AUD

Auditing

Code: **AUD001** Day: **Wednesday**
Abstract ID: **0194** Time: **16.00-17.30**
Room: **Q013**

Accountants' Value Preferences and Moral Reasoning

Mohammad J. Abdolmohammadi
(mabdolmo@bentley.edu)
Bentley College, Waltham, MA
Co-author(s): **C. Richard Baker**

This paper examines the relationship between accountants' personal values and their moral reasoning. In particular, we hypothesize that there may be an inverse relationship between accountants' "Conformity" values and moral reasoning. This is important because the literature suggests that accountants' conformity with rule-based standards may be one reason for their relatively lower scores on instruments that measure moral reasoning. We administered the Rokeach Values Survey (Rokeach 1973) and the Defining Issues Test (Rest 1979) to 164 graduating accounting students enrolled in courses at two universities in the US. As entrants into the accounting profession these subjects bring their values and moral reasoning to bear on their judgments and decisions in the workplace. We collected data at the beginning and the end of the semester to determine the test-retest reliability of our measurements. We find a highly significant inverse relationship between "Conformity" values and moral reasoning, however we also find that in a general sense graduating accounting students do not prefer Conformity above other personal values such as Self-actualization and Idealism. We also find positive relationships between accountants' Self-actualization and Idealism values and their moral reasoning. Implications for instruction and research are discussed.

Code: **AUD002** Day: **Wednesday**
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Room: **Q013**

The Role of Country and Firm-Specific Factors in the Voluntary Demand for Independent Audits

Jere Francis
(francis@missouri.edu)
University of Missouri
Co-author(s): **Inder Khurana***,* **Xiumin Martin, Raynolde Pereira**

Using a World Bank sample of 5,082 private firms from 62 widely diverse countries, we report three primary findings. First, we find that firm-specific incentives relating to agency costs are significant in explaining the voluntary use of audits around the world, irrespective of country level institutional differences. Second, more general country level factors are also significant in explaining voluntary audits. Third, both firm-specific and country factors have significant explanatory power over either set of these two factors alone. However, country factors consistently dominate firm-specific incentives in explaining the use of voluntary audits, and this result holds when the sample countries are partitioned into high and low levels of economic development based on per capita GDP. Country factors have more than seven times the explanatory power relative to firm factors in countries with high economic development, and about 60 percent more explanatory power in countries with low economic development. We interpret these results as providing evidence that governance structures (including accounting and auditing) are largely endogenous to a country's legal and institutional environment. That is, governance structures are generally of higher quality in countries that have stronger legal systems and other institutions that support private contracting. The corollary of course is that governance (and accounting) is weaker is less developed countries that typically have weaker institutions. Thus the study provides evidence questioning if higher quality governance practices can be effectively mandated absent the enabling country level institutions that make such practices credible and the net payoffs positive from improved governance structures.

Code: **AUD003** Day: **Wednesday**
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Mandatory audit firm rotation in Spain: A policy that was never applied

Nieves Carrera
(nieves.carrera@ie.edu)
Instituto de Empresa Business School, Madrid
Co-author(s): **Emiliano Ruiz-Barbadillo***,* **Christopher Humphrey, Nieves Gomez-Aguilar**

In recent debates on mandatory auditor rotation, Spain has assumed a real prominence as a claimed practical example of where mandatory auditor rotation did not work and was duly abolished. The main objective of this paper is to demonstrate that at no stage was the mandatory rotation requirement enforced on Spanish auditors. Further, the revision and removal of the Spanish law on mandatory auditor rotation have been rather politicised processes, which have made little reference to Spanish audit experience. Indeed, while Spain has been cited internationally for rejecting mandatory rotation on empirical grounds, the paper shows how Spanish political parties and regulators have recently been debating whether to "re-introduce" such a regulation. The evidence in this paper derives from congressional hearings, financial newspapers and documents produced by the professional associations of auditors in Spain. After examining the Spanish experience with mandatory audit firm rotation, the clear implication of our study is that considerable caution needs to be taken in today's international auditing arena when analysing the standpoints and claims made by professional associations and the evidence they provide to support their arguments for and against regulatory reform.

Code: **AUD004** Day: **Wednesday**
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Room: **Q114**

The determinants of the choice of joint-auditors by French listed companies

Sophie Marmousez
(marmousezs@hec.fr)
HEC School of Management, Paris

We examine the determinants of the choice of joint-auditors by French listed companies, since, according to French law, every listed company is required to hire two auditors performing together the audit. In the prior literature on accounting choices, some studies examined the choice of auditor. However, the choice of joint-auditors, as a practice specific to France, seems to have been ignored. Thus our paper contributes to the literature by utilizing a unique legal background. It is generally acknowledged that audit market is segmented into at least two categories: large (Big 4) and small (non-Big 4) auditors. We expect that the choice of auditors is related to some characteristics of the auditee: size, listing on American or English markets, internationalization degree, ownership structure, leverage, proportion of intangible assets, and profitability. We test our hypotheses on a sample of 179 listed companies of the SBF 250 index on 31 December 2003. Our test uses an ordinal logistic regression with a dependant variable that consists of a measure of the choice of joint-auditors and our hypothesized variables (size, leverage, etc.) as independent variables. Final results provide evidence that size, internationalisation degree and ownership structure are associated with the choice of joint-auditors. The choice model indicates that firms characterized as relatively larger and more international, not controlled by inside shareholders are more likely to choose two Big 4 auditors.

Code: **AUD005** Day: **Wednesday**
Abstract ID: **0913** Time: **16.00-17.30**
Room: **Q114**

Lending relationships, IPOs, and the effect of auditor quality on costs of debt

Monika Causholli
(monika.causholli@cba.ufl.edu)
University of Florida, Gainesville
Co-author(s): **Robert Knechel**

In this paper, we use a sample of U.S. initial public offerings (IPOs) from 1986 to 1998 to re-examine the question of whether young firms can benefit from the presence of a Big Six auditor in the form of lower cost of debt financing. We attempt to incorporate in the study the newly issued public firms' existing banking relationships. Additionally, we consider use of equity proceeds in debt reduction, as another factor suggested by Pagano *et al.* (1998) to affect costs of debt at IPO time. Consistent with prior literature, we find that: (1) firms that are young at IPO time pay higher interest rates; (2) use of equity proceeds in debt reduction is significantly associated with lower costs of debt financing; (3) after accounting for use of equity proceeds, auditor reputation plays a very significant role in lowering the cost of debt financing; (4) older firms benefit more than younger firms from the presence of a reputable auditor.

Code: **AUD006** Day: **Wednesday**
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Room: **Q114**

Does the Capital Market price the Statutory Audit? Evidence from ComRoad

Joerg Richard Werner
(jrwerner@uni-bremen.de)
University of Bremen
Co-author(s): **Jochen Zimmermann**

Recent accounting scandals have often been connected with audit failures. These audit failures provide a unique opportunity to investigate into the role of the statutory audit as a collapse of the independent assessment mechanism signals the value increment of the audit. In our paper, we analyse the case of ComRoad, one of the major German accounting scandals. The auditor KPMG failed to detect ComRoad's fraudulent accounting over several years. We investigate the German capital market, namely the segments of DAX, MDAX and NEMAX in the year 2002, when the audit failure became public. In an event study, we show how the breaking scandal tarnished the reputation of all reports that were audited by KPMG and that, by losing the value increment of the statutory audit, KPMG's clients suffered from significantly lower excess returns.

Code: **AUD007** Day: **Wednesday**
Abstract ID: **0158** Time: **16.00-17.30**
Room: **Q115**

Gendered career rein: A gender analysis of the certification process of auditors in Sweden

Sven-Olof Collin
(sven-olof.collin@e.hkr.se)
Kristianstad University College
Co-author(s): **Karin Jonnergård, Pernilla Qvick, Betina Silferberg, Sevdia Zabit**

The accounting and auditing business has been claimed to be a gendered industry. Even though as many women as men enter the business, high positions as partnerships appear as a privilege for men. Earlier research has indicated that this selection process starts early on the career ladder. In this paper we investigate the gendered character of the early phase of qualification to become certified auditor. We offer a set of hypotheses that predict certification time, with special emphasis on the gendered character of the factors. We test the hypotheses on the population of newly certified auditors in Sweden. The results indicate that there are differences between the sexes, but that the factors even out each other, implying no important difference in certification time. We conclude that there is a slight gendered career rein. An interesting feature of the model is that it can explain more of male than female certification time, thus implying that even the theory offered is gendered.

Code: **AUD008** Day: **Wednesday**
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Room: **Q115**

Changes in the Market Reaction to Audit Opinions in China

Robert Czernkowski
(r.czernkowski@unsw.edu.au)
University of New South Wales, Sydney
Co-author(s): **Yi Wang, Wendy Green**

This study examines the response of the market to qualified audit opinions of companies listed on the Shanghai Stock Exchange after the introduction of several key regulatory changes. The comparison of the results for the period 1999-2003 to earlier studies provides evidence of changes to market valuation of the audit and assurance function. Further, through the examination of market reactions to avoidable and unavoidable audit opinions the study provides an empirical application of the Melumad and Ziv (1997) theoretical model. In addition, both the form and content of the audit opinions are examined. Finally, the study refines the market reaction models used in earlier studies through the introduction of additional explanatory variables, such as the Chinese "special treatment" status. A sample of 3128 company/year audit opinions are examined, with 386 modified audit opinions and 2742 unqualified audit opinions. Overall, the findings of this study suggest that the value placed on audit opinions by the Chinese market has changed since earlier studies. Further, when modified audit opinions are classified by type, the market reacts to the severest forms of audit opinions: going concern opinions, qualified opinions with explanatory notes and disclaimers. In addition, the study provides evidence of different market reactions to opinions with different information content.

Code: **AUD009** Day: **Wednesday**
Abstract ID: **0914** Time: **16.00-17.30**
Room: **Q115**

Perceptions of Audit Quality, three years after the Fall: Views of Auditors, Auditees and Investors

Angus Duff
(angus.duff@paisley.ac.uk)
University of Paisley, Ayr

This paper considers perceptions of audit service quality attributes based on questionnaire responses from the perspective of three groups: 183 audit engagement partners in the UK (auditors), 121 finance directors of listed UK companies (auditees) and 111 UK-based fund managers (investors), sampled in February 2005. Responses are compared to a similar questionnaire study (Duff, 2004) sampling similar audit market participants (121 auditors, 75 auditees and 74 investors) in February 2002, coincident with the Enron/Andersen debacle. Audit service quality is measured using *AUDITQUAL* (Duff, 2004), with factors labelled: Reputation, Capability and Assurance (Technical Qualities); Empathy and Responsiveness (Service Qualities); and Expertise and Experience (Auditee/Auditor Relationship) and a uni-dimensional Independence factor. Insights emerge from temporal and group differences. The revised *AUDITQUAL* model is applicable to both 2002 and 2005 datasets, with minor factorial non-invariance found across the two times of administration for auditee and auditor samples, and invariance demonstrated for the investor sample in 2002 and 2005. Second, inter-group factorial differences are attenuated from 2002 to 2005, with eight parameters non-invariant in 2005, compared with 12 (of 25) non-invariant parameters in 2002, indicating groups have a more common understanding of the attributes of audit service quality. Third, mean scores on 'technical' audit factors (Technical Qualities, Auditor/Auditee Relationship, Independence) fell from 2002 to 2005, while Service Qualities mean scores rose from 2002 to 2005 for each of the three groups.

Code: **AUD010** Day: **Wednesday**
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Room: **Q115**

The determinants of auditor changes in the voluntary sector: Evidence from UK charities

Walter Masocha
(walter.masocha@stir.ac.uk)
University of Stirling
Co-author(s): **Alan Goodacre, Vivien Beattie**

The market for audit services in any given country comprises distinct sub-markets, typically listed private sector, unlisted private sector, charity and non-charity not-for-profit. Audit market research has focused heavily on the private sector. Auditor change studies have examined a wide range of factors that could trigger a change decision, including agency variables, corporate governance characteristics, top management changes and opinion shopping. However, to our knowledge, no study has previously examined auditor changes in the charity sector in any country. The objective of the present paper is to investigate the generalisability of auditor change determinant models developed in the private sector and to identify factors that are peculiar to the charity sector. Based on a large dataset of 276 UK charities (138 that changed auditor between 1999 and 2003 and a matched set of charities), this study develops a logit regression model of the determinants of auditor change. The results show that charities are more likely to change auditor if the incumbent auditor is 'top tier', if the new auditor has greater expertise in the charity sector, if the charity has an audit committee and if the charity income has fallen significantly. In contrast with the private sector, the desire to reduce the audit fee is not a determinant of change. This probably reflects the relatively low audit fees paid by charities.

Code: **AUD011** Day: **Wednesday**
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Room: **Q115**

Six pathways to explain auditors' ethical behavior in the going concern task

Andres Guiral
(andresg@ucr.edu)
University of California, Riverside
Co-author(s): **Waymond Rodgers, Jose Antonio Gonzalo**

Theory predicts that auditor-reporting behavior may be influenced by the perceived consequences of disclosing going-concern opinions uncertainty in the audit report. Some empirical results have found a relationship between economic and cultural incentives and the propensity to issue going concern opinions, such as client loss, audit fees, the fulfilling prophecy, loss of reputation, exposure to lawsuits risk, etc. Previous research has illustrated an ethical analysis of the dilemmas faced by auditors in the going concern decision using only two streams of Western ethical thought: deontology and consequentialism. We build on previous research analyzing auditors' ethical behavior regarding the going concern opinion in a Throughput Model. Six pathways (ethics of care philosophy, deontology point of view, psychological egoism, relativism perspective, utilitarian position and virtue ethics outlook) highlight how different philosophical perspectives may be used to explain the controversial auditor's going concern decision.

Code: **AUD012** Day: **Thursday**
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Room: **Q114**

Is Mandated Internal Control Reporting Necessary? The Experience of Listed Dutch Companies

Rogier Deumes
(r.deumes@aim.unimaas.nl)
University Maastricht
Co-author(s): **Robert Knechel**

The purpose of this study is to examine voluntary reporting on internal control as a monitoring mechanism to reduce agency costs. Theoretical and empirical agency literature has shown that company management voluntarily adopts monitoring mechanisms in the presence of potential agency problems. By testing the hypothesis that company management voluntarily reports more (less) on internal control in the annual report if agency problems are higher (lower), this study examines whether voluntary reporting on internal control serves as a monitoring mechanism. Company characteristics proxy for agency problems and a disclosure index measures the extent of voluntary reporting on internal control. The sample consists of Dutch companies listed on the Amsterdam Stock Exchange during the period 1997 to 1999. While the Sarbanes-Oxley Act of 2002 has settled the issue in the US for the time being, the debate about internal control reporting continues. A study of voluntary reports can inform the debate about mandatory reporting by providing insight into the costs and benefits of internal control reporting. The main results indicate that voluntary reporting on internal control can be viewed as a monitoring mechanism. Controlling for other factors, the extent of reporting on internal control is systematically related to company characteristics that proxy for agency problems.

Code: **AUD013** Day: **Thursday**
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Room: **Q114**

Does Auditor Rotation Influence Audit Quality: The Contested Hypotheses Tested on Swedish Data

Tagesson Torbjörn,
(torbjorn.tagesson@e.hkr.se)
Kristianstad University
Co-author(s): **Sjödahl Linus, Olsson Hanna, Svensson Johan, Sven-Olof Collin**

Auditor independence is considered a key factor when ensuring high audit quality. Advocates for auditor rotation argue that rotation improves audit quality due to its positive influence on auditor independence. Opponents argue that rotation does not lead to improved audit quality, since the independence is gained at the expense of the auditors' knowledge of business structure and routines. The aim of our study is to investigate the relationship between rotation and audit quality. We use agency theory to derive the advocate view and stewardship theory to derive the opponents' hypothesis. These hypotheses were tested on Swedish data. The results indicate only weak support for the hypothesis that rotation influence audit quality. The weakness is partly due to measurement problems. The proxies used in the literature appear to measure different facets of audit quality. Through an interpretation of a factor analysis, we suggest two main facets, perceived audit quality, which is significantly influenced by auditor rotation, and actual audit quality, which is not influenced by rotation.

Code: **AUD014** Day: **Thursday**
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Room: **Q114**

An Exploration of the Effectiveness of Audit Committees in Saudi Arabia: Some Empirical Evidence

Ehsan Al-Moataz
(ealmoataz@yahoo.com)
Umm Al-Qura University, Makkah, Saudi Arabia
Co-author(s): **Andrew Higson**

The role and responsibility of audit committees has come under intense scrutiny in the last decade. As a result, the need to evaluate the effectiveness of their performance has never been a higher priority. In this study, six audit committee members, internal auditors and external auditors of Saudi corporations were interviewed (i.e. eighteen people in total). The objective of these interviews was to gain an insight into the views of the respondents about the effectiveness of audit committees as well as the problems they face in carrying out their responsibilities.
There was a consensus between respondents that audit committees have had limited success in doing what they were expected to do. Most of interviewees saw little or no advantage to having audit committees. The problems identified included: audit committees tended to have few meetings; there was usually no charter or agenda setting out the work of the audit committee; the committees usually comprise the chief executive directors and other directors from the board and other members were often chosen on the basis of friendship.
The growing acknowledgement of the importance of corporate governance has resulted in ideas and procedures that were once the preserve of very large Western corporations being adopted more generally worldwide. Very little attention has been paid to the appropriateness of such developments – it has almost been taken for granted that such developments are beneficial.

Code: **AUD015** Day: **Thursday**
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Room: **Q115**

Auditors' Liability under Prospect Theory

Jochen Bigus
(jochen.bigus@uni-osnabrueck.de)
University of Osnabrück, Germany

This paper analyzes unilateral auditors' liability assuming that the auditor has preferences according to *Prospect Theory*, thus, it considers loss aversion, risk-seeking behaviour with losses and weighting of probabilities. Compared to an Expected Utility maximizer the auditor has less incentives to take care under Prospect Theory when there is strict liability or negligence with a precise standard of due care. With a vague standard of due care results are mixed. With Prospect Theory, a negligence rule induces fewer distortions than a strict liability regime.

Code: **AUD016** Day: **Thursday**
Abstract ID: **0539** Time: **9.00-10.30**
Room: **Q115**

The Effect of Different Audit Fees and Possible Legal Recourse on the Inducement of Trust in the Market: A Theory and an Experimental Examination

Tatsuhiko Kato
(cfv68230@nyc.odn.ne.jp)
Meiji University, Tokyo

The received wisdom is that a costly but high accuracy audit can induce trust in the securities market. However, in Japan apparently most of managers prefer a less costly but low accuracy audit. They tend to believe that the audit report's accuracy is not increasing, depending on the audit fees. Some people fear that this may compromise the credibility of the Japanese securities market. The aim of this paper is to examine whether introducing a high quality audit or the regal recourse can enhance trust in the securities market. Our signaling model is extended, taking into account the possible regal recourse against managers. It is based on next two assumptions. Auditing is not perfect and sometimes makes a mistake. The court can find with difficulty any proof that managers have behaved honestly, and hence sometimes investors will lose. Our model predicts that when the regal recourse is possible, it is much easier to obtain the pooling equilibrium, in which the opportunistic managers behave honestly. Our experiment is conducted based on this model. Four laboratory markets are made. In the first market auditing isn't available, while in other three each manager can voluntarily purchase it. In one of these markets he can only choose a less costly but low accuracy audit. In other two he manager can choose a more costly but high accuracy audit, too. In the last market together with auditing the regal recourse is possible.

Code: **AUD017** Day: **Thursday**
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Room: **Q115**

Audit quality and tax-induced earnings management in UK private firms

Brenda Van Tendeloo
(brenda.vantendeloo@ua.ac.be)
University of Antwerp

This paper examines audit quality and tax-induced earnings management in private firms. Prior research has shown that audit quality provides a constraint on earnings management for public firms (e.g. Becker et al., 1998; Francis et al., 1999) as well as for private firms (Van Tendeloo and Vanstraelen, 2005). Since tax incentives are expected to play a large role in private firms' earnings management behaviour, Big 4 audit firms are also expected to do a better job in constraining tax-motivated earnings management, compared to non-Big 4 audit firms. On the other hand, the provision of both audit services and tax advisory services might lead auditors to help their clients in their tax planning, hereby encouraging tax-motivated earnings management. Relying on a sample of private UK firms, this paper investigates to what extent Big 4 auditors constrain or enhance tax-motivated EM in private firms. Our results suggest that Big 4 auditors help their clients in engaging in tax-induced earnings management.

Code: **AUD018** Day: **Thursday**
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Room: **Theatre O**

Audit partner rotation, earnings quality and earnings conservatism

Donald Stokes
(Donald.Stokes@uts.edu.au)
University of Technology, Sydney.
Co-author(s): **Caitlin Ruddock, Jane Hamilton, Stephen Taylor**

We provide evidence of an association between audit partner rotation and the quality of earnings. It is a requirement for Australian firms that the engagement partner be identified by name in the annual report. Using a sample of 3,621 firm-years between 1998 and 2003, we show that audit partner changes most likely reflecting partner rotation (i.e., they are not due to a switch of audit firm) are associated with lower signed unexpected accruals, and that for Big 5 clients this relation is driven by smaller positive unexpected accruals following partner changes. This result is consistent with more conservative reporting following a rotation of audit partner, and this interpretation is further supported by evidence suggesting a significant increase in the asymmetrically timely recognition of economic losses when firms have a change of audit partner. Our tests also show that these effects occur predominantly among clients of Big 5 audit firms, and that any effect is concentrated in the latter part of our sample period, when partner rotation was a professional requirement. We therefore conclude that audit partner rotation is associated with incrementally greater conservatism in financial reporting, but only in circumstances where the ability of client firms to resist partner rotation is reduced by mandatory partner rotation requirements.

Code: **AUD019** Day: **Thursday**
Abstract ID: **0308** Time: **11.00-12.30**
Room: **Theatre O**

The probative value of audit evidence – the state of the art and avenues towards a general theory

Ulfert Gronewold
(gronew@rz.uni-potsdam.de)
University of Potsdam

Auditors must assess whether financial statements present fairly the actual state of a firm's affairs. However, this state usually belongs to the past and does not remain in existence when the audit is carried out. Thus, it can no longer be observed by the auditor. Rather, the auditor is dependent on audit evidence to draw conclusions about the relevant affairs. A correct evaluation of the evidence's probative value is crucial for audit quality, as it is indispensable for a correct reconstruction of the relevant affairs. Accordingly, professional auditing standards require auditors to assess evidence critically, including consideration of possible fraud. These requirements have been tightened particularly in response to the recent increase in financial statement manipulations. However, no established theory on this vital auditing problem is available. Prior research is scattered and scarcely noticed by today's auditing research. Scientific progress in this field requires a thorough synthesis of the scattered findings as a preparatory step for any future research. Therefore, this paper offers (1) a conceptual framework of the determining factors of audit evidence's probative value and (2) a systematic review of the relevant auditing literature. Conceptual frameworks are an important research instrument for theory development and for directing future research. Accordingly, the paper concludes with an outline of future research opportunities.

Code: **AUD020** Day: **Thursday**
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Room: **Theatre O**

Signaling in the Accountant Labor Market

John Sweeney
(jtsweeney@wsu.edu)
Washington State University
Co-author(s): **Charles Bame-Aldred**

Employers are imperfectly informed regarding the productivity of potential employees, and therefore rely on signals of quality in their hiring decisions. In this study, we investigated the signaling ability of education, professional certification, and experience on the starting salaries for over 1,000 job placements in the United States accountant labor market during the period 2000 - 2003. Our results indicated that accountants with a Big 4 background commanded an average starting salary premium exceeding $10,000 (U.S.), compared to similarly qualified job seekers without Big 4 experience. The amount of this premium varied with tenure, reaching almost $40,000 for placed accountants with over eight years of Big 4 experience. In addition, participants in the accountant labor market who were certified public accountants received, on average, a starting wage of $11,400 more than non-CPAs. Advanced education also signaled quality, as accountants holding a masters degree received approximately $7,700 more than job seekers with only the bachelors degree. Our results confirm that Big 4 experience, CPA certification, and a graduate degree serve to signal quality in the accountant labor market.

Code: **AUD021** Day: **Thursday**
Abstract ID: **0118** Time: **14.00-15.30**
Room: **Q114**

Assessment of Self, Peers, Superiors and Subordinates On Possession of Detailed Expert Audit Attributes

Mohammad J. Abdolmohammadi
(mabdolmo@bentley.edu)
Bentley College, Waltham, MA

Forty three auditors were asked to assess the degree to which they believed themselves, their peers, superiors, and subordinates possessed each of 25 attributes of expertise in auditing. Analyses of the data render four major findings. First, 16 attributes (e.g., current knowledge, problem solver) are increasingly more important for higher professional ranks and expertise levels. The remaining nine attributes that are generally innate in nature (e.g., intelligence, quick thinker) are not different. Second, perceived possession of expert attributes indicates that professional rank is a reasonable proxy for levels of expertise. Third, in comparison to expert specialists, specialty candidates over assess possession of attributes of their superiors, while competent specialists (i.e., intermediate experts) under assess possession of attributes of their superiors and subordinates. Finally, auditors' self and peer attribute possession assessments indicate a self inflated rating bias for specialty candidates and competent specialists, but not for expert specialist who assess other experts at higher levels of attribute possession than themselves. Implications for accounting practice, education and research are discussed.

Code: **AUD022** Day: **Thursday**
Abstract ID: **0198** Time: **14.00-15.30**
Room: **Q114**

The Impact of Industry Specialization on the Audit Pricing: An Empirical Analysis

Mara Cameran
(mara.cameran@unibocconi.it)
Bocconi University, Milan

Previous studies carried out in Italy show that auditor size has an impact on the audit fees paid by non-financial clients. Furthermore, following the suggestions of the more recently published articles on audit fees in specific countries (Simon and Taylor, 2002; Basioudis and Fifi, 2004) the ability of individual audit firms to extract premium rents/discounts has been investigated. It was found that large auditor premium could be attributed only to KPMG (Cameran, 2005). This study examines whether intra-Big audit fee differences is a general phenomenon or is attributable to a specific market segment. Industry specialization may impact in different ways: in Hong Kong findings for Big audit firm specialists show a fee premium and for non Big Six specialists an audit fee discount, as the result of the development of production economy as a means of securing market share through lower-priced audits (DeFond et al., 2000). In this paper the audit fees in financial industries (banks and insurances) are studied. Audit pricing model is used to test the existence of an "auditor effect". Data – 318 observations for insurances and 387 for banks referred to the years 1999-2001 – shows that in both industries there are differences in price behaviour among big audit firms. Moreover some big auditors extract premium rents, while others apply discounts.

Code: **AUD023** Day: **Thursday**
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Room: **Q114**

The effects of audit partner experience, industry specialization and client pressure on audit quality

Ann Vanstraelen
(ann.vanstraelen@ua.ac.be)
University of Antwerp
Co-author(s): **Frank Moers**, **Erik Peek, Roger Meuwissen**

This paper addresses the question to what extent audit partner experience and audit partner industry specialization influence audit quality in situations of high and low client pressure. Previous studies on audit quality have mainly been conducted at the level of the audit firm, while audits are performed by individual auditors. Ultimately, the competence and independence of the audit partner signing the audit report determine the quality of the audit. This study is based on Belgian data for the period 1999-2003. These data enable us to trace careers and construct client-portfolios of auditors. Furthermore, Belgium has a quite unique institutional characteristic in that auditors are appointed for renewable 3-year audit mandates. This allows distinguishing between high (year of mandate renewal) and low (other years of mandate) client pressure. Overall, our results show that experience as an auditor increases the level of audit quality. However, we find that in a high-pressure environment, the positive association between auditor experience and audit quality disappears. This suggests that experienced auditors are sensitive to potential client loss. With respect to audit partner industry specialization, we find that the interactive effect of industry-specific experience and client pressure on audit quality is negative. This suggests that auditors who specialize in an industry protect their investment and may yield to client pressure in audit conflict situations.

Code: **AUD024** Day: **Thursday**
Abstract ID: **0283** Time: **14.00-15.30**
Room: **Q115**

Absence of Differentiation between Big and Non-Big Auditors in the Restriction of Earnings Management: Lack of Incentives or Methodology Problem?

Manuel Cano-Rodríguez
(mcano@ujaen.es)
University of Jaén, Spain

Although the size of the auditing firm has been frequently linked to a higher audit quality, empirical works have shown that big auditors are not always more effective that non-big auditors in restricting earnings management practices. This lack of differentiation has been explained by the absence of incentives for providing a high quality audit (Kim et al., 2003). Nevertheless, results of most of these empirical papers are based on the estimation of discretionary accruals, what makes these results questionable ought to the low reliability of the discretionary accruals models. In this work, I use an alternative methodology, based on the earnings management practices for achieving targets, to a sample with low incentives for providing high quality audits. Results show (after controlling for the potential biases of taxes, the scaling variable, and self-selection bias) that big auditors restrict more effectively earnings management than non-big auditors, what contradicts the incentives hypothesis.

Code: **AUD025** Day: **Thursday**
Abstract ID: **0483** Time: **14.00-15.30**
Room: **Q115**

Determinants of audit pricing revisited: Audit-firm and partner characteristics and the Big N price premium

Marleen Willekens
(marleen.willekens@econ.kuleuven.be)
Katholieke Universiteit Leuven
Co-author(s): **Ann Gaeremynck**

Prior research into audit fees has been based on a theoretical model (Simunic 1980) which treats audit fees as the by-product of a production function. However, very little attention has been devoted to testing audit-firm characteristics, as most variables tested in audit fee research are auditee-related (i.e. size, complexity and riskiness). Most prior studies only test crude audit-firm measures, such as Big N indicator variables or audit-firm and/or partner industry specialisation measures. Significant Big N price premia and industry specialization results are then explained as the consequence of quality differentiation by the large firms (De Angelo 1981). Unlike prior studies we test the impact of a set of audit-firm cost and revenue as well as partner characteristics on audit fees. For a large sample (9,918 observations) of Belgian companies we compare the results of a traditional audit fee model including a Big N dummy as the only audit-firm characteristic, with a more refined model that includes a set of relevant audit-firm and partner characteristics. Consistent with prior research we find a significant Big N price premium when testing the traditional model (excluding the more refined audit-firm characteristics). However, this result disappears when audit-firm characteristics are added to the audit fee model. We find that – ceteris paribus – partner experience, the percentage of partner hours at audit firm level, and the percentage of total audit-firm revenue generated from other than statutory audit engagements are associated with audit fee discounts. On the contrary, audit-firm experience, partner expertise and audit-firm expertise are associated with higher audit fees.

Code: **AUD026** Day: **Thursday**
Abstract ID: **0735** Time: **14.00-15.30**
Room: **Q115**

Experimental Evidence on the Effects of Disclosing Conflict of Interest - The Influence of Experience and Reputation

Christopher Koch
(ChrKoch@sfb504.uni-mannheim.de)
Mannheim Business School
Co-author(s): **Carsten Schmidt**

Disclosure of conflict of interest is currently seen as an effective tool for ameliorating the independence of auditors. Cain, Loewenstein and Moore (2005) provide evidence for perverse effects of disclosing conflict of interest as it might change advisor's behavior negatively. With a controlled experimental design, we replicate their findings with inexperienced subjects. However, we find that as subjects gain experience these results revert and auditors give less biased advice when their conflict of interest is disclosed. This has also a positive influence on the estimates of investors. As a negative side effect, we find that such a disclosure disturbs reputation building. Our results imply that the perverse effects found by Cain et al. 2005 might be of little relevance for the audit environment where main actors are experienced. Disclosure of fees might rather be an effective tool which motivates ethical behavior of auditors though the sanctioning effects have to be considered.

Code: **AUD027** Day: **Thursday**
Abstract ID: **0114** Time: **16.00-17.30**
Room: **Q114**

Auditor merger, audit quality and audit fee: Evidence from the PricewaterhouseCoopers merger in the UK

Yuping Jia
(y.jia@uvt.nl)
Tilburg University, Netherlands
Co-author(s): **Rong Ding**

Abstract: Using UK data of publicly listed companies audited by big-X and non big-X auditors before and after the PricewaterhouseCoopers merger in 1998, we find that the audit quality (measured by earnings quality of their clients) for big-X auditors improved in the post-merger period as 1) income-decreasing mechanism (negative discretionary accruals) are used to a greater extent; 2) value relevance of earnings and earnings change (measured by R-square) significantly increased and 3) earnings smoothing becomes less prominent after the merger. Furthermore, we find evidence that in the post-merger period there is a significant increase in audit fee for PwC and other big-X client firms, which suggests that the effect of collectively enhanced market power of big-X auditors (which tends to increase audit fee) dominates the effect of cost savings from the merger (which tends to lower audit fee).

Code: **AUD028** Day: **Thursday**
Abstract ID: **0281** Time: **16.00-17.30**
Room: **Q114**

The Association between Audit Quality and Fees Paid to Auditors: Revisited

Jeong-Bon Kim
(afjbkim@inet.polyu.edu.hk)
Hong Kong Polytechnic University
Co-author(s): **Jong-Hag Choi, Yoonseok Zang**

In this paper, we develop and test the hypothesis that the incentive structure of auditors and the associated audit quality, proxied by the magnitude of opportunistic earnings management, differ systematically between the two distinct situations, that is when auditors are overpaid relative to their expectation on the normal level of fees (i.e., abnormal audit fees are positive) and when they are underpaid (i.e., abnormal fees are negative). In so doing, we first decompose realized fees into two components, namely normal fees and abnormal fees by estimating a fee expectation model that is similar to conventional fee models used in previous audit fee research. We then estimate various regressions of the magnitude of discretionary accruals on abnormal fees and other control variables, separately, for the full sample, the subsample with positive abnormal fees, and the subsample with negative abnormal fees. The results of various regressions using a sample of 9,818 firm-year observations over the 2000-2003 period reveal that the associatioon between abnormal fees and the magnitude of discretionary accrual is insignificant for the full sample, significantly positive for the subsample with positive abnormal fees, and significantly negative or insignificant for the subsample with negative abnormal fees. The above results strongly suggest that the fee-quality association is conditioned on the sign of abnormal fees or whether auditors are overpaid or underpaid. Relevant implications of our results to policy makers and academic researchers are discussed.

Code: **AUD029** Day: **Thursday**
Abstract ID: **0360** Time: **16.00-17.30**
Room: **Q114**

Evidence from the UK: Audit fees, non-audit fees, and auditor reporting on stressed companies

Ilias Basioudis
(i.g.basioudis@aston.ac.uk)
Aston Business School, Birmingham
Co-author(s): **Marshall Geiger, Vaggelis Papanastasiou**

The accounting profession has come under increased scrutiny over the past years about the growing amount of non-audit fees from audit clients and the possible negative impact of such fees on auditor independence. Providing lucrative non-audit services (NAS) to clients may make it more likely that auditors concede to the wishes of the client management. Such concerns are particularly salient in the case of reporting decisions related to going concern uncertainties for financially stressed clients. This study empirically examines assertions that auditors may act more favourably towards those clients from whom they receive higher NAS fees. We examine the audit reports rendered to financially stressed companies in the UK and the relative magnitude of non-audit fees (and audit fees) paid by such companies to their auditors. In our analysis, we control for financial stress, reporting lag, default status, and management plans. Results indicate that financially stressed companies with high audit fees are *more* likely to receive a going-concern modified (GCM) audit opinion, whereas those stressed companies with high non-audit fees are *less* likely to receive a GCM opinion. Additional analyses also provide similar conclusions, and indicate that our results are robust across alternative specifications. Overall, we find evidence of a significant adverse effect of NAS fees on auditor reporting judgments for our sample of UK distressed companies

Code: **AUD030** Day: **Thursday**
Abstract ID: **0115** Time: **16.00-17.30**
Room: **Q115**

An empirical approach to the competitiveness of the audit market: Some evidence from the leadership context in Spain

Cristina de Fuentes
(cristina.de-fuentes@uv.es)
Universidad de Valencia
Co-author(s): **Maria Antonia Garcia-Benau, Consuelo Pucheta Martinez**

Since Zeff and Fossum (1967) first showed that the majority of audit reports were signed by what have become known in the specialist literature as the ‘Big Audit Firms’ (BAF), researchers have sought to understand the structure and operation of the audit market in different countries. In part, this is because regulators have expressed concerns over the possible effects of market concentration in the hands of an ever smaller number of firms. Important in this regard are the Metcalf Report (1976), the Nera Report (1992) and the Resolution concerning the Commission Green Paper *Function, position and civil liability of the mandatory auditor in the European Union* (1977). Following the two mega-mergers of recent years, the sequence of *Big Six-Big Five-Big Four* has only served to revive such fears, as section 701 of the Sarbanes-Oxley Act 2002 vividly shows, not to mention recommendations of the Coordinating Group on Auditing and Accounting and of the Treasury Committee in the UK, as Beattie et al. (2003) recently reminded us. Curiously enough, this unease has been expressed in Spain not only by government but also by the Big Audit Firms themselves. For example, John Scott, President of KMPG, recently affirmed: *“It is unthinkable that the present concentration of the audit market will last more than four years.”* The existing literature contains studies seeking to assess the competitiveness of audit services from a variety of angles.

Code: **AUD031** Day: **Thursday**
Abstract ID: **0196** Time: **16.00-17.30**
Room: **Q115**

Audit Fee Rigidities in the Presence of Market Frictions: Evidence and Explanations

Clive Lennox
(accl@ust.hk)
HKUST Hong Kong
Co-author(s): **Andrew Ferguson, Stephen Taylor**

In a world of frictionless markets, prices would respond instantaneously to changes in demand and supply. Nevertheless, economists recognize that imperfect competition and imperfect information can cause price movements to be “sticky”. Accounting researchers have conducted many studies of audit pricing, but they have not tested whether audit fee changes are sticky and, if so, whether the stickiness is attributable to market imperfections. This study has three main findings. First, there are significant rigidities in the pricing of audit services. In particular, actual fees change much less frequently than would be expected in frictionless audit markets. Second, fee rigidity is positively associated with audit market concentration. Third, fees are more rigid in a downwards direction than in an upwards direction. The asymmetry in fee rigidity is not attributable to audit market concentration, but it is likely due to imperfect information about audit quality.

Code: **AUD032** Day: **Thursday**
Abstract ID: **0357** Time: **16.00-17.30**
Room: **Q115**

Some Evidence on the Role of Insider Share Ownership in Audit Pricing for Firms with Weak Corporate Governance

Marion Hutchinson
(m.hutchinson@business.uq.edu.au)
University of Queensland
Co-author(s): **Ferdinand Gul**

This study extends the recent literature on corporate governance risk and audit pricing by showing that different levels of insider share ownership is associated with audit pricing and that this relation is moderated by the existence of corporate governance problems. More specifically, there is a non-monotonic relation between insider share ownership and audit fees for the 1310 US firms. The results of this study also demonstrate that this non-monotonic association is more significant for firms with the corporate governance problems associated with low growth opportunities (Jensen 1986) or a dual leadership structure (CEO duality). The results also suggest, albeit indirectly, that insider ownership as a managerial incentive for reducing agency conflicts is likely to be economically irrational for firms with high growth opportunities or with a separate chairperson and CEO.

Code: **AUD033** Day: **Friday**
Abstract ID: **0313** Time: **11.00-12.30**
Room: **Q114**

The determinants of auditor change in the UK audit market

Shamharir Abidin
(sa11@stir.ac.uk)
University of Stirling
Co-author(s): **Vivien Beattie, Alan Goodacre**

Auditing has an important role in the corporate governance process and, therefore, it is important to understand why companies choose particular levels of audit assurance and why, given the costs involved, companies change their auditor. The present study uses 177 companies that changed auditor between 1999 and 2003 together with matched non-auditor change companies to develop a logit regression model of the determinants of auditor change. It examines the effect of auditee, auditor and audit characteristics on the likelihood of audit change, including consideration of the link between other governance mechanisms and auditing and the role of non-audit services. Over the period, the average rate of auditor change was 6% per annum. Internal governance issues such as audit committee independence, the duality of chairman/CEO as well as the size/quality of the incumbent auditor were found to be significant determinants. Expected future growth in the company, rather than past growth, and audit fee reduction were positively related to audit change probability. Lower perceived auditor independence, proxied by a high ratio of non-audit services to audit fees was also found to be significantly positively associated with auditor change, consistent with companies changing auditor to improve the perception of auditor independence.

Code: **AUD034** Day: **Friday**
Abstract ID: **0318** Time: **11.00-12.30**
Room: **Q114**

A Going Concern Content Analysis of Audit Reports in Bankrupt Companies

Michael Maingot
(maingot@management.uottawa.ca)
University of Ottawa
Co-author(s): **Daniel Zeghal**

The purpose of this study if to examine (1) the uncertainty indicators leading to a going concern (GC) modified audit report (2) the uncertainty conditions associated with the company's survival status (3) the uncertainty messages communicated in the audit report and in the footnotes (4) the GC situations leading to a company's ultimate failure. We selected a sample of 112 US publicly traded companies in the construction and manufacturing industries which filed for bankruptcy for the years 201, 2002 and 2003. Information was collected from annual reports on the EDGAR database. We found that companies in the GC group disclosed substantially more uncertainty conditions than the non-going concern (NGC) group. On average, the GC group disclosed 7.65 events while the NGC group disclosed 3.7 events. Companies in the two groups disclosed comparable amounts of uncertainties during the fiscal year prior to bankruptcy filing. Also, disclosure volume was similar between the two groups. The overall score of the uncertainty message communicated in the audit report and in the footnotes was similar between the GC active and the GC inactive group. For companies that did not receive a modified audit report (NGC) prior to bankruptcy filing, we found that the overall uncertainty score was similar between the NGC active and the NGC inactive group.

Code: **AUD035** Day: **Friday**
Abstract ID: **0354** Time: **11.00-12.30**
Room: **Q114**

Auditors' forecasting in going concern decisions: Framing, confidence and information processing

Andres Guiral
(andresg@ucr.edu)
University of California, Riverside
Co-author(s): **Waymond Rodgers**

Forecasts provide a key factor in determining whether a client remain a going-concern. Auditors' judgments and decision choices may be called upon to evaluate a forecast that could shed light on a company's going-concern status. This research attempts to model evaluations and choice and two additional components influencing auditors' opinions in the going concern task: decision framing (general frame and specific frame) and confidence in the decision that is made. A field experiment was conducted in which auditors assessed a company's forecasted financial statements and made a decision about whether to issue an examination report supporting the statements. A revised information processing model was presented and tested that added the roles of framing and confidence in auditors' decision making. Using PLS and ANOVA analysis, it was found that decision framing influenced auditors' perception. Further, perceived understanding influenced subsequent evaluations of the reasonableness of client-provided financial forecasts, which in turn influenced decisions about whether to issue an assurance letter supporting the forecasted financial statements.

Code: **AUD036** Day: **Friday**
Abstract ID: **0284** Time: **11.00-12.30**
Room: **Q115**

Sourcing of internal auditing: An empirical study

Anne-Marie Kruis
(anne_mk@hotmail.com)
Erasmus University Rotterdam
Co-author(s): **Hilco van Elten, Roland Speklé**

This paper studies the factors associated with organizations' internal audit sourcing decisions, building from a previous study by Widener & Selto (1999; henceforth W&S). In their study, W&S used Transaction Cost Economics (TCE) to explain the governance of internal auditing. Our study seeks to replicate their results, using newly collected data from 66 companies headquartered in the Netherlands. Our findings are supportive of W&S. Like W&S, we find asset specificity and frequency (both individually and in interaction) to be significantly associated with sourcing decisions. These findings are robust against different model specifications, and they hold across variously defined samples. We conclude that the W&S results are reproducible in different conditions, enhancing the credibility of the TCE-based explanation of organizations' internal audit sourcing practices.

Code: **AUD037** Day: **Friday**
Abstract ID: **0703** Time: **11.00-12.30**
Room: **Q115**

Enterprise Risk Management and Internal Auditing in large Italian companies: A multiple case study

Marika Arena
(marika.arena@polimi.it)
Politecnico di Milano
Co-author(s): **Giovanni Azzone**

Recent financial scandals focused increasing attention on mechanisms for providing companies reasonable assurance in the achievement of firms' business objectives; great relevance has been given to Enterprise Risk Management (ERM) and Internal Audit (IA). Though the relation between these two elements is not always clear, the publication of the CoSO ERM framework (2004) highlighted the need for its exploration. This paper reports on a study, carried out in Italy in the 2005, aimed at investigating the relation between ERM and IA in 8 non-financial Italian companies. Based on the available literature two elements were considered for exploring this relation: (1) internal auditors' role within ERM and (2) integration of ERM and IA activities. The research approach was based on a multiple case study and findings were assessed during a round table, which involved several actors of the firms analysed. A first set of results shows three different roles of internal auditors within ERM processes: (1) assurance; (2) support to the implementation, (3) process management. Second, the findings highlight two patterns in the development of ERM and internal auditing activities: (1) no integration, (2) partial integration. Third, the findings present factors driving the adoption of different solutions, which resulted related with: business culture, available competences and resources, complexity and dynamism faced by the organizations; and implications of these configurations are discussed.

Code: **AUD038** Day: **Friday**
Abstract ID: **0945** Time: **11.00-12.30**
Room: **Q115**

Continuous Monitoring of Business Process Controls: A Pilot Implementation of a Continuous Auditing System at Siemens

Michael Alles
(alles@business.rutgers.edu)
Rutgers Business School
Co-author(s): **Gerard Brennan, Alexander Kogan, Miklos Vasarhelyi**

In this paper we report on the approach we have developed and the lessons we have learned in an implementation of the monitoring and control layer for continuous monitoring of business process controls (CMBPC) in the US internal IT audit department of Siemens Corporation. The architecture developed by us implements a completely independent CMBPC system running on top of Siemens' own enterprise information system which has read-only interaction with the application tier of the enterprise system. Among our key conclusions is that "formalizability" of audit procedures and audit judgment is grossly underestimated. Additionally, while cost savings and expedience force the implementation to closely follow the existing and approved internal audit program, a certain level of reengineering of audit processes is inevitable due to the necessity to separate formalizable and non-formalizable parts of the program. Our study identifies the management of audit alarms and the prevention of the alarm floods as critical tasks in the CMBPC implementation process. We develop an approach to solving these problems utilizing the hierarchical structure of alarms and the role-based approach to assigning alarm destinations. We also discuss the content of the audit trail of CMBPC.

Code: **AUD039** Day: **Friday**
Abstract ID: **0475** Time: **14.00-15.30**
Room: **Q114**

A Risk Perspective on Fraudulent Financial Reporting

Wally Smieliauskas
(smieli@rotman.utoronto.ca)
University of Toronto

This paper analyzes the relationship of fraud risk assessments to other risk assessments by auditors. The PCAOB (2005, 17) notes this is a problem area of current practice. The major findings are as follows. First, the study identifies the crucial role of benchmarks in forensic accounting to help differentiate between intentional and unintentional misstatements. Second, the paper shows the importance of not allowing the major categories of risks identified here from getting too high. This explains the need to set acceptable levels of these risks either by standard setters as a matter of broad policy, or by individual practitioners as part of the terms of specific engagements. Third, this paper clarifies how the fraud risk of SAS No. 99 relates to the traditional audit risk model framework.

Code: **AUD040** Day: **Friday**
Abstract ID: **0685** Time: **14.00-15.30**
Room: **Q114**

Auditors and the Rhetoric of Risk: A Post-Enron Analysis

Rihab Khalifa
(rihab.khalifa@wbs.ac.uk)
Warwick Business School
Co-author(s): **Christopher Humphrey, Keith Robson**

While some commentators have suggested that the accounting profession responds somewhat rhetorically to perceived crises with a raft of technical discourses, which remain loosely coupled to changes in practice, in this paper it is evident that the profession has responded to Enron by withdrawing or downplaying a technical discourse that had been meant to prevent just such a crisis. In this paper we not only show that such discourses could 'wear out' and fade, but also demonstrate that responses from the profession to crisis, do not always end up focusing on the technicalities of audit. Further, while the profession's responses to such crisis have often been portrayed in relatively uniform terms in the auditing literature, our interviews with a range of large and small firm audit partners reflect a more disjointed, and to an extent, disinterested response. We explore the nature of such responses and what they reveal about the nature of 'crisis' in the auditing arena, the contemporary status and strength of the auditing function and the value of regulatory reform. In particular, we consider the implications for the practice of auditing if the discourse of 'technical solution' has a limited ability to function as a legitimate defence at a time of crisis.

Code: **AUD041** Day: **Friday**
Abstract ID: **0805** Time: **14.00-15.30**
Room: **Q114**

The Occurrence of Fraud and the Response of the Auditor: Empirical Evidence from the Netherlands

Roger Meuwissen
(r.meuwissen@aim.unimaas.nl)
Universiteit Maastricht
Co-author(s): **Steven Maijoor, Harold Hassink**

This paper studies the occurrence of fraud in the Netherlands in the period 1995-2002 and the response of the auditor once fraud is detected. In particular this study investigates whether auditors comply with the fraud regulation when responding to indications of fraud and what factors are the drivers of this response. We conducted a survey among all audit partners of the thirty largest Dutch audit firms. In total, 326 partners participated resulting in a response rate of 27%. Overall, the results indicate that compliance with applicable fraud regulation is mixed. Written reports to the supervisory body are required in all cases of management fraud or material fraud, but in reality are issued in 41% of the cases of management fraud and in 40% of the cases of a material fraud. Furthermore, in less than 20% of the cases where the auditor is required to report the fraud to a central governmental agency, the auditor actually reports the fraud. This non-compliance seems to be associated with the experience of the auditor, the familiarity with fraud, and the importance of the client. In particular, we find that compliance with fraud regulation is higher for more experienced auditors, for auditors who are more familiar with fraud cases, and for less important clients.

Code: **AUD042** Day: **Friday**
Abstract ID: **0770** Time: **14.00-15.30**
Room: **Q115**

Consulting Revenue Sharing, Auditor Effort and Independence, and Regulation of Auditor Compensation

Xiaohong Liu
(acliu@ust.hk)
Hong Kong University of Science and Technology, Kowloon

To mitigate the problem that the joint provision of audit and non-audit services by audit firms may provide an incentive for auditors to issue unwarranted audit opinions for fear of losing non-audit revenues, the Securities and Exchange Commission (SEC 2003) issued a new regulation that prohibits an audit partner from being compensated for the direct sale of non-audit services to audit clients. By developing a conceptual framework of the interactions among the new regulation, the profit-sharing rules of audit partnerships, and the behavior of auditors, I show the effects of such regulatory changes on partnership sharing rules and the effort and reporting decisions of auditors. I find that audit firms will strategically change their profit-sharing rules in response to the regulation that prohibits the compensation of auditors from varying with consulting revenues, and that although such a regulation encourages truthful reporting, it may have an undesired negative effect on auditor effort. I analyze the tradeoff between the benefit of the regulation that is due to the inducement to report truthfully and the cost of the regulation that is due to less diligent audit work, and derive the conditions under which the regulation can improve the welfare of the economy, which is defined as the total payoff to both audit firms and their clients.

Code: **AUD043** Day: **Friday**
Abstract ID: **0898** Time: **14.00-15.30**
Room: **Q115**

International audit firms as strategic networks – The evolution of global professional service firms

Hansrudi Lenz
(hansrudi.lenz@mail.uni-wuerzburg.de)
University Wuerzburg, Germany
Co-author(s): **Marianne James**

The evolution of large international audit firms was driven by client needs and legal regulations specific for the audit industry. The organizational structure of these professional service firms can be characterized as a specific form of a strategic network. The national member firms have to adapt to their different legal, cultural and economical national environment. In particular, the legal rules in the audit sector establish barriers of entry for foreign competitors and prevent more common forms of market entry, e.g. the acquisition of another audit firm or the establishment of a subsidiary in a foreign country. Networks of audit firms are a prime example of hybrid governance structures between markets and hierarchies and are organized by contractual relations between legal and economically autonomous partnership entities from different countries. The networks are controlled by a committee structure. Strategic decisions are made by one or more lead firms. The paper describes the governance structure of international audit firm networks. Furthermore, we analyze how coordination and incentive problems, e.g. hold-up and moral hazard situations, in this network structures are dealt with. Exclusive rights, referral work, brand names, network-specific investments and profit pooling are means to ensure that network members cooperate together.
Research method: Empirical Archival

Code: **AUD044** Day: **Friday**
Abstract ID: **1128** Time: **14.00-15.30**
Room: **Q115**

A transactions cost analysis of the associations between company characteristics and purchases of management advisory services from auditors and other consultants

Pamela Kent
(p.kent@business.uq.edu.au)
University of Queensland
Co-author(s): **Andrew Carrick**

This study, using transaction cost economics as a theoretical framework, seeks an understanding of a company's decision to purchase Management Advisory Services (MAS) from their auditor and other consultants. Results using Australian company observations show that factors that influence a company's decision to purchase external MAS include: organizational structure, size, internal change and rate of growth. Other factors relating to the decision to purchase MAS from their auditors and other consultants include leverage, industry, return on assets, auditor ("big five", "non- big five") and audit report (qualified/unqualified).