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Managing audits to manage earnings: The impact of diversions on an auditor's detection of earnings management

Benjamin L. Luippold [a,*], Thomas Kida [b], M. David Piercey [b], James F. Smith [b]

[a] Babson College, United States
[b] University of Massachusetts Amherst, Isenberg School of Management, United States

ABSTRACT

This study examines an aspect of earnings management that we refer to as audit management. We define audit management as a client's strategic use of diversions to decrease the likelihood that auditors will discover earnings management during the audit. Specifically, we examine whether diverting auditors' attention to either clean financial statement accounts or accounts that contain other errors affect an auditor's ability to uncover earnings management. Auditors performed analytical review, searching financial statements for unusual fluctuations suggestive of errors. Following prior studies, we seeded an intentional accounting error which created an unusual fluctuation that allowed the client to meet an earnings target. We manipulated whether management provided a diversionary statement that explicitly identified risk in other areas of the audit, and whether those areas were clean or contained other detected errors that had no impact on earnings. We find that auditors' earnings management detection is worst when they are diverted to clean accounts and best when auditors are diverted to accounts that contain other errors. Our results suggest that managers can potentially exploit an audit management tactic as simple as a diversion to a clean area to reduce auditors' effectiveness at detecting earnings management. The implications of these findings for audit and decision making research are discussed.

Introduction

Earnings management has been a topic of great interest in both the popular press and academic literature (e.g., Chen, Kelly, & Salterio, 2011; Dechow, Hutton, Kim, & Sloan, 2012; Guerrera, 2012). In fact, attempts to manipulate financial performance have become so widespread that books have been written on earnings management strategies (e.g., Giroux, 2003; McKee, 2005). This study discusses an aspect of earnings management that we refer to as audit management. We define audit management as a client's strategic use of diversions to decrease the likelihood of auditors discovering managed earnings during the audit. Evidence suggests that managers strategically attempt to conceal earnings management (e.g., Beasley, Carcello, Hermanson, & Neal, 2010; Bowlin, Hobson, & Piercey, 2014; Knapp, 2010).

Our study investigates whether managers who manipulate earnings can successfully employ diversions to influence auditors' detection of unusual fluctuations during analytical review. That is, we investigate whether diversionary statements made by the client (i.e., identifying areas of risk in the financial statements to lure the auditor away from managed earnings) affect an auditor's detection of managed earnings contained elsewhere in the financial statements. In

* Corresponding author. Address: Babson College, Accounting & Law Division, Babson Park, MA 02457, United States. Tel.: +1 (781) 239 5995; fax: +1 (781) 239 5930.

E-mail addresses: bluippold@babson.edu (B.L. Luippold), tkida@isenberg.umass.edu (T. Kida), piercey@isenberg.umass.edu (M.D. Piercey), jfs@isenberg.umass.edu (J.F. Smith).

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an experiment, we seeded an earnings management error (i.e., an intentional misstatement used to meet an earnings target) into financial statements, creating an unusual fluctuation for auditors to detect.[1] We test whether auditors detect earnings management when they are diverted to: (1) accounts that contain no errors, or (2) accounts that do contain errors, but have no impact on earnings.

In the study, auditors completed analytical review procedures on the financial statements of a hypothetical client in order to determine if any unusual fluctuations (suggestive of errors) were present. In all conditions, an earnings management error (which reduced compensation expense and accruals) was embedded into the financial statements, creating an unusual fluctuation in that account that resulted in the client meeting analysts' forecasted earnings. We manipulated whether or not management provided a diversionary statement that informed the auditor of a personnel change in the department responsible for non-current assets. This statement was designed to elevate the perceived misstatement risk in that area and lure the auditor away from the earnings manipulation. We also manipulated whether the accounts in this other area identified by the diversionary statement were clean or contained other errors that offset, and therefore had no impact on earnings.

Managers may be motivated to divert auditors to areas that contain, or do not contain, other errors. For example, if managers point auditors to ostensibly risky areas that are clean, auditors may conclude that the client's accounts are likely to be accurate in other areas as well. This would most likely result in a strong diversion effect. Conversely, management may want to direct auditors to areas that contain other errors, thinking that these other errors may occupy their attention, leading auditors to feel satisfied that they are detecting misstatements and "doing their job," resulting in auditors feeling less compelled to discover other errors. However, auditors are also trained to practice professional skepticism (Nelson, 2009; Quadackers, Groot, & Wright, 2014), and the diversion to the other errors should elevate their sensitivity to the risk of material misstatement in the remainder of the financial statements, resulting in greater overall audit effort and a greater likelihood that they would find the earnings manipulation. We therefore investigate the impact of management intentionally directing auditors to both clean accounts and accounts containing errors.

Our findings are consistent with our predictions. Specifically, we find that auditors' detection of earnings management was worst when they were diverted to clean financial statement accounts, and best when they were diverted to accounts containing other errors, with earnings management detection in between these levels when no diversions were used (whether other errors were present or not). Overall, these results suggest that if management directs auditors to accounts that contain errors, the discovery of those errors heightens their sensitivity to errors in other areas of the audit. However, if auditors are directed to clean accounts, the use of diversionary statements can deter auditors from finding earnings management. These findings have significant implications for auditors and decision researchers in general.

Testing diversions to accounts both with and without other errors allows us to demonstrate significantly different reactions from auditors to two basic strategies that management could use to divert auditors from an area used to manage earnings. The different effects also provide possible insight into why diversions to clean areas may be an effective means of concealing earnings management. On one hand, even though the other errors do not impact earnings, diverting auditors toward them increases auditors' sensitivity to the risk of material misstatement in other areas of the audit. In contrast, diverting auditors to ostensibly risky areas that turn out to be clean appears to make those auditors less vigilant in their search for errors elsewhere in the financial statements. These results suggest that managers can potentially exploit an audit management tactic as simple as a diversion to a clean area because such a diversion reduces auditors' effectiveness at detecting earnings management elsewhere in the financial statements. This extends the literature on auditor skepticism by identifying one type of claim that managers could make to mislead auditors without raising red flags (Nelson, 2009; Quadackers et al., 2014). Additionally, it contributes to the accounting literature on auditing and earnings management with evidence of how managers can conceal material misstatements from auditors in order to manage earnings (Beasley et al., 2010; Beasley, Carcello, Hermanson, & Lapides, 2000; Boone, Khurana, & Raman, 2012; Caramanis & Lennox, 2008; Chen et al., 2011).

Our study also contributes to decision making research (in both psychology and auditing) that investigates the effectiveness of diversionary tactics. As we explain in Section 'Background literature', psychology literature on distraction suggests that diversions to other errors would be an effective means of concealing earnings management. In contrast, our finding that earnings management detection is greatest when auditors are diverted to accounts that contain errors suggests that our context provides a boundary condition to the predictions of the psychology literature on distractions, based on the task-specific experience of auditors and their reaction to the other errors. Furthermore, our findings contribute to the accounting and psychology literature on information pursuit effects (Bastardi & Shafir, 1998, 2000; Nelson & Tayler, 2007; Redelmeier, Shafir, & Aujla, 2001), by demonstrating how management diverting auditors to search other accounts can amplify auditors' reactions to what is (or to what is not) in those other accounts. Thus, we not only contribute to the accounting literature on earnings management and auditing, we also contribute to the general judgment and decision making literature on diversion, distraction, and information pursuit effects.

Diversions can have important practical implications beyond the setting of deliberate earnings management. For example, even when managers are not deliberately managing earnings with a particular account, they may still prefer that auditors pay more attention to areas where

[1] While auditing standards typically characterize unintentional misstatements as errors and intentional misstatements as fraud, we use the term error in its more generic sense to refer to any departure from accuracy.