



ELSEVIER

Contents lists available at [ScienceDirect](http://www.sciencedirect.com)

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

Issues raised by studying DeFond and Zhang: What should audit researchers do? ☆



John Donovan ^a, Richard Frankel ^{a,*}, Joshua Lee ^b, Xiumin Martin ^a, Hojun Seo ^a

^aOlin Business School, Washington University in St. Louis, Campus Box 1133, One Brookings Drive, St. Louis, MO 63130-4899, USA

^bCollege of Business, Florida State University, 821 Academic Way, Tallahassee, FL 32306-1110, USA

ARTICLE INFO

Available online 16 September 2014

JEL classification:
M3

Keywords:
Auditors
Audit quality
Regulatory intervention
PCAOB

ABSTRACT

We view audit-quality choice as one among many that managers make to maximize firm value. We question whether audit-quality differences among publicly traded companies are of significant interest to investors, clients, and auditors and ask for research on this topic. Relatedly, we ask for research on whether auditors and their clients show behavior consistent with regulated audit quality exceeding the audit quality level demanded absent regulation. We propose that researchers incorporate the competitive advantages of auditors and the institutional features of the audit process into the definition of audit quality. We propose that audit quality research test for externalities and inefficiencies to understand whether auditors and their clients are choosing the efficient level of audit quality. We note the legislative, judicial, and executive powers residing in the PCAOB.

© 2014 Elsevier B.V. All rights reserved.

1. Introduction

DeFond and Zhang (2014) analyze and organize empirical auditing research. Their heroically-comprehensive review defines audit quality and suggests factors affecting its demand and supply. We comment on their definition of audit quality and the demand and supply structure, mindful that any attempt to fit this varied literature into an economic order would result in generality and inconsistency. Our purpose is not to analyze DeFond and Zhang (2014). Rather, we rely on this review of the audit literature to draw conclusions about the direction of this research. We take issue with the current course of empirical archival audit research and suggest an alternate heading. A focus on audit quality bends research to topics of interest to regulators who emphasize higher audit quality based on a belief that auditors should do their utmost to prevent firms from managing earnings or committing fraud. Audit quality research is often motivated by regulatory interest in the link between a given independent variable (e.g., auditor tenure, nonaudit fees, audit partners) and audit quality. We propose researchers adopt a client/auditor centered view. This view goes beyond measuring costs of higher audit quality, though that would be a good start. The perspective is broader than an increased emphasis on costs, because it asks questions of interest to clients, auditors, and investors. For academics, it relegates audit quality to a position of one variable among many chosen to maximize firm value and questions the economic significance of cross-sectional variation in audit quality. If the overall effect on firm value is small, the case for finding another statistically significant relation that adds more depth to the story is

☆ We thank Michael Alles, Ray Ball, Mark DeFond, Tom Fields, Joseph Gerakos, Bjorn Jorgensen, Al Kent, Richard Lambert, David Pearson, Ira Solomon, Jieying Zhang, and Jerry Zimmerman. Discussions with Nick Dopuch were especially helpful.

* Corresponding author.

difficult to support. An auditor/client centered view asks researchers to consider whether cross-sectional variation in audit quality is a factor of critical concern to auditors and their clients in the broad samples used for tests and calls for research on this question. Moreover, it emphasizes that externalities are necessary to support a view that clients, auditors, contracts, and judges will not produce outcomes consonant with the efficient audit-quality levels. It searches for these externalities and deviations from a full-information competitive equilibrium. It examines the specific methods available to auditors to verify financial information to understand auditors' competitive advantage in supplying information relative to others (e.g., analysts, whistle blowers, the financial press, etc.). This discussion also includes thoughts on the Public Company Accounting Oversight Board (PCAOB).

The editors assigned us the task of reviewing DeFond and Zhang. Because we stray from this task, we close this introduction by emphasizing that DeFond and Zhang provide an essential and well located forward operating base, giving clear views of the past engagements while offering a position from which to measure and direct future maneuvers.

2. The contents of DeFond and Zhang (2014)

A summary of DeFond and Zhang's (2014) lengthy work is apt to be reductionist. Ours is: their paper summarizes the empirical audit literature, classifying papers based on whether they relate to the supply or demand for audit quality and critiquing the conclusions drawn. The work runs over 100 pages in manuscript form and contains approximately 560 citations. To incorporate all these papers the authors must resort to descriptive enumeration. The coverage is useful to readers, like us, who only know a subset of these papers but are searching for an exhaustive introduction to guide further reading and identify unexplored research questions. DeFond and Zhang (2014) wisely choose to highlight and cover more papers rather than to expansively summarize. Summaries cannot substitute for primary sources. The paper will propel students into the literature. It gave us an opportunity to remedy deficiencies in our knowledge of empirical facts and techniques. The summary appears comprehensive, and none of the researchers we spoke to expressed concern about omitted papers.

DeFond and Zhang's taxonomy gives a glimpse of the integrated whole. They organize their review around questions seeking a deeper understanding of the demand and supply for audit quality rather than around the proxies used in research.

Table 1

Dependent variables and independent variables mentioned in DeFond and Zhang (2014)

This table presents dependent variables and independent variables contained in DeFond and Zhang (2014). Variables shown in bold are suggested by DeFond and Zhang as variables for future research.

Independent variables	Dependent variables
GC Audit opinions	Internal control opinions
Material misstatements	Managerial ownership
AAERS	Leverage
Restatements	State ownership
Discretionary accruals	Cash flow rights
Meeting or beating benchmarks	Initial public offerings
Accrual quality	Corporate Governance
Market reaction	Internal Audit function
Earnings response coefficients	In house versus outsource internal audit and internal control functions
Accounting conservatism	Stakeholder information asymmetry
Cost of capital	Nonaudit services
Big-N	Voluntary audits
Industry specialization	Industry specialization
Market share	Auditor office size
Audit fees	Auditor tenure
Auditor changes	Big-N
Client retention	Fee premiums
Auditor lobbying	Auditor effort/conservatism
	Client retention
	PSLRA
	Legal regimes
	Misstatement risk
	Sustainability audits
	Audit firm ownership structure
	Audit firm compensation schemes
	Audit quality control systems
	Critical audit matters
	Internal audit function
	Personal characteristics of auditor, e.g. expertise, gender
	Audit committee independence
	Audit committee expertise
	Litigation risk
	New PCAOB variables

Download English Version:

<https://daneshyari.com/en/article/5086670>

Download Persian Version:

<https://daneshyari.com/article/5086670>

[Daneshyari.com](https://daneshyari.com)