A rubric for assessing managerial influence on audit independence and audit quality

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ABSTRACT

The purpose of this paper is to explore five aspects of the client-firm relationship that influence an audit engagement and impact auditor independence and audit quality.

We explore five aspects of managerial influence to identify the likelihood of auditor independence violations and audit failure. The five aspects are power, ethics, complexity, aggressiveness, and business risk. Utilizing the five aspects, we develop a rubric for gauging the strength of each element in predicting the likelihood of violations and audit failure. The rubric provides a means for objectively identifying high-risk client-firm relationships that may benefit from PCAOB inspections with an eye toward strengthening independence and audit quality, and reducing agency costs to market participants.

The rubric will only be useful to entities with inside information: public accounting firms for documenting auditor independence risk and audit failure risk within an engagement, and to the PCAOB for targeting firm inspections. The rubric developed in this paper is meant to provide firms with a model for furthering discussions on how to assess, monitor and evaluate aspects of auditor independence and audit quality.

This paper adds to the body of knowledge that explores aspects of auditor independence and audit failure from a practical point of view. Practitioners and the PCAOB will find the paper useful for improving cost and process efficiencies.

Keywords: Audit quality, auditor independence, PCAOB, Sarbanes Oxley Act, Audit engagement planning

INTRODUCTION

The Big 4 accounting firms appear serious about improving auditor independence and audit quality. In fact, their very survival might depend on it. Big 4 audit quality publications stress the nature of their importance and their incorporation into the firm's daily practice. These steps are necessary to strengthen and maintain the existing structure used for third party attestation services. Although measures taken inside the firm to address independence and audit quality are important, other measures that capture intricate aspects of the client-firm relationship are missing. This paper examines the client-firm relationship and anticipated agency costs that arise from managerial influence and accounting discretion on auditor independence and audit quality.

The paper explores five aspects of managerial influence to identify the likelihood of auditor independence violations and audit failure. The five aspects are power, ethics, complexity, aggressiveness, and business risk. Utilizing the five aspects, a rubric is developed for gauging the strength of each element in predicting the likelihood of violations and audit failure. Public accounting firms will find the rubric useful for documenting efforts to assess the risk of independence violations and the potential for audit failure. The PCAOB will find the rubric useful for targeting firm inspections.

Over 2,000 public accounting firms (US and non-US) are registered with the PCAOB.[1] The PCAOB conducts regular, periodic inspections of hundreds of accounting firms each year. Targeting inspections of high-risk firms requires the use of meaningful filters. The rubric provides a means for identifying high-risk client-firm relationships that may benefit from PCAOB inspections for strengthening independence and audit quality and reducing agency costs to market participants. With the passage of the Sarbanes Oxley Act of 2002, the PCAOB is responsible for auditing the auditors. They have identified areas in need of improvement and at the top of the list is auditor independence. In response, accounting firms may find the need to explicitly demonstrate they have assessed and addressed auditor independence and audit failure deficiencies. Imbedding measures of assessment is critical for addressing issues of independence and audit deficiencies.

The global marketplace depends on public accountants to provide high-quality assurances, reducing agency costs associated with audit failures. High quality financial reporting is paramount to the evaluation and pricing of complex financial securities that form the bedrock of the capital markets.

The balance of the paper is organized as follows: 1) a review of the audit independence and audit quality literature, 2) a review of the five aspects of managerial influence, 3) the development and use of the rubric, and 4) summary and future research.

AUDIT INDEPENDENCE AND AUDIT QUALITY LITERATURE REVIEW

Auditors provide valuable services to the capital markets. Their primary role is to audit company financial information and internal controls to obtain reasonable assurance that the financial statements are free of material misstatements and conform to US GAAP. Third-party attestation of the financial statements gives investors greater assurance of the credibility of the financial statements. This assurance reduces the cost of capital (Mansi et al., 2004).

A successful (high quality) audit attests to two aspects of the financial reporting process: 1) the audit provides reasonable assurance that there are no material misstatements that cause the financial statements to be grossly misleading to those who depend on them, and 2) the audit provides reasonable assurance that management has designed aspects of internal control that are sufficient to mitigate risk of a material misstatement.[2] FASB No. 2014-15, (*Presentation of Financial Statements – Going Concern* (Subtopic 205-40): *Disclosures of Uncertainties About an Entity's Ability to Continue as a Going Concern)* codified management's going-concern responsibilities into GAAP. This guidance requires the inclusion of audit assurance that management has evaluated whether there is substantial doubt about an entity's ability to continue as a going concern and whether they have provided the related disclosures. Management must provide forwarding looking information that encompasses the upcoming twelve-month cycle with respect to issues of going concern. A high-quality audit, therefore, is an audit that provides valid and reliable information to the public for the upcoming twelve-month period following the date of the financial statement presentation.[3]

Audit quality is affected by auditor independence and auditor competence. Auditor independence relates to the ability of the auditor to carry out an audit in an objective manner and to provide certain assurances to external parties and other stakeholders including shareholders, employees, creditors, and customers. Auditor competence refers to the technical ability of the auditor to adequately plan and carry out an audit for the same purpose.

The Sarbanes Oxley Act of 2002 (SOX) provides safeguards to strengthen auditor independence and auditor competence. SOX Section 301 redirects the hiring, firing and compensation of the external auditor to the board of directors, audit committee; previously the responsibility of the management team. SOX prohibits auditing firms from providing services such as bookkeeping, information system design, human resource functions, legal services, appraisal or valuation services, and internal audit functions for audit clients. Auditors can, however, provide certain tax services to audit clients (Barrett, 2003). SOX establishes the PCAOB. The PCAOB audits the auditors and examines aspects of the firm that impact auditor independence as well as auditor competence. The PCAOB makes recommendations to address direct violations, weaknesses and auditor deficiencies. Audit firms are expected to respond and address PCAOB assessments and provide evidence that measures are taken to strengthen firm independence and quality. Because of PCAOB scrutiny, the Big 4 accounting firms are actively monitoring their own performance and increasing their focus on strengthening independence and audit quality. Audit quality reports are available on Big 4 web sites and detail many of the aspects these firms deem necessary for moving forward. [4]

Since the passage of the Sarbanes Oxley Act of 2002 (SOX) many improvements have been made to improve audit quality, but many challenges still exist. In an (12/15) address to the AICPA[5], Helen Munter, Director of the PCAOB Division of Registration and Inspections, identifies those improvements and challenges. Improvements include: 1) advances in the tone-at-the-top of the firm, 2) training for auditors on complex audit topics, 3) new practice aids and checklists, 4) coaching and support to auditor teams, and 5) monitoring the quality of work performed. Challenges include: 1) recurring audit deficiencies, 2) ineffective remedial actions to address deficiencies, 3) root cause analysis of past audit failures, 4) inconsistent execution of audit methodology, and 5) monitoring of independence. Munter (2015) states that auditor independence is the most acute problem. Examples of recent violations include the audit firm: 1) buying consulting practices, 2) performing impermissible non-audit services, 3) violating five-year rotation requirements (audit engagement manager), and 4) entering questionable financial relationships that compromise personal independence.

Establishment of the PCAOB is one of several aspects of SOX that has strengthened financial reporting and financial disclosures by publicly-held firms. Other measures, like firm rotation, are used in the European Union and the United States. Chasan (2014) suggest that mandatory auditor rotation will enhance audit quality and improve independence. Hamilton et al., (2005) and Mostafa (2010) find mandatory rotation at the firm level improves independence and earnings quality at the same time. Several studies, however, find that auditor rotation does not enhance audit quality but rather, long-term auditor tenure improves audit quality (Cameran et al., 2015; Lennox, 2013; Jackson et al., 2007; Johnson et al., 2002; Myers et al., 2003). Lennox (2013) argues that policy-makers should limit the ability of management to switch auditors.

A fundamental conflict becomes evident in the literature stream: firm level expertise is necessary to effectively perform an audit, but on the other hand, long-term tenure reduces independence and increases the probability of audit failure.

Although these studies are useful in assessing future initiatives, they fail to address the underlying problem that undermines auditor independence. Audit financial arrangements that benefit the firm and its partners, create a conflict of interest which increases the potential for independence violations. Assigning the PCAOB the responsibility of inspecting and assessing auditor independence is an important first step, but more work is necessary. We believe an assessment of managerial influence and accounting discretions would add to the understanding of the dynamics that impact audit quality and guide further regulatory action.

MEASURES OF MANAGERIAL INFLUENCE

Five measures are defined for identifying managerial influence over auditor independence and audit quality: 1) power surrounding the contractual agreements between the client and the firm (Barrett, 2003), 2) ethical values and organizational culture of the client, 3) the use of complex financial arrangements/transactions, 4) accounting aggressiveness, and 5) the business risk of the client's operating environment.

Power

Power is an important force in the client-firm relationship. Client's, able to assert power over a firm, may exert significant influence over the scope of the audit and resulting audit quality. Large clients, who constitute a significant portion of the firm's revenue base, may find they are able to assert power and shape/influence aspects of the scope of the engagement. Barrett (2003) finds that If a client's fees constitute a substantial proportion of the firm's revenues, unconscious bias enters the relationship and influences the auditor's judgment. In response to concerns over auditor independence and influence, the Sarbanes Oxley Act of 2002 required accounting firms to divest consulting operations from their auditing businesses; however, the taxation services remained. Even so, with or without the inclusion of taxation services, independence may be impaired and undue influence over auditor's independence may exist. Removing the consulting services may have reduced the magnitude of the dynamic, but the dynamic persists and has the potential to create a conflict of interest between the client and the firm. This conflict of interest increases the probability of an audit failure when the balance of power resides with the client. Methods for quantifying the power variable include: 1) significant portion of firm's revenue, 2) the existence of non-audit related services including tax preparation and advisement, and 3) length of client-firm relationship.

Client Ethical Values and Organizational Culture

Organizational intangibles, such as ethical standards, management style (tone-at-the-top), integrity, reputation, and organizational culture contribute to the internal control environment, and are as important as traditional internal control measures[6]. Highly ethical firms reduce the probability of independence violations and audit failure. (Kerns, 2003). Strong business ethics, cooperative management style and integrity lead to higher quality decision-making, creating value for all stakeholders. An organization has several reasons to operate in an ethical manner, including satisfied employees, higher productivity, stronger reputation, avoidance of fines and litigation, competitive strategic advantage, ability to attract talent and protect shareholder wealth. Ethical decision-making may consider short-term impacts, but places a greater value on long-term consequences. Highly ethical businesses are unlikely to use their power in the audit engagement to commit fraud or engage in aggressive accounting treatment. They avoid developing close ties and relationships with auditors to maintain a culture of independence and integrity. Even in audit engagements where the client has substantial power over the firm, they are unlikely to use it to if they value and exhibit strong ethical behaviors.

Unethical behavior includes failing to disclose material information that impacts the auditor's findings, providing fraudulent information that falsifies documents or engages in fraudulent behavior to manipulate the results. Less obvious unethical behaviors include the use of managerial dominance (form of bullying) for influencing accounting matters.

Methods for quantifying this variable include: 1) evidence of fines, fees, investigations (including whistleblower investigations), violations and litigation, 2) high levels of employee turnover, 3) past or present evidence that management has failed to disclose or falsified documents related to the audit, 4) weak integration of internal controls (or lack of internal control resources) throughout organization, 5) switching auditors, and 6) management fails to address concerns expressed by past audit teams.

Complexity

The third aspect relates to accounting complexity. Even in situations where the client has strong ethical values, firm complexity increases the risk of audit failure (Churyk and Stenka, 2014).

Many organizations have complex financial and operational relationships. Both managers and auditors are required to accurately analyze complex situations and apply the appropriate accounting principles. This analysis requires strong technical knowledge, critical thinking ability, and clear communication skills. Auditors and managers require the expertise to accurately assess and evaluate transactions, valuations, and estimates for proper accounting treatment. Knowledge of advanced accounting issues such as fair value accounting, asset securitization, consolidating special purpose entities, foreign currency translation, accounting for derivatives and hedging transactions, leases, revenue recognition, pension accounting, equity compensation arrangements, and other topics are necessary to effectively manage the engagement. Understanding the level of complexity in the engagement can also assist in assigning appropriate personnel to an audit engagement for reducing the risk of audit deficiencies.

Quantifying complexity requires an analysis of the types of GAAP principles used by the client and the nature of the business and industry. Evidence of frequent restatements may also indicate issues of complexity. Existence of unprecedented accounting dilemmas arising from unique or evolving industry transactions are additional areas of concern.

Aggressiveness

Conservatism should be paramount to the auditor's application of various choices in applying GAAP (Weaver, 2012). Aggressive accounting practices involve the use of optimistic projections when applying accounting standards to create financial statements that present a more favorable picture of the company. Examples of aggressive accounting practices include 1) underestimating asset reserves (inventory and receivables) 2) capitalizing expenditures (recording an expense as an asset), 3) over allocating overhead to inventory to reduce cost of goods sold or lowering capitalization limits on fixed assets to reduce expenses, 4) revenue recognition that occurs before all necessary obligations are met. Management may engage in aggressive accounting practices for several reasons including 1) bonuses tied to profitability results, 2) loan covenants that require maintenance of certain ratio results, and 3) compensation packages tied to stock prices.[7]

Evidence of accounting aggressive exists when client estimates reflect optimistic projections of income and assets. Motivation for using aggressive accounting practices relates to the use of incentive pay (managerial bonuses, restricted stock, and stock options) and the magnitude of incentive pay as a portion of total pay. A clear and unbiased assessment of transactions that require to use of accounting judgments that impact income and assets is necessary to uncover aggressive accounting practices.

Business Risk

Business risk includes any operational and financial factor that may contribute to an organization's failure. Business risk should capture the likelihood of experiencing a going concern issue in the upcoming operating cycle or one year whichever is shorter. The auditor must ensure that significant depth and breadth is exercised in interpreting performance and financial position, including the use of external credit ratings for assessing the magnitude of business risk and going concern issues. Table 1 provides a list of the potential risk factors and types of data that are indicative of high business risk[8]. Measures for assessing business risk include industry saturation, stock performance, breach of debt covenants, rumors or evidence of take-over bids, number of and trends in short positions in client stock, recent news that negatively impacts future client revenue stream or changes in client cost structure.

THE RUBRIC

The full rubric is presented in TABLE 2. Each of the established criteria can be ranked a score of 0, 1, 2 or 3. The highest score in the rubric indicates the greatest level of risk and the lowest score in the rubric indicates the least level of risk. For levels 1 through 3 (not 0), the rubric accumulates and each level includes examples of the preceding level(s) to rate that score.

The Criteria

Within the power criteria, a level 0 score indicates that client fees are 5% (or less) of total revenues of the firm. A level 1 score indicates that the firm completes engagements for the client beyond the audit engagement (such as tax preparation or advisement). A level 2 score includes evidence of a long-term client engagement (5 years or more) or evidence of coziness between firm and client. A level 3 score includes all qualitative factors in level 1 and 2, and client fees more than 10% of total firm revenues.

Within the ethics and organizational culture criteria, a level 0 score indicates the client has no history of violations or litigation that involve questionable ethical practices. The client may also provide preventive measures such as yearly ethical training to all employees, availability of anonymous communication from employees to internal control department (whistleblower), strong tone-at-the-top, low evidence of employee turnover, positive employer rankings, etc. Level 1 indicates some level of ethical dilemmas within the firm resulting in above average levels of employee turnover or evidence of issues coming from employees through whistleblower venues. Level 2 indicates evidence of any one or more of: 1) a history of recent ethical issues, 2) fines, fees, SEC violations, safety violations, environmental violations, income tax violations, excessive customer complaints, and 3) litigation related to ethical issues. Level 3 indicates evidence of any one or more of: 1) falsified documents, 2) failure to disclose relevant information, and 3) managerial aggressiveness (bullying) or tone-at-the-top issues.

Within the complexity criteria, a level 0 score indicates the client has a small number of complex GAAP applications, a simplified corporate structure with few intercompany transactions. A level 1 score indicates the client has several complex GAAP applications, some use of intercompany transactions, derivatives, foreign currency translation adjustments. A level 2 score indicates the use of multiple complex GAAP applications, may include transfer pricing among operational units, mark-to-market transactions and a high percentage of comprehensive income transactions (in $) relative to total income. A level 3 score is reserved for clients encountering unprecedented accounting issues unique to industry or infrequent in application.

Within the aggressiveness criteria, a level 0 score implies the client applies conservative estimates and the accounting firm confirms evidence of more aggressive estimates. A level 1 score finds evidence of some aggressive practices and some managerial compensation is tied to accounting metrics. A level 2 score finds several examples of aggressive accounting practices and moderate to high levels of compensation tied to accounting metrics. A level 3 score includes level 2 parameters as well as executive compensation tied to stock performance measures.

Within the business risk criteria, a level 0 score indicates stability in stock prices, achievement of EPS targets with little evidence of aggressive accounting practices (a 0 or 1 in aggressiveness criteria) and may be an industry in early life-cycle phase. A level 1 score indicates one or more of the following measures are evident: 1) EPS targets are reached but aggressive practices exist, 2) rumors or credit rating adjustments, and 3) increasing industry maturity and saturation has occurred. A level 2 score indicates one or more or the following measures are evident: 1) increased stock volatility as measured by standard deviation or 2) industry at saturation. And any one or more of the following measures are evident: 1) EPS target has been missed with aggressive accounting tactics, 2) external credit rating downgraded, or 3) debt covenant breached. A level 3 score indicates one or more of the following: 1) rapidly declining stock price, 2) increasing number of short positions, 3) industry in decline or consolidation, and 4) rumors or evidence of take-over bids.

Summary of the Rubric

The five area scores are added together to quantify the level of managerial influence and accounting discretion. The range of values are as follows:

- 0 – 3 total points = low levels of managerial influence and accounting discretions; low risk of independence violations and audit failure
- 4-7 total points = moderately low levels of managerial influence and accounting discretions; moderately low risk of independence violations and audit failure
- 8-11 total points = moderately high levels of managerial influence and accounting discretions; moderately high risk of independence violations and audit failure
- 12 – 15 total points = high levels of managerial influence and accounting discretions; high risk of auditor independence violations and audit failure

SUMMARY AND FUTURE RESEARCH

This paper develops a rubric for assessing managerial influence that may impact auditor independence and audit quality. The rubric contains five criteria that can be used as a tool for assessing the level of risk inherent in a client-firm relationship for assessing the potential for independence violations and audit failure.

With the passage of the Sarbanes Oxley Act of 2002, the PCAOB is responsible for auditing the auditors. They have identified areas in need of improvement and at the top of the list is auditor independence. In response, accounting firms may find the need to explicitly demonstrate they have assessed and addressed auditor independence and audit failure deficiencies. Their survival might even depend on it. Imbedding measures of assessment and addressing potential issues that arise is critical for addressing issues of independence and audit deficiencies. The rubric developed in this paper is meant to provide firms with a model for furthering discussions on how to assess, monitor and evaluate aspects of auditor independence and audit quality. Proactive accounting firms, seek to improve their reputation in the marketplace, and address deficiencies identified by the PCAOB and may find it beneficial to create firm-level measures of internal control related to auditor independence and audit failure.

Accounting firms may determine a need for their own internal audit function, performing functions like the PCAOB, as a first line of defense to address issues important to audit quality. More explicit efforts are needed to strengthen independence and resolve audit deficiencies. The global marketplace depends on public accountants to provide high-quality assurances, reducing agency costs associated with audit failures. High quality financial reporting is paramount to the evaluation and pricing of complex financial securities that form the bedrock of the capital markets.

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APPENDIX

TABLE 1: Risk Factors and Business Risk

Risk factor	Indicators of High Business Risk
Profitability & Operations	Decreasing profitability from declining sales or increasing costs (or both); negative cash flows from operations; shrinking market share; increasing competition; litigations and claims; inadequate quality control; use of aggressive accounting practices to boost profitability; client reputation; history of restatements; volatile pattern in profitability ratios; safety violations; deteriorating facilities; regulatory violations
Working Capital	Slowing cash conversion cycle, slowing turnover ratios, and other liquidity issues, declining customer satisfaction; loss of customers; lagging collections; unresolved billing disputes; significant returns and allowances; high number of warranty claims; late payments to creditors; difficulty in maintaining vendor relationships; obsolescent inventory; significant inventory shrinkage

Financial Position	High debt ratio or debt-equity ratio; use of off-balance sheet financing and special purpose entities to obscure debt; related party transactions that involve use of leverage
Innovation	Failure to develop new product lines in response to changing market dynamics; lack of R&D; failure to upgrade property, plant and equipment; failure to use innovative technology in all aspects of operations including the management of information; failure to use appropriate overhead allocation methods; organizational culture incompatible with change; failure to consider externalities and environmental concerns; lack of social responsibility; lack of strategic direction/vision
Internal Controls	Management fails to respond to concerns expressed by audit team; management fails to provide data in a timely fashion; inadequate resource allocation to internal auditing department; weak integration of internal controls throughout organization
Executive Compensation Packages	Incentives that drive short-term profit making decisions at the expense of long-term success; failure to incorporate non-financial aspects in compensation incentive packages; failure to mitigate potential negative consequences of compensation practices
Human Resources	High employee turnover; incompetent workforce/shallow talent pool; high number of employee complaints;
External Environment	Risk in supply chain; political and economic instability; lack of environmental controls to meet regulations; failure to balance strategic priorities to consider external environment; use of external credit rating agencies or other agencies that provide assurances to auditor

TABLE 2: The Rubric: Managerial Influence As Predictors For Auditor Independence and Audit Quality

Criteria	0	1	2	3
Power	Client fees are 5% or less of total firm revenues	Client fees are more than 5% of total firm revenues; Client engages firm in additional services, such as tax preparation	Long-term client engagement (5 or more years); some evidence of coziness between firm and client	Client fees are more than 10% of total firm revenues
Ethics & Organizational Culture	No history of violations; recipient of awards	Above average levels of employee	One or more of the following: history of recent	One or more of the following: management

	recognizing ethical conduct; whistleblower available within firm (no issues expressed); ethics training for employees; strong tone-at-the-top	turnover; minor whistleblower issues arise; some customer complaints; some fees or fines; some issues with vendors	ethical issues; major fines, fees, SEC and other investigations or IRS violations; excessive employee turnover; excessive customer complaints; vendor complaints; litigation	falsifies documents; fails to disclose relevant information; aggressive managerial leadership and tone-at-the-top
Complexity	Relatively few complex GAAP utilized; corporate structure is simple with few intercompany transactions	Several complex GAAP utilized; some intercompany transactions evident; some use of derivatives; may have foreign currency translation issues; evidence of past restatements	Many complex GAAP utilized; use of transfer pricing between units; multiple mark-to-market transactions; significant portion of comprehensive income transactions; frequent restatements	Unprecedented accounting issues arise during engagement
Aggressiveness	Conservative accounting estimates	Relatively small number of aggressive practices; low to moderate levels of compensation tied to accounting metrics	Significant number of aggressive practices; moderate to high levels of compensation tied to accounting metrics	Executive compensation tied to stock performance
Business Risk	Stable stock price; EPS targets are made with little evidence of aggressive accounting tactics;	One or more of the following: EPS targets are made but evidence of some aggressive practices;	One or more of the following: 1) Increased volatility in stock relative to peers; 2) industry	One or more of the following: 1) Rapidly declining stock price; 2) increasing number of short

	industry may be in its growth phase	rumors of credit rating adjustments; increasing industry saturation	saturation. One or more of the following 1) EPS target has been missed with aggressive accounting practices; 2) credit rating downgraded; 3) covenants breached	positions; 3) industry in decline or consolidation evident; 4) rumors or evidence of take-over bids
Total				

Each level includes examples of the preceding level(s) to rate that score.

- 0 – 3 total points = low levels of managerial influence and accounting discretions; low risk of independence violations and audit failure
- 4-7 total points = moderately low levels of managerial influence and accounting discretions; moderately low risk of independence violations and audit failure
- 8-11 total points = moderately high levels of managerial influence and accounting discretions; moderately high risk of independence violations and audit failure
- 12 – 15 total points = high levels of managerial influence and accounting discretions; high risk of auditor independence violations and audit failure.

Endnotes:

[1] https://pcaobus.org/Inspections/Pages/InspectedFirms.aspx

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