FARview Podcast Series, written report: #6 Ganesh Krishnamoorthy

Audit committee involvement and audit quality

In the FARview Podcast Series, FAR staff members conduct interviews with academics and professionals regarding the practical relevance of academic research in the field of auditing. This written report contains an edited transcript of the interview.

Ganesh Krishnamoorthy is a full professor at the accounting department of the D'Amore-McKim School of Business at Northeastern University in Boston, where he also acts as the Accounting Group Chair. Most of his research interest in the past 20 years has been in the area of corporate governance, and more specifically on the role of audit committees, auditors, management and key players in assuring the highest quality financial reports are provided to the capital markets and to other stakeholders.

Key points
- The purpose of this project is looking at the *determinants* of audit committee involvement in the external audit quality and importantly at the *impact* of the involvement on final audit quality.
- This requires studying 'soft' concepts like culture, leadership, trust and cohesion.
- It is not only hard to measure these concepts, but it is also hard to gather data. How do you get access to audit committee members to tell you about what really happens within an audit committee room? This will be the real challenge.
- The fulfillment of the expectations is dependent on how much data comes through from audit firms, audit committees and other stakeholders.

There is a lot of variability in audit committee characteristics and their effectiveness. The overall impression is that audit committees are doing a good job and that they are improving over time. An important remaining question is what really drives audit committee involvement in determining audit quality. Therefore, with his project team members, in this FAR-study, Ganesh Krishnamoorthy is looking at the *determinants* of audit committee involvement in the external audit quality and importantly at the *impact* of the involvement on final audit quality.[1] What is the state of affairs?

Ganesh, you and your research team just finished writing up a literature review and practice note on your FAR-project. Could you elaborate a bit more on the approach of your project?
'Our approach is that financial reporting quality and audit quality are the result of a team effort, with many players in the governance mosaic. One player is management, which is primarily responsible for preparing the financial statements. Furthermore, players are also those charged with oversight of the financial reporting and audit process, which are largely, but not exclusively, the auditors and the audit committee. We want to improve our understanding of how the audit committee, management

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[1] In addition to Ganesh Krishnamoorthy, the FAR project team members include Rogier Deumes, Sanne Janssen, Mathijs van Peteghem, Caren Schelleman, Ulrike Thuerheimer and Ann Vanstraelen.

(particularly the CFO) and the external auditors interact. How does this lead to the objective of having the highest quality audit that the capital markets demand and deserve? One thing unique to our project is the approach. Practitioners will understand the importance of having a holistic, more broad-based approach.'

What makes the approach unique?
'The first unique aspect is the notion that we look at audit quality as an interplay between multiple players, as just mentioned. The second aspect of our approach is that we try to delve into the substance of a lot of regulations and practices that are in place. I would like to give two examples. One is the notion of independence. Most places around the world have a requirement for all audit committee members to be independent. You can be independent in form, but that is different from having an independent mindset. For example, are you independent in questioning management when they need to be confronted? That is independence in substance. Form and substance might differ. The other example I would like to give is power. Most audit committees have power on paper, bestowed on them by the board and regulatory authorities, such as the SEC in the US. The question is whether audit committees exercise this power in reality. We hope that we really can go 'under the hood' regarding these issues. The third strength of our study is the multi-method approach. We believe that going beyond the archival, data-driven approach from public sources, and focus on soft behavioral components, will enhance the quality of the study and what we can learn. Last and not least, we want to go into the 'black box' of the audit committee. Our focus is on the process that takes place within the audit committees and on the interactions with the auditor. This is an overview of what we are trying to accomplish, which may be overly ambitious.'

A lot of issues remain understudied because of limited data availability. How are your research methods geared towards this?
'Most of the studies have used publicly available data, which is partly caused by potential litigation exposure of using private data. For example, there is a lot of data on the demographics of audit committee members and on audit committee composition, independence and expertise. That data is important, but how does all that come into play when the audit committee and the auditor interact? How does that impact the audit process and the audit quality? So, we need the archival data to be supplemented with interview and survey data from audit committee members and audit firm personnel. Here, the support from FAR is really critical.'

The data all come from the Netherlands. How is that representative for the rest of the world?
'Most of the research on audit committees is currently in the US-context. One could argue that, as long there is not going to be a worldwide effort to bring all of the data together, there are going to be institutional settings that will be different. Clearly, what we find will need to be interpreted with caution, when we are trying to extrapolate to other places. But that limitation holds not just for Dutch data. It is a general inherent limitation. In order to interpret Dutch data, it is important to ask: to what extent is the institutional setting similar to other countries? For example, the Dutch institutional

environment in which corporations and capital markets operate, in many ways is similar to many of the Western European and US-markets. Taking that as an assumption, the conclusions we may draw might be of value to audiences in other places. But it is important to be careful when interpreting data.'

Your research is also focused on so-called 'soft components' and informal procedures of the audit process. Could you give an example?
'For example, if you want to count the number of audit committee members who have financial expertise, you might be able to define financial expertise as people who have an accounting background or have been a CFO. Using that definition, you can parse through publicly available data and count how many people have financial expertise, and what type of expertise that is. However, soft components are more behavioral. So, for example, when you talk about culture, there is no hard set of data. It is sometimes hard to address how audit committee members work together. That is related to culture and to how cohesive the audit committee is. Like in audits, some teams are super functional, while other teams are very dysfunctional, where people just can't stand each other. Part of this is due the organizational culture. That is an example of a soft component. Another example is leadership. What kind of leader makes a good audit committee chair? That is hard to get your arms around. It has been difficult to study these important topics. If it would have been easy, it would have been done before. So, it is hard to measure these concepts, but maybe a bigger problem is the availability of the data. How do you get access to audit committee members to tell you about what really happens within an audit committee room? We will need to go to that level. This will be the real challenge.'

How are you going to define clear definitions and the variables that you will be using for the soft components?
'Auditors are not the first to think about, for example, cohesion or leadership. There are disciplines which are fundamentally better situated to understand how to define these constructs and measurement, like psychology and sociology. We draw on these mother disciplines when finding ways to define and measure our variables. In some instances, we want to be careful about not providing a definition, especially when there are multiple definitions. One has to be careful about not providing a definition which might in fact impose one on the respondent, and bias their response. This is a tight rope to walk. We would like, for example, the participants to essentially answer the question of trust. Trust is a concept that, even though people can have different interpretations, generally people understand how much they can rely on another person's statement or rely on what another party is telling.'

How do you measure trust, for example?
'In behavioral research, we use various types of scales. Regarding trust, a question to an audit committee member might be: 'what is the level of trust between the external auditor and the audit committee?' The response scale could be an interval type of scale, where the two anchors are 'very low' and 'very high' and a 'don't know' or 'doesn't apply' option. In many instances, you have to be able to get a measure. If the underlying

definition of trust is different across participants, or their response is not being captured adequately by the scale, one way in which we will know about that is by a huge variance in the responses. When there is a lot of 'noise' in the data, that noise will manifest itself in a huge variability. We also use open-ended questions. For example, we could ask an audit committee member: 'what does trust mean to you?' In behavioral research, typically we don't want to impose definitions on the participants. In the pilot phase, we learn from the data and we can refine our questions if open-ended answers on what trust means to them differs from what we intended to.

Another component is cohesion. Unlike trust, people might think what is actually meant by it. We ask there 'to what extent does the audit committee act as one group?' Our notion of asking for cohesion is how do you feel about acting in unison, as one group? As opposed to asking: 'to what extent do you think the audit committee is cohesive?' In that case, you might get responses all over the place. Not because they don't know whether or not the audit committee is cohesive, but because they don't really understand what cohesion is referring to.

There is always this difficult line. What we are trying to do is to figure out where we can draw on the literature and provide some guidance on what the construct is. In other instances, where the construct is more apparent to most people, we make the judgment of asking them for it. And perhaps, get some markers through our qualitative data to make sure that we are not off the mark.'

This summarizes where the project is at this point in time. What are the steps that will be taken in the near future?
'We are still in the very initial stages of gathering data. We haven't really done any analysis, yet. This is one of those projects with lofty goals, with very ambitious expectations. The fulfillment of the expectations is dependent on how much data comes through from audit firms, audit committees and other stakeholders. At this point, we are still working with FAR and the firms to see how we can best get the data. We are thankful to FAR, firms and audit committees for working with us. But it is a hard nut to crack. We are cautiously optimistic and hopeful that we will see the data and start to work on what the data is telling us.'

For more information concerning the project, please refer to:
https://foundationforauditingresearch.org/en/news/far-literature-review-practice-note-audit-committee-involvement-and-audit-quality/

The Foundation for Auditing Research (FAR) is an autonomous research institute that is focused on developing and disseminating scientific knowledge concerning audit quality. FAR pursues these objectives by facilitating relevant and rigorous academic audit research via collaboration between academia and audit practice.