

**AN EXAMINATION OF THE EFFECT OF  
CONSULTATION REVIEW AND FEE SIZE ON AUDITOR  
JUDGMENTS**

**Barbara Vinciguerra**  
Moravian College

Key Words: consultation review, audit judgments, auditor independence, audit quality control,

JEL Classification: M42

**Abstract**

Prior research has shown that direct and indirect incentives in the audit environment can influence auditor judgment. The auditing profession suggests that certain firm-level quality control structures can reduce the effect that potential environmental biases can have on judgment-based decisions. The purpose of this paper is to examine the effects of a firm-level quality control, consultation review requirement, on auditor judgment where the auditor has incentives to be biased toward accepting the client's aggressive accounting method. Fifty-two experienced auditors were given a case study where an audit client was proposing an aggressive change in estimate. Consultation review requirement (required, not required) and fee size (high, low) were manipulated in the case materials. Three judgments were examined: allowability of the proposed accounting treatment under GAAP; assessment of the appropriateness of the proposed accounting treatment in the circumstances; and the likelihood of accepting the client-proposed accounting treatment. The results indicate that

consultation review requirement resulted in more conservative judgments regarding the appropriateness of the accounting treatment. In addition, results show that, contrary to the audit profession's suggestion, consultation review requirement reduced the likelihood of accepting the aggressive accounting treatment when fees were low, but not when fees were high.

## INTRODUCTION

The purpose of this paper is to examine the effect of consultation review requirement on auditor judgment when threats to independence are present. Johnstone et al. (2001) present a model that suggests that incentives in the audit environment such as financial dependence and interpersonal relationships may increase independence risk and influence the outcome of judgment-based decisions.<sup>1</sup> The concern is that auditor independence could be compromised because auditors' incentives, such as the desire to maintain client relations, may result in an auditor's acquiescence to client management's preference for an overly aggressive accounting treatment. Johnstone et al. (2001) contend that mitigating factors such as firm quality control policies, regulatory oversight, firm culture, and individual auditor characteristics may reduce the influence of the incentives. This paper will utilize the Johnstone et al. (2001) independence risk framework to examine whether a financial incentive, fee size, and a mitigating factor, consultation review requirement influence an audit judgment.

The consultation review is a firm-level quality control that was recommended by the Panel on Audit Effectiveness as a means of improving auditor independence when determining the

---

<sup>1</sup> Financial dependence includes the relative magnitude of fees, the desire not to lose a client, and the reputational value of a relationship with a high profile client (Johnstone et al. (2001)).

appropriateness of a company's accounting choices (Advisory Panel on Auditor Independence 1994; Glazer and Fabian 1997; AICPA 1997). Consultation review involves the assessment a specific accounting issue by a technical accounting unit within the firm. The consultation review is purported to mitigate independence risk by providing the auditor with access to unbiased experts in the field who can research and identify the appropriate resolution of an accounting issue. These experts are presumed to be unbiased since they are not subject to the same client pressures as the engagement team. Little prior research has examined the ways in which tools under the control of firms such as the consultation review policy and other firm-level quality controls affect auditor judgment. These policies may have a significant effect on audit judgments and audit outcomes. For example, Arthur Andersen was criticized in the Enron audit because their policies on accounting consultation allowed the regional partner to overrule the judgments made by the experts in the national Professional Standards Group (McNamee and Borrus 2002). These experts in the Enron case were often critical of the accounting practice of Enron management but their advice on technical matters went unheeded due to the firm's policy.

Previous academic research has examined the effects of a variety of incentives and disincentives to auditor independence on auditor judgment including audit fee size, risk of client loss, management advisory service fees, litigation risk, audit risk, accountability pressure, and the combined effect of benchmarks and directional goals (Farmer 1987; Lord 1992; Hackenbrack and Nelson 1996; Windsor and Ashkanasy 1995, Kadous et al. 2003). The current study extends the literature by examining the impact of the consultation review, a specific firm-level quality control measure on the judgment regarding the likelihood of accepting an aggressive client-proposed accounting treatment.

Fifty-two experienced auditors from five national and international accounting firms participated in the study. Auditor participants were given a detailed case where they were asked to assess the likelihood that they would accept a client's aggressive

accounting treatment. The case situation involved the assessment of the adequacy of the liability for warranties, which requires a judgment-based decision. Consultation review requirement and fee size were manipulated in the case materials. In order to realistically vary the review requirement, this paper uses an audit situation for which consultation is recommended, but not required under AICPA Best Practice for Accounting Consultations (AICPA 1997). Auditors whose judgments were subject to consultation review were required to complete a written consultation review request form that followed AICPA Best Practices for Consultation Review. These auditors were required to state the nature of the accounting issue, document alternatives considered, and state the accounting treatment recommended by the auditor. Fee size was manipulated as high or low in the case materials by varying the relative size of the fees and importance of the client to the auditor and audit firm.

## **THEORY AND HYPOTHESIS DEVELOPMENT**

### **Introduction**

Johnstone et al. (2001) present a framework for examining factors affecting independence risk and discuss how these factors interact with situational factors to affect audit quality. Direct incentives (contingent fees, financial dependence, potential employment) and indirect incentives (interpersonal relationships, auditing work of self or firm) increase independence risk; however, they point out that a judgment-based decision is necessary for independence risk to affect audit quality.<sup>2</sup> A judgment-based decision contains some uncertainty regarding the appropriate decision or valuation judgment, thus allowing for the possibility that incentives could bias the auditor's judgment. Where there is a clear answer, such as when an accounting treatment is unambiguously prohibited by GAAP, there is no room for bias to influence judgment. The profession contends that factors such as

---

<sup>2</sup> A judgment based decision includes difficult accounting issues that require significant estimates or alternative measurement criteria, audit conflict decisions regarding the nature of audit evidence and materiality decisions (Johnstone et al., 2001).

firm quality control policies, regulatory oversight, firm culture, and individual auditor characteristics may mitigate the effects of the potential biases.

Prior accounting research has examined auditor judgments in the presence of various environmental incentives and disincentives that may influence an auditor's willingness to accept a client's aggressive reporting preference, particularly when authoritative guidance is not specific (Hackenbrack and Nelson, 1996; Farmer, 1987; Lord 1992; Windsor and Ashkanasy 1995, Johnstone, et al. 2001). Much of this prior research has focused on incentives such as fees and client retention concerns and disincentives in the external environment such as audit risk, litigation risk, and client financial condition. In addition, Kadous et al. (2003) has examined whether establishing benchmarks for quality would influence the likelihood of accepting an aggressive client preferred accounting treatment.

### **Effect of Consultation Review and Fee Size on Auditor Judgment**

The motivated reasoning literature describes how judgments can be influenced by a variety of goals, including directional goals and accuracy goals. Directional goals motivate an individual to arrive at a particular conclusion whereas accuracy goals motivate an individual to arrive at the most accurate conclusion possible. Although directional goals can influence judgment, decision makers are also motivated to be rational and therefore can only draw the desired conclusion if they can develop a rationale to justify the conclusion. Accuracy goals can result when decision makers expect to defend their judgments to others (Kunda 1999). In terms of the audit literature, directional goals would be consistent with independence risks that might impose a bias in favor of the client-preferred position. Accuracy goals are consistent with independence safeguards such as quality control and oversight. Kunda states that "accuracy goals, when paired with

directional goals will often enhance rather than reduce bias. This is because the more extensive processing caused by accuracy goals may facilitate the construction of justifications for desired conclusions” (Kunda 1990, p. 487). Therefore, motivated reasoning theory suggests that the more extensive processing required where there is an accuracy goal could result in greater bias, not less bias as suggested by the profession.

A consultation review requires the audit team to consult with a technical accounting group within the firm regarding the appropriate treatment of an accounting issue and justify their choice of preferred accounting treatment.<sup>3</sup> The Advisory Panel on Auditor Independence (1994) suggests that a consultation unit that is structured as a separate technical function will prevent auditors from resolving issues in ways that unduly favor client interests over professional standards. Policies requiring in-firm consultation are purported to mitigate independence risk because they ensure that the audit team has access to experts who provide technical and professional guidance but who are not subject to the same client retention pressures as the audit team hierarchy. Presumably, the consultation unit will make judgments based on the application of GAAP, and will be less likely to be influenced by client pressures. In practice, a formal consultation should increase accountability for accuracy since the audit team must provide the accounting consultation unit with written support regarding the accounting alternatives considered and the rationale for a tentative conclusion.

The literature on accountability and decision making suggests that accountability will result in more conservative judgments in situations where there is no objectively correct answer (Hoffman and Patton, 1997). Hoffman and Patton (1997) found that accountability to superiors resulted in more conservative fraud risk judgments. They contend that conservative judgments

---

<sup>3</sup> In best practice firms, the audit team normally sends a report to the consultation unit that includes the client’s name and background information, a detailed description of the form and substance of the transaction, accounting alternatives considered, tentative conclusions and supporting rationale.

are considered more defensible, likely as a result of audit training and the ramifications of failure to uncover errors (Hoffman and Patton, 1997). Lord (1992) found that auditors were more likely to issue qualified opinions when they were told that senior partners would review their responses. Based on the notion that more conservative judgments are more defensible to accountable others, requiring auditors to obtain an accounting consultation could be expected to result in more conservative judgments.

Critics of the accounting profession contend that in the interest of client service, auditors may be inclined to act as client advocates rather than as objective third parties, also preferring accounting choices that promote the client's interests. Positive accounting theory asserts that managers will select reporting methods that promote their own self-interest. In other words, managers will opt for accounting methods that decrease earnings in the presence of regulatory and political pressure; in the absence of these factors, managers will prefer methods that increase net income (Watts and Zimmerman 1978).

Furthermore, Bazerman et al. (1997) assert that it is impossible for auditors to maintain independence due to information processing limitations referred to as the self-serving bias. Research on the self-serving bias indicates that when people are called on to make impartial judgments, those judgments are likely to be subconsciously biased in favor of the judge's self-interest. According to Bazerman et al. (1997, 2002) aspects of the auditing environment such as competition and an emphasis on client development exacerbate the self-serving bias. For example, if maintaining client relations is in the auditor's best interest, the auditor may accept client management's aggressive accounting estimate. If litigation risk is of great concern, the auditor may prefer a more conservative estimate.

Farmer et al. (1987) found that the threat of loss of a client increased the auditor's likelihood of accepting an aggressive accounting treatment and a high threat of litigation reduced the likelihood of accepting an aggressive accounting treatment. Lord

(1992) found that accountability pressure reduces the likelihood that an auditor will allow an aggressive accounting treatment. In addition, Lord (1992) found evidence that accountability pressure interacts with elements in the environment (fee size, provision of MAS services, and competitive environment) moderating the influence of these factors on auditor judgment under client pressure. Hackenbrack and Nelson (1996) examined whether auditors used the vague language in accounting standards to justify their decisions. They examined the effect of engagement risk level and accounting standard on an auditor's determination as to whether or not an amount can be reasonably estimated. They found that auditors tend to make reporting decisions favored by incentives and apply vague language in standards to justify their decisions (Hackenbrack and Nelson 1996).

Extending motivated reasoning theory, Kadous, Kennedy, and Peecher (2003) examined whether requiring auditors to identify the most appropriate method of accounting as a benchmark will amplify the influence of directional goals on accounting method choice. They found that auditors' acceptance of a client preferred aggressive accounting treatment is higher when the auditor has higher goal commitment and when a quality assessment is performed, i.e., auditors are more susceptible to their directional goals when they make a quality assessment. Furthermore, they found the same interaction relationship when the judgment was to rate the appropriateness of the client-preferred accounting treatment. Auditors rated the appropriateness of the accounting treatment higher where directional goal commitment is high and quality assessment is high (Kadous et.al. 2003).

In practice, auditors are guided to consider the economic substance of transactions when considering the proper accounting treatment and should consider the allowability under GAAP as well as the appropriateness of the accounting treatment in the circumstances (AICPA 2000, Advisory Panel on Auditor Independence 1994)) when making a judgment-based decision. This distinction is important because it recognizes that within

GAAP there may be a range of possible choices. This study examines the effect of client fee size and consultation review requirement on three judgment-based decisions: rating the allowability of the accounting treatment under GAAP; rating the appropriateness of the accounting treatment in the circumstances; and rating the likelihood of accepting the client's preferred accounting method.

Motivated reasoning theory predicts that bias may be enhanced when accuracy goals are paired with directional goals as long as the decision maker can rationalize the choice. In the current study, consultation review is asserted to enhance an accuracy goal whereas fee size is asserted to enhance a directional goal. Following motivated reasoning theory it is hypothesized that the independent variables fee size and consultation review will interact such that consultation review will reduce the rating of allowability, appropriateness and likelihood of accepting the client-preferred aggressive accounting treatment to a greater extent when fees are low than when they are high. Therefore, hypotheses one through three predict an interaction between Consultation review requirement and Fee size.

**H<sub>1</sub>:** Consultation review will reduce the auditor's rating of the allowability of the client's preferred accounting treatment to a greater extent where fees are low than when fees are high.

**H<sub>2</sub>:** Consultation review will reduce the auditor's rating of the appropriateness of the client's preferred accounting treatment to a greater extent where fees are low than when fees are high.

**H<sub>3</sub>:** Consultation review will reduce the likelihood of accepting a client's aggressive accounting treatment to a greater extent where fees are low than when fees are high.

## **METHOD**

The study utilizes a 2x2 between subjects experimental design, where two levels of fee size (high/low) and two levels of consultation review requirement (required/not required) are manipulated in the case study. Participants in all groups were required to complete a questionnaire where they assessed the likelihood of accepting the client's proposed accounting treatment, allowability of the accounting treatment under GAAP, and the appropriateness of the accounting treatment.

### **Description of Research Instrument and Task**

The audit task in this study involves a judgment regarding the adequacy of an accounting estimate for the estimated liability under warranties. Participants are given a rich context in which to assess the judgment. In the basic case materials, participants are given a description of the company, a discussion of the accounting issue, and descriptions of the applicable accounting standards and authoritative literature. Participants are also provided with audit evidence, including a monthly summary of sales and past history of warranty claims. They are informed that management reduced the amount of warranty reserves required, claiming that improvements in quality control systems would reduce future claims. The reduction in the warranty reserve results in a material change in estimate. In addition, client management does not plan to disclose the change in estimate in the footnotes.

There is little history supporting the change in estimate. Additional information included in the case suggests that warranty claims have declined significantly in the first few quarters after the process change; however, there is also information to suggest that the new reserve may be too low. The case states that the company is narrowly in compliance with its debt covenants; requiring the company to accrue additional charges to its estimated liability under warranties would result in a covenant violation. Given the existing loan covenants, the materiality of the change in estimate, the lack of disclosure, the limited amount of reliable claims

history, the accounting treatment that management is proposing is aggressive. Participants are informed that there is no additional information available beyond the case materials. In addition, participants are informed that the audit report is due in less than one week leaving no time to gather additional history.

### **Participants**

Fifty-two experienced auditors from five national and international public accounting firms participated in the study. Case materials were distributed to auditor participants via a contact at the participant's firm. One hundred and twenty-six questionnaires were distributed resulting in fifty-two usable completed case responses or a response rate of 41%. Completed cases were returned directly to the author to ensure confidentiality. Participants were asked to assume that they were in the position of making a decision for the audit team; therefore, auditors at the senior level and above were chosen as the target group of participants. Mean total years of experience equaled 9.67 years. Fourteen participants reported their rank as senior associate (27%), thirty-four participants reported their rank as manager (65%), and four participants reported their rank as partner (8%).

### **Variables and Measurement**

**Independent Variables.** The independent variable *fee size* is manipulated in the case materials as high or low. At the high level, participants are told that the audit client is large in terms of engagement hours and engagement profitability relative to the local office and the auditor participant's client base. At the low level, the audit client is small in terms of engagement hours and engagement profitability relative to the firm and the auditor participant's client base. *Consultation review requirement* is manipulated in the case materials as required or not required. At the consultation review required level participants are required to complete a consultation review request form. The consultation review request form requires the auditor to detail the nature of the issue, the alternatives considered, and the alternative recommended

by the audit team, which is consistent with AICPA Best Practices (AICPA 1997).

**Dependent Variables.** The judgment regarding the allowability under GAAP is measured as the subject's response to the statement, "The client's proposed accounting treatment is allowable under GAAP." Responses are measured using an eleven point scale with the anchors of 0 (Strongly Disagree) to 10 (Strongly Agree). The judgment concerning the appropriateness of the accounting treatment is measured as the subject's response to the statement, "The client's proposed accounting treatment represents the most appropriate accounting treatment in the circumstances." The judgment concerning the likelihood the auditor would accept the proposed accounting treatment is measured as the participant's response to the statement, "What is the likelihood that you would recommend accepting the client's proposed treatment for warranty costs, that is, accepting an accrual at .5% of sales and no disclosure of the change in estimate?" Responses are measured using an eleven point scale with the anchors of 0 (Definitely would not accept) and 10 (Definitely would accept).

## RESULTS

### Analysis of Questionnaire Items

Several items were included in the case materials in order to test various assumptions made by the author. Results from the preliminary analyses can be found in Table 1. The case was designed to present a situation that auditors viewed as realistic, that presented the participants with a client position that was aggressive, and required a subjective accounting judgment in a gray area in the application of GAAP. Participants were asked to evaluate whether the case situation describes a situation that auditors could encounter in practice and whether the client's proposed accounting treatment reflects the treatment that client management is likely to prefer in practice anchored on a scale from

0 (strongly disagree) to 10 (strongly agree). The situation realism and client position realism items have means of 9.08 and 7.52 respectively, indicating that participants viewed the situation and client position as realistic. Participants were asked to describe the client's proposed accounting treatment on scale ranging from 0 (very aggressive) and 10 (very conservative). This item had a mean of 1.82 indicating that participants agreed with the author's assertion that the client's proposed treatment was aggressive. The case was intended to present a gray area in the application of GAAP, but not to evoke a fraudulent financial reporting hypothesis. Participants were also asked to evaluate the client's position regarding the warranty accrual on a scale ranging from 0 (legitimate adjustment in the ordinary course of business) to 10 (fraudulent financial reporting). The mean score on this item was 5.20 indicating that, on average; participants were neutral with respect to whether the nature of the accounting treatment was fraudulent financial reporting.

In order to assess whether the case represented a judgment call in the application of GAAP, participants were asked to assess whether the client's position is allowable under GAAP and whether it was appropriate in the circumstances. These items were anchored on a scale of 0 (strongly disagree) and 10 (strongly agree). The mean score for allowability was 5.16 and 2.10 with respect to appropriateness in the circumstance. Taken together, these items reflect a client position that participants view as being in a gray area under GAAP, but not necessarily the most appropriate in the circumstances. Response to the question regarding likelihood of accepting the client's proposed accounting treatment on a scale anchored at Definitely would not accept (0) to Definitely would accept (10) was 2.3. Participants were also asked to evaluate the likelihood that others at their firm would allow the client's proposed treatment in the scenario presented in this case anchored on a scale of Strongly Disagree (0) to Strongly agree (10). The mean score for likelihood that others would allow the treatment was 4.3. The results of these analyses are included in Table 1. While likelihood of accepting is low, it appears to be

reasonable given the aggressive nature of the accounting treatment. Results of ANOVA indicate no differences across cells for any of the measures with the exception of the dependent variables in this study.

**Table 1**  
**Questionnaire Items**

	<i>Mean</i>	<i>Std. Dev.</i>
Situation realism (0) = strongly disagree; (10) = strongly agree	9.08	1.14
Client position realism (0) = strongly disagree; (10) = strongly agree	7.52	2.12
Describe the client's proposed accounting treatment (0) very aggressive; (10) very conservative	1.82	1.44
The client's proposed accounting treatment is allowable under GAAP (0) = strongly disagree; (10) = strongly agree	5.06	3.09
The proposed accounting treatment represents the most appropriate accounting treatment in the circumstances (0) strongly disagree; (10) strongly agree	2.10	1.78
Use the scale below to describe your view of the client's proposed accounting treatment (0) legitimate adjustment in the ordinary course of business; (10) fraudulent financial reporting	5.20	1.75
What is the likelihood that you would recommend accepting the client's proposed treatment for warranty costs, that is, accepting an accrual at .5% of sales and no disclosure of the change in estimate? Definitely would not accept (0) and Definitely would accept (10).	2.31	2.26
Others at my firm would allow the client's proposed treatment in the scenario presented in this case. (0) strongly disagree; (10) strongly agree	4.31	2.84

**Hypothesis Testing**

Means and standard deviations of the dependent variables by experimental group are included in Table 2. Analysis of Variance was used to test for differences in the dependent variables among the experimental groups<sup>4</sup>. Results of ANOVA for H1 and H2 are included in Table 3. Results of the test of H<sub>3</sub> is included in Table 4.

**Table 2**  
**Mean Rating of Allowability, Appropriateness, and Likelihood of Accepting Client Preferred Accounting Treatment by Condition**

Fee Size	Consultation Review Required	Consultation Review Not Required
High		
- Allowable	4.38	5.23
- Appropriate	1.44	3.15
- Likelihood of Accepting	2.50 n= 16	2.15 n= 13
Low		
- Allowable	4.63	5.76
- Appropriate	1.00	2.29
- Likelihood of Accepting	.75 n= 8	3.00 n= 17

Hypothesis 1 predicted an interaction effect between Fee Size and Consultation Review Requirement on the auditors’

<sup>4</sup> Data diagnostics indicated possible violations of the assumptions of normality and constant variance. A square root transformation of the dependent variable resulted in significant improvements in the distribution of the data. Examination of diagnostics on the transformed data indicated that the assumptions were not violated, thus parametric tests based on the transformed data were used to test the hypotheses

assessment of the allowability of the accounting treatment under GAAP. ANOVA results indicate no main or interaction effect of the independent variables on the assessment of the allowability of the accounting treatment under GAAP, resulting in a rejection of Hypothesis 1. See Table 3 Panel A.

Hypothesis 2 examined the relationship between Fee Size and Consultation Review Requirement on the assessment of the auditors' rating of appropriateness of the accounting treatment in the circumstances. An interaction of Fee Size and Consultation Review Requirement was predicted, where Consultation Review would reduce the assessment of the appropriateness of the accounting treatment where fees were low, but not where fees were high. Results indicate a main effect of consultation review requirement but no significant interaction effect of Consultation Review\*Fee Size. Therefore, Hypothesis 2 is rejected. See Table 3 Panel B.

Further analysis of the main effect of consultation review requirement on the rating of the appropriateness of the client-proposed accounting treatment is included in Figure 1. Consultation review requirement appears to reduce subjects' assessments of the *appropriateness* of the accounting treatment overall for both the high and low fee conditions. This finding is interesting in light of the earlier finding that Size and Consultation Review Requirement did not influence the auditors' assessment of the *allowability* of the accounting treatment under GAAP. In addition, it is consistent with prior research indicating that accountability may lead to more conservative judgments.

**Table 3**  
**ANOVA**  
**Rated Allowability and Appropriateness of Client Preferred Accounting Treatment**

**Panel A: Assessment of allowability under GAAP**

Source	df	Mean Square	F	Sig
Corrected Model	3	.409	.596	.620
Intercept	1	211.636	308.436	.000
<b>Size</b>	1	.005	.008	.930
<b>Review</b>	1	.982	1.431	.237
<b>Size*Review</b>	1	.207	.302	.585
<b>Error</b>	50	.686		

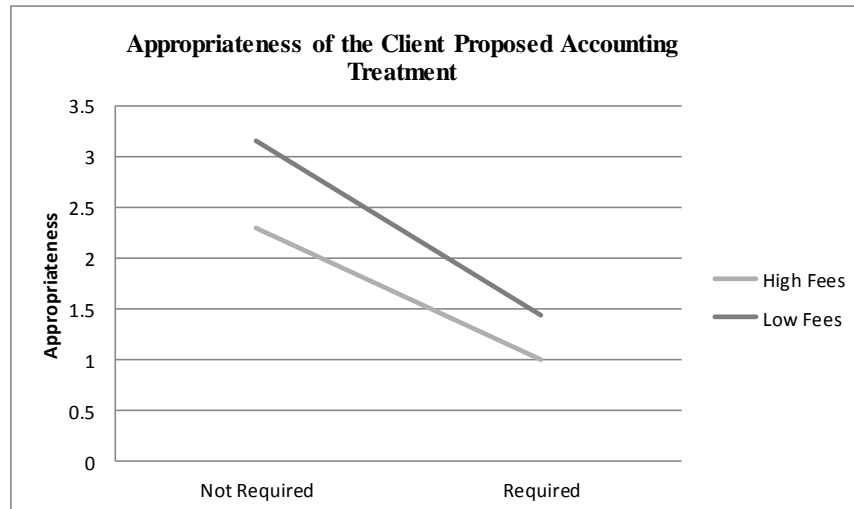
$R^2 = .035$ (adjusted  $R^2 = -.023$ )

**Panel B: Assessment of appropriateness in the circumstances**

Source	df	Mean Square	F	Sig
Corrected Model	3	1.606	2.833	.048
Intercept	1	65.780	116.055	.000
<b>Size</b>	1	.911	1.607	.211
<b>Review</b>	1	4.576	8.073	.006
<b>Size*Review</b>	1	.016	.028	.867
<b>Error</b>	50	.567		

$R^2 = .145$ (adjusted  $R^2 = .094$ )

**Figure 1**  
**Interaction Effect: Rating of Appropriateness of Accepting the Client Proposed Accounting Treatment (H2)**



Hypothesis 3 examined the relationship between fee size and consultation review requirement on the judgment regarding the likelihood of accepting the client-proposed accounting treatment. An interaction between fee size and consultation review requirement was predicted; specifically, that consultation review requirement will reduce the likelihood of accepting the client-proposed method to a greater extent where fees are low than where fees are high. Results of the ANOVA indicate that there is a significant interaction between fee size and consultation review requirement ( $p=.057$ ). See Table 4 Panel A. Further analysis of the interaction is included in Figure 2. The analysis supports Hypothesis 3. The likelihood of accepting the client-proposed accounting treatment is reduced where consultation review is required and fees are low, but not where fees are high. Contrary to the profession's assertion that consultation review will reduce auditor bias, the results of this study show that consultation review

will result in more conservative judgments where there is less incentive to be biased (where client fees are low, but not where they are high).

**Table 4**  
**Rated Likelihood of Accepting Client Preferred Accounting Treatment**

**Panel A: ANOVA**

Likelihood of Accepting Client Preferred Accounting Treatment

Source	df	Mean Sq.	F	Sig
Corrected Model	3	1.524	2.171	.103
Intercept	1	68.021	96.913	.000
<b>Size</b>		.635	.905	.346
<b>Review</b>	1	2.461	3.507	.067
<b>Size*Review</b>	1	2.675	3.811	.057
<b>Error</b>	50	.702		

$R^2 = .115$ (adjusted  $R^2 = .062$ )

**Panel B: ANCOVA Controlling for Rated Allowability**

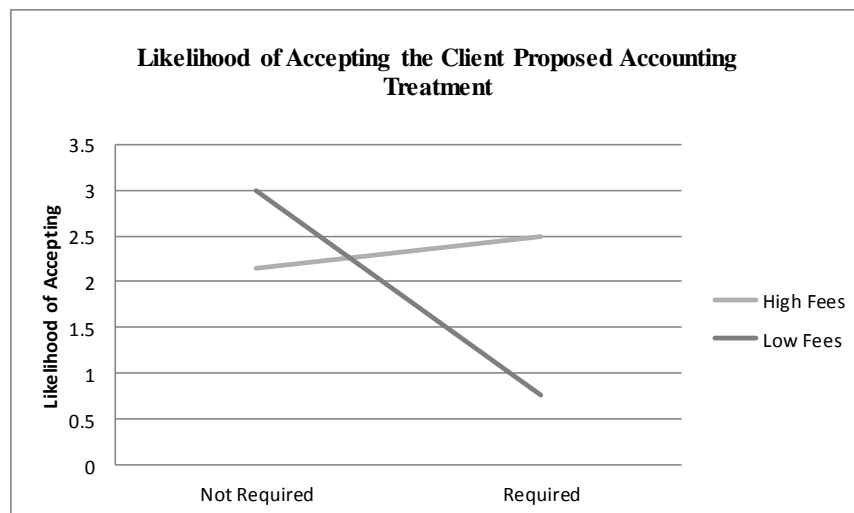
Likelihood of Accepting Client Preferred Accounting Treatment

Source	df	Mean Sq.	F	Sig
Corrected Model	4	3.371	6.310	.000
Intercept	1	9.240	17.295	.000
<b>Appropriate</b>	1	8.915	16.686	.000
<b>Size</b>	1	.0446	.083	.774
<b>Review</b>	1	.039	.074	.786
<b>Size*Review</b>	1	3.317	6.208	.016
<b>Error</b>	49			

$R^2 = .340$  (adjusted  $R^2 = .286$ )

Testing of hypothesis 2 indicates that there is a main effect of consultation review requirement on the assessment of the appropriateness of the client-proposed accounting treatment. Additional testing was done given the related nature of the assessment of the appropriateness of the client-preferred treatment and the likelihood of accepting the client-proposed accounting treatment and the finding that appropriateness was associated with the independent variables in the study. Analysis of Covariance was used to assess the relationship between the independent variables and the likelihood of accepting the client-proposed accounting treatment, controlling the subjects' rating of the appropriateness of the client-proposed accounting treatment. Results are included in Table 4 Panel B. Results indicate that after controlling for the assessment of the appropriateness of the client-preferred accounting treatment, the interaction between consultation review and fee size remains significant ( $p=.016$ ).

**Figure 2**  
**Likelihood of Accepting the Client Proposed Accounting Treatment (H3)**



### **Summary, Implications, and Limitations**

The profession contends that firm level quality controls, such as the consultation review, will reduce auditor bias in the presence of risks to independence. Motivated reasoning theory predicts that a firm-level control such as the consultation review will not reduce bias where threats to independence are present because the more extensive processing required where there is an accuracy goal could result in greater bias, not less bias as suggested by the profession. This study investigates whether the consultation review requirement audit fee size influence auditor judgments in the face of independence risk. The audit task in this study involved judgments regarding the allowability, appropriateness and the likelihood of accepting an aggressive accounting estimate for warranties. These are judgment-based decisions given that the client-preferred method is in a gray area of GAAP, the estimate has a range of possible outcomes, and requires that exercise of judgment in determining the best possible accounting treatment.

The results show an interaction between consultation review requirement and fee size for the judgment on the likelihood of accepting the aggressive accounting treatment. Consultation review resulted in more conservative judgments where fees were low but not where fees were high. Contrary to the profession's contention that consultation review would reduce bias, this study found that where independence risks were present (high fees group), consultation review requirement did not reduce the likelihood of accepting the aggressive accounting treatment. Only where independence risk was low (low fees group) did consultation review result in more conservative reporting. In other words, consultation review resulted in more conservative reporting only when auditors were not faced with a conflicting incentive related to fee size.

An analysis of the results of this study should be examined in light of its limitations. The small sample size raises issues regarding the statistical power and external validity of the study.

The sample was derived from several large firms in the Philadelphia and New York area. Generalizing to other firms, small firms, or other geographic areas may not be appropriate. In addition, the study attempted to capture a complex decision in an experimental setting. The author attempted to provide the participants with a rich context in which to evaluate the decision, however, real decision makers would likely have more information available to them.

## REFERENCES

- Advisory Panel on Auditor Independence. 1994. Strengthening the Professionalism of the Independent Auditor: Report to the Public Oversight Board of the SEC Practice Section, AICPA from the Advisory Panel on Auditor Independence.
- American Institute of Certified Public Accountants (AICPA). 1997. Best Practices – Accounting Consultations, Communications with Boards of Directors/Audit Committees, and Communications with SEC staff. SEC Practice Section of the AICPA.
- American Institute of Certified Public Accountants (AICPA). 2000. *Audit Committee Communications*. Statement on Auditing Standards No. 90. New York, NY: AICPA
- Bazerman, M.H., G.F. Lowenstein and K.P. Morgan. 2002. Why Good Accountants do Bad Audits. *Harvard Business Review* (November): 97-102.
- Bazerman, M.H., K.P. Morgan and G.F. Lowenstein. 1997. The impossibility of auditor independence. *Sloan Management Review* (Summer): 89-94.
- DeZoort, F.T. and A.T. Lord. 1997. A Review and Synthesis of Pressure Effects Research in Accounting. *Journal of Accounting Literature* Volume 16, p. 28-85.
- Farmer, T.A., L.E. Rittenberg, and G.M. Trompeter. 1987. An Investigation of the Impact of Economic and Organizational Factors on Auditor Independence. *Auditing: A Journal of Practice and Theory* 7(1):1-14.
- Glazer, A.S. and S.L. Fabian. 1997. Practice Management: Best Practices for CPA Firms. *Journal of Accountancy* 184(7):93-97.
- Hackenbrack, K. and M.W. Nelson. 1996. Auditors' Incentives and Their Application of Financial Accounting Standards. *The Accounting Review* 71(1): 43-59.
- Hoffman, V.B. and J. M. Patton. 1997. Accountability, the Dilution Effect, and Conservatism in Auditors' Fraud Judgments. *Journal of Accounting Research* 35(2) p. 227-237.

- Johnson, V.E. and S.E. Kaplan. 1991. Experimental Evidence on the Effects of Accountability on Auditor Judgments. *Auditing: A Journal of Practice and Theory* 10(Supplement), p. 96-107.
- Johnstone, K.M., M.H. Sutton, and T.D. Warfield. 2001. Antecedents and Consequences of Independence Risk: Framework for Analysis. *Accounting Horizons* 15 (1): 1-18.
- Kadous, K., S.J. Kennedy, and M.E. Peecher 2003. The Effect of Quality Assessment and Directional Goal Commitment on Auditors' Acceptance of Client-Preferred Accounting Methods. *The Accounting Review* 78(3): 759-778.
- Kunda, Z. 1990. The Case for Motivated Reasoning. *Psychological Bulletin* 108:480-498.
- Kunda, Z. 1999. *Social Cognition: Making Sense of People*. Cambridge, MA: The MIT Press.
- Lord, A.T. 1992. Pressure: A methodological consideration for behavioral research in auditing. *Auditing: A Journal of Practice and Theory* 11(2): 89-98.
- McNamee, M. and A. Borrus. 2002. Out of Control at Andersen: Internal Memos Detail How the Firm's Unusual Controls Allowed its Enron Team to Call the Shots. *Business Week* April 8, 2002 Issue 3777: 32.
- Watts, R.J. and J.L. Zimmerman. 1978. *Positive Accounting Theory*. Englewood Cliffs, NJ: Prentice Hall.
- Windsor, C.A. and N.M. Ashkanasy. 1995. The Effect of Client Management Bargaining Power, Moral Reasoning Development, and Belief in a Just World on Auditor Independence. *Accounting, Organizations, and Society*, 20 (7/8): 701-720.