

Puzzle

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A continuing puzzle, in any case to me, is why most observers, regulators, journalists, academics, and indeed often audit practitioners as well, consider statutory corporate auditing to be in trouble; deep trouble. To these observers, statutory auditing has major quality problems and statutory audit failures are a major problem. These concerns exist in the Netherlands and in most advanced economies. In fact, the only country that appears to be unaffected is Belgium. In Belgium statutory auditing is seen to do just fine. I live in Belgium.

The puzzle surfaced again during the first FAR Conference that this MAB issue is devoted to. The point I will make here is that, in effect, the Belgians see this mostly correctly: corporate statutory auditing in the world is doing fine most of the time. Audit quality is a very worthy object of research and attention, but not because of an audit quality crisis.

One of the nice results of auditing regulation in the European Union, the Auditing Directive, is that it has led to a common terminology. That Directive defines the statutory audit, the statutory auditor and audit firm, engagement partner, public interest entity, regulatory oversight of the corporate statutory audit and so on. The Directive starts off with a list of these definitions. The Directive is the 'Statute'. It is a written law about corporate statutory audits passed by the European Parliament. It regulates the auditing of the financial statements of EU companies: corporations to be more precise. The Directive is part of EU Company Law, hence its existence explains which corporations in the EU need to undergo a statutory audit. The financial statements themselves are regulated in a companion EU Company Law Directive: the Accounting Directive. I explain this in some detail because I find that Dutch students, being taught often using US textbooks, sadly are often unaware of this set-up. Students form a sizeable, and loyal, part of the MAB's readership. So, hopefully, the description of this simple set-up, will help them. One more point, enlightening hopefully to the students as well: the IFRS regulation, mandating EU listed corporations to use IASB IFRS, is part of emerging EU Securities Law, not of EU Company Law.

Why did I just say 'puzzle'? What is puzzling about this widespread belief, but not in Belgium, that statutory corporate audits in the EU have a serious quality problem? The puzzle is this: a careful look at the facts does not produce a truly important statutory audit quality problem in the EU and elsewhere.

Let us focus on the Netherlands to substantiate this proposition. I could do the analysis for other developed economies as well. The same result would follow. Indeed, also in Belgium.

It is very helpful that there is so much information available about the Dutch market for statutory audits these days in the Netherlands. That is also a convenient consequence of the Auditing Directive and its precursors. I will use somewhat rounded numbers. It will be straightforward to do the analysis in, almost, exact numbers. These days there are 18.5 thousand active auditors in the Netherlands. About half of them run their own businesses. That is, they are in private practice. The other half are 'auditors in business or in government'. Of the auditors in private practice, 1800 are the Dutch statutory auditors. They are the auditors that can sign off on the quality of Dutch audited corporate financial statements. There are, these days, somewhat less than 400 registered audit firms. They are registered with the Netherlands Authority for the Financial Markets (AFM). This registration also 'creates' the registration of the 1800 statutory auditors working for these firms. A small number of Dutch audit firms are, also by the AFM, allowed to audit the financial statements of the most prominent, 'systemically' important, Dutch companies: listed corporations, financial institutions and, in the near future, even a number of important non-corporate entities (regulated health insurers for instance). These companies are, in Auditing Directive terms, Public Interest Entities (PIEs). All this forms the supply side of the Dutch audit market.

Note that we can also, these days, observe, on the supply side, the engagement audit partners by name. This is again a consequence of audit regulation. We know who they are and from where they work, for which audit firm. We could indeed quite easily find out who these 1.800 individuals, the statutory auditors in the Netherlands, are. It is about the quality of their work that we are having a discussion. It is important to keep that in mind. This is not an abstract exercise. For instance, the 2015 AkzoNobel statutory auditor was E.H.J. van Leeuwen RA, KPMG Accountants NV. Googling will then provide additional information easily. Again, it is possible to do this in other EU member states as well.

The demand side of the audit market in the Netherlands looks as follows. Some 22 thousand Dutch corporations are mandated to be audited every year. These are the large and medium-sized Dutch corporations (Accounting Directive defined). Among them are, and this is a number that proved somewhat difficult to precisely establish, 1100 PIEs. There are also voluntary (statutory audit based) financial statement audits. We know that there are 'larger' small Dutch corporations that purchase them. How many of these voluntary audits there are is not well known.

How can statutory financial statement audit quality

be observed in the Dutch audit market in the aggregate? I will use a simple effective approach to giving an answer to that question, initiated by Jere Francis (2004). Francis, by the way, also spoke at the FAR Conference, but about something else. The obvious answer is to look for the number of statutory audit failures observed in the audit market over a period of time and compare that number with the total number of statutory audits carried out during the same period. Suppose we do that for the 2005 to 2014 period. A ten year period means that the '10 year' number of statutory audit failures should be compared with the 220 thousand statutory audits carried out in the period (or with 11 thousand PIE audits) to determine audit quality in the aggregate. There is no 'register' of audit failures. But, it is obvious that the number of statutory audit failures in that period dwarfs in comparison to the 220 thousand audits carried out, and to the 11 thousand PIE audits. Even if we somehow weighed the audit failures, in terms of value destroyed, that is, of consequences, that conclusion would still hold. It could be objected that zero audit failures is the only acceptable outcome, but that is not a serious objection. Failures will occur. The important thing is to keep its number low.

Why then is there this strong feeling of a general statutory audit quality problem in the Netherlands? One important reason is that observed audit failures are magnified. The press does this. Other observers, even practitioners, can be seen to do this as well. It is important to see that this magnifying behavior is very effective. It does indeed create a sense of crisis. That crisis feeling then leads to political, regulatory reactions and the audit profession reacting to those reactions. The recent NBA (Koninklijke Nederlandse Beroepsorganisatie van Accountants - The Royal Netherlands Institute of Chartered Accountants) recommendations list, over 50, for a reform of the Dutch audit industry and market is particularly a strong example. And of course, creating the FAR is the result of one of these recommendations.

Furthermore, a serious additional audit failures magnifying voice in the Netherlands, surprisingly, is that of the Dutch audit market supervisor: the AFM. The AFM in recent years has carried out Dutch audit engagement quality investigations and has chosen to publicize its finding prominently in the Dutch financial and general press. Having an active oversight body is good of course. Provided that its field research is impeccable. Several observers, myself included, have criticized the AFM's research methods regarding this issue. So far these critical remarks have been blown away by the storm of criticism battering the Dutch audit industry, that also the AFM has created. That 'storm' should be seen in perspective, and I provided that perspective above. The statutory audit quality problem in the Netherlands is not a large problem

seen in that perspective. So the AFM's behavior presents a puzzle in itself.

It would be interesting to find out how the AFM's statutory audit quality research was received by the other 28 EU audit market regulators. That would provide yet another perspective on the seriousness of the audit quality issues in the Netherlands. As I said, in Belgium, calm reigns on the statutory audit quality front. That observation alone provides a valuable perspective on the Dutch audit quality 'storm'. How can there be this difference between two adjacent countries?

As I explained, FAR can certainly be seen as a product of the audit quality 'storm'. The atmosphere at the FAR conference was well. Much discussion was devoted to the 'root causes' of audit quality problems. Not so much by the speakers, but certainly by the audience. Audit quality concerns loomed large.

I think it is wise to 'fight back' against the 'storm' and those that created it. I counsel, also to the FAR, a different, optimistic, positively spirited, approach to auditing research and the need for such research. Statutory auditing, despite its name, was not invented by regulators. Audit demand originates from the creation, also not invented by regulation, of the corporation as a fundamental business contract in a market economy. Given that auditing is an important 'administrative technology', it is important that it continues to improve. It is that which creates the fundamental demand for audit quality improvement and innovation. This is true for both audit firm 'technology' and audit regulator 'technology'. Careful research into audit quality, and innovative design for audit quality, both within audit firms and within audit oversight bodies, should be the driving force of auditing research. A force that comes from within. As well as, and I am an academic educator, a driving enlightening force for the teaching of auditing and its techniques.

I was involved in an earlier attempt to do just that: the Maastricht (Accounting and) Auditing Research Center (MARC). That was in the early 1990's. The FAR is a much more substantial attempt, this time deeply involving the audit firms themselves. This represents important progress, which holds a lot of promise for the future of auditing research and audit technology innovation and design in the Netherlands. ■

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