Auditors' Employment With Clients And Interaction With Their Former CPA Firm

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Article:

It is not unusual for auditors to accept employment with audit clients upon leaving the audit firm. For example, Inthoff (1978) found that approximately 20 percent of the auditors in his sample accepted employment with a client firm. However, in recent years, the Independence Standards Board (ISB), the Securities and Exchange Commission (SEC), and the American Institute of Certified Public Accountants (AICPA) have expressed concerns about auditors' employment with their audit clients. Such concerns primarily relate to possible impairment of auditor independence. For example, the ISB noted that "a concern with partners or professional staff joining clients is that the remaining audit team members, because of their past relationship with the professional now in a position of importance with the client, may be reluctant to challenge the decisions or positions taken by the former partner or other professional" (1999: 13). Hence, this topic is of considerable interest not only to the accounting profession but also to financial statement users as well as corporate managers.

The objective of this study is to provide empirical evidence about the perceptions of company executives and managers about their ability to resolve disagreements with their auditors who happen to be their former employers. While prior research has studied the perceptions of users and auditors (Imhoff, 1978; Parlin and Bartlett, 1994) on employment with audit clients, this is the first study that looks at clients' perceptions about their influence on auditors. Perceptions may be particularly useful in this context because (1) actual data about resolving disagreements with former colleagues are extremely difficult to obtain, and (2) perceptions can influence actions. We believe that this research is relevant to the general concern about auditors' employment with audit clients.

The next section examines the background arid develops the research questions. This is followed by a description of method and results, and the article ends with summary and conclusions.

BACKGROUND AND RESEARCH QUESTIONS

Auditors' employment 1,vith their audit clients has been the focus of regulators for a number of years. Over 20 years ago, the Commission on Auditors' Responsibilities (1978) recommended that public accounting firms be prohibited from helping their former employees find employment with clients. In 1993, the AICPA recommended, as a step to enhance the confidence of the public in auditor independence, that the SEC and other regulators proscribe the hiring of the audit partner by the client for one year after the partner ceased to serve a client. The SEC (1994) noted its concern about auditors' employment with their former clients, but stated that it would be difficult, if not impossible, for the SEC to promulgate such rules, The SEC (1994) elaborated on independence problems that arise in the context of auditors going to work for their former clients, but suggested that the AICPA should address this issue.

The Independence Standards Board (ISB) came into existence in 1998 with the mission to establish independence standards applicable to audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets (ISB, 1998). One of the issues on the ISB agenda was the employment of auditors with audit clients, after leaving an audit firm. The ISB expanded its focus beyond the audit partner, and examined issues associated with the hiring of members of the audit team by the client. The efforts of the ISB culminated with issuance of its Standard No. 3, *Employment with Audit Clients*, in July 2000 (ISB, 2000). This standard describes safeguards that firms should implement when their professionals join audit clients. The standard's requirements are effective for employment with audit client situations arising after December 31, 2000. This was the last standard is-sued by the ISB before it was dissolved on July 31, 2001.

The ISB (1999) noted that there are three concerns when professionals leave CFA firms to join audit clients. First, members of the audit team, who may have been friendly with or respectful of a former colleague when he or she was with the firm, would be reluctant to challenge the decisions of the former colleague and may not exhibit the appropriate skepticism or objectivity.[1] Second, when auditors resign to accept positions with audit clients, there may be questions about whether the individuals exercised appropriate level of skepticism during the audit process prior to their departure. Third, the former auditor may be familiar enough with the audit approach and testing strategy of the CPA firm so as to be able to circumvent its design.

In support of its concerns, the ISB stated that "contributing to the current concerns regarding audit professionals joining clients have been several, well publicized financial scandals where alumni of the audit firm held positions of responsibility at the client" (1999: 4). The ISB also noted that regulators from other countries have expressed similar concerns about the interaction between former professional employees and CPA firms. As stated by the ISB (1999), interest in this issue extends beyond the US. The European Contact Group (composed of representatives of the eight largest international networks of accounting firms) and the International Federation of Accountants also have noted concerns about auditors going to work for their former clients (ISB, 1999). In addition, the Public Oversight Board's Advisory Panel on Audit Effectiveness (POB, 2000) also has placed on record its concern about this issue.

Prior Research on Auditors' Employment with Clients
Imhoff (1978) surveyed auditors and financial statement users (e.g., bankers and financial analysts) to evaluate auditor independence when an auditor accepted employment with a client. He used hypothetical scenarios to obtain responses on a number of questions. The scenarios were varied to reflect the time elapsed between the audit engagement and accepting employment and whether the auditor held a supervisory position at the audit firm. He found that both groups' concern over auditor independence decreased as time elapsed between working on the audit engagement and accepting employment increased, or when the auditor worked in a non-supervisory position.

In an experimental study, Firth (1981) examined bankers' perceived lending decisions in the face of auditor-client relationships. Responses from over 1,200 bankers showed that bankers tended to grant smaller loans to a company whose financial director was previously a partner in the accounting firm compared to a situation when no alumni of the accounting firm was employed in the company. This illustrates the potential economic consequences of auditor employment with their clients.

Koh and Mahathevan (1993) examined middle managers' perceptions of auditor independence related to client employment. The results indicated that independence concerns increased as the time period between the last audit and accepting employment decreased. For subsequent audits, independence concerns were related to rank of the auditor when she left the firm and to her current position with the client organization.

In an experimental study, Parlin and Bartlett (1994) showed that auditors set a higher materiality thresh-old when the controller of the client company is a former colleague. This demonstrated that auditors' independence is impaired when dealing with clients who are former employees.

Research Questions

Financial statement users are concerned about auditor independence and they perceive auditors going to work for their clients as a threat to independence. Prior research shows that there are differences between the perceptions of auditors and users regarding the effect of such employment on independence (Imhoff, 1978). However, prior research has not looked at the perceptions of audit clients who are alumni of CPA firms. Audit clients who are CPA firm alumni would have better knowledge about this issue and perhaps personal experience in dealing with the auditors who are their former employers. CPA firm alumni are important constituents in this issue and their perceptions would be of interest to financial statement users and policy makers. Hence, as a first step, it is useful to examine whether audit firm alumni believe that they can resolve disagreements with their auditors if the auditors were their former employers.

Therefore, the first research question examined is:

> *RQ1: Do the alumni of CPA firms believe they can resolve disagreements with their auditors. more easily if the auditors were their former employers?*

Factors Associated With Alumni Perceptions

There are many issues related to auditors' employment with clients and interaction with the former audit firm where empirical evidence may be useful before additional policy prescriptions are made. These issues include whether auditors' employment with clients affect perceptions of auditor independence, what factors impact those perceptions, and whether actions such as prohibiting this practice or having a "mandatory cooling-off period" would remedy the concerns about auditor independence. However, it may be extremely difficult to obtain archival data from audit engagements about such interactions and their impact on auditor independence. Studying perceptions are useful because perceptions can influence the actions of managers related to their negotiations with independent auditors.

Factors identified by the ISB as having potential impact on auditors' independence include: (1) whether the professional served as a member of the audit team, (2) the rank she held at the firm and has accepted at the client company, (3) the length of time that has elapsed since the professional left the firm, (4) the circumstances of her departure, and (5) the nature of relationship between the professional who joined the client and the current engagement partner. Our study looks at the first three factors and their impact on perceptions of clients who are alumni of CPA firms. The following paragraphs describe the research questions examined in our study.

Rank: ISB Standard No. 3 notes that one would have greater concern when a senior level professional (such as a partner or other professional with a supervisory responsibility) joins a client compared to professionals with lower levels of responsibility. The concern relates to whether the auditor could remain completely unbiased in dealing with a former partner or manager who now works for the client. Prior research (Imhoff, 1978; Koh and Mahathevan, 1993) has also found significant association between rank and concern over independence. Moreover, in the context of resolving disputes, Ponemon (1992) found that moral reasoning is related to rank in public accounting. Accordingly, the second research question is:

> *RQ2: Are the perceptions of former employees of CPA firm about their ability to resolve disagreements involving CPA firms and client companies related to their rank upon departure?*

Time Elapsed Since Departure: ISB Standard No. 3 further states that the procedures described in Standard No. 3 should be adapted depending on the length of time that has elapsed since the professional left the firm. Alumni who had left recently may believe they can resolve disagreements with their former firm more easily than alumni who had left the firm a long time ago. This is because they would still have close relationships with the audit personnel in their former firm. Koh and Mahathevan (1993) found that users' and managers' perceptions on auditor independence were related to time-elapsed since having the firm. Accordingly, the third research question is:

RQ3: Are the perceptions of former employees of CPA firms about their ability to resolve disagreements involving CPA firms and client companies related to the time elapsed since their departure?

Area of specialization: The ISB (1999) noted that one of the reasons for concerns about alumni working for clients was that the former employee might be familiar with the audit approach of the CPA firm. We expect that alumni from the audit area would be more familiar with the audit approaches and methods used in the former firm, and hence can be expected to have different responses about resolving disputes with their former firm than alumni from other areas. Firth (1981) notes that the alumni's knowledge of the audit firm's techniques could adversely affect auditor independence. Therefore, the fourth research question examined in this study is:

RQ4: Are the perceptions of former employees of CPA firms about their ability to resolve disagreements involving CPA firms and client companies related to the area of specialization within the former firm?

Gender: Prior researchers have used gender as an explanatory factor for a variety of issues related to public accounting. Gender differences have been documented with respect to practice development (Hooks *et al.*, 1994), job satisfaction (Bullen and Martin, 1987; Gaertner *et al.*, 1987; Maupin and Lehman, 1994), perceived discrimination (Trapp *et al.*, 1989), stress levels (Collins, 1993), turnover (AICPA, 1994; Hooks and Cheramy, 1994), and impact on factors associated with turnover (Dalton *et al.*, 1997). However, prior research has not examined if there are gender differences in the auditor independence perceptions. In the area of ethical behavior, Larkin (2000) found that female internal auditors had greater ability to identify ethical conduct compared to their male counterparts. Moreover, studies have shown that men negotiated significantly better outcomes than women (for a review, please see Stuhlmacher and Walters, 1999). Public accounting has been a male-dominated profession for a long time. Hence, it may be possible that men are more likely to believe they can resolve disagreements with their former firm com-pared to women. Therefore we ask:

RQ5: Are there gender differences in the perceptions of former employees of CPA firms about their ability to resolve disagreements involving CPA firms and client companies?

METHOD

Data were collected from alumni of Big 5 accounting firms through responses to a questionnaire survey.[2] Survey instruments were mailed to 757 alumni selected randomly from the alumni directories of five offices of Big Five firms in two major cities, but 80 questionnaires were returned because of unknown address changes. After one month, we mailed a second request along with another copy of the survey instrument to non-respondents from three offices. We received 204 usable responses. Since this study focuses on perceptions of CPA firm alumni in industry, we deleted 69 responses from alumni who were either still in public accounting or had retired.

The ISB (2000) has suggested that concerns about alumni going to work for clients may be lower when significant time has elapsed after the professional has left the CPA firm. Along these lines, it is likely that with the passage of time there will be fewer friends and colleagues of the alumni still working with the CPA firm. Further, there have been significant changes in the audit approaches and personnel policies of the large public accounting firms in recent years. Hence, we deleted 52 responses from alumni who had left their former firm more than 10 years ago. (As discussed later, we performed sensitivity analyses by including these responses and obtained results substantively similar to those reported in this article). Thus, our final sample had 83 respondents.[3]

Table 1 provides demographic de-tails about the respondents. Twenty-five of the respondents (30%) had left the firm at the rank of manager or partner. The average time elapsed since leaving the firm was 5.6 years. Thirty-two (39%) of the respondents were female. Forty-six of the respondents (55%) had worked in the audit area.

Table 1
Demographic Profile of Respondents

Panel A: Rank upon departure

Rank	No. of responses (%)
Junior	15 (18)
Senior	43 (52)
Manager	11 (13)
Senior Manager	9 (11)
Partner	5 (6)

Panel B: Time since departure

Mean	5.6 years
Median	5.5 years

Panel C: Gender

Gender	Frequency (%)
Female	32 (39%)
Male	51 (61%)

Panel D: Area of specialization

Rank	No. of responses (%)
Audit	46 (55)
Tax	14 (17)
MAS	17 (21)
Other	6 (7)

Table 2
Resolving Disagreements

"If I were in a position of authority, I believe I could resolve disagreements with our auditors more easily if the auditor was my former CPA firm."

Response	No. of responses (%)
Strongly Agree	6 (7%)
Agree	15 (19%)
Neutral	31 (38%)
Disagree	20 (25%)
Strongly Disagree	9 (11%)

RESULTS

Research Question I

Table 2 provides results related to the first research question. Overall, 21 respondents (26%) agreed or strongly agreed that they could resolve disagreements with the auditors more easily if the auditor was the former CPA firm. However, a greater proportion of respondents (36%) disagreed or strongly disagreed with such a statement. The difference was not statistically significant

Research Questions 2 to 5

Table 3 provides results from univariate analysis of research questions two through five. Since the median for the time elapsed variable was 5.5 years, we split the data for that variable based on whether the employee had left the firm more than five years ago. The data indicate that rank and time since leaving the firm are not significantly associated with perceptions about ability to resolve disagreements, but gender ($p = .03$) and area of specialization ($p = .09$) are significantly associated with the responses.

Table 4 provides results from a multiple regression to examine the effects of rank, time elapsed since leaving the firm, area of specialization, and gender on alumni perceptions. The dependent variable is the respondents' perceptions about the ability to resolve disagreements with the auditor when their former CPA firm serves as the auditor of their cur-rent employer. The overall model is statistically significant (F = 2.67, p .03). The coefficients for RANK and PAST (which measures the time since leaving the firm, in years) are not significant in the regression. However, the coefficient for FEM is negative and significant ($p < .05$), indicating that female alumni were less likely to indicate that they could resolve disagreements more easily if their former CPA firm serves as the auditor for their current employer. The coefficient for AUD is positive and significant ($p < .05$), indicating that alumni from the audit area were more likely to indicate that they could resolve disagreements more easily if their former CPA firm serves as the auditor for their current employer.

Table 3
Univariate Analysis of Perceptions - Means

Variable	Yes	No	T-statistic	p-value
Partner or Manager	3.00	2.80	0.75	.454
More than 5 years since leaving firm	2.73	3.03	1.21	.231
Audit area	3.04	2.63	1.72	.089
Female	2.56	3.06	2.15	.035

Note: The values represent average values of responses to questions about ability to resolve disagreements, on a five point scale where 5 = strongly agree and 1 = strongly disagree. We reversed the scale (from the one used in the questionnaire) for ease of presentation.

Table 4
Regression Analysis
Model: RSLV = f (RANK, PAST, AUD, FEM)

Variable	Coefficient	T-statistic	p-value
INTERCEPT	2.96	8.18	.000
RANK	0.24	0.89	.377
PAST	-0.05	-1.07	.287
AUD	0.58	2.31	.024
FEM	-0.57	-2.27	.026

Model F = 2.67, p = .03, R-sq. = .13

Legend:
RSLV = Responses on five-point scale of ability to resolve disagreements if auditor were former CPA firm.
RANK = 1 if manager or partner, 0 otherwise.
PAST = Time elapsed (years since leaving CPA firm).
AUD = 1 if area of specialization was auditing, 0 otherwise.
FEM = 1 if female, 0 if male.

Additional Analyses

We performed additional analysis by including a dummy variable indicating if the former CPA firm of the respondent was currently providing audit or other services to the current employer.[4] Since this group of alumni is actually interacting with their former firms, their perceptions may reflect their actual experience with the auditors and hence could be valuable in the debate regarding auditors' employment with their clients. The co-efficient for the dummy variable was positive and marginally significant ($p < .10$), indicating that alumni who joined their client companies were more likely to agree that they could resolve disagreements more easily with their auditors (i.e., their former CPA firm). The significance of the other variables in the regression remained substantively similar.

Alumni who had spent a longer dine with the CPA firm may believe they can resolve disagreements more easily with the former CPA firm. However, as may be expected, the tenure and rank variables were highly correlated. Hence, we performed additional analysis by including a variable measuring tenure with the CPA firm instead of the rank variable. The tenure variable was not significant at conventional levels, but the FEM and AUD variables continued to remain significant in the model.

As noted earlier, we deleted responses from individuals who had left the firm more than 10 years ago. We also performed sensitivity analyses by deleting only responses from those who had left the firm (1) 15 years ago, and (2) 20 years ago. Substantively similar results were obtained for such samples, with gender and area of specialization (but not rank or time elapsed since leaving the CPA firm) being significant in the regressions. We performed our analysis on the full sample of 135 alumni also. In this sample, the time elapsed variable was negative and significant ($p < .05$), the gender variable was significant at p .067, and the area of specialization variable was significant at $p < .05$.

Taken together, the results indicate that rank and time elapsed were not associated with alumni perceptions about their ability to resolve disagreements. The results provide support for the position that gender and area of specialization are associated with alumni perceptions about their ability to resolve disagreements with the former CPA firm.

SUMMARY AND DISCUSSION

The issue of audit firm alumni going to work for clients of the firm has been an issue of considerable concern to regulators arid users of financial information because of its perceived effect on auditor independence. However, there is little empirical evidence related to the magnitude of the problem. Prior research has attempted to evaluate the perceptions of users and auditors regarding auditors' employment with their clients. This study provides perceptions of CPA firm alumni about their ability to resolve disagreements when their former CPA firm also serves as the auditor of their current employer.

The results indicate that 26% of alumni believe they can resolve disagreements more easily if their former CPA firm serves as die auditor of their current employer; however, a greater proportion (36%) disagree with such a statement. These results are interesting, given the significant interest expressed by the SEC and the ISB about the relationship between auditors and their former colleagues.

The ISB identified rank and time elapsed since leaving the firm as important factors in the context of concerns related to auditors going to work for their clients. Prior research (Imhoff 1978; Koh and Mahathevan, 1993) on users and auditors showed that these two factors impact perceptions about auditor independence. Neither of these two factors was significantly associated with alumni perceptions about their ability to resolve disagreements with their former CPA firm. However, consistent with expectations, alumni from the audit area were more likely to agree that they could resolve disagreements more easily if the former CPA firm served as the auditor. In our opinion, these results suggest that CPA firms may need to sensitize employees in the audit area to maintain professional skepticism when dealing with client personnel who are alumni of the firm.

The results also indicated that male alumni were more likely to agree that they could resolve disagreements more easily if the auditor of their current employer was their former CPA firm. This result adds to the general literature about gender differences in CPA firms and provides interesting questions for further research. For example, do male alumni believe they can resolve disagreements more easily when the engagement partner or manager is also male?

We conclude with some limitations arid avenues for further research. First, given the exploratory nature of this study, we did not specify a specific type of disagreement More importantly, there is no presumption that resolving disagreements with the auditors is necessarily bad. Concern should arise only when the independence of the auditor is impaired. It is possible that responses may vary, depending on the nature of the disagreement Second, as with any study relying on a survey, there is the issue of response-bias. Third, we only examined one side of the issue in this study. Future research also could examine the perspective of auditors about their ability to resolve disagreements when a former colleague is working for a client of the C.PA firm. An interesting issue for future re-search is to examine if the perceived ability to resolve disagreements will vary depending on (1) area of disagreement (for example, revenue recognition versus asset valuation) and (2) type of financial reporting decision (for example, accrual versus disclosure).

Notes:

[1] The ISS noted that "it's conceivable that the auditor's judgment regarding materiality could be swayed when determining whether a friend's aggressive accounting should be reversed, if the auditor's insistence on such a reversal would reflect badly on the friend" (1999: 13).

[2] A copy of the relevant questions is given in the appendix. The survey also included questions (not shown in the appendix) about the organizational identification of the respondents.

[3] Late respondents are usually deemed to be a proxy for non-respondents and we did not observe significant differences between early and late respondents ($p > .20$ for all factors examined in this study.)

[4] Twenty-six of the respondents (31 percent) indicated that the former CPA firm provided audit or other services to their current employer.

APPENDIX — QUESTIONNAIRE

Please check the appropriate answers.

I. Background

Are you an ex-employee of just one national CPA firm? Yes ☐ No ☐

If No, do not proceed and return this questionnaire. Otherwise, please answer the following:

1. Which CPA firm ______________________.
2. How long were you employed? years ______ and months ______.
3. Upon departure, what was the approximate size of the professional staff

   (a) in the CPA firm's office ______ and (b) in your department ______.
4. What was your specialization upon leaving?

   Audit ☐ Tax ☐ MAS ☐ Other (pl. specify) ________________.
5. Generally, CPA firms have the following job titles from the lowest to the highest level. Please indicate your title upon departure. Even if your firm did not follow these job titles, please check the one that you feel is equivalent.

   Junior ☐ Senior ☐ Manager ☐ Senior Manager ☐ Partner ☐
6. What was your date of departure (month and year) __________.

II. Please pick a number from the scale to show how much you agree or disagree with each statement and check the corresponding box to the right of the item.

scale

1 = strongly agree, 2 = agree, 3 = neutral, 4 = disagree, 5 = strongly disagree

	strongly agree 1	2	3	4	strongly disagree 5
7. I would like to see my former CPA firm be our auditors (if they are not currently our auditors).	☐	☐	☐	☐	☐
8. I would like to see my former CPA firm provide us other services.	☐	☐	☐	☐	☐

9. When the opportunity arises, I recommend my former CPA firm to my friends and business acquaintances. ☐ ☐ ☐ ☐ ☐

10. If I had the authority, I would not reappoint my former CPA firm if they were our current auditors. ☐ ☐ ☐ ☐ ☐

11. If I were in a position of authority, I believe I could resolve disagreements with our auditor more easily if the auditor was my former CPA firm. ☐ ☐ ☐ ☐ ☐

III. Demographic Data

12. Male ☐ Female ☐

13. Current Job Title ______________________.

14. Is your former CPA firm currently auditors of the company or organization in which you are employed? Yes ☐ No ☐

15. Does your former CPA firm currently provide any other services to the company or organization in which you are employed? Yes ☐ No ☐

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