The individual style of audit partners influences how firms are rated

blogs.lse.ac.uk/businessreview/2016/01/14/the-individual-style-of-audit-partners-influences-how-firms-are-rated/

1/14/2016

We examine the persistence and economic consequences of variations in reporting style across audit partners in individual engagements. Based on an analysis of audits performed over a six-year period by the Swedish subsidiaries of the Big 4 accounting firms (Deloitte, Ernst & Young, KPMG, and PwC), we find that:

- aggressive or conservative reporting is associated with the particular engagement partners who head the audits over and above any influence of the Big-4 firms that employ them,
- these individual differences in reporting style persist over time and across clients, and
- they contribute significantly to such economic factors as the credit ratings that client firms receive and how they are assessed by stock investors.

These results hold both for private companies which dominate our sample but also for listed companies. Specifically, we show that a firm audited by an engagement partner who is consistently aggressive is more likely than other companies (other factors being equal) to be penalised through higher interest rates, lower credit ratings, and greater perceived likelihood of insolvency.

If the company is public, it is also likely to be penalised by a lower Tobin's Q, a measure that reflects investor approval of a firm and optimism about its prospects. In short, we find that the reporting differences of lead auditors have a significant effect on both the lending and equity markets.

We gauge the accounting styles of auditors, whether aggressive or conservative, in two principal ways: (1) through their propensity to issue going-concern opinions, the warnings about firms' future viability that auditors insert in financial reports of distressed companies, and (2) by their tendency to err on the high or low side in estimating the value of accounting accruals, non-cash items such as accounts receivable or inventory.

Patterns of aggressiveness and conservatism proved highly persistent over the years. For example, an auditor with a prior history of frequently erring in failing to issue going-concern opinions for firms that subsequently went bankrupt (a year or less later) had a three to four times greater chance of repeating the same reporting error in future years. Further, the repeated tendency to fail in this way negatively affects perceptions of a client's creditworthiness.

Other factors being equal, it raises by a full percentage point banks' estimates that a client will be insolvent within 12 months, a substantial bump considering that the mean estimate for companies' insolvency risk is 1.886 percent. In contrast, no evidence emerged that a partner's record of 'false positive' signals — issuing a going-concern opinion when not needed — has an effect on any of the credit measures.

Collectively, the findings of our study emphasise the importance of analysing audit quality at the level of the individual auditor. Since the auditor's reputation is a potentially critical aspect of audit quality, the reported findings are likely of interest to practitioners, regulators, academics, and users of financial statements. As a matter of fact, our study received media attention, including by The New York Times, and it was singled out for attention by PCAOB Chairman Doty, who cited its focus on "situations in which you have a continuous long record of identification of the engagement partner." At the same time, we agree with the discussant of our study, W.R. Kinney, to be cautious about how independent research is interpreted and used to inform and/or justify evidence-based standards to protect investors.

Notes:

- *This article is based on the authors' paper Does the Identity of Engagement Partners Matter? An Analysis of Audit Partner Reporting Decisions, Contemporary Accounting Research, Volume 32, Issue 4, pages 1443–1478, Winter 2015.*
- *This post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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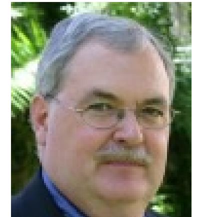

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