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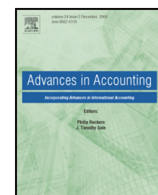

Managing risk in a poor economy: The association between economic activity and auditor response to risk☆

Penelope Bagley [a,1], Jack W. Dorminey [b,*], Dwayne McSwain [c,2], Tracy Reed [a,3]

[a] Appalachian State University, Walker College of Business, Department of Accounting, Boone, NC 28608, United States
[b] West Virginia University, College of Business and Economics, Department of Accounting, Morgantown, WV 26506, United States
[c] Sam Houston State University, College of Business Administration, Department of Accounting, Huntsville, TX 77341, United States

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ABSTRACT

We examine the association between economic climate and auditor risk acceptance as measured by the auditors' reaction to internal control weaknesses. We hypothesize and find that auditors address risk in a way that is conditioned on the economic environment. In particular, we find that during periods of weak economic activity, auditors tend to assess lower risk premiums and are less likely to resign in response to an adverse ICFR opinion. However, we find evidence that economic factors do not influence fees assessed by incoming auditors following a resignation in the presence of an ICFR weakness. Our results indicate that auditors modify their engagement risk strategies during challenging economic times and accept higher levels of risk to attract and retain clients. For the riskiest clients, however, economic factors do not appear to influence auditors' risk pricing.
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1. Introduction

Subsequent to the passage of the Sarbanes–Oxley (SOX) Act (U.S. House of Representatives, 2002) and the continuing developments guided by the Public Company Accounting Oversight Board (PCAOB), the issue of engagement risk continues to be a major concern for the audit profession. Audit partners must give careful consideration to the selection and retention of clients while maintaining a balance with regard to the audit risks each client represents. Pre-SOX studies show that auditors react to engagement risk, as auditor resignations are more likely to occur when companies indicate signs of being high-risk clients (e.g., Bockus & Gigler, 1998; Krishnan & Krishnan, 1997; Shu, 2000). Post-SOX studies reiterate that auditors are less likely to continue with high-risk clients (e.g., Elder, Zhang, Zhou, & Zhou, 2009; Landsman, Nelson, & Rountree, 2009). Resignations, however, result in a loss of revenues to the firm. Audit firms are for-profit enterprises and must also make client engagement and continuance decisions based on their need for income and the economic environment in which they compete. Weak economic conditions have placed financial pressures on audit firms, forcing them to consider cost-cutting options such as lay-offs and spending cuts (Ramos, 2009). The increased financial pressure may also cause audit firms to alter how they manage their client-based revenue stream; for example, they may be *less* likely to resign from engagements when there is a high need for the income generated by the engagement. The purpose of this paper is to examine whether poor economic conditions change auditors' risk management policies, particularly the auditors' willingness to retain and properly price risky clients.

We examine the association between auditor resignations and the presence of a material weakness in internal control, as indicated by an adverse opinion on internal controls over financial reporting (ICFR), and what impact the recent economic recession has had on such resignations in an effort to gain insight into how economic conditions impact a firm's risk management. An increase in auditor resignations following an adverse ICFR opinion is consistent with an auditor reacting to a perceived increase in engagement risk associated with the opinion (Ashbaugh-Skaife, Collins, & Kinney, 2007). However, difficult economic times may alter the profit-risk tradeoff, making a marginal increase in risk preferable to a resignation. An alternative reaction to the perceived increase in risk associated with an adverse ICFR opinion is to charge clients a risk premium (Canada, Sutton, & Kuhn, 2009; Hogan & Wilkins, 2008; Hoitash, Hoitash, & Bedard, 2008; Pratt & Stice, 1994; Raghunandan & Rama, 2006). In a difficult economic climate, however, the fear of losing a client may result in an auditor's unwillingness or inability to fully price the risk associated with that particular client. Accordingly, we further investigate auditor fees following an adverse ICFR opinion. We also provide insight into whether economic factors influence subsequent auditors risk pricing for what we assume are the riskiest clients, those with an adverse ICFR opinion whose auditors have resigned.

☆ Data availability: Data used in this paper are derived from publicly available sources.
* Corresponding author. Tel.: +1 304 293 7845.
E-mail addresses: bagleypl@appstate.edu (P. Bagley), jack.dorminey@mail.wvu.edu (J.W. Dorminey), mcswain@shsu.edu (D. McSwain), reedtn@appstate.edu (T. Reed).
[1] Tel.: +1 828 262 6209.
[2] Tel.: +1 936 294 1284.
[3] Tel.: +1 828 262 6125.

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We use a sample of ICFR filers from November 15, 2004, through January 5, 2012, to investigate the association between adverse ICFR opinions and auditor resignations and fees in varying economic environments. We use the Leading Index for the United States provided by the Federal Reserve Bank of Philadelphia to measure the economic environment. We find evidence that audit firms are willing to accept more risk when the economy is poor. In particular, audit firms are more likely to continue with risky clients than they would be in more prosperous times. Although they continue to charge a risk premium to high-risk clients, as represented by those with an adverse ICFR opinion, the risk premium is significantly lower when the economy is weak. Given that prior literature shows a link between increased auditor fees and likelihood of auditor dismissal (Ettredge, Li, & Scholz, 2007), the observed decrease in risk premiums may represent an effort by firms to lower the likelihood of their dismissal. However, for those clients considered the most risky (i.e., auditor resignations following adverse ICFR opinions during a recession), the economic state does not appear to impact the risk premium successor auditors charge. Thus, audit firms appear to alter their risk management policies and accept more risk when the economy is weak. However, when considering risk pricing for the riskiest of clients, the economic environment is not a factor.

Our paper extends both the accounting risk management literature and the literature that examines the influence of economic factors on the audit. Prior risk management literature has examined how audit firms use resignations and fees to manage engagement risk (e.g., Bockus & Gigler, 1998; Johnstone & Bedard, 2004; Krishnan & Krishnan, 1997; Lee, Mande, & Ortman, 2004; Munsif, Raghunandan, Rama, & Singhvi, 2011; Pratt & Stice, 1994; Shu, 2000). We extend the literature by examining how the use of these risk management tools is altered by the economic climate. Our paper also contributes to the limited research examining the impact of economic factors on the audit. Prior literature investigates changes in audit fees and audit quality during various economic climates (e.g., Ettredge, Fuerherm, & Li, 2014; Krishnan & Zhang, 2014; Leone, Rice, Weber, & Willenborg, 2013). Most similar to our study, Schroeder and Hogan (2013) examine changes in client portfolios across varying economic climates and regulatory changes (i.e., Audit Standard 2 versus Audit Standard 5). While Schroeder and Hogan (2013) examine changes in financial, audit, and auditor risk of client portfolios as a whole, we extend their research by focusing on a subset of risky clients, those with adverse ICFR opinions, and how audit firms manage risk related to those particular clients over the various economic climates.

Our paper provides important insights to both practitioners and policy makers regarding risk management practices. Quality control standards at both the PCAOB and American Institute of Certified Public Accountants (AICPA) require firms to have policies and procedures in place to re-evaluate whether to continue client relationships each year, including examining various risk factors associated with client continuance (AICPA, 2011; PCAOB, 2003). Our results indicate that the economic environment impacts fee premium and retention decisions related to risky clients. Thus, our results demonstrate that practitioners are flexible with risk thresholds, indicating that firms' policies and procedures on quality control allow for variability in fee and retention decisions. Regulators and practitioners alike should keep in mind this need for flexibility when creating new policies and regulations in this area. Further, we provide insight into mechanisms other than cost-cutting that auditors use to manage their budget in difficult times. In particular, we provide evidence that auditors change how they manage their client base and risk profile, possibly in an effort to retain revenues.

Lastly, coupled with the findings of Ettredge et al. (2014), our findings provide insight regarding audit quality for high risk clients during difficult economic times. Ettredge et al. (2014) find that fee pressure during the economic downturn is associated with reduced audit quality. While we do not investigate the origins of the observed reduced fee premiums assessed to high risk clients during poor economic times (i.e., client pressure or auditor motivated), a reduction in fees as a result of client pressure may be associated with reduced audit quality for riskier clients, the exact clients in which higher quality audits are critical.

The remainder of this paper is organized into four sections. Section 2 discusses the background literature and develops the hypotheses. Section 3 describes the methodology and sample selection procedures used to investigate our research question. Results are presented in Section 4. Section 5 summarizes and concludes the paper.

2. Background and hypotheses

Auditor departures, whether initiated by the client or the auditor, occur for a variety of reasons. Extant research has shown client characteristics, such as size, leverage, management changes, and audit committee composition can result in an auditor change (Carcello & Neal, 2003; DeFond, 1992; Ettredge et al., 2007; Johnson & Lys, 1990; Krishnan, 1994). Audit firm departures can also be motivated by disagreements over audit fees or a mismatch between services requested and those able to be performed by audit firms (Ettredge et al., 2007; Turner, Williams, & Weirich, 2005). Still other factors, such as the presence of internal control deficiencies (ICD), are associated with auditor changes (Ashbaugh-Skaife et al., 2007; Elder et al., 2009; Ettredge et al., 2007; Krishnan & Visvanathan, 2007; Thevenot & Hall, 2011).

2.1. Internal controls and auditor changes

Several recent research studies reveal a link between ICDs and auditor changes. Krishnan and Visvanathan (2007) directly test whether auditor changes are higher for firms that report ICDs versus those that do not report deficiencies. Findings support their hypotheses that firms reporting ICDs have more auditor changes than those without deficiencies. Thevenot and Hall (2011) find that entity level ICDs in particular, which are arguably more severe than account specific deficiencies, impact auditor changes. Ashbaugh-Skaife et al. (2007) examine auditor changes further and find that both auditor resignations and auditor dismissals are associated with higher frequencies of ICDs. Ettredge, Heintz, Li, and Scholz (2011) further Ashbaugh-Skaife et al. (2007) and find that firms receiving an adverse ICFR opinion are positively associated with auditor dismissals in particular. Auditor dismissals following the disclosure of ICDs and/or adverse ICFR opinions may occur for many reasons: to find a more compliant auditor, to punish the auditor for non-performance when the ICD is found by management versus the auditor, or, relatedly, to signal users of management efforts to improve overall financial reporting quality (Ashbaugh-Skaife et al., 2007; Ettredge et al., 2011). In contrast to Ettredge et al. (2011), Elder et al. (2009) examine the relationship between auditor resignations and ICDs. Using data from the year immediately following SOX implementation, they find that auditor resignations are more likely for firms with ICDs than for those without. Elder et al. (2009) conclude that the resignations are an effort made by the auditor to control litigation risk.

2.2. Auditor resignations and litigation risk

Auditor resignations motivated by an increase in litigation risk is a common finding among academic research (Bockus & Gigler, 1998; Johnstone & Bedard, 2004; Krishnan & Krishnan, 1997; Lee et al., 2004; Shu, 2000). Auditor resignations are more likely to occur when a company has high financial distress, high variability in stock returns, low auditor independence, and the receipt of a modified opinion, particularly a going concern opinion (Krishnan & Krishnan, 1997; Lee et al., 2004). Auditor resignations are also more likely following a restatement, especially one that is attributable to fraud or reverses a previously reported income, when there is a client disagreement, or when there are reportable events within the company (Huang & Scholz, 2012; Krishnan & Krishnan, 1997). All of these factors most likely increase the litigation risk for the auditor.

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