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A review of archival auditing research[☆]

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ABSTRACT

We define higher audit quality as greater assurance of high financial reporting quality. Researchers use many proxies for audit quality, with little guidance on choosing among them. We provide a framework for systematically evaluating their unique strengths and weaknesses. Because it is inextricably intertwined with financial reporting quality, audit quality also depends on firms' innate characteristics and financial reporting systems. Our review of the models commonly used to disentangle these constructs suggests the need for better conceptual guidance. Finally, we urge more research on the role of auditor and client competency in driving audit quality.

1. Introduction

Auditing is valued for its ability to provide independent assurance of the credibility of accounting information, which improves resource allocation and contracting efficiency. The growing complexity of business transactions and accounting standards increases auditing's potential to add value. In recent years, changes of unprecedented magnitude have fundamentally altered the audit market landscape for both auditors and their clients. For the first time in history the public accounting profession in the US is under direct government regulation. The result is a sea change in the supply and demand dynamics of the audit markets, and a surge in research that seeks to better understand the drivers of audit quality. The purpose of our review is to summarize and critique the recent auditing research, and to provide direction for future research.

The archival auditing research empirically addresses auditing-related questions, predominantly using economics-based methods of inquiry and analysis. We limit our review to this literature because it is a burgeoning line of research and because we are constrained by our expertise. We do not systematically review the auditing research that draws its inferences from experiments, surveys, or theory. Our goal is to identify the fundamental questions being addressed, what we have learned, inherent problems with the literature, and what needs to be learned going forward. Our target audience is accounting researchers and Ph.D. students

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with a general interest in understanding the auditing literature, and auditing researchers interested in an economics-based review of the archival literature. Consequently, we limit the scope of our review primarily to studies published in the major general interest accounting journals. We also restrict our review primarily to studies that are published from 1996 through mid 2013 in order to focus on recent developments in the literature.[1]

We organize our review around an economics-based framework that examines the supply and demand forces that shape the audit market. A dominant feature of the literature we review is its primary focus on audit quality. As a result, we structure our discussion around the following four questions: (1) What is audit quality? (2) What drives client demand for audit quality? (3) What drives auditor supply of audit quality? and (4) What are the regulators' concerns about audit quality? We characterize the demand for audit quality as a function of client incentives and competencies, and the supply of audit quality as a function of auditor incentives and competencies. We separately examine regulators' concerns because of the profound nature of the recent regulatory changes in the US audit markets and the large volume of research motivated by these changes.[2] Table 1 provides an outline of our review. [3]

Our first set of observations comes from considering the question "What is audit quality?" We observe that most of the commonly used definitions of audit quality portray auditing as a binary process, whereby auditors either succeed or fail in detecting GAAP violations. In contrast, we argue that auditors' responsibilities extend well beyond the simple detection of "black and white" GAAP violations, to providing assurance of financial reporting quality. This responsibility arises from professional auditing standards that require auditors to consider "the quality, not just the acceptability" of the client's financial reporting (SAS 90). It is further reflected in the audit opinion, which provides assurance that the "financial statements are fairly presented in accordance with GAAP," since fair presentation requires faithful representation of the firm's underlying economics (FASB, 1980, SFAC No. 2). The auditor's broad charge to consider financial reporting quality is also consistent with court rulings that hold auditors liable for misleading financial statements even when those statements strictly comply with GAAP. Collectively, these arguments suggest that audit quality is a continuous construct that assures financial reporting quality, with high quality auditing providing greater assurance of high quality financial reporting.

Audit quality improves financial reporting quality by increasing the credibility of the financial reports. Thus, audit quality is a component of financial reporting quality. While difficult to define, financial reporting quality is also determined by the firm's financial reporting system, which maps its underlying economics into the financial reports; and the firm's innate characteristics, which determine its underlying economics. Together, the firm's financial reporting system and innate characteristics affect the quality of the pre-audited financial statements, which constrain the achievable level of financial reporting quality. Accordingly, we define higher audit quality as "greater assurance that the financial statements faithfully reflect the firm's underlying economics, conditioned on its financial reporting system and innate characteristics."

We also observe that while the literature uses a large number of proxies to measure audit quality, there is no consensus on which measures are best, and little guidance on how to evaluate them. To address this issue, we draw on the perspective we gain from our review to provide a framework for choosing among and interpreting the commonly used proxies. We first note that the proxies fall into two inherently different groups; outputs of the audit process, such as auditors' going-concern (GC) opinions, and inputs to the audit process, such as auditor size. We further classify the output-based measures into four categories – material misstatements, auditor communication, financial reporting quality, and perceptions; and the input-based measures into two categories – auditor characteristics and auditor–client contracting features (such as audit fees). We then identify several dimensions that characterize each category's unique strengths and weaknesses. One dimension is how directly the auditor influences the proxies in each category. Material misstatements, for example, are directly under the auditor's influence, while perception-based measures, such as the cost of capital, are a longer walk. Another dimension is whether the proxies capture relatively more egregious audit failures, such as material misstatements, or relatively less egregious earnings management, such as measured by high discretionary accruals (DAC). Yet another dimension is whether the proxies capture actual or perceived audit quality, where proxies such as earnings response coefficients (ERCs) capture perceived quality, and measures such as restatements capture actual quality. Finally, we evaluate the proxies based on measurement issues, such as whether measurement error is particularly problematic.

Based on our evaluation of these dimensions, we conclude that no single category paints a complete picture of audit quality. We therefore recommend that when possible, researchers use multiple proxies from different categories to take advantage of their strengths and attenuate their weaknesses.[4] However, because the proxies in each category reflect different dimensions of audit quality, we do not necessarily expect agreement across categories. For example, while a given threat to audit quality may lead to within-GAAP earnings management, as proxied by benchmark beating, it may not rise to

[1] We focus our review on the major studies that exemplify trends in the literature, and do not necessarily include every study published during this time period.

[2] While the literature focuses primarily on audit quality, it also examines the audit process and audit efficiency. Most of these studies, however, still have implications for audit quality. For reviews of the audit quality research from a different perspective than ours, see Francis (2004, 2011) and Knechel et al. (2013).

[3] We thank Donovan et al. (2014) for pointing out the inter-relatedness of our demand and supply factors. We classify papers based on demand and supply factors because it is a useful technique for grounding our review in a structured economic framework, and do not mean to oversimplify the complex interactive nature of audit markets.

[4] We emphasize, however, that we do not recommend triangulating across all proxies, because it is neither practical nor desirable. Rather, we suggest comparing measures across the broad categories, which are few in number.