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Literature Review

The Effect of Audit Culture on Audit Quality

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Introduction

In 2014, the professional body for accountants in the Netherlands (NBA) indicated that audit quality did not live up to the public's expectations. One of the main corrective measures suggested by the NBA was an improvement in audit culture (NBA, 2014). Although audit culture can be an important determinant of audit quality, the extant academic literature has not payed much attention to audit culture. This paper provides an overview of the literature on audit quality and audit culture as a determinant of audit quality. Before we turn to our core topic of audit culture, we provide a brief overview of the definition and determinants of audit quality in general as well as an overview of organizational culture and cultural control.

Audit Quality

One of the first definitions of audit quality is developed by DeAngelo (1981). She posits that "the quality of audit services is defined to be the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach." (p. 186). DeAngelo (1981) refers to the phenomena 'breach', now commonly referred to as 'misstatement'. This definition, however, runs short when looking at 'modern' audit quality. Whereas misstatements are an indicator of poor audit quality, quality relates to more than just misstatements nowadays. That said, the effectiveness of an audit is difficult to assess even after the work has been performed (Power 2003). Examples of audit quality visible as output of the audit process are going-concern issues, the audit review process, and PCAOB or SEC enforcement actions following inspections (Gibbins and Trotman 2002; Christensen et al., 2016). Despite the importance of audit quality and the large body of research investigating the topic, regulators, investors, and researchers have not come to a widely-accepted definition, composition, and measurement of audit quality (e.g., Bedard, Johnson and Smith 2010; Christensen et al. 2016). As Bedard et al. (2010) conclude, one should not focus on a single indicator of audit quality but on a broad array of indicators to get a multi-dimensional picture of audit quality.

Following Bedard et al. (2010), numerous Audit Quality frameworks that take on such a multi-dimensional perspective were developed (e.g., DeFond and Zhang 2014; Francis 2011; Knechel et al. 2013; PCAOB, 2013, IAASB, 2014; CAQ, 2019). Several of these frameworks classify the factors relevant to audit quality in categories related to audit inputs, processes, and outcomes (e.g., Francis, 2011; IAASB, 2014). Inputs are the core aspects that are put into the audit, like the individual characteristics of the audit team such as professional skepticism, knowledge, and expertise. The audit process represents the implementation of audit inputs, i.e., the testing procedures that are applied by the engagement team. As mentioned before, outcomes are often uncertain or unobservable. Existing frameworks relate them to, for example, the actual quality of the financial statements, the expressed audit opinion, and the accuracy of accruals (e.g., Knechel et al. 2013). Moreover, the basic version of the framework is often extended to include factors like interactions with, e.g., regulators and users of financial statements and contextual factors (e.g., the litigation environment) as relevant determinants of audit quality (e.g., IAASB 2014).

Overall, researchers agree that audit inputs and the management of these inputs are crucial determinants of audit quality. It can be argued that the auditors are the most crucial inputs, because a significant part of the audit firm’s value consists of the value of its auditors' knowledge and skills. In the auditing literature this is labeled auditor competency, where auditor competency refers to the auditor’s ability to deliver high audit quality, which includes knowledge and skills (DeFond and Zhang 2014). It is important to note that there is significant variation in auditor competency, not only between ranks but also within ranks. Despite the importance of human capital to audit firms, there is relatively little archival research on auditor competency (DeFond and Zhang 2014). Most of this research examines audit *firm* competency measured as industry specialization or office size. However, a number of recent studies examine individual auditors and find that signing auditors/engagement partners exhibit significant variation in proxies of audit quality (e.g., Gul, Wu, and Yang 2013; Knechel, Vanstraelen, and Zerni 2015).

Organizational Culture and Cultural Control[1]

Culture is often understood to comprise shared basic assumptions, customs, myths, and ceremonies that communicate underlying beliefs and is evidenced by values reflected in individual and group behaviors (Reigle 2001). Essentially, culture establishes the parameters of acceptable and unacceptable behavior (Jenkins et al. 2008). Visible symbols of culture represent integration into the organization. For example, standards of dress, membership in civic, professional, and religious organizations, and expectations regarding work hours and workplace behavior all communicate an organization's culture and expectations regarding behavior (Reigle 2001). Culture ''establishes recognized and accepted premises for decision making'' (Hood and Koberg 1991, 12). In sum, organizational cultures are built upon shared beliefs, norms, attitudes, and ways of behaving. These cultural norms are embodied in written and unwritten rules that are meant to govern employees' behaviors (Drury 2000). That is, expected behaviors, or norms, result from culture.

While an organizational culture does not develop over night, and typically only changes slowly, firms can make use of a set of tools to increase the likelihood that all organizational members share the firm's norms and values. In particular, personnel and cultural controls attempt to minimize the divergence of preferences among organizational members in order to create goal alignment. Fundamentally, they aim at motivating employees to either control their own behaviors (by means of personnel controls) or to control each others' behaviors (by means of cultural controls) (Merchant 1998; Merchant and Van der Stede 2017). As these controls are exerted on oneself or from peers on one another, organizations cannot directly implement them but can only create the circumstances that encourage people to engage in these forms of control.

[1] See also Grabner (2009)

Personnel controls aim at ensuring that personnel will perform at a high level and in congruence with company goals (Widener 2004). The major mechanisms through which personnel controls can be exerted are selection and placement of employees and employee training and development. Selective staffing aims at increasing the probability that applicants hired for a job will fit the job requirements, as well as the company's value system, and usually involves a resourceintensive multi-stage recruiting process. Similarly, training facilitates that employees will do a good job, as it serves as a means of clarifying expectations in terms of desired actions and results, and it provides information on how to best perform the assigned tasks (Merchant 1998; Merchant and Van der Stede 2017).

Cultural controls represent a set of values, social norms, and beliefs that are shared by members of the organization and influence their actions (Govindarajan and Fisher 1990). Cultural controls operate through mechanisms used by work groups to regulate the behavior of their own peers and to bring them into line when they deviate from group norms. As opposed to the forms of hierarchic control, cultural control is exercised by peers over one another (Drury 2000). Cultural controls prompt employees to work together in a synergistic fashion and are based on methods that encourage mutual monitoring (Merchant 1998; Merchant and Van der Stede 2017). Thus, organizations can not directly impose these controls on employees but only have an indirect influence by using methods of shaping culture and, thus, effecting cultural controls. Tone from the top, codes of conduct, and group rewards are the most important of these mechanisms. Value communication via tone from the top signals and enforces shared values and beliefs and guides the actions of employees by giving them the ability to determine what is supposedly in the best interest of the organization (Büschgens et al. 2013). Tone from the top is viewed as an informal control practice that comprises common values, beliefs, and traditions and thus can direct the behavior of group members (Falkenberg & Herremans, 1995). It is a powerful form of cultural control (Merchant & Van der Stede, 2017) whose power emerges from its ability to manage the behavior of employees in ambiguous and/or unexpected situations, where it addresses the limits of formal control systems that are, however, designed for specific and/or predictable events (Falkenberg & Herremans, 1995). Codes of conduct are formal written statements about an organization's philosophy of doing things and aim at communicating to employees what behaviors are expected from them even in the absence of clearly stated rules. Notably, these codes of conduct can only contribute to cultural control when management is committed to them and deliberately communicates this to their subordinates. The provision of rewards based on group performance also stimulates cultural controls, as this encourages team work and mutual monitoring. Basically, group rewards delegate performance monitoring from management to the employees' co-workers, as their individual compensation is directly affected by their peers' effort levels and productivity (Merchant 1998; Merchant and Van der Stede 2017).

While a strong organizational culture is generally perceived as a positive firm feature, this is not necessarily the case. Just like suitable organizational cultures can contribute to success, flawed cultures often play a crucial role in important problems experienced by companies (e.g., Enron, Volkswagen emissions scandal, etc.). First, a strong organizational culture can create blind spots or become a source of inertia given the lack of critical questioning and lack of diversity in opinion (Merchant and Van der Stede, 2017). Second, it is important to note that the effect of a strong organizational culture on desirable and undesirable employee behavior depends on the values that underly the organizational culture and that are subsequently lived up to by the employees. A well-developed organizational culture can even lead to severe unfavorable outcomes, as the famous example of Arthur Andersen reminds us of (e.g., providing certain financial or internal control advice to the audited entity, earnings management, fraud, exploiting gaps in accounting standards) (Kelly and Earley, 2009) . Since then, the values underlying audit firm culture have received an increased amount of attention by audit firms, and many audit firms have engaged in long-term culture change projects (Suddaby, Gendron, and Lam, 2009).

Audit Culture

Organizations and their culture play an important role in structuring the conditions by which professional work is conducted. This is no different for audit firms (Gaynor et al., 2016; Knechel et al., 2013).The auditing profession has historically viewed firm culture as unique and proprietary, the very essence of the firm (Jenkins et al. 2008). In several of the existing practitioner frameworks, audit culture is mentioned as an important determinant of audit quality. According to Financial Reporting Councils' (FRC) 2008 Audit Quality Framework, culture is mainly driven by actions of the leadership of the audit firm. For example, the leadership can show that they value high audit quality and emphasize the importance of 'doing the right thing' in the public interest and the effect of doing so on the reputation of both the firm and individual auditors. Also the Center for Audit Quality includes leadership and culture in its Audit Quality Disclosure Framework (CAQ, 2019). Leadership should set the tone at the top, but establishing core values, principles, and codes of conduct that recognize audit quality is vital as well. Culture and core values influence many behaviors related to audit quality, such as professional skepticism and professional judgment. Further, culture influences attitudes and behaviors, such as coaching, consultation, compliance, remediation, innovation, and continuous improvement, which are critical to audit quality. Likewise, the Framework for Audit Quality from the International Auditing and Assurance Standards Board mentions values, ethics, and attitudes as factors that help ensure audit quality (IAASB, 2014).

Whereas audit culture is proposed as a determinant of audit quality by almost every "practitioner" framework, academic support on the topic is limited. Over the years, several academic papers have put audit firm culture explicitly on the research agenda (e.g., Carpenter et al. 1994; Jenkins et al. 2008; Knechel et al. 2013), but not many of the topics identified as interesting future research opportunities have been addressed to date. More recent studies focus on specific components of organizational culture, such as the organizational error climate or ethical environment. Gronewold and Donle (2011) found that an organization's error climate influences auditors' individual predisposition toward handling their own errors, which eventually influences auditors' predisposition towards handing their clients' errors. Bobek, Dalton, Daugherty, Hageman (2017) investigated the ethical environment of accounting firms and industry firms and found that certified public accountants (CPAs) working at Big Four firms perceive a significantly stronger ethical environment compared to those at other firms. Additionally, Shafer (2008) concluded that perceptions of the ethical climate in an audit firm have a significant effect on intentions to commit ethically questionable acts. In a similar fashion, Svanberg and Öhman (2016) found that auditors in audit firms with a strong ethical culture are indeed more likely to exhibit objectivity in their work than are auditors in less supportive cultures. Finally, Carpenter et al. (1994) found that a firm's audit culture systematically influences its members' materiality judgement.

A noteworthy exception to the lack of academic evidence on the importance of audit firm culture for audit quality is Pierce and Sweeney (2005), who conducted semi-structured interviews with 12 audit partners from three of the Big Four firms. Their findings provide evidence that all the partners place a high degree of confidence in a wide range of less formal procedures that fit the description of culture.[2] For example, getting the right people into the firm and training them properly is deemed as one of the crucial factors to ensure audit quality by the partners.

Conclusion

In sum, the current, state of the art literature lacks a comprehensive understanding of: (1) How audit culture affects audit quality and (2) What an audit culture that is effective in supporting high audit quality looks like and how it can be shaped. Audit firms in the Netherlands have been

[2] Pierce and Sweeney (2005) use the term "clan control" instead of "culture". Clan control encompases a correct person-job fit, training, and shared rituals and ceremonies (Ouchi, 1979). As such, it is similar to culture as we define it.

asked to increase their focus on audit quality and to *create* an organizational culture that prioritizes audit quality. Given audit firms' continuing efforts in creating an audit culture that supports audit quality, but, at the same time, the lack of research on this matter that can guide audit firm practice, our projects aim to address this gap. With our research, we will be able to provide insights into how to establish such a culture. In particular, we will analyze, both with qualitative interviews as well as a quantitative survey, how different aspects of corporate culture affect (employees' perceptions of) audit quality. Whereas earlier research and surveys focused merely on measuring the degree of shared cultural norms within the company (the status quo), we intend to take it one step further. We will focus on how culture can be built and which mechanisms need to be in place in order to do so. In addition, we will take into account the interplay between culture and other corporate systems and procedures, such as performance measurement, that might provide conflicting incentives; an issue that is left unaddressed to date.

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