Industry Norms, Regulator Concerns and Audit Judgment

Abstract

This paper investigates the effect of industry norms on auditor's support for the client-preferred accounting. We conducted a 2*2 between-subjects experiment based on the inconsistent revenue recognition practices in Chinese real estate industry. We manipulated the two independent variables industry norms (present vs. absent) and regulator concerns (present vs. absent). Our results suggest that auditors are more likely to support client's choices if client-preferred accounting is aligned with one of the industry norms. Further analysis found that the impact of industry norms was only pronounced when the matter was of concern to regulators. Meanwhile, we find that legal risk does play a mediation role in the effect of industry norms on audit judgment. These results remind regulators that the different industry norms may allow for opportunistic behaviors in the principle-oriented environment.

Keywords: audit judgment; industry norms; regulator comment letters; motivated reasoning

Industry Norms, Regulator Concerns and Audit Judgment

Introduction

The principle-oriented International Financial Reporting Standards (IFRS) have been widely accepted all over the world. These standards are considered as imprecise and require practitioners to use more professional judgments. It increases the second-guess of regulators (Agoglia, et al, 2011), and lead to higher legal risk for auditors (Hail, 2010). Kadous and Mercer (2012) find that compliance with industry reporting norms provide auditors with safe harbor protection from negligence verdicts when accounting standards are imprecise. But would the auditor exploit the safe harbor effect of industry norms to make choices that are more inclined to clients' wishes?

The purpose of this study is to examine whether the industry norms would reduce the auditors' legal risk perception and thus more likely to encourage the auditors to support the clients' accounting methods. In this study, industry norms refer to the prevailing accounting practices in an industry. Further understanding the impact of industry norms on auditors' decisions is crucial because it could provide insight about the additional benchmarks used by auditors under imprecise accounting standards.

Chinese Accounting Standards (CAS) have substantially converged with IFRS. In China, the real estate companies recognize revenue either at the completion of handover procedure or at the completion and official inspection of the project. Both practices are considered as industry norms though the latter may be several months earlier than the former. Furthermore, the most litigation risk faced by the auditors in China are from the sanctions imposed by regulators (Chan and Wu, 2010). If the regulator express concerns on a specific issue, the legal risk on the issue will increase. Therefore this paper will further examine how regulator concerns affect auditors' consideration of industry norms.

We use motivated reasoning theory and current research on negligence verdict to make predictions about the influence of industry norms. On one hand, individuals’ decision processes are influenced by their goals and that “individuals committed to directional goals, or goals to reach a preferred conclusion, are more likely to reach their desired conclusion” (Kadous, Kennedy and Peecher, 2003). And in the field of auditing, prior study find that auditors have directional goals of supporting client preferred methods and tend to exploit ambiguity inherent in accounting standards to justify those methods (Hatfield et al., 2011; Ng and Tan, 2003; Lord and DeZoort, 2001; Salterio and Koonce, 1997). On the other hand, in most cases, whether the auditor exercised reasonable care and competence is assessed relative to the levels that other professionals in the field would apply in the same situation (Causey and Causey 1991). That is, an auditor should be judged negligent if she/he fail to choose the accounting policy that other reasonably careful auditors would. In other words, the auditor can be defended if the accounting treatment preferred by the client conforms to an industry norm. Thus, when client-preferred accounting is aligned with one of the industry norms, auditors will perceive less risk and are more inclined to support client’s choices. As this effect is based on the risk perception, it may change depending on whether the auditors perceive their legal risk increased, say, when the regulator express concerns on the specific issue.

We test our hypotheses with an experiment. We invited 76 auditors to participate in the experiment and asked them to assume to be the audit manager who was in charge of auditing a real estate enterprise. One pre-sale of commercial residential apartment’s project of a public company has been completed construction and inspection but has not been delivered to the customer yet. The client believes that revenue can be recognized in the current year. And the participants are required to make their decision of supporting the client or not. We carry out our study using a 2×2 between-subjects experiment and manipulate the two independent variables industry norms (present vs. absent) and regulator concerns (present vs. absent). The participants are randomly divided into four groups to evaluate their propensity to agree to recognize revenue in the current year and their perception of litigation risk.

We find that auditors are more likely to support client's choices if client-preferred accounting is aligned with one of the industry norms. Further analysis suggest that the impact of industry norms is only pronounced when the matter is of concern to regulators. We assume that auditors base their decisions on their perception of legal risk. This paper finds that legal risk perception does play a mediation role in the effect of industry norms on audit judgment. The main experiment is based on the background of CAS No.14 issued by the Ministry of Finance of China in 2006. Since the new revenue standard has been in effect, it is not known whether the above result still exist under the new standard. Through supplementary analysis, we find that the precision of new income standards (CAS No.14, 2017) has been considered as improved and the effect of industry norms on audit judgment has been weakened.

The main contributions of our study are as follows. Firstly, Kadous and Mercer (2012) provides evidence that jurors will take into account of the industry norms in judging auditors' negligence liability. Following their research, Grenier et al (2015) argues that auditors would herd to industry norms to mitigate the elevated litigation exposure associated with imprecise standards. However they assumed rather than empirically investigated how auditors use the industry norms. This paper extends this line of research by investigating whether auditors would herd to the industry norm that benefits them most. Secondly, this paper provides more evidence of the motivated reasoning in audit judgment under imprecise standards. Previous studies find that auditors will take advantage of the ambiguity of accounting standards (Hackenbrack and Nelson 1996; Salterio and Koonce, 1997; Ng and Tan 2003) and the inherent complexity of auditing standards (Hatfield et al., 2011) to prove the rationality of client-preferred accounting. The result of this research suggest that auditors will also take advantage of the industry norms and use it to justify the client-preferred accounting. Thirdly, this research also contributes to the literature on regulator comment letter, key audit matter and new revenue accounting standards. Our results show that auditors' decision will be impacted if the regulator express concern on the issues addressed as a key audit matter. This result supplement our understanding of how the key audit matters impact the auditor's legal risk (Gimbar Hansen & Ozlanski, 2016;Brasel, Doxey, Grenier, & Reffett, 2016). Though the new revenue standard is still principle-based, our study shows that the new principles seem to be clearer. Finally, these results remind the regulators that different industry norms not only jeopardize the comparability, but also allow for opportunistic behaviors in the principle-oriented environment.

The remainder of this study is structured as follows. In section 2, we develop the hypotheses. Section 3 describes the experimental design as well as the participants. Section 4 reports the results as well as tests of mechanisms and additional analyses, and section 5 concludes.

BACKGROUND AND THEORETICAL DEVELOPMENT

Background

The principle oriented IFRS has been widely used in the world. China signed a joint statement with the International Accounting Standards Board (IASB) on November 8, 2005, formally confirming that China's accounting standards system has substantially converged with IFRS. In April

2010, the Ministry of Finance of China released the Roadmap for the Continuous Convergence of CAS and IFRS which clarified the goal of the convergence (MOF, 2010). In academic research, principle-oriented standards are as also considered as imprecise standards as there are less guidance (for example, Agoglia et al, 2011). Thus China also adopts an imprecise standard system. One of the examples is the revenue recognition. Since 2006, the revenue standard was based on the “risk and reward transferring model”. In 2018, a new revenue standard was published which was based on the “control model”, converging with IFRS 16.

For many years, most Chinese enterprises in the real estate industry take the completion of the handover procedure as the transfer point of risk and reward. But some large public real estate companies recognize revenue immediately after the completion and official inspection of the project, if they have already received payment or had collection rights, such as Vanke. In most cases, the construction completion could be several months earlier than the handover procedure completion. Although Chinese Security Regulatory Committee has expressed concerns about the incomparability of the two different accounting practices (CSRC, 2013, 2014), nothing has changed so far. And it is not clear whether the two different industry norms would cause other problems rather than incomparability. We searched for the annual report of 2018 and find that the two different practices continue to exist even when the new revenue standard is already in effect.

Industry Norms and Audit Judgement

Prior studies have examined the effects of accounting standard precision on preparer (Psaros and Trotman 2004; Agoglia et al. 2011) and auditor behavior (Trompeter 1994; Hackenbrack and Nelson 1996; Gibbins et al. 2001; Nelson et al. 2002; Kadous et al. 2003; Ng and Tan 2003; Segovia et al. 2009) as well as legal risks (Hail et al. 2010; Kadous and Mercer, 2012).In particular, Kadous and Mercer (2012) use an experiment to find that compliance with industry reporting norms appears to provide auditors with safe harbor protection from negligence verdicts when accounting standards are imprecise. In their setting, the participants are mock jurors. However, whether the auditors will take advantage of the safe harbor of industry norms still need further test.

There is agency problem between auditors and clients. The company's stakeholders entrust the auditor to audit the company's financial position, the results of its operations and cash flows during a given period so as to guard against the opportunism behavior of the management. Meanwhile, the auditors are directly paid by the company. Therefore, they face the conflict of public interest and personal interest. Especially when client management exerts pressure, audit partners may be inclined to accept management's decision (PCAOB, 2011). In our opinion, auditors are more likely to support client-preferred accounting when there are different norms in the industry and one of them is in line with the client's preferences.

Firstly, motivated reasoning theory holds that individuals who are committed to directional goals engage in biased reasoning to reach those goals (Kunda1990, 1999). Directional goals refer to conclusions superior to others. Individuals with directional goals search for, interpret and process information in a biased way in order to reach their desired conclusions. Prior study find that auditors have directional goals of supporting client method choices, and they may take advantage of the ambiguity of accounting standards (Hackenbrack and Nelson 1996; Salterio and Koonce, 1997; Ng and Tan 2003) and the inherent complexity of audit standards (Hatfield et al., 2011) to deduce the rationality of clients' decisions. As long as the decision is justified, auditors are likely to accept the method preferred by the client (kadous, 2003). For example, auditors support client preferred methods when in-house precedents are ambiguous (Salterio and Koonce, 1997). However, Kadous

(2003) find auditors will increase the intensity of effort devoted to justifying the client-preferred method. This additional justification effort will increase acceptability of that method. Thus, even quality assessments cannot increase auditors' objectivity.

In the setting of this paper, according to the motivated reasoning theory, the ambiguity of imprecise standards provides discretion for auditors to support client method choices. In this premise, industry norms improve acceptance of client's preferences and auditors will take advantage of industry norms to justify client’s choice.

Secondly, even in the US, it is generally difficult to prove fraud against auditors because proof of intent to deceive or reckless behavior is required. Consequently, most litigation against auditors alleges negligence rather than fraud (Causey and Causey,1991; Grubbs and Ethridge, 2007). It is similar in China. In defining negligence, the practice of other professionals in the same situation are often taken into account (Causey and Causey, 1991). That is, an auditor should be judged negligent if she/he fail to make the correct accounting treatment that other reasonably careful auditors would. In other words, the auditor can be defended if the accounting treatment preferred by the client conforms to an industry norm. Thus, when client-preferred accounting is aligned with one of industry norms, the auditor will perceive less risk and are more inclined to support client’s choices, even though it might be more aggressive.

Thus, we formally state the following hypothesis:

H1: when client-preferred accounting is aligned with one of the industry norms, the auditors are more inclined to support client’s aggressive choice.

Regulator Concerns

In China, auditors are facing less litigation risk than the U.S., but the risk of regulatory sanction is not negligible (Firth et al, 2012). As indicated by Chan and Wu (2010):” Although Chinese auditors’ level of exposure to litigation risk is less than that of their US counterparts, there are regulatory bodies in place to oversee audit firms”. Besides sanctions of Chinese Securities Regulatory Commission (CSRC), the inquiry letter issued by the stock exchanges is also a powerful regulatory tool. Since 2013, the regulators of Chinese stock market reformed the information disclosure regulation. The pre-disclosure approval has been changed to post disclosure review. Specifically, after the public companies disclose their financial reports, the stock exchanges may issue inquiry letters on important matters in the financial reports (Chen Yunsen, 2018). According to WIND database, Shanghai and Shenzhen stock exchanges have issued an increasing number of inquiry letters about financial reports year by year, with a total of 970 inquiry letters in 2018. Among which, the accounting issues account for 43%.

Generally speaking, the focus of the inquiry letter about financial reports is closely related to the key matters of the audit work, such as weak internal control, risk of going concern, litigation issues, etc. If the financial report audited by the auditor is inquired by exchanges, the audit risk will increase significantly (Chen et al., 2018). In particular, according to the requirements of Auditing Standards of Chinese Certified Public Accountants No. 1504 -- Communication of Key Audit Matters in Audit Reports, auditors need to disclose the audit procedures of the key audit matters in detail in the audit reports from January 1, 2018. We checked inquiry letters about the financial report in 2018 and find that the exchange would also directly inquire the listed companies and their auditors about the key audit matters (such as CSG, 000012). The exchange's concerns to this issue superimpose the high risk of key audit matters, which reduces the risk tolerance of auditors. Auditors will invest more time and energy in the audit work. And they will become more conservative, especially on the key audit matters. Therefore, we expect that the exchange concerns may moderate the main effect of industry norms on auditors' decision. Specifically, when regulators are particularly focused on a key audit matter, auditors may be more conservative and thus the industry norms will have less impact on auditor's support for client's aggressive decisions.

Conversely, there is another explanation. Many research suggests a weak regulatory environment in China (Chan and Wu, 2011; Firth et al, 2012). In the absence of legal constraints, auditors face less legal risk. Therefore, they are prone to compromise with clients because of income dependence. Under this premise, the safe harbor effect of industry norms does not play a role. In other words, the auditor is likely to support the client's decision, whether or not the industry norms exist. However, when it is known that a key audit matter is concerned by the exchange, the auditor faces higher reputation risk, litigation risk and administrative penalty risk (Chen et al., 2018). In this case, industry norms, one of which is aligned with client's preference, justify the client's decisions. Then auditors are more inclined to support the client. In contrast, without industry norms as a safe harbor, auditors are less inclined to compromise with clients given the higher potential risks. Therefore, when regulators are particularly focused on a key audit matter, industry norms will have more impact on auditor's support for client decisions.

Therefore, we formally state the following two competing hypotheses:

H2a: When regulators specifically focus on a key audit matter, industry norms will have more impact on auditor's support for client's aggressive choice on that matter.

H2b: When regulators specifically focus on a key audit matter, industry norms will have less impact on auditor's support for client's aggressive choice on that matter.

RESEARCH DESIGN

Participant

Through personal connection, we invited 76 auditors from local accounting firms to participate in our experiment. We sent out and collected electronic questionnaires by online questionnaire platform called Wenjuanxing. The participants were randomly divided into four groups and took an average of 25 minutes to fill out the questionnaire. In order to ensure that participants completed the questionnaire carefully and effectively, before the questionnaire distribution process, we obtained the support from partners and senior managers of the accounting firms, who invited auditors with professional experience to answer directly. Meanwhile, we communicated with some participants directly beforehand and afterwards to further improve participants' participation, which also facilitated more appropriate analysis of experimental results.

Table 1 shows the participant profile. Participants have a mean age of 31. Most of them are female (71%), which is higher than the current proportion of female CPAs in China (50.33%, 2017) as shown on website of the Chinese Institute of Certified Public Accountants. Their average working experience is 6.86 years, which imply that they have reached the management level and have rich audit experience according to the normal promotion system of the accounting firm. In addition, most of the participants are familiar with accounting standards and key audit matters (KAMs). And less than 50% of them are familiar with the real estate industry, which helps us to study the effect of industry norms. If the participants are familiar enough with the real estate industry, it will reduce manipulating effect of industry norms.

Table 1

Descriptive Statistics

	industry-norms/regulator-concerns	Industry- norms/no-regulator-concerns	no-industry-norms/regulator-concerns	no-industry-norms/no-regulator-concerns	Total
AGE	33.35	29.95	31.05	31.94	31.47
	(6.73)	(5.07)	(6.58)	(6.06)	（6.11）
GENDER	0.12	0.29	0.50	0.22	0.29
	(0.33)	(0.46)	(0.51)	(0.43)	(0.46)
WORKING	7.88	7.05	6	6.61	6.86
LIFE	(4.88)	(4.96)	(3.34)	(7.15)	(5.15)
Familiar with	72.06	68.33	66	61.67	66.97
Standards	(13.12)	(17.84)	(20.10)	(25.95)	(19.75)
Familiar with	56.18	43.10	43	37.5	44.67
Industry	(22.88)	(22.94)	(25.57)	(25.10)	(24.58)
Familiar with	67.94	55.71	51.5	42.22	54.14
KAMs	(15.52)	(25.56)	(23.46)	(30.01)	(25.47)

We find that most individual characteristics are not associated with participants' binary decision either in favor of or against the client's choice. Participants' age (p=0.849), experience (p=0.535), familiarity with KAM (p=0.355) are unrelated to their binary decision. However, gender is significantly related to participants' judgement. We find that female auditors are more inclined to support the client preferred treatment than are male auditors, which may be because the number of female participants is much higher than that of males. In addition, the more familiar participants are with the industry, the more likely they are to agree with client's choice. People who are more familiar with the real estate industry have a better understanding of the various norms existing in the industry. According to our hypothesis, they are more likely to take advantage of industry norms to support client's preference.

Material and Design

We carry out our study using a 2×2 between-subjects experiment and manipulate the two independent variables industry norms (present vs. absent) and regulator concerns (present vs. absent). For industry norms, we provided two popular revenue-recognition policies and representative companies in the real estate industry to participants in industry-norms conditions, and participants in no-industry-norms conditions were not provided (see Appendix I). For regulator concerns, we provided the material of inquiry letters to participants in regulatory-concern conditions, and participants in no-regulatory-concern conditions were not provided (see Appendix Ⅱ). Specifically, the material includes inquiry letters issued on key audit matters of revenue recognition in 2017.

The participants were instructed to assume that they are the engagement manager and in charge of the current audit of a commercial real estate development company for the financial year ending at December 31, 2018. They are planning to audit the current-year revenue recognition of pre-sale of commercial residential houses and one of them has been completed construction and inspection but the key has not been delivered to customer yet. The management believes that revenue should be recognized in the current year. However, some auditors in the audit team believe this is too aggressive. Because standards do not indicate clearly which time-point shall be considered as the transfer of risk and rewards, thus requires the auditor to make professional judgment. We informed participants that this client was important to them in order to motivate their directional goals to support the client's choice.

The experimental instrument begins with instructions for participants and Chinese Accounting Standards (CAS) No.14 issued in 2006. Participants then received the information on pre-sale arrangements, company background information and commercial residential houses information. Besides, the material includes the client and other auditors' judgement and their respective explanations. Four groups all obtained the above information and received corresponding manipulation material respectively.

Dependent Variable

The primary purpose of this study is to investigate the effects of industry norms on audit judgement. Therefore, our main dependent variable is participants' ratings of the likelihood that they support the client-preferred accounting (0 = Not at all likely, 100 = Extremely likely). We also gathered their binary decisions (0 = Not support, 1 = Support), as well as several other measures related to auditors' decision-making process. We ask the legal risk that auditors perceive if they support client (0-100). Finally, participants responded to some manipulation check question and demographic questions.

RESULT

Manipulation Check

To evaluate the effectiveness of our manipulations of industry norms, we asked participants if the case materials mentioned revenue recognition policies of Vanke and China Merchants Shekou. Of the 76 participants responding to this question, 60(79%) responded correctly. The 16 participants who answered incorrectly were all in the no-industry-norms condition, some of whom we interviewed after the questionnaire. They said “because they thought that Vanke and China Merchants Shekou mentioned in the question are representatives of the industry, and they subconsciously chose yes". In addition, we asked each participant to indicate whether the case materials involved inquiry letters issued on key audit matters of revenue recognition in 2017 to verify that they attended to our manipulation of regulator concerns. Of the 76 participants responding to this question, 49 (64%) responded correctly. The 27 participants who answered incorrectly were all in no-regulatory-condition.

Although our manipulations seem ineffective, the participants who responded incorrectly are all those who didn’t receive the relevant material and unconsciously chose yes, which has little influence on the test of the hypothesis. Therefore, we report results for all participants in the tests below.

Hypothesis Test

Participants chose either in favor of the client or not, based on their understanding of accounting standards and background information. Participants who were not able to make certain choice are classified as ‘‘Null’’. Table 2, Panel A and Figure 1, Panel A show the number and percentage of auditors that support client-preferred accounting (i.e., recognize revenue in current year).

To test our hypotheses, we firstly use auditors’ binary decision as our dependent variable. Table 2, Panel B reports the simple main effect of industry norms and regulator concerns. H1 predicts that auditors are more inclined to support client’s choices when client-preferred accounting is aligned with one of industry norms. To test H1, we assign 1 to the industry-norms condition and 0 to no-industry-norms condition. As we expected, participants in the industry-norms condition (50%) are more likely to support the client than another condition (29.41%) and the difference is statistically significant (χ^2=3.088, $p < 0.1$). When it comes to H2, Table2, and Panel C reports the moderation effect of regulator concerns. We find that when a matter has caught the attention of regulators, auditors are more likely to take advantage of industry norms to justify and support the client-preferred accounting (mean $_{\text{industry-norms/regulator concerns}}$=62.5% vs. mean $_{\text{no-industry-norms/regulator concerns}}$=26.32%, χ^2=4.644, $p < 0.05$), while the effect is not significant when there is lack of regulators concerns (mean $_{\text{industry-norms/no-regulator concerns}}$=40% vs. mean $_{\text{no-industry-norms/no-regulator concerns}}$=33.33%, χ^2=0.163，$p > 0.1$).

Further, we provide evidence from our tests of auditors' ratings of the likelihood that they support the client-preferred accounting. Unlike auditors' binary decisions, the continuous dependent variable allows for more sensitive statistical tests (Kadous 2000). In table 3, Panel A, we report the mean and standard deviation by experiment condition. Results are also displayed graphically in Figure 1, Panel B. To test our hypotheses, we estimate an ANOVA model of auditors' ratings of the likelihood that they support clients. The results confirm the hypothesis once again. The auditor with industry norms is more inclined to support client choice ($F = 2.87$, $p < 0.1$) and this effect is significant only in regulator-concerns condition(F=3.01，p<0.1), otherwise not(F=0.36，p>0.1).

Therefore, we believe that the results from our analysis provide important insights into the need for the regulators to consider industry norms in combination with the inquiry letters.

Table 2

Descriptive Data

Panel A: Binary Decision

Regulator Concerns

Industry Norms	regulator-concerns	no- regulator-concerns	Total
industry-norms	62.5% N=16	40% N=20	50% N=36
no-industry-norms	26.32% N=19	33.33% N=15	29.41% N=34
Total	42.86% N=35	37.14% N=35	

Panel B：Simple Main Effect- Chi-square Test

Factor	df	χ^2	p(two-tailed)
Industry Norms	1	3.088	0.079
Regulator Concerns	1	0.238	0.626

Panel C：Planned Contrasts

Hypothesis	result	χ^2	p(two-tailed)
H2a：Industry-norms/regulator concerns VS. no-industry-norms/regulator concerns	support	4.644	0.031
H2b：Industry-norms/no-regulator concerns VS. no-industry-norms/no-regulator concerns	nonsupport	0.163	0.686

Table 3

Descriptive Data

Panel A: continuous dependent variable-mean (standard deviation)

	Regulator Concerns		
Industry Norms	regulator-concerns	no- regulator-concerns	Total
industry-norms	56.18 （31.40） N=17	51.43 （33.21） N=21	53.55 （32．07） N=38
no-industry-norms	37.25 （34.43） N=20	45.28 （30.12） N=18	41.05 （32.28） N=38
Total	45.95 （33.99） N=37	48.59 （31.56） N=39	

Panel B：Simple Main Effect-One Way ANOVA

Factor	df	MS	F	p(two-tailed)
Industry Norms	1	2968.75	2.87	0.0946
Regulator Concerns	1	132.71	0.12	0.7261

Panel C：Planned Contrasts

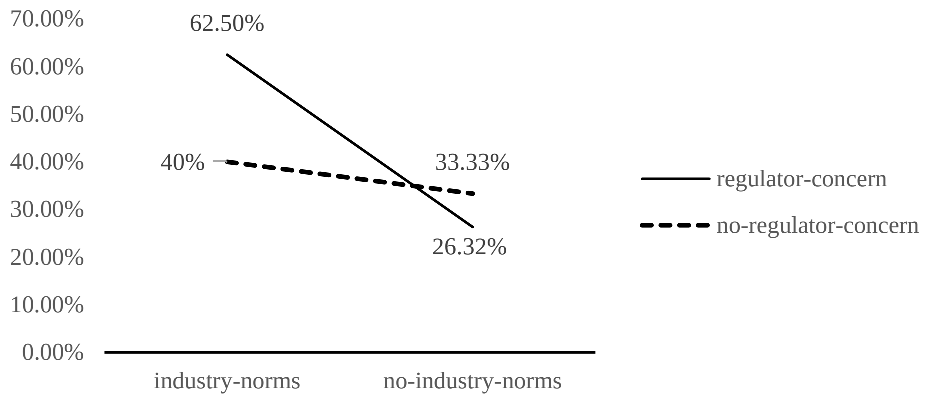
Hypothesis	result	F	p(two-tailed)

H2a：Industry-norms/regulator concerns VS. no-industry-norms/regulator concerns	support	3.01	0.0917
H2b：Industry-norms/no-regulator concerns VS. no-industry-norms/no-regulator concerns	nonsupport	0.36	0.5511

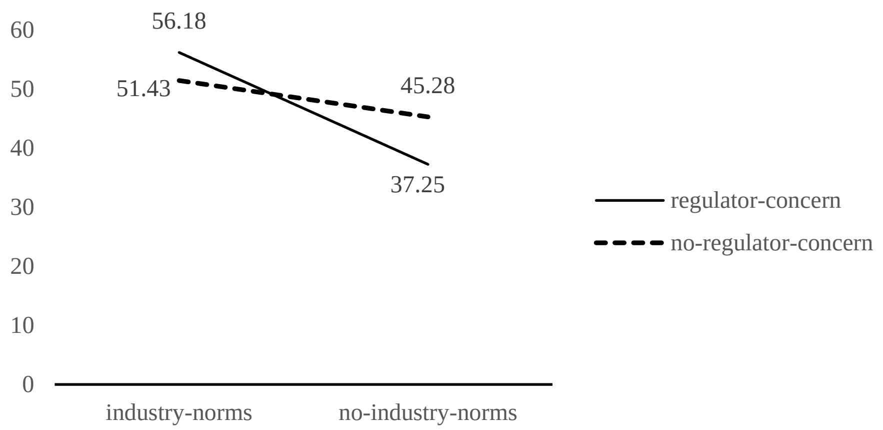
Figure 1

Propensity to support the client-preferred accounting

Panel A: **Binary Decision**



Panel B: **continuous dependent variable**



Mediation of legal risk perception

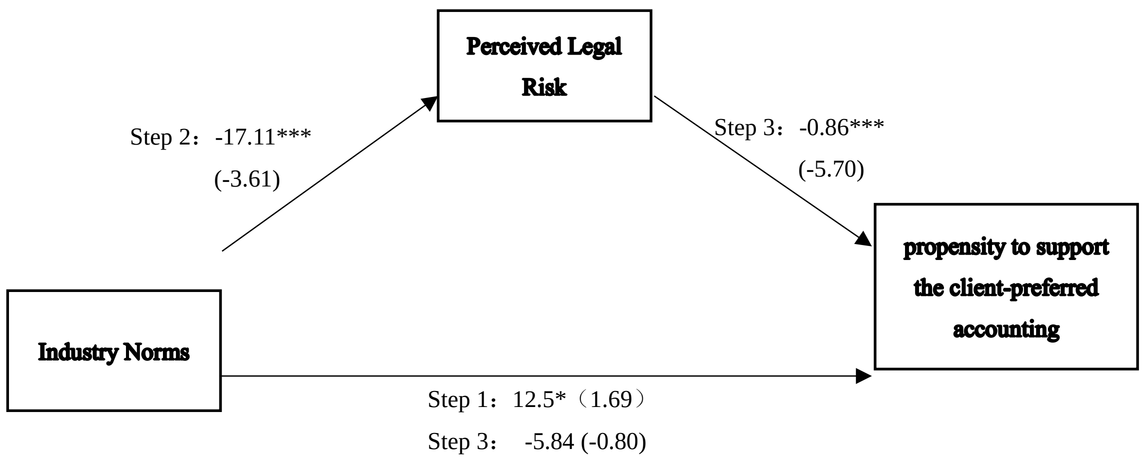
While our results provide evidence in support of our hypotheses, they do not demonstrate auditors' decision process. According to motivated reasoning and current research on negligence verdict, we theorize that industry norms appropriately provide reasons for supporting and justifying the accounting treatment that clients prefer, which reduces the perceived legal risks. To validate this theory, we exam the mediation effect of legal risks. To measure *perceived legal risk*, we asked participants to rate on a 100-point scale, with larger values representing higher legal risk that auditors perceive.

Figure 2 shows the results of the mediation analysis. First, we document a significant main effect of *industry norms* on *auditors' propensity to support the client-preferred accounting* ($p=0.095$), such that auditors familiar with industry norms are more likely to support the client-preferred accounting. Second, we establish a significant relationship between *industry norms* and *perceived legal risks* ($p=0.001$). And coefficient is negative, which is consistent with argument underlying H1. Finally, we included *perceived legal risks* in the general liner model on propensity to support the client-preferred accounting, and the significance of *industry norms* is fully mediated (p <

0.001). Consistent with the theory underlying H1, these results suggest that the presence of industry norms does provide a safe harbor (Kadous and Mercer, 2012), which reduces the auditors' perceived legal risk and thus makes auditors tend to satisfy the client's choice.

Figure 2

Consideration of Perceived Legal Risk as Mediating the Relationship between Industry Norms and Audit Judgement



***,**,* Indicate p＜0.01,p＜0.01,p＜0.1, respectively; P-values represent two-tailed tests.

Supplement Analysis

In May 2014, IASB released a new revenue standards (IFRS 15). Then the Chinese Ministry of Finance issued the revised CAS No.14 (new version of revenue standards) in July 2017. The criterion of revenue recognition changed from "transfer of risk and reward" to "transfer of control". Considering the norms in the real estate industry is under the old version of revenue standards, so our main experiment is based on the background of CAS No.14 issued in 2006. But at the final phase of the main experiment, we provided the new version of revenue standards and asked the participants whether the new version was more precise than the old version. And we also ask them to rate the likelihood that they support the client-preferred accounting under the new version of revenue standards. As a result, 85.5 percentages of the subjects believed that the new version was relatively more precise, and under the new version, the main effect of industry norms disappeared ($F=0.43$, $p=0.51$). This result may suggest that the “control model” is better than the “risk and reward model”. But the result shall be interpreted cautiously as it is a within subject design and may be contaminated.

CONCLUSION

With the widely adoption of and convergence with IFRS, the principle-oriented IFRS bring challenges to auditors in making professional judgment all over the world. Because the flexibility underlying the imprecise standards, auditor’s legal risk may be higher. But Kadous and Mercer (2012) find that compliance with industry reporting norms appears to provide auditors with safe harbor protection from negligence verdicts when accounting standards are imprecise. And on that premise, our focus is whether the auditors will take advantage of the safe harbor of industry norms to defend themselves to support client-preferred accounting. China’s real estate industry provides appropriate setting to answer this question because there are two prevailing revenue recognition timing point. Thus we designed an experiment with a case of a real estate company and test whether auditors will be more likely to agree with their client when they know the client’s choice is consistent with one of the industry norms.

We find that when client-preferred accounting is aligned with one of industry norms, the auditors are more inclined to support client’s choices. And when the matter has caught the attention of regulators, auditors are more likely to take advantage of industry norms to justify and support the client-preferred accounting, while the effect is not significant when there is lack of regulators concerns. This is because there is agency problem between auditors and clients. The auditor has the motivation to accept client-preferred accounting for compensation, and they also face the supervision of exercising reasonable care and competence from some parties, such as inquiry letters issued by exchanges. Industry norms appropriately provide reasons for supporting and justifying the accounting treatment that clients prefer, which reduces the perceived legal risks. This paper finds that legal risk does play a mediation role in the effect of industry norms on audit judgment. The main experiment is based on the background of CAS No.14 issued by the ministry of finance of China in 2006. Through supplementary analysis, it is found that the accuracy of new income standards (CAS No.14, 2017) has been improved and the effect of industry norms on audit judgment has been weakened.

Our study has limitations, the impacts of which can be addressed in future research. First, due to the limited sample size, this paper sets the client’s preference as "recognize revenue in current year". If the client wish to postpone the recognition of the revenue in next year, it is unclear whether the auditor's judgment will still be significantly affected by industry norms. Second, new version of revenue standards has been implemented from January 1, 2018. Although the questionnaire eventually asked the auditor’s judgment under the new version of revenue standards, and we have preliminary results that the precision of new income standards (CAS No.14, 2017) has been improved and the effect of industry norms on audit judgment has been weakened. However, the within subject design may contaminate the results. Finally, with regard to regulator concerns, this paper manipulates the post-event supervision of exchanges that are subject to non-administrative penalties. In addition, auditors are also facing the regulation of CSRC and MOF, so relevant researches can be done in the future.

REFERENCES

Agoglia, C. P., T. S. Doupnik, and G. T. Tsakumis. 2011. Principles-based versus rules-based accounting standards: The influence of standard precision and audit committee strength on financial reporting decisions. The Accounting Review 86 (3): 747–767.

Causey, D. Y., Jr., and S. A. Causey. 1991. Duties and Liabilities of Public Accountants. 4th edition. Mississippi State, MS: Accountant's Press.

Chan, K. and Wu, D., 2011. Aggregate quasi rents and auditor independence: Evidence from audit firm mergers in China. Contemporary Accounting Research, 28(1), pp.175-213.

Chen Yunsen, Deng Yilu and Li Zhe. Can Non-administrative Penalty Regulation Improve Audit Quality? — Evidence from inquiry letters. Auditing Research,2018 (05):82-88. (in Chinese)

CSRC, 2013. Chinese Security Regulatory Committee's regulatory report on the accounting issues of the public firms in annual reports.

http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201409/P020140912498106569050.pdf

CSRC, 2014. Chinese Security Regulatory Committee's regulatory report on the accounting issues of the public firms in annual reports http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201510/P020151023572439686786.pdf

Deloitte. 2013. Comment Letter: PCAOB Rulemaking Docket No. 034. Available at: http://pcaobus.org/Rules/Rulemaking/Docket034/132b_Deloitte.pdf

Firth, M., Mo, P.L. and Wong, R.M., 2012. Auditors' organizational form, legal liability, and reporting conservatism: Evidence from China. Contemporary Accounting Research, 29(1), pp.57-93.

Gibbins, M., S. Salterio, and A. Webb. 2001. Evidence about auditor-client management negotiation concerning client's financial reporting. Journal of Accounting Research 39 (3): 534–563.

Grubbs, J. K., and J. R. Ethridge. 2007. Auditor negligence to third parties revisited. Journal of Legal, Ethical and Regulatory Issues 10 (1): 75–89.

Hackenbrack, K., & Nelson, M. W. (1996). Auditors' incentives and their application of financial accounting standards. The Accounting Review, 71 (1), 43-59.

Hail, L., C. Leuz, and P. Wysocki. 2010. Global accounting convergence and the potential adoption of IFRS by the U.S. (Part II): Political factors and future scenarios for U.S. accounting standards. Accounting Horizons 24 (4): 567–588.

Hatfield, R. C., Jackson, S. B., & Vandervelde, S. D. (2011). The effects of prior auditor involvement and client pressure on proposed audit adjustments. Behavioral Research in Accounting, 23 (2), 117-130.

Kadous, K., and M. Mercer. 2012. Jury verdicts against auditors under precise and imprecise accounting standards. The Accounting Review 87 (2): 565–587.

Kadous, K., Kennedy, S. J., & Peecher, M. E. (2003). The effect of quality assessment and directional goal commitment on auditor's acceptance of client-preferred accounting methods. The Accounting Review, 78 (3), 759-778.

Lord, A. T., & DeZoort, F. T. (2001). The impact of commitment and moral reasoning on auditors' responses to social influence pressure. Accounting, Organizations & Society, 26 (3), 215-235.

Ministry of Finance of China. The Roadmap for the Continuous Convergence of CAS and IFRS. Accounting Research, 2010 (04):89-90. (in Chinese)

Nelson, M., J. Elliott, and R. Tarpley. 2002. Evidence from auditors about managers' and auditors' earnings management decisions. The Accounting Review 77 (Supplement): 175–202.

Ng, T., & Tan, H-T. (2003). Effects of authoritative guidance availability and audit committee effectiveness on auditors' judgments in an auditor-client negotiation context. The Accounting Review, 78 (3), 801-818.

Organizational structure/offices/Documents/final-report.pdf

Psaros, J., and K. Trotman. 2004. The impact of the type of accounting standards on preparers' judgments. Abacus 40 (1): 76–93.

Public Company Accounting Oversight Board (PCAOB). (2011). Concept Release on auditor independence and audit firm rotation. PCAOB Concept Release No. 2011-006 (August). Washington: PCAOB.

Salterio, S., Koonce, and L. (1997). The persuasiveness of audit evidence: The case of accounting policy decisions. Accounting, Organizations & Society, 22 (6), 573-587.

Segovia, J., V. Arnold, and S. Sutton. 2009. Do principles- vs. rules-based standards have a differential impact on U.S. auditors' decisions? Advances in Accounting Behavioral Research 12: 61–84.

Trompeter, G. 1994. The effect of partner compensation schemes and generally accepted accounting principles on audit partner judgment. Auditing: A Journal of Practice & Theory 13 (2): 56–68.

APPENDIX I：Industry Norms

Two popular revenue-recognition policies and representative companies in the real estate industry

Revenue-Recognition Point	**Representative Companies**	**Accounting Policy**
Completion of the Project Inspection (Construction Completion Stage)	Vanke (000002) AVIC SUNDA (000043) Oceanwide (000046)	Take Vanke as an example: Real estate sales recognize revenue after the completion of construction and acceptance，signing a sales contract, obtaining the payment certificate of the property delivered by the buyer according to the sales contract (usually receiving a deposit equivalent to 20% or more of the contract amount or/and confirmed the rest of the payment arrangements)
Completion of the Handover Procedure (Delivery Stage)	China Merchants Shekou (001979) Beijing Capital Development (600376) Poly (600048)	Take CMSK as an example: Real estate sales recognize revenue after the completion of construction, acceptance and transfer procedures.

APPENDIX Ⅱ：Regulator Concerns

In recent years, Shanghai and Shenzhen Stock Exchange have comprehensively sorted out and upgraded their business rule systems. According to regulatory requirements of “being legal, strict and comprehensive”, they have strengthened their supervision. The intensive issuance of inquiry letters is one of the manifestations, which shows the power of the frontline supervision of the exchange. Especially, the inquiry letter about financial reports is a powerful non-administrative regulation to regulate the financial reports of listed companies.

In the real estate industry, **the exchange attaches great importance to the regulatory verification of revenue recognition.** More than 80 percent of inquiry letters about financial reports in this industry are related to revenue. Meanwhile, revenue recognition is also a key matter in the annual report audit. According to statistics, about 70 percent of audit reports in 2017 disclosed revenue as a key audit matter. Especially, **the exchange issued an inquiry letter about KAM to a leading company,** which asked the company to disclosure additional information about the transfer of risk and reward, as well as **asked auditors to elaborate on audit procedures.**

In this experiment, the audit team plans to disclosure revenue recognition as a key audit matter.