



## An exploratory study of the pressures and ethical dilemmas in the audit conflict



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### ABSTRACT

The present study analyzes the pressures perceived by auditors in their professional activity. Furthermore, it explores the ethical acceptability of questionable practices and the way auditors resolve the conflicts of interest with which they are confronted. This paper also studies the influence of the size of the audit firm and the experience of the auditors on the perception of pressures, their ethical judgment, and the way of resolving conflicts of interest.

Data were collected through a questionnaire administered to auditors from small and medium-sized audit firms in Spain, members of REA (Registro de Economistas Auditores).

This study contributes to the international academic literature on auditing behavior, as it provides new empirical data on the pressures perceived, not only those from the audit client, which have been extensively studied in the academic literature, but in addition, it highlights pressures arising from the audit firm itself that could also have a detrimental effect on the audit quality. It also contributes to the understanding of the effect of these pressures on the behavior of auditors.

The results of this study are also of particular relevance for the legal and professional Spanish auditing regulators as they face, at this moment, the challenge of developing a set of ethical standards that should improve the ethical judgment and behavior of accounting professionals.

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### Un estudio exploratorio de las presiones y dilemas éticos en el conflicto de auditoría

#### RESUMEN

El presente estudio analiza las presiones percibidas por los auditores en el ejercicio de su actividad profesional. Así mismo, explora la aceptabilidad ética de ciertas prácticas cuestionables y la forma en que los auditores resuelven los conflictos de interés a los que se enfrentan. Este trabajo estudia además la influencia del tamaño de la firma de auditoría y de experiencia de los auditores en la percepción de presiones, su juicio ético y la forma de resolver los conflictos de interés.

Para llevar a cabo este objetivo, se ha realizado una encuesta a los miembros del Registro de Economistas Auditores (REA).

Este estudio contribuye a la literatura académica internacional sobre el comportamiento en la auditoría, ya que proporciona nuevos datos empíricos sobre las presiones percibidas, no sólo las provenientes del cliente de auditoría, que han sido ampliamente estudiadas por la literatura, sino que además, pone de relieve las presiones procedentes de la propia firma de auditoría, y su efecto perjudicial para la calidad de la auditoría. Además, avanza en la comprensión del efecto de estas presiones en el comportamiento final de auditor.

Los resultados de este trabajo son de especial relevancia para la regulación legal y profesional de la auditoría en España que se enfrenta al reto de desarrollar unas normas de ética que guíen el comportamiento de los auditores.

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## 1. Introduction

Audit firms are subject to the market rules, and therefore, their profitability depends on the relationship between audit fees and the cost of performing the audit engagement (IAASB, 2014). In pursuit of profitability, audit firms will try to minimize the costs of the services provided. However, in order to fulfill their attest function, auditors must perform high quality audits, which could increase the cost of the audit engagement.

Some authors argue that audit firms' culture has changed in last years, so that, increasingly, they prioritize business goals (Wyatt, 2004), although firms, still, formally display the idea of the public interest in the exercise of their activity (Davenport & Dellaportas, 2009).

The audit market has become increasingly competitive in the last decades and, even more so in the wake of the current economic crisis. This environment has led to more power on the part of audit clients and, therefore, the pressures they put on audit firms have been sharpened. These pressures are evidenced both in the negotiation of the audit engagement fee as well as in clients' power to influence auditors' judgment regarding certain accounting practices (Boyd, 2004).

The decisions of the audit firm on how to manage this conflict between cost and quality (McNair, 1991) or, what some authors have called a conflict between commercial and professional goals (Gendron, Suddaby, & Lam, 2006; Hanlon, 1994; Picard, Durocher, & Gendron, 2014; Sweeney & McGarry, 2011) will affect the audit quality. Audit quality is defined as the market-assessed probability that an auditor will detect errors and irregularities (technical skills) and report them (independence) (DeAngelo, 1981). In this sense, the knowledge and experience of the auditors of the engagement, the time devoted to the engagement and the auditors' ethical values and attitudes would be shown both on the detection of errors and irregularities, and on the disclosure of them, once detected (IAASB, 2014) and, accordingly, will directly affect the audit quality. Therefore, in this context, auditors will suffer pressures from the audit client and from the audit firm as well.

The behavioral accounting literature has expressed concern about how pressures can affect professional accountants' attitudes and performance (DeZoort & Lord, 1997; Lord & DeZoort, 2001), however, it has focused mainly in the pressures from audit clients. There is a need for further research on the pressures from within the audit firm that arise due to the inherent conflict between cost and quality.

The existence of pressures will involve a reduction in the quality of the audit services, to the extent that the auditor succumbs to these pressures. In this regard, the behavior of auditors will depend on the ethical acceptability of the situations that they are confronted with, and also, on the reference groups and factors that auditors consider when resolving the conflicts of interest faced.

The aim of this study is to explore the specific pressures faced by Spanish auditors both from the audit firm and from the audit client, to analyze the auditor's ethical judgment of several questionable practices as well as to determine the way auditors resolve conflict of interests. In addition, this paper studies the influence of the size of the audit firm and auditors' experience on the issues under study.

This paper contributes to the very scarce literature on the effect of pressures on the final behavior of auditors. Further, it progresses in the analysis of the influence that ethical judgment and the way of resolving ethical conflicts have in auditors' capacity to withstand client's and audit firm's pressures. Moreover, by providing evidence of the actual pressures that Spanish auditors face this paper extends prior research regarding the organizational context in which the audit work takes place.

The study contributes also to the knowledge of the particularities of small and medium-sized audit firms, which, despite

the important volume they represent in Europe, have been so far neglected in the audit literature (Azkue, 2012; Serrano Madrid, Ruiz Barbadillo, & Martínez Conesa, 2013).

In addition, most studies in this field have been conducted in Anglo-Saxon environments, where the profession has a long tradition, and with the legal system based on the common law or non legalistic approach. Therefore, understanding the pressures and how auditors resolve the conflicts of interest in a socio-politically different context to the commonly studied countries, contributes to the academic literature on the behavior of auditors and its influence on the auditing quality in the global context of financial markets.

Further, the results of the study are fully timely and relevant for the audit regulation in Spain, and particularly, for the current development of the ethical standards. These standards should take into consideration the pressures faced by professionals in their activity and the factors taken into account for their resolution in order to issue useful and contextually adapted ethical standards.

The paper is structured as follows: after this introduction, we present the theoretical framework and the research questions focusing on the pressures faced by auditors, their ethical judgment and the conflict of interest's resolution. We then introduce the methodology used in the research. In Section 4, we present the results obtained and finally, the conclusions, limitations and future research lines are put forward.

## 2. Literature review and research questions

### 2.1. Pressures perceived by auditors in their professional activity

The conflict between commercial and professional goals will affect the auditor employee at the firm, as he or she will suffer pressures that will affect the search for errors and irregularities, as well as the pressures related to the disclosure of the same, once discovered.

In order to cope with the increasing price competition, audit firms will seek to minimize the costs of the audit engagement to obtain the maximum profitability of the service. An audit budget reduction will more likely imply that fewer resources are devoted to the search for errors and irregularities, which ultimately would threaten the audit quality.

One of the most effective cost control in audit engagement is through the control of time (Otley & Pierce, 1996). However, too tight time budgets cause undesirable behaviors (Alderman & Deitrick, 1982; Lightner, Leisenring, & Winters, 1983; Otley & Pierce, 1996; Pierce & Sweeney, 2004; Svanberg & Öhman, 2013). If the auditor employee believes that the budgeted hours by his or her firm are not sufficient to achieve the desired result, he or she can behave meeting the budget or working more hours than those budgeted. In the first case, the quality will be difficult to achieve, as the auditor may not be able to obtain the necessary evidence, or do not properly document the work done or do not find, due to lack of time, important information on the audited company. If the auditor chooses the second option, this is, to spend more hours than those budgeted, he or she can report the actual hours or understate the hours worked. Prior studies show that underreporting of time is a common practice among auditors, however, this practice leads to unintended consequences such as misleading staff evaluations, lost revenue for the audit firm, unrealistic future budgets and audit quality reduction acts on future audits (Otley & Pierce, 1996; Svanberg & Öhman, 2013; Sweeney & Pierce, 2006).

Another alternative for the audit firms to reduce the audit cost is to select less experienced personnel for the engagement team. This might have as a consequence a less competent engagement team and, therefore, will pose a serious threat for audit quality (DeZoort & Lord, 1997). If the audit team lacks the necessary technical

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