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Audit time pressure and earnings quality: An examination of accelerated filings

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ABSTRACT

Using publicly available data from annual reports, we find that SEC rule changes (33-8128 and 33-8644) that impose time pressure on the audits of registered firms have a negative impact on earnings quality, which we interpret as evidence of lower audit quality. Consistent with our predictions, we find that the 10-K accelerations reduced audit quality only when it actually reduced the number of days from year-end to audit report date, and that this effect was more acute for smaller, accelerated filers and during the initial deadline change (relative to the second). We also provide insights into the quality of these audits by conducting a survey of thirty-two retired audit partners. Survey results underscore the challenges time pressure imposes on receiving and evaluating complex valuations (such as for derivatives, pensions, and goodwill) and resolving audit adjustments.

1. Introduction

Securities and Exchange Commission (SEC) rules 33-8128 and 33-8644 substantially reduced the 10-K filing period for large accelerated filers and accelerated filers by 15 days, from 90 days after fiscal year-end to 60 and 75 days, respectively (SEC 2002, 2005).[1] For many firms and their auditors, such regulation led to exogenously imposed year-end time pressure to meet the new filing deadlines. This setting provides a natural experiment that we use to provide archival evidence on the effect of time pressure on audit/earnings quality. We also provide rich qualitative information related to the pressure audit firms experienced during the acceleration periods, areas in which time pressure resulted in audit difficulties, the ways in which audit firms attempted to alleviate the pressure, and the resulting quality of accelerated audits. The combination of our archival and qualitative data allows us to further explore the impact of regulatory-induced pressure on audit firms and contribute to an emerging stream of literature that explores the impact of controversial regulatory changes on the quality of information supplied to financial statement users.

Experimental and survey research has shown that increasing audit time pressure may limit the extent to which auditors employ a questioning mind and critically evaluate evidence (e.g., McDaniel, 1990; Otley & Pierce, 1996; Willett & Page, 1996; Asare, Trompeter, & Wright, 2000; Braun, 2000; Coram, Ng, & Woodliff, 2004; Nelson, 2009; PCAOB, 2012). Archival evidence illustrates that fewer audit hours, in general, are associated with lower quality earnings (Caramanis & Lennox, 2008). Our setting is one in which we know the extent and source of time pressure and allows us to contribute

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[1] According to rule 33-8128 (SEC 2002), an accelerated filer (AF) is a firm that meets the following conditions at the end of its fiscal year: 1) Its common equity public float (the part of equity not held by management or large shareholders) was $75M or more as of the last business day of its most recently completed second fiscal quarter; 2) The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; 3) The company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and 4) The company is not eligible to use Forms 10-KSB and 10-QSB. A large accelerated filer (LAF) is defined as an AF with a worldwide market value of outstanding voting and non-voting common equity held by non-affiliates of $700M or more (SEC 2005). A non-accelerated filer (NAF) is a firm that does not meet the definition of an AF.

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archival results to complement and triangulate existing experimental/survey research exploring the effect of time pressure on audit quality.

We extend prior studies which make use of this setting (e.g., Bryant-Kutcher, Peng, & Weber, 2013; Doyle & Magilke, 2013; Impink, Lubberink, van Praag, & Veenman, 2011; Krishnan & Yang, 2009) by examining whether it is the extent of time pressure placed on the *audits* that is associated with lower earnings quality. We also identify conditions under which firms that were seemingly affected by the acceleration did *not* experience a reduction in earnings equality (i.e., firms that needed to file earlier, but did not need to reduce audit delay to do so). Our analyses enable us to more definitively describe the effects of the SEC 10-K accelerations and to identify the conditions under which such accelerations *do not* impair the quality of earnings. This allows us to speak to how *future* accelerations and/or other regulatory activity may impact financial reporting quality based on the extent to which they would place time pressure on contemporary audits. Thus, this research should assist U.S. and international regulatory organizations considering future accelerations of financial reports.

In our study, we first describe how exogenously-induced increases in time pressure may substantially impact the audit approach and limit year-end testing of account balances and transactions. We use audit delay, defined as the length of time from a company's fiscal year-end to the date of the auditor's report (Ashton, Willingham, & Elliott, 1987), to develop a continuous measure of audit time pressure and to group firms based on the extent to which they were most affected by the deadline change. We categorize firms as: already filing before the new deadline (i.e., unaffected by the accelerations) (Group A); needing to file the 10-K earlier, but not required to reduce audit delay to do so (Group B); or, those for which complying with the SEC accelerations of 10-K filings required a reduction in audit delay (Group C). Time pressure is determined by (1) the extent to which it was necessary to reduce the audit delay to meet the new deadline (calculated as the prior year audit delay minus the current year deadline in days) and (2) whether a firm is classified as being in Group C.

Greater time pressure at year-end increases the likelihood that auditors are faced with a choice between having their clients miss the filing deadline because they are unable to obtain sufficient appropriate evidence by the 10-K filing deadline or performing a rushed, lower quality audit. We use working capital accruals to proxy for audit/earnings quality (Dechow & Dichev, 2002) and find no evidence that the deadline reductions negatively affected the earnings quality of Group A and B firms. In short, if 10-K accelerations do not put time pressure on the audit, earnings quality is not significantly affected. Conversely, we *do* demonstrate that both the extent of time pressure faced by auditors to meet the accelerated 10-K deadlines, and the audits of Group C firms in general, are associated with lower earnings quality. We also find that both of our time pressure measures are positively associated with the likelihood that the audit is not complete by the accelerated deadline (i.e., the firm files their 10-K with the SEC late). We next explore whether time pressure differentially affected accelerated filers vs. large accelerated filers, as well as the earnings quality of firms during the first (75 day deadline) vs. second deadline change (60 day deadline). Our evidence suggests that audit time pressure has a more negative effect on the earnings quality of accelerated filers (relative to large accelerated filers), and for the initial deadline change (relative to the second), during the 10-K acceleration periods.

We then conduct a survey of audit partners that asked them to provide both qualitative and quantitative data related to one specific 10-K acceleration of a client they served. Providing support for our time pressure proxies, we find participants felt a fair amount of time pressure on these audits and that the pressure they felt was significantly associated with the number of days by which the audit report was accelerated. Consistent with our archival analysis, the vast majority of partners indicated that the audits of large accelerated filers were better equipped to handle the time pressure caused by the accelerations. Providing insight into why (or, via what avenue) time pressure negatively affected earnings quality, we find audit time pressure is positively associated with the level of difficulty associated with resolving audit adjustments. With respect to identifying "best practices" for ameliorating the effects of time pressure, partners indicate that working more hours, performing more interim testing, and rescheduling the audits of non-public companies were the most effective strategies. On the other hand, increasing the use of computer assisted audit techniques on the audit was not deemed to be an effective strategy. Finally, an exploratory analysis of our survey responses suggests that, for 10-K accelerations, interim testing and the percentage of partner time spent at the client are positively associated with the effectiveness of audit procedures, reducing the difficulty associated with resolving year-end audit adjustments, and overall audit and financial reporting quality.

Overall, the combination of our archival and survey-based evidence should inform deliberations by U.S. and non-U.S. regulatory bodies considering future filing accelerations.[2] Regulators should be acutely aware of the extent to which such accelerations may impact the amount of time pressure placed on the financial statement audit. Our aforementioned results related to accelerated filers suggest that caution should be taken before considering a further reduction for smaller firms (e.g., from 75 to 60 days) or expanding accelerations to even smaller, non-accelerated filers (who currently still face a 90-day filing deadline). If such accelerations are undertaken in the future, audit firms can strive to increase the extent to which the best practices we identify can be implemented on a particular audit. In sum, our study will inform audit teams charged with handling any future events or regulatory acts that place greater year-end time pressure on the audit team. For example, the majority of our survey respondents indicated that the recently proposed PCAOB standard in relation to expanding the content of the audit report would induce additional year-end time pressure on the auditor and potentially impair audit quality.

The remainder of the paper is organized as follows. Section 2 provides background and develops our hypothesis and research question. Sections 3 and 4 describe our archival and survey analyses, respectively. Section 5 provides our conclusion.

2. Background and theoretical development

2.1. SEC regulation

Shortly after the passage of the Sarbanes-Oxley Act (SOX), the

[2] For example, the European Commission has been contemplating a reduction in audit delay to improve the timeliness of communications between auditors and stakeholders (see question number 11 in the European Commission Green Paper, Audit Policy: Lessons from the Crisis (available at: http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf). In Canada, the filing deadline for publicly traded companies was reduced from 140 to 90 days in 2004. Over time, Canada may consider emulating the current 10-K filing deadlines imposed by the SEC. Also, our results can inform SEC deliberations related to foreign filers. Foreign issuers recently experienced a reduction in their filing deadline from 6 months to 4 months. It seems logical that the SEC might consider a further reduction to this deadline (i.e., to 90 days, as originally proposed), and the current accelerated deadline applies to all foreign issuers regardless of size. Our findings suggest that separating foreign issuers into different filing groups might be appropriate.