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The Effects of Organizational Structure on Communication Within Audit Teams

Holly R. Rudolph and Robert B. Welker

SUMMARY

Some audit researchers suggest that high levels of audit team structure may encumber communication within audit teams by impeding information-gathering activities. Others suggest that structure benefits communication by coordinating and controlling information flows. This study evaluated these arguments by examining the relationship between the structure of audit teams and selected communication variables (information overload, boundary spanning, satisfaction with supervision, and accuracy of information). Questionnaire data were gathered from a national sample of 109 audit teams, with three auditors responding from each team (i.e., n = 327). Information overload, satisfaction with supervision, and accuracy of information were less in audit teams with greater structure. The implication is that the level of structure adopted by teams has both positive and negative effects on communication, with structured teams providing greater control over information overload but impairing satisfaction with supervision and the accuracy of information.

Key Words: Organizational structure, Audit structure, Communication, Audit teams.

Data Availability: Please contact the first author concerning data availability.

The Effect of Relationship and Reward on Reports of Wrongdoing

Joseph J. Schultz, Jr. and Karen L. Hooks

SUMMARY

Failure to detect fraud results in serious consequences for external auditors. Increasingly, professional guidance and evidence point to the importance that communication plays in detecting fraud. The research reported in this paper investigated several auditing experts' propositions about communication's role in detecting fraud: (1) communication from client personnel is important in detecting fraud; (2) the likelihood of receiving sensitive communications from client personnel is heavily dependent on the strength of the relationship between the auditor and the person knowledgeable of any wrongdoing; and (3) the willingness to communicate is influenced by the knowledgeable person's understanding of who might be benefited by the wrongful act—the perpetrator, the organization to which the perpetrator belongs, or both. This last matter is relevant to reporting on management fraud because the fraud often involves (at least) short-term benefit to the perpetrator, the company, and the knowledgeable observer. The experts' suggestions and previous research related to communication of wrongdoing resulted in our securing input from 20 highly experienced partners. Five partners served as expert consultants prior to execution of a controlled experiment which used auditing students. The other 15 participated in telephone interviews to establish a check on our experts' perceptions. The experiment examined two propositions: (1) strength of relationship between an observer of wrongdoing and a potential report recipient affects the likelihood that the wrongdoing will be reported, and (2) the likelihood of a report on the wrongdoing is impacted by who will benefit from the misdeed. The appropriateness of using a student setting is discussed. The experimental results, which came exclusively from students, indicated that stronger relationships between the observer of wrongdoing and the potential report recipient resulted in more reports. The results showed no relationship between the beneficiary of the wrongdoing and the frequency of reports. Partners' experiences and perceptions clearly support the experimental variables' relevance to the external audit environment and the importance of communication. In particular, their collective experiences and perceptions support the proposition that the stronger the relationship between the auditor and client personnel, the greater the likelihood of receiving a report about sensitive matters related to the financial statements.

Key Words: **Fraud detection, Communication.**

Data Availability: **Instruments are available from the authors. Due to confidentiality agreements made with the university Institutional Review Board, the data are not available to others.**

The Error Detection of Structural Analytical Procedures: A Simulation Study

Yining Chen and Robert A. Leitch

SUMMARY

Given the requirement of SAS No. 56 and the increasing pressures to minimize audit costs, there is a need to develop more sophisticated analytical procedures that can increase the effectiveness and efficiency of an audit. Prior research suggests that structural models including the futuristic concept of an "information dual" may be good for this purpose. This study extends the work of Wheeler and Pany (1990) and Wild (1987) and investigates the prediction and error detection performance of structural analytical procedures using the monthly financial statements of a large number of simulated companies. These companies represent various sales behavior patterns and degrees of economic stability.

We develop a generic structural model that explicitly incorporates interdependencies among the accounting numbers and key exogenous variables that drive the economic environment of the company. When compared to the ARIMA, X-11, and Martingale models, our structural model performs better from an overall perspective. However, it does not perform better than the stepwise model which indirectly incorporates information on the structure of an organization's economic activities. The results indicate that the performance of each model, with respect to alpha and beta risks, tends to be a function of the testing approach used. We use both the positive and negative testing approaches. The sales behavior pattern has a significant impact on the performance of each model. All models tend to perform better for companies that have a greater degree of stability in their business and economic activities. In general, our results suggest that auditors can improve the prediction and error detection capability of analytical procedures by using the information inherent in the natural structure of accounting systems which reflect business and economic activities.

Key Words: Analytical procedures, Structural model, Error detection, Simulation, Risk.

Data Availability: Contact the authors.

An Empirical Investigation of the Auditor's Decision to Project Errors

Randal J. Elder and Robert D. Allen

SUMMARY

Statement on Auditing Standards No. 39 requires that auditors project to the population being sampled the dollar errors in tests of details of balances. This study uses an archival approach to examine auditors' sample error projection decisions for inventory and accounts receivable errors from audits conducted by three large accounting firms. This archival approach provides a rich environment for describing the auditor's sample projection decision.

We suggest that sample evaluation consists of both error quantification and error resolution. Consistent with previous experimental research, auditors often fail to quantify errors by projecting them to the population. The decision to project an error is related to several factors, including the materiality of the error, direction of the error, type of test, and audit firm characteristics. Error immateriality was the most common documented reason for not projecting an error. Although most errors were small in relation to planning materiality, failure to project seemingly immaterial amounts may increase audit risk by an unacceptable amount, especially if sampling risk is not considered. The auditors in our study did not explicitly consider sampling risk in making error projections. Consistent with previous research, error containment was also associated with the decision to not project errors. We suggest that this strategy is used for large errors as part of the auditor's resolution of the error. Professional standards indicate that auditors should consider qualitative aspects of errors (AU § 350.27), but do not address whether error containment is appropriate. The results of this study suggest the need for further guidance and additional research in the use of error containment, and of the consideration of sampling risk in the evaluation of errors.

Key Words: Error projection, Audit sampling, Error containment, SAS No. 39.

Data Availability: Data used in this study are available on request. The data were provided on condition of anonymity; the audit firms and clients will not be identified.

The Relationship Between Client Advocacy and Audit Experience: An Exploratory Analysis

Christine M. Haynes, J. Gregory Jenkins and Stacey R. Nutt

SUMMARY

This paper reports the results of an exploratory study designed to investigate whether auditors assume the role of client advocate. Results indicate that auditors did not automatically assume an advocacy position. However, when client interests were made salient, experienced auditors exhibited behavior consistent with advocacy. These results are discussed in light of the conflicting incentives faced by auditors and recent criticisms that auditors may lack the impartiality necessary to provide reliable audits. Given the exploratory nature of this study, further research appears to be warranted so that a more complete understanding of the auditor's willingness to act as a client advocate may be gained.

Key Words: Client advocacy, Client preferences, Auditor objectivity.

Data Availability: Data used in this analysis may be obtained from the authors.

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