Jere Francis: ‘Auditors are not really what people think they are’

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Jere Francis previously worked at several universities in the US and in Australia. Most of his career Francis spent as a professor at the University of Missouri-Columbia. He also worked as an accountant at Haskins and Sells, a legacy firm of Deloitte. His research interests lie in the area of auditing, financial reporting and international accounting. His academic papers have been cited over 25000 times. Recently, Francis started his position as the Foundation for Auditing Research Chair at Maastricht University.

As a knowledgeable non-European, the American professor Jere Francis can provide a relatively objective view on the current developments in the field of auditing in The Netherlands: ‘I think, that if there is a structural deficit, it is not in the organizational aspect of the audit firms, rather than in the limits of the investigative tools of the auditors’.

You’ve been visiting The Netherlands for about 25 years now. In what sense do you think the auditing profession in The Netherlands is unique?
‘I have always felt that The Netherlands was very advanced in the way it regulates the auditing profession. The Netherlands was also one of the first countries the PCAOB felt comfortable relying on the local inspection process. What also makes the Dutch unique, and which always struck me, is the number of high-leveled practitioners who are invited to research conferences and who are interactive participants in the conferences. There is a tradition of close interaction in the Netherlands between the accounting profession and universities. This is reflected in the Foundation for Auditing Research (FAR), and it was important in my decision to take up the FAR chair.’

The Dutch committee on the future of the accountancy-sector (the ‘CTA’) has recently released an interim discussion report. What are your thoughts on the report?
‘The overall tone is positive and productive. The committee appears to be sharp and objective. The report is not proposing any radical interventions. It recognizes that an audit will never be perfect. There will always remain corporate failures and frauds that go undetected by the auditor. An auditor increases the likelihood that there is no material misstatement present, but an audit doesn’t guarantee it. Auditors are not really what people think they are. It is amazing that even highly knowledgeable company officers naively think that an unqualified audit report means that the financial statements are correct. There is still an expectation gap.’

So that gap isn’t justified?
‘Allow me a comparison. The mortality rate in surgical procedures is surprisingly high, depending on the surgery. In some medical areas the mortality rate is as high as 25 percent and it averages around 5 to 10 percent. So that is a lot higher than you would think. The question is whether the death of a patient during surgery is the surgeon’s fault. Typically, we don’t sue doctors when somebody dies in surgery. Now compare this to the ‘mortality rate’ in auditing, which expresses the fraction of audits where the auditor fails to uncover a material fraud. This rate is quite low as can be concluded on the basis of available data. My colleague, UM-researcher Patrick Vorst collected SEC data of companies that were investigated by the SEC and that were judged to be engaged in earnings manipulation misreporting. Misreporting happens in less than a half percent of the observations. The point is that corporate

misreporting that goes undetected by the auditor is really low. This begs the question how much we should invest in building a better model of the audit. It is extremely likely in an audit that there is no malfeasance. And often it is not the auditor's fault that a company commits a fraud. For the companies that are sanctioned by the SEC for misreporting, the auditor is only co-blamed in half of the cases. The interpretation is that in 50 percent of the cases an auditor is not to blame to have missed the problem. Fraud mostly begins with the corporate governance and the management of the company.'

So, you do have some suggestions for the committee?
'Well, no and yes. In the CTA report, I liked the fact that when 'incidents' come up -which is a nice euphemism- that we should learn from them. Are there structural issues involved? That is a very good point. When auditors uncover a problem, after the fact, but particularly in real-time, there ought to be a way for the information to be shared within the profession, so that the profession can learn. What causes these events to happen within clients and how can we learn from them to audit better? We should not be primarily interested in *who* caused the problems, but in whether there were structural or systemic issues that need to be fixed. A good example of this occurs in the National Transportation Safety Board in the US, which analyzes major accidents for systemic problems. In auditing, we don't do that, because auditors are reluctant to share information about mistakes or perceived mistakes. If we would do that we could build a database that can be used by practitioners and researchers to build better audit models and methodology. Moreover, even within an audit firm, auditors are reluctant to share this kind of information. So, even the firms have a rather impoverished knowledge of the fraud process. We need to learn more from the frauds. These are not caused by structural defects within the audit firm, which seems to be recognized in the CTA report, it is more a case of auditors having limited skills in detecting financial misreporting. I would argue that the problem has more to do with a defect within the auditor's investigative technology. An atmosphere seems to exist where auditors would only do their work properly when nothing goes wrong. This is impossible. I give the committee full credit for acknowledging that there will be "incidents" and we should not treat them as audit failures.'

Does fear get in the way when building knowledge databases on, for example, fraud?
'In the US, litigation is certainly a concern. That is probably less of a concern in The Netherlands. And given the fact that analyzing root causes of problems can be done with a certain level of anonymity, I don't see why the identity of a client and the auditor has to be known. The occurrences are relatively infrequent. There are some surveys in which partners have been asked how often they have found an intent to misstate by management. The rate is really low, only 1 or 2 percent of the engagements. So individual partners have very little direct experience in dealing with a client who is actually engaging in misreporting. So, it is easy to assume that there is no problem. If we would have this data and share it collectively, we would build better knowledge of the circumstances that drive misstatements and facilitate this kind of behavior. The data will not be shared on a case-by-case basis, but with an aggregate analysis.'

What are main problems that practitioners would like to have solved in the short run?
'They would like to have better risk assessment models. Unfortunately, you can't produce them overnight. You need data to create a better model. To model financial misreporting risk, you need to have examples of misreporting, a sufficient sample to work with. Patrick Vorst's paper, that I mentioned earlier, contains 25 years of SEC data and they had 300 unique companies with misreporting going on out of 250.000 firm years. It is hard to build good models with such a small sample of misreporting firms.'

Do audit firms invest enough in research themselves?
'For years I've been quite frustrated by the fact that firms don't invest more in internal R&D. R&D intensive companies like Apple invest about 10 percent of their sales in R&D. That is about the threshold for a company where knowledge is critical. But audit firms, which are also considered to be knowledge businesses, invest almost nothing in internal R&D. They hire consulting firms for R&D work, rather than thinking about what needs to be done to make auditing better, and build it from the ground up within the firm. Furthermore, firms too often decide at a high level how they want to reshape their audit focus, without actually testing its effectiveness or even its feasibility: can the audit teams work with newly developed technology?'

What topics you will examine in your current and future research?
'I think of my own work in the past 25 years as focusing on what I would call more granular levels of the organization. My early work shows that there are Big 4/non-Big 4 differences in audit outcomes and that there are differences within the Big 4 firms based on their industry expertise. There are also inter-office differences even within the same firm, and these effects may be ever larger than difference between firms. Office size in particular seems to be associated with high-quality audits. Most recently I have started to explore partner differences and their effects on audit quality outcomes. We need to learn more about what drives good quality audits and what drives lower quality audits. However, audit firms really don't like to talk about the existence of low-quality audits. They think in terms of a binary model: that the audit is either okay or it is not okay. I believe audit quality is better thought of as a continuum from unacceptably low quality to very high quality. There should be more acknowledgment that some audits are better than others and that audits can be improved. I'm using the FAR chair position as an opportunity to get inside the black box of an audit firm. My goal is to learn more about the personal characteristics of partners and managers, and how personal differences affect the work of engagement teams and the quality of their audits. I also intend to investigate how the organizational or structural characteristics of accounting firms can facilitate the quality audits. This kind of research is of fundamental importance in understanding the personal and organizational drivers of high-quality audits, and it can only be done with the kind of access to the firms and proprietary data that comes with the FAR chair. So, I'll keep on studying what factors lead to better quality audit outcomes, like before, but with a much finer level of granularity. Audit firms should create a better culture to somehow facilitate the production of consistent high-quality audits. I think we also need improved evidence gathering procedures, more advanced audit investigative technology, to better be aware of conditions that might lead to client misreporting. I think, that if there is a structural deficit, it is not so much in the organizational aspect of the audit firms, rather than in the limits of the investigative tools of auditors. This is a bit different from what the CTA has in mind. It would be a somewhat more positive step than the kind of 'gotcha!' mentality that is often expressed in the public debate about auditors and the quality of their work.

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