. They obtain research published, posted online, or presented at conference(s) from 2007 through mid-2015, but mostly after 2011.
Findings:	<ul style="list-style-type: none"> • Not enough is known about how well disclosure of critical or key audit matters gives users the information they need to understand the audit. <ul style="list-style-type: none"> • Experimental evidence suggests that Critical Audit Matters (CAMs) disclosed in the auditor's report may (1) draw users' attention to areas discussed in the CAMs, (2) scare some nonprofessional investors away from companies with CAMs, (3) influence auditor liability and legal damages in unintended ways, (4) and discourage auditors from bringing problems to the attention of passive audit committees. Furthermore, experimental evidence suggests that (1) the impact of additional disclosure from the auditor upon users may vary depending upon management disclosures and (2) managers may be reluctant to share information about accounting estimates with auditors who are required to make additional disclosures about these estimates. • Preliminary archival evidence from the U.K. is mixed in terms whether CAMs have a positive association with audit fees and audit quality, but suggests CAMs have no relationship with financial statement's informativeness. • Research about the French justifications of assessments disclosure suggests that they are generally boilerplate and uninformative, and they have no impact on audit quality (after the year of implementation). • Archival research from the U.S. on the effect of explanatory language on unqualified audit reports suggests that (1) some types of explanatory language provide information about financial reporting quality and (2) non-going concern explanatory language can increase/decrease disagreement among investors. • A review of stakeholder responses to the IAASB's proposed audit reporting initiatives suggests that stakeholders generally approved of the changes, but had differing opinions of how much change was needed. • There is no evidence available about whether assurance on other information in the audit report gives users the information they need to understand the audit. • Auditor commentary on going concerns appears to not give users the information they need to understand the audit. <ul style="list-style-type: none"> • Although most studies find the going concern audit reports useful, one study finds them not incrementally valuable when they merely focus users' attention on management's going concern disclosures.

research summary

Findings:

- Disclosure of the audit partner's name does give users the information they need to understand the audit.
- Although some studies provide mixed evidence about whether disclosing the audit partner's name increases audit quality, other studies suggest that (1) different audit partners are associated with different levels of audit quality and (2) the restatement history of the audit partner may scare off some potential investors. However, higher audit fees appear to be the cost of disclosing this useful information.
- Disclosures related to auditor independence and tenure give users some of the information they need to understand the audit.
- Although a review of prior research suggests no link between non-audit services (NAS) and auditor independence, a recent study found that total NAS fees are associated with higher (lower) audit quality for issuers (non-issuers).
- Although a review of prior research does not find decreased audit quality for firms with longer audit firm tenure, a recent study suggests that long audit firm tenure is only associated with decreased audit quality for audits of non-issuers.

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