

**The Effect of Performance Feedback and Client Importance
on Auditors' Ethical Judgments**

James Lloyd Bierstaker
Department of Accountancy
College of Commerce & Finance
Villanova University
Villanova, PA 19085-1678
Phone: (610) 519-4340
Fax: (610) 519-5204
e-mail: james.bierstaker@villanova.edu

Anna M. Cianci
Department of Accounting
LeBow College of Business
Drexel University
Philadelphia, PA 19104
Phone: (215) 895-4981
Fax: (21) 895-6279
Email: amc66@drexel.edu

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Abstract

This paper examines the impact of performance feedback and client importance on auditors' ethical judgments. It is predicted that performance feedback and the importance of the auditors' client will impact auditors' ethical judgments. Furthermore, it is predicted that auditors who receive positive feedback and are auditing a less important client will make the most ethical judgments. To test these predictions, an experiment was conducted in which 71 experienced auditors made ethical judgments related to a relatively more or less important client after receiving positive or negative performance feedback. Consistent with our predictions, auditors who received positive feedback made more ethical judgments compared to auditors who received negative feedback. In addition, auditors made more ethical judgments when auditing a less important (compared to a more important) client. Finally, auditors who received positive feedback and audited a less important client (the lowest amount of pressure) made more ethical judgments than the other three groups. Future research should explore whether auditors understand the implications of performance feedback and client importance on their ethical judgments and whether training and decision aids can be developed to mitigate the potentially detrimental influence of these factors on auditors' judgments.

Keywords: ethical judgments, performance feedback, auditor judgment, client importance

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1. Introduction

Professional audit firms use performance feedback as a basis for compensation, promotion, and directing employees' careers (Kaplan and Reckers 1985). Supervisory feedback is important to auditors' job satisfaction, career development, turnover intentions, and knowledge sharing (Patton 1995; Gregson 1990; Vera-Munoz et al. 2006). Underlying the use of feedback is the implicit assumption that it can improve the performance of individuals, teams and the organization (Brown and Porter 2006). Yet there is limited evidence to support this presumption, in spite of the investment in time and resources to use feedback as a performance-improving tool.

The client is an integral part of the audit engagement. An auditor's incentive to compromise independence may depend on the importance of the client (DeAngelo 1981b). For example, auditors may permit more aggressive financial reporting for more important clients (Farmer et al. 1987) and more important clients have more earnings management opportunities (Nelson, Elliott, and Tarpley 2002). While prior research has examined the effect of various client characteristics including client importance on audit judgment (e.g., Walo, 1995; Braun 2001; Gibbins and Trotman, 2002), no study has examined the influence of client importance on ethical judgments or the interactive effects of performance feedback and client importance on any audit judgments. Examination of these issues is particularly important in light of concerns regarding the potential ethical lapses involving professional auditors (Levitt 1998; Jones et al. 2003).

This paper examines the effects of performance feedback and client importance on auditors' self-focused and external-focused ethical judgments. Prior research shows that negative feedback exerts pressure on employees to enhance performance (e.g., VandeWalle,

Cron, & Slocum, 2001; Herold & Fedor 1998) and that client importance is an element of engagement pressure (Braun 2001). Research on ethical decision-making suggests that increased pressure can induce unethical behavior (Lord and DeZoort, 2001; for review see Jones et al., 2003). Together, these two research streams suggest that pressure from negative feedback and from increased client importance can have a dysfunctional effect on the performance of an ethical task. We examine both feedback and client importance to determine their potentially detrimental effects on auditors' ethical judgments.

Prior research suggests performance feedback may improve or diminish task performance (Kluger and DeNisi 1996). Consistent with prior psychology research on feedback sign (Koestner & Zuckerman, 1994; Sujan, Weitz, & Kumar, 1994; VandeWalle, Cron, & Slocum, 2001; Herold & Fedor 1998), we hypothesize that negative (positive) feedback will increase pressure, which, in turn, will impair (enhance) ethical task performance. Regarding the effects of client importance, we reason that the more important a client is the more pressure that the auditor may feel to comply with the client's reporting preferences. Thus, as client importance increases, ethical performance will be impaired. We also expect auditors under the least amount of pressure (positive feedback, less important client) will make the most ethical judgments.

Prior research on ethical decision-making indicates that such decisions are influenced by the nature of the ethical tasks (Jones, 1991). While prior research identifies the consequences of ethical decisions as an important dimension along which to differentiate ethical tasks (Jones, 1991), the effect on ethical judgments of this dimension has not been examined. In addition, prior research has not examined the interactive effects of feedback or client importance on different ethical tasks. In this study, we distinguish between self-focused (i.e., consequences of task are self relevant) and external-focused (i.e., consequences of task are relevant to others)

ethical tasks. We reason that performance feedback has more consequences for the self than others, while the importance of the client has consequences for others (i.e., the client, the CPA firm, the public) besides the self. Therefore, we expect that positive (compared to negative) feedback will enhance ethical task performance on the self-focused ethical task because positive feedback will alleviate pressure on the auditor to behave unethically. On the other hand, very important client (compared to a less important client) will impair ethical performance on an external-focused ethical task since the auditor will feel pressure to behave in a manner that produces an outcome that pleases the client.

To examine the hypothesized effects of feedback and client importance, seventy-one auditors were assigned to one of four conditions created by fully crossing performance feedback and client importance. Each participant reviewed background information and then made two separate ethical judgments. The self-focused ethical judgment involved the reporting of audit work and the external-focused ethical judgment involved writing-off obsolete inventory. The decision to report the amount of audit work has consequences for the auditor (self-focused), whereas the inventory write-off also has direct consequences for the client (external-focused).

Consistent with expectations, performance feedback and client importance did affect auditors' ethical judgments, depending on the nature of the ethical task. Specifically, auditors who received positive (compared to negative) feedback made more ethical judgments in a self-focused ethical task. In addition, auditors made more ethical judgments in an external-focused ethical task when auditing a less important (compared to a more important) client. Finally, auditors who received positive feedback and audited a less important client (the lowest amount of pressure) made more ethical judgments than the other three groups.

The remainder of this paper is organized as follows. Section 2 presents prior research and develops hypotheses. Sections 3 and 4 present the experiment and results, respectively. Section 5 discusses future research directions and presents concluding comments.

2. Literature Analysis and Hypotheses Development

2.1 Ethical Decision-Making: Consequences for the Self and Others

An ethical issue is a problem, situation, or opportunity that requires the decision-maker to choose among several actions that must be evaluated as right or wrong, ethical or unethical (Ferrell and Raedrich, 1991, p.35). An integral part of audit decision-making is the ethical dimension. Professional standards require ethical decision-making and firm manuals emphasize the importance of truthful reporting of work performed. Such reporting records serve as a basis for billing and establishing future work standards. In this paper, ethical tasks require truthful reporting of information that affects the auditors' private circumstances (self-focused), or reporting of information that affects the public's circumstances (external-focused). In the current study, a self-focused ethical task requires the decision maker to communicate private information about her performance on a technical task, a communication that could be used to evaluate the efficiency of her performance and thereby have significant consequences for the particular decision maker (i.e., the self). For example, a staff auditor may be required to indicate the time spent on confirming receivables relative to a time budget. In this way, an ethical task involves truthful reporting. Identification of this task as an ethical task is consistent with prior research that has identified underreporting as an unethical behavior that auditors sometimes engage in (e.g., Ponemon 1992; Dirsmith & Covaleski 1985).

In the current study, an external-focused ethical task requires the decision maker to adhere to relevant professional standards while considering the aggressiveness of a client's

accounting choices. The consequences of these accounting choices can be significant for the public since they are reported in the financial statements. For example, an auditor may be confronted with a decision involving the write-off of inventory – a decision that affects the earnings per share (EPS) that investors observe and use to make their investment decisions. Such a decision to write-off inventory may be viewed as an *ethical* decision that affects the public since auditors' professional code of ethics (i.e., AICPA *Code of Ethics* Rules 101 and 102) requires alliance to public service and professional skepticism when confronted with pressure from client management to comply with a client-preferred method of accounting.

2.2 Performance Feedback

Performance feedback is an important part of performance management programs aimed at providing auditors with mentoring and continuous feedback so that staff achieve their goals and advance to the next level (Accounting Office Management & Administrative Report 2006).¹ All of the major accounting firms have training sessions in which auditors, at varying levels, are instructed on how to give performance feedback. Moreover, many personnel decisions are based on feedback communicated after every audit engagement and at periodic intervals. Underlying this emphasis on feedback is the assumption that feedback, regardless of its sign (i.e., positive or negative), improves performance. However, there is limited empirical evidence in accounting and mixed evidence in psychology to support this assumption. To a large extent, accounting research on feedback has primarily focused on comparisons between different types of feedback

¹We limit our focus to information provided by a supervisor on the subordinate's task performance relative to that of her peers. Other forms of feedback, which are beyond our scope, include instructive feedback (e.g., feedback detailing methods for improvement), task generated feedback (e.g., a trial balance that does not balance), and personal feedback (e.g., the supervisor does not like an auditor's attire).

(e.g., task-oriented versus outcome-oriented) and has not examined the effects of feedback sign on performance (e.g., Ashton, 1990; for review see Hunt 1995).²

Overall, there have been inconsistent and inconclusive results in the accounting and psychology literatures on the effectiveness of outcome feedback (OFB) in improving judgment performance. Based originally on the law of effect (Thorndike, 1913), this research conceptualizes positive feedback as reinforcement and negative feedback as punishment. From this view, it follows that both positive and negative feedback should improve performance because one reinforces “correct” behavior and the other punishes “incorrect” behavior. Empirical evidence examining this law, however, is mixed (for review, see Adams, 1978; Salmoni et al., 1984; Bilodeau, 1969). In a meta-analysis, Kluger and DeNisi (1996) found that feedback improved performance on average, but over one-third of the evidence showed that feedback actually decreased performance.

Research on affect may shed light on these mixed feedback effects. Affect research has found that (1) positive feedback produces positive affect (including interest, excitement, pride, and enthusiasm) which is associated with low pressure or effort; and (2) negative feedback produces negative affect (including guilt, fear, and nervousness), which is associated with high pressure or effort (e.g., Koestner & Zuckerman, 1994; Sujan, Weitz, & Kumar, 1994; Tang & Sarsfield-Baldwin, 1991; VandeWalle, Cron, & Slocum, 2001; Herold & Fedor 1998; Sweeney & Wells, 1990; Kernis & Johnson, 1990).

Research on ethics suggests that negative affect (Gaudine & Thorne, 2001) and increased pressure (Jones & Ryan, 1997; Shafer, Morris, & Ketchand, 1999) are associated with less ethical decision-making. In particular, Lord and DeZoort (1997) find that obedience pressure

²Ashton (1982) and Hammond (1987) provide references to the literature on outcome feedback; see also Jacoby et al. (1984). A great deal of psychology research has also examined the effects of different types of feedback (e.g., Werts et al., 1995; Baron, 1988).

significantly increases auditors' willingness to sign off on a materially misstated balance. In contrast, positive affect and reduced pressure is posited to lead to ethical decision-making. Positive affect may improve a person's ability to identify ethical dilemmas because associative networks in memory contain a greater amount of information with positive affect tags (Bower 1981), thereby allowing information in memory to be available for retrieval (Gaudine and Thorne 2001). Gaudine and Thorne (2001) propose that positive affect increases the probability that a person will identify moral issues, interpret them in an appropriately complex ways, and generate viable alternative courses of action. Based on this research, we expect that the negative affect and high pressure generated from negative (relative to positive) feedback will impair ethical performance for both self-focused and external-focused ethical tasks. On the other hand, based on prior research we expect positive feedback will enhance ethical performance.

H1: Auditors who receive negative feedback will make less ethical judgments than those who receive positive feedback on a self-focused ethical judgment.

H2: Auditors who receive negative feedback will make less ethical judgments than those who receive positive feedback on an external-focused ethical judgment.

2.3 Client Importance

The American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct requires auditors to be objective – i.e., “to be impartial, intellectually honest, and free of conflicts of interest” – and to be independent in fact and appearance (AICPA 2004). Auditor objectivity and independence are central to the value of the audit opinion since without them, third parties would have little reason to rely on the auditor in assuring that financial statements represent what they purport to represent (Jensen and Meckling 1976; Watts and Zimmerman 1986). One critical aspect of independence is the auditors' ability to withstand pressures from the client (DeAngelo 1981a) such as pressure to allow aggressive accounting treatments

(Shockley 1982). However, auditors have been criticized for the failure to exercise independent judgment under such circumstances (e.g., Schuetze 1994; Public Oversight Board 1993; Levitt 1998).

Consistent with psychology research indicating that audit judgments are often unconsciously and powerfully biased in a manner that is consistent with the decision-maker's incentives (Fiske and Taylor 1991; Bazerman et al. 1997), audit research suggests that pressures confronting auditors can have deleterious effects on audit judgment (see DeZoort and Lord 1997 for a review). For example, studies indicate that obedience and time pressures influence auditors' willingness to sign-off on materially misstated accounts and underreport time (e.g., Kelly and Margheim 1990; McDaniel 1990; Ponemon 1992; Lord and DeZoort 2001). Time pressure may also focus auditors on accumulating audit evidence documentation and reduce their focus on qualitative aspects of misstatements that may indicate fraud (Braun 2000). Similarly, the presence of fee pressure from clients can create an incentive for audit seniors to emphasize cost control, potentially impairing audit effectiveness (Houston 1999; Margheim and Kelley 1992; Public Opinion Board 1999; Bierstaker and Wright 2001).

Research demonstrates that decision-makers tend to make decisions that are preferred by those viewed as powerful others (Gibbins and Newton, 1994; Quilliam, 1993; Tetlock et al., 1989; Tetlock, 1983). Brown et al. (1999) suggest that when auditors know the preferences of powerful others, auditors may have difficulty disentangling preferences of powerful others from their own beliefs. Hanno and Kida (1996) find that the consequences of the decision such as displeasing a powerful other may alter both the decision process and the decision. Bierstaker and Wright (2005) find that partner preferences influence both the nature and extent of subordinates' planned audit testing and its relationship to assessed risks.

One “powerful other” who can have significant influence over the auditor is the client. Auditors’ economic dependence on the client’s service fees has been found to impact auditors’ budgeting behavior and willingness to accept a client-preferred reporting method (e.g., Hackenbrack and Nelson 1996; Houston 1999). In addition, clients may engage in “opinion shopping” if their auditor refuses to waive client-opposed proposed adjusting journal entries (Hendrickson and Espanbodi 1991). Levitt (1998) contends that “auditors, who want to retain their clients, are under pressure not to stand in the way.” Thus, this economic dependence may cause the auditor to compromise with the client on reporting issues.

As the market for audit services becomes more competitive, retaining clients has become increasingly important to a firm’s profitability (Cohen and Trompeter 1998). Incentives exist for auditors to agree with the client whenever possible in order to maintain client relations and business (Lochner, 1993; Schuetze, 1994). In addition, maintaining positive client relations is emphasized in the socialization process in public accounting (e.g., Covalleski et al. 1998; Scandura and Viator 1994; Emby and Etherington 1996) and is an important dimension in the performance evaluation of auditors (Hooks et al. 1994; Emby and Etherington 1996). Therefore, pressure to maintain a major client relation may bias the auditor’s judgment to support a client’s preference and client-preferred reporting methods (Hackenbrack and Nelson 1996; DeZoort and Lord 1997) and to “see it the way the client does” (Levitt 2000), especially in the case of accounting estimates such as potential inventory obsolescence (Wright and Wright 1997) and when the client accounts for a relatively large share of office fees.

Prior studies provide evidence of the influence of the client’s position on auditors’ judgments. Clients can exert strong pressures on auditors to accept their perspective, particularly on ambiguous accounting matters (e.g., Johnson et al., 1991; Anderson and Koonce, 1995; Shah,

1996; Einhorn and Hogarth 1985; Nelson and Kinney 1997). Salterio and Koonce (1997), for instance, found that auditors tend to follow the client's position when the available precedents are mixed but not when all available precedents pointed to the same accounting treatment. Similarly, Trompeter (1994) found that audit partners' judgments were more influenced by client-imposed pressures when the authoritative literature was ambiguous, but not when the perceived risk of litigation was high.

In this paper, we examine the effects of client importance (in terms of the client's percentage of the firm's revenues) on auditors' ethical judgments. Few studies have investigated client importance directly, and their results have been mixed. Braun (2001) did not find that the size of client fees influenced auditors' judgments about proposed adjusting journal entries but Nelson, Elliott, and Tarpley (2002) found that auditors are more likely to require adjustment of earnings management attempts that are attempted by small clients. In addition, Moreno and Bhattacharjee (2003) found that lower rank auditors (staff and seniors) judged the obsolescence risk to be lower when provided with information on additional client business opportunities than when such information was not provided, but higher rank auditors (managers and partners) did not. The current paper extends this research by examining auditors' ethical judgments in response to client importance.

While the socialization process, performance evaluation, and economic incentives may encourage the maintenance of positive client relations (Cohen and Trompeter 1998), the auditors' role as an impartial evaluator of financial statements (Advisory Panel on Auditor Independence 1994), their concern with legal liability (Johnstone 2000; Rich et al. 1997; Trompeter 1994; also see Gibbins 1984; Gibbins and Emby 1985), Rules 101 and 102 of the *Code of Ethics* which require them to be unbiased and impartial may discourage their agreement

with client preferences.³ Specifically, an auditors' professional code of conduct requires alliance to public service and professional skepticism when confronted with pressure from client management to comply with a client-preferred method of accounting. Therefore, auditors' adherence to their code of ethics when confronted with pressure from management to, for instance, write off inventory may be viewed as an ethical decision that affects the public.

Thus, auditors must balance the trade-off between maintaining client relationships and maintaining objectivity. We suggest that the net effect of these competing factors implies that the auditor is less likely to be objective regarding more influential clients for those ethical judgments that impact the client, but not for those judgments that do not impact the client. Despite the fact that external-focused (versus self-focused) ethical tasks have implications for the public, auditors will feel greater pressure to comply with the wishes of high importance clients as compared to low importance clients because they are aware of greater potentially negative implications for themselves of not pleasing high importance clients. This reasoning leads to the following hypothesis:

H3: Auditors will make less ethical judgments on an external-focused ethical task when working on an audit engagement for a client of High (compared to Low) Importance.

While the self-focused task most directly relates to the auditor's job performance, auditors are aware that displeasing the client is likely to have negative ramifications for their job performance as well. However, auditors in the low client importance condition will be under the least amount of pressure from the client. In addition, positive feedback has been shown to induce positive affect and low pressure, also raising the likelihood of ethical behavior. Therefore,

³ In addition, auditors have an incentive to establish a reputation for objectivity in order to generate client service revenues since the demand for the auditor's services is dependent on his/her reputation for objectivity. For example, Reynolds and Francis (2000) do not find that Big Five auditors report more favorably for their large clients, and suggest that reputation protection dominates auditor behavior.

auditors in the low client importance condition who receive positive feedback are likely to behave more ethically than auditors in any of the other conditions. These associations are captured in the following hypothesis:

H4: In the Low Client Importance Condition auditors who receive Positive Feedback will make the *most* ethical judgments compared to those of auditors in all other conditions.

3. Method

3.1 Participants

The questionnaire was mailed to approximately 600 auditors identified from an AICPA mailing list and from a listing of accounting graduates of a southeastern university. A total of 71 auditors participated in the experiment resulting in an 11.8% response rate. The mean (σ) public accounting experience of participants was 6.37 (3.39) years. Table 1 presents the means, standard deviations, and cell sizes for the background information on the auditors who participated in this study. Most auditors were from local or regional firms and held the rank of staff or senior auditor.⁴

Insert Table 1 about here

To further assess their relevant experience, participants were asked to indicate their experience with selecting a sample of property additions for audit testing (one of the experimental tasks) on a scale from 1 (Not At All Experienced) to 10 (Extremely Experienced). The mean (σ) for this question was 7.42 (2.06). Participants were also asked to indicate their experience with evaluating potentially obsolete inventory (the external experimental task) on a

⁴ Demographic variables (i.e., experience, firm size) were not significant and when included as covariates did not affect the results

scale from 1 (Not At All Experienced) to 10 (Extremely Experienced). The mean (σ) for this question was 5.77 (1.77). Overall, these results suggest participants had sufficient experience with the experimental tasks.

3.2 Experimental Materials and Procedures

Participants performed two audit tasks. For the first task participants were told that they were doing work in the property area for VMC, a hypothetical public company and audit client, vouching additions for the year. The audit program indicated that a sample of all items over \$100,000 should be selected, plus a judgmental sample of smaller items. When they went to take the sample, they were the only auditor at the client's office that day. There was no one around to answer questions about the appropriate size of the judgmental sample. Based on their own judgment 30 smaller items were selected, since there were about 200 such items, so 30 (i.e., 15%) seemed like a reasonably good proportion of these small additions. The results were as follows: the items over \$100,000 contained no misstatements and the first 10 small additions contained no misstatements. However, the remaining 20 small additions contained several misstatements. Nevertheless, they were not sure if these misstatements were material and whether the correct sample size was used.

On the following workday before they had time to share the findings with any other audit team member, they received an urgent e-mail from Gary Johnson, the supervising senior auditor, which indicated that read as follows: "I hope you are done with vouching the additions. As I am sure you know, the sample for the small additions should not exceed 5. This is consistent with our firm's sample selection procedures described in our audit manual. Specifically, a sample size of 5 is appropriate based on materiality considerations, the stratified sample approach which identifies all individually material items and the strength of internal controls over the acquisition and payment

cycles. We need to be careful with how much time we spend in the property area as this does not represent a critical area."

Based on these facts, participants were asked to assess the likelihood that they would report the 25 extra small additions they sampled and the findings from this extra 25-item sample to Gary Johnson on a scale from 1 (*Not At All Likely that I would report to Gary Johnson*) to 10 (*Highly Likely that I would report to Gary Johnson*).

For the second audit task, participants were told that the year-end audit of VMC was almost complete except for an issue regarding the potential obsolescence of some specialized inventory items. VMC's management believes that inventory should not be written down because there is a market in Asia that would absorb any excess inventory that has not been sold at the end of the year. In the past, inventory problems were immaterial but participants were told they have some concerns that the amount may be material this year. Currently, EPS based on unaudited financial information is \$1.14 and analysts' forecasts of EPS for VMC is \$1.14. If the potentially obsolete inventory is written off, EPS will be reduced by \$.04 to \$1.10. After considering all the relevant evidence and conferring with other audit team members, it appears that professional judgment is required. That is, the evidence does not clearly support writing off the potentially obsolete inventory or keeping it on the books. Based on this information, participants were asked to indicate the likelihood that they would recommend that the inventory be written off on a scale from **1** (*Extremely Unlikely*) to **10** (*Extremely Likely*).

3.3 Independent variables and dependent variables

There are two independent variables: performance feedback and client importance. Participants in the negative performance feedback condition were told that the results of their annual review indicated their performance was in the 10th percentile of what is expected of

senior auditors of the firm. That is, 10% of senior auditors performed worse than you did, and 90% performed better. Participants in the positive performance feedback condition were told that the results of their annual review indicated their performance was in the 90th percentile of what is expected of senior auditors of the firm. That is, 90% of senior auditors performed worse than you did, and 10% performed better.

Participants in the low client importance condition were told that VMC is a minor audit client for your firm, making up less than 1% of the revenues of your firm's total revenues.

Participants in the high client importance condition were told that VMC is a major audit client for your firm, making up 10% of the revenues of your firm's total revenues.⁵

There are two dependent variables: 1) the likelihood of reporting to the audit supervisor that 25 extra items were sampled and the results and 2) the likelihood of recommending to the client that inventory be written off.

3.3 Manipulation checks

The effectiveness of the performance feedback manipulation was assessed by asking participants to indicate whether they received a good or bad annual performance evaluation. The effectiveness of the client importance manipulation was assessed by asking participants to indicate if the audit client they were assigned to (i.e., VMC) is a major (i.e., made up 10% of your CPA firm's revenues) or a minor client (i.e., made up less than 1% of your CPA firm's revenues). Four auditors who failed a manipulation check, and two auditors who returned incomplete instruments, were removed from the sample.⁶

⁵ Previous auditing research generally has used client size as a proxy for client influence, based on DeAngelo's (1981) analysis.

⁶ Inclusion of the responses from participants who failed the manipulation check did not affect the results. The analyses testing the hypotheses do not include the participants who failed the manipulation check.

4. Results

4.1 Descriptive statistics

In the experimental questionnaire, participants were asked to indicate the extent to which they agreed with a series of statements on a scale from 1 (strongly disagree) to 10 (strongly agree). As shown on Table 2, participants tended to agree (mean) [standard deviation] with the following statements: 1) deciding to report the 25 extra sample items and the related findings from this sample to a superior is the more ethical decision (6.66) [2.54], 2) deciding to recommend to the client that the potentially obsolete inventory be written-off is the more ethical decision (5.72) [2.63]⁷, 3) receiving a good or bad performance evaluation involves a great deal of *self-serving considerations (i.e., the consequences of the evaluation directly impact me)* (6.10) [2.37], 4) receiving a good or bad performance evaluation involves a great deal of *considerations for the public (i.e., the consequences of the evaluation directly impact the public)* (3.75) [2.15], 5) the decision to report 25 extra sample items and the related findings from this sample to a superior involves a great deal of *self-serving considerations (i.e., the consequences of the decision directly impact me)* (6.59) [2.12], 6) the decision to recommend to the client that the potentially obsolete inventory be written-off involves a great deal of *considerations for the public (i.e., the consequences of the decision directly impact the public)* (6.41) [2.86]. Therefore, participants acknowledged that reporting the 25 extra sample items and recommending inventory obsolescence were the more ethical decisions ($t(t > 5 \text{ (the midpoint)}) = 5.70, p < .001$ for the sample task; $t(t > 5) = 2.31, p = .024$ for the inventory task).

Insert Table 2 about here

⁷ This is significantly above the midpoint of 5 ($t = 2.31; p = 0.024$ (2-tailed)).

4.2 Test of hypotheses

Performance Feedback

The first hypothesis predicts that auditors who receive negative feedback will make less ethical judgments than those who receive positive feedback on a self-focused ethical judgment. For the sample size (“self-focused”) ethical task, participants rated the likelihood that they would report the 25 extra items they sampled and their findings to their superior from 1 (*Not At All Likely*) to 10 (*Highly Likely*). As shown in Table 3, auditors in the positive feedback condition had a mean likelihood (standard deviation) of 8.08 (1.06), compared with 7.50 (1.24) for auditors in the negative feedback condition. As shown on Table 4, these differences across conditions are significant ($F = 4.55$; $p = 0.02$), supporting H1.

Insert Table 3 about here

Insert Table 4 about here

The second hypothesis predicts that auditors who receive negative feedback will make less ethical judgments than those who receive positive feedback on an external-focused ethical judgment. For the inventory (“external-focused”) ethical task, participants rated the likelihood that they would recommend to the client that the inventory should be written off on a scale from 1 (*Not At All Likely*) to 10 (*Extremely Likely*). As shown in Table 3, auditors in the positive feedback condition had a mean likelihood (standard deviation) of 7.81 (1.10), compared with 7.41 (1.05) for auditors in the negative feedback condition. As shown on Table 5, these differences across conditions are significant ($F = 2.66$; $p = 0.05$, one -tailed), supporting H2.

Insert Table 5 about here

Client Importance

The third hypothesis predicts that auditors will make less ethical judgments on an external-focused ethical task when working on an audit engagement for a client of High (compared to Low) Importance. As shown in Table 3, auditors in the low client importance condition had a mean inventory write-off likelihood rating (standard deviation) of 7.89 (.87), compared with 7.36 (1.22) for auditors in the high client importance condition. As shown on Table 5, these differences across conditions are significant ($F = 4.36$; $p = 0.02$), supporting H3.

The fourth hypothesis predicts that auditors in the low client importance condition who receive positive feedback will make the *most* ethical judgments compared to those of auditors in all other conditions. Since we are predicting an ordinal interaction, contrast coding (1,1,1,-3) was used as prescribed in Buckless and Ravenscroft (1990). The results are significant for both the self-focused ($F = 4.19$; $p = 0.02$) and external-focused ($F = 6.52$; $p = 0.01$) ethical tasks, supporting H4.

5.0 Conclusions

This study seeks to obtain a better understanding of how auditors balance various pressures that arise from performance feedback and client importance— an area with limited prior research. There are three main findings. First, auditors who received positive performance feedback made more ethical judgments on both a self-focused and external-focused auditing task. Second, auditors assigned to more important clients made less ethical judgments on an external-focused auditing task than auditors assigned to less important clients, despite the fact

that this judgment had implications for the public. Third, auditors who received positive feedback and who were assigned to clients of low importance made the most ethical judgments.

Overall, these results show that negative feedback can have an unintended deleterious effect on ethical judgments. In addition, the client characteristic of client importance is negatively associated with ethical task performance on an external-focused ethical task. These results have implications for the audit profession and academic audit research. By increasing our understanding of pressures that cannot be eliminated in audit practice, such as performance reviews, negative feedback from PCAOB inspection reports, and incentives to maintain relationships with major clients, strategies are needed to mitigate the effects of these pressures such as additional training about complex trade-offs between audit effectiveness and client retention (DeZoort and Lord 1997). Specifically, while negative feedback should not be eliminated, the deleterious effects of such feedback should be considered and appropriate debriefing must be in place to minimize these effects on audit judgments. Likewise, auditors should be made aware of the influence on ethical task performance of client's differing in importance. However, this may not be effective if performance feedback produces an unconscious bias (Wilks 2002). Future research could explore if raising auditors' awareness of the potentially detrimental effects of negative performance feedback and client importance on their ethical judgments may help to mitigate the impact of these factors. Moreover, future research could explore the extent to which quality control mechanisms such as internal peer review, second partner review and partner rotation are capable of minimizing client importance effects.

These findings are also important to regulators. Recent concerns have been raised about auditor independence, as evidenced by the recent ban on many non-audit services for auditors of

publicly held clients. Our findings suggest that even when only audit services are performed, client importance may still influence auditors' ethical judgments. In addition, negative performance feedback may also affect these judgments. Given the current scrutiny of auditing profession and potentially negative findings of PCAOB inspections, it is likely auditors may encounter some form of negative feedback during their careers. Future research is needed to investigate ways of mitigating the influence of client importance and negative performance feedback on auditors' judgments.

A limitation of this study is that auditors worked on the task alone and made judgments rather than decisions, which are common limitations of experimental research. Working in isolation tends to diminish group affiliation and the ethically positive benefits that might be forthcoming through a company's socialization process (Dubinsky, Howell, Ingram, and Bellenger, 1986). Future research could examine the ethical decisions of auditors working in groups, and if the detrimental effects of negative performance feedback and pressures imposed by important clients are diminished in a group setting.

A second limitation of this study is that most of the participating auditors held the rank of staff or senior, and were from regional or local CPA firms. Since Moreno and Bhattacharjee (2003) found that lower rank auditors (staff and seniors) judged the obsolescence risk to be lower when provided with information on additional client business opportunities than when such information was not provided, but higher rank auditors (managers and partners) did not, future research with auditors of higher rank is needed to examine if the influence of client importance is mitigated by experience. Nevertheless, the auditors who participated in this study did have the requisite experience for the experimental tasks. Future research could examine if auditors from Big 4 firms behave differently than auditors from local or regional firms in this task setting.

However, firm size was not correlated with auditors' ethical judgments in this study. Finally, the response rate of our participants is lower than some other survey research with auditors (Scarborough et al. 1998; Raghunandan et al. 2001), although it is slightly above other more recent survey research (Beasley et al. 2005).

The findings of this study suggest auditors are willing to make tradeoffs based on client importance even when their judgments have implications for the public. Future research is needed to examine other factors such as materiality or potential litigation that may mitigate client importance effects. Future research is also needed on the extent to which quality control mechanisms such as manager or partner review of the senior auditor's work, internal peer review, second partner review, or PCAOB inspections may mitigate client pressures.

At the same time, these quality control mechanisms produce positive or negative performance feedback. Thus, future research on the sources of performance feedback in the ever-changing audit environment would also be valuable. For example, auditors' reaction to PCAOB inspection reports, a relatively new source of (generally negative) performance feedback, is important and needed. On the other hand, it is possible audit firms may be more reluctant to give negative feedback than in the past because of concerns about staff retention rates. If feedback from the firm is predominantly positive, there may be ramifications for audit quality if technical task performance is diminished and less competent staff retained.

While moral intensity's influence on various measures of ethical decision-making (i.e., awareness, judgment, intent, behavior) has been investigated, the factors that influence moral intensity have not been widely examined. In this study, a self-focused task and an external-focused task were examined. Future research on ethical judgments and decisions made by auditors that have consequences for the public is needed. For example, decision process tracing

research would be valuable for understanding more about how auditors tradeoff client importance versus potential harm to shareholders or employees.

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Table 1
Descriptive Statistics for Background Information on Participating Auditors

Panel A: Years of Experience

Background Information	Mean	SD	n
Years of Experience ¹	6.37	3.39	71
Experience with Selecting a Sample of Property Additions for Audit Testing ²	7.42	2.06	71
Experience with Evaluating Possibly Obsolete Inventory ³	5.77	1.77	71
Number of Certifications ⁴	1.05	.22	60

Panel B: Other Background Information

Rank of Auditor ⁵	Partner	Manager	Senior	Staff	Other	Non-Response
<i>n</i>	6	8	28	12	0	17

Panel C: Other Background Information

Level of Education ⁶	Undergraduate	Masters	PhD	Non-Response
<i>N</i>	40	12	0	19

Panel D: Other Background Information

Firm Type ⁷	Local	Regional	National
<i>N</i>	45	20	6

1 Participants responded to the background question: How many years have you been an external auditor (i.e., public accountant)?

2 Participants responded to the background question: Please indicate your amount of experience with selecting a sample of property additions for audit testing. Please indicate your response on a scale of 1 (Not At All Experienced) to 10 (Extremely Experienced).

3 Participants responded to the background question: Please indicate your amount of experience with evaluating potentially obsolete inventory. Please indicate your response on a scale of 1 (Not At All Experienced) to 10 (Extremely Experienced).

4 Participants responded to the background question: Please indicate the certifications (i.e., CPA, CIA, CMA, etc.) you currently possess.

5 Participants responded to the request: Please indicate your rank by checking the appropriate item: Partner, Manager, Senior Auditor, Staff Auditor, and Other.

6 Participants responded to the background question: Please indicate your current level of education (Circle one): undergraduate, masters, PhD.

7 Participants responded to the background question: Please indicate the type of CPA firm you currently work for (Circle one): national, regional, local.

Table 2
Descriptive Statistics for Background Information on Theoretical Propositions
n = 71

Participants responded to the background question indicated below using a scale of 1 (<i>Strongly Disagree</i>) to 10 (<i>Strongly Agree</i>):	Mean	SD
In this questionnaire, I think that deciding to report the 25 extra sample items and the related findings from this sample to a superior is the more ethical decision than deciding not to report the 25 extra sample items and the related findings from this sample to a superior.	6.66	2.45
In this questionnaire, I think that deciding to recommend to the client that the potentially obsolete inventory be written-off is the more ethical decision than deciding to not recommend to the client that the potentially obsolete inventory be written-off.	5.72	2.63
In general, I think that receiving a good or bad performance evaluation involves a great deal of <i>self-serving considerations (i.e., the consequences of the evaluation directly impact me)</i> .	6.10	2.37
In general, I think that receiving a good or bad performance evaluation involves a great deal of <i>considerations for the public (i.e., the consequences of the evaluation directly impact the public)</i> .	3.75	2.15
In this questionnaire, I think that the decision about reporting 25 extra sample items and the related findings from this sample to a superior involves a great deal of <i>self-serving considerations (i.e., the consequences of the decision directly impact me)</i> .	6.59	2.12
In this questionnaire, I think that the decision to recommend to the client that the potentially obsolete inventory be written-off involves a great deal of <i>considerations for the public (i.e., the consequences of the decision directly impact the public)</i> .	6.41	2.86

Table 3
Descriptive Statistics for Dependent Variables
Model: Performance Evaluation X Client Importance

Panel A: Ethical Task #1 (Sample Size Judgment, Self-Focused Task)

Performance Evaluation			
Client Importance	Good Evaluation Mean (SD) (n)	Bad Evaluation Mean (SD) (n)	Total Mean (SD) (n)
More Important Client (10% of Firm Revenues; High Engagement Pressure)	7.89 (1.05) (19)	7.41 (1.06) (17)	7.67 (1.07) (36)
Less Important Client (Less Than 1% of Firm Revenues; Low Engagement Pressure)	8.28 (1.07) (18)	7.59 (1.42) (17)	7.94 (1.28) (35)
Total	8.08 (1.06) (37)	7.50 (1.24) 34	7.80 (1.18) 71

Panel B: Ethical Task #2 (Inventory Judgment, External-Focused Task)

Performance Evaluation			
Client Importance	Good Evaluation Mean (SD) (n)	Bad Evaluation Mean (SD) (n)	Total Mean (SD) (n)
More Important Client (10% of Firm Revenues; High Engagement Pressure)	7.47 (1.31) (19)	7.24 (1.15) (17)	7.36 (1.22) (36)
Less Important Client (Less Than 1% of Firm Revenues; Low Engagement Pressure)	8.17 (.71) (18)	7.59 (.94) (17)	7.89 (.87) (35)
Total	7.81 (1.10) (37)	7.41 (1.05) (34)	7.62 (1.09) 71

Table 4

Sample Size Ethical Task

Univariate ANOVA Results (Dependent Variable: Likelihood of Reporting Sample Size Results)

Model: Client Importance X Performance Evaluation

Source	Type III Sum of Squares	df	F	Sig
Corrected Model ^a	7.60	3	1.89	.139
Intercept	4302.83	1	3216.23	.000
Client Importance	1.386	1	1.036	.312
Performance Evaluation	6.09	1	4.55	.037
Client Importance X Performance Evaluation	.189	1	.141	.708
Error	89.636	67		
Total	4420.00	71		
Corrected Total	97.239	70		

^aR Squared = .078 (Adjusted R Squared = .037)

Table 5
Inventory Write Off Task

Univariate ANOVA Results (Dependent Variable: Likelihood of Recommending Inventory Write Off)

Model: Client Importance X Performance Evaluation

Source	Type III Sum of Squares	df	F	Sig
Corrected Model ^a	8.319	3	2.77	.067
Intercept	4109.42	1	3700.03	.000
Client Importance	4.84	1	4.36	.041
Performance Evaluation	2.95	1	2.66	.108
Client Importance X Performance Evaluation	.512	1	.461	.499
Error	74.41	67		
Total	4205.00	71		
Corrected Total	82.73	70		

^aR Squared = .101 (Adjusted R Squared = .060)

TABLE 6
Correlations among Ethical Judgments, Experience, and Other Background Information

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
1) Sample Size Ethical Judgment	—	.676 (.000)	-.204 (.089)	.082 (.497)	-.152 (.206)	.170 (.194)	-.037 (.795)	.317 (.007)	.162 (.177)	-.239 (.045)	-.003 (.98)	-.256 (.031)	-.214 (.073)	.106 (.377)	.061 (.614)	-.319 (.007)	-.035 (.772)	-.162 (.178)	-.022 (.853)
2) Inventory Ethical Judgment		—	-.235 (.048)	.015 (.899)	-.291 (.014)	-.056 (.673)	-.045 (.75)	.069 (.568)	-.003 (.98)	-.085 (.48)	-.011 (.926)	-.209 (.08)	-.240 (.044)	-.014 (.911)	-.058 (.633)	-.155 (.195)	-.012 (.923)	-.214 (.073)	-.58 (.000)
3) Experience			—	.34 (.004)	.415 (.000)	-.056 (.67)	-.057 (.688)	-.005 (.966)	.099 (.412)	-.018 (.882)	.094 (.436)	.137 (.256)	.25 (.035)	-.141 (.241)	.092 (.443)	.055 (.648)	.078 (.516)	.03 (.804)	.291 (.014)
4) Experience with Ratios				—	.313 (.008)	.025 (.847)	.152 (.283)	.111 (.359)	.036 (.769)	.018 (.884)	-.05 (.681)	-.085 (.481)	.034 (.778)	-.163 (.175)	.119 (.321)	.168 (.161)	-.059 (.625)	.008 (.944)	.029 (.813)
5) Experience with Obsolete Inventory					—	.201 (.124)	-.049 (.729)	-.008 (.948)	.134 (.265)	.022 (.852)	.083 (.494)	.073 (.547)	.076 (.53)	.047 (.696)	-.04 (.742)	.044 (.717)	.067 (.581)	-.056 (.641)	.239 (.044)
6) Number of Certifications						—	-.12 (.429)	.208 (.111)	-.115 (.381)	-.187 (.152)	.144 (.273)	-.057 (.666)	-.111 (.399)	.096 (.466)	-.16 (.223)	-.111 (.399)	-.176 (.178)	.088 (.506)	.154 (.24)
7) Education Level							—	.10 (.48)	-.02 (.889)	-.123 (.385)	-.036 (.798)	.004 (.976)	.111 (.432)	.036 (.803)	-.15 (.29)	-.076 (.592)	.209 (.136)	-.282 (.043)	.019 (.895)
8) PQ10a								—	-.019 (.872)	-.085 (.48)	.111 (.358)	-.080 (.508)	.037 (.758)	.035 (.77)	-.052 (.669)	-.049 (.685)	-.193 (.107)	-.097 (.419)	.136 (.258)
9) PQ10b									—	.113 (.35)	-.129 (.283)	-.054 (.653)	.037 (.761)	.057 (.64)	.103 (.393)	-.145 (.229)	.059 (.626)	.166 (.165)	.103 (.392)
10) PQ10c										—	.002 (.986)	.14 (.245)	-.065 (.591)	-.04 (.738)	.216 (.071)	.079 (.51)	-.006 (.963)	.033 (.785)	-.078 (.519)
11) PQ10d											—	-.062 (.609)	-.041 (.736)	.024 (.84)	.042 (.731)	-.146 (.226)	-.094 (.436)	-.042 (.731)	.103 (.392)
12) PQ10e												—	.22 (.066)	-.185 (.122)	-.07 (.563)	-.107 (.376)	.138 (.252)	.042 (.73)	.005 (.967)
13) PQ10f													—	-.221 (.064)	.038 (.754)	-.167 (.165)	.169 (.159)	-.049 (.683)	.03 (.805)
14) PQ10g														—	-.021 (.859)	-.058 (.631)	.081 (.502)	.116 (.335)	.143 (.234)
15) PQ10h															—	.127 (.29)	-.146 (.226)	.013 (.914)	.062 (.606)

16) PQ10i	—	-.083 (.494)	.139 (.248)	-.161 (.179)
17) PQ10j		—	-.096 (.424)	-.091 (.452)
18) PQ10k			—	.133 (.27)
19) PQ10l				—

1 Participants responded to the request: Based on these facts, what is the likelihood that **you** would report the 25 extra small additions you sampled and the findings from this extra 25-item sample to Gary Johnson? Please indicate your response on a scale from 1 (***Not At All Likely that I would report to Gary Johnson***) to 10 (***Highly Likely that I would report to Gary Johnson***).

2 Participants responded to the request: Please indicate your assessment of the likelihood that you would recommend to the client that the inventory be written off. Please indicate your response on a scale from 1 (***Not At All Likely***) to 10 (***Extremely Likely***).

3 In the post-experimental questions, participants indicated the amount of audit experience they had (in years).

4 In the post-experimental questions, participants indicated their amount of experience with *selecting a sample of property additions for audit testing* on a scale of 1 (***Not At All Experienced***) to 10 (***Extremely Experienced***).

5 In the post-experimental questions, participants indicated their amount of experience with *evaluating potentially obsolete inventory* on a scale of 1 (***Not At All Experienced***) to 10 (***Extremely Experienced***).

6 In the post-experimental questions, participants indicated the certifications (i.e., CPA, CIA, CMA, etc.) that they currently possess.

7 In the post-experimental questions, participants indicated their current level of education (i.e., undergraduate, masters, PhD).

8 Participants indicated their agreement with the following statement using a scale of 1 (***Strongly Disagree***) to 10 (***Strongly Agree***): In this questionnaire, I think that deciding to report the 25 extra sample items and the related findings from this sample to a superior is the more ethical decision than deciding not to report the 25 extra sample items and the related findings from this sample to a superior.

9 Participants indicated their agreement with the following statement using a scale of 1 (***Strongly Disagree***) to 10 (***Strongly Agree***): In this questionnaire, I think that deciding to recommend to the client that the potentially obsolete inventory be written-off is the more ethical decision than deciding to not recommend to the client that the potentially obsolete inventory be written-off.

10 Participants indicated their agreement with the following statement using a scale of 1 (***Strongly Disagree***) to 10 (***Strongly Agree***): In general, I think that receiving a good or bad performance evaluation involves a great deal of *self-serving considerations* (i.e., *the consequences of the evaluation directly impact me*).

11 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In general, I think that receiving a good or bad performance evaluation involves a great deal of *considerations for the public (i.e., the consequences of the evaluation directly impact the public)*.

12 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In general, I think that working on an audit engagement of a major client (i.e., the client is 10% of the CPA firm's revenues) involves a great deal of *self-serving considerations (i.e., the consequences of the audit directly impact me)*.

13 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In general, I think that working on an audit engagement of a major client (i.e., the client is 10% of the CPA firm's revenues) involves a great deal of *considerations for the public (i.e., the consequences of the audit directly impact the public)*.

14 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In general, I think that working on an audit engagement of a minor client (i.e., the client is less than 1% of the CPA firm's revenues) involves a great deal of *self-serving considerations (i.e., the consequences of the audit directly impact me)*.

15 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In general, I think that working on an audit engagement of a minor client (i.e., the client is less than 1% of the CPA firm's revenues) involves a great deal of *considerations for the public (i.e., the consequences of the audit directly impact the public)*.

16 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In this questionnaire, I think that the decision about reporting 25 extra sample items and the related findings from this sample to a superior involves a great deal of *self-serving considerations (i.e., the consequences of the decision directly impact me)*.

17 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In this questionnaire, I think that the decision to recommend to the client that the potentially obsolete inventory be written-off involves a great deal of *self-serving considerations (i.e., the consequences of the decision directly impact me)*.

18 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In this questionnaire, I think that the decision about reporting 25 extra sample items and the related findings from this sample to a superior involves a great deal of *considerations for the public (i.e., the consequences of the decision directly impact the public)*.

19 Participants indicated their agreement with the following statement using a scale of **1 (Strongly Disagree)** to **10 (Strongly Agree)**: In this questionnaire, I think that the decision to recommend to the client that the potentially obsolete inventory be written-off involves a great deal of *considerations for the public (i.e., the consequences of the decision directly impact the public)*.