

If auditors are like Belgian beers, which style would you prefer?

Discussion of “Auditor style and financial statement comparability” by Francis, Pinnuck, and Watanabe (2014)

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SUMMARY Recent research by Francis, Pinnuck, and Watanabe (2014) has shown that financial reporting outcomes are influenced by the audit firm’s unique audit style. They argue that audit firm styles are driven by their “unique set of internal working rules that guide the auditor’s application of accounting and auditing standards” (Francis, Pinnuck & Watanabe, 2014). In our discussion, we zoom in on this study and call for further research on the factors that determine audit styles. Specifically, we emphasize the importance of extending this research from the audit firm level to the level of the audit office, audit team, and individual auditor. We conclude with the notion that intense collaboration between audit firms and academia is instrumental in opening the black box of audit styles to extend our knowledge on the root causes and drivers of audit quality.

PRACTICAL RELEVANCE Extending our knowledge on the factors that shape audit styles as well as their effects on the audit process and audit quality is important to improve (or safeguard) audit quality. Specifically, a deeper understanding of audit styles at the level of the audit firm, audit team or individual auditor and its implications for the audit process and audit quality might assist audit firms in optimizing their client-firm matching, audit methodology, audit team compositions as well as audit staff hiring, performance appraisal, and promotion decisions.

1 Introduction

In their paper “Auditor Style and Financial Statement Comparability”, Francis, Pinnuck, and Watanabe (2014) (hereafter: FPW) investigate whether financial reporting outcomes are influenced by the audit firm’s unique audit style. They measure style at the audit firm level, assuming that differences in audit styles are a consequence of firm-specific working rules, guidelines, and templates (i.e., audit methodology) that influence the interpretation and application of auditing stand-

ards. FPW examine the effect of audit style differences by analysing earnings comparability of clients audited by the same auditor in the same industry and fiscal year (i.e., the closeness of two firms’ reported earnings). The findings of this study, and his ongoing research, were presented by Jere Francis at the Foundation for Auditing Research (FAR) Conference on May 9, 2016. FPW’s findings indicate that, despite the existence of general auditing standards, each audit firm has its own unique audit style and, as such, they provide evidence of “a new channel through which auditor characteristics affect audited financial statements” (Francis, Pinnuck & Watanabe, 2014, p. 607). This interesting finding generates numerous opportunities for future research on the drivers and consequences of different audit styles.

In our discussion, we zoom in on FPW’s research question and findings, and call for further research on the factors that shape and define audit styles. Throughout this article, we use the analogy with Belgian beers, as they can be categorized in style groups according to colour, flavour, strength, ingredients, production method, recipe, history, or origin (Wikipedia, n.d.). Just like there is no single ingredient that determines a beer’s aroma, appearance, and flavour, there are numerous factors at the level of the audit firm, office, audit team and individual auditor that shape and define audit styles. We argue that a thorough understanding of the drivers and financial reporting consequences of these unique styles is important as audit firms may use these insights to improve and safeguard audit quality. Specifically, audit firms may optimize their style by changing the ingredients (e.g., the audit team, the individual audit partner) or production process (e.g., audit methodology) in order to improve their audit quality. Therefore we need to dig deeper into the specificities of audit styles at various levels of analysis (firm, office, team, individual auditor) and its influences on financial reporting and audit quality.

We structure our article as follows. In section 2, we dis-

cuss recent research on audit styles at the level of the audit firm and office, and call for research that investigates audit styles at the audit team and individual level. In this section, we provide a summary of FPW's findings as well as a discussion of their study. Based on prior research, we also provide insights into contextual factors that are likely to influence individual audit styles. In section 3, we provide suggestions to open the black box of audit styles and highlight the need for a strong collaboration between the auditing profession and academia. Finally, we conclude our article in section 4.

2 Audit styles at various levels of analysis

2.1 Summary of FPW's findings on audit styles at the audit firm level

FPW examine the effects of audit styles on financial statement comparability at the audit firm level. They assume that each Big 4 firm has its own audit style as a result of unique in-house working rules (i.e., firm-specific audit methodology) that guide the auditors in interpreting and applying auditing and accounting standards. As such, they expect a pair of companies audited by the same Big 4 firm to have more comparable earnings than a pair of companies audited by two different Big 4 firms. Using U.S. data from 1987 through 2011, FPW measure accounting comparability in three ways. First, they examine cross-sectional similarities of total and abnormal accruals for firm-pairs in the same industry using the same Big 4 auditor versus firm-pairs with two different Big 4 auditors. Second, they measure the degree to which earnings of a pair of companies in the same industry and audited by the same Big 4 auditor, covary across time. Third, they test whether audit firm indicator variables are helpful in explaining the level of accruals reported by each individual client firm. In a nutshell, FPW's findings show that two companies in the same industry and year indeed have more comparable earnings when they are audited by the same Big 4 audit firm, which suggests that audit clients are subject to specific audit firm styles.

In the second part of the study, FPW test whether companies audited by the same Big 4 auditor have more comparable earnings than companies audited by the same Non-Big 4 auditor. FPW expect that Big 4 audit firms have a greater capacity to incur the fixed costs associated with developing and implementing in-house standardized rules for implementing auditing and accounting standards compared to Non-Big 4 firms. Moreover, as a result of their larger and more dispersed staff, Big 4 firms are also likely to have a greater need for controls that guide professionals in interpreting these standards than Non-Big 4 firms. Consistent with this line of reasoning, FPW report weak but significant evidence that audit styles at Big 4 firms indeed have

a greater effect on accounting comparability, compared to audit styles at Non-Big 4 firms.

2.2 Discussion of FPW's findings

Overall, FPW's findings are important for our understanding of the role of large audit firms in producing financial statement comparability. Although FPW provide some insights into the term "audit style", many questions are spurred by their findings, providing opportunities for future research. For example, 'what is an audit style?', 'why would an audit style occur at the firm level given that auditors and audit engagements are unique?', 'what are the drivers of audit styles?', 'what are the differences in audit styles between audit firms?', 'do audit styles influence the audit process and ultimately audit quality?', 'how do different styles between audit partner and engagement team members interact with the style of the client (e.g., negotiation strategy)?', 'are audit styles observable for the client and do they influence auditor retention decisions or audit fees?', 'how can audit firms mitigate any adverse effects of audit styles?'. Following our analogy between audit styles and Belgian beers, we call for further research into the ingredients, processes, and circumstances that lead to specific flavours, types, and styles as well as variations in the level of quality of the delivered product.

On a more critical note, the finding that financial reporting outcomes are influenced by audit firm style seems to be at odds with the idiosyncratic nature of audit engagements. The outcome of an audit is not only influenced by audit firm policies and internal working rules, but also by client characteristics, audit teams, and the timing and extent of planned audit procedures (Knechel, Krishnan, Pevzner, Shefchik & Velury, 2013). One of FPW's robustness tests provide support for this view by showing that the audit style effect does not apply to non-routine transitory transactions. Hence, future research may zoom in on the factors that shape audit styles at the level of the audit team and individual auditor, and on identifying specific (decision-making) contexts where style effects are most likely to occur and influence audit quality.

The results of FPW also indicate that companies audited by the same Big 4 auditor have more comparable earnings than companies audited by the same Non-Big 4 auditor. Although their explanation for this finding seems logical (i.e., the greater capacity of Big 4 auditors to incur the fixed costs in developing in-house standardized rules), there might be alternative explanations for this effect, such as differences in team composition and client acceptance decisions between firms or self-selection of certain types of professionals and clients into different types of audit firms.

Following up on the issue of self-selection, FPW acknowledge that clients are not randomly assigned to

an auditor, rather, they choose one. In their study, this issue is addressed by considering motives for a client choosing a particular auditor based on its accounting production function. Specifically, they removed firm-pairs that were audited by industry specialist auditors from the sample, as well as firm-pairs that constituted of close competitors. Although the main results remained unchanged, these tests did not consider other audit firm-specific factors that might influence auditor-client matching. As mentioned previously, audit firms are likely to attract auditing professionals with a certain profile and set of skills and traits (i.e., individual style) and have their own policies regarding client acceptance. Furthermore, as suggested by participants at the FAR conference, client-partner matching is an important quality monitoring tool for audit firms. That is, in assigning audit clients to audit partners, firms take the profiles of both the client and the audit partner into consideration (e.g., personality, expertise, past experience) when assessing the appropriateness of a specific match. This view is consistent with prior research on auditor-client negotiating (Fu, Tan & Zhang, 2011; Brown & Wright, 2008; Hatfield, Agoglia & Sanchez, 2008), showing that potential effectiveness and efficiency gains are achieved when there is a match between auditor negotiating experience and client negotiating style. Overall, this line of thought supports our call for further research on audit style effects at the team and individual auditor level. Indeed, future research is needed to explore various audit styles and its relationships with client-partner matching decisions, the audit process, and audit quality.

Finally, although FPW assume that firm-specific audit styles are shaped by standardized interpretations and applications of auditing and accounting standards, the study remains silent on the various types of audit styles, the specific aspects of audit styles that are most likely to influence financial statement outcomes, and how audit styles differ among audit firms. A reason for the difficulty in addressing these issues might be that audit styles are not readily observable. This is consistent with the view that a financial statement audit is considered a credence good where outcome quality (and hence also audit style) is unobservable (Knechel et al., 2013; Causholli & Knechel, 2012). Unlike Belgian beers where style differences are apparent, it is hard to define and observe variations in audit styles and audit outcomes among the Big 4 firms because they all use the same language in their audit reports and have the reputation of a high quality global accounting service provider. Of note, the recent development of disclosing key audit matters in the auditor's report creates opportunities for large audit firms to show their audit style (IAASB, 2015), providing new avenues to study such style differences.

2.3 Audit styles at the office level

Kawada (2014) extends the research of FPW by analysing the effects of audit styles on earnings comparability at the *local office level*. He shows that two companies in the same industry and year have more comparable earnings when they are audited by the same local Big 4 office compared to firms audited by different offices of the same audit firm. These results suggest that the audit firm style effects documented by FPW are (at least partially) attributable to practices at the audit office level. Kawada (2014) explains the existence of audit styles at the office level by referring to localized training (i.e., conducted by each practice office) on the implementation of the firm's overall audit methodology. Although the study by Kawada (2014) does not consider audit styles at the audit partner level, he points at the importance of the individual auditor in the context of financial statement comparability. This is consistent with some archival auditing studies (Hardies, Breesch & Branson, 2016; Aobdia, Lin & Petacchi, 2015; Knechel, Vanstraelen & Zerni, 2015; Gul, Wu & Yang, 2013; Chen, Sun & Wu, 2010), which show that an analysis of audit partner characteristics provides a stronger test in explaining audit quality differences compared to analysing auditor characteristics measured at the office or audit firm level. Hay, Knechel, and Willekens (2014, p. 351) similarly emphasize the importance of the individual auditor and state that "because the audit is a human activity conducted by individual auditors, the quality of a specific audit is conditional on individual auditor characteristics and the incentives that auditors face". This is also consistent with prior research, which usually focuses on the individual auditor as a unit of analysis when investigating auditor judgement and decision making (Bonner, 2008; Nelson & Tan, 2005; Libby & Luft, 1993; Wallman, 1996). Therefore, as we will argue, the audit is likely influenced by audit styles at the individual or team level, perhaps even more heavily than audit styles at the firm or office level.

2.4 Audit styles at the team and individual level: A fruitful avenue for future research

Although factors at the firm and office level are important in determining audit styles, we argue that it is equally (if not more) important to also consider factors at the team and individual level. As with Belgian beers, it is not just the brewery (i.e., the audit firm) that determines the style but also the ingredients (e.g., the client, the audit team, and the individual audit partner) and the production method (i.e., audit methodology). At the team level, review styles and team leadership styles are important factors that influence the audit process and ultimately audit quality. Review styles refer to individual differences in working practices and preferences regarding the review of audit

working papers. Prior research shows that there is substantial variation in review styles at the audit partner level (Pierce & Sweeney, 2005; Gibbins & Trotman, 2002), and that audit partners and managers change their review style based on the contextual factors of the audit engagement (e.g., client risk, time budget pressure, experience, goals of preparers). As Rich, Solomon, and Trotman (1997) argue, junior auditors even anticipate the manager's review style and ex-ante stylize the content and format of their working papers by choosing the type of audit evidence, how it is gathered and interpreted, selecting documentation type, and determining the order and frame in which the evidence is presented. Overall, these findings indicate that review styles are different at the team level and that team members respond to the style of the reviewer by changing the extent and documentation of the audit work which potentially affects audit quality.

Team leadership styles refer to differences in the way the (senior) manager or audit partner leads the audit team. Prior research in management shows that team leaders play an important role in team performance and effectiveness by composing the team, structuring the work, providing feedback, challenging team members, and managing relationships within the organisation (Morgeson, DeRue & Karam; 2010; Burke et al., 2006). Similarly, prior research in auditing highlights the importance of audit team leadership (e.g., Pierce & Sweeney, 2005; Otley & Pierce, 1996; Kelley & Margheim, 1990), and the role of the auditor-in-charge (e.g. Bik and Hooghiemstra 2016; Gold, Gronewold & Salterio, 2014; Sweeney, Arnold & Pierce, 2010; Jenkins, Deis, Bedard & Curtis, 2008). For example, Otley and Pierce (1996) show that a leadership style characterized by high levels of consideration towards junior auditors is associated with less dysfunctional audit behaviour (an example of dysfunctional audit behavior is the superficial review of documents) as it generates mutual trust, respect, and motivation. Given that these studies provide evidence of the influence of team leadership styles on the behaviour of team members, we expect team leadership as well as characteristics of the auditor-in-charge to have a substantial effect on audit styles, and subsequently on audit quality.

At the individual level, audit styles are likely to be determined by factors such as personality and cognitive styles. Cognitive styles refer to individual differences in the acquisition, processing, storing, and transmission of information (Fuller & Kaplan, 2004; Gul, 1984) and are typically influenced by specific task attributes, personality traits, and experience (Bryant, Murthy & Wheeler, 2009; Pincus, 1990; Bernardi, 1994; Gul, 1984). Examples of cognitive style aspects that have been shown to have an effect on the audit process and audit outcomes are moral development (Bernardi, 1994), focus on facts and details versus intuition, in-

ternal versus external locus of control (Bryant et al., 2009), and receptiveness of ambiguous information (Pincus, 1990; Gul, 1984). Also personality traits such as risk tolerance, integrity, moral development, overconfidence, and level of professional scepticism are likely to feed into audit style differences at the individual level (Knechel et al., 2015; Quadackers, Groot & Wright, 2014; Gul, 1984). In a Dutch context, research by Vaassen, Baker, and Hayes (1993) indicates that there are differences in cognitive styles between individual auditors, and that firms tend to hire auditors whose cognitive style is aligned with the structuredness of the firm's audit approach (i.e. audit style at the firm level). On the whole, the results of studies in this research area suggest that personality and cognitive styles are important factors in differentiating the behaviour of individual auditors, their audit style, and potentially audit quality.

2.5 Contextual factors that influence audit styles

In addition to the drivers of audit styles at the various levels as described above, the development of individual audit styles is likely to be influenced by contextual factors, such as client type, regulatory enforcement or the nature of accounting rules (e.g., principles-based versus rules-based). Indeed, future research on audit styles should consider potential moderating factors that influence audit styles, because financial auditing is in nature characterised by interactions between the auditor and several stakeholders (e.g., clients and regulatory inspectors) (Trotman, Bauer & Humphreys, 2015; Nelson & Tan, 2005). At the regulatory level, audit styles are likely to be influenced by the way external regulators exercise power in their oversight of audit firms. Although external oversight is a factor outside the audit engagement, the auditor's perception about the intensity and strictness of regulatory oversight is likely to affect auditor behaviour. In this respect, recent research by Dowling, Knechel, and Moroney (2015) emphasizes the importance of a regulator's enforcement style as a determinant of how audit firms manage inspection risk (see also discussion by Van Buuren & Wong, this issue). Their findings show that audit partners generally perceive the regulator's enforcement style as coercive (i.e., formalistic) rather than collaborative (i.e., facilitative). As an unintended consequence, audit firms tend to increase the visibility of compliance (i.e., form over substance, documentation stylization), potentially reducing audit quality (Dowling et al., 2015). Thus, the regulator's enforcement style has an influence on the way audits are conducted (i.e., the audit process), indicating the need to consider its effects when examining audit styles.

Further, the nature of accounting rules and the extent to which these are "rules-based" versus "principles-based" may also have an effect on the extent to which

individual audit styles develop and translate into specific financial statement outcomes. Therefore, it would be interesting to study audit styles in an international context and relate observed audit style effects to differences in accounting standards as well as regulatory enforcement. This would shed more light on the extent to which these contextual factors stimulate or hamper the development of audit styles at the various levels (firm, office, team, and individual auditor).

3 Opening the black box of audit styles

Opening the black box of different audit styles and increasing our understanding of the factors that influence audit styles (and hence the audit process and audit quality) is important for auditing practice. Specifically, considering the demand side, clients may use their understanding of various audit styles when selecting the audit firm and office that best fits their needs and preferences. From the perspective of the supply side, audit firms may use these new insights into various audit styles when composing audit teams and deciding on team-client combinations that decrease audit risk and safeguard audit quality. Making audit styles observable and transparent also creates opportunities for audit firms to invest in or reward certain behaviours and traits that are consistent with their firm's culture, philosophy, and strategy (i.e., styles at the firm and office level). This would also promote more efficient self-selection of professionals into the various audit firms (i.e., individual level). Overall, further knowledge on audit styles and its potential mechanisms to mitigate adverse effects is important for the audit profession to enhance audit quality.

Of course, opening the black box of audit styles and their effects on the audit process and audit quality would require an intense collaboration between the auditing profession and academia. The initiative of the Dutch audit firms, organized in the FAR, has the potential to enable researchers to gain unique understanding of the auditing profession since one of its missions is to facilitate data collection for projects that require proprietary data from audit firms. Until now, most auditing research was restricted to publicly available resources, which limited the possibilities of archival research to focus on the specificities of audit inputs and processes and the effects on audit quality (Knechel et al., 2015, 2013). In this section, we provide our thoughts on how audit firms can assist in opening the black box of audit styles and their effects on the audit process and audit quality.

Specifically, in order to gain insight into the various factors that shape audit styles at the firm, office, team, and individual level, academics need access to "inside" audit information (e.g., audit working papers) and insiders (e.g., by interviews, surveys, experiments). Interviews with practitioners may be helpful in exploring the dif-

ferent styles auditors use in current practice and the different factors that play a role in "shaping" these audit styles. In these interviews, researchers should not only focus on the individual auditor, but also on factors at the audit team, office, and firm level. As explained, it is also important to consider contextual factors at the client and regulatory level. Based on the outcomes of such exploratory research, further research may engage in more detailed mapping and defining of auditors' different styles, for example by administering surveys to audit staff in different levels, teams, and firms. These questionnaires may focus on the different ingredients or factors that potentially drive audit styles.

Close collaboration with audit firms would not only allow academics to shed more light on the factors that shape audit styles and their effects on the audit process and audit quality, it would also allow researchers to refine and expand their measures of audit quality. Indeed, most studies focusing on audit quality use publicly available audit output measures to assess audit quality, such as restatements, going-concern opinions, and abnormal (DeFond & Zhang, 2014). However, there are important limitations associated with these audit quality proxies, such as high measurement error (i.e., abnormal accruals), applicability to financially distressed clients only (i.e., going-concern opinions) or infrequent occurrence (i.e., restatements and going-concern opinions) (DeFond & Zhang, 2014; Van Raak & Thürheimer, this issue). Therefore, access to proprietary data is desirable, such as internal quality review findings, partner performance evaluations, violations of independence requirements, adjusted/unadjusted audit differences, and pre-audited earnings. Furthermore, access to firm personnel is beneficial for conducting interviews and administering surveys. This would allow researchers to gain much deeper insight into the drivers and root causes of audit quality and potential control mechanisms firms can use to enhance audit quality.

4 Conclusion

The research of FPW addresses an interesting and innovative research question and is the first to show that financial statement comparability is affected by unique "style" differences between audit firms. Although FPW provide some insights into the potential drivers of audit styles, many questions remain unanswered. We propose extending this research from the audit firm and office level to the audit team and individual level in order to unravel the multitude of factors that shape audit styles. Following our analogy with Belgian beers, we call for further research into the various ingredients (individual auditor and firm/office characteristics, team composition), processes (firm and office-specific methodologies and working rules) and circumstances (accounting standards and regulatory enforcement) that lead to specific flavours, types, and styles.

An increased understanding of the factors that jointly influence audit styles and their effects on the audit process and audit quality is important as it might assist audit firms in optimizing client-firm matching, audit team compositions, and the firm's hiring, performance appraisal, and promotion decisions. We believe that the initiative of the Dutch audit firms organized in the FAR is instrumental and promising in allowing researchers to gain a unique insight in the auditing profession and to increase our understanding of the factors that influence audit outcomes and hence audit quality. But let's take a beer first. Cheers! ■

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