

A view from practice – What audit firm leaders expect from audit research and how they see their role in strengthening the bridge between practice and science

Presentations by Egbert Eeftink, Michael de Ridder, and Marco van der Vegte (all FAR Board members and audit firm Assurance leaders)

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1 Introduction

The eight largest audit firms in the Netherlands (Deloitte, EY, KPMG, PwC and Baker Tilly Berk, BDO, Grant Thornton and Mazars jointly) have taken the initiative to establish the Foundation for Auditing Research (FAR) by providing the necessary research funds and research data. Stichting Accountantsfondos has recently joined them. Affiliation with FAR is furthermore open for all audit firms and departments, both large and small, public audit firms as well as internal audit functions and government audit departments. With that, FAR provides for a unique collaboration between practice and science, strengthening the learning curve of the audit industry and its stakeholders, feeding accountancy education, and bolstering the accountancy research community in the Netherlands and abroad. The affiliated firms will arrange access to relevant audit firm data for well-defined research projects. Audit firms have agreed to open up the “black box” of the audit in order to make significant steps forward.

In return, what do audit firms expect from auditing research in general and of the FAR more specifically?

How do they define audit quality? Which conditions, determinants, and root causes do they deem important in driving audit quality in daily life? What are their main (research) questions? And how do they view their contribution in strengthening the bridge between practice and science in auditing? The heads of audit of three of the eight affiliated audit firms spoke during the FAR conference to share their view on the relevant research agenda: Egbert Eeftink, Michael de Ridder, and Marco van der Vegte (the latter also as part of the panel discussion as reflected elsewhere in this MAB issue), all three also being members of the FAR Board.

This article proceeds to cover these questions as follows. First in section 2, the view from practice on the need for and goals of FAR is detailed, followed by the role of the firms themselves in FAR’s objectives in section 3. Section 4 covers the firms’ view on how they see audit quality and section 5 the areas for research strengthening this quality. This article concludes with the audit practice’s expectations of the research community and FAR in section 6.

2 The need for FAR

The ultimate reason for establishing FAR was what in the Netherlands was called “Freaky Thursday” with the publication on September 25, 2014 of three important reports on the status and plans for improvement of the auditing profession. Michael de Ridder illustrates:

“The trusted auditor was no longer trusted. And that really struck at the heart of what makes us relevant. (...) But it was also the day when the accountancy profession really came to recognize the need for change. Never before had the intrinsic motivation been so powerful to work with full conviction on improving and strengthening our profession.”

It was the Working Group on the Future of the Profession (2014) proposing 53 measures to strengthen the audit profession. One was the establishment of the autonomous research institute that FAR now is. A number of other important steps have been taken since, amongst which the installation of external members in the supervisory boards of firms, changes in the remuneration policies to focus on quality, and the introduction of audit quality indicators. However, as Michael de Ridder continues: *“We have set a new course, but the road to change is still full of challenges. Embedding a quality- and learning-oriented culture will take time. It’s not just a switch that you can turn on or off.”*

The heads of audit support deepening of (root cause) analyses as well as putting academic rigor behind potentially effective interventions to improve audit process and audit quality, validating and expanding the audit quality indicators that really matter to better monitor and steer audit quality, and enriching the “story of the audit” geared towards better public understanding of the nature, extent, and value of the audit. In other words of Michael de Ridder: *“Getting to know the causes of mistakes and entering into real discussion on those causes – both internally and externally – aims to put an end to an approach that amounts to no more than treating the symptoms.”*

3 The role of the firms in auditing research

In the meantime the firms have held promise – FAR is established – but more importantly, firms are in good spirits to structurally contribute to auditing research by providing data and financial support. That is a distinct change compared to the last two decades. That relevance and rigor are two sides of the same coin, was not always recognized by both practice and the academia. Where academics said that researchers need access to new and better proprietary firm data on drivers of audit quality to take the research on audit quality to the next level (e.g., Knechel et al., 2013, pp. 405, 407)¹, practitioners did not always view existing research as being relevant and useful and gave little importance to research in developing auditing practices

and regulatory policies. To date, however, empirical audit quality research has been inherently limited as researchers have to rely on indirect measures of audit quality due to a lack of internal firm data (see the paper of Van Raak and Thürheimer in this issue of MAB). This lack of collaboration may be due to “the focus by practitioners on short-term problems rather than more fundamental and long-term issues, and the research incentives of academics to pursue topics that may not necessarily be of interest or relevance to practice” (Francis, 2011, p. 144).

Why is it that only now a research institute as FAR has been established? The Dutch firms also point the finger to themselves. Michael de Ridder:

“It is largely the fault of the audit industry itself that top-class research on the auditing process was discontinued in the nineteen-nineties due to a lack of data from the firms. That we, as the founding firms, really are serious this time, is clear from the fact that we are making our data available. That data is probably more important than the money that we are investing in FAR.”

Hence, FAR provides for a unique opportunity to reconcile these seemingly contradictory perspectives, boost collaboration between practice and science, and present a research agenda that is both relevant and rigorous. Challenges enough, of course, such as getting the right data in a reliable way within the boundaries of client confidentiality, personnel privacy, and firm liability risk management. But firms are committed and up for a well-intended effort to keep their promises to the academic community, their stakeholders, and to themselves. After all, it are the audit firms that are the first to reap fruits from FAR’s endeavors to improve audit practices.

4 What is audit quality?

Practitioners acknowledge the fact that there is no universally agreed definition of what audit quality is. Marco van der Vegte, however, presents a clear ambition for the auditing profession: *“Being the organizations and the profession that clients, regulators, the public, and talent hold up as a role model of quality, integrity, and positive change”*. The sheer challenge for audit firms to deliver a “high quality audit” is the question: high quality to whom? That even becomes more apparent at the level of the audit partners in whose personal judgement and decision making the different stakeholders’ perspectives come together and need to be weighted. Marco van der Vegte postulates what could be called a multi-stakeholder perspective on audit quality, from four stakeholder perspectives:

- From the perspective of the audit team and the audit firm: driving smarter and more effective audits, focusing attention on the areas that matter most. This includes, amongst other aspects, a deeper understanding of the client’s business, a targeted

response to risk assessment, and increased transparency through enhanced auditor reporting;

- From the perspective of the audit client and its supervisory board: a thorough process, without surprises, and meeting deadlines. I.e., a painless audit, with early identification and fast resolution of issues, at reasonable cost;
- From the perspective of the regulators: executing an audit performed in accordance with applicable standards and in compliance with law and regulation, and firms' management focusing on culture and behavior in driving audit quality; and
- From the perspective of the public: an audit as a role model for integrity and executing an audit that, unless indicated otherwise, confirms the going concern of a company and identifies all areas of non-compliance.

Egbert Eeftink concurs, but also notes that *“now more than ever, we as practitioners need to be able to articulate clearly and consistently what audit quality means to us as practitioners and to our stakeholders”*. He continues by saying: *“Even if we do not exactly know what audit quality is, we need a common language, we need audit quality indicators and we need an overall quality framework. This should help us talk about the right things, to monitor how we are doing, and to help us steer into the right direction.”* From a practical stance, he details four fundamental needs in driving audit quality:

- First of all, auditing contributes to the effective functioning of capital markets by reducing information risk. With the globalization of capital markets, auditing is increasingly an international service – *so we need a large degree of consistency in what we do*;
- Second, in an international setting, we communicate about audit quality across a widespread network organization, involving teams and audit clients in over 100 different countries – *so we need a common language when we talk about audit quality*;
- Third, even if we do not exactly know what audit quality is, we need to be able to monitor how we are doing and what we can do to steer and improve our performance – *so we need audit quality indicators*; and
- Fourth, to safeguard the quality of the complex service we provide, we need to be able to demonstrate how we do this. If not directly to investors or other stakeholders, then at least to our regulators on the basis of International Standard on Quality Control 1 (ISQC1) or its US-equivalent – *which means we need an overall audit quality control system*.

At the same time, Egbert Eeftink warns for what he appealingly calls the “fatal attraction” of audit quality indicators:

“There is currently a huge and diverse activity in this area; at standard setters, regulators and within audit firms. This is an important development and I see the potential in this area. But I am also somewhat concerned

about the fatal attraction it may have: we should not end up with an overload of audit quality indicators that may become a goal in itself.”

He points to outcome-based indicators that may be the easiest for monitoring of and reporting on audit performance. But what the profession needs are “smart” indicators on input and process factors to steer on the underlying elements of audit quality. Michael de Ridder underlines this need for better diagnoses, by saying: *“All too often we still find ourselves unable to say why defects remain in an audit. That can result in incorrect assumptions about what constitutes an appropriate intervention and/or what is required in a new piece of legislation or regulations”*. In other words, it is essential to gain a better understanding of the deeper-lying root causes. To start off with the question: what makes a root cause analysis an effective one?

5 Areas for research

FAR believes that audit quality can be studied from three perspectives, following the definition of audit quality by DeFond and Zhang (2014)²:

- Clients' control environments, reporting systems and innate characteristics: Firms are becoming increasingly complex, in terms of business models, systems of control, and how the audited firms' underlying economics are reflected in their financial statements;
- Audit firms' organizational settings and conditions for creating an organizational culture and architecture that increases the likelihood of audit staff achieving greater assurance and that strengthens incremental learning; and
- Stakeholders and environmental forces, which may include auditors' communication (effectiveness of auditors' reporting), audit quality from multiple stakeholder perspectives, the environmental context of the audit (e.g. in terms of audit industry and markets), and the external supervision and regulatory environment.

Hence, FAR's focus encompasses the entire financial reporting and assurance supply chain. FAR believes that research has the potential to identify those factors that influence audit quality in daily practice. More specifically potential interesting areas for research, as underscored by the heads of audit in their speeches, are:

- Audit inputs, such as audit team composition and interaction, the personal characteristics of audit partners and staff, their workload, and the knowledge, skills, and experience of auditors in relation to the complexity and context of the audits they are currently performing;
- The audit process of planning, collection, and interpretation of audit evidence, which may include risk assessment, audit methodologies and tools, the intrinsic quality of audit evidence, the nature, timing,

and extent of audit procedures, and time and budget (pressures);

- Auditors' intentions and behaviors, such as judgment and decision making, professional skepticism, partner involvement throughout the audit, dysfunctional auditor behavior, and auditor-client negotiations regarding audit findings;
- Audit outcomes, which may include communication, such as the usefulness of audit reporting and the economic consequences of audit outcomes;
- Audit firm organization, governance, and culture, which may include governance structures, benefit schemes, quality control systems and indicators, firm and team culture, and the roles of firm networks.

Moreover, practitioners call for a comprehensive view on the auditing practice, rather than singling out and looking at certain elements in isolation, modelling out other variables that may impact the phenomenon of study. Egbert Eeftink, in this regard, sees auditing as a ball game "*which needs to take place in a field with at least three (and perhaps more) boundaries*". In his view, these are:

1. the boundary of functionally appropriate performance – i.e. audit quality and audit relevance (or audit value);
2. the boundary of viable economics – this is where production efficiency comes in; and
3. the boundary of an acceptable HR workload, including talent attraction and development – this includes the attractiveness of auditing for the next generation.

He continues: "*So I ask myself: should audit research focus on one of the boundaries of the field separately, such as audit quality or efficiency? Or should audit research try to look at the field more widely, and try to understand how and due to which forces the ball moves between the different boundaries?*"

In other words, academics are invited to contribute to the demystification of the auditing profession with clients, stakeholders, and the public at large. As was noted by Michael de Ridder: "*The tragedy of our profession is that our hard work takes place – for the most part – out of sight of the public*".

6 Expectations of FAR and the research community

One of the tasks of FAR is to make current academic knowledge and new findings from FAR commissioned research accessible for professionals, standard-setters, legislators, regulators, and other stakeholders. All affiliated audit firms hope to continue strengthening the bridge between science and practice by proactive interaction through conference, round-table discussions, master classes, and above all, intensive collaboration on the research projects FAR wishes to commission. Through that, the firms believe the Dutch profession to lead the way internationally. Expectations from practice on the contribution of FAR and the research community are thus high, as Michael de Ridder summarizes:

"Our intentions are good, but we need research for the next step. Quite simply because you researchers can strengthen and improve our profession. Because you provide us and our stakeholders with the independent observations needed for an honest and factual discussion. What we want are facts!"

And why wouldn't research surprise, or even confuse audit practitioners? That may really add to breakthrough changes in the profession. Is the profession prepared to embrace research outcomes that undermine generally held assumptions and paradigms on which the current audit practice is built? That the Dutch audit firms are open for the challenge, is clear from a closing remark of Egbert Eeftink:

"I think FAR can bridge different scientific disciplines to ensure we are looking at audit quality from different functional angles. (...) If we do not learn, we lose our relevance and become obsolete. Research by distinguished academics can help lift our beautiful profession, provide us with better insights into how we work and how we learn. And be a better and a proud auditor." ■

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Notes

■ Knechel et al. (2013, p. 404), for example, note: "Archival research related to inputs and processes requires access to proprietary data in the possession of the insiders, while experimental, survey, and qualitative research requires access to insiders within the audit process (audit teams, management, and inspectors)."

■ "We define high audit quality as greater assurance of high financial reporting quality. (...) [i.e.,] greater assurance that the financial statements faithfully reflect the [audited] firm's underlying economics, conditioned on its financial reporting system and innate characteristics" (DeFond & Zhang, 2014, pp. 275-276). This definition "reflects audit quality's continu-

ous nature, encompasses the auditor's broad responsibilities, and recognizes audit quality as a component of financial reporting quality that is bounded by the [audited] firm's reporting system and innate characteristics" (DeFond & Zhang, 2014, p. 313).

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