FAR Research project
What do we know about group audits?

By Denise Hanes Downey and Anna Gold

SUMMARY Despite concerns about the quality of group audits, recently raised by practice, inspectors, regulators, and standard setters, only a limited number of academic studies have specifically examined these engagements to date. This paper first describes some of the concerns about group audits to explain why research in this area is important and has the potential of providing a valuable contribution to practice. Then, we review the limited extant research available on group audits. Following, we present an overview of our own ongoing research project “Coordination and Communication Challenges in Global Group Audits: Evidence from Component Audit Leaders”, in which we examine (1) the determinants of coordination and communication challenges, (2) the degree to which the strategies described mitigate such challenges, and (3) how, ultimately, component auditors’ perceptions of engagement performance are affected. We finalize the paper with a discussion of possible implications of our research for practice.

1 Introduction
While a typical financial statement audit of a company based in one country is a complex process, conducting audits of large multinational groups further increases such complexities by requiring collaboration and communication between multiple auditors in many different locations. The term “group audit” refers to the audit of financial statements of a corporation comprised of more than one segment or “component”. Such corporations are typically domiciled in one country or region, but maintain operations in a number of other regions or foreign jurisdictions. The group auditor is responsible for providing assurance over the consolidated financial statements and is often based in the same region or jurisdiction as the corporation’s headquarters. In a regular (i.e., non-group) audit, a single audit firm performs the work necessary to issue the audit report. In contrast, in a group audit, other firms (termed “component auditors”) are engaged in other jurisdictions to perform audit work over the “local” operations of the corporation. These component auditors may or may not belong to the same global network firm as the group auditor (see Carson, Simnett, Vanstraelen & Trompeter, 2017; Downey & Bedard, 2017). The work performed by component auditors for the group audit can range from a full scope audit of local operations to an audit of specific account balances or specific audit procedures (IFAC, 2007), and is coordinated by the group auditor. However, component auditors may also complete a standalone audit of local operations to comply with jurisdictional requirements, commonly referred to as statutory audits. Thus, group audits differ from regular (non-group) audit arrangements in that multiple audit firms are involved, the work is performed across jurisdictions, the corporations audited tend to be large and complex, and auditors must attend to different requirements (e.g., group vs. statutory requirements).

Group auditors are responsible for planning and supervising the work of component auditors (IFAC, 2007). For example, ISA 600 outlines that in planning the engagement group auditors must gain an understanding of the component auditor, set materiality, and ensure significant risks are assessed and addressed (IFAC, 2007). Further, in supervising the engagement, the group auditors are charged with communicating with component auditors, assessing the sufficiency and appropriateness of evidence obtained, communicating with management/those charged with governance, and maintaining documentation (IFAC, 2007). Given that regulations focus on the responsibilities of group auditors, component auditors may be viewed largely as executors of the instructions/work designated by the group auditor. In other words, they perform substantive audit work over local operations as specified by the group auditor. Consistent with this notion, the group auditor assumes responsibility for the work performed by component auditors. As a result, if a component auditor fails to detect an error/fraud that is material to the group financial statements, the group auditor is liable. This liability should, but does not always, encourage the group auditor to be appropriately involved in the component auditor’s work (see IAASB, 2015). This paper first describes some of the concerns about
group audits that have recently been raised by standard setters and regulators to explain why research in this area is important and has the potential of providing a valuable contribution to practice. Then, we review the limited extant research available on group audits. Following, we present an overview of our own ongoing research project “Coordination and Communication Challenges in Global Group Audits: Evidence from Component Audit Leaders,” in which we examine (1) the determinants of coordination and communication challenges, (2) the degree to which the strategies described mitigate such challenges, and (3) how, ultimately, component auditors’ perceptions of engagement performance are affected. We conduct this study in collaboration with the Foundation for Auditing Research (FAR), the International Auditing and Assurance Standards Board (IAASB), the Institute of Chartered Accountants of Scotland (ICAS), and the International Association for Accounting Research and Education (IAAER). We finalize the paper with a discussion of possible implications of our research for practice.

2 Why is research on group audits important and how does it contribute to practice?

In bearing the ultimate responsibility for coordination and completion of the audit over the group financial statements, the group auditor directs, supervises, and reviews the work performed by component auditors (IFAC, 2007). Audit firms, inspectors, and regulators, however, are concerned about significant variation in group auditors’ actual involvement in the work performed by component auditors (IAASB, 2013). In the United States, the Public Company Accounting Oversight Board (PCAOB) is additionally concerned about the extent of work being performed by component auditors and the lack of transparency provided to investors pertaining to the extent of this work (e.g., Doty, 2011c). The concern around this lack of transparency stems from inconsistency in the quality of group audits inspected by the PCAOB, as well as the inability to inspect (either individually or jointly) the work of component audits in approximately a dozen non-U.S. jurisdictions (Doty, 2011a; PCAOB, 2016a). Broader inspection results provided by the International Forum of Independent Regulators (IFIAR 2017) support that audit deficiencies are frequent and recurring on group audits (IFIAR, 2017). More than half of the members of IFIAR inspected public interest entities in 2016, finding an 11 percent deficiency rate in group audits. These findings suggest that group audits are not only one of the most important challenges facing the profession today, but also draw attention to firms’ quality control systems, including internal inspections, as potential mechanisms to improve the consistency of group audit quality (IFIAR, 2017).

Although inspection results typically do not make it possible to identify group audits’ deficiencies or to understand the nature of challenges faced, large frauds such as Parmalat, Royal Ahold/U.S. Foodservices, and Satyam provide details into circumstances leading to group audit failures. These cases suggest that group audit issues range from inadequate performance of basic audit tasks (e.g., the component auditor failing to appropriately execute confirmation testing) to generally failing to apply audit standards (e.g., the group auditor being insufficiently skeptical or failing to provide adequate supervision). In the case of Royal Ahold/U.S. Foodservices, it is not hard to imagine how coordination and communication challenges between the Netherlands-based group auditor and its U.S. affiliate could lead to audit deficiencies, and a failure to discover ongoing fraudulent activities at Ahold’s subsidiary U.S. Foodservices. The group audit of Royal Ahold comprised dozens of individual operating units, which were very loosely organized under one corporate umbrella, rendering planning and coordination extremely challenging (Knapp & Knapp, 2007).

In the United States, PCAOB board members and inspectors suggest that group audit deficiencies include unresolved problems between the group and component auditors, insufficient audit testing and/or audit documentation, or, in egregious cases, non-performance of the requested work (Doty, 2011b; Munter, 2014; PCAOB, 2016b; 2017). While our own research as described later in this paper will not directly test the relationship between coordination and communication challenges and audit deficiencies, one can envision how problems related to communication and coordination between group and component auditor are likely to contribute to each of the above examples provided by inspectors. In fact, regulatory and inspection bodies have explicitly identified insufficient coordination and communication as a root cause of many audit deficiencies (e.g., Doty, 2011c; Munter, 2014). Despite the concerns about the quality of group audits, raised by practice, inspectors, regulators, and standard setters, only a limited number of academic studies have specifically examined these engagements to date. As a result, factors underlying the challenges observed on these audits as well as the appropriateness of regulatory responses (if any) need to be better understood. Before introducing our own research question, we review the extant literature on group audits.

3 What does the literature tell us?

We have identified six studies that are directly relevant to the topic of group audits, reflecting the challenges and opportunities with respect to this area of audit research. We review key themes from the existing literature below, providing a background for our own work in progress.
Audit Quality – Prior research using Australian archival data suggests that group audits improved following the implementation of the revised ISA 600, particularly for engagements led by smaller firms (Carson et al., 2017). Although the use of component auditors is associated with higher fees, surprisingly, results also suggest that audit quality is lower when group and component auditors belong to the same global firm network. In the U.S., Dee, Lulseged and Zhang (2015) find evidence that disclosure of component auditors, who do not sign a report for U.S. issuers, is associated with lower audit quality (measured as performance-adjusted discretionary accruals) and a negative market reaction (measured as cumulative abnormal returns) when compared to a matched sample of companies where such disclosure is not required. While both studies provide initial insight, many questions in respect to the quality of group audits and underlying contributing factors remain unresolved.1

Audit Planning – A key area of concern related to the planning of group audits is the calculation and allocation of materiality (IAASB, 2013). Stewart and Kinney (2013) develop a model to assist auditors in determining component materiality that aims to ensure both effectiveness and efficiency, while acknowledging the varied approaches to materiality currently adopted in practice. The model includes many important factors affecting group audits, but finds group-level controls (defined as controls applied to one or more components by group management) and the structure of components (i.e., whether or not subgroups of similar components exist, increasing cohesiveness within the group) to be of greatest importance. Sunderland and Trompeter (2017) highlight that a need still exists for work examining the scoping of significant and non-significant components as well as survey based work examining actual materiality levels used in the field.

Audit Execution and Team Dynamics – In a detailed field study of a 1997 European group audit, Barrett, Cooper and Jamal (2005) find that Canadian component auditors do not passively follow the group auditor’s instructions or the firm’s global risk based audit methodology. Rather, the component auditor adapts these coordinating mechanisms based on their environment and experiences. While the study implies that the production of the group audit is a fluid dialog between the group and component auditors, it is unlikely that such findings hold in today’s highly globalized and regulated environment.

A more recent examination of 150 group audits of U.S. registrants finds that larger, public clients with a greater number of components and local statutory audit requirements contribute strongly to challenges experienced by group auditors (Downey & Bedard, 2017). This study investigates the effectiveness of three coordination/communication strategies that are supported by management literature and used by audit firms. Downey and Bedard (2017) find that the most common coordination and communication strategy, modularization, is the least effective in mitigating challenges. Modularization relies on advanced scripting of work (e.g., detailed instructions and templates) and standardization of interactions (e.g., sharing deliverables at interim and closing) between team members to minimize interdependencies during fieldwork. Under this strategy successful integration requires auditors to adhere to the defined plan, as changes/adaptations are difficult to communicate or observe in real time. The second strategy, ongoing communication, focuses on the development and use of communication channels, as well as the content and ease of communication (e.g., onsite visits by the group auditor, involvement of the component auditor in meetings, and reliance on conference calls, email, etc.). However, ongoing communication (defined as the availability/use of communication channels) also yields limited effects in Downey & Bedard (2017). This result could suggest an unwillingness or inability of component auditors to access firm tools, despite deployment by firm networks.

The most effective coordination and communication strategy examined is tacit coordination, defined as leveraging/developing common ground between team members (Downey & Bedard, 2017). For example, the component audit may be staffed with individuals who previously worked on the engagement or have expertise in areas requested by the group auditor. While effective, this strategy depends largely on component audit team staffing, which the group auditor may or may not be able to influence. Thus, many question remain as to how to improve coordination and communication between group and component auditors. As described in the next section, our ongoing study intends to answer some of these questions by extending the study by Downey and Bedard (2017) to the component auditor’s perspective.

Finally, in a recent publication, Sunderland and Trompeter (2017) also provide many interesting suggestions for future research pertaining to execution of group audits and the group and component auditor dynamics. These include questions pertaining to staffing of group audits and assessing risk across the entity, mechanisms to improve knowledge management and communication, identification of factors leading to over-reliance on component auditors, and factors that influence poor documentation.

4 Introduction to our research questions
The component auditor perspective (as opposed to the group auditor perspective) is noticeably missing from existing research and, in many instances, regulatory discussions. However, considering that component auditors often perform the majority of work on group
audits (e.g., Doty, 2011a), this is an important perspective to investigate. For instance, the study by Downey and Bedard (2017) was conducted from the group auditor perspective; hence, it was not possible for the researchers to identify why strategies may not work (e.g., adaptation at the component level) or how to facilitate the implementation of more effective strategies (e.g., staffing interventions) from a component auditor perspective. We endeavor to fill this gap in the literature by studying the component auditor perspective in our ongoing research project “Coordination and Communication Challenges in Global Group Audits: Evidence from Component Audit Leaders.”

Component auditors are likely to provide insight into key concerns of firms, regulators, and inspectors, including: (1) the involvement of group auditors; (2) the communication between group and component auditors; (3) the nature, timing, and extent of the group auditor’s review of component audit work; (4) the need for site visits by the group auditor; and (5) the determination of risk/materiality at the component level (see IAASB 2015; IFIAR 2017; PCAOB 2016a). While our primary focus will be on Dutch component audits performed on behalf of group auditors in the United Kingdom and Germany, in a later stage, we will also compare Dutch component audits to Indian and Australian component audits to provide greater insight on the potential impact of culture. We expect that certain client factors and engagement characteristics make it more difficult for group and component auditors to anticipate each other’s actions (e.g., larger, more complex engagements) and therefore will be associated with more challenges and lower performance (Srikanth & Puranam, 2011; Puranam & Ravendran, 2012). As discussed in the previous section, Downey and Bedard (2017) suggest that firms seek to mitigate these effects using three types of coordination and communication strategies, with varying levels of success. First, recall that while group auditors often employ the modularization strategy (i.e., advanced scripting of work and standardization of interactions between team members to minimize interdependencies during fieldwork), it is suggested to be the least successful coordination and communication strategy (Downey & Bedard 2017). We intend to explore underlying reasons on the component side that may explain the implementation of more effective strategies (e.g., staffing interventions) from a component auditor perspective. We endeavor to fill this gap in the literature by studying the component auditor perspective in our ongoing research project “Coordination and Communication Challenges in Global Group Audits: Evidence from Component Audit Leaders.”

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5 Key messages and possible implications for practice

Concluding, our study endeavors to provide the following three major insights about group audits from a component auditor perspective, complementing the study by Downey and Bedard (2017), which focused solely on the group auditor perspective. We intend to offer insights into the determinants of coordination and communication challenges (RQ1), the degree to which the strategies described mitigate such challenges (RQ2), and how, ultimately, perceptions of engagement performance are affected (RQ3). We envision that our study findings will offer several implications for practice, listed by research question below.

RQ1. What is the influence of specific client factors (e.g., client size/structure, registrant status) and engagement characteristics (e.g., risk, complexity, statutory audit requirements) on the degree of coordination and communication challenges experienced in global group engagements? *Implications for practice –* By investigating the influence of client factors and engagement characteristics on the level of coordination and communication challenges experienced by component auditors, we will provide insights into the drivers of specific concerns raised by the IAASB Working Group on Group Audits (IAASB, 2015). Our results will highlight whether challenges are associated with specific client ownership structures, greater number of components, language/cultural barriers, and/or specific statutory audit pressures/requirements. We envision that our results will increase awareness in audit practice about circumstances that may be particularly susceptible to coordination and communication challenges in a group audit setting. As a result, we aid audit firms in becoming better equipped to properly identify and ultimately deal with such challenging situations.

RQ2. What coordination and communication strategies (i.e., modularization, tacit coordination,
and ongoing communication), help to mitigate challenges encountered?

Implications for practice – First, insights gained regarding the modularization strategy will inform audit firms and standard setters about the effectiveness of various quality control mechanisms, such as group audit partner supervision and direction, as experienced by the component auditor. Second, our exploration of the tacit coordination strategy from the perspective of component auditors will offer recommendations on the appropriate level of group auditor control over component auditor staffing and training. Third, our focus on ongoing communication strategies will inform practice on specific areas throughout the audit process where communication between group auditors and component auditors is problematic, an area which the IAASB has repeatedly raised concerns about (e.g., IAASB, 2013; 2015). In particular, identifying underlying reasons why these communication problems arise will benefit both audit firms’ and standard setters’ knowledge base, will potentially enhance the conduct of group audits through enriching the communication between group and component auditors, and may aid in the refinement of the applicable auditing standards (i.e., ISA 600).

RQ3. How are component auditors’ perceptions of engagement performance (e.g., audit efficiency and the quality of the work performed) ultimately affected by (a) client factors and engagement characteristics, (b) coordination and communication strategies, and (c) specific challenges?

Implications for practice – Despite the raised concerns over audit quality and auditor performance in the group audit setting (IAASB, 2014; IAASB, 2015), very little is known about the underlying factors that contribute to the observed decrease in audit quality when component auditors are relied on, or ways to mitigate such effects. Our study will provide insights into this “black box”, which will ultimately contribute to the conduct of high quality group audits.

In conclusion, our study will contribute to practice by identifying helpful mechanisms as well as barriers to achieving high audit quality in global group audits, which will result in practical recommendations to be used in practice. From an academic perspective, our study builds upon, complements and validates research findings by Downey and Bedard (2017), by considering aspects of group audits experienced and only observable to component auditors, rather than solely the perspective of the group auditor. Hence, the results of the study will allow us to compare and contrast these separate but interrelated parties regarding their experiences and perceptions of determinants and outcomes of group audit challenges.

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Notes

In the U.S., audit reports issued on or after June 30, 2017 are required to publicly disclose the name and location of component auditors performing five percent or more of the total audit hours. For component auditors performing less than five percent of the audit, the total number of firms involved and the aggregated percentage of work they perform are to be disclosed (PCAOB, 2015). Once required, these public disclosures will allow archival researchers to explore the impact of the component auditor location and proportion of the work allocated to foreign jurisdictions on audit quality (e.g., restatements and other proxies). However, these studies will only address questions pertaining to location of the audit labor and are unlikely to provide further insights into the audit process.
“Group audits should be a priority in research on audit quality” (Denise Hanes Downey).

Professor Hanes Downey opens the dialogue by asking the audience: who do they typically collaborate with when undertaking group audits. “Auditors inside or outside your network?” Research on which type of collaboration occurs more in group audits, is inconclusive. Of the two articles on this topic, one states that most group audits are conducted within the group’s own network, while the other article poses the opposite. One of the conference attendee’s answers: “It is not important to me whether the component auditor is part of my own organization or not, as long as we both apply the same rules and regulations and try to uphold the same level of quality. It is only a matter of efficiency, irrespective of whether it is in or outside the network, because we use the same tools for the reporting process”. A different attendee states that although technically it is not obligatory to involve a component auditor from the same organization, he thinks that the component auditors are often members of the group auditor’s own network.

In 2013, PCAOB inspection staff identified audit deficiencies in more than 40 percent of the inspected work performed by component auditors. Even though group audits are a top 4 inspection area discussed by IFIAR and PCAOB, only a handful of studies have investigated the processes within group audits. Furthermore, people are often aware of the constituency of group audits. “I was surprised to encounter many savvy business people and senior policy makers who are unaware of the fact that an audit report that is signed by a large US firm may be based, on the whole, on the work of affiliated firms with completely separate legal entities in other countries...”, said PCAOB Chairman Doty in 2011. One of the few studies on group audits was conducted by Ann Vanstraelen in 2017. This study concluded that the audit quality was lower for the Big 4 engagements involving components from within the network pre- and post-implementation of ISA 600 (Carson et al., 2017). The question as to what causes this lower audit quality is raised. According to Vanstraelen: “Lower audit quality could be caused by overreliance on the network. You assume that members of your network comply with the same quality standards as you and use the same manuals. However, this may not always be the case in practice. If you work with people outside of your network, you are probably a bit more skeptical and check things”.

Hanes Downey adds that component auditors are not passive followers. “Group audits are really a process of going back-and-forth between the auditors and the group leader. However, this is not always conveyed by the standards”. One of the conference participants shares anecdotal evidence of a group audit leader who always visits his component team auditors, irrespective if they originate from within or outside his network, or whether it is Australia or Italy. If there is a new component member, that group audit leader wants to meet them, shake their hand and look them in the eye. “Is this a good approach to enhancing audit quality?” Professor Hanes Downey replies that the importance of site visits is emphasized by the IAASB Working Group, in that such visits indeed may seem to have a positive impact on audit quality.

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