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Audit team time reporting: An agency theory perspective ☆

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ABSTRACT

While some research suggests that explicit incentives to meet time budgets have recently been reduced at audit firms, there is also evidence indicating that audit seniors and staff still feel at least implicit pressure to meet budgets. We examine the possibility that both of these findings tell a part of the story. Specifically, we explore whether, and under what conditions, seniors and staff are implicitly encouraged to underreport time through future engagement staffing decisions and the performance evaluation process. Further, we consider the extent to which agency theory can serve as a framework for understanding how the incentives of audit managers and partners influence how they view underreporting by their engagement staff. We place participants in a scenario in which they are responsible for evaluating an engagement senior who appears to have worked more hours than were budgeted. We manipulate the senior's reporting accuracy (underreporting versus accurate reporting) and the desirability of the client (more versus less desirable). We find that, when managers' agency-related incentives conflict more strongly with those of the firm (more desirable client), they tend to tacitly encourage underreporting through their evaluations of the senior's performance. Managers are also more likely to request an underreporter on a future engagement. In contrast, partners placed in the same setting show no evidence of encouraging underreporting. Thus, our results suggest that managers' tacit encouragement of underreporting is contrary to what the "principals" of the firm (i.e., partners) appear to want. Further, while firms may have reduced their emphasis on formal, explicit incentives to underreport, it appears likely that implicit manager incentives persist.

Introduction

Our study examines the role agency incentives play in diminishing the effectiveness of firm policies aimed at reducing underreporting of time. Specifically, we explore the extent to which, and under what circumstances, superiors implicitly encourage such behavior in audit staff. Underreporting occurs when an auditor does not record all hours worked on a particular engagement and is believed to negatively affect audit quality, to lead to other unethical and dysfunctional audit behaviors that can increase audit risk, and to result in incorrect information being used in client pricing and retention decisions (e.g., Donnelly, Quirin, & O'Bryan, 2003; Public Oversight

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Board, 2000; Shapeero, Koh, & Kilough, 2003). As a consequence, audit firm policies expressly prohibit underreporting (McNair, 1991).

Although meeting time budgets has traditionally been a significant performance evaluation focus in audit firms (Lightner, Adams, & Lightner, 1982; McNair, 1991), a survey of partners and managers conducted by Buchheit, Pasewark, and Strawser (2003) suggests that such formal, explicit emphasis on meeting budgets has ebbed. However, there is also evidence indicating that audit seniors still feel pressure to underreport (Sweeney & Pierce, 2006). One possibility is that both of these findings tell a part of the story. That is, explicit pressure to meet budget may in fact be reduced, while implicit pressure still exists (e.g., seniors do not want to appear less valuable or productive than peers who report meeting budget; Sweeney & Pierce, 2006). Our study explores whether staff are still implicitly encouraged to underreport time through future engagement staffing decisions and the performance evaluation process and, if so, the extent to which agency theory can serve as a framework for understanding how incentives perpetuate the behavior, as well as a basis for creating potential solutions.

Audit managers and partners have, at times, differing incentives with respect to the time reporting behavior of the engagement team. Agency theory predicts that partners, as "principals" of the firms, have a longer-term perspective and, thus, believe that their interests align closely with those of the firm as a whole (e.g., better retention of good, honest employees who are reluctant to misreport hours worked; more accurate costing figures for better client acceptance/retention decisions and better long-run alignment of resources). As a result, partners are likely to prefer that their engagement teams report their time accurately. However, managers are likely more influenced by shorter-term incentives to complete the engagement within the budgeted time (e.g., to avoid fee pressure on desirable clients; to impress partners with good realization rates) (Sweeney & Pierce, 2006). Managers also spend more time with staff at the worksite than do partners, resulting in managers having more accurate information regarding staff hours (Otley & Pierce, 1996). This informational advantage provides managers with an opportunity to act on their incentive to implicitly encourage engagement team underreporting. We, therefore, explore how the differing roles (and related incentive structures) of audit managers and partners influence how they view the practice of underreporting, anticipating that managers and partners will act differently, but in a manner consistent with agency theory predictions (i.e., as agents and principals, respectively).

Agency theory predicts that, where there is strong conflict between the incentives of the principal and agent, the agent will tend to act in his/her self-interest when provided the opportunity (e.g., an informational advantage over the principal). If no strong conflict exists, then the agent's actions will tend to align more with the principal's incentives (Jensen & Meckling, 1976). Thus, if an agency framework applies in the underreporting context, one would expect that the strength of managers' (conflicting) incentives influences their tendency to encourage the behavior. One factor that affects the strength of such a conflict relates to desirability of the client. For example, if a manager has a strong preference for a particular client (e.g., the client is close to home or the manager gets along well with client management), he or she is more likely to have a stronger desire for a subordinate to underreport in order to maintain audit fees near their current levels to help promote client retention and, in turn, increase the likelihood he/she remains assigned to this desirable client. In contrast, there are generally other engagements that a manager finds less attractive and is less interested in retaining. On such less desirable clients, the strength of the agency conflict is lessened, and the manager is more likely to be more accepting of budget overruns.

We conduct two experiments to investigate the influence agency incentives have on underreporting. In separate manager and partner experiments, we place participants in a scenario in which an engagement senior and her staff appear to have worked more hours than were budgeted. We ask participants to assume they are the senior's immediate supervisor (i.e., the manager on the engagement) and task them with evaluating the senior's performance. We manipulate reporting accuracy; that is, whether staff underreport (i.e., report meeting the budget) or report all the hours worked (i.e., report exceeding the budget). We also manipulate client desirability (i.e., more desirable versus less desirable).

Our results indicate that, through their evaluation of staff who exceed budget, managers are more likely to tacitly encourage underreporting (relative to accurately reporting exceeding budget) when client desirability is high. When the client is less desirable, managers' preference for underreporters dissipates (i.e., their preferences begin to reverse). These results are consistent with agency theory expectations, as managers behave more like agents, acting in their own interest when their incentives conflict with the firm's, but acting more in the firm's interest when there is no strong conflict between their incentives and the firm's. We also find that managers are more likely to request an underreporter on a future engagement. Further, we find that reporting accuracy influences managers' future staffing decisions through its effect on staff evaluations; however, this mediating relationship is moderated by client desirability (i.e., moderated mediation). Specifically, managers' evaluations of the senior's performance are more predictive of their willingness to select the senior for a future engagement when client desirability is high than when it is low.

In contrast, partners who assume the role of the senior's immediate supervisor (i.e., manager) show no preference for the underreporter, on average, either through their evaluations of the senior or their future staffing preferences. However, our results are not supportive of our predictions that partners will react to underreporting as firm guidance suggests. That is, partners in the accurate reporting condition do not evaluate the senior significantly higher, nor are they significantly more likely to request the senior for a different engagement, than those in the underreporting condition.

To explore this difference between our expected results and our observed results for partners, we examine the