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The Theory of Auditing Economics: Evidence and Suggestions for Future Research

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The Theory of Auditing Economics: Evidence and Suggestions for Future Research

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ABSTRACT

Analytical auditing research provides underlying theory for the economic analysis of auditing. Despite its importance, there have been no papers that provide a comprehensive review of research conducted in this area. This monograph reviews existing analytical auditing research. I identify the assumptions and key economic forces addressed in selected papers and provide suggestions for future research by summarizing and critiquing the existing research. I develop a framework that incorporates the demand for and supply of audits and considers the economic incentives and strategic interactions of individuals or organizations involved in the audits. Using this framework, I examine three questions: Why do we need financial statement audits? What determines the assurance production and reporting? How do parties interact within an audit and in markets? This monograph intends to stimulate further analytical auditing research and help guide research using other methodologies.

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Introduction

Financial statement audits are essential in maintaining well-functioning markets. Research on the economics of auditing has grown significantly in light of accounting scandals and regulatory reforms in recent years. As an important component of auditing economics, analytical auditing research considers individuals involved as economic agents maximizing utilities and derives equilibrium solutions. This research can help us understand the economic impact of auditing and help provide theory motivation for research using other methodologies. Despite the importance of this type of research, there have been no papers that provide a comprehensive review of research conducted in this area. This monograph provides a review of existing auditing economic theory, highlights the limitations of the literature, and discusses possible future research. Specifically, the objective of this monograph is two-fold: to provide researchers who are interested in analytical auditing with an overview of the existing literature, and to explain auditing theory to researchers who employ other methodologies, such as archival or experimental, and help guide their research.

Analytical research based on agency theory often overlooks the fact that auditing is an economic service requiring input and cooperation

from the auditees (Knechel *et al.*, 2020). Most analytical research focuses on audit supply. Publications on demand, audit market competition, and regulatory impact are limited. For example, we lack a coherent theoretical argument for the co-existence of audit committees, internal auditors, and external auditors and for explaining the extent to which these three functions are substitutes or complements. How do the characteristics of an audit committee affect its choice of auditors, audit fees, and audit quality?

Existing research on assurance production covers audit partnership and compensation, competency requirements, audit-staff scheduling, sampling, and materiality analysis. We need more research on capital investment (including the impact of technology advancement), audit firm organizational structures, audit engagement teams, audit partner compensation, and the audit labor market. Though there is no conclusive definition of audit independence, a few papers analyze how various factors may influence auditors' reporting decisions, such as low-balling (i.e., pricing initial audits below cost) and contingent fees. For example, research shows that contingent fees and opinion shopping do not necessarily result in untruthful reporting. Moreover, due to uncertainty, it is often not clear cut whether an accounting estimate records the underlying economic transaction fairly, which leaves room for negotiation. However, the existing research on manager-auditor negotiations is limited. More research on negotiations is needed.

Most research on the mechanisms that motivate auditors to work hard and report truthfully is about the impact of auditor liabilities. Existing research has identified conditions under which increasing auditor liability may or may not increase audit effort, investment, and social surplus. Future research could consider the impact of liability on auditors' reporting decisions, audit fees, and strategic interactions with clients, and analyze the effects of ethics and auditor reputation. Moreover, audit failures can result in a loss of social surplus (fewer projects being funded due to a lack of investor confidence). But auditors rarely consider this loss. Hence, regulatory intervention is essential in restoring investor confidence in corporate financial disclosures. We need further research in this area.

Moreover, there are limited theories explaining audit firm/partner and client matching, auditor changes, the current market structure, or the impact of audit market competition on audit fees and audit quality. We also lack theories illustrating why we observe the segregation of the audit market by Big and Non-Big audit firms and how Big vs. Non-Big audit firms would respond to various new regulations. I will review each of the aforementioned areas of research and then provide suggestions for future research, which will additionally be summarized in Section 8.

This review makes the following contributions. First, a theoretical overview of existing analytical research helps identify important unexplored research questions. Highlighting these questions can stimulate additional research, which will help improve the usefulness and effectiveness of auditing. Second, though theory often lays out the foundation of empirical or experimental hypotheses, theory papers are not often cited in other types of research because researchers may not be aware of the existence of these papers. Reviewing these papers is intended to help better connect auditing theory with other types of research and help researchers using other methods to develop strong theoretical reasoning, especially when the *ex ante* arguments are unclear. Third, using survey data gathered among the participants of the 2019 Journal of Accounting Research (JAR) Conference, Hail *et al.* (2020) reports that there is substantial doubt about reproducibility in accounting research. This problem is less likely to exist for analytical studies. Analytical research using a mathematical modeling approach is typically replicable since the conclusions are proved mathematically. However, the implications of these studies may be limited to particular assumptions used to set up the theoretical framework. Reviewing these papers can summarize key findings under various assumptions or institutional settings, and thus, can provide better and more-robust policy implications.

The rest of the monograph is organized as follows. Section 2 presents the framework used to organize this review. Section 3 explains why we need financial statement audits and reviews the research on the demand for auditing. Section 4 discusses the research relating to the supply of auditing. Section 5 examines the literature on the interaction of auditees and auditors in markets, including audit market competition and auditor-client matching. Section 6 presents strategic auditing. I discuss several

stylized auditing models in Section 7. Section 8 critiques the existing analytical research and suggests future research. Section 9 concludes.

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