

# Debate on Public Audit Oversight enforcement: it is all about procedural justice?

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**SUMMARY** This article provides a reflection of the paper as presented and discussed at the FAR conference of 9 and 10 May 2016 “Public Oversight of audit firms: the slippery slope of enforcing regulation” written by Robert Knechel, Carlin Dowling and Robyn Moroney (hereafter KDM, 2016). KDM describe the perceptions of auditors from the Big 4 audit firms and the regulator<sup>1</sup> in Australia regarding the correlation between regulatory enforcement style and its perceived impact on audit quality. We believe the paper is relevant and timely, because it documents well the current divergence of perceptions between auditors and regulators on how to continue their pursuit for higher audit quality. We argue that the paper could be strengthened by offering the authors’ views on what is required from both parties to realign their expectations.

**PRACTICAL RELEVANCE** The external oversight of auditors has been operational for nearly a decade. Although the interviewed auditors seem positive about the effects of regulation on audit quality in the past years, the current enforcement style is perceived to be coercive and appears to trigger unintended effects. We argue that an increase of procedural justice might help to align mutual expectations between auditors and regulators. In our view, an important first step in this process is to clearly define audit quality, because enhancing audit quality was the motivation of establishing audit oversight. In all, the paper by KDM fuels the need for a dialogue on the effectiveness of auditor oversight.

## 1 Audit quality and supervisor enforcement styles

### 1.1. Research objective

First, we will provide a summary of the paper by KDM. After a series of corporate accounting scandals between 2000 and 2005, the oversight of the audit profession was considered insufficient and the need was identified to strengthen oversight. As a consequence, regulatory bodies around the world started playing a more

active role and regulations were tightened. Among the implemented measures are audit firm inspections, through which regulators aim to improve the quality of public audits. The purpose of these inspections is to identify weaknesses and deficiencies in how an audit is conducted. The findings of the investigations along with suggestions for improvements are then communicated to the audit firms through (publicly available) inspection reports (see FRC, 2016; PCAOB, 2016). To examine the effectiveness of these inspections, Church and Shefchik (2011) examined the number of deficiencies found in PCAOB’s inspection reports in the years 2004 to 2009 and found a decline in deficiencies over the years, suggesting that inspections indeed improve audit quality. Yet, it is also possible that audit firms become better in anticipating on inspections. To gain a better understanding of how audit firms manage inspections, Knechel et al. (2016) interviewed audit partners from Big 4 firms, mid-tier firms and regulators in Australia. More specifically, using the slippery framework (Kirchler, Hoelzl & Whal, 2008) as a theoretical lens the authors examine how the enforcement style of an oversight body affects how audit firms react to inspections.

### 1.2 The slippery-slope framework

The slippery-slope framework describes how regulatees behave and comply with regulations (Kirchler et al., 2008). The main idea of the framework is that compliance behavior depends on *how a regulator exercises power* on the one hand and *the amount of trust* between regulator and regulatee on the other.

Power refers to the likelihood that the regulator will detect and punish non-compliance with the objective to adjust behavior of the regulatee (Kirchler et al., 2008). A regulator that conducts frequent inspections and punishes misbehavior with high penalties is seen as having high power. In contrast, a regulator that is negligent with inspections and rarely imposes sanctions on noncompliance has low power.

In the slippery-slope model by Kirchler et al. (2008), a regulator is considered to exercise power on a continuum from a full-coercive approach to a full-collaborative approach. The coercive approach refers to the use of full power to enforce compliance. Consequently, the coercive authority imposes fear and uses punishments to enforce compliance. In contrast, in the collaborative approach the regulator takes a low power, facilitative enforcement role; the regulator educates and supports the regulatee in making the right choices. Thus, the regulator-regulatee relationship in the collaborative enforcement style is not built on exercising power, but instead on trust.

Further, the slippery-slope model suggests that a regulator can achieve full compliance regardless of the enforcement style: either by exercising high power in the coercive enforcement style or by increasing trust in the collaborative style.

### 1.3 Audit quality and enforcement style

In their study, KDM report that the Australian audit partners perceive the enforcement style of the Australian regulator, the Australian Securities and Investment Commission (ASIC), as predominantly coercive; the publicly available inspection reports and media headlines are examples of the coercive use of the regulator's power. This coercive enforcement style renders a lot of power to the ASIC, but at the same time impedes the development of perceived trust between the two parties. The results as presented in the paper suggest a mismatch between the perceptions of auditors and audit authorities regarding the effectiveness of enforcement styles to enhance audit quality. The regulator's perception is that with an increase in enforced compliance, audit quality improves: rules and standards establish an understanding of audit firm responsibilities and inspections are important to identify hazards for corrective action. Auditors however believe that an abundance of rules is not beneficial to audit quality and might even lead to unintended effects, such as ticking-the-box and form over substance approaches. For instance, KDM report that auditors spend extra time on areas that the regulator considers important, even when in their view it adds little value to the audit. This finding suggests that audit firms anticipate inspections by addressing issues solely in order to satisfy the inspectors' expectations, and not for reasons of audit quality. KDM argue that the implementation of rules is important to safeguard against audit failures, but the audit regulator must be careful that it does not exceed the so-called 'tipping-point': the threshold where enforced compliance starts having adverse effects on audit quality. Hence, KDM advocate that regulators should reflect on their prevailing enforcement style and consider whether it actually improves audit quality or gives rise to unwanted effects.

In the next section, we will provide some feedback on the assumptions made in the paper and provide suggestions on how to strengthen the relevance of the paper.

## 2 Discussion

### 2.1 Concerns regarding the slippery slope framework

We appreciate that the authors try to theoretically explain why and how enforcement styles can trigger higher compliance, but we doubt whether the slippery slope framework by Kirchler et al. (2008) is appropriate for this purpose. Our main concerns include the validity of the (implicit) assumptions in the slippery slope model for the public auditing context and the appropriateness of the concept of 'trust'.

#### 2.1.1 Validity of assumptions

First of all, we argue that a high level of compliance can only be reached if there are clear, unequivocally interpreted compliance rules. For example, in the case of the determination of income taxes - for which the slippery slope was originally developed -, a lot of detailed rules are developed. Consequently, in most cases, there will be no discussion on how to determine the taxable income and the amount of taxes to be paid. In the case of disagreement, the company is able to appeal against the tax assessment and the court will decide on how to interpret a tax rule. Because the rules are clear and strict, the tax authorities are able to enforce tax compliance to a high level. In other words, the concept of 'clarity of the rules' is missing in the framework. Without clear rules, the tax authorities cannot effectively enforce compliance, whatever strong powers the tax authorities have (like fines, jail, etc.). Thus, clear rules are an essential condition to be able to comply in the first place. As discussed later, we argue that the current public auditing context does not (always) meet this condition.

Second, the slippery slope model assumes that a 100% compliance is possible, independent of the selected enforcement strategy. Achieving a 100% compliance score is a strong assumption, even for rules-based tax frameworks. Moreover, because the model suggests that a 100% compliance can be achieved regardless of the selected enforcement style, the selection of the enforcement style is reduced to a simple equation of costs and benefits; hence the tax authority or regulator should select the cheapest strategy. Although the model is only used as a 'theoretical lens' by KDM, we believe the assumptions used in the model are possibly too strong to be valid in a real life tax enforcement situation it tries to describe.

Third, besides concerns regarding the external validity of the slippery slope model itself, we question

whether this model is appropriate as a theoretical lens to describe the perceptions of the effectiveness of enforcement strategies of audit supervision authorities by auditors and regulators. As mentioned before, the slippery slope framework is developed for the context of the rules-based tax compliance context. The tax compliance context is quite different from the public auditing context. First, the objective of the tax rules are clear: determine the taxable income and the amount of taxes to be paid. In the case of auditing, the objective is open for different interpretations: assurance should be delivered on whether the financial statements represent a 'true and fair view'. Besides that the concept of a 'true and fair view' does not result in black and white accounting solutions (e.g., think of a valid range of fair value estimates), there is no commonly accepted definition of audit quality (IAASB, 2015c; DeFond & Zhang, 2014; Knechel et al., 2012). Audit quality is not defined in the auditing standards: it is only mentioned once that the audit partner should "emphasize (a) the importance to audit quality [...] and (b) the fact that quality is essential in performing audit engagements." (IAASB, 2015a, par. A3, p.140). Furthermore, even in the Framework of Audit Quality, the IAASB refrains from providing a definition of audit quality (IAASB, 2015b, appendix 1, par. 1, p.40). If the objective of the audit and hence audit quality is not well defined, we argue that it is hard to develop measures that increase the level of audit quality, let alone how to enforce audit quality. In other words, contrary to the tax context, it is difficult to set a minimum level of audit quality, let alone the complexities of defining the highest level of audit quality possible in a context of extensive professional judgment.

Fourth, by using the slippery slope model as a theoretical lens, it is unclear whether and to which extent KDM consider self-regulation and professional virtues as an effective means to safeguard compliance of auditing standards. The paper is silent on why auditors are reluctant to comply with auditing standards resulting in the need of a regulator: is it because of a lack of professional virtues or because audit quality is too unclear and too vague?

### 2.1.2 Procedural justice

One alternative way to interpret KDM's research results is to apply the concept of procedural justice. In our reading of the results, there seems to be a lack of procedural justice. Procedural justice "concerns how justice is administered. Key aspects of a just legal system are that the procedures are fair and transparent." (Brooks & Dunn, 2012, p. 146). In the case of auditing supervision, the regulator's decision-making process is perceived by auditors as a black box; it may be even injustice towards auditors. Further, auditors perceive

reluctance to appeal against the regulator's decisions, because the regulator represents both the supervisor role and grants the audit licenses. Moreover, the audit professionals do not appreciate the generalized conclusions in the regulators' reports, because the conclusions are based on a small, in their view not representative, sample, but they are communicated as being representative for the 'current state of audit quality delivered by the audit firms'. Such concerns by audit professionals signal low perceived procedural justice: transparency on how findings are weighted and interpreted by the regulator in its verdict regarding the audit quality and when - based on what criteria - a finding is considered representative for the audit firm or the audit profession as a whole.

We argue that the trust in the fairness of audit oversight goes beyond the performance of the audit supervisory agency and its employees: it is about 'trust in the supervisory system itself'. In other words, trust in the system of audit oversight does not only depend on whether the audit oversight inspector has experience in examining the quality of audit files properly. We argue that trust is primarily driven by the fact that an inspector followed the audit oversight procedures properly.

Let us explain the difference with the example used by KDM: speeding tickets. The rules for car-driving in western countries are developed in a democratic process based on common power sharing (trias politica): legislature (parliament), an executive (police), and a judiciary (judges). So, if parliament intends to make society safer, it authorizes a traffic law. In a good traffic law and associated implemented acts, the principles and rules are described in terms of what is allowed in traffic (which vehicles are allowed on the public roads), what is prohibited (maximum speed limits), the enforcement process (allowed speed detection methods including calibrating of speedometers and training of officers) and the enforcement power (stopping of cars, proportionate punishment, including transparent and consistent determination of fines, when drivers should be prosecuted, who is allowed to impose fines and right of appeal, etc.). Imagine a car driver who is stopped by a police officer for speeding. The trust of the car driver in the enforcement regime will not be primarily based on whether the police officer acts in a nice manner or his or her high personal experience with enforcing speed limits, it will be based on the validity of the enforcement action;

- a. There should be a valid reason: the correctly calibrated speedometer objectively detected speeding;
- b. Based on the formal procedure and the use of the formal tables (preferably an automated decision) the punishment is determined: a fine based on a formally authorized tables, given the circumstances;

- c. The car driver will receive a formal speeding ticket and preferably pays it to the fine governmental collecting agency, not to the police officer directly;
- d. The car driver is informed about the right to appeal and how and to which extent privacy procedures apply.

Similarly, in the case of enforcing compliance of auditing standards, we argue that procedural justice is the driver of perceived trust in the supervisor. In order to satisfy the procedural justice in the audit oversight context, the supervisor should - in our view - meet the following requirements:

- a. Valid reasons to accuse an auditor of delivering improper audits. This requirement includes a validated and transparent process of (1) assessing audit quality and (2) decision-making regarding the final conclusion: acceptable or not-acceptable audit quality. Note that 'assessing audit quality' requires an appropriate benchmark of what audit quality is, i.e., a clear and comprehensive definition of audit quality, a validated measurement instrument of audit quality, a review team with sufficient knowledge and experience, and a process in which review quality is safeguarded. The decision-making process requires at least a proper *audi alteram partem* ('hear the other side too') and checks and balances to safeguard a well-balanced and objective decision-making process by the regulator;
- b. Based on the conclusion of the review outcome, the punishment should be determined in a transparent and consistent manner and in such a way that auditors will not be surprised by the sanction. Consistent and transparent determination of sanctions requires formally authorized and publicly available categories of auditor misconduct and the related sanctions;
- c. The destination of the fine payments should be transparent and, to ensure objectivity, not be beneficial to the supervisor itself. Preferably, the fines should be beneficial to supporting the objective of increasing the level of audit quality, like research projects;
- d. A transparent procedure is adopted for the right of appeal against a decision by the supervisor and a complaint procedure in the case of inspector misconduct;
- e. A transparent procedure with checks and balances on how and which review findings are communicated to the public and how the quality of such reports is safeguarded. An important aspect in this respect is how, i.e., based on what criteria, the findings of a small inspection sample are generalized to the quality delivered by an audit firm or the auditing profession as a whole.

In the paper by KDM, there are a lot of quotes suggesting frustrations by audit partners related to the requirement of 'validity' of the accusation of auditor misconduct regarding audit quality. We argue that the lack of a proper definition of audit quality and hence the lack of an objective measurement of audit quality, can be an important source of these frustrations. In the paper, there are also findings regarding the generalizations and tone of the supervisor's report on audit quality.

## 2.2 Relationship between enforcement-styles, compliance and perceived audit quality

### 2.2.1 Positive effect of auditor oversight

The results as reported by KDM suggest that about 80% of the maximum level of audit quality is already met and that the current debate between the auditors and the regulator concerns the last 20%. Interestingly, KDM suggest that the regulator believes that an even stronger coercive enforcement style will enable a 100% audit quality level. However, in the paper, no information is provided on what kind of audit quality the regulator is envisioning. The auditors, however, believe that a stronger coercive enforcement style is likely to result in a lower level of audit quality. Unfortunately, in the current version of the paper, no information is provided on what this 20% actually represents and why the perceptions of the regulator and the auditors differ significantly. Some quotes in the paper seem to point into the direction that different views exist between the regulator and the auditor what audit quality actually represents.

### 2.2.2 Agreement is seemingly a possibility

Interestingly, the results as reported by KDM suggest that during the period in which the auditors and the regulator perceived a positive effect of auditor oversight, both auditors and regulator also perceived the then applied collaborative enforcement style as 'effective'. The paper however, is relatively silent on this period and focuses on the shift towards the coercive enforcement style. The quotes in the paper clearly suggest the coercive enforcement style renders a lot of frustration among the auditors. However, it could be interesting to address the question why and when the discrepancy between the two parties started. Would different expectations regarding audit quality help explain this phenomenon? Or due to differences in ambition regarding the level of audit quality to be achieved? Why did the supervisor change its enforcement style or is this 'style change' a misperception by the auditors? Finally, it would be interesting to further elaborate on why the supervisor started to use a communication style with generalizations that are only based on small samples.



### 3 Conclusion and research opportunities

In all, the paper addresses an important and emerging topic in the auditing profession. With the focus on examining the perceived effectiveness of auditor oversight enforcement styles on audit quality, the authors initiate an important debate: are the auditing profession and the oversight body heading in the right direction? In our view, this debate should lead to the development of an effective auditing oversight enforcement model, supported by both the public and the auditing profession.

In order to achieve this, we would like to suggest the following. First, future research may consider the theoretical analysis of the results from the perspective of procedural justice, because it may be an explanation for the frustration voiced by the audit partners in the quotes in the KDM-paper. Second, future research can

examine why and when the perceptions regarding the effectiveness of the enforcement style started to differ between auditors and regulators. Further, in our view it would be relevant for future research to consider what is needed to align mutual expectations between auditors and inspectors again. Possibly, examining how other industries, such as education and medicine, cope with inspections might be an interesting starting point. Finally, we emphasize the importance to prioritize the development of a clear and comprehensive definition of audit quality. ■

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### Notes

1 ■ Note that we use (audit) regulator, audit supervisor and audit authority interchangeably.

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