

# Case Materials on Auditor Independence

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# Agenda



# Our Agenda

- **The importance of auditor independence for reliable financial reporting**
  - Activity #1: The Market Game
- **Classroom Discussion**
  - Motivation for independence
  - Linking independence and reporting quality
  - Research for use in the classroom
- **Deeper dive into individual auditor independence**
  - Activity #2: Assembling the Audit Team





# Our Case Materials

- Award-winning Auditor Independence Education Materials (AIEM)
  - Developed by Deloitte & the University of Illinois Center for Professional Responsibility in Business and Society
- Contents
  1. Video
  2. Five case studies with teaching materials, solutions, and separate student materials
  3. Student handout
  4. In-class laboratory market game
  5. Separate student website for student materials
- Covers five key areas of independence:
  1. What independence is and why it's important
  2. Professional skepticism
  3. Serving the public interest
  4. The public accounting profession and its role in capital markets
  5. The independence concepts and rules that apply to a public accounting firm and its professionals

<https://business.illinois.edu/responsibility/curriculum/>



illinois.edu



College of Business at Illinois

Center for Professional Responsibility in Business and Society

# Activity #1 – Market Game



# The Market Game



# Market Game

- This is a market with teams of buyers & sellers.
- To begin each period, seller teams choose a price & quality.
  - We will collect these decisions & record (& show) them.
- Then, each buyer team has an opportunity to purchase from one seller team at the listed quality grade & price.
- Quality grade can be one of the following levels: (1) Lower; (2) Middle; and (3) Higher.
- Better grades cost more for sellers to produce & are worth more to buyers.



# Market Game

- Each buyer can purchase only one unit per period.
- Each seller can sell up to two units per period; each unit has the same sales price. The second unit costs \$1 more than the first unit; unsold units incur no cost.
- Buyers earn money by purchasing products at a price below their value, which depends on the quality grade.

**Buyer Earnings = Value for Grade Purchased - Seller's Price**

**Seller Earnings = Sales Price - Cost of Grade Produced**







# Market Game

- When all sellers have selected their prices & grades, we will collect these sheets and enter the prices and grade in the record table.
- Cards will be drawn online at the beginning of each round to determine the first buyer to make a purchase decision.
- After selling a unit, the seller chooses whether or not to sell an additional unit at a cost of \$1 more; if the additional unit is sold, it must be at the same price & grade as the first unit.
- Use the table on your sheet to calculate your earnings each period.



# Market Game

- We will monitor the market to ensure that all teams follow the rules.
- At the end of each round, we will discuss the trading results & the behavior of our market.

**Any Questions?**

What's the prize  
for winning?



# Market Game

**Now let's begin!**

Sellers & Buyers

Remember to not to discuss your decisions  
with other sellers & buyers.



# Market Game: Modification

**Seller Quality will Now be Available Only After  
Trading is Completed**



# Market Game: Modification

## **Verifier Team:**

One Seller team will now be selected to be the Verifier Team

- You will market your services to Sellers only.
- Sellers: Verifier will post an audit report about quality before trading begins for your team, but not for the other sellers.

**We will hold a private auction – Highest Bid Wins**





# Market Game: Debriefing

What happened?

What does this have to do with assurance, independence, or reporting quality?



# Market Game: Debriefing

- Seller cost structure:

	<i>Lower Grade</i>	<i>Middle Grade</i>	<i>Higher Grade</i>
Cost of first unit	\$1.40	\$4.60	\$11.00
Cost of second unit	\$2.40	\$5.60	\$12.00

- Buyer value structure:

	<i>Lower Grade</i>	<i>Middle Grade</i>	<i>Higher Grade</i>
Value	\$4.00	\$8.80	\$13.60



# Market Game: Debriefing

- When both sellers and buyers know quality and price in advance, market forces move toward socially optimal levels of production for different quality levels.
- Even when both sellers and buyers know quality and price in advance, society might be better off if a grade other than highest quality is traded.



# Market Game: Debriefing

- What happened when buyers did not know quality in advance?
  - When quality is not readily observable to buyers ahead of time, they will be more reluctant to engage in trade.
- When quality is not known in advance, the lower number of trades that do occur typically will include some buyers getting “ripped off”.
  - Because buyers may still trust the seller to not sell lower quality products at prices typically associated with higher quality products.



# Market Game: Debriefing

- Did any seller try to establish a reputation for credible signaling about quality? If so, were sellers rewarded?
  - Sometimes honest sellers are rewarded but sometimes not.
  - If not, sometimes sellers become dishonest to dupe buyers.
- When reputations can't be established, sellers who want to be honest will pull out of the market.
  - Sellers fear buyers will have big doubts about quality.
- Only sellers who hang around try to rip off buyers. Buyers realize this & don't trade (Lemons Market).
  - Low quality/price sellers hang around too; buyers trade.





# Market Game: Debriefing

- But, behold the power of assurance!
  - An independent verifier helps restore (optimal) trade.
  - Sellers will voluntarily pay for assurance services.
- Auditor (verifier) independence is critical!
  - Trade can grind to a halt if buyers don't trust verifiers to be independent from sellers.



# Classroom Discussion



# Motivation: Fundamental Conflict

- A potential conflict of interest always exists between the auditor and the client.



Compensation



Social Interaction



“Impossibility of Auditor Independence”





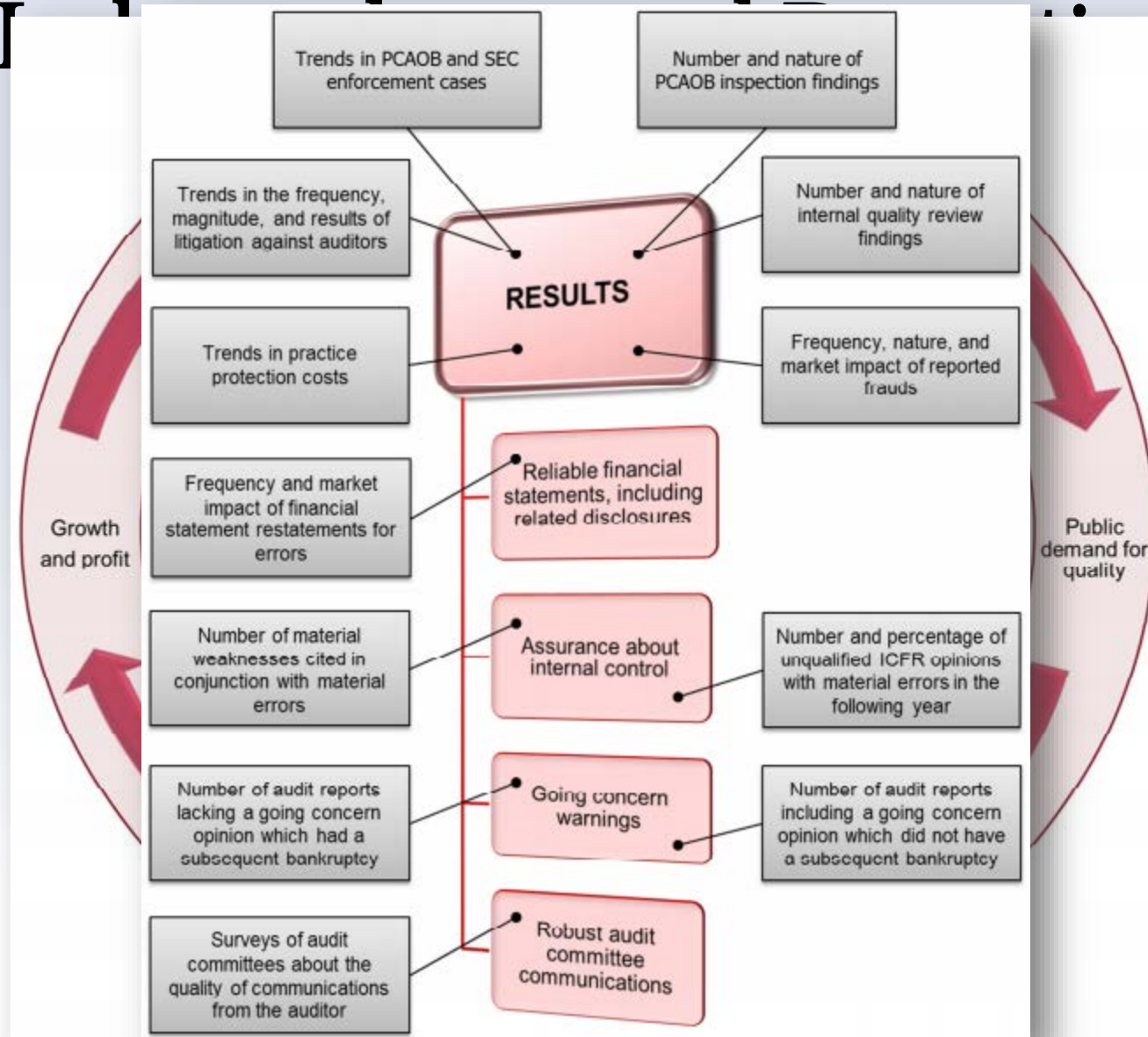
# Linking Independence and Reporting Quality

- DeFond & Zhang (2014) – “We define higher audit quality as greater assurance of high financial reporting quality.”
  - “greater assurance that the financial statements faithfully reflect the firm’s underlying economics, conditioned on its financial reporting system and innate characteristics.”



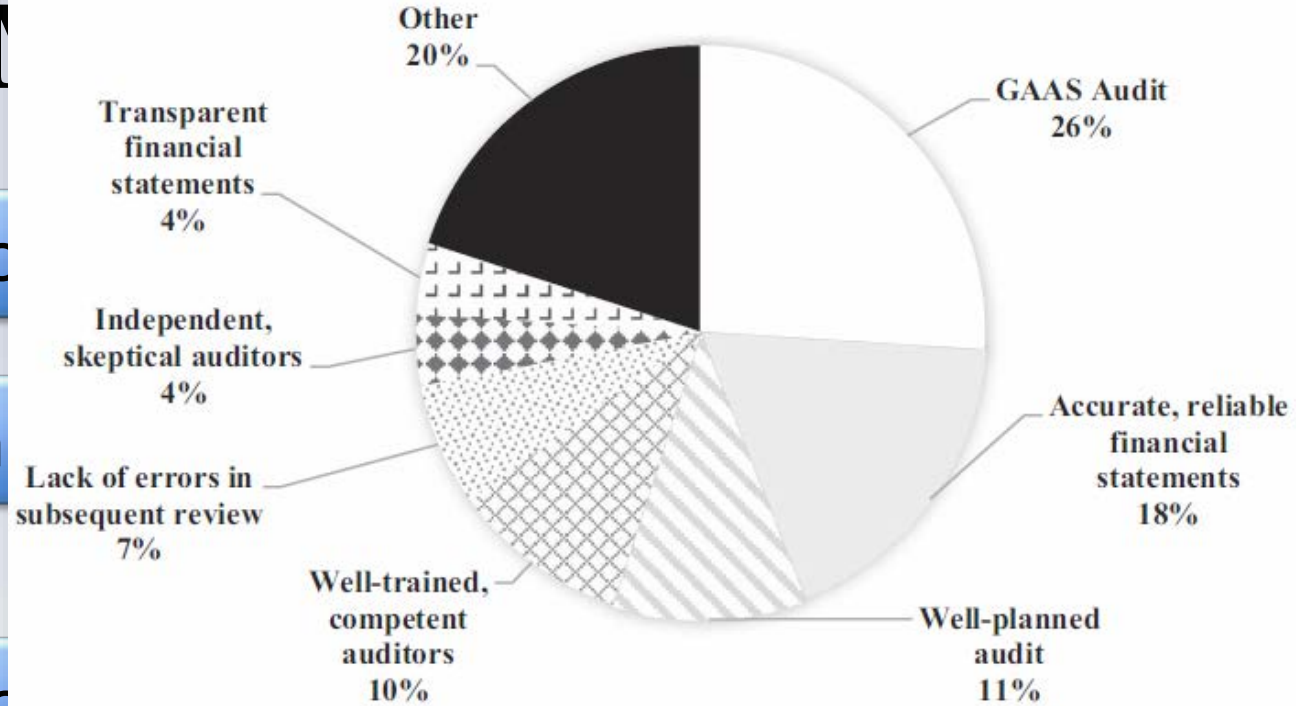
# Linking I

# g Quality





# AUDITOR DEFINITIONS OF AUDIT QUALITY



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Audit Co

Opinion Sh

Client Importance

Tenure

Rotation

User Expectations

Fees

NAS

Low-balling

Partner Signature



# So Many Interesting Topics

Audit Committee

Internalized  
Incentives for fraud

Opinion Shopping

Cooling off period

Client Importance

Rotation

Tenure

User Expectations

Fees

NAS

Low-balling

Partner Signature



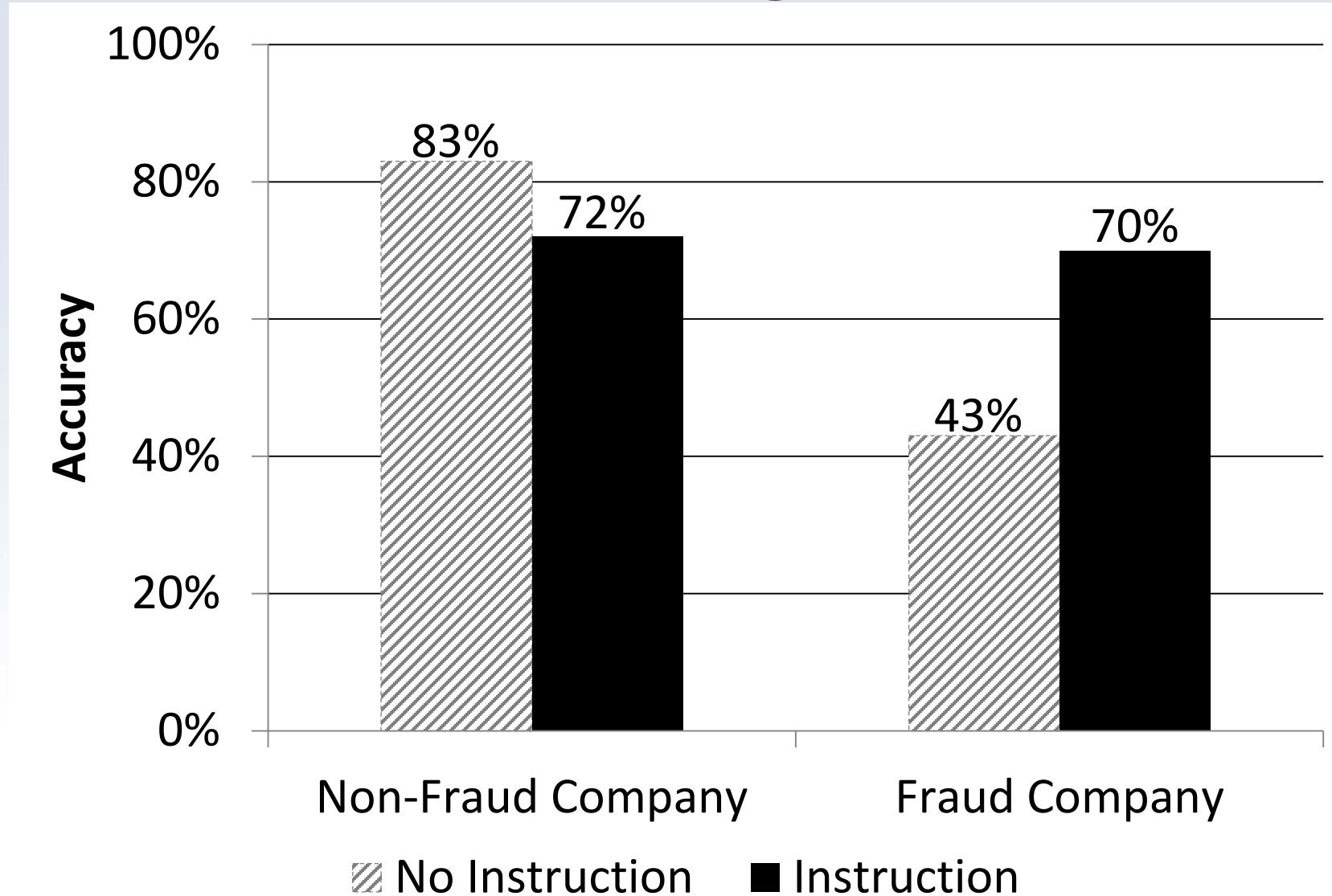


# (Dis)incentives to Detect Fraud are Internalized

- Disincentives & Incentives to find fraud
- Become more reluctant skeptics over time
  - PEDMIN (primary error detection minimization, Friedrich 1993)
  - Motivated reasoning (Kadous et al. 2003; Clor-Proell & Nelson 2007)



# Hobson, Mayew, Peecher, Venkatachalam (2017, Fig. 1)



# Activity #2 – Individual Auditor Independence





# Individual Auditor Independence Case

**Deloitte.**



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Independence

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Auditor independence education materials: The importance of being independent

Case Study 3: Assembling the audit team

