

**Effects of Auditor Consultation and Audit Committee Attitude on
Managers' Accounting Choice**

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ABSTRACT

We conduct an experiment to provide evidence on the extent to which managers' accounting choice is jointly influenced by whether consultation is sought and communicated by the external auditors, and the audit committee's attitude toward accounting method quality. Results indicate that in the presence of an incentive to use an aggressive method, managers are more likely to use a more appropriate method recommended by auditors when they are told about the auditors' consultation with in-house technical advisors who also recommend the use of the more appropriate method. However, this effect is only observed when the managers perceive the audit committee's support for the more appropriate method to be low. We also find that the use of consultation by auditors does not significantly influence managers' perceived justifiability of using a less appropriate method but increases their perception of auditors' likelihood of insisting on the use of the most appropriate method.

Keywords: auditor consultation, audit committee attitude, accounting choice, influence tactic

Data availability: Please contact the authors.

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INTRODUCTION

In recent years, regulators around the world have focused on ways to enhance financial reporting quality, following several high-profile accounting scandals. A major determinant of financial reporting quality is the quality of accounting policies and methods used to recognize and measure transactions and events. While prior research has examined factors affecting auditors' decisions on clients' accounting choices (e.g., Hackenbrack and Nelson 1996; Salterio and Koonce 1997; Kadous et al. 2003), little research has been conducted on factors affecting managers' accounting choices. Archival studies on published financial statements examine the joint decisions of auditors and managers but do not provide direct evidence on factors influencing managers' decisions, since a firm's audited financial statements are a joint negotiated product of its managers and auditors (e.g., Antle and Nalebuff 1991; Gibbins et al. 2001; Libby et al. 2002; Nelson et al. 2002). Understanding factors affecting managers' accounting choices is important since the responsibility for the preparation of financial statements lies with the firms' managers, and research suggests that managers' preferences and actions can exert a significant influence on auditors' decisions (e.g. Hackenbrack and Nelson 1996; Salterio and Koonce 1997; Kadous et al. 2003; Ng and Tan 2007) and the audit process (McCracken et al. 2007).

In this study, we examine the extent to which managers' accounting choices are jointly influenced by whether consultation is sought and communicated by the external auditors, and the audit committee's attitude toward accounting method quality, a dimension of audit committee effectiveness. Prior research indicates that consultation with experts for the resolution of complex and contentious accounting issues is an important quality control mechanism within

audit firms (Gibbins and Emby 1985; Danos et al. 1989; Salterio and Denham 1997), and enhances the justifiability of auditors' decisions (Kennedy et al. 1997). Further, such consultations are used by both auditors and their clients in their negotiations of accounting issues (Beattie et al. 2001; Gibbins et al. 2001; McCracken et al. 2007).¹ However, systematic experimental evidence is lacking on the extent to which the use of such consultations influences managers' judgments and decisions, either independently or in combination with other features in the environment, such as attributes of the audit committee.² Providing evidence on this issue contributes to both theory and practice by providing a better understanding of the roles of, as well as the interplay between, the different control mechanisms in enhancing the decisions of financial statement preparers and, consequently, financial reporting quality.

We examine the moderating role of audit committee's attitude toward accounting method quality given that prior research indicates that various proxies for audit committee effectiveness is positively associated with the quality of financial reporting (e.g., Beasley et al. 2000; Klein 2002; Abbott et al. 2004; Bédard et al. 2004), and auditor decisions (e.g., Carcello and Neal 2000; Ng and Tan 2003). However, direct evidence on the impact of audit committee attributes on managers' decisions is scant. Furthermore, while prior research suggests that audit committees may have varying attitudes toward financial reporting and governance practices (e.g., Dezoort et al. 2003a, 2003b; Beasley et al. 2007; Hunton and Rose 2007), no research to our knowledge has investigated the implications of such differential audit committee attitudes on managers' accounting choices. Providing evidence on this issue is important given prior anecdotal evidence

¹ Although such consultations can be solicited by the client as well as the auditor (e.g., Gibbin et al. 2007; McCracken et al. 2007), we examine a context where the auditor is the party who seeks the consultation and communicates its results to the client.

² See Ng and Shankar (2007) and Shankar and Ng (2008) for recent research on the effects of advice received through consultations on auditors' decisions.

suggesting that audit committees' corporate governance roles may be driven (or dominated) by the very managers they are supposed to oversee (Cohen et al. 2002, 2008; Beasley 2007). Thus, our study contributes to a better understanding of the "corporate governance mosaic" (Cohen et al. 2004) by demonstrating whether audit committees' attitudes and preferences influence financial reporting quality through its impact on managers' decisions.

We conduct a mailed experiment where chief financial officers and chief executive officers (hereafter the managers) of listed companies in Singapore provide judgments on an accounting issue involving the choice of accounting methods for recognizing revenue for a new sales contract. We provide an incentive for managers to adopt a less conservative method that is deemed by the external auditors to be a less appropriate method relative to an alternative, more conservative, method by telling them that the use of the more appropriate method (but not the less appropriate method) will lead to negative consequences for the company in terms of a failure to meet previously announced earnings projections and prior year earnings. Prior research indicates that firms have incentives to manage earnings to meet these earnings targets (e.g., Burgstahler and Dichev 1997; Kasznik 1999). We manipulate, between subjects, the presence/absence of auditor consultation (by telling half the managers that the auditors have consulted their in-house technical advisors who have similarly recommended the use of the more appropriate method) and the audit committee's attitude toward accounting method quality (in terms of its propensity to support the most appropriate vs. acceptable accounting methods for financial reporting in the past). We also measure the managers' perception about the method that the audit committee will likely support in the case under consideration.

Our results indicate that managers are more likely to use the more appropriate method when they are told about the auditors' consultation than when they are not. However, whether

this effect of auditor consultation is moderated by audit committee effectiveness depends on the specific operationalization of audit committee attitude. Specifically, when it is operationalized based on our manipulation of the audit committee's general attitude toward accounting method quality (i.e., whether it has demonstrated in the past that it will support the most appropriate vs. acceptable accounting methods), the effect of auditor consultation is not moderated by audit committee attitude. In contrast, the effect of auditor consultation is moderated by participants' perceptions about the method that the audit committee will likely support in the case under consideration. Specifically, the effect is only observed when the managers perceive the audit committee's support for the more appropriate method to be low, but not when it is high. The latter result is robust to alternative measures of managers' judgments relating to accounting choices, including managers' assessments of the accounting method that will ultimately be used in the audited financial statements after the auditors' discussions and negotiations with the management and audit committee, as well as their perceptions of the accounting method that will likely be used by a typical listed company CEO. In addition, we also provide some evidence on the justification vs. strategic role of auditor consultation in influencing managers' decisions. Our results indicate that the presence of auditor consultation does not significantly influence managers' perceived justifiability of using a less appropriate method (in contrast to the findings of Kennedy et al. 1997, who examine auditors' perceptions) but increases their perceptions of auditors' likelihood of insisting on the use of the most appropriate method. These results suggest that auditor consultation enhances managers' perceptions of auditors' bargaining power vis-à-vis the client, and is consistent with a strategic role.

Our study contributes to the literature in several ways. First, it provides more direct evidence on factors influencing managers' accounting choice (see Libby et al. 2002) by

demonstrating experimentally how it is jointly affected by the use of consultation by auditors and the perceived attitude or preference of the audit committee. Examining this issue using archival methods would be difficult without gaining access to private communications between auditors and managers as well managers' unobservable perceptions about the audit committee's attitudes and preferences. Second, we extend prior research on the role of auditor consultation (Kennedy et al. 1997) by demonstrating that such consultation by auditors can play a strategic role in enhancing managers' perceptions of auditors' bargaining power and negotiated outcomes, underscoring its importance in the auditor-client negotiation process (see Gibbins et al. 2001). Third, our study contributes to research on the effects of audit committee attributes by demonstrating how it's propensity to support high quality accounting methods can serve as a substitute mechanism for auditor consultation in affecting managers' decisions. Importantly, our study demonstrates that the specific measure of audit committee's attitude matters. Our finding that the effect of auditor consultation is moderated by managers' perceptions of the audit committee's support for the most appropriate accounting method in the specific case at hand, but not by the audit committee's general attitude toward accounting method quality, suggests the importance of clear communication of the audit committee's stand on individual contentious accounting issues that could arise from time to time in the financial reporting process.

The rest of the paper is organized as follows: We develop our hypothesis in the next section. This is followed by a description our research methods and a discussion of our results. We conclude with a discussion of the main findings, limitations and opportunities for future research.

HYPOTHESIS DEVELOPMENT

Prior research suggests that consultation by auditors increases the perceived justifiability of their decisions on ambiguous accounting issues (Kennedy et al. 1997). Indeed, consultation with knowledgeable individuals is an important quality control mechanism widely practiced in audit firms (e.g., Gibbins and Emby 1985; Gibbins and Mason 1988) and emphasized by the profession (e.g., AICPA 1996, 2006; IAASB 2006). Despite its importance, little research has been conducted on how consultation by auditors influences the decisions of managers who play a key role in determining financial reporting quality, either independently or jointly with other corporate governance mechanisms such as audit committees.

In the auditor-client negotiation process, consultation by auditors can serve as a form of negotiation tactic to influence the outcome of their negotiations of accounting issues with managers. Recent research has begun to examine how the use of negotiation tactics by auditors, such as a reciprocity-based strategy and differential timing of auditors' concessions, could influence the outcomes of auditor-client negotiations (e.g., Sanchez et al. 2007; Tan and Trotman 2007), although none has examined the effects of the use of consultation by auditors on managers' financial reporting decisions. The negotiation literature suggests using the support or endorsement of others can be useful in enhancing the user's negotiation power (see Lewicki 2006 for a review). However, research in psychology suggests that the use of such "coalitions" to persuade someone to do something may be an ineffective influence tactic, as it can be viewed by the influence target as manipulative or coercive (e.g., Yukl and Falbe 1990; Falbe and Yukl 1992; Yukl and Tracy 1992; Yukl et al. 1996).

Yukl et al. (1996) present a dyadic influence model which specifies three key factors affecting the success of influence attempts: namely, the influence tactics adopted by the agent,

the power of the agent, and the content or nature of the requested action (such as whether it is important or interesting to the target of the influence attempt). Figure 1 reproduces the model from Yukl et al. (1996: 310). While the model suggests that these factors could potentially interact to jointly affect the outcomes of influence attempts, Yukl et al. (1996) find only significant main effects of the individual factors but not significant interaction effects, based on critical incidents provided by influence agents and targets. We draw on Yukl et al.'s (1996) influence model to develop our hypothesis on the joint effects between auditor consultation and audit committee effectiveness on managers' accounting choice. In our study, the external auditors recommend that the company should use the more appropriate of two alternative accounting methods for recognizing revenue, as it better captures the economic substance of the transaction. As the auditors' requested action relates to enhancing financial reporting quality, managers are likely to perceive the content of the auditors' requested action to be important.

We argue that in the presence of an incentive for managers to use a less appropriate accounting method (such as to avoid a negative earnings surprise), consultation by auditors can increase managers' propensity to adopt a more appropriate accounting method in at least two ways. First, when the auditors communicate their in-house technical advisors' recommendation to use the more appropriate method, which is also consistent with their recommendation, this can potentially reduce (increase) the managers' perceived justifiability of adopting the less (more) appropriate method (see Kennedy et al. 1997, who examine auditors' rather than managers' justifiability perceptions). The theory of motivated reasoning suggests that individuals may be biased to reach a preferred conclusion, but only to the extent they are able to justify the conclusion (Kunda 1990). Thus, to the extent that the auditor consultation lowers their perceived justifiability of using the less appropriate method, managers are more likely to use the more

appropriate method proposed by the auditor. We term this justifiability-influencing effect of consultation as its “justification role”.

Second, the use of consultation by auditors can also increase managers’ perceptions about the auditors’ bargaining power either directly, by causing managers to believe that the auditors will be more likely to insist on the use of the more appropriate method in their negotiations or discussion with managers, or indirectly, by causing managers to believe that the audit committee will be more likely to support the more appropriate method in the presence of the technical advisors’ recommendation.³ We term this effect of consultation as its “strategic role”.

While the above ways in which consultation could influence managers’ decisions involve different mechanisms, they both suggest that managers are more likely to adopt the more appropriate method in the presence of auditor consultation. However, it is likely that other factors in the environment that could increase auditors’ bargaining power, such as the effectiveness of the audit committee, can potentially moderate the effect of consultation, since they can serve as substitute mechanisms in influencing managers’ decisions. Prior research suggests that the effectiveness of the audit committee is positively associated with the quality of financial reporting (e.g., Beasley et al. 2000; Klein 2002; Abbott et al. 2004; Bédard et al. 2004), although more direct evidence on its impact on managers’ decisions is lacking. We posit that the effect of auditor consultation will be stronger in the absence of an effective audit committee, consistent with the notion that an effective audit committee (i.e., one that supports high quality accounting policies and methods) serves as a substitute mechanism for auditor consultation in influencing managers’ accounting choice. Yukl et al.’s influence model (see Figure 1) similarly suggests that the influence agent’s power (in our study, the external auditors’ bargaining power

³ Note, however, that Yukl’s model does not explicitly consider the effect of influence tactics on the agent’s power.

which is enhanced by an effective audit committee) could interact with the agent's influence tactics to jointly determine the influence outcomes. Our hypothesis pertaining to the joint effects of auditor consultation and audit committee attitude is formally stated as follows:

H1: The use and communication of consultation by auditors will increase managers' propensity to use more appropriate accounting methods, particularly when the audit committee's attitude is to support acceptable (vs. the most appropriate) accounting methods.

METHOD

Design

We employ a 2 x 2 between-subject design, with Auditor Consultation (*No Consult* vs. *Consult*) and Audit Committee (AC) Attitude (*Support Acceptable* vs. *Support Appropriate*) as the independent variables. In the experiment, participants are asked to assume the role of Chief Executive Officer (CEO) of a hypothetical listed manufacturing company.⁴ They are told that the company has entered into a new sales contract this year, and that there are two alternative accounting methods for recognizing the revenue from the contract. One method (Method A) is more conservative and, if used, will result in the company not being able to meet its previously announced earnings projections or to exceed its prior year earnings, which is likely to adversely affect the company's share price. The other method (Method B) is less conservative and, if used, will enable the company to meet its previously announced earnings projections and exceed its prior year's earnings. Additionally, all participants are told that preliminary discussions with the

⁴ Although our participants include both CEOs and CFOs, we hold constant the role of the decision maker (i.e., CEO) in the experiment given that CEOs are likely to have the final say on accounting choices, and that CFOs likely have an intimate knowledge of and/or a significant influence on their CEOs' decisions (e.g., Gibbins et al. 2007).

external auditors indicate that both methods are currently acceptable methods under generally accepted accounting principles (GAAP). However, the external auditors believe that Method A (i.e., the more conservative method) better captures the economic substance of the transaction, and is therefore the more appropriate method. Thus, while Method A is deemed by the external auditors to be the more appropriate method, there is an incentive for the company and its managers to adopt the less appropriate method (i.e., Method B) to avoid the adverse consequences associated with the use of Method A. Consistent with Ng and Tan (2003), we provided general descriptions of the accounting issue to control for differential technical knowledge about specific accounting issues among participants.

We manipulate Auditor Consultation by informing participants in the *Consult* condition that the external auditors have consulted their in-house technical advisors who have similarly identified Method A as the more appropriate method and have recommended that the company should use Method A to enhance its financial reporting quality. This information is not provided to participants in the *No Consult* condition. We manipulate the AC's attitude toward accounting method quality by varying the AC's propensity to support acceptable vs. the most appropriate accounting methods. Specifically, we hold constant the composition of the audit committee by informing all participants that the company's AC is made up of three independent directors, one of whom has financial expertise. Participants in the *Support Acceptable* condition are told that the audit committee has demonstrated in the past that it is willing to support any accounting method as long as it is acceptable under GAAP, even though it may not be the most appropriate method. In contrast, participants in the *Support Appropriate* condition are told that the audit committee has demonstrated in the past that it will support the most appropriate accounting methods to enhance the company's financial reporting quality, even though there may be other

methods that are also acceptable under GAAP. Our operationalization of AC Attitude recognizes the socially constructed meaning of AC effectiveness (e.g., Gendron and Bédard 2006) and controls for differential interpretations about the relations between AC composition and AC effectiveness among managers. This is also consistent with calls by researchers to examine the substance underlying effective corporate governance mechanisms beyond their forms (e.g., Gendron and Bédard 2006; Cohen et al. 2007).

Our main dependent variable of interest is participants' accounting method choice. Specifically, we ask them which of the two accounting methods they would most likely use to recognize the revenue from the new sales contract (i.e, Method A or Method B).⁵ In addition, we also elicit participants' assessments of the accounting method that will be ultimately used in the audited financial statements (see e.g., Libby and Kinney 2000; Ng and Tan 2003). Specifically, after they have indicated their decision on which accounting method they would use, participants are told to assume that "the external auditors have communicated to the audit committee that although both Method A and Method B are acceptable methods under GAAP, they prefer Method A as they believe that it better captures the economic substance of the transaction, and is therefore the more appropriate method than Method B". They are then asked to indicate which of the two accounting methods they believe will ultimately be used in the audited financial statements for recognizing the revenue from the new sales contract, after the external auditors' discussions and negotiations with the management and audit committee. Lastly, to address potential concerns with social desirability bias in our results (see e.g., Fisher 1993), we also ask participants to indicate which of the two accounting methods they believe a typical CEO of a

⁵ We also elicit a continuous measure of participants' judgment by asking them to indicate which accounting method they would prefer to use, on a ten-point scale with 0 labeled "Definitely Method A", 5 labeled "Neutral" and 10 labeled "Definitely Method B". Since this judgment measure is basically an input to participants' accounting method choice, we report the results based on the dichotomous decision variable.

listed company would most likely use to recognize the revenue from the new sales contract. We report the results pertaining to these two additional dependent variables as part of our further analyses.

Participants and Administration

Participants are CEOs and CFOs of listed companies based in Singapore. The study was conducted in conjunction with a survey of top management's perceptions of the internal audit profession commissioned by the Institute of Internal Auditors Singapore (see Ng et al. 2007 for survey findings). We identified the names of 970 CEOs and CFOs from the listed companies' latest available annual reports, and mailed them the experimental instrument along with the internal audit survey questionnaire and a self-addressed prepaid return envelope.

The experimental instrument provided a short introduction to the study, followed by the case scenario which contains a description of the hypothetical client, the accounting issue, the client's AC (manipulated at two levels as described earlier), and, for participants in the *Consult* condition, the external auditors' consultation with their in-house technical advisors (as described earlier). Participants were randomly assigned to each of the four experimental conditions arising from crossing our two independent variables, Auditor Consultation and AC Attitude. After reading the case materials, participants were asked to make a series of decisions relating to the case, before proceeding to complete a debriefing questionnaire containing our manipulation check and other questions. We also elicited some demographic information about our participants via the internal audit survey questionnaire.

To encourage responses, prospective participants were told that we would donate a fixed amount, for each response received, to a charity organization selected by respondents from a list of five charities. They were asked to respond in about a month's time, and a reminder was sent to

them after the deadline had lapsed. A total of 67 responses to the experimental study were received, yielding a response rate of 7%. The low response rate is reasonable given the nature of the participants (CEOs and CFOs) and the amount of time and effort needed to complete both the experimental study and the internal audit survey (comprising a total of eleven pages of materials). The response rate is also consistent with the 7% response rate reported in another study targeting a similar respondent group comprising top executives of major corporations in Singapore (Teoh et al. 2007), as well as the 6.5% response rate in an experimental study administered via email targeting high-level auditors in the U.S. (Kadous et al. 2003: 768).

Among the 67 respondents, one did not provide a decision on the accounting choice, our main dependent variable of interest. Thus, our analysis is based on a final sample of 66 respondents, comprising 49 CFOs and 17 CEOs. On average, participants' companies have total revenues of S\$670 million and 3,193 employees. Their audit committees are made up of an average of 3.3 members, 84% of whom are independent directors and 54% of whom have financial expertise on average. None of these organizational variables vary significantly at the 5% level between experimental conditions, between the CFO and CEO groups, or between early and late responders. The CFOs (CEOs) have an average age of 42 years (51 years) and an average working experience of 17 (27) years. The CFOs have, on average, significantly more experience than the CEOs in financial accounting (9.6 vs. 3.2 years respectively), management accounting (10.7 vs. 4.0 years respectively) and external auditing (3.1 vs. 0.1 years respectively; all p -values < 0.05).⁶ Although the CEOs have more years of experience serving on audit committees than the CFOs (means = 3.1 and 1.6 years respectively), the difference is not statistically significant ($p = 0.289$). These demographic variables do not vary significantly across

⁶ Unless otherwise stated, two-tailed p -values are reported. One-tailed p -values are reported for directional tests.

experimental conditions after controlling for the participant group. We obtain similar results for our hypothesis tests when we rerun our analyses using only the CFO participants. Hence we present our results based on the combined group.

RESULTS

Manipulation and Other Checks

We perform a check on our manipulation of Auditor Consultation by asking participants, in the post-experimental questionnaire, whether the external auditors consulted their in-house technical advisors on the accounting method for recognizing the revenue from the new sales contract. The majority of the participants in the *No Consult* condition (78%) answer “No” or “Not mentioned” while the majority in the *Consult* condition (85%) answer “Yes”, suggesting that our advice manipulation is effective.⁷ To test our manipulation of AC Attitude, we ask participants to rate how likely the AC would support any accounting method as long as it is acceptable under GAAP, even though it may not be the most appropriate method. Participants’ ratings are significantly higher in the *Support Acceptable* condition than the *Support Appropriate* condition (means = 6.5 and 4.5 respectively on an 11-point scale with 0 = extremely unlikely, 10 = extremely likely; $p = 0.004$), suggesting that our manipulation of AC Attitude is successful.⁸

In addition, we also provide some evidence on the justification vs. strategic role of consultation by external auditors on managers’ judgments. Specifically, as discussed in our

⁷ We obtain similar results for our hypothesis tests when we eliminate participants who did not respond correctly to this question.

⁸ In additional questions, four participants did not correctly indicate that both methods are acceptable methods under GAAP, another 7 participants did not correctly indicate that Method A is more appropriate than Method B, and a further 8 participants did not correctly indicate that the use of Method A but not Method B will lead to adverse consequences for the company. We obtain similar results for our hypothesis tests when we exclude these participants’ responses.

hypothesis development, consultation by auditors may potentially reduce managers' perceived justifiability of adopting the aggressive, less appropriate method (i.e., plays a justification role) and/or enhance their perception of the auditors' bargaining power (i.e., plays a strategic role). To provide evidence on the justification role of consultation, we ask participants to indicate the extent to which they believe it is justifiable to use Method B (the aggressive method) on the grounds that it is an acceptable method under GAAP, even though it may not be the most appropriate method (using an 11-point scale with 0 = not at all justifiable, and 10 = completely justifiable). Results of an ANOVA (untabulated), with Auditor Consultation and AC Attitude as independent variables and participants' justifiability rating as the dependent variable, indicate that neither the main effects of Auditor Consultation and AC Attitude nor their interaction effect is statistically significant (mean rating = 5.3; $p > 0.326$). Thus, consultation by auditors does not appear to influence managers' perceived justifiability of using the aggressive method. These results are not consistent with a justification role of consultation by auditors.⁹

To provide evidence on the strategic role of consultation by auditors, we ask participants to indicate the extent to which they believe the external auditors would insist on the use of the most appropriate revenue recognition method (using an 11-point scale, with 0 = very low extent; 10 = very high extent). The ANOVA results (untabulated) indicate a statistically main effect of Auditor Consultation ($p = 0.016$) and a marginally significant interaction between Auditor Consultation and AC Attitude ($p = 0.087$). Tests of simple effects indicate that in the *Support*

⁹ We also ask participants the same question at the end of the debriefing questionnaire, assuming that the use of neither method will lead to significant negative consequences for the company. Participants' ratings similarly do not vary significantly across experimental conditions (mean rating = 4.5; $p > 0.501$), although these ratings are significantly lower than the previous ratings based on the case where significant negative consequences are associated with the use of Method A, the more appropriate method ($p = 0.021$). These results suggest that managers consider it to be more justifiable to use a less appropriate accounting method when doing so enables the company to avoid negative consequences that could result from the use of a more appropriate method. See Kennedy et al. (1997) for a similar finding using auditor participants.

Acceptable condition, the ratings are significantly higher in *Consult* condition than in the *No Consult* condition (means = 6.9 and 4.0 respectively; $p = 0.006$). However, in the *Support Appropriate* condition, the ratings are not significantly different between the two Auditor Consultation conditions (means = 6.2 and 5.7 respectively; $p = 0.594$).¹⁰ These results suggest that, particularly in the absence of an effective AC that supports the most appropriate accounting methods, consultation by auditors leads managers to anticipate stronger opposition by the auditors to the use of a less appropriate accounting method (i.e., by insisting on the use of the most appropriate method), presumably due to a perceived increase in the auditors' bargaining power. These results are consistent with a strategic role of auditor consultation, and suggest that consultation with experts and an effective AC are substitute mechanisms in enhancing auditors' bargaining power vis-à-vis the managers.

We further explore whether managers' anticipation of greater insistence on the use of the more appropriate method by auditors who have consulted their technical advisors is due, at least in part, to their perception that the audit committee will be more likely to support the more appropriate method in the presence of auditor consultation. Specifically, we ask participants to indicate (as part of the debriefing questions) which revenue recognition method the AC would most likely support in the case (using an 11-point scale with 0 = Definitely Method A; 5 = Neutral; 10 = Definitely Method B).¹¹ An ANOVA with participants' response to this question as the dependent variable and with AC Attitude and Auditor Consultation as independent variables yield no statistically significant main or interaction effects at the 5% level. These

¹⁰ In a similar vein, the ratings are higher in the *Support Appropriate* condition than the *Support Acceptable* condition in the absence of consultation by auditors (means = 5.7 and 4.0 respectively; $p = 0.043$, one-tailed) but not in its presence (means = 6.2 and 6.9 respectively; $p = 0.491$), suggesting that an effective AC increases managers' perception of auditors' bargaining power, particularly in the absence of auditor consultation.

¹¹ One participant did not provide a rating. Thus, our analysis using this measure is based on the remaining 65 participants.

results suggest that managers' perceptions about the specific method the AC will support 1) are not affected by the presence or absence of auditor consultation; and 2) are distinct from the AC's general attitude toward accounting method quality as manipulated in the experiment, and may therefore influence their decisions in ways different from our manipulated AC attitude variable.

Test of Hypothesis

We predict that in the presence of an incentive to use an aggressive, less appropriate, accounting method, managers are more likely to use a more appropriate accounting method proposed by the auditors when they are told that the auditors have consulted their in-house technical advisors who have recommended the use of the more appropriate method, particularly when the audit committee's attitude is to support acceptable (vs. the most appropriate) accounting methods. Table 1, Panel A, presents the descriptive statistics on the proportion of participants choosing the more appropriate method (henceforth $P_{\text{Appropriate}}$) for each of the Auditor Consultation / AC Attitude conditions. The categorical ANOVA results, presented in Panel B of Table 1, indicate a statistically significant main effect of AC Attitude, with a higher $P_{\text{Appropriate}}$ in the *Support Appropriate* condition than the *Support Acceptable* condition ($P_{\text{Appropriate}} = 0.83$ and 0.67 respectively; $p = 0.035$, one-tailed), and a marginally significant main effect of Auditor Consultation, with a higher $P_{\text{Appropriate}}$ in the *Consult* condition than the *No Consult* condition ($P_{\text{Appropriate}} = 0.82$ and 0.69 respectively; $p = 0.061$, one-tailed). However, the interaction effect is not statistically significant ($p = 0.818$).¹²

¹² We obtain similar results when we perform a logistic regression using participants' (mean-centered) response to the manipulation check question on AC effectiveness (reported earlier) as a continuous independent variable instead of our manipulated dichotomous AC effectiveness variable.

Recall that we manipulate AC Attitude in terms of the AC's general attitude toward accounting method quality in the past. This operationalization of AC attitude may not accurately reflect managers' beliefs about the actual accounting method that the AC will likely support in the case, given that at least some managers may believe that the AC will support a more aggressive method to avoid negative consequences for the company, regardless of their general attitude toward accounting method quality. We therefore use an alternative operationalization of AC attitude based on managers' perceptions of the likelihood that the AC will support the more appropriate method in the case (reported earlier). To facilitate our analysis, we recoded participants' ratings into a dichotomous variable (henceforth AC Support), with ratings of 4 and below coded as 1 (high AC support for the more appropriate method), and ratings of 5 and above coded as 0 (low AC support for the more appropriate method).¹³ Table 2, Panel A presents the $P_{\text{appropriate}}$ for each of the Auditor Consultation and AC Support conditions, while Panel B presents the categorical ANOVA results on the managers' accounting method choice. Results indicate a statistically significant interaction effect between Auditor Consultation and AC Support ($p = 0.015$) as well as a statistically significant main effect of AC Support ($p = 0.000$). Tests of simple effects indicate that when perceived AC support for the more appropriate method is low, $P_{\text{appropriate}}$ is significantly higher when managers are told that the external auditors have consulted their in-house technical advisors than otherwise (proportions = 0.67 and 0.31 respectively; $p = 0.021$, one-tailed). In contrast, when perceived AC support is high, $P_{\text{appropriate}}$ does not vary between the two Auditor Consultation conditions (proportions = 0.90 and 1.00

¹³ We obtain similar results when we eliminate responses of participants who provide a rating of 5 (labeled Neutral). We also obtain similar results when we reperform the analysis using a logistic regression based on participants' (mean-centered) ratings instead of the dichotomous measure.

respectively; $p = 0.136$).¹⁴ These results (using an alternative, issue-specific, measure of AC attitude) provide support for H1, and suggest that the use of consultation by auditors could reduce managers' propensity to use an aggressive accounting method, particularly when the managers believe that the AC is less likely to support the more appropriate method in the specific case under consideration.

Additional Analysis

Managers' perceptions of the accounting method ultimately used

To provide evidence on the extent to which consultation by external auditors and AC attitude influence managers' perceived outcome of auditor-client negotiations (cf. Libby and Kinney 2000; Ng and Tan 2003), we perform a categorical ANOVA with Auditor Consultation and AC Support as independent variables and the accounting method that participants believe will ultimately be used in the audited financial statements after the external auditors' discussions and negotiations with the management and audit committee as the dependent variable. Consistent with our main results on managers' accounting choice reported above, there is a statistically significant interaction effect between Auditor Consultation and AC Support ($p = 0.032$). The main effects of Auditor Consultation and AC Support are also statistically significant ($p < 0.032$).¹⁵ Tests of simple effects indicate that when AC Support is low, a significantly higher

¹⁴ Further tests indicate that in the No Consult condition, $P_{\text{Appropriate}}$ is significantly higher when perceived AC Support is high than when perceived AC Support is low ($P_{\text{Appropriate}} = 1.00$ and 0.33 respectively; $p = 0.000$, one-tailed). However, in the Consult condition, the difference in $P_{\text{Appropriate}}$ between the two AC Support conditions is only marginally significant ($P_{\text{Appropriate}} = 0.90$ and 0.69 respectively; $p = 0.075$, one-tailed). These results suggest that consultation somewhat moderates the influence of perceived AC support on managers' accounting choices.

¹⁵ In contrast, when we use the manipulated variable of AC Attitude instead of the measured AC Support variable, only the main effect of Consultation is statistically significant ($p = 0.033$), with a higher proportion of participants believing that the more appropriate method will be ultimately used when they are told that the external auditors have consulted their in-house technical advisors than otherwise (proportions = 0.91 and 0.72 respectively). Neither the main effect of AC Attitude nor the interaction effect between Consultation and AC Attitude is statistically significant ($p > 0.493$).

proportion of participants believe that the more appropriate method will ultimately be used when they are told that the external auditors have consulted their in-house technical advisors than otherwise (proportions = 0.77 and 0.40 respectively; $p = 0.016$, one-tailed). In contrast, when AC support is high, all the participants believe that the more appropriate method will ultimately be used, regardless of consultation by the auditors. These results provide further support for our hypothesis on the joint effects of consultation and AC attitude on financial reporting quality.

Managers' perceptions of the accounting choices of other CEOs

To provide some evidence on whether our results are sensitive to social desirability bias (see Fisher 1993), we elicit an alternative, indirect measure of managers' accounting choice by asking participants to indicate which accounting method they believe a typical CEO of a listed company would most likely use to recognize revenue from the new sales contract. Results of categorical ANOVA (untabulated) indicate a marginally significant interaction effect between Auditor Consultation and AC Support ($p = 0.083$) as well as a statistically significant main effect of AC Support ($p = 0.001$). Tests of simple effects indicate that when AC Support is low, a marginally higher proportion of participants believe that a typical CEO will use the more appropriate method when they are told that the external auditors have consulted their in-house technical advisors than otherwise (proportions = 0.15 and 0.00 respectively; $p = 0.062$, one-tailed). In contrast, when AC support is high, the proportions do not vary significantly between the two Auditor Consultation conditions (proportions = 0.30 and 0.47 respectively; $p = 0.282$).¹⁶ Although the descriptive statistics suggest that the participants generally view a typical CEO to be less likely to use the more appropriate method compared to themselves, the consistent results

¹⁶ We obtain similar results when we use the manipulated variable of AC Attitude instead of the measured AC Support variable.

of the statistical tests provide evidence that social desirability bias does not pose a significant threat to our main finding regarding the joint effects of consultation and AC attitude.

CONCLUSION

Our study demonstrates the joint effects of consultation by external auditors and the audit committee's attitude toward accounting method quality on managers' accounting choice decisions. The results show that in the presence of incentives to use a less appropriate accounting method, knowledge of auditors' consultation with expert advisors enhances managers' propensity to use a more appropriate accounting method for financial reporting, particularly when they perceive the audit committee's support for the more appropriate method to be weak. Additional evidence suggests that consultation by external auditors causes managers to anticipate greater insistence by auditors on the use of the more appropriate method. In contrast to Kennedy et al. (1997)'s finding that consultation by auditors enhances the perceived justifiability of auditors' decisions, our results indicate that managers' perceived justifiability of inappropriate accounting decisions is not influenced by auditor consultation but by negative consequences associated with these decisions. Taken together, these results suggest that consultation by auditors serves a strategic role rather than a technical justification role in influencing managers' judgments. These results underscore the importance of the use and communication of consultation by external auditors in their negotiations with clients, and suggest that auditor consultation and audit committee effectiveness are substitute mechanisms in mitigating managers' propensity to engage in inappropriate financial reporting practices. Such consultations are particularly important when auditors are faced with ambiguous accounting issues where authoritative guidance is lacking. Prior research indicates that audit committee effectiveness has

a more significant influence on auditors' perceived audit outcomes when authoritative guidance on accounting issues is lacking (Ng and Tan 2003). Our results suggest that in such situations, consultation by external auditors play a critical role in mitigating the negative impact of ineffective audit committees on financial reporting quality.

Our study has several limitations, which also provide opportunities for further research. First, we examine a situation where managers (in the *Consult* condition) are told that the auditors have consulted their in-house technical advisors who agree with the auditors' choice of the most appropriate accounting method. Thus, our study provides a joint test of the effects of 1) consultation by auditors, 2) the receipt of a recommendation from advisors supporting the auditors' position, and 3) communication of the outcome of the consultation to managers by auditors. Thus, our study does not speak to situations where the technical advisors disagree with auditors' preliminary position, or where conflicting advice is received by auditors from different sources. Although Kennedy et al.'s (1997) findings suggest that the act of consultation enhances perceived justifiability of auditors' decisions even if the advice received is not subsequently followed, knowledge of conflicting advice received by auditors may negatively influence managers' perceptions of auditors' bargaining power. However, such conflicting advice may, in the first place, be less likely to be communicated by auditors to managers. Future research could shed light on how differences in consultation outcomes influence auditors' communication strategy with managers.

Second, we do not explicitly tell managers whether the auditors' consultation is binding or non-binding in nature, nor measure their assumptions regarding this issue. It is possible that the extent of managers' reactions to auditor consultation may vary depending on whether the consultation is binding or non-binding on auditors' decisions, since a binding (vs. non-binding)

consultation would more significantly constrain the auditors' ability to deviate from the advisors' recommendations and, consequently, their propensity to concede to management's preferences. Future research could examine how the structure of the consultation process may systematically affect the judgments of both the auditors and managers.

Third, although our study measures participants' judgments about the audit committee's support for the alternative accounting methods, we do not directly examine the judgments of audit committee members, which may be influenced by the presence/ absence of auditor consultation. Although we provide evidence that auditor consultation does not influence managers' perceptions of the audit committee's propensity to support the more appropriate accounting method, and that our results extend to managers' perceptions of the negotiated outcome after the auditors' discussions with the audit committee, providing more direct evidence on audit committee members' judgments is important given their critical role in corporate governance. Nevertheless, Beasley et al. (2007) find mixed involvement of audit committees in reviewing alternative accounting treatments, while Cohen et al. (2008) report that only about half of the interviewed auditors feel that the audit committees play an important role in resolving auditor disputes with management, presumably because such disagreements are typically resolved before they are brought up to the audit committees (see also, Gendron and Bédard 2006; Gibbins et al. 2007). Therefore, our study sheds light on factors that could influence managers to adopt high quality accounting methods proposed by the auditors, thereby avoiding escalation of disputes to the audit committee level. Further research could more directly examine how consultation by auditors affect audit committee members' judgments, and conversely, how audit committees' support for high quality accounting methods influences auditors' consultation behaviors.

In conclusion, our study contributes to a better understanding of factors affecting managers' accounting choices. Our findings suggest that the strategic use and communication of consultation by auditors and differential perceptions about the audit committee's support for high quality accounting methods by managers can have significant implications for financial reporting quality through their influence on managers' accounting choices. These results should be of interest to financial statement preparers, auditors, audit committees and regulators interested in upholding the quality of financial reporting.

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FIGURE 1

Influence Model
(Source: Yukl et al. 1996: 310)

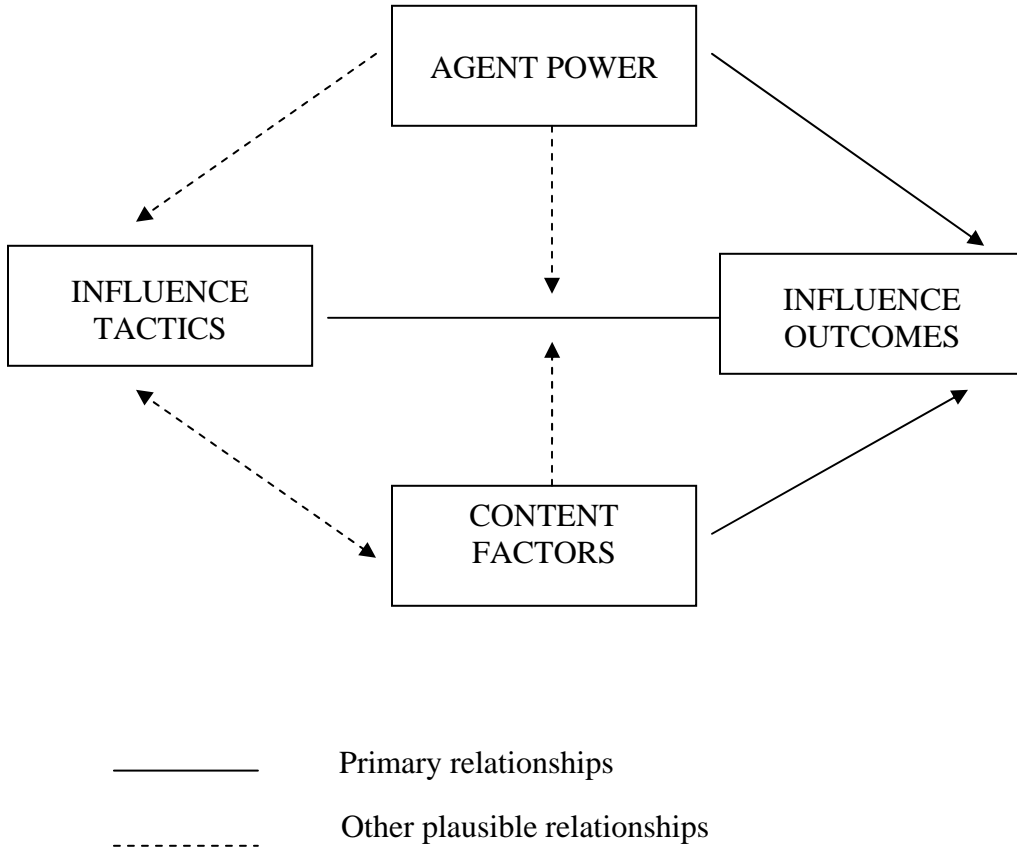


TABLE 1

Effects of Auditor Consultation and Audit Committee (AC) Attitude on Managers' Accounting Choice

Panel A: Descriptive Statistics on Proportion of Managers Choosing the More Appropriate Accounting Method ($P_{\text{Appropriate}}$)

AC Attitude		Auditor Consultation		
		<u>No Consult</u>	<u>Consult</u>	<u>Average</u>
<i>Support</i>	$P_{\text{Appropriate}}$	0.58	0.72	0.67
<i>Acceptable</i>	Sample size	12	18	30
<i>Support</i>	$P_{\text{Appropriate}}$	0.75	0.94	0.83
<i>Appropriate</i>	Sample size	20	16	36
Average	$P_{\text{Appropriate}}$	0.69	0.82	0.76
	Sample size	32	34	66

Panel B: Categorical ANOVA Results on Managers' Accounting Choice

Effect	df	χ^2	p-value
Auditor Consultation (ADC)	1	2.40	0.061*
AC Attitude (ACA)	1	3.28	0.035*
ADC x ACA	1	0.05	0.818

* Denotes one-tailed p-values.

TABLE 2**Effects of Auditor Consultation and Perceived Audit Committee (AC) Support on Managers' Accounting Choice****Panel A: Descriptive Statistics on Proportion of Managers Choosing the More Appropriate Accounting Method ($P_{\text{Appropriate}}$)**

AC Support		Auditor Consultation		
		<u>No Consult</u>	<u>Consult</u>	<u>Average</u>
<i>Low</i>	$P_{\text{Appropriate}}$	0.33	0.69	0.50
	Sample size	15	13	28
<i>High</i>	$P_{\text{Appropriate}}$	1.00	0.90	0.95
	Sample size	17	20	37
Average	$P_{\text{Appropriate}}$	0.69	0.82	0.75
	Sample size	32	33	65

Panel B: Categorical ANOVA Results on Managers' Accounting Choice

Effect	df	χ^2	p-value
Auditor Consultation (ADC)	1	1.88	0.171
AC Support (ACS)	1	21.41	0.000
ADC x ACS	1	5.90	0.015