Social responsibility audits can bias financial ones

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During the past decade, auditors have found a booming new business: reviewing reports on companies' environmental, social, and governance (ESG) activities. ESG reporting among S&P 500 companies grew 80% from 2010 to 2020, with nearly half the companies hiring auditors to give seals of approval.

But while ESG reporting brings new opportunities for auditors, it can also bring new headaches, according to a new study from Texas McCombs. Test subjects who engaged auditors to review their ESG reports often pressured them to be more lenient on their financial reports —and auditors were more likely to give in.

"Auditors are becoming more and more involved in ESG auditing, and an unintended byproduct of that might be emboldening reporters to be more aggressive in income and balance sheet reporting," says Steven Kachelmeier, professor and chair of accounting.

Companies get bolder, he says, because they feel socially responsible activities should earn them moral credit in other areas. They might feel they deserve less strict interpretations of their financial conditions, leaving auditors to walk a tightrope.

The dilemma arises because auditing is not always an exact science. Some financial figures are estimates open to debate.

For example, a company might argue for a lower number for uncollectible loans. Writing off fewer loans would increase its reported income. An auditor might argue for a higher number. The two would negotiate the final figure.

"In auditing, there's this friction between serving the customer and keeping the customer in check," Kachelmeier says.

Cutting reporters some slack

To find out how ESG reviews might spill over into financial audits, Kachelmeier simulated those negotiations experimentally, with co-authors Jeremy Douthit and Ben Van Landuyt, both of The University of Arizona. The findings are published in the journal *Accounting,*

Organizations and Society.

They randomly divided subjects into "reporters" and "auditors." Then, they simulated the process of ESG reviews. Reporters answered five trivia questions, while auditors rated how many of their answers were correct.

Some reporters were in a "pro-social" group, for which each correct answer resulted in a $2 donation to a charity.

To model the effects of collaboration, some pairings of auditors and reporters discussed the questions and answers together. Others worked independently.

Finally, the subjects simulated negotiations over a financial report. They bargained over the estimated value of a business asset.

The researchers found that:

- When reporters were both pro-social and collaborative in the ESG review, they were 20% more aggressive in the financial review, arguing for higher numbers.
- Auditors were more likely to concede to pro-social reporters for their preferred financial numbers.

A follow-up experiment mirrored the first, with one crucial difference. Auditors did not collaborate with reporters on the simulated ESG review. Without that collaboration, they were less likely to cede ground when reporters took aggressive financial positions.

"This suggests that you might need that additional element of collaboration for the auditor to be more lenient with the reporter," says Kachelmeier.

The research has implications for investors and regulators, he says. Aggressively negotiated reports run the risk of inflating numbers. That can potentially misrepresent a company's value to investors and shareholders.

To lessen that risk, regulators might consider limiting collaboration: the extent to which auditors should be allowed to consult with clients while reviewing their ESG reports.

"It's a fine line," Kachelmeier says. "This is one more factor for regulators to consider in terms of the age-old debate around the ability of auditors to objectively agree on reported values."

More information: Jeremy D. Douthit et al, Does auditor assurance of client prosocial activities affect subsequent reporter-auditor negotiations?, *Accounting, Organizations and Society* (2024). DOI: 10.1016/j.aos.2024.101550

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