

Does the Identity of Engagement Partners Matter? An Analysis of Audit Partner Reporting Decisions



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Research Questions

- Are there systematic differences in the reporting decisions of audit partners across clients and over time?
 - Do audit partners systematically reveal an aggressive or conservative reporting style?
- If there are differences in audit partner reporting styles, do they have economic consequences to the client?
 - Does the market recognize and price differences in engagement partner reporting styles?



Main Findings

- Evidence from audit reports (Type 1 & 2 errors) and earnings properties (predictability of cash flows and abnormal accruals) support the conclusion that aggressive or conservative reporting is a systematic partner attribute.
 - Results hold both for private and publicly listed companies
- The market imposes a cost on client firms audited by audit partners who exhibit aggressive reporting.
 - Higher interest rates, worse credit ratings and less favorable insolvency forecasts (private).
 - Lower Tobin's Q (public).



Hypothesis 1

- Auditors differ in terms of expertise, incentives and risk preferences → **who** does an audit may matter [Nelson and Tan 2005; Nelson 2009]
 - Partner and team attributes may be more indicative of audit quality than office or firm attributes [Kilgore et al 2012]
 - Are these attributes stable over time?
- Many regulators require disclosure of the lead or signing audit partner (Mandated in the EU, Australia).
 - *PCAOB Release No.2011-007: "... it is the engagement partner who is at the center of the effort. He or she is responsible for the engagement and its performance."*

Hypothesis 1 (continued)

- Disclosure of lead or signing partner may increase accountability [ACAP 2008]
- However, firms have many control measures to support consistent audit quality, e.g., internal inspections, second partner review, technical support.
- Little is known if audit quality varies systematically across audit partners (in contrast to offices or teams).
 - Disclosure may only be relevant if there are observable quality differences across partners.
 - Some archival evidence that audit quality is directly influenced by the audit partner [Carey and Simnett 2006, Chen et al 2008, Chi et al 2009, Zerni 2012, Gul et al 2013]

Hypothesis 1 (continued)

- ***Hypothesis 1: Aggressive or conservative audit reporting is systematically influenced by individual engagement partners across clients and over time.***
- Variables of interest:
 - History and pattern of Type I and Type II errors for first time going concern opinions.
 - Properties of client earnings, i.e., accrual persistence.
 - Past abnormal accruals



Hypothesis 2

- Reliable financial information is associated with lower financing costs.
- Individual audit partners perceived as aggressive or conservative in their reporting decisions could influence investor perceptions of financial statement reliability.
- The valuation of a client depends on the audit report for that client as well as the audit reports of other clients of the same auditor, i.e., auditor performance on one client can influence the information risk of other clients with the same partner [Beyer and Sridhar 2006]



Hypothesis 2 (continued)

- ***Hypothesis 2: Observable audit partner reporting decisions are associated with the market-perceived credit risk and cost of debt of a client.***
- Test variables
 - Credit rating
 - Independent forecasts of default
 - Client borrowing costs [Pittman and Fortin 2004; Mansi et al 2004]
 - Tobin's Q (public companies)



Data

- Why Sweden?
 - Longstanding partner signing requirement.
 - Most businesses file audited financial reports.
- *All* clients of individual Big 4 auditors' who act as an auditor-in-charge or as a deputy auditor for at least one public client between fiscal years 2001-2008.
- Exclude non-B4 firms, joint audits and financial firms.
- Auditor appears in the sample for a minimum of 4 consecutive years
- Data includes office location, dates of certification.
- First two years are used to calculate prior error frequencies, tests based on subsequent years.
- Different samples for different analyses.



Tests of Hypothesis 1

- *Relative* incidence of audit reporting errors as proxied by issuing (or not) a going concern opinion (GCO).
 - *PRIOR_FAIL1*: Type I Error (conservative reporting), i.e., issuing a GCO when client survives.
 - *PRIOR_FAIL2*: Type II Error (aggressive reporting), i.e., issuing a non-GCO when client fails in the subsequent year.
- Probability of reporting failure = $f(PRIOR_FAIL1, PRIOR_FAIL2, \text{control variables, auditor specific variables, fixed effects})$.

Tests of Hypothesis 1 (continued)

- Predictability of operating cash flows conditional on prior reporting errors:
 - $OCF(t+1) = f(ACCR(t), OCF(t), PRIOR_FAIL1, PRIOR_FAIL2, \text{interaction terms, control variables, fixed effects})$.
- OCF = difference between accrual-based income before extraordinary items and accounting accruals.
- ACCR = change in noncash current assets minus change in current noninterest-bearing liabilities minus depreciation and amortization.
- Secondary analysis:
 - $PRIOR_NEGDACC \rightarrow PRIOR_FAIL1$
 - $PRIOR_POSDACC \rightarrow PRIOR_FAIL2$

Tests of Hypothesis 2

- Credit Risk = $f(PRIOR_FAIL1, PRIOR_FAIL2, \text{control variables, auditor-specific variables, fixed effects})$

Where Credit Risk is:

- CRATE (1=high risk, 5=low risk)
- RISK (0.01-99.99, higher values indicate more risk)
- DEBTRATE (interest expense/average debt)
- Tobin's Q (for public companies)



Descriptive Statistics

- Chance of Type I error = 4.2%
- Probability of having a *prior* Type 1 error = 4.1%.
- The 25th percentile for Type 1 error is zero, suggesting some clustering across partners.
- Chance of Type II error = 76.8%
- Probability of having a *prior* Type 2 error = 66.9%.
- Correlation with accruals:
 - *PRIOR_FAIL1* and *PRIOR_NEGDACC* = 0.474
 - *PRIOR_FAIL2* and *PRIOR_POSDACC* = 0.328
- Both Type 1 and Type 2 errors are correlated with measures of economic effects.

Results: GCO reporting (Tables 4/5)

Variable	All non-bankrupt (n=22971)	Not bankrupt low risk (n=20127) ^A	Not bankrupt high risk (n=2844) ^B	Bankrupt (n=922)
PRIOR_FAIL1	5.156 ***	2.623 **	7.32 ***	-6.693 ***
PRIOR_FAIL2	-0.096	-13.714 ***	-0.902	3.8860**
FAIL1_FIRM	ns	ns	ns	ns
FAIL2_FIRM	ns	ns	ns	ns
PRIOR_NEGDACC	12.790 ***	7.320 ***	15.150 ***	-10.001 ***
PRIOR_POSDACC	-0.169	-14.886 ***	-1.398	9.124 ***
TENURE	-	ns	-	-
OFFSIZE	+	ns	+	ns

A: insolvency risk < 3.05%

B: insolvency risk > 3.05%

→ Reasonably strong support for H1

Results: Earnings Properties (Table 5)

Interaction term with →	ACCR	OCF
PRIOR_FAIL1	-1.001 **	-0.895 **
PRIOR_FAIL2	-0.536 **	-0.642 ***
PRIOR_NEGDACC	ns	-1.792 ***
PRIOR_POSDACC	-2.744 ***	ns

→ Additional, slightly weaker, support for H1.

Results: Economic Effects (Tables 7/8)

Variable	CRATE (n=18613)	RISK (n=18163)	DEBTRATE (n=12806)	RISK (n=18613)
PRIOR_FAIL1	ns	ns	ns	ns
GCO x FAIL1				-8.496 *
PRIOR_FAIL2	-1.796 ***	3.042 ***	0.0057 ***	2.924 ***
GCO x FAIL2				14.108 **
PRIOR_NEGDACC	ns	ns	ns	ns
GCO x NEGDACC				21.521 **
PRIOR_POSDACC	-3.830 ***	7.249 ***	0.018 ***	7.794 ***
GCO x POSDACC				-14.186 *
TENURE	+	-	ns	-

→ Reasonable support for H2.



Results for Public Companies

- Too few GCOs to allow for direct test of likelihood of issuing GCO report.
- Predictability of OCF: $ACCR \times PRIOR_FAIL1$ not significant. All other interactions are negative.
- Test using discretionary accruals:
 - $PRIOR_FAIL1/PRIOR_NEGDACC$ negatively associated with total, income \uparrow and income \downarrow accruals.
 - $PRIOR_FAIL2/PRIOR_POSDACC$ positively associated with total, income \uparrow and income \downarrow accruals.
- Economic effect (Tobins Q): Only $PRIOR_FAIL2$ has an effect (-0.3685 ***).



Additional Tests and Limitations

- Results hold when performing some additional tests including:
 - further control for endogeneity
 - adding office-level dummies
- Limitations:
 - **Endogeneity**
 - Big 4 audit partners only
 - Small sample of bankrupt clients
 - Cannot test effect of mandated disclosure of partner identity [Carcello and Li 2013]



Conclusions

- We observe systematic (rather than randomly distributed) differences across audit partners in terms of aggressive or conservative reporting styles.
- We observe strong economic effects of audit partner reporting style with the market penalizing clients of partners who report aggressively.
- These results are in addition to any firm or office effects that may influence audit quality.
- Consequently, audit partner identity can be economically useful information to the readers of financial statements in the current and future periods.

Thank you!

