

# Panel discussion: A multi-stakeholder perspective on audit quality and audit research

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On May 9, 2016, the first day of the FAR conference, a panel discussion was chaired by professor Henriëtte Prast (Chair of the FAR Board). Four stakeholders - an audit practitioner, an academic, a non-executive director, and an audit regulator - presented and discussed their thoughts about the following issues

- how to improve audit quality,
- the importance of collaboration between academics and practitioners (and the role of FAR therein),
- the oversight and regulatory climate, and
- the stakeholder expectations of auditors.

Participants welcomed the opportunity to discuss these issues with Marco van der Vegte (Head of Audit of Deloitte the Netherlands and FAR Board member), Barbara Major (on behalf of Authority Financial Markets (AFM, the Dutch auditor oversight body), Jan Nooitgedagt (non-executive director), and Marleen Willekens (audit researcher at the University of Leuven). In the following narrative report the interactive debate on a multi-stakeholder perspective on audit quality and audit research is presented.

**Marco van der Vegte**, partner at Deloitte and member of the FAR Board.

*Q: What do you expect from FAR as the “love baby” of the audit industry and academics?*

I have high expectations because a good relation between the profession and the academic world can really add value. In this respect I would like to share some thoughts about what encompasses audit quality from the following four perspectives:

1. audit team and audit firm;
2. audit client and the supervisory board;
3. the regulator;
4. the public.

In my view we need a broader concept of audit quality also encompassing the audit process and users' expe-

riences instead of a narrow compliance quality perspective. This is important because the quality of our work is at the core of our existence and determines our societal relevance. Audit quality is affected by audit firms, the profession, audit clients, the regulators, the public and our employees not to forget. Being a role model of quality, integrity and being able to positively adopt to change is key. It is also important that auditors recognize relevant matters and take the opportunity to make an impact and create what I would call an exceptional experience. The moment that “matters” could be an event or irregularity at the client where the auditor steps up, informs the supervisory board and if needed the regulator and public at large.

In other words, a relevant characteristic of audit quality is “a unique client experience”. If we agree that an audit is a process or a project, unique client experiences should be of a consistent high level as quality should be consistent. We should also recognize that culture and behavior are the primary drivers of audit quality improvements. In this respect I emphasize that rewarding people who deliver consistently high quality positively, is a basic fundament for enhancing audit quality.

The following issues are relevant from a quality perspective for both audit firm and team:

- assessing the culture as audit firm;
- a portfolio analysis of business risks of the audit firm;
- a deep understanding of clients' business;
- targeted response to risk assessment;
- identify and act on moments that matter most;
- demonstrate professional skepticism;
- increased transparency for example by including Key Audit Matters in the auditor's report. But as an audit firm we have to consider how to further increase transparency on what we have been doing and how we integrate technology and analytics in the audit process;
- finally, how we can provide a meaningful experience for talent and at the same time organize good team spirit and effort.

If we look from an audit client and supervisory board perspective, quality encompasses a thorough audit process, no surprises and meeting deadlines. But quality also means that firm and auditor are able to deliver valuable insights and also use latest technology. Someone who is able to early identify issues and offers solutions at reasonable costs. The question is if clients are interested in the findings of inspections by regulators. Based upon US and UK experiences, it is still unclear whether the supervisory boards will choose a specific audit firm based on findings of inspections by regulators. There are also clients that just want a painless process, a smooth audit and nothing more.

My observation is that regulators assess firm culture and behavior as drivers of audit quality but at the same moment test compliance of the audit process with the applicable auditing standards, relevant laws and regulation.

Finally, audit quality from the perspective of the public. They see an audit firm as a role model for integrity, objectivity and executing audits that, unless indicated otherwise, confirms the going concern of the company and identifies all areas of non-compliance.

*Q: Culture is something relatively static, it slowly changes over time. However, the audit sector nowadays acknowledges that culture is important and has to change. You have people in business for longer periods of time who are part of the culture. Don't you need new influx if you want to change culture in your firm?*

It starts with realizing that we are a regulated business. Having that recognition starts with our own management and supervisory boards. We should be aware that, being a regulated profession, we have to meet the expectations of the public and that we had to change our mindset in the last couple of years of what we believe is quality. Our audit partners and external auditors have to realize again that audit quality really matters and drives our performance and remuneration. Therefore we have to be sure that a balanced set of performance measures is in place. The bar for audit partners has been raised in recent years and some of them were not able to meet this bar left the firm. Changing the tone of our accountants is more difficult than changing the tone of a new student. You need new students who are capable to change the culture of the firm. The influx of the last three to four years already has a totally different background than people that are in for twenty years. That is a change in itself. Involving young people with six to eight years of experience in your audit quality program has a great impact.

*Q: Do you think something has to change in the curriculum of the students who want to become auditors to enable them to contribute to a cultural change?*

What can help improving culture - and there is already a lot of effort taken there - is for example team building and looking for new ways to set the tone of audit staff. We can positively influence mindsets at university as well as at firm level. However, compared with twenty years ago, the mindset is probably not that different. In my view the impact of regulators, media as well as of the public changed significantly partly caused by audit failures.

The second speaker is **Barbara Majoor**. Barbara is professor at Nyenrode University. She has been partner at KPMG and Deloitte and is currently working with the AFM, which is the Auditors Oversight Body in the Netherlands.

I would like to share some thoughts about audit quality from the perspective of the regulator. A regulator in fact defines audit quality as having sufficient appropriate audit evidence to justify the audit opinion. In the Netherlands we apply a relatively simple system. An audit file could have sufficient audit evidence or insufficient audit evidence. In the past (2014) the publication of our inspection report confirmed the need for improvement of audit quality. The establishment of FAR is one of the measures taken by the profession. We think a thoroughly root cause analyses is of great importance. Researchers could help us to develop methods to perform such analyses systematically to understand the real drivers for audit quality.

I will share some further thoughts about audit quality from a regulatory perspective. The quality of the audit is depending on the view and perception of other important stakeholders like investors and audit committees as well. This is an important area for further research. We think that one of the important drivers is the culture within an audit firm as culture can shape individual behavior. Behavior of partners, staff and other employees determine audit firm culture. We think that the introduction of new governance measures within audit firms will improve audit quality. In the Netherlands all big audit firms already introduced supervisory boards to monitor the board, having a specific role in driving audit quality. Last but not least, the expertise and experience of the individuals (partner, staff etc.) drive audit quality. In other words, knowledge and competence of the partner, culture-oriented factors like leadership and team composition contribute to audit quality. Culture also embraces softer capabilities that affect audit quality, such as the system of evaluation, appraisal and remuneration of individ-

uals. And of course audit quality is supported by up to date auditing standards and methodology. It won't surprise that the oversight strategy of the Dutch regulator focuses on inspection of audit files but also on monitoring culture, behavior and whether firms are implementing improvement measures to maintain and strengthen audit quality. In our regulatory system we use both instruments and they should interact in our strive to improve audit quality.

*Q: Given the fact that your employer (regulator) has concluded that several audits did not meet standards, does that mean that auditors lack expertise and competence? Other question, when talking about culture, rewards and good behavior, do you suggest that there should not be focus on intrinsic motivation but good behavior should be triggered by external incentives like money?*

We don't believe that, if an audit file is not up to standards, the root cause is always pointing towards a lack of competence. Auditors could have the right competences but they were not or incorrectly applied in a specific audit. There could be other "root causes" like time pressure, unbalanced team composition, teams not being challenged enough, etc. As mentioned before, academic research could help understanding this kind of root causes and drivers of audit quality.

Regarding your second question, we believe that in the end auditors are most of the time motivated to do a good audit but you can help them in shaping their behavior. We would be happy if all auditors were intrinsically motivated to deliver high quality but we have to be realistic as we don't live in an ideal world.

**Jan Nooitgedagt** is former CFO of Aegon NV and is currently member of several supervisory boards and audit committees. He has been an auditor in public practice for thirty years.

*Q: I was just wondering, what went wrong the last 20 years?*

Your question reminds me of an experience in my early years as junior staff member. A senior partner visited one of our clients in a bad financial condition and said to the director that his car was too big and too expensive. He said if you don't change your car, I don't want to audit the financial statements anymore. That kind of behavior created a memorable impression. The partner was able to say what you probably, can't say to a company director anymore. I think something went wrong over the last 20 years. The FAR should research the reasons thereto.

I have a couple of statements to share with you that could give some further insights. One of my observations as auditor and board member is that the profes-

sion should be more proud of the services being offered. The audit profession is key for all stakeholders, including investors, regulators, board members and so on. I really appreciated my auditor when I was CFO who told me what went well and what went wrong anywhere in the world. And don't forget, information from the business units upwards is always filtered as they want to please you as they depend upon you. I became more aware of the importance of the auditor's role after leaving the profession. Again, we have to restore the trust of all stakeholders.

One of my concerns is that I feel, and I might be wrong, that there have not been major developments in audit techniques, methods, software. Recently a US colleague told me that the whole audit profession can be automated. I have not seen it yet, but it would not surprise me if at least testing and checking would become fully automated processes. But of course a lot has changed in a positive way. In my view audit firm rotation is a positive development, the extended auditor's opinion will add value and also the role of the auditor in shareholders meetings is improving and adding value. These have been positive changes, but as said before changes in audit techniques have been insufficient. I also feel that auditors should more and more challenge the board and discuss techniques, risk assessment and controls. In this respect I would welcome research into the quality of discussions between auditors and boards as a very relevant research topic.

Already from the early days of the profession, the big issue is that the auditor will be paid by the auditee. I know it's still true but I don't hope that it will ever change. I don't see a net positive effect if a supranational government body will decide who will be the auditor and pay the bill. But given the size of the big 4 and opportunities for growth, you have to ask yourself: is the audit the core product or is it a by-product? I think this question should be central in future discussions. Do we really need to have audit-only firms? I think that won't be easy as consultancy services are in general much more profitable than audits. I remember in my time as Chair of the Board of EY we had to fight to keep our large financial audit clients because we could sell a lot of consultancy services instead. In my view, audit should be at least the key product of the audit firms including the big four. It won't surprise but you as researchers could also help answering this important question.

*Q: You just shared that your children don't want to become an auditor. Could you tell us what were their main objections?*

They probably haven't seen their father that much. Being an auditor is a tough job. You have to work also

during weekends. I remember we were not allowed to go skiing between January and May. Lot of young people want to go skiing and spend their time alternatively. Another reason could be that accountancy is probably not that sexy anymore.

*Q: You were saying that your experience is that there was some pressure on doing other things like consultancy instead of audit services. At least in the minds of the employees this could make audits less interesting. Could that also affect the culture of the firm?*

In my experience it is very difficult to have different disciplines who have different business models and profit profiles. It is almost impossible that one discipline is twice as profitable as other disciplines. In the end people don't want to share profits or losses with each other. What is helping is that the audit is becoming more profitable again. I hope that auditors will be as profitable again as other services being offered. If not, than it will become difficult for firm leadership to keep all professionals satisfied.

**Marleen Willekens** is professor of accounting and auditing at the University of Leuven.

I would like to reflect on audit quality and the link between practice and academia. When I was preparing for this talk some issues came up in my mind. First what is audit quality but also what have we learned, what do we not know about audit quality. There is a lot we do not know but a lot has been discussed already today [and reflected in this MAB issue]. One of the reasons we lack understanding, is that a lot of relevant data are not available for researchers. There are probably other reasons too. In this respect I would like to ask our colleagues here why regulators are not always interested in what we find in audit research. I remember for example the EU Green Paper<sup>1</sup> about the audit profession that included rather extreme statements that were not really backed up by available research findings. What can we do about this?

Over the years I have felt that a lot of the people in practice are also not that interested in what we study. I can actually understand that to a large extent, but why is practice than not using us more often? We are free and independent researchers. We can tell you things about your organization if we get the right data. Why has that not happened in the past? I am sure there is an explanation for all that we could talk about together.

Now, let us go back to the concept of audit quality. There are a number of audit quality frameworks out there. Basically if we look into the audit quality framework of the International Auditing and Assurance Standards Board (IAASB), it says that input is import-

ant, output is important, there is context and there is also interaction between the stakeholders involved.

When we zoom in on inputs and outputs, what they also say in that framework is that there are different levels that matter. The auditors level, the engagement, the audit firm, national level, or office level and I can even think of more levels. We have to take the level into account as researchers. To link this to research we are going to look at all these elements at the different levels that have been specified in the framework. That means that we need data on that and in general terms the data that could be used are available within the firms. Data about engagements teams, background of team members, independence codes, how competencies are stimulated, education. But also on firm level, what is the governance structure, quality control systems and so on.

When we look at the input level, we don't know much because of lack of data. We know more about the output because more information is available in the public domain, like audit reporting, earnings quality but also transparency reports. Here we have done a lot more academic work. Now moving on, if we want to open the audit firm black box, what relevant questions could we try to answer? One question is 'what is the effect of the variable audit firm level control and quality mechanisms on the quality of audit engagements?' Another question we could address is about human resource practices of different audit firms and how to link that to style elements as recognized in prior archival work. Another question is how audit team composition affects audit quality. Most current research studies still have an implicit audit firm constant quality assumption. We can investigate the impact of such characteristics on audit quality in future research.

I also think that the incremental effect of auditing on the quality of financial information is something that we haven't explored a lot because relevant data about the audit and its effect on the financial statements is not available up to now. If this data is made available to academics, the incremental effect could be studied as well as how the primary attributes of an audit effect the various indicators that have been specified in the frameworks. So getting more data about attributes like audit methodology and audit process steps.

We have seen in several studies that "one size does not fit all". In the study we presented earlier today [as included in the paper of Nolder and Duiverman in this MAB issue] we had different types of clients in our sample.

Different stakeholders had different expectations and different types of organizations may value audit quality differently. We still know very little about this kind of differences.

Finally, a lot of interesting experimental work in auditing research is already available that have looked at judgmental issues. What we could label archival judgment research and actually based on working papers and information that we get from audit firms, validate some or several of these studies and see whether those results that have been obtained from experimental studies are actually holding when we are doing them again with archival data. This was in a nutshell what I wanted to share with you and let's hope that we make progress here together.

### Further questions

*Q. Is it hard for audit committees to assess audit quality and what can be done to improve that?*

Jan Nooitgedagt: Most audit committee members are not auditors by education. They don't exactly know what audit techniques are and how an audit is performed. It all starts with risk assessment of the company, what you do internally as audit committee and what the auditor is doing, comparing that and having discussions about the main issues and the audit approach. But there are huge differences in audit committees in understanding of what auditors exactly do and of what methods and techniques auditors apply.

Barbara Majoor: It is hard for audit committees to really understand the audit process of gathering audit evidence. What kind of techniques the team is applying, how they assess the information and how they draw their conclusions is difficult to understand. In my view audit quality indicators can help to solve this problem. Further research should make clear which indicators are linked to audit quality in practice.

*Q. Why are regulators not so much interested in research and why didn't they do more with research results?*

Barbara Majoor: A regulator has to deal with many stakeholders, politicians for example. I think regulators don't always have time to take research into account, because in case of incidents politicians want to respond very quickly by taking measures. It would be great if research could help to evaluate incidents including taking measures.

*Q. The focus of the audit are the financial statements but more than once a client said that there is much more next to the financial statements. Audits could help to improve clients internal control system as well. For academics it may be an important question: what is the value of an audit?*

Marleen Willekens: The added value of the audit is much more than just checking the financial state-

ments. What comes out of the process can lead to recommendations that may improve various systems but also other suggestions. I also think that this is very much dependent of the type of organization you are auditing.

Marco van der Vegte: There are a lot of things that come with the audit like for example we do culture assessment at clients. As part of understanding the tone-at-the-top, which is also a key driver for a company for their own quality. What's their tone at the top and what drives the mentality and the mindset of a company? We do culture assessments as part of the audit. So I can give numerous examples of things we do in an audit that are not visible to the public but which can also sell the audit as a service much better.

Jan Nooitgedagt: I must admit that nobody is talking about audit quality during the selection process of a new auditor. That is an interesting research question, why is the selection of an auditor not based on audit quality?

*Q: what is the role of audit clients in this regard? Why don't audit committees understand what the auditor really does? Is this because the auditor and the company don't talk about the engagement at all or is this completely dealt with by the CFO, instead of the audit committee?*

Jan Nooitgedagt: The latest development is that we need persons with a finance background in an audit committee but I also see more and more people like myself with an audit background. I think that there is a difference if you do or don't understand the language of an auditor. I don't believe that it is a lack of communication any more, the auditor is always attending the meetings of audit committees. The issue is that the discussions become more and more technical and difficult to follow for non-auditors.

Marco van der Vegte: What we have been seeing is that auditors were extremely busy with the team to make sure that they were compliant with the standards to be tested by peers and by regulators. Now we see improvements, it is time again to think about what is the value of the audit. For example, I had a session last week for two days with professionals from ten countries to do role plays from the perspectives of the audit committee, the CEO, the controller and others versus the audit team. We concluded there are some communication issues. For example, we concluded that our assumption that the CEO does not have time for us and is less interested because we are irrelevant to him is incorrect. In the end the CEO also wants to talk to the auditor. Playing these role games can help understand our stakeholders in such a way that we as auditors can

become proud and enthusiastic again and regain public trust.

*Q: we talk a lot about the supply side of auditing how to improve audit quality but I think that the question is on the demand side of audit quality. What are the demand side issues and where is the demand for audit quality coming from? Who is the customer for audit quality?*

Jan Nooitgedagt: We have to admit that if we wouldn't have the oversight body of accountants (AFM) I don't know if we would have discussed this topic this serious today.

Marco van der Vegte: That is also a difference if we look at how we are being regulated in the Netherlands and in the US versus countries very close nearby. The mindset is really different. The openness and the discussions that we have here are different from those when I talk to my component auditors in Germany. For example because they do have a different mindset on what is audit quality and what drives audit quality.

*Q: do you think that investors in other countries care about audit quality?*

Marco van der Vegte: I am sure they care about audit quality. In the end they want assurance that the financial statements are free of material misstatements.

Jan Nooitgedagt: I have to disappoint you here. I did many road shows in my role as CFO but nobody ever asked me about the auditors' opinion.

Barbara Majoor: I think when everything is going well nobody talks about audit quality while in case of an incident everybody will be talking about audit quality and asking for further regulation and oversight. Interest for audit quality is always there.

Marleen Willekens: Actually you could reverse that; if everybody talks about it, why would we need a regulator if everybody asks for it?

Barbara Majoor: If we go back in history, the consequence of some of the incidents is that people ask for institutional measures like independent oversight.

Jan Nooitgedagt: I think that researchers should try to answer this question.

Closing remarks by Henriëtte Prast: I've seen a lot of the research on audit quality and the regulator's perspective on audit quality seems to adopt the view that each additional hour spend on an audit can contribute equally to audit quality. And I hear that the point that was made earlier; why should regulators care about audit inefficiency? However, we should recognize that a lot of profitability that we see from audits today have been realized on the back of junior auditors who have been asked to work extensive hours. My own anecdotal data as a professor is that my best and brightest students are no longer attracted to the profession because of the incredible demands. They say they don't want to be an auditor because in today's world the busy season lasts for 12 months a year. They want to join a CPA firm but they want to work in the consulting branch of the CPA firm. I think this has a direct impact on audit quality but I don't have the research to support it but I think further studies that assess the human factor and how the human factor can contribute to audit quality are welcome. All panelists confirm the need to pay attention to this issue and expect FAR to support this kind of studies. ■

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## Notes

■ See special issue of MAB, 86(5), 2012.