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Do school ties between auditors and client executives influence audit outcomes? ☆

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ABSTRACT

We identify connected auditors as those who attended the same university as the executives of their clients. Using manually collected data from China, we find that connected auditors are more likely to issue favorable audit opinions, especially for financially distressed clients. Moreover, companies audited by connected auditors report significantly higher discretionary accruals, are more likely to subsequently restate earnings downward, and have lower earnings response coefficients. Lastly, connected auditors earn higher audit fees. Collectively, our evidence suggests the impairment of audit quality when auditors and client executives have school ties and the presence of social reciprocity derived from school ties.

1. Introduction

How social ties between economic agents such as financial analysts, investors, and corporate executives and directors affect business decisions has been an important question recently researched in the accounting and finance literature (e.g., Cohen et al., 2008, 2010; Fracassi and Tate, 2012; Hwang and Kim, 2009; Nguyen, 2012). Auditors play a crucial role in ensuring the quality of financial reports, a key information source for many important economic decisions. The interactive nature of the audit negotiation and verification process makes the audit setting a relevant one in which social ties are likely to influence auditors' and managers' decisions. Understanding whether and how social ties between the audit partners and executives of client firms impact decision making and ultimately affect audit outcomes is of great interest to academics, investors, and regulators. However, the existing literature has been limited to settings where audit clients employ former partners of the accounting firm as senior managers or directors (Baber et al., 2014; Geiger et al., 2008; Lennox, 2005; Menon and Williams, 2004).

Social ties can take many forms and those arising from sharing an educational link are one form that could potentially affect the decision making process. In our study, we focus on school ties in analyzing and understanding the effect of social

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connections between audit partners and client firms on audit outcomes. We expect the educational institutions attended by individuals to form an effective basis for social ties for several reasons. First, if two individuals attended the school at the same time, personal bonds might get established via interaction on campus. Second, if the individuals attended the same university/campus at different times, they may have common interests or backgrounds that help foster ties later, via alumni associations or donation programs. Third, the school might offer unique imprinting due to the type and quality of its education. Such imprinting bonds the alumni together, allowing them to interact with the values of the school (Massa and Simonov, 2011). Therefore, we operationalize school ties by identifying individuals who attended the same universities for undergraduate or graduate degrees as having school ties, without requiring them to have attended the school at the same periods, at the same campuses, or for the same majors.

Compared with connections created through prior employment examined in prior studies (Lennox, 2005; Lennox and Park, 2007; Menon and Williams, 2004; Naiker and Sharma, 2009), school ties can be a better proxy for social connections to test precisely their effect on decision making in the audit setting. As noted in the abovementioned studies, documented evidence of impaired audit quality when former accounting firm partners are executives of client firms can be explained by (1) compromised independence, induced by the "cozy" relationship between accounting firms and their former employees, and (2) the superior knowledge and ability of affiliated executives with prior experience at the audit firm (Lennox, 2005). Given that an auditor's trust of a client derived from a past work relationship co-exists with the client's intimate knowledge of the audit firm's audit testing methodology obtained from previous employment, we are unable to draw unambiguous conclusions about the impact of social connections on audit outcomes based on these studies. Using school ties allows us to overcome such a concern.

We focus on the Chinese audit market, where data for both the identities of signing auditors and their education information are obtainable. There are other benefits of using the Chinese setting beyond data availability. First, the impact of social ties is likely to be more pronounced when the market is relatively inefficient and the legal system and enforcement are weaker (Allen et al., 2005). In such an environment, due to higher transaction costs in the marketplace, economic agents tend to rely more on alternative non-market channels such as social ties to conduct business. China's economy is characterized by weak law enforcement and the pervasiveness of transactions based on connections rather than arm's-length principles. Anecdotal evidence suggests that school ties play an important role in the relationship-based economic environment in China.[1] We thus expect this setting would allow us to examine the impact of school ties with relatively high statistical power. Second, China has a much less concentrated audit market than in developed countries (DeFond et al., 2000; Wang et al., 2008). Such a market structure makes the auditors more likely to succumb to managerial pressure to retain clients.

Using Chinese non-financial firms listed in the A-share market between 2006 and 2011 as our sample, we find that 511 (out of 5,040), or 10.14%, of the sample firm–years have at least one top executive (CEO, CFO, or board chairperson) who has a school tie with one of the signing auditors. Regression results show that when school ties exist between auditors and executives, the probability of a clean audit opinion or a less severe modified audit opinion (MAOs) is higher. In addition, higher reported discretionary accruals and higher audit fees are more likely. A propensity score matching (PSM) approach, which considers the endogeneity arising from the choice of individual auditors, generates consistent results. We also explore within-firm variations and document that changes in the auditor–executive relationships are followed by changes in audit quality and audit fees in the expected direction.

Further analyses show that connected auditors are also more likely to issue clean opinions in a subsample of financially distressed companies. Moreover, firms audited by connected auditors exhibit lower earnings response coefficients (ERCs) and have a greater likelihood of subsequent downward restatements than firms audited by non-connected auditors. Taken together, our results suggest that auditor–executive school ties undermine audit quality. Accordingly, the higher audit fee enjoyed by connected auditors does not represent greater audit effort or audit quality. Rather, it represents auditor–executive reciprocation. Our findings corroborate the evidence from prior studies that the demand for high-quality financial reporting in China is typically low (Piotroski and Wong, 2012). Given the pressure to retain and attract clients and the relatively low litigation risk environment, it is perhaps not surprising that Chinese auditors can be tempted to compromise their independence and curry favor with management (DeFond et al., 2000; Wang et al., 2008).

Our study contributes to the literature in a couple of ways. First, we contribute to the literature on the role of social networks in accounting and finance by documenting the effect of school ties on audit outcomes. Independence is a key element for a monitoring mechanism to function. Prior studies examine the effect of social ties on monitoring in the boardroom and show that social ties between directors and executives compromise director independence and thus impair the effectiveness of board monitoring (e.g., Bruynseels and Cardinaels, 2014; Fracassi and Tate, 2012; Hwang and Kim, 2009). We focus on another important monitoring mechanism, namely, external auditors. Our findings suggest that social ties between auditors and managers may act as a catalyst for them to build up a collusive relationship, which is detrimental to the effectiveness of auditor monitoring.

Second, our paper also contributes to the emerging literature that examines the variation in audit quality across individual auditors (e.g., Carcello and Li, 2013; Goodwin and Wu, 2014; Gul et al., 2013). There have been calls for researchers to

[1] For example, in 2011, several Nankai University alumni were convicted of providing classified macroeconomic data and were sentenced to jail. These alumni worked at the Financial Research Institute of the People's Bank of China, securities companies, and asset management companies (see http://finance.sina.com.cn/china/20120502/023011962670.shtml, in Chinese). In addition, in the recent anti-corruption crackdown at the China National Petroleum Corporation, three of the four former executives under investigation were alumni of the Southwest Petroleum University (see http://finance.sina.com.cn/chanjing/gsnews/20130828/023916582348.shtml, in Chinese).