Journal of
Empirical Research In Accounting

Alzahra University, Faculty of Social Sciences and Economics
Empirical Research in Accounting, Fall 2024, V. 14, No. 53, pp.35-40

Investigating the Effect of Auditor's Prior Commitment and Risk on Evaluation of Subsequent Events[1]

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Received: 2024/05/06
Accepted: 2024/06/18

Research Paper

INTRODUCTION

Subsequent events are events that occur between the reporting date and the date of approval of the financial statements and auditors are obligated to evaluate and react properly to these events. Subsequent events are assessed nearly at the end of the audit process when a large portion of the audit job is conducted. The evidence offered by the Public Company Accounting Oversight Board, as well as academic analysis, indicates that subsequent event audits are replete with shortcomings and deficiencies. Such deficiencies pertain to the identification, evaluation and adoption of proper measures when facing such events.

A key problem regarding the audit of subsequent events is that auditors are incapable of reacting appropriately and sufficiently to type I subsequent events that are identified near the end of the audit process. Type I subsequent events require that financial statements be adjusted following the completion of the audit which might create a challenging situation between the auditor and the management.

According to the escalation of commitment theory, we can say that when facing events that pique their attention following the completion of a considerable amount of audit work, auditors lack sufficient motivation to take the appropriate measures and, in fact, they are "committed" to the expectation that financial statements are fairly presented. Hence, the

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present study sought to answer the following questions: are auditors less likely to make any adjustments concerning subsequent events in the presence of prior commitments to the management regarding the fair presentation of financial statements compared to when no such prior commitments exist? The findings of previous studies in this field show that auditors can be over-committed to their prior measures and are less likely to consider any evidence contradicting these measures in their report. Therefore, in the present study we can anticipate that by creating the expectation that financial statements are fairly presented during the audit process, auditors can potentially escalate their commitment to this viewpoint and hence, take fewer appropriate measures for making necessary adjustments regarding subsequent events. Considering that the findings of some studies on escalation of commitment theory denote a negative relationship between risk factors and commitment, in this study, we investigated the effect of prior commitment on decision-making in the presence of high and low levels of control environment risk.

The findings of this study contribute to the development of the literature on the audit of subsequent events and offer some evidence on decision-making in which commitment increases due to the relationship between the auditor and the employer and the viewpoint that no significant issues exist regarding the fair presentation of financial statements; by negatively affecting the quality of an auditor's judgment, this escalatory behavior can inhibit proper judgment concerning subsequent events at a time when modifying the report can change the financial status of the customer from net profit to net gain. These findings reveal that auditors' judgments are susceptible to escalation of commitment in cases where auditors are reluctant to disagree with previous decisions communicated to the management. Moreover, the findings of this study offer new directions for improving the conditions regarding the audit of subsequent events. In auditing subsequent events, auditors might be notified of an event after the date of the balance sheet but they might not always act in a way that leads to the reevaluation of audit conditions or the report. In such circumstances, auditors should always be ready to consider new information at the final stages of the audit process, notwithstanding their prior talks with the management.

RESEARCH METHODLOGY

The present research belongs to the field of judgment and decision-making studies and, considering the interdisciplinary nature of our research hypotheses, we have adopted an experimental research design which is implemented through a test. The research data were collected using an instrument comprised of two sections: an experimental test and a questionnaire. In the experiment section, the research case study was made available to the participants and in the questionnaire section, following the completion of the test, questions regarding the self-monitoring personality trait along with demographic questions were presented to the subjects. To establish the content validity, the research questionnaire and case study were presented to university professors and experts and appropriate adjustments were made in line with their expert opinions. The questionnaire's reliability was also established using Cronbach's alpha. independent multifactor analysis of variance was used to test the research hypotheses.

Considering that this research aims to investigate the effect of commitment regarding the fair presentation of financial statements as well as control environment risk on auditor's judgment about subsequent events and since each independent variable was manipulated at two levels, we adopted a between-groups factorial design (2x2) and each participant was randomly assigned to one of four groups. The research population of this study includes supervisors, senior supervisors, managers and partners who were employed in auditing organizations certified by Tehran Securities & Exchange Organization in 2023. Ultimately, 130 individuals participated in this study. This study was conducted in 2023.

RESEARCH FINDINGS

The first hypothesis investigates the main effect of an auditor's prior commitment to managers on their assessment of inventory impairment. The first hypothesis posits that auditors identify smaller (larger) audit adjustments, in dollar value, for subsequent events recognized following (before) their commitment to managers regarding their initial view about the fair presentation of financial statements. The main effect of prior commitment on the subjects' evaluation of inventory impairment is statistically significant ($F_{(1,126)} = 6.370$, $p = 0.013$). Therefore, at a 95 percent confidence level, we can argue that prior commitment influences the dollar value of audit adjustment.

Next, post-hoc analysis was conducted to further analyze the main effects. Considering the unequal size of the studied groups and equal between-group variances, we applied the Gabriel post hoc test. The output of the post hoc test shows that under low levels of risk, average audit adjustments when no prior commitment exists are significantly higher compared to a time when auditors have prior commitments (no commitment = 7.22; prior commitment = 5.14; $p = 0.007$); however, in situations with high levels of risk, this relationship is not observed (no commitment = 7.14; prior commitment = 7.06; $p = 1.000$). To be more specific, when risk levels are high, no statistically significant difference exists in terms of proposed audit adjustments when auditors have a prior commitment to the manager concerning the fair presentation of financial statements relative to a time when no such prior commitments are made. Next, we can see that for auditors with prior commitment, average audit adjustments in a low-risk control environment are significantly lower compared to a high-risk control environment (low-risk = 5.14; high-risk= 7.06, $p = 0.011$). These conditions reveal that auditors suggest fewer audit adjustments to the management when, in a low-risk control environment, subsequent events are identified following the auditor's commitment to the management regarding their initial view about the fair presentation of financial statements. Therefore, according to these findings, we can state that the effect of prior commitment observed in low-risk conditions cannot be generalized to high-risk conditions. As a result, auditors identify an employer's high level of risk and will resort to their decision-making strategies to confront high levels of risk in evaluating and analyzing subsequent events, The above-mentioned findings confirm the second research hypothesis which states under a low-risk control environment, auditors’ prior commitment to the management regarding the fair presentation of financial statements has a greater diminishing effect on the proposed audit adjustments sum, in dollar terms, relative to a high-risk control environment.So, control environment risk moderates the effects of prior commitments on auditors’ evaluation of subsequent events.

CONCLUSION AND SUGGESTIONS

One characteristic of dealing with subsequent events is that such evaluations are frequently assayed at the end of the audit process, particularly at a time when auditors have already communicated their initial viewpoint regarding the fair presentation of financial statements to the management, therefore, one of the concerns of lawmakers concerning such events is that sometimes auditors cannot properly react to these events when they are identified during the audit process or overlook new evidence once the audit is complete. Although auditors are obliged to react to subsequent events, a major concern in this regard is that, due to such circumstances, auditors might escalate their commitment to their initial decision and be inclined to stick to their initial decision and commitment, and hence fail to make sufficient adjustments for a subsequent event which causes a material change to the reported profits in the financial statements of the audited unit. Our findings regarding the first research hypothesis indicate that auditors make fewer audit corrections of subsequent events when these events are identified after communicating their initial viewpoint regarding the fair presentation of financial statements to the management. In contrast, when these events are identified before communicating the auditor's viewpoint to the management concerning the fair presentation of the financial statements of the audited unit, auditors suggest more corrections regarding these events. These findings are related to the extant literature on the behavior based on auditors' initial decisions and are in line with the findings of Jeffrey (1992) and Phang and Fargher (2019); the findings of this study revealed that the audit process can encourage auditors to engage in such behaviors in their evaluation. Based on the escalation of commitment theory, Jeffrey (1992) states that when the outcomes of subsequent events are unsatisfactory and contradict prior expectations regarding the fair presentation of financial statements auditors' prior commitments can, most likely, influence their decision-making process regarding subsequent events.

Our findings regarding the second hypothesis reveal that auditors make fewer audit adjustments when, in low-risk environment conditions, subsequent events are identified after they have offered their initial view about the fair presentation of financial statements. According to these findings, we can state that the effect of prior commitment observed in low-risk conditions cannot be generalized to high-risk conditions. To be more specific, increased risk levels lead to a reduction in auditors' commitment to their initial decision and make them reconsider their evaluation of risk regarding subsequent events. Therefore, by identifying an employer's high level of risk, auditors will show a greater level of professional doubt when evaluating and analyzing subsequent events and resort to appropriate decision-making strategies to confront high levels of risk. These findings are in line with those of Phang and Fargher (2019).

The findings of this study can provide important feedback for auditors, the Audit Organization of Iran, other audit institutions, as well as the Iranian Association of Certified Public Accountants. With regard to audit operations, the main findings of this study show that auditors might display escalatory behavior regarding the evaluation of subsequent events when such events are identified following initial reports to the management about the fair presentation of financial statements. Church (1991) explicates the behaviors based on the escalation of commitment in auditing and states that a potential cause for observing such behaviors might be that drawing the employer's attention to subsequent events and suggested modifications of financial statements after the audit can indicate the acceptance of the inferior quality of the initial audit process. The present study offered some evidence showing that auditors face some hurdles in changing their decisions after committing to the management or the audit supervisor. In practice, during the audit process, auditors are obliged to frequently communicate their views to the management, collect some audit evidence, or offer some explanation for resolving audit issues before

publishing their report. Accordingly, once auditors have completed their evaluations and reported their initial view to the management they might be unable to pay sufficient attention to inconclusive evidence identified at the end of the audit process or be reluctant to change their initial viewpoint. This finding is important since the escalation of bias in the completion of the audit process, as identified in this study, might affect the outcome of the audit.

Keywords: Subsequent Events, Prior Commitment, Control Environment Risk.

JEL Classification: M42.