

## PRACTICE SUMMARY

# The Effects of Judgments of New Clients' Integrity upon Risk Judgments, Audit Evidence, and Fees

Philip R. Beaulieu

Auditors in the planning stage are concerned about the integrity of clients because it affects fraud risk, especially in the case of new clients, with whom auditors are less familiar. Fraud is an element of auditors' business risk, and when they perceive low integrity in their clients they may increase the amount of audit evidence collected, resulting in higher audit fees. Therefore, judgments of client integrity are expected to be linked to business risk, audit evidence extent, and ultimately audit fees due to concerns about fraud.

Auditors are also concerned about client integrity because it affects their ability to believe clients. This concern, known as "source credibility," affects combined risk (inherent and control risk) because low source credibility increases the likelihood that a company's financial statements might contain a material misstatement. Auditors may compensate by collecting additional, perhaps external, evidence. Thus, client integrity affects audit extent and fees through two risk judgments, business risk (because integrity is related to fraud) and combined risk (because integrity indicates the attitudes of clients towards disclosure of information).

Sixty-three Canadian audit partners were provided a case about a potential audit client for which information about the client's CFO indicated either high or low integrity. For example, the CFO was either respected or not respected in the local business community. After reading the case, participants were asked to judge business and combined risk, and to recommend audit extent and fees. They were later asked to judge the integrity of the CFO and, as expected, lower integrity judgments were associated with higher levels of both business and combined risk. Higher risk judgments were related to greater audit evidence extent and fees. The key finding is that there are situations when auditors are willing to compensate for questionable integrity by increasing audit extent. However, this study does not compare the effectiveness of such compensatory strategies to screening strategies, i.e., refusing to accept clients of questionable integrity.

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## SUMMARY

Client integrity concerns auditors when they plan new audit engagements because it is related to both fraud risk and the source credibility of clients. Auditors may increase audit work and fees when they judge integrity to be below normal. In an experiment, a sample of 63 Canadian audit partners read information about a prospective audit client, including information about the client's CFO. This information was manipulated to support a judgment of either high or low integrity. As hypothesized, judgments of client integrity were negatively related to risk judgments, audit evidence extent recommendations (indirectly through risk judgments), and fee recommendations (indirectly through risk judgments and extent recommendations).

**Keywords:** source credibility; business risk; combined risk; audit evidence; fraud.

Management integrity has always been a major concern to auditors, but well-publicized frauds, such as the Charles Keating/Lincoln Savings and Loan fiasco, have increased awareness of client integrity among auditors and the public. SAS No. 82 on misstatements arising from fraudulent financial reporting is one result of this awareness; concern applies to both current clients (post-engagement) and potential clients (pre-engagement). Prior research has shown that client integrity judgments are an important component of acceptance decisions (Ayers and Kaplan 1998; Asare et al. 1994). However, it is not known whether, after new clients have been accepted, auditors in the planning stage compensate for below normal integrity by adjusting evidence collection and/or audit fees. Three sets of linkages are posited in this paper: between judgments of client integrity and risk, risk judgments and audit evidence extent, and finally between extent and audit pricing.

Although integrity judgments in audit planning are motivated by the risk of fraud, integrity is also related to the willingness of clients to make the full and fair disclosures relied upon by their auditors. This issue is called source credibility, i.e., whether sources of information inspire belief in their representations (Beaulieu 1994). If auditors judge that new clients have acceptable integrity, and thus are credible, then they are more likely to believe what they are told and what they read. If they question clients' integrity, then they may carry out additional audit procedures. The theoretical argument in this paper is that auditors judge clients' integrity as a means of assessing both fraud risk, which affects primarily the auditor's business risk, and source credibility, which affects combined

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risk (inherent and control risk). Subsequent recommendations regarding collection of audit evidence and audit pricing indirectly depend upon the assessed level of integrity via two risk judgments (business risk and combined risk), each with its primary concern (fraud and source credibility, respectively). Source credibility has been studied in other accounting contexts, such as commercial lending (Beaulieu 1994) and earnings forecasts (Hirst et al. 1999), but has received less attention in the context of new audit clients.

The paper also makes a methodological contribution to the research examining client integrity. In experiments involving client integrity and the related topic of source credibility for client acceptance and other auditing tasks, manipulations tend to provide subjects with *conclusions* related to integrity or source credibility, rather than supplying *evidence* bearing upon it (e.g., Goodwin 1999; Peecher 1996; Hirst et al. 1999; Houston et al. 1999a; Maines 1990).

Offering categorical conclusions about integrity and related constructs such as source credibility has the advantage that the manipulation is strong, but carries the disadvantage that it may be too strong. The problem is that in practice, categorical classifications of integrity as high or low are seldom available, and this is especially true of new audit clients where information asymmetries are greater than for continuing clients. These manipulations avoid the comparatively challenging questions of how auditors arrive at these rankings of integrity, what information they use, and whether this information directly affects their judgments of risk.

In this study, audit partners were asked to rate information about client behavior, which can be commonly observed, for content relevant to integrity judgments. Information judged to be indicative of positive (high) or negative (low) integrity was included in the experimental instrument, in the form of a short paragraph describing the client firm's CFO. A different sample of 63 Canadian audit partners from three Big 6 accounting firms then made planning judgments. Results indicate that judgments of client integrity were negatively related to assessments of auditor's business risk and combined risk, that the risk judgments were positively related to recommended audit evidence collection, and that evidence was positively related to recommended audit fees.<sup>1</sup> Thus, there were significant linkages from integrity to risk judgments, from risk judgments to evidence collection, and from evidence collection to fees.

The key finding is that client integrity is negatively related to recommended evidence collection (indirectly through risk judgments), suggesting that auditors are willing to compensate for questionable integrity by increasing audit extent. According to the theory described in the following section, one implication of relatively low integrity is that clients are difficult to believe, i.e., they have low source credibility. Thus, the theory explains this result as a compensatory judgment policy in which evidence collection is adjusted in response to the perceived credibility of clients. Prior research examining client integrity does not establish this association (e.g., Ayers and Kaplan 1998; Goodwin 1999; Peecher 1996).

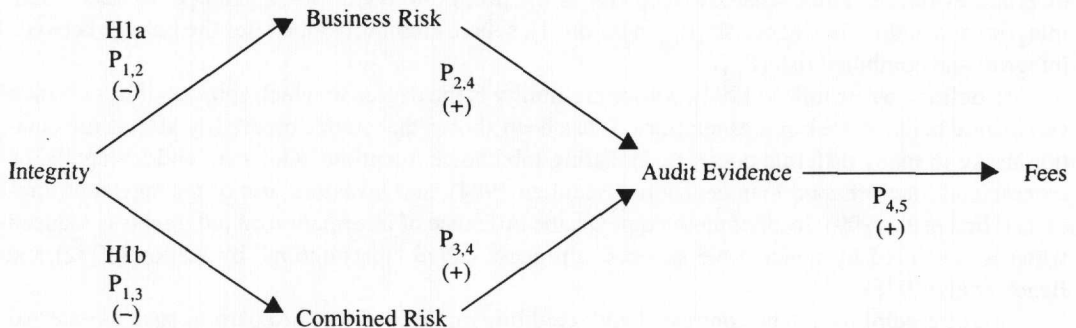
## HYPOTHESES

In this section, integrity is linked to business risk via the concept of fraud risk, and to combined risk through the concept of source credibility. Linkages are then extended from risk judgments to recommended audit evidence collection, and from the latter to audit fee recommendations. The hypotheses are summarized in the form of a path diagram (Figure 1).

Business risk is defined as "the probability that an auditor will suffer a loss or injury to his professional practice" (Brumfield et al. 1983, 60), including costs related to litigation, sanctions imposed by regulators, insurance, and impaired professional reputations. Auditors consider a number of factors when judging business risk, including relative auditor expertise and additional billing

<sup>1</sup> For convenience, the term "auditor's business risk" is shortened to "business risk" hereafter. The term does not refer to the client's business risk.

FIGURE 1  
Summary of Hypotheses in Path Diagram Form<sup>a</sup>



Indirect effect of integrity on audit evidence (H2):

$$P_{1,4} = (P_{1,2} * P_{2,4}) + (P_{1,3} * P_{3,4})$$

Indirect effect of integrity on fees (H3):

$$P_{1,5} = P_{1,4} * P_{4,5}$$

<sup>a</sup> Hypothesized signs appear in parentheses.

opportunities (Asare et al. 1994); litigation and profitability (Asare et al. 1994; Huss and Jacobs 1991); and the possibility of an initial public offering and competing auditors' pricing strategies (Johnstone 2000). Business risk is negatively related to the reputation of a firm's management and principal owners (Brumfield et al. 1983), and reputation is considered an indicator of integrity by auditors (see the "Method" section).

It is assumed that a lack of integrity increases the risk of fraud. Although this assumption may be considered tautological—only dishonest people commit frauds, and therefore they lack integrity—it can be supported by evidence. In a study of Accounting and Auditing Enforcement Releases (AAERs) issued during the period 1987–1997 by the U.S. Securities and Exchange Commission (SEC), Beasley et al. (1999) found that two of the most common motivations for fraudulent financial reporting alleged by the SEC were (1) to increase benefits from insider trading, or to obtain greater cash proceeds upon issuance of new securities, by increasing stock price; and (2) to conceal theft of assets. These motivations characterize management of low integrity.

Individuals of low integrity pose significant business risk to auditors, mainly due to increased litigation risk. The existence of management fraud is a significant factor in litigation against auditors (Carcello and Palmrose 1994; Palmrose 1987; St. Pierre and Anderson 1984). However, although motivations may be inferred after frauds have been detected, they are not observable *ex ante*. It is an empirical question whether auditors judge observable client behaviors in terms of integrity, and use them to infer the motivations of their clients. If they do so, high integrity assessments will be associated with lower judgments of business risk.



**H1a:** Auditor evaluations of client integrity relate negatively to judgments of business risk.

In terms of the audit risk model, client integrity has specific implications with respect to source credibility. This is because clients are the primary source of information for auditors, and detection risk can be reduced in cases where it is difficult to believe clients by gathering additional, perhaps external, evidence. Thus, whereas fraud risk is the prime motivator of the linkage between client integrity and auditor business risk ( $P_{1,2}$  in Figure 1), source credibility motivates the linkage between integrity and combined risk ( $P_{1,3}$ ).

As defined by Beaulieu (1994), source credibility is the degree to which sources of information can inspire belief in their representations. It has been shown that source credibility affects information usage in many different contexts, including job choice intentions (Coleman and Irving 1997), commercial loan officers' loan decisions (Beaulieu 1994), and investors' use of management forecasts (Hirst et al. 1999). In all of these contexts, the influence of information on judgments is reduced when it is offered by noncredible sources, a process called "discounting" by Kelley (1972) and Beach et al. (1978).<sup>2</sup>

Source credibility can be contrasted with credibility conveyed by third parties, such as external auditors, who are themselves the subject of this study. In the audit-planning context, source credibility refers to whether audit clients can inspire auditors' belief in their disclosures, particularly information impounded in financial statements. Since auditors both presume that auditees act in good faith to make engagements economically and operationally feasible (CICA 1995), they are concerned about their clients' attitudes regarding disclosure and presentation of information.

With respect to the audit risk model, low source credibility increases the likelihood that a company's financial statements might contain a material misstatement through two avenues. First, the risk may exist regardless of the existence of an internal control system; clients of poor integrity (and consequently low credibility) may be so determined to avoid proper disclosure of information that no form of control can deter them. This is inherent risk (CICA 1997, 5130.10). Second, low source credibility may directly subvert internal control systems, for example through a lack of commitment on the part of management to a high level of internal control (see Johnstone 2000). In this way, client integrity affects control risk (CICA 1997). Indeed, Canadian auditors are required by section 5200 of the CICA Handbook (1997) to assess client integrity during their evaluations of internal controls. "Control environment factors" (Appendix B to Section 5200, CICA 1997) are to be included in these judgments; the first factor listed is "Management philosophy and operating style," and the first example of philosophy is management's "integrity and ethical values."

Inherent and control risk are referred to jointly as "combined risk." The discussion above suggests the following hypothesis.

**H1b:** Auditor evaluations of client integrity relate negatively to judgments of combined risk.

The next linkage is between risk judgments and audit evidence. Johnstone (2000) modeled the client acceptance decision as a process of risk evaluation and risk adaptation that includes three strategies: screening clients based on their risk characteristics (e.g., financial viability), screening

<sup>2</sup> There is a related behavioral auditing literature about reliance on internal auditors. One factor considered by external auditors when deciding whether to rely upon the work of internal auditors is their objectivity, which is measured by factors such as reporting structure. For instance, internal auditors may report directly to the audit committee (high objectivity) or to the controller (low objectivity) (Margheim 1986). Objectivity probably affects source credibility of internal auditors, and reliance on them affects audit extent by external auditors. However, the findings regarding objectivity vary; it has been found to be unimportant in reliance decisions (Margheim 1986), a nontrivial consideration (Schneider 1984), and a significant factor (Messier and Schneider 1988). Given the variability of findings and the lack of an explicit link in the literature between objectivity and source credibility, the literature is noted here rather than in the body of the paper.



based on the audit firm's risk of loss, and proactively adapting to client acceptance risks by adjusting audit work and fees. She found that audit partners participating in an experiment used the two screening strategies but did not apply a proactive adaptation strategy.

These findings may apply to the role of client integrity in audit planning for new clients, but two aspects of Johnstone's (2000) method are relevant. First, although she manipulated information that might affect judgments of integrity, namely the attitude of top management toward internal control and management's relationship with the prior auditor, she did not manipulate client integrity directly. Second, she sampled partners from one Big 5 firm in which a checklist technology for linking risk judgments with possible adaptations was fairly new, and possibly not accepted by the partners. In this study integrity is explicitly manipulated and audit partners are sampled from three firms. It thus remains an empirical question whether linkages extending from judgments of integrity to risk judgments, and then to recommended evidence collection, will be found.

There is little research examining whether auditors use compensating mechanisms, for example, increasing audit procedures when they judge the credibility of sources to be relatively low. The effectiveness of such responses depends upon the type of evidence used; reliance on internal (as opposed to external) evidence may not be functional. The most relevant research is by Shaub (1996), an experiment about auditors' trust of clients in an audit-planning scenario. If trust is at least partially a reaction to source credibility, then auditors may compensate for low source credibility by changing their audit plans. Shaub (1996) presented auditors with eight scenarios containing information about previous experience with a client. Many of the variables manipulated appear to bear on the source credibility of the client, especially accuracy of the prior year's inventory count and the incentive for misstatement based on a previous business decision. When the prior year's inventory count was described as being less accurate, auditors were found to be more likely to require additional audit procedures. This paper extends Shaub (1996) by employing an experimental task involving a new client, and by directly manipulating client integrity.

Other research has found that auditors respond to greater client risks such as financial condition by adjusting audit work (Houston et al. 1999a; O'Keefe et al. 1994; Pratt and Stice 1994; Simon 1985; Simunic and Stein 1990, 1996; Walo 1995). The gap in the literature is that these adjustments have not been posited as mechanisms used to compensate for perceptions of low client integrity.

Houston et al. (1999a) suggests that there are two paths leading from judgments of client integrity to evidence collection, one passing through business risk and the other through combined risk. They found that when a material misstatement is intentional (suggesting fraud), business risk dominates the audit risk model in explaining evidence collection recommendations. This corresponds to the linkage consisting of paths  $P_{1,2}$  and  $P_{2,4}$  in Figure 1. However, Houston et al. (1999a) found that when a material misstatement is an error, the audit risk model explains planned evidence collection. Houston et al. (1999a) did not analyze this finding in terms of source credibility or client integrity, and their experiment was not designed to detect a relationship between integrity and evidence collection. Their result can nevertheless be positioned in Figure 1 as the linkage comprised of paths  $P_{1,3}$  and  $P_{3,4}$ , where the implications of client integrity regarding source credibility are of greater concern than fraud *per se*. The following hypothesis suggests that the effect of client integrity upon audit evidence recommendations is mediated by business risk (reflecting awareness of fraud risk) and combined risk (in which source credibility is an issue).

**H2:** Auditor evaluations of client integrity relate negatively to their recommendations for audit evidence, indirectly through their judgments of business risk and combined risk.

Hypothesis 3 addresses the final linkage between audit evidence and fees. Pratt and Stice (1994) and Houston et al. (1999a, 1999b) found in experiments that recommended audit evidence is positively associated with audit fee recommendations. Using archival data from one public accounting firm, Simunic and Stein (1996) found that fees responded to litigation risk increases in approximately the



same proportion as increases in effort (total hours).<sup>3</sup> Hypothesis 3 predicts that this effect is partially the result of integrity judgments and their influence on risk judgments and evidence collection (H1a, H1b, H2).

**H3:** Auditors’ judgments of client integrity relate negatively to audit fee recommendations, indirectly through their judgments of business risk and combined risk, and recommended audit evidence collection.

Figure 1, a path diagram, shows all predicted relationships in all four hypotheses. As noted previously, H1a and H1b imply that path coefficients  $P_{1,2}$  and  $P_{1,3}$  will be negative. Hypothesis 2 posits that  $P_{2,4}$  and  $P_{3,4}$  will be positive; the indirect effect of integrity on audit evidence ( $P_{1,4}$ ) is calculated by summing the products  $P_{1,2} * P_{2,4}$  (the indirect effect through business risk) and  $P_{1,3} * P_{3,4}$  (through combined risk). Finally, according to H3 the total indirect path  $P_{1,5}$  extending from integrity to fees will be significant, and if  $P_{1,5}$  is negative, path  $P_{4,5}$  from audit evidence to fees must be positive.

**METHOD**

**Materials**

An instrument used by Pratt and Stice (1994) was adapted for use in this experiment. Called a “Prospective Audit Client Evaluation Form,” it contained four sections describing a manufacturing firm’s operations and management, predecessor auditor, industry and economic information, and financial statements including industry comparisons. Participants were asked to evaluate litigation risk associated with this potential client, its financial condition, and to make recommendations regarding an audit plan and client fees. The only information in the Pratt and Stice (1994) version that might have related to management integrity stated that turnover had been low, none of the managers had criminal convictions, and that background checks were conducted when managers were hired. A short paragraph describing behaviors of the CFO (discussed further below) relevant to integrity judgments was added to the management description.

The integrity of individual executives is important to the performance of any firm, but especially in smaller firms (Beaulieu 1994). To increase the relevance of the CFO’s integrity, the firm was described as being smaller than the industry median (about one-half the size). This relatively small firm trading on the Toronto Stock Exchange had been audited by a regional firm, but was expecting to grow through expansion into the United States, and wished to hire a Big 6 auditor. There were other minor changes in the wording of the instrument to conform with customary usage in Canada.

A question in the Pratt and Stice (1994) version asking for a judgment of litigation risk was changed to request a judgment of business risk. The revised business risk question lists loss of reputation, adverse publicity, and litigation as risks associated with audit engagements.

**Integrity Information**

One goal of this research was to compile a list of client behaviors that auditors encounter in practice and use to form integrity judgments, and test whether these judgments affect risk judgments, recommended audit evidence collection, and audit fee recommendations. The behavior of a key executive was selected for study, based upon the assumption that it is likely to affect behavior throughout an organization. Executives of large and small firms (Haas 1990; Vitell and Festervand 1987; Weiss 1986) believe that this assumption is valid and it has been supported by research in

<sup>3</sup> The papers cited in this paragraph all address the issue of risk premium—an increase in audit fees charged by auditors when they perceive risks that cannot be controlled by increasing audit costs. In the presence of a risk premium, the auditor’s business risk explains some variation in fees incremental to that explained by audit effort. Risk premia are not the focus of this paper, but are addressed in footnote 8.





ethical behavior (e.g., Carroll 1978; Stead et al. 1990). Falkenburg and Herremans (1995) interviewed employees of firms that varied in size and found that although the behavior of CEOs influences ethical behavior generally, the effect is greater in small organizations than in large ones. In a study of fraudulent financial reporting, Beasley et al. (1999) found that companies committing financial statement fraud were relatively small and that top senior executives were frequently involved.

One difficulty is that while most auditors likely attend to a large set of client behaviors when they judge risk, only a portion of these relate to integrity. Other behaviors may simply be correlated with risk, or may be personality traits with which individual auditors feel more or less comfortable. Agreement among auditors regarding integrity information was sought. Seven audit partners working for seven different firms were interviewed to obtain a preliminary list of behaviors by prospective client principals, or policies and conditions in client firms, that they considered signals of integrity. Other behaviors used in the instruments of Anderson and Marchant (1989), Pincus (1989), and Beaulieu (1994) were added to the list. The behaviors taken from Beaulieu (1994) were used by commercial loan officers to judge the character of borrowers, which is strongly related to integrity. A list of 22 integrity facts, describing either a key executive of a prospective audit client or conditions in the executive's firm, was distributed as a questionnaire to 33 Canadian audit partners. Twenty-five questionnaires were returned, a response rate of 76 percent.

Respondents rated the facts on a seven-point scale, where 1 indicated poorest integrity and 7 indicated strongest integrity. A rating of 4 meant that a fact provided no information about integrity. All 22 facts, their average ratings, and standard deviations, are shown in Table 1. Ratings of positive facts (above 4.0) tended to be stronger than ratings of negative facts; a lack of negative information constrained the total amount of integrity information that could be included in the instrument, if equal numbers of positive and negative facts were to be used in each condition of the experiment.

There were two criteria for inclusion of facts in the case (Beaulieu 1994, 1996). First, the standard deviation of a fact's ratings must be less than or equal to 1.0, indicating general agreement. Second, the mean rating of a fact must be greater than or equal to 5.0, or less than or equal to 3.0. This indicates that on average, audit partners view the fact as a positive or negative signal of client integrity. The standard deviations of all ratings were below 1.0, satisfying the first criterion. The ratings of eight positive facts were greater than or equal to 5.0 but only two negative facts were rated less than or equal to 3.0. It was desired to have an equal number of positive and negative facts in both conditions of the experiment, as in Beaulieu (1994, 1996). Therefore, the negative fact with the next-strongest rating was added (fact 22), resulting in three facts in each version of the case. Positive facts that specifically mentioned the executive, as opposed to conditions in his/her firm (e.g., fact 1), were selected in order to maximize consistency with the negative condition, in which the executive was always mentioned. All respondents except one stated that they had considered at least one of the integrity facts selected for the instrument in their client acceptance decisions, and all selected facts were mentioned by respondents.

The negative facts (14, 19, and 22) provide information indicating that a contact in the client firm may have lied about the existence of a law suit, was not respected in the local business community, and did not provide all the documentation as had been promised. The positive facts (5, 11, and 15) indicate that the contact person volunteered information, was respected in the business community, and provided documentation as had been promised. No direct conclusion about the client's integrity, or his motives, is provided in these facts.

Four of the six facts selected had been used as signals of borrowers' character by commercial loan officers in Beaulieu (1994): 5, 14, 15, and 22. The main difference between this experiment and Beaulieu, apart from the audit setting and participation of auditors rather than loan officers, is that the audit client case instrument is much longer and more detailed than Beaulieu's (1994) instrument. The latter consisted of a numbered list of 26 items, eight of which concerned the borrower's character.

Another neutral fact (17, the CFO's marital status, mean rating = 4.08) was added to contribute realism while being uninformative about integrity. Thus, in the positive and negative integrity



**TABLE 1**  
**Integrity Facts and Their Ratings<sup>a</sup>**

Facts	Average Rating	Standard Dev.
1. The client firm has stated rules about personal conduct or ethics.	5.73	0.83
2. There are good interpersonal relationships among this executive and other key executives of the client firm.	5.00	0.75
3. The executive appears to spend more money on clothes, his/her car, and office furnishings than most executives.	3.77	0.51
4. When you toured the firm's business premises, employees gave brief answers to your questions about their jobs and the firm's operations. None offered to discuss these topics more fully.	3.50	0.58
<b>5. At your first meeting the executive answered your questions patiently, and volunteered additional information.</b>	<b>5.38</b>	<b>0.80</b>
6. The executive was referred to your firm by a major legal firm in your area.	5.38	0.75
7. The executive appears to be looking for lower audit fees.	3.88	0.43
8. The executive prefers to follow an "aggressive" policy with respect to taxes.	3.69	0.55
9. The executive is an active member of several local community organizations.	4.92	0.63
10. The executive returns your phone calls promptly.	4.62	0.57
<b>11. The executive is respected in the local business community.</b>	<b>5.65</b>	<b>0.63</b>
12. Apart from giving you a list of shareholders of record, the executive did not describe the minority shareholders of his/her firm with you or discuss them.	3.69	0.55
13. The executive frequently mentioned the names of leading figures in your community, whom he/she knows personally.	3.81	0.49
<b>14. The executive stated that the client firm had not been named as a defendant in any legal actions over the last three years. A background check showed that a former senior officer of the firm had filed a wrongful dismissal suit against the firm. The suit was recently settled out of court.</b>	<b>2.81</b>	<b>0.85</b>
<b>15. When you visited the executive's business, he/she had available all the documentation regarding his/her firm that he/she had promised to provide.</b>	<b>5.12</b>	<b>0.77</b>
16. At your first meeting the executive answered your questions quickly, making it difficult to ask follow-up questions.	3.62	0.50
<b>17. The executive has never been divorced. He/she has been married for twelve years.</b>	<b>4.08</b>	<b>0.27</b>
18. New employees of the client firm are screened carefully.	5.15	0.67
<b>19. The executive is not respected in the local business community.</b>	<b>2.23</b>	<b>0.76</b>
20. The executive offered to meet you at a local restaurant. He/she drank wine throughout that meeting.	3.81	0.49
21. When you toured the firm's business premises, employees answered your questions about their jobs fully, and many of them offered to discuss these topics in detail.	5.23	0.82
<b>22. When you visited the executive's business, he/she did not provide all of the documentation regarding his/her firm that he/she had promised to provide earlier.</b>	<b>3.23</b>	<b>0.51</b>

<sup>a</sup> A 1 indicates lack of integrity and a 7 indicates strong integrity. A rating of 4, the midpoint, is no indication of integrity. Numbers in bold indicate facts included in the instrument.

conditions there were four facts included in a paragraph describing the client firm's CFO, three of which were intended to affect judgments of integrity. The integrity manipulation was between subjects.

### Other Information

In order for integrity to be a salient factor in client acceptance risk judgments, some conditions conducive to unethical behavior should be present. As in Pratt and Stice (1994), the case describes a management incentive plan that provides a bonus pool of 4 percent of net income. Loebbecke et al. (1989) classify performance-based compensation plans as indicators of motivation to commit fraud.

Financial statements of firms in financial distress are more likely to contain material misstatements than is true of other firms (Kreutzfeldt and Wallace 1986), and firms in distress are more likely to engage in accounting manipulations (Kinney and McDaniel 1989; Starbuck et al. 1978; Sutton and Callahan 1987; Whetten 1980). Consequently, concern about financial condition is likely to heighten auditors' sensitivity to issues of integrity. However, obvious financial distress may cause auditors to reject clients before they consider integrity. The relatively moderate approach of inducing some variance in participants' judgments of financial condition was chosen for this instrument. Asset structure was manipulated, as in Pratt and Stice (1994), by varying an industry median comparison so that the percentage of the client's inventory and receivables to total assets was either 50 percent above the median or equal to it. Variation in participants' judgments of the client's financial condition did result.<sup>4</sup>

### Measurement of Variables

Client integrity, business risk, combined risk, recommended audit evidence, and audit fees are measured in the form of questions posed at the conclusion of the client acceptance case. Each question asked participants to rate the client compared to a normal manufacturing client on an 11-point scale where 0 (10) indicated much lower (higher) than normal. Regarding integrity, even though it was manipulated (positive/negative), participants' judgments of client integrity are used to test whether judgments affect assessments of business and combined risk (H1a and H1b).

### Participants

Contacts at three (then) Big 6 firms provided lists of partners who would likely have experience auditing the type of client described in the instrument: a relatively small, public manufacturing firm.<sup>5</sup> The instrument was mailed to the resulting list of 211 auditors. A cover letter identified the author, identified the topic of interest as client acceptance judgments, and indicated that the case would probably require less than 45 minutes to complete. As an incentive, respondents were told that they would receive summaries of the results. Responses were received from 67 auditors, a response rate of 32 percent.<sup>6</sup> Four respondents reported virtually no experience with this type of client and were thus deleted from the sample, resulting in a final sample of 63 partners.

<sup>4</sup> One of the questions following the case asked for a judgment of the client's overall financial condition on an 11-point scale, 0 indicating much worse than a normal client and 10 indicating much better than normal. The mean judgment was 5.78, with a standard deviation of 1.46 and range of 3 to 9. The asset structure manipulation contributed modestly to this variance; the mean judgment was 5.51 when the ratio of inventory and receivables to total assets was above the industry median and 6.07 when it was at the median ( $t$ -statistic = 1.51,  $p$  = .137).

<sup>5</sup> Participants in this sample lived in a different geographic region of Canada than those who responded to the pretest of integrity facts.

<sup>6</sup> This response rate is in the middle of what Kerlinger (1986) considered the expected response rate for mail surveys, 20–40 percent. Ayers and Kaplan (1998) also had a response rate of 32 percent. Pratt and Stice (1994) could not report a response rate because their sampling procedure did not allow a calculation. Houston et al. (1999a) could not calculate a response rate, but 60 percent of their distributed cases were completed.



A reminder to participate in the experiment was also mailed. Responses of auditors who replied before and after the follow-up were compared in order to test for a nonresponse bias. Fifty percent (53 percent) of those who responded early (late) received the positive version of integrity, so there was no correlation between response and experimental condition. Also, mean integrity ratings in each condition (positive and negative) did not differ significantly between early and late responders. The three accounting firms were represented by 13, 16, and 34 audit partners; there were no significant differences in integrity ratings between any firms. Therefore, there was no evidence of a nonresponse bias.

## RESULTS

### Manipulation Check

Participants rated the CFO's integrity on an 11-point scale, 0 indicating much worse than a normal client and 10 indicating much better than normal. The average rating in the negative character condition was 3.39 and in the positive condition, 5.65. These ratings are below and above the midpoint (5.0), and the difference in ratings is significant ( $t = 8.86$ ,  $p < .001$ ). Therefore, the manipulation was successful, but whether it motivated a response in risk judgments remains to be tested in the path analysis. As stated earlier, the following analysis uses the integrity ratings themselves, not the categories (negative and positive integrity).

### Descriptive Statistics

Table 2 presents descriptive statistics for the five variables included in the path diagram. Mean scores lie between 4.5 and 6.3 on an 11-point scale, where 0 indicates much lower than a normal client and 10 indicates much higher than normal. Therefore, on average the client was rated near a normal client (5.0). Participants did not use the extreme points of the scale, with responses ranging from 2 to 9.

A correlation matrix appears in Table 3. Integrity is negatively related to the remaining four variables, although its correlation with fees is not statistically significant. The correlation between the two mediating variables, business risk and combined risk, is 0.11 and not significant. All other correlations are positive and significant.

### Path Analysis

Participants were asked whether a proposal should be submitted to the client. All of them recommended proposing, as was expected given the moderate level of risk judgments in Pratt and

TABLE 2  
Descriptive Statistics

Variable	Mean	Standard Dev.	Minimum	Maximum
Integrity <sup>a</sup>	4.52	1.51	2	8
Business risk	5.92	1.32	2	9
Combined risk	5.37	1.34	2	8
Audit evidence	6.32	1.15	3	8
Fees	5.84	1.14	3	9

<sup>a</sup> All variables are measured on an 11-point scale where 0 = much lower than normal client, 10 = much higher than normal.

TABLE 3  
Correlation Matrix

	Integrity	Business Risk	Combined Risk	Audit Evidence	Fees
Integrity	1.00	-.37 (.003) <sup>a</sup>	-.42 (.001)	-.24 (.066)	-.15 (.235)
Business risk		1.00	.11 (.400)	.36 (.004)	.25 (.050)
Combined risk			1.00	.48 (.000)	.28 (.025)
Audit evidence				1.00	.47 (.000)
Fees					1.00

<sup>a</sup> p-levels in parentheses are for two-tailed tests.

Stice (1994). Thus, it is assumed in the following analysis that the client is acceptable, and that judgments represent audit planning for a new client.

The path analysis is presented in Figure 2. Integrity is negatively related to both business risk ( $P_{1,2} = -.37$ ) and combined risk ( $P_{1,3} = -.42$ ), as predicted by H1a and H1b, respectively. Hypothesis 2 requires that business risk and combined risk be positively related to audit evidence; they are ( $P_{2,4} = .31$  and  $P_{3,4} = .45$ ). The indirect effect of client integrity on evidence ( $P_{1,4}$ ) predicted in these hypotheses follows two routes, through business risk and combined risk, and is calculated in equation (2).

$$\begin{aligned}
 P_{1,4} &= (P_{1,2} * P_{2,4}) + (P_{1,3} * P_{3,4}) \\
 &= (-.37 * .31) + (-.42 * .45) \\
 &= -.30.
 \end{aligned}
 \tag{2}$$

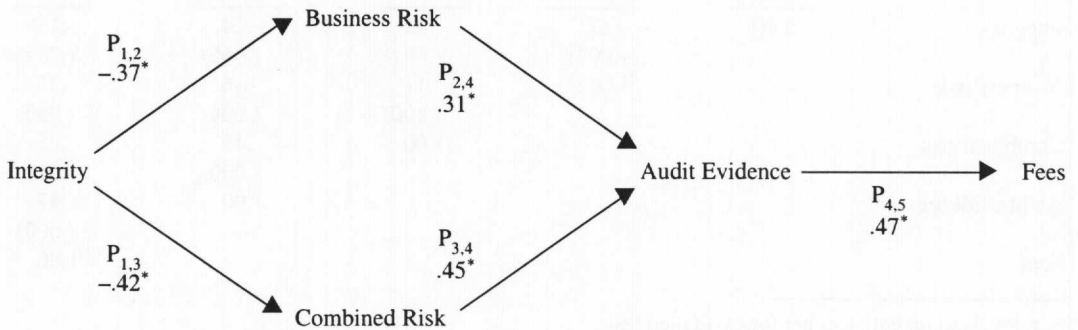
The associated t-statistic is  $-3.6$  ( $p < .01$ ), supporting H2. According to H2, both business risk and combined risk are mediating variables that alter the relationship between an independent variable (client integrity) and a dependent variable (audit evidence). Additional regression analysis indicated that the two risk variables are true mediators of the relationship between integrity and audit evidence.<sup>7</sup>

The final linkage  $P_{4,5}$  between audit evidence and fees is .47 and significant also. The total indirect effect of client integrity on fee recommendations (H3) is calculated as ( $P_{1,4} * P_{4,5}$ ) =  $-.14$  and has a t-statistic of 2.73 ( $p < .01$ ). Although this coefficient is statistically significant, only 2 percent of the variance in fees ( $-.14^2$ ) is explained by integrity judgments. Recall also that the pairwise correlation of integrity and fees (Table 2) was not significant. However, overall the goodness of fit of the model is acceptable. The root mean square residual (RMR) is .032 and adjusted goodness-of-fit index (AGFI) is .966.

<sup>7</sup> As recommended by Baron and Kenny (1986) the mediating roles of business risk and combined risk were tested by estimating three regressions. In the case of business risk, integrity was first regressed on business risk. The effect of integrity was negative and significant, as required by Baron and Kenny (1986). Second, integrity was regressed on audit evidence, and again the effect was negative and significant, as required. Third, both integrity and business risk (the mediator) were regressed on audit evidence. The effect of business risk was positive and significant, and the effect of integrity was still negative but not statistically significant. Thus, the mediator business risk changed the relationship between integrity and audit evidence; as required by Baron and Kenny (1986), the direct effect of integrity upon audit evidence was not as strong when business risk was entered into the regression (step three). The regression results were the same for combined risk, the other mediating variable.



**FIGURE 2**  
**LISREL Estimates of Path Coefficients**



Goodness of fit

Root mean square residual (RMR) = .032  
 Adjusted goodness-of-fit index (AGFI) = .966

\*  $p < .01$ .

In order to supply further evidence in support of the proposed model, an alternative model was estimated with direct linkages between integrity and audit evidence, integrity and fees, business risk and fees, and combined risk and fees. Although the goodness of fit is similar to that of the original model (RMR = .015, AGFI = .983), none of the added coefficients is significant. This result increases confidence in the paths proposed in Figure 1. Therefore, it is likely that integrity judgments affect recommended evidence collection indirectly through judgments of business and combined risk, and there is support for the theory that auditors' concerns about fraud risk and source credibility motivate these indirect linkages.<sup>8</sup>

**DISCUSSION**

The integrity of new audit clients was assumed to be related to source credibility (i.e., belief in client representations) in addition to the risk of management fraud. Three linkages involving new client integrity were studied: between auditors' judgments of client integrity and their risk judgments, risk judgments and audit evidence collection, and between evidence collection and audit pricing. In an experimental client acceptance task, Canadian audit partners' judgments of client integrity were negatively related to judgments of business risk and combined risk, and there was also a positive relationship extending from the risk judgments, through recommended audit evidence collection, to fee recommendations. Thus, there was support for all three linkages, and a combined indirect effect of judgments of client integrity on audit pricing was supported (although integrity accounted for little of the variance in fee recommendations).

<sup>8</sup> In the alternative model, the coefficient for the direct path from business risk to fees is positive but not significant. This indicates that there is no risk premium; the auditor's business risk does not explain variation in fees incremental to the variation explained by evidence collection.

The strong linkage between integrity and evidence collection is especially interesting, suggesting that once auditors have accepted new clients, in planning their audits they may still adjust evidence collection in response to client integrity. In other words, at times it is possible that auditors use compensatory judgment policies with respect to client integrity and audit evidence. This is a new finding in the behavioral auditing literature and could be incorporated in other streams of research. For example, Peecher (1996) examined auditors' justification processes in the context of planning-stage analytical procedures. He manipulated client integrity and auditors' preferences for justifying investigation of client-provided explanations of account balances. In the latter manipulation, auditors were (1) discouraged by their firm from undertaking costly investigations; (2) encouraged to be objective; or (3) encouraged to be skeptical of client explanations. Peecher (1996) found that client integrity and auditors' preferences regarding justification interactively affected their judgments of client explanations. However, he did not include recommended evidence collection as a dependent variable; additional insights might be obtained by combining the effects of a firm's general policy regarding skepticism of clients (referred to as justification preferences by Peecher [1996]) with individual auditors' ability to make trade-offs between perceived client integrity and evidence collection. If integrity were manipulated as in this paper (i.e., through observable facts rather than conclusions), tension could be created between the demands of firm policy and individual trade-off judgments.

A methodological contribution concerns elicitation of integrity judgments through manipulation of client behaviors, rather than providing conclusions about a client's integrity or source credibility in an instrument. Integrity judgments were affected by information supplied as expected in this experiment and these judgments were strong enough to produce the hypothesized effects on risk judgments, recommended audit evidence collection, and fee recommendations.

A related limitation is that client integrity was described in written materials, not witnessed directly by the participants. Although written descriptions of integrity are an accepted method in related research (Beaulieu 1994, 1996), there is still concern that auditors may respond differently to live clients. Also, no theory of client integrity or source credibility was used to guide selection of behaviors used to indicate integrity, resulting in unclear construct validity. Integrity information rated in the pretest as indicative of high or low integrity was assumed to bear upon the issue of source credibility, but the latter construct was not tested directly. Nevertheless, this experiment addressed the task of judging observable client behaviors, a task that has been neglected in prior research.

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