The impact of contextual factors on auditors' ability to resist management pressure

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Abstract

This study examines the impact of the extend to which auditors will be able to justify errors in case of litigation, the strategy of the audit firm, the authority of the client's management to choose the audit firm and the extend to which auditors are successful in their careers on auditors' willingness to allow errors in financial statements under mangement pressure. The results show that all factors, with the exception of audit firms strategy, significantly influence auditors' ability to resist management pressure.

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1. Introduction

Financial statements contain information about the financial position and results of companies and this information is used by users of these statements for a large number of decisions. Loan officers in banks, for instance base their loan decisions usually on information in financial statements and financial analysts and shareholders use this information to determine whether it is advisable to invest in the companies concerned.

However, financial statements are also used by shareholders and supervisory directors to evaluate managers of companies and managers' compensation often depends on information in financial statements. Therefore, users of statements cannot be sure that financial statements prepared by the managers of a company provide a true and fair view of the company's financial situation and hence users demand that financial statements be audited by an independent financial expert (a public auditor). It is essential of course that these auditors are indeed independent and that their audits are not influenced by the client's management.

In recent years however, concern about auditors' independence has been expressed by regulatory authorities (SEC Report 1994) and the accounting profession itself (POB Reports 1993/1994). They have emphasized the fact that managers control the current and future audit fees that the audit firm hopes to obtain from the audit, and therefore are in a powerful position in audit conflict situations. Empirical studies do indicate that managers exert pressure on auditors in audit conflict situations to allow errors in financial statements by (subtly or overtly) threatening to break off the relationship with the audit firm, and that auditors regularly yield to this pressure (Van de Poel and Schilder, 1990 and Wieleman et al., 1990).

In this study we investigate whether auditors' willingness to allow errors in financial statements under pressure from the management of audited companies, is influenced by the nature of the error, the audit firm's strategy, the management's authority to choose the audit firm and the auditors' success in their careers.

The remainder of this paper is organized as follows. In section 2 some prior research is reviewed and hypotheses are formulated with respect to the effects of the above-mentioned factors on auditors' independence. Section 3 describes the experiment that has been conducted to test the hypotheses and section 4 describes the results. The results are discussed in section 5.

2. Prior research and hypotheses

Introduction. In recent years several authors have studied auditors' independence and factors that affect this independence. Most of these studies however concern the perceptions of users of financial statements. Although these studies are relevant because users' trust in financial statements is determined by their perceptions of auditors' independence, this research gives only limited insight into auditors' actual behavior in audit conflict situations. Research into auditors' behaviour in audit conflict situations is sparse, however. Lord (1992) has investigated the impact of client characteristics and competition on auditors' independence, and Hackenbrack and Nelson (1996) have investigated the impact of engagement risk on auditors' willingness to permit aggressive reporting methods under management pressure.

Nature of the error. Errors in financial statements are risky for auditors because these errors may be discovered by users and may lead to lawsuits and claims against the auditor who wrongly approved the statements. In recent years the number of lawsuits and claims against auditors has increased sharply, and for that reason auditors are much more mindful of the legal consequences of errors when auditing financial statements.

Jurisprudence suggests that the bare fact that a statement contains errors is not enough reason to convict auditors and to sustain claims, but that also has to be proved that the audit was not carried out with “reasonable care and skill” (Gwilliam, 1987). Herewith a mayor point is whether the audit was carried out in conformity with generally accepted auditing standards.

Sometimes errors in financial statements clearly show that the auditor did not carry out the audit with “reasonable care and skill”, i.e. in accordance with generally accepted auditing standards. This is the case, for instance, if losses are applied against the equity of the company (whereas auditing standards require that such losses should be booked against the results), or if the statements contain real estate that is not owned by the company (whereas auditing standards require that in case of real estate a cadastral search into the ownership should to be carried out). In a lawsuit the auditor will not be able to justify such errors and therefore such errors will lead to conviction of the auditor and to allowance of claims. Therefore, it can be expected that auditors will not be willing to accept these types of errors under management pressure.

Sometimes however, auditors are pressured to accept errors in financial statements of which it is much more difficult to demonstrate that the auditor acted culpably. This is the case, for instance, if provisions in the balance sheet are set at a wrong level on the basis of subjective estimates or if real estate is valued at a wrong level on the basis of a (wrong) report by a broker. Even if it becomes clear later on that the statement contained errors, it is usually impossible to prove that the auditor did not carry out the audit with “reasonable care and skill”, and such errors usually do not lead to conviction of the auditor and to allowance of claims in court. Therefore, it can be expected that auditors will more willing to accept these types of errors, because they can justify such errors better in case of litigation.

These observations lead to the following hypothesis:

H1 There is a positive relationship between auditors' willingness to allow errors in financial statements under management pressure, and the extend to which they will be able to justify these errors in case of litigation.

Strategy of the audit firm. In recent years competition in the audit market has increased sharply. As a result, audit firms feel an increased need to stand out from others and many audit firms do this by specializing in certain industries or types of clients (Langendijk, 1994). Sometimes such a strategy is also the result of specific expertise within the audit firm and the need to use this expertise optimally.

Audit firms communicate their strategies concerning the desired composition of their clients to their employees and they are expected to put in extra effort to bring in the desired clients and to prevent such clients from leaving the audit firm. If the last unhoped should happen, then the management of the audit firm will critically investigate whether the loss of the client was inevitable and if they reach the conclusion that the auditor who was responsible has made an inadequate effort to prevent the loss of the client, this will have a negative impact on his evaluation. So, if the strategy of the audit firm is directed at specialization in certain types of clients, the auditors of the audit firm will put in extra effort to prevent such clients from leaving. Therefore, it may be expeced that if such clients pressure auditors (with the subtle or overt threat to break off the relationship with the audit firm), auditors will yield to such pressure sooner.

The above leads to the following hypothesis:

H2 If the strategy of the audit firm is directed at specialization in certain types of clients, auditors will yield sooner if the management of such clients exert pressure to allow errors in financial statements.

Management's authority to choose the audit firm. Research shows that the use of threats in negotiations is effective only if the threats are credible, i.e. if the person who is uttering the threats is able to carry them out (Pruitt and Carnevale, 1993). To auditors who are put under pressure by the auditiees management with the threat to leave the audit firm, this means that this threat will only be effective if the auditee's management do have the authority to choose another audit firm if the auditor does not give in.

Managers' authority to choose audit firms varies greatly in practice however. If the auditee is an autonomous company of which all shares are owned by the manager, then this manager has full power to choose the audit firm. If the auditee is part of a concern, however, the audit firm is usually chosen by the management of the concern and the management of the auditee do not have much influence. In situations where an audit committee exists, the influence management has on the choice of the audit firm usually is limited also. As a consequence, it may be expected that auditors will be more susceptible to management pressure if the management of the auditee has more influence on the choice of the audit firm.

This leads to the following hypothesis:

> **H3 There is a positive relationship between auditors' willingness to allow errors in financial statements under pressure from the auditee's management, and management's authority to choose the audit firm.**

Success auditors. Auditors in audit firms have to pass through a great number of ranks before they, with a successfull career, are accepted as partner in the audit firm. Auditors are evaluated on a large number of criteria to determine whether they should be promoted to a higher rank. At the beginning of their career they are evaluated mainly on technical skills, but later on social and commercial skills (the ability to bring in new clients and the ability to maintain good relations with clients, thus preventing them from leaving the audit firm) will become increasingly important.

As we have seen, auditors regularly are put under pressure by the clients's management with the threat to break off the relationship with the audit firm. If auditors do not give in to the client's wishes, the relationship with the client's management will become strained. Furthermore, there is a risk that the client's management carries out its threat and breaks off the relationship with the audit firm, and therefore auditors who are not susceptible to management pressure run a greater risk of loosing clients. Because the loss of clients has a negative impact on the way auditors are evaluated, it can be expected that auditors who are not susceptible to management pressure will be less succesful in their careers than auditors who are susceptible to management pressure.

This leads to the following hypothesis:

> **H4 There is a positive relationship between auditors' willingness to allow errors in financial statements under management pressure, and the extent to which they are successful in their careers.**

3. Method

Research method. Experiments have been chosen as a method of testing the hypotheses. In experiments independent variables are manipulated under controlled circumstances to determine their impact on dependent variables and for that reason experiments are the best method of testing hypotheses about causal relationships between variables.

The artificial conditions of experiments (e.g. the use of students and oversimplified tasks) are sometimes mentioned as a reason why experimental results are difficult to generalize to real world settings. For this reason real auditors have been chosen as subjects in this study and they have been asked to perform common tasks from audit practice (e.g. making decisions on financial statements in audit conflict situations). Therefore, the results of this study are expected to hold in the real world too.

Sample. Data have been gathered from Dutch certified public auditors, because these are qualified to issue an opinion about financial statements and will negotiate with the auditee's management in audit conflict situations.

Respondents were selected as follows. From a list of all Dutch certified auditors two groups of practising auditors were selected, namely (1) successful auditors (auditors who became partner in a Big 5 audit firm within 10 years after becoming a certified auditor), and (2) less successful auditors (auditors who became a certified auditor 20 or more years ago and who have not yet been accepted as a partner in a audit firm at this moment). From both groups 50 auditors were selected at random and were asked by telephone to participate in the study. A questionnaire was sent to the 94 auditors who were willing to participate and 61 questionnaire were returned. After two reminders another 21 auditors returned the questionnaire. So, of the 100 auditors that were approached a total of 82 returned the questionnaire, giving a response rate of 82.0%. Of the respondents, 39 (78%) were “successful auditors”, and 43 (86%) were “less successful auditors”. Respondents’ mean age was 51.8 years (SD 4.8 years) and on average they had been certified auditors for 22.0 years (SD 4.8 years).

Instrument. Data were collected with the help of a questionnaire. This questionnaire describes the case of a medium-sized bank where the management and the auditor disagree about the bank’s financial statements. The auditor is of the opinion that these statements contain a material error and he insists that this error should be corrected, but the management of the bank disagrees and exerts pressure on the auditor to approve the statements. The conflict has escalated so much that the management of the bank considers to break off the relationship with the audit firm. With the help of the three variables mentioned in hypotheses 1, 2 and 3, eight scenarios are described. Respondents are asked to assume they are the auditor in the case and they are asked to indicate for each scenario (on a 7-point Likert scale) how likely it is that they will yield to the pressure from the bank’s management and will accept the financial statements. Demand and learning effects are minimised by presenting the scenarios in random order and by formulating the case in the most neutral language possible. The case is described in appendix A, which also contains an example of the scenarios.

Experimental design. This study examines the effects of three experimental factors (nature of error, strategy of the audit firm and auditee’s management authority in audit firms selection), and one group factor (success auditor) on auditors’ willingness to accept errors in financial statements under management pressure. The experimental task consisted in repeated judgements on all eight possible combinations of the experimental factors and the experimental design can be defined as a repeated measures block design with three experimental factors and one grouping factor. The factors and their levels are described in table 1.

Levels Factors	Level 1	Level 2
<u>EXPERIMENTAL FACTORS</u>		
• nature error	justifiable	unjustifiable
• strategy audit firm	emphasis on financial institutions	no emphasis on financial institutions
• management's authority	large	small
<u>GROUPING FACTORS</u>		
• success auditor	successful	not successful

Table 1 Factor levels

<u>Data analysis.</u> Data were analyzed with the help of ANOVA, because of ANOVA's unique abilities to examine the effects of categorial variables and interaction effects. The significance of both the main effects and the interaction effects was examined at the 0.05 level. To obtain additional information on the relevance of the effects, the explained proportion of the variance (ω^2) was computed for all significant effects.

4. <u>Results</u>

The results of ANOVA are summarized in table 2. It shows the main effects of the three experimental factors and the grouping factor, and the interaction effects. All main effects are significant at the 0.05 level, with the exception of audit firm's strategy, so hypothesis 2 has to be rejected. The interaction effects are not significant either. Table 3 presents the ω^2 and relative ω^2 of all significant effects. It shows that by far the greater part of the variance (55.0%) is explained by the nature of the error.

	SS	df	MS	F	p
Main effects					
nature error (N)	1593.334	1	1593.334	816.058	0.000
strategy audit firm (S)	0.843	1	0.843	0.432	0.511
management's authority (A)	9.929	1	9.929	5.085	0.024
success auditor (Su)	13.439	1	13.439	6.883	0.009
Interaction effects					
NS	0.014	1	0.014	0.007	0.933
NA	1.465	1	1.465	0.750	0.387
Nsu	1.285	1	1.285	0.658	0.418
SA	0.038	1	0.038	0.020	0.889
Ssu	1.355	1	1.355	0.694	0.405
Asu	3.088	1	3.088	1.581	0.209

Table 2 ANOVA

Effects	F	ω^2	Relative ω^2
Nature error	816.058	0.550	0.987
Management's authority	5.085	0.003	0.005
Success auditor	6.883	0.004	0.007

Table 3 Variance explained by significant effects

The marginal means of the dependent variable are presented in table 4 (a high value indicates a high willingness of the auditor to yield to management pressure). Table 4 shows a higher willingness to yield if auditors think that they will be able to justify the errors in case of litigation, and if the auditee's management has a great influence on the selection of the audit firm, which confirms hypotheses 1 and 3. Hypothesis 4 predicts that there is a positive relationship between auditors' willingnes to allow errors in financial statements under management pressure, and the success auditors have in their careers. Table 4 however shows that this relationship is <u>negative</u>, so hypothesis 4 has to be rejected.

Factors	Level 1	Level 2
nature error	4.601	1.476
strategy audit firm	3.076	3.000
management authority	3.165	2.912
success auditor	2.888	3.174

Table 4 Marginal means for factor levels

5. <u>Conclusions and discussion</u>

As was expected this study shows that the auditors' willingness to accept errors in financial statements under management pressure is high if auditors think that they will be able to justify these errors in case of litigation, and if the auditee's management has a great influence on the selection of the audit firm.

The success auditors have in their careers was a relevant factor too, but contrary then was expected more successful auditors were found to be less willing to yield to management pressure. There are several possible explanations for this result. One explanation is that successful auditors usually are partners in audit firms and loss of a client will therefore have a less negative impact on their careers (because they are already partner). Another explanation is that successful auditors have more social skills and power of persuasion, and therefore are better able to convince clients of their point of view in case of conflicts, which will prevent them from leaving the audit firm. Further research will have to bring more clarity.

Literature

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Case

The financial statements of a medium-sized bank are audited by a certified public auditor. During the past year the management of the bank and the auditor differed in opinion about the financial statements of the bank. According to the auditor, these statements contain a material error and he insists that this error should be corrected, but the management of the bank disagrees. The conflict has escalated so much that the management has declared that they are considering breaking off the relationship with the audit firm.

Some authors have suggested that the willingness of auditors to yield to management pressure is influenced by the following factors:

1) Nature of the error.

   In the scenarios the extent in which the error can be justified to third parties is described as “justifiable” or “unjustifiable”. When the error is described as “justifiable” the auditor is of the opinion that the error is a material accounting error which should be corrected, but that he will be able to justify this error to third parties. This is the case, for instance, if provisions in the balance sheet are set at a wrong level on the basis of on subjective estimates. When the error is described as “unjustifiable”, the auditor not only is of the opinion that het error is a material accounting error, but also that he will not be able to justify this error to third parties. This is the case, for instance, if the statements contain real estate from which cadastral search has indicated that the bank is not the owner.

2) Strategy of the audit firm.

   In the scenarios the strategy of the audit firm is described as “emphasis on financial institutions” or as “no emphasis on financial institutions”. When the strategy is described as “emphasis on financial institutions” the audit firm has relatively few financial companies (banks or assurance companies) as a client and the audit firm actively strives to increase that sort of clients. When the strategy is described as “no emphasis on financial institutions” the audit firm does not strives to increase specificly the number of financial companies as client.

3) Authority auditee’s management in audit firm’s selection.
   In the scenarios the authority of the auditees management to chose the audit firm is described as “large” or “small”. When management’s authority is described as “large” the management of the bank has a decisive influence on the selection of the audit firm. When management authority is described as “small”, management’s influence on the selection of the audit firm is small, which for instance is the case when the bank is part of a concern and the audit firm is chosen by the management of the concern.

Eight scenarios are described below with the help of the a forementioned factors. Supposing that you were the auditor of the bank, you are requested to estimate the probability that you will accept the financial statements of the bank as it was prepared by the bank’s management. Please indicate this probability on a 7-point scale by circling one of the figures from 1 to 7. Figure 1 indicates that you consider the probability that you will accept the statements to be very low and figure 7 indicates that you consider this probability to be very high.

<u>Scenario 1</u>

- nature of the error	: justifiable
- strategy of the audit firm	: emphasis on financial institutions
- authority auditees management in in audit firms selection	: large

Your estimate of the probability that you will accept the financial statements of the bank (circle one of the numbers from 1 to 7):

1	2	3	4	5	6	7
very low probability of accepting						very high probability of accepting