

# Are auditors independent of their clients? A review of past research and discussion of research opportunities in Europe

**Presentation to the Accounting Faculty  
Coller School of Management  
Tel Aviv University**

# Outline

- Overview of research questions archival auditing researchers have been interested in
- Defining auditor independence
- Selective literature review on auditor independence and economic bonding
- Overview of the (changing) auditing landscape in Europe
- Discussion of certain European-centric studies
- Suggestions for future research

## The Real Domain

### Inputs:

- Auditor independence
- Effort
- Expertise and knowledge
- Client co-operation and internal systems
- Reputation

Audit quality



### Outputs:

- Auditor opinion
- Auditor report
- Financial statements (reporting quality)

## The Research Domain

### Independent variables:

- Fees (audit and non audit)
- Audit hours
- Industry expertise
- Auditor size
- Tenure; rotations; joint auditors
- Institutional factors



### Dependent (outcome) variables:

- Auditor opinion (clean, qualified, GC)
- Auditor report (e.g., content)
- Measures of reporting quality
- Regulatory/enforcement outcomes

# Audit Quality

- Hard to observe
- Difficult to quantify
- Difficult to define
- DeFond and Zhang (2014): “We define audit quality as greater assurance of high reporting quality”
  - Need to operationalize high reporting quality
- DeAngelo (1981): “the market-assessed joint probability that a given auditor will both detect a breach in the client’s information system, and report the breach”
  - Narrow definition of auditors’ work?
- Audit quality and independence are intertwined: “The supply of audit quality is affected by auditor incentives for independence,” (DeFond and Zhang, 2014)

# Definitions of Independence (1)

- American Institute of Certified Public Accountants (AICPA), “[t]he auditor must maintain independence in mental attitude in all matters relating to the audit”
- The Securities and Exchange Commission (SEC): “[a]n auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment”
- FRC (UK): “Independence is freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity.”



# Definitions of Independence (2)

- International Ethics Standards Board for Accountants (IESBA) code: Independence is:
  - Independence of mind - the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
  - Independence in appearance - the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit or assurance team's, integrity, objectivity or professional skepticism has been compromised.

# Economic Bonding

- Client managers pay the fees
  - In the US following SOX this responsibility rests with the audit committee (but is the committee free of CEO influence?)
- The “bribe” perspective: These fees can be used to influence auditor judgement; hence higher fees capture economic bond
  - Short of the threat of dismissal which can send a negative signal to investors
  - Non-audit fees may be the main channel
- The effort perspective: higher fees are paid when the auditor exerts more effort
  - For example, when task complexity is greater
- The “something else” perspective: e.g., client risk , litigation risk

# Fee-based Measures

- Audit fees (typically log of)
- Non-audit fees (typically log of)
- Total fees (typically log of)
- Abnormal fee measures
  - Based on the residual from a regression model for normal fees (see next slide)
  - Despite best modelling effort, some question whether the residual represents economic bonding
- Fee ratios, such as  $\text{non audit fee} / (\text{audit fee} + \text{non audit fees})$



# A Typical Fee Model

- Need to account for factors known to affect the fee measure
- Since many such factors have been identified, the model can become “rich”:

*LAF*

$$\begin{aligned} &= \alpha + \beta_1 LTA + \beta_2 FOREIGN + \beta_3 ROA + \beta_4 ARINV + \beta_5 LOSS \\ &+ \beta_6 BIG + \beta_7 DEC + \beta_8 LEV + \beta_9 SWITCH + \beta_{10} SEG + \beta_{11} CFO \\ &+ \beta_{12} CRAT + \beta_{13} MRET + \beta_{14} GROWTH + \beta_{15} MA + \beta_{16} RISK \\ &+ \beta_{17} LAG + \beta_{18} ACC\_FIL + \beta_{19} LIT + \beta_{20} DISC + \beta_{21} EMPL \\ &+ \beta_{22} SPEC + \varepsilon \end{aligned}$$

Residual represents abnormal fee

TAU 29 November 2016 © Gilad Livne

# Fees and Opinions

Study	Sample properties: period (P), sample size (S) and jurisdiction (J)	Fee measure(s)	Outcome measure(s)	Main findings and conclusions
Craswell, A., D.J. Stokes, and J. Laughton. 2002. JAE	P: 1994 & 1996 S: 1,062 & 1,045 J: Australia	(1) ratio of client audit fees to audit firm's total <u>national</u> audit plus non-audit fees (2) ratio of client audit fees to audit firm's total <u>office</u> audit plus non-audit fees	Propensity to issue qualified opinion	Fees are not associated with the occurrence of qualified opinions => economic bond does not distort auditor incentives
DeFond, M., K. Raghunandan, and K.R. Subramanyam. 2002. JAR	P: 2000 S: 1,158 financially distressed firms J: USA	(1) Unexpected fee ratio (non-audit/total fee) (2) Unexpected audit fee (3) Unexpected total fee (4) Unexpected non-audit fee	Propensity to first time issue Going Concern (GC) opinion	Fees are not associated with the occurrence of GC opinions => economic bond does not distort auditor incentives
Blay, A. D., & Geiger, M. A. 2013. CAR	P: 2004-2006 S: 1,479 financially distressed firms J: USA (post-SOX)	(1) Future total fees (2) Current non-audit fees (3) Current audit fees (4) Current (non-audit fees/total fees)	Propensity to first time issue Going Concern (GC) opinion	Current and future non-audit fees reduce the occurrence of GC opinions => economic bond does distort auditor incentives

# Discussion: Blay and Geiger (2013)

A rich logistic model:

$$\begin{aligned} OPINION = & \beta_0 + \beta_1(SIZE) + \beta_2(PROBANKZ) + \beta_3(AGE) + \beta_4(BETA) \\ & + \beta_5(RETURN) + \beta_6(VOLATILITY) + \beta_7(LEV) + \beta_8(PLOSS) \\ & + \beta_9(ROA) + \beta_{10}(INVESTMENTS) + \beta_{11}(CFFO) \\ & + \beta_{12}(ISSUE\_DEBT) + \beta_{13}(ISSUE\_EQUITY) + \beta_{14}(SELL\_ASSETS) \\ & + \beta_{15}(DISC\_OPER) + \beta_{16}(BIG4) + \beta_{17}(REPORTLAG) + \beta_{18}(DFT) \\ & + \beta_{19}(\log(FUTURE\_FEES)) + \beta_{20}(\log(CUR\_TOTAL\_FEE)) + \beta_{21}(\log(CUR\_AUDIT\_FEE)) \\ & + \beta_{22}(\log(CUR\_NAS\_FEE)) + \beta_{23}(\log(CUR\_FEERATIO)) + \varepsilon \end{aligned}$$

# Discussion: Blay and Geiger (2013)

Parameter	Exp. sign	Model 1		Model 2 <sup>b</sup>		Model 3		Model 4		Model 5		Model 6	
		Coefficient	p-value	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value
<i>log(FUTURE_FEES)</i>	-			-0.03	0.04								
<i>log(CUR_TOTAL_FEE)</i> ?						0.03	0.84					0.06	0.68
<i>log(CUR_AUDIT_FEE)</i> ?								0.15	0.31				
<i>log(CUR_NAS_FEE)</i>	-							-0.05	0.02				
<i>CUR_FEERATIO</i>	-									-1.70	0.01	-1.72	0.01
Pseudo $R^2$		0.30		0.40		0.31		0.31		0.31		0.31	

- Audit fees do not seem to constitute a bribe, but not clear if they represent audit effort either
- The negative coefficient on NAS and FEERATIO (NAS/Total Fees) is consistent with “bribe”, but what is the economic significance?
- Note the significant result on future fees: the auditor is rewarded in the future if they “compromise” today
- Results are somewhat counter-intuitive: Wouldn't we expect auditors in distressed firms to be less amenable to economic bond as legal threat and reputation risk are stronger?
- Perhaps auditors in distressed firms are asked to do lots of non-audit work (tax related?)
- Short period (2004-06) – is it representative of the post-SOX experience as a whole?

# Fees and Reporting Quality

Study	Sample properties: period (P), sample size (S) and jurisdiction (J)	Main variable(s) of interest	Outcome measure(s)	Main findings and conclusions
Frankel., R., M. Johnson, and K. Nelson. 2002 TAR	P: 2000 S: 3,074 J: USA	(1) Non-audit/total fee (2) Rank of non-audit fees (3) Rank total fees	(1) Prob (earnings surprise = the difference between actual EPS and the last available consensus median forecast) (2) Probability of meeting or just beating analyst forecasts by 1 cent (3) Discretionary accruals	Non audit fees are associated with earnings management (EM) but audit fees are negatively related to EM
Ashbaugh, H., R. LaFond, and B.W. Mayhew. 2003 TAR	P: 2000 S: 3,170 J: USA	(1) Audit fee (2) Non-audit fee (3) Total fee (4) Non-audit/total fee	(1) Same first two measures as in Frankel et al. 2002. (2) Performance adjusted accruals	Non audit fees are not associated with EM; mixed evidence about audit fees and EM
Gul, F.A., C.J.P, Chen and J.S.L. Tsui. 2003 CAR	P: 1993 S: 648 firms J: Australia	(1) Abnormal accruals	(1) Total audit fees  <i><u>Note the reversal of dependent and independent variables</u></i>	Positive abnormal accruals are associated with higher audit fee. Consistent with aggressive EM is “acceptable” when clients pay large fees

# Fees and Reporting Quality

Study	Sample properties: period (P), sample size (S) and jurisdiction (J)	Main variable(s) of interest	Outcome measure(s)	Main findings and conclusions
Larcker, D.F., and S.A. Richardson. 2004. JAR	P: 2000-2002 S: 5,103 J: USA	(1) Non-audit/total fee paid by client (2) Total fee paid by client to the auditor/total auditor-level revenue	(1) Abnormal accruals (signed and absolute)	Fee ratios are negatively related to EM. This is inconsistent with economic bonding
Causholli, M., D.J. Chambers, and J.L. Payne. 2014 CAR	P: 2002-2003 (pre-SOX) & 2005-2007 (post-SOX) S: 4,078 & 4,985 J: USA	(1) Low NAS fee indicator (representing potential growth opportunity for NAS) (2) Actual change in NAS fee in t+1 (3) Interaction between (1) and (2)	(1) Abnormal current accruals (signed and absolute)	Pre-SOX: The “promise” of more NAS work impairs independence, as is seen from the positive sign on the interaction term. Post-SOX: No relation

# Discussion: Causholli et al. (2014)

- Expand on the idea that auditor “co-operation” in the current period buys them higher fees in the future
- Examine fees at the same city and industry in an attempt to capture partner-level fees (partner identity is unknown in the US)

Main variables:

OPFEE = Fee growth opportunity; essentially an indicator for currently low fees

NY\_PCT = Realized change in non-audit fees

OPFEE\*NY\_PCT = Cases where there was potential to grow fees and this has materialized

# Discussion: Causholli et al. (2014)

- Investigate the relation between abnormal accruals and these measures
- Abnormal accruals:

$$\frac{CA_t}{AT_{t-1}} = \lambda_1 \frac{1}{AT_{t-1}} + \lambda_2 \frac{\Delta SALE_t}{AT_{t-1}} + \lambda_3 \frac{IB_{t-1}}{AT_{t-1}} + \varepsilon_t$$

- Regression model:

$$\begin{aligned} ADCA_t = & \phi_0 + \phi_1 OPFEE_t + \phi_2 NY\_PCT_t + \phi_3 (OPFEE \times NY\_PCT)_t + \phi_4 GROWTH_t \\ & + \phi_5 (GROWTH \times NY\_PCT)_t + \phi_6 LNNASF_t + \phi_7 TENURE_t + \phi_8 CFO_t \\ & + \phi_9 LEV_t + \phi_{10} LITIG_t + \phi_{11} MB_t + \phi_{12} MV_t + \phi_{13} LOSS_t + \phi_{14} FIN_t \\ & + \phi_{15} LCA_t + \phi_{16} SPEC_{t-1} + \phi_{17} Y(0)_t + \varepsilon_t. \end{aligned}$$



# Discussion: Causholli et al. (2014)

## Pre-SOX (2000-2001)

Variable	Total discretionary accruals	
	Estimated coefficient	<i>t</i> -statistic
Intercept	0.082***	2.64
<i>OPFEE</i>	-0.015***	-34.58
<i>NY_PCT</i>	-0.013***	-4.13
<i>OPFEE</i> × <i>NY_PCT</i>	<b>0.019***</b>	<b>2.51</b>
<i>GROWTH</i>	0.007***	24.25
<i>GROWTH</i> × <i>NY_PCT</i>	-0.003	-1.04
<i>LNNASF</i>	0.000	0.07
<i>TENURE</i>	-0.001***	-6.03
<i>CFO</i>	-0.084***	-2.94
<i>LEV</i>	0.023**	2.37
<i>LITIG</i>	0.024***	8.36
<i>MB</i>	0.002***	2.99
<i>MV</i>	-0.006***	-3.79
<i>LOSS</i>	0.011	1.29
<i>FIN</i>	0.020***	193.32
<i>LCA</i>	0.222***	13.81
<i>SPEC</i>	0.005***	27.70
<i>Y(0)</i>	-0.006***	-8.22
Adjusted <i>R</i> <sup>2</sup>	0.215	
<i>N</i>	4,078	

## Post-SOX (2005-07)

Variable	Total discretionary accruals	
	Estimated coefficient	<i>t</i> -statistic
Intercept	0.041***	7.16
<i>OPFEE</i>	-0.004***	-11.11
<i>NY_PCT</i>	-0.005	-0.81
<i>OPFEE</i> × <i>NY_PCT</i>	<b>0.004</b>	<b>0.28</b>
<i>GROWTH</i>	0.017***	4.17
<i>GROWTH</i> × <i>NY_PCT</i>	0.001	0.06
<i>LNNASF</i>	-0.000	-0.15
<i>TENURE</i>	-0.000	-0.55
<i>CFO</i>	-0.015	-0.94
<i>LEV</i>	0.015***	9.80
<i>LITIG</i>	0.009***	7.61
<i>MB</i>	0.001	0.95
<i>MV</i>	-0.003***	-13.05
<i>LOSS</i>	0.028***	6.14
<i>FIN</i>	0.014***	7.26
<i>LCA</i>	0.276***	6.96
<i>SPEC</i>	-0.001	-1.21
<i>Y(6)</i>	-0.000	-1.00
<i>Y(7)</i>	0.003***	15.32
Adjusted <i>R</i> <sup>2</sup>	0.181	
<i>N</i>	4,985	

## Discussion: Causholli et al. (2014)

- The authors focus on the positive coefficient on the interaction term  $OPFEE * NY\_PCT$
- But the negative coefficient on either  $OPFEE$  or  $NY\_PCT$  is baffling. The authors simply say: “This result is consistent with the view that NAS do not always negatively influence audit quality.”
- The use of one abnormal accrual model is also questionable

# Audit Tenure and Reporting Quality

Study	Sample properties: period (P), sample size (S) and jurisdiction (J)	Tenure measure(s)	Outcome measure(s)	Main findings and conclusions
Johnson, E., I. Johnson, I.K. Khurana, and J.K. Reynolds. 2002 CAR	P: 1986-1995 S: 2,463 J: USA	(1) Short-tenure: 2-3 years (2) Medium tenure: 4-8 (3) Long tenure: 9 and over years	(1) Absolute abnormal accruals (from the modifies Jones model) (2) Persistence of the accrual component in earnings (the coefficient on current CFO in a regression of future earnings)	(1) Strong association of short tenure with abs. abnormal accruals for short tenure (2) Weaker persistence for short tenure Early years are more prone to audit errors
Geiger, M.A., and K. Raghunandan. 2002 AJPT	P: 1996-1998 S: 117 bankrupt firms J: USA	Natural log of tenure in years	Probability of a Going Concern modified opinion	The probability of CG opinion increases with tenure
Myers, j., Myers, L., and T. Omer, 2003 TAR	P: 1988-2000 S: 42,302 J: USA	(1) 1-2 years (2) 3-4 years (3) Tenure > 5 years	(1) Current accruals (2) Discretionary accruals (Jones model)	Auditors appear to place greater constraints on both income-increasing and income decreasing accruals as the auditor-client relationship lengthens 19

# Audit Tenure and Reporting Quality

- The evidence in the previous slide suggests long tenure is “good” in the US
- But there is conflicting evidence elsewhere:
  - Chi and Huang (2005) find for Taiwanese firms abnormal accruals decline in the first years of the audit firm tenure, but increase afterwards
  - Chen et al. (2008), also in Taiwan but using different methodologies to measure audit quality, fails to document a relation between accruals and tenure
  - In Belgium Knechel and Vanstraelen (2007) do not find any effect of long tenure on the issuance of going-concern opinion

# The European Auditing Landscape

# Regulatory Changes in the EU

In the last decade there have been several changes, concerning the following spheres of auditors' work in Europe

- Partner rotations
- Audit firm rotations
- Restrictions on non-audit services (NAS) and fees
- New auditor report
- Limitations and caps to auditor civil liability

I will next describe some of these changes – I believe that these changes open up opportunities for research

# Differences Across Member States

- Changes in regulations leave implementation flexibility to a member state
  - Some examples to follow
- Absent EU regulation there have been differences, such as:
  - Disclosing engagement (lead) partner identity
    - See Carcello and Li (2013, TAR) for first time effect of revealing partner identity in the UK
  - Requiring audit firm rotations
  - Restrictions on the provisions of NAS
  - Single vs. joint audits
- These differences could be investigated to gain new insights

# Partner Rotations

- Required in the EU since 2006
- Flexibility among member states as to the frequency
  - UK: 5 years
  - Italy: 6 years
  - Allowed: 7 years
- Cross-country differences in cooling-off periods
- Under new ISA 700 (effective 12/2016) the name of engagement partner should be disclosed
  - This has been the case in Italy for many years
  - In the UK this has been required for reports of periods ending from April 2009



# Mandatory Audit Firm Rotations

The new EU legislation introduces additional requirements for EU public interest entities (PIEs<sup>1</sup>), including mandatory firm rotation (MFR). The key MFR provisions are as follows.

<b>Baseline measure<sup>2</sup></b>	<b>10-year mandatory audit firm rotation for all PIEs in the EU</b>
<b>Member State options available to:<sup>3</sup></b>	Extend the period once for up to a maximum further <b>10 years</b> where a public tendering process is conducted – to a <b>maximum term of 20 years</b> .
	Extend the period once for up to a maximum further <b>14 years</b> where there is a joint audit arrangement – to a <b>maximum term of 24 years</b> .
	Implement a <b>shorter rotation period</b> .  For example, Italy will be able to retain their existing rotation requirement of nine years.

Source: KPMG

# Mandatory Audit Firm Rotations

## First-time adoption:

- If firm tenure > 20 years on 16/6/16 it must be rotated by 17 June 2020
- If firm tenure > 11 but less than 20 years on 16/6/16, it must be rotated by 17/6/2023
- If firm tenure > 2 but less than 11 years on 16/6/16, it must be rotated by
  - 17/6/2016 if engagement started before 17/6/2006
  - 10 years after beginning of engagement if this is after 16/7/2006

# Restrictions on NAS

- Under new regulation there will be a cap on NAS fees = 70% of audit fees (based on a three-year average)
- Many services will be prohibited (from 2016)
- Current practice varies across countries
  - For example, in the UK Ethical Standards have strongly discouraged NAS

# New Auditor's Report

- Following changes in the UK, and International Standards of Auditing, and the 2014 EU Regulation, the form and content of the auditor's report is changing in the EU
  - In particular, ISA 700 & 701
  - But many standards have been recently revised – requires careful analysis
  - The EU broadly adopted the ISAs, but member states can make their own modifications (will discuss the case in the UK)
- One innovation concerns the identification and communications of Key Audit Matters (KAMs):

“Key audit matters—Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.” (ISA 701)

# New Auditor's Report

- Guidance as to how KAMs should be identified and *communicated* in the new report
- EU regulation now requires the statutory auditor to declare that the prohibited non-audit services were not provided and that they remained independent of the audited entity in conducting the audit; and
- Indicate any services, in addition to the statutory audit, which were provided by the statutory auditor or the audit firm to the audited entity and its controlled undertaking(s), and which have not been disclosed in the management report or financial statements

# New Auditor's Report

The UK has gone further with the new auditor's report already in 2013

- Greater detail is required to be provided about KAMs including a summary of the auditor's response to those risks; and where relevant, key observations arising with respect to those risks.
- An explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole.
- Quite long: See separate Auditor Report for Vodafone 2015

# Limitations and Caps to Auditor Civil Liability

## The UK:

- Joint and several liability whereby the deep-pocket auditor may pay for other parties' fault
- Change in the law: “Since 2008 auditors have been permitted, under the terms of the Companies Act, to use Liability Limitation Agreements (LLAs) to reduce the threat of litigation from clients. LLAs are clauses built into the terms of an engagement that impose a cap on the amount of compensation that can be sought from the auditor. These must be approved by shareholders annually and be upheld by judges as ‘fair and reasonable’ when cases arise.” (Source: [www.accaglobal.com](http://www.accaglobal.com))

# Limitations and Caps to Auditor Civil Liability

The EU (see also

[http://ec.europa.eu/finance/auditing/liability/index\\_en.htm](http://ec.europa.eu/finance/auditing/liability/index_en.htm)):

- “In June 2008, the European Commission recommended that member states find a way to limit auditor liability to try and encourage competition in the audit of listed companies and to protect EU capital markets .”  
(Source: [www.accaglobal.com](http://www.accaglobal.com))
- “Since unlimited joint and several liability may deter audit firms and networks from entering the international audit market for listed companies in the Community, there is little prospect of new audit networks emerging which are in a position to conduct statutory audits of such companies”.  
(Commission Recommendation, (2008/473/EC))



# Limitations and Caps to Auditor Civil Liability

- Practice varies across member states: UK has adopted limitations. In Germany there is a statutory caps of a fixed monetary amount. In France, this is disallowed. (Source: ICAEW)
- Australia in 2004 introduced proportionate liability for all claims for economic loss. New South Wales has introduced a scheme for auditors that caps their liability at 10 times the audit fee for substantial audits, subject to a maximum of A\$20m. (Source: ICAEW)



# European-specific Studies

- Next I briefly discuss three different studies from France, Sweden and Italy
  - Each takes advantage of a unique setting
- 
- André et al. (2016, EAR) explore if the French requirement for joint auditors is more costly than one auditor; they further explore if joint audits deliver better reporting quality.
  - To do so they need observations from other countries where there is a single auditor. These are UK and Italy.
  - Sample period is 2007-2011 with 210 French companies, 279 UK companies and 142 Italian companies

# André et al. (2016, EAR)

**Table 3.** Natural logarithm of audit fees regressed on auditor, client, and engagement attributes (full sample)

Panel A. Regressions<sup>a</sup>

Variables	Expected sign	Model 1	Model 2
Constant		-1.942*** (-5.894)	-1.857*** (-5.461)
UK	?	-0.299*** (-4.800)	
IT	?	-0.478*** (-7.400)	
ATLEASTABIG4	+	0.393*** (5.589)	
ONEBIG4FR	+		0.327*** (2.941)
TWOBIG4FR	+		0.483*** (4.089)
NONBIG4UK	?		-0.430** (-2.522)
BIG4UK	?		0.090 (0.776)
NONBIG4IT	?		-0.423*** (-3.168)
BIG4IT	?		-0.110 (-0.914)

Two Big auditors are more expensive than one. Possible explanations:

1. Collectively they exert more effort
2. There is co-ordination cost
3. Better opportunity to extract rent

# André et al. (2016, EAR)

**Table 6.** Abnormal accruals regressed on auditor, client, and engagement attributes (full sample)

Panel A: Regressions<sup>a</sup>

Variables	Abs AWCACC		ABNACC	
	(1)	(2)	(3)	(4)
Constant	0.374*** (4.150)	0.339*** (4.380)	-0.023 (-0.740)	-0.024 (-0.790)
UK ?	-0.021 (-0.940)		0.002 (0.430)	
IT ?	-0.025 (-0.900)		0.005 (0.810)	
ATLEASTABIG4 ?	0.003 (0.110)		-0.006 (-0.760)	
ONEBIG4FR ?		0.037 (1.441)		-0.001 (-0.135)
TWOBIG4FR ?		0.019 (1.266)		-0.006 (-0.765)
NONBIG4UK ?		0.019 (0.329)		0.018* (1.688)
BIG4UK ?		0.006 (0.482)		-0.003 (-0.382)
NONBIG4IT ?		0.034 (0.786)		-0.006 (-0.241)
BIG4IT ?		-0.001 (-0.085)		0.002 (0.311)

No evidence that, if both auditors exert more effort than a single auditor, audit quality improves. On the other hand, no evidence of economic bonding either. May reflect an inefficient system (or protecting labor).

# Zerni et al. (2012, EAR)

- While in France joint audits are prescribed by law, in Sweden client firms can voluntarily elect to employ joint auditors
- It stands to reason that if client firms choose to do so, this must be beneficial in some way; perhaps:
  - Negotiate lower fees than under a mandatory regime (not tested)
  - Signalling value – committing to higher audit quality (impossible to use this signal when joint audits are required)
    - The cost of the signal may be financial (more fees) but also greater scrutiny and less reporting flexibility
    - So this setting may speak as to the value of auditing

## Zerni et al. (2012, EAR)

- Zerni et al. (2012) use propensity score matching to control for lack of sample randomness and endogeneity problems
  - For example, firms that want to borrow may select joint auditors, which then can explain why joint audits are associated with lower borrowing costs
- They find evidence in support of signaling
  - Joint audits are more expensive
  - Joint audits are associated with more conservative accounting
  - Joint audits are associated with higher credit ratings
- Yet, it is not clear that these benefits would extend to mandatory joint audits

# Cameran et al. (2015, AJPT)

- Analyse the Italian setting where audit firm rotations were required since 1975
- Using proprietary data (2006-09, 667 obs.) they examine the behaviour of audit fees, audit hours and abnormal working capital accruals around mandatory and voluntary firm rotations
- Firm rotations involve loss of client-specific knowledge, so the incoming auditor may need to exert more effort, and at the same time, may be more prone to mistakes and client manipulations
- To get the engagement, the incoming auditor may low-ball the fees

# Cameran et al. (2015, AJPT)

**Mandatory Rotation on Audit Fees, Engagement Hours, and Abnormal Working Capital Accruals (AWCA)**

<u>Dependent Variables</u>	<u>Exp. Sign</u>	<u>(1)</u> <i>LN_AF</i>	<u>(2)</u> <i>LN_AF</i>	<u>(3)</u> <i>LN_H</i>	<u>Exp. Sign</u>	<u>(4)</u> <i>AWCA</i>
Intercept	?	3.870*** (0.000)	3.379*** (0.001)	1.213 (0.513)	?	-0.826 (0.274)
<i>MANROT</i>	?		-0.179*** (0.000)	0.158** (0.014)	?	-0.002 (0.923)
<i>VOLROT</i>	?		0.026 (0.726)	0.081 (0.506)	?	0.015 (0.622)
<i>PRE_MANROT</i>	?		0.071** (0.011)	-0.011 (0.796)	?	-0.007 (0.626)
<i>PRE_VOLROT</i>	?		0.021 (0.518)	0.166 (0.357)	?	-0.032* (0.051)
<i>LN_H</i>	+	0.736***	0.754***			

Low-balling

More hours worked (but without pay)

No EM

Recouping of fees in later years

(the authors provide more evidence on this in the paper)



# Suggestions for Future Research

- Identify a unique or unusual feature in the audit market in your home country (or elsewhere)
- Discuss with auditors and regulators
  - What is the reason for this feature?
  - How well does it function?
- Form a research agenda
  - Think of the research question
  - Assess if you can shed light on an unresolved issue

# Suggestions for Future Research

- Search for unique data
  - Example: Amir et al. (2014) got access to auditors' criminal records in Sweden
- Follow changes in regulations
  - EU regulation
  - Auditing standards
  - Country-specific
- The audit profession will be changing radically and sooner than we may think
  - Big data analytics
  - Cross-country variations in adoption
  - Employment and education effects
  - Demise of the Big players?

# Specific Examples for Future Research

- Transition rules for mandatory firm rotations imply that these rotations would take place after a range of tenure years
  - Provides an opportunity to assess the efficacy of the rotation rules (is 10 years better than 15?)
- Different partner rotation rules (i.e., differences in max tenure) may be exploited
- Partner names will be disclosed more widely - will allow large datasets exploration of individual (personal) attributes and their effect on audit quality

# Summary

- The audit research is vast, but still growing
- I believe there are many research opportunities
  - Israeli context
- I hope you have found interesting
- Looking forward to discussing research ideas

# References

- Amir, E., Kallunki, J.P. and Nilsson, H., 2014. The association between individual audit partners' risk preferences and the composition of their client portfolios. *Review of Accounting Studies*, 19 (1): 103-133.
- André, P., Broye, G., Pong, C., & Schatt, A. 2016. Are joint audits associated with higher audit fees? *European Accounting Review*, 25 (2): 245-274
- Ashbaugh, H., LaFond, R., and Mayhew, B.W. 2003. Do non-audit services compromise auditor independence? Further evidence. *The Accounting Review* 78 (3): 611–639.
- Blay, A. D., & Geiger, M. A. 2013. Auditor Fees and Auditor Independence: Evidence from Going Concern Reporting Decisions. *Contemporary Accounting Research*, 30 (2): 579-606.
- Cameran, M., Francis, J.R., Marra, A., & Pettinicchio, A. 2015. Are there adverse consequences of mandatory auditor rotation? Evidence from the Italian experience. *Auditing: A Journal of Practice & Theory* 34(1), 1-24.

# References

Carcello J. V., and Li. C. 2013. Costs and Benefits of Requiring an Engagement Partner Signature: Recent Experience in the United Kingdom. *The Accounting Review* 88 (5): 1511-1546.

Causholli, M., Chambers, D.J., and Payne, J.L.. 2014. Future nonaudit service fees and audit quality. *Contemporary Accounting Research*, 31 (3): 681-712

Chen, C. Y., C. J. Lin, and Y. C. Lin. 2008. Audit partner tenure, audit firm tenure and discretionary accruals: does long auditor tenure impair earnings quality? *Contemporary Accounting Research* 25 (2): 415-445

Chi W., H. Huang. 2005. Discretionary accruals, audit-firm tenure and audit-partner tenure: Empirical evidence from Taiwan. *Journal of Contemporary Accounting & Economics* 1 (1): 65-92.

Craswell, A., Stokes, D.J., and Laughton, J. 2002. Auditor independence and fee dependence. *Journal of Accounting and Economics* 33 (2): 253–75.

# References

DeFond, M., Raghunandan, K., and Subramanyam, K.R. 2002. Do non-audit service fees impair auditor independence? Evidence from going concern audit opinions. *Journal of Accounting Research* 40: 1247–1274.

Frankel., R., Johnson, M., and Nelson, K. 2002. The relation between auditors' fees for non-audit services and earnings management. *The Accounting Review* 77 (Supplement): 71–105.

Geiger, M.A., and K. Raghunandan. 2002. Auditor tenure and auditor reporting failure. *Auditing. A Journal of Practice and Theory* 21 (1): 12-67.

Johnson, E., I. Johnson, I.K. Khurana, and J.K. Reynolds. 2002. Audit firm tenure and the quality of financial reports. *Contemporary Accounting Research* 19: 637-660.

Myers, J., L.A. Myers, and T.C Omer. 2003. Exploring the term of the auditor-client relationship and the quality of earnings: A case for mandatory auditor rotation? *The Accounting Review* 78: 779-800.

Zerni, M., Haapamäki, E., Järvinen, T. and Niemi, L. (2012). Do joint audits improve audit quality? Evidence from voluntary joint audits. *European Accounting Review*, 21(4), 1- 35.