# The effect of client identity on audit quality in Iran

Ahmad Abdollahi
Department of Accounting, Golestan Institute of Higher Education,
Gorgan, Iran
Email: ahmabdollahi@gmail.com
Fatemeh Riahi
Department of Accounting, Golestan Institute of Higher Education,
Gorgan, Iran
Email: fateme.riahi@yahoo.com
Soraya Saadi
Department of Accounting, Golestan Institute of Higher Education,
Gorgan, Iran
Email: saadisoraya@yahoo.com

**Abstract.**
According to Social Identity Theory (SIT), people tend to classify themselves and others into various social categories, such as organizational membership, religious affiliation, gender, and age cohort. As these examples suggest, people may be classified in various categories, and different individuals may utilize different categorization schemas. Categories are defined by prototypical characteristics abstracted from the members. Although client familiarity is desirable from the auditor's perspective, identifying with clients and client identity threatens auditor objectivity. The aim of this paper is explanation about the extent to which auditors identify with clients, the effect of auditor-client identification on auditors' client acquiescence to client-preferred treatment, and, finally, whether the harmful effects of Auditor-client identification can be extended to a broader set of reduced audit quality acts. The results of literature review show that client identity influence on audit quality and it may be serious for auditing profession.

**Key words:** Social Identity Theory, client identity, audit quality

## Introduction

Investors perceive a lower quality of accounting information when the audited company's management exerts influence on auditors (Dhaliwal, Gleason, Heitzman, & Melendrez, 2008; Lambert, Leuz, & Verrecchia, 2007). At the same time, valueadded audit services e i.e., clienteservice activities resulting from an audit that are not directly related to verifying the financial statements, such as providing information and advice beyond core audit services e are found to be most abundant when the auditor has a strong relationship with the client (Herda & Lavelle, 2013). In addition, clients prefer a relational approach from their auditors (Fontaine & Pilote, 2011, 2012), but client desire to have a committed and relationally oriented auditor appears difficult to reconcile with the need for auditor objectivity (€Ohman, H€ackner, & S€orbom, 2012). The present study addresses this problematic issue by examining the impact of auditoreclient identification on auditor objectivity and audit quality by applying social identity theory to the auditoreclient relationship. Bamber and Iyer (2002, 2007) suggested that auditors identify with their clients and that this identification reduces auditor objectivity in such a way that an identifying auditor tends to acquiescence to the client's preferred accounting position.

The Independence Standards Board identifies auditors' familiarity with the client as one of five threats to auditor independence (ISB 2000a).To foster auditor independence and objectivity, the Sarbanes-Oxley Act of 2002 bans auditors from various consulting activities, tightens partner rotation requirements, and raises the issue of accounting firm rotation. The untested assumption behind these new regulations is that the close ties between auditor and client are inappropriate because they impair auditors' objectivity in performing the audit, which in turn contributes to perceived audit failures such as Waste Management, Global Crossing, MicroStrategy, and Enron. Yet auditors must be familiar with their client and its management to understand the client well enough to plan and perform an effective and efficient audit (Auditing Standards AU 311). This conflict between: (1) auditors'need to be familiar with the client in order to perform the audit, versus (2) the threat to objectivity from this familiarity, have led critics to argue that it is not possible to expect auditors to exercise objective, unbiased judgment (e.g., Bazerman et al. 2002).

We extend this research by examining a broader set of behaviours. In particular, we examine whether the effects of auditoreclient identification extend to reduced audit quality (RAQ) acts. The RAQ acts considered here constitute unethical time-saving acts having no immediate relationship to client preferences, and previous research has found that RAQ acts arecaused primarily by time budget pressure (TBP) (e.g., Coram, Ng, &Woodliff, 2003; Otley & Pierce, 1996a; Pierce & Sweeney, 2004;Willett & Page,1996). However, Cianci and

Bierstaker (2009) argued that the underlying mechanism of the relationship between TBP and RAQ acts is cognitive bias caused by TBP. Affected by this bias, auditors believe that they can take such timesaving shortcuts as superficially reviewing client documents or false signoff without increasing audit risk. Auditors who identify with their clients are likely to suffer from a similar biasing of their judgment. Consequently, auditoreclient identification is a likely cause of RAQ acts.

The remainder of this paper is made up of two parts and then is ends with statements ; firstly,it introduces two essential charts for understanding social identity theory and justifying costomer identity , then the third section examines the professional recognition reform framework for the acceptance of audit clients and the reduction of audit quaiity and concludes the last part of this article.

**Social Identity Theory and the justification for the client identity construct**

Whenever HQ managers are assigned abroad to work as expatriates, they enter a social milieu, namely the foreign country, in which they have to interact with a series of people, including local staff (HCNs). How will they see themselves in their interactions with local staff and how will local staff view them? This is what sociologists mean by identity (Haslam et al., 1999). Valsiner (2007) defines identity as the sundry ways in which individuals see themselves and others within their social milieu. This can also be described as the different selves that individuals adopt in their social interactions. Identity is constructed on multiple spheres or levels (Cole, 1996; Valsiner, 2007) and there are three basic types of identity. The first is personal identity (Perry, 2008), the aspects of individuals that define their personality. In the case of our two focal groups, personal identitywould apply to the manner inwhich individualmembers behave or interrelatewith others (e.g.,whether they are outgoing, polite, trustworthy, optimistic, etc.). The second is role identity (Ashforth, 2001),which includes professional or organizational identity. As its name suggests, this refers to the part an individual is expected to play within a group (e.g., manager, auditor, salesperson, etc.). All localmembers of staff have a role to playwithin their milieu (i.e., the subsidiary's environment), and that role will complement the parts played by others (e.g., corporate expatriates). Finally, there is social identity, which is imposed by demographic variables, such as gender, age, ethnicity, or nationality. Tajfel (1972, 292) identifies social identity as “the individual's knowledge that he belongs to certain social groups together with some emotional and value significance to him of this group membership”. People derive their self-concept (identity) largely fromthe social group to which they belong. Social identity is thus containedwithin the individual (Hogg & Abrams, 1988).

Social Identity Theory holds that individuals’ social identity results from a selfcategorization process, through which individuals cognitively group themselves with others. As such, Social Identity Theory potentially provides a cognitive-based explanation, in contrast to aeconomic-dependency explanation, for why clients may have too much influence over their auditors. According to the theory, individuals classify themselves into multiple social groups, such as occupation, organization, division, gender, nationality, ethnicity, and age (Turner 1987; Ashforth and Mael 1989). These multiple identities are distinct, and may be compatible or competing with one another (Wallace 1995; Scott 1997). Researchers find organizational identification in a variety of settings, including work groups (e.g., Wan-Huggins et al. 1998), soldiers (Mael and Ashforth 1995), college alumni (Mael and Ashforth 1992), accounting firm alumni (Iyer et al. 1997), journalists (Russo 1998), cooperative extension agents (Scott 1977),and auditors (Bamber and Iyer 2002).

These self-categorizations act as a point of departure for thinking and relating, and so social identity increases the likelihood that the individual internalizes the group’s norms and values. Adoption of a particular identity affects the way individuals interpret information and make decisions (Lembke and Wilson 1998). Individuals tend to identify with groups whose values appeal to the individual (Alvesson 2000). Moreover, these self-categorizations may be viewed as separate and distinct identities so that, for example, identification with one’s employing organization does not necessarily preclude identification with one’s profession (Lachman and Aranya 1986; Wallace 1995; Bamber and Iyer 2002). Nevertheless, individuals who see themselves primarily as professionals are likely to identify less with their employing firm, since the firm is secondary for their identity (Alvesson 2000). Identification affects outcomes. For example, Deetz (1995) reports that professionals who identify with a client are more likely to underreport the actual hours worked on a project because they did not want the client to pay for work performed somewhat inefficiently. Iyer (1998) finds that accounting firm alumni are more likely to steer business to their former accounting firm. King (2002) reports experimental evidence that a sense of social identity among auditors partially counters the self-serving biases suggested to compromise auditors’ objectivity, and Towry (2003) finds that team identity affects an incentive system’s effectiveness.

Social Identity Theory predicts that service organization employees whose direct interaction with clients is a major part of their work will begin to identify with their clients. For example, Alvesson (2000, 1109) finds that computer consultants who work at the client’s location on a daily basis for many months report that “they sometimes knew the client company better than their own employing company and that they experienced identity and loyalty problems.” Auditors may work at the same client on a daily basis for long periods and on a recurrent yearly basis. To perform an effective and efficient audit, auditors must understand the client's business, accounting and information systems, and know its key personnel (AU 311). Auditors may also view a client as a potential future employer. For all these reasons, auditors are likely to identify with their clients.

Three antecedents of auditoreclient identification were examined by Bamber and Iyer (2007), who found that the effects of auditor tenure, client importance, and client image, respectively, on auditor acquiescence were mediated by auditoreclient identification. Supporting a large body of social psychological research, Dutton et al. (1994) argued that the longer a person remains with an organization, the more salient the organizational membership becomes for self-categorization. Bamber and Iyer (2007) confirmed that the length of time that an auditor has worked on the audit engagement (i.e., auditor tenure) is positively related to auditoreclient identification.

Furthermore, auditors will tend to identify more with clients that they deem important. Such clients are often the largest clients of an audit firm (Chung & Kallapur, 2003), and auditors invest more time and effort in important clients, though small clients may be important for non-Big 4 firms due to the relative size of the audited company. Auditors are sometimes recruited by their clients (Dart & Chandler, 2013), a situation that causes auditors to value clients as potential employers as well. Social identity theory and evidence from Bamber and Iyer (2007) suggest that the positive effect on auditors' self-image provided by association with important clients in combination with the amounts of time that auditors allocate to such clients stimulate audit client identification. Finally, social identity theory suggests that people identify with groups that have an appealing image, increasing individual self-esteemand image (Haslam, 2001; Tajfel & Turner,1985). For these reasons, we expect to confirm Bamber and Iyer's (2007) results and find that auditors identify more with clients having a positive image in the eyes of the general public, auditors, or both.

**Professional identification, auditors' client acquiescence, and RAQ acts**

If auditors do exhibit significant levels of client identification, it is necessary to determine when this affiliation compromises auditor objectivity. Objectivity requires the auditor to make unbiased audit judgments instead of simply acquiescing to the client's wishes (ISB 2000a). Rule 102, Integrity and Objectivity, of the AICPA *Code of Professional Conduct* requires that a member "shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others. Objectivity is at the heart of the auditor's value to society: to provide an unbiased opinion on the fairness of the financial statements (Johnstone et al. 2001). Given their professional training, auditors may be able to control the extent of their identification with the client so that it does not impair their professionalism and objectivity. Alternatively, identification with the client may interfere with auditors' objectivity by inducing judgment bias. In a study of lawyers in a large city, Wallace (1995) finds that professionals can be highly committed to both their organization and their profession, and that identification with one does not necessarily affect their identification with the other. Similarly, Bamber and Iyer (2002) find that auditors exhibit relatively low levels of conflict between identification with their employing firm and identification with their profession, suggesting that auditors can manage competing demands from their firm and profession. If auditors can manage these competing demands, perhaps they can also maintain their objectivity despite identifying with the client.

While prior research has not directly examined how client identification affects auditors' judgments, there is reason to believe that it impairs auditors' objectivity. The Independence Standards Board's *A Conceptual Framework for Auditor Independence* (2000a) lists familiarity: "threats that arise from auditors being influenced by a close relationship with an auditee," as one of five threats to auditor independence.5 Johnstone et al. (2001) identify interpersonal relationships between the auditor and client as an incentive that creates a risk to independence.

Moreover, in his analysis of accounting professionalism, Arthur Wyatt (2004, 50) suggests "keeping the client happy and doing what was necessary to retain the client achieved prominencethat did not exist prior to the advent of the successful consulting arms within the firms…… Healthy skepticism was replaced by concurrence. Accordingly, that auditors' identification with their clients impairs their objectivity so that the likelihood auditors acquiesce to the client-preferred treatment increases with the extent to which they identify with the client.

Several auditor behaviours identified as RAQ acts have been examined in previous research, including accepting weak client explanations (Coram et al., 2003; Pierce & Sweeney, 2004; Willett & Page, 1996), superficially reviewing client documents (Dalton & Kelley, 1997; Kelley & Margheim, 1987; Pierce & Sweeney, 2004), and inadequately investigating accounting principles (McNair, 1991; Otley & Pierce, 1996a). Moreover, research has found that auditors in some cases reject awkward-looking items from a sample (Coram et al., 2003; Willett & Page, 1996), inappropriately rely on the client's internal control (Pierce & Sweeney, 2004), fail to pursue questionable items (McNair, 1991), and sign off prematurely (Alderman &Deitrick, 1982).These RAQ acts are closely related to TBP in audit firms and this pressure is the most commonly observed cause of these behaviours. RAQ acts have been so closely associated with TBP that they may be interpreted simply as ways for auditors to save time in order to attain time budgets, but Cianci and Bierstaker (2009) offered an alternative way of looking at the phenomenon. They demonstrated that TBP causes auditors to suffer from biased judgment, which in turn causes RAQ acts to become more frequent. This judgment bias, i.e., efficiency-mediated estimation, means that auditors discount negative information, emphasize positive information about the client's accounting as more relevant, and make favourable assessments of the client's internal control as demands for efficiency increase. This in turn means that auditors can perform RAQ acts to save time in the belief that these acts do not involve an audit risk increase.Cianci and Bierstaker (2009) explained auditors' biased judgment with reference to motivated reasoning theory (Kunda,1990, 1999). This theory claims that individuals with directional goals conduct biased searches for and overestimate the importance of evidence supporting their preferred conclusion (Ditto, Scepansky, Munro, Apanovitch, & Lockhart, 1998; Lundgren & Prislin, 1998). Consistent with motivated reasoning theory, accounting research has provided evidence that auditors make judgments in favour of client-preferred alternatives in response to efficiency concerns (Bierstaker, Bedard, & Biggs, 1999; Glover, Prawitt, Wilks, & McDaniel, 2005; Haynes et al., 1998) and other evidence suggests that auditors can have the goals of being efficient and supporting client-preferred positions (DeZoort & Lord, 1997; Johnstone, Bedard, & Biggs,2002). Of particular importance in this respect is the similarity of these effects to the inclination of auditors to take a collective's (group or organization) interest to heart (Hogg, 2003; Sedikides & Brewer, 2001; Turner et al.,1987), which is likely to appear when the auditor identifies with clients. In total, these observations suggest that auditors who identify with their clients are more likely to commit RAQ acts than are other auditors. Similarly, Deetz (1995) found that professionals who identify with a client are more likely to under-report time.

While client identification may pose a threat to auditor objectivity, other features of the audit may offset this threat. One factor is auditors' professional identification. Research on the organizationaleprofessional conflict experienced by auditors has claimed that professional commitment or professional identity is separated from and precedes other commitments for this strongly professional group (Aranya & Ferris, 1984; Aranya, Pollock, & Amernic, 1981; Carrington, Johansson, Johed, & €Ohman, 2013; Shafer, Park, & Liao, 2002; Shafer & Wang, 2010). According to the social identity argument, auditors who identify with their profession tend to internalize the values and norms of the profession, their behaviour being highly governed by these values and norms.If it is correct to hypothesize that the propensity to acquiescence to the client's preferred accounting position increases with increasing client identification, the opposite should hold for professional identification. This reasoning is supported by Jenkins and Lowe (1999), who argue that auditors could be either advocates for their clients, supporting strong client identification, or public watchdogs, supporting strong professional identification. For the same reasons that auditors tend to acquiesce less to the client-preferred treatment when they have a stronger professional identity (Bamber & Iyer, 2007), we expect auditors with a stronger professional identity to be less likely to commit various RAQ acts. Auditors who are less independent should have a higher tendency to neglect the audit rigor compromised by RAQ acts.

## Discussion and conclusions

This study extends previous literature on the the effect of client identity on audit quality in Iran.

We found that identification with clients varies substantially between auditors, and that client identification is lower than professional identification on average. Partly contrary to this result, Hogg, van Knippenberg, and Rast III (2012) argued that identification across organizational boundaries is difficult to achieve if there are intergroup identity clashes. We recognize that an auditoreclient relationship could well involve intergroup clashes because the auditor's professional identification is strong and being an auditor entails maintaining a certain distance from the client. In the view of researchers such as Fontaine and Pilote (2011, 2012) and Herda and Lavelle (2013), auditors should establish a relational approach to their clients. However, the present study provides further evidence of the impairment of auditor objectivity that may be caused by relaxing the requirement for an arms-length auditoreclient relationship. We found that

auditors' client identification serves to impair auditor objectivity because auditors who identify relatively more with their clients are more likely to acquiesce to the client-preferred treatment of a material accounting issue. This effect was demonstrated using a measure of the extent that the auditor's judgment is biased.We also found that auditors who are more experienced are less likely to acquiesce to the client's position, supporting previous findings (Bamber & Iyer, 2007).Also, Cianci and Bierstaker (2009) found that the effect of TBP on RAQ acts is explained by cognitive bias. They argued that TBP causes the auditor to look more favourably on the client's internal control, and that this assessment by the auditor in turn causes the auditor to inappropriately believe that foregoing some substantive testing, in order to save time, will have less adverse effects.

We found that increasing client identification increases not only the auditor's tendency to acquiesce to the client-preferred treatment of a material accounting position, but that the auditor is more likely to commit a range of RAQ acts.

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