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**Controversies in Future Audit Quality:
A multi-stakeholder perspective**

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FOUNDATION FOR AUDITING RESEARCH

In the Public Interest

Philip Wallage

The 2nd International FAR Conference on June 7 and 8 focused on the topic 'Controversies in Future Audit Quality – A multi-stakeholder perspective'. With a challenging Minister of Finance, a critical oversight body, enthusiastic and renowned (inter)national academics, a broad and engaged audience, the Conference brought new and relevant insights for both academics and practitioners. Controversies regarding audit quality were discussed and several academics presented the status of their FAR research projects. The current MAB-FAR issue presents an overview of the interactions between multiple stakeholders and of the research projects.

First Olof Bik reports the views of multiple stakeholders about the *future of audit quality*. In the following I wish to refer to a few interesting remarks that were made during the conference.

According to one very important stakeholder, Jeroen Dijsselbloem, Minister of Finance, the audit profession should show initiative to regain public trust after recent audit failures and deficiencies reported by the Authority Financial Markets (AFM)[1]. According to Dijsselbloem pressure should not come from politics to the sector, but rather from the sector towards politics, with suggestions on how to make improvements. Discussing the need for quality improvement, AFM board member Gerben Everts claimed, that the current earnings model hinders professionals to act in the public interest. He feels the sector itself should put forward suggestions to improve the business model.

Marco van der Vegte (Deloitte) referred to the "multi stakeholder" definition of audit quality outlined in the NBA Green paper (2017). He emphasized the importance of developing a common definition of audit quality incorporating different perspectives to bridge the current expectation gap in order to restore trust.

Pieter Paul Saasen (BDO) cautioned against moving towards a compliance driven sector in which everyone just follows the standards instead of applying professional judgment and taking responsibility. He also noted that changing an industry, a profession, or a firm, requires a lot of time.

All stakeholders agreed that academic research as initiated by FAR should contribute to the improvement of audit quality. For example, root cause analyses should address problems by pinning down more precisely where things have gone wrong and how they can be improved.

This view is also supported by Jan Bouwens in his paper *"Can research improve audit practice?"* as empirical evidence also shows the importance to study audit practices as in any other sector differences in efficiency and quality of practices exist. Understanding methods and organization of work can help improve quality in a rapidly changing environment.

The next paper by Olof Bik and Julia Wijnmaalen presents an overview of the conference panel discussion: *"A true and fair value of the audit sector"*. Two audit practitioners (Agnes Kant and Michael De Ridder, PwC), an investor (Martijn Bos, Eumedion) and an academic (Chris Humphrey, University of Manchester) took the stage to discuss the need for change within the auditing profession. Five topics were discussed:

1. What is the added value of an audit?
2. What is good auditing?
3. How should regulators approach the audit sector?
4. How can future talent be attracted?
5. What are the challenges the profession faces and what does the future look like?

Referring to the future of auditing, professor Humphrey noted that "if the job of the audit is to enhance trust in society, and the audit sector is successful we will need less auditing, as auditing is there because we do not trust each other". Assuming that "complete" trust can never be reached, has to be earned and maintained, the future of auditing seems to be bright.

Pursuant, academics presented a number of research projects under the auspices of the FAR and gave an overview of what is known about each research area. The first Research Project summarized in this MAB-FAR Issue is *"The loss of talent: A threat for audit quality?"* Frank Moers (Maastricht University) explains that the development and retention of talent is a key concern of audit firms. Therefore, one of the goals of the project is to provide insights into how audit firms' Performance Management Systems can be redesigned to limit talent loss as far as possible. Given the team nature of the auditing function and that people are affected by their peers, it is expected that team composition can strengthen or weaken the development of individuals. These results of the project will provide insights into making well-informed staffing decisions that maximize individual and team performance.

Kris Hardies (University of Antwerp) presented the status of the FAR Project entitled *"Professional skepticism: A trending concept in need of understanding"*. Professional skepticism is an important auditor characteristic to ensure high audit quality. However, many questions

about the effect of professional skepticism on the quality of the audit are still unanswered. For example is it necessary for all members of an audit team to maintain professional skepticism? Also, what are the consequences of professional skepticism on various audit outcomes and which elements of the audit processes are affected by professional skepticism? By addressing these research questions, this project will help audit firms to understand variation in the professional skepticism profiles across engagement team members. It will also provide insights on organizational conditions that may help audit firms to improve audit processes and quality.

A paper about the FAR Research Project *"The effects of multiple team memberships on individual auditors' performance"*, was presented by Reggy Hooghiemstra (University of Groningen).

Working in multiple engagement teams simultaneously is at the heart of how auditing firms organize their employee activities. As such, individual auditors are members of more than one engagement team at the same time (i.e., occupy multiple team memberships, or MTMs). The researchers provide some ideas about how to (re)organize individual work within audit firms in order to allow all employees to thrive within such an environment.

While auditors in the early phases of their career probably learn and develop most from being on many different engagement teams, they also struggle the most with having to switch between those teams. The project aims to provide insights to help solving this dilemma.

The final paper in this issue describes the FAR Research Project *"Coordination and Communication Challenges in Global Group Audits: Evidence from Component Audit Leaders"*. Denise Hanes Downey (Villanova University) and Anna Gold (Vrije Universiteit Amsterdam) 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.

Despite concerns about the quality of group audits only a limited number of academic studies have examined these engagements to date. The paper first describes why research in this area is important and has the potential of providing a valuable contribution to practice. The authors expect that 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. Audit firms could become better equipped in properly identifying and ultimately dealing with such challenging situations. Results could also 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).

Concluding, I am hopeful that this MAB-FAR issue will contribute to further understanding of the importance of academic research for the audit profession by solving controversies in audit quality and to retain and maintain greater public trust in the audit profession. For this purpose an open multi-stakeholder dialogue as created during the 2nd FAR conference is essential. ∎

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Notes

1 The Authority for the Financial Markets is responsible for public oversight of audit firms in the Netherlands.

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The future of audit quality: A multi-stakeholder perspective

By Olof Bik

INTRODUCTION Audit quality. The FAR invited multiple stakeholders to share their views during the conference on 7 and 8 June 2017. This paper provides an integrated review of the topics discussed by the stakeholders in their presentations as well as the subsequent discussions with the audience. The discussions touched upon five main topics:

1) What are the multi-stakeholders' perspectives on audit quality?
2) Is the profession on the right track of regaining public trust?
3) What is the role of external supervision and regulation in regaining public trust?
4) What should the next steps be for the auditing profession?
5) What is the role of scientific research therein?

THE STAKEHOLDERS The first stakeholder to share his views was Marco van der Vegte. Van der Vegte is a member of the FAR Board as well as of the Public Interest Commission of the Dutch Professional Body of Auditors (NBA), and he just resigned as Deloitte's Assurance leader. The second stakeholder was Pieter-Paul Saasen, who spoke in his role as BDO's Head of Audit. Furthermore, Saasen participated in the Working Group on the future of the auditing profession (2014) and is a member of the Public Interest Commission of the NBA. The third stakeholder was the current Minister of Finance of the Netherlands Jeroen Dijsselbloem. In his role as Minister he has been a driving force behind the reform programs in the auditing industry. The last stakeholder to take the floor was Gerben Everts. Everts represents another key driver for audit reforms in the Netherlands. He is a member of the AFM board, chairs the Monitoring Group, and he is active in several international boards, such as IOSCO and IFIAR.

Additional stakeholder views on the future of the auditing profession reference are given in the PANEL DISCUSSION paper also included in this MAB issue.

1 A multi-stakeholder perspective on audit quality

"There is more to audit quality, than merely compliance to the standards" (Marco van der Vegte, Deloitte).

According to the Public Interest Commission, there is more to audit quality, than merely compliance with the standards. As there are several stakeholders interested in the work of auditors, there are also different perspectives as to what audit quality actually is. The combination of different stakeholders and different perspectives might be a major cause of the so-called expectation gap. Van der Vegte states that the report of the Monitoring Commission Accountancy in October of 2016 also touches on the unclarity. He postulates *"We need a common definition, one that is more than only a quantitative interpretation of audit quality. There is a need for a more qualitative approach to audit quality"*. He continues by outlining the multi-stakeholder perspective definition of audit quality outlined in the Green paper issued by NBA at the FAR conference on 7 June 2017. Four perspectives should be taken into account when talking about audit quality:

- Public interest quality: acting in the public interest is more than just complying with the standards; it means that an auditor needs to be there when it matters and act on signals that are relevant to society at large.
- Value added quality: what is the value of the audit by an external auditor to an audited company? How can the auditor help companies and its boards to improve their operations? Auditors should share their knowledge and experience from, for example, working with different companies.
- Compliance quality: this aspect is about compliance with auditing standards and regulations set out by policymakers and the external regulator.
- Process quality: process quality touches upon how auditing is performed by audit teams and firms. How should we organize the engagement team? What processes do we have in place to accept the client? How do we ensure consistent quality?

Everts underlines the broad scope used in the Green Paper to describe audit quality. *"It is very good to involve different angles, perspectives and discussions"*. However, he also acknowledges that the regulator tends to have a slightly different perspective on audit quality. In PIE licensed audit firms, for example, audit quality is about serving the public interest and being compliant with audit standards. Other perspectives on audit quality are 'nice to haves'.

Van der Vegte strongly believes that in order to restore integrity and trust in the profession there needs to be a common definition of audit quality that incorporates different perspectives to bridge the current expectation gap. Hence, he has called upon all stakeholders to provide input for the Green paper in order to get to that one definition that allows us to move forward in the sector.

"From a mid-tier perspective it feels as if you're running a marathon with different starting points" (Pieter-Paul Saasen, BDO).

Saasen identifies a dedicated movement towards an increased audit quality environment that was initiated by the profession itself. *"Improving audit quality can be considered a journey and we, as a profession, are not there yet. We need time to change because changing an industry, a profession, a firm requires a lot of time"*. However, all audit firms in the Netherlands were told to comply with the same 53 measures proposed by the Working Group for the future of the auditing profession (2014). *"From a mid-tier perspective it feels as if you're running a marathon with different starting points"*. There are many differences between the audit firms; for example, differences in resources, client base and culture. So, it is impossible for all firms to achieve the same level at the same moment in time. Moreover, what is the audit quality level that we need to achieve? The definition of audit quality is very different for a controller at Unilever NV compared to someone who owns a family business. In the latter example, the auditor is considered to act as a trusted advisor to that family, and not so much for the interest of the public or investors. However, this family business auditor needs to comply with the same standards as an auditor of a large international trading company. Yet the contexts and goals of any audit differ significantly. Saasen therefore suggests that the sector should consider the example of the SME auditing standards developed in Scandinavian countries, as it prevents auditors getting caught in the middle between auditing standards and delivering a qualitative audit tailored to the client and circumstances. There, auditors do not have a "one size fits all" mentality.

2 Is the profession on the right track of regaining public trust?

"To me, accountancy stands for independence […], reliability and accuracy" says Dijsselbloem. However, the current situation is that both the seal of approval and the added value of the work an auditor is questioned and doubted by the public. The challenge faced by the profession is to increase audit quality and restore trust in audit firms and auditors. Dijsselbloem acknowledges the progress the sector has made; however, he is also aware that the sector still has a long way to go. For him, an indicator of progress was an article in the *Financieele Dagblad in 2016 in which* several corporate executives complained that the relationship between them and their auditor had become a lot more complicated since the new regulations came in force. *"I thought this was great news! It signals that difficult conversations are taking place"*.

"Where are we on our journey to improve audit quality?" asks Everts. According to both the AFM and the Monitoring Committee Accountancy, progress on strengthening quality controls, beefing up internal oversight and achie-

ving a cultural change, has been slow. A lot more work needs to be done to restore trust and ensure that the public interest are being upheld. Nonetheless, Everts is feeling quite positive because *"the ground work has been done, the foundation is in place and it is now up to the sector to convince the audience they can deliver their promise"*.

"If we have to take so many measures, are we doing the right things? Are we in the heart of the matter?" Dijsselbloem ponders out loud. At the end of last year, the Monitoring Commission on Accountancy evaluated the effectiveness of the 53 measures and concluded that the measurements are not going to solve structural problems. The Commission identified several issues that still need to be addressed in order to improve audit quality, such as the impact of the business model on audit firm culture, balance between private and public interests and one definition of 'audit quality'. These issues are also marked as the root-causes of audit failures. Dijsselbloem: *"I think that the heart of the matter lies in the business model – it is the customer that pays and therefore stays. How can you ensure standards of integrity and quality and withstand pressure from the customer?"* Everts also taps into the last statement by saying: *"The current funding structure hinders professionals to act in the public interest. Can you really be independent when you are paid directly by the company whose accounts you are checking?"* He feels that the sector itself should put forward suggestions to improve the business model, test them diligently and then implement the changes.

"I fear a situation of shared irresponsibility" (Pieter-Paul Saasen, BDO).

Saasen proposes that it is time to reflect on the 53 measures. He asks: "Is the profession on the right track?" He sees the profession moving towards a compliance driven sector in which everyone just follows the standards instead of applying professional judgment and taking responsibility for what actually needs to be done. Professionals seem to hide behind rules and regulations as they fear the consequences of a condemning file inspection and the enforcement consequences. Saasen fears it creates a situation of "shared irresponsibility" because professionals no longer rely on their professional judgment and none of them, therefore, want to take individual responsibility. *"Professional judgement is the foundation of our profession; it requires softer factors such as professional experiences, client relationship and situational factors"*. Professor Humphrey shares Saasen's views and states: *"Auditing is in danger of becoming a check-list function instead of a professional function"*.

As a regulator, Everts hopes that future competition between audit firms is based on quality instead of variables such as fees. *"Compliance must be considered in context. Professional judgement must be complied with as well. Key inspection findings therefore rightfully focus on lack of professional judgement and not on minor check-list omissions - as some would*

like the public to believe". And, ideally, the firms should not be informed by the AFM about the lack of audit quality. No, firms themselves should inform the AFM about the lack of audit quality and should communicate as to which mitigating actions have been taken.

3 What is the role of external supervision and regulation in regaining public trust?

"Auditors need to demonstrate parrhesia – act and think independently under difficult circumstances" (Jeroen Dijsselbloem). "The stricter rules we have introduced now must help auditors to resist peer pressure; however, they cannot generate a real change. The real change in corporate culture needs to come from the inside". In his speech, Everts refers to an article in the (Dutch Newspaper) NRC of 29th May 2017 based on research by Therese Grohnert (who is currently conducting research on behalf of the FAR) on learning within an audit setting. Grohnert's work shows that more work needs to be done to create an environment within auditing firms in which colleagues can learn from one-another and learn from mistakes. Everts points to the absence of a learning climate in firms as a possible cause of audit failure. "The way the firms currently structure their work acts as a brake on quality improvement". Firms work with large teams consisting mostly of juniors whose professional judgement has not matured yet, and he concludes there is no time for professional discussions due to efficiency demands.

A large shift in mindset is necessary according to Everts and this has to do with the difference between theory and practice. That attitude needs to change. "Theory is practice. At least it should be. That is what new talent should be told!" Moreover, the regulatory focus is not merely on box-ticking. The AFM wants to bring about a different approach to auditing so that it can serve the public interest better. "What I would really like to see is the work of auditors going beyond simply performing checks". Hence, the AFM introduced many regulatory initiatives that strengthen governance, structure and the culture of the profession.

"The current method is what it is, but if the outcome implicates that you are underperforming, do something about it!" (Jeroen Dijsselbloem)
Willem Buijink of the FAR Board and the Open University asks both Dijsselbloem and Everts about the methodology behind AFM's statement regarding the supposedly 45% deficient audits and how these findings relate to the 11,000 statutory audits conducted in the Netherlands. Does this mean that over 5,000 audits are deficient? He asks what is the AFM's basis for such a statement. Dijsselbloem answers that a debate about the methodology is good as "methods can always be improved". However, Dijsselbloem is reluctant about changing the method "because as soon as there is a critical outcome from a supervisor, we go back to the

method and say 'the method is wrong'. [...] My point of view is that the method used at this moment is what it is, but if the outcome implicates you are underperforming, do something about it! Is it possible to have a parallel debate about the method? Sure. But don't postpone the difficult question to improve audit quality".
Everts responds by saying that "the 45% is not something we actively highlight to the audience, as if 45% of all audits are not according to standard procedures". He explains that the AFM examines the operating effectiveness of the internal control environment of a firm. It selects files and runs them through auditing procedures, just like with every other audit. The AFM found weaknesses in the internal control environment in all the four Big firms. Subsequently, the AFM asks the firms how they select the riskier audits and how they evaluate them. The AFM then randomly selects files from the pile including those that received extra attention from internal control. Two alternative conclusions can be drawn from this: One, these files are higher risk, so it is of no surprise that you find audit weaknesses. Or two, you can argue that these files had already been recognized as being high risk, so you will probably not find weaknesses as these files have received special attention. "The overall conclusion is, independent of methodology used, that internal controls do not function effectively. Here, the regulator and the firms agree. We see positive development and potential for further improvements supported by good practices; investing in internal quality controls is the key vector for improving audit quality".

4 What should the next steps be for the auditing profession?

"Let's cooperate, let's connect and let's work on our shared goal of improving the governance, structure and culture within the audit sector. Thereby improving audit quality" (Gerben Everts, board member AFM).
The generally agreed upon view is that successful transformation of the auditing profession and sector can only take place if all stakeholders work together. A cooperation grounded in mutual respect, trust and open dialogue. Everts stresses that the AFM "is not a prosecution office focusing solely on fines for non-compliance". According to him, audit quality can only improve if all stakeholders work together: the audit profession, the regulator and the academics. The regulator is not the enemy that designs regulation after regulation in an ivory tower. He says: "The audit firms and the AFM are fully aligned to the fact that inconsistent audit quality needs to be tackled and this journey goes way beyond a pure compliance exercise".
Everts has a very clear image as to what the sector's next steps should be. "First the sector should take a humble approach. Do not constantly test the waters or pick a fight with the regulators or policy makers. Secondly, the sector, together with the regulator and the Monitoring Commission, has

to take the initiative to reflect on the 53 measures and propose a 'Plan B'. Do not wait for Parliament to make decisions. *You have to be assertive and pro-active as a sector*". Finally, he says there is a need for a firm-specific approach to strengthen audit quality. How is audit quality failure linked to the specific characteristics of individual firms? *"These three things need to be attacked with speed and energy"*, he concludes. As to new approaches in auditing, Everts invites practitioners to test regulation in the AFM innovation room. *"Join the AFM to see what regulation works and what does not in a changing environment with block chain, data analytics and new technologies becoming more mainstream. We cannot afford that standards and regulation would uphold developments which could very well be part of the solution vis-à-vis audit quality problems"*.

"The sector should pressurize policy makers to uphold audit quality instead of the other way round" (Jeroen Dijsselbloem, minister of Finance)

Dijsselbloem confirms that a lot has already happened and that the public should not expect *"the full Monty in the short term. However, half a Monty in the medium term would be very welcome"*. He also points out that the auditing profession differs from other sectors in that many of the proposed reforms have to come from the sector itself and not from legislation or regulation. The auditors have taken the lead and initiative in the public debate. *"You are not forced to change, but you understand that there is an issue and take action"*. This initiative is a great asset in terms of credibility. The next steps could be to tell Parliament and the Minister "look you need to change legislation further to uphold our quality and integrity, you need to protect us and support us when we have difficult conversations with our clients. That would be my preferred approach because then, the sector can keep applying pressure to uphold audit quality on policy makers instead of the other way around". Dijsselbloem proposes that if the sector really wants to regain trust, it should offer initiatives. And not the ministry nor the regulator. *"I would be really delighted to see messages going from the sector to society to show openness to society"*.

It is for these very same reasons that Pieter-Paul Saasen invites the audit firms, the professional body, audit regulators and audit educators to a learning envi-ronment and change dialogue. *"I would kindly like to invite Dijsselbloem and Everts to join us as major parties involved in our journey. Maybe FAR would want to host this and provide a 'safe haven' for a learning environment for the profession to determine its next steps"* he concludes.

5 The role of scientific research in regaining public trust

"The FAR needs to 'science the hell out of the problem'" (Jeroen Dijsselbloem).

The FAR facilitates independent research based on empirical data from the audit firms in the Netherlands to identify the determinants and drivers of audit quality. The foundation aims to strengthen the learning curve of the industry, disseminate knowledge, inform regulators and policymakers and, ultimately restore trust in the sector. All four stakeholders independently mention the important role of the FAR. Yet, the stakeholders have different views about as to what exactly the FAR provides.

Van der Vegte states that the FAR is relevant because it facilitates the conversation between practitioners and academics. Saasen agrees and hopes that the foundation can act as a safe haven where the profession can learn and have an open dialogue with the stakeholders such as the regulator and policy makers. Additionally, Saasen sees the FAR could play an active role in helping the sector increase the level of audit quality by finding answers to the most pressing questions.

The regulator expects a more content related role for the FAR to assist the audit profession in its current journey. Everts mentions several research topics that he feels should receive attention. For example, research on audit quality indicators. What indicators lead to audit quality? Moreover, Everts calls for more innovative research. What are the current innovations and how can audit standards tap into these developments? Dijsselbloem quotes Matt Damon in the movie *The Martian* to describe how he perceives FAR's role: *"The FAR needs to 'science the hell out of the problem'."* Dijsselbloem makes this remark to emphasize that more profound analyses are needed to address problems in the audit profession. These analyses will pin down more precisely where things have gone wrong and can be improved. ■

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Can research improve audit practice?

Jan Bouwens

Imagine that you want to decide what auditor to select and there are two potential auditors on the market to audit your financial statements. One auditor will make sure that the whole world believes that the financial statements of your company reflect the economic conditions your firm faces and makes sure that this believe is warranted. The second auditor is less able to provide that level of assurance. Which auditor will the company select?

In the case I present the choice seems to be simple: the company will be choosing the auditor that provides the highest level of assurance. However, companies that want to conceal their real value may still want to resort to the low-assurance auditor as long as stakeholders (shareholders, customers, banks, etc.) in the end value the stock of that company higher when they are informed via the low assurance auditor than they would value a company audited by the high assurance auditor who does reveal the real value of the company. The question is, can companies fool the stakeholder by overstating their value and by finding an auditor who is willing to endorse the overstatement? According to the accounting researchers Donovan, Frankel, Lee, Martin and Seo this situation cannot exist because the following mechanism is bound to unfold.

Companies that select auditors that either inadvertently present inaccurate financial statements or try to mislead stakeholders with their financial statements are very likely to be exposed (e.g., Dyck, Morse & Zingales, 2010).[1] As a consequence the stakeholders will not embark into a business relation with a company selecting a low-assurance auditor that helps them to hide inaccurate financial statements. Hence, these companies do not come into existence, and if they did, they would immediately disappear as they would be unable to find a stakeholder that would want to do business with them. As far as audit firms are concerned Donovan et al. (2014) would predict that audit firms who render a subpar audit service cannot exist as no company could benefit from selecting a deficient auditor. As this mechanism is in place this would lead Donovan et al. (2014) to conclude that it is futile to conduct research into auditing:

"We [researchers] tend not to concern ourselves with the quality of products that result from a competitive equilibrium where we believe that consumers and pro-

ducers are acting rationally with full information." DeFond presented the opposite opinion at the second auditing conference of the Foundation for Auditing Research (June 2017, see also DeFond & Zhang, 2014; DeFond, Lennox & Zhang, 2016). Who is right?

Indeed, if it was the case that companies would not enter into the market unless they were at least clearly as good in producing value and in conveying their achievements as timely and accurate as their competitors and that if they were to enter the market that they would dissolve almost instantaneously than it would make no sense to study the work of auditors for inefficient auditors would not exist.

The economic literature, however, has advanced beyond the idea that Donovan et al. (2014) put forward. Indeed, this literature takes issue with the puzzle over the astounding differences in productivity between companies and countries. For example, for a U.S. sample Syverson (2004) shows that plants residing at the 90th percentile produce 400 percent more than plants in the 10th percentile on a per-employee basis. About 50 percent of these differences in labor productivity are accounted for by how inputs differ, like capital intensity. An important part of these differences, however, are explained by different management practices these companies have adopted (Bloom et al., 2007, 2010 and 2013). Bloom et al. (2007) group these management practices into four areas: operations, monitoring, targets and incentives. It appears to be the case that companies who operate under conditions where they have given little attention to either of these areas are relatively less efficient and effective. Yet, these companies do exist and survive (sometimes by lack of competition).

We can make the following observations based on the findings of Bloom et al. (2007, 2010 and 2013). First (1) less efficient companies exist next to more efficient companies, (2) companies differ in the composition of their input factors and (3) they differ in levels of management sophistication.

This empirical evidence provides several reasons why it is important to study audit and assurance practices. Like with non-audit firms there is much to learn of how auditors create conditions that allow them to assume and retain a position in their environment (Pfeffer & Salancik, 1978). Firms compete for resources

and their management procures and deploys input factors in differing ways. Auditors are not different than any other firm in how they must deal with a changing environment by adopting new working methods and management practices. However, as Bloom et al. (2007) show there are clear efficient and inefficient modes of organizing the work. We know extremely little of what these modes are in audit firms. We also do not know what are potential efficient combinations. In fact it is not even known what constitutes an effective or and efficient audit. Give way to audit research! ■

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Notes

1 They find that frauds are at some point detected. In 24 percent of cases it is the auditor who reveals the fraud.

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Panel discussion: A true and fair value of the audit sector

By Olof Bik and Julia Wijnmaalen

"It is an interesting time to work in auditing; it is difficult, but it feels great to be a part of this moment" (Agnes Koops, PwC).

INTRODUCTION On Wednesday the 7th of June, four distinguished panelists took the stage on the first day of the FAR conference to discuss the need for change within the auditing profession. The discussion between the four members and the audience was chaired by Professor Robert Knechel of the University of Florida, academic member of the FAR Board, and member of the PCAOB Standing Advisory Committee. Five topics were discussed during the panel discussion:

1. What is the added value of an audit?
2. What is good auditing?
3. How should regulators approach the audit sector?
4. What are the challenges the profession faces and what does the future look like?
5. How to attract future talent?

These five discussion topics form the structure of this paper. The panel consisted of two audit practitioners, an investor and an academic. One of the practitioners, Agnes Koops, is a member of the PwC Assurance Board with a focus on human resources. Michael de Ridder was the second panelist. De Ridder is a member of the PwC Board, as well as of the FAR Board and speaks on behalf of the Dutch body of professional auditors. The third panelist was Martijn Bos. Bos is the Reporting and Audit policy advisor at Eumedion. Eumedion is a non-profit organization that represents institutional investors' interests in the field of corporate governance and sustainable performance. The next panelist was Professor Christopher Humphrey from the University of Manchester. The focus of his research field is international financial regulation, auditing practice and accounting education. Humphrey is also a member of the Institute of Chartered Accountants in England and Wales (ICAEW).

Professor Knechel starts the panel discussion with a reflection: "I have been working in audit education, practice and research for more than forty years and some of the issues that were being discussed over the years have not changed. In the eighties and halfway through the nineties this idea of firms and academics partnering up to do research was fairly usual. We lost that for a while. It is very nice that FAR has been able to resuscitate that relationship to help us understand auditing better. We have had at least ten years of regulation, we have been discussing about audit quality a lot longer and there have been many changes in the profession lately but we still have to do a lot more!"

1 What is the added value of an audit?

"Why can't auditing be more about improving society instead of just assuring financial statements?" (Christopher Humphrey, University of Manchester).

What is the added value of an audit? This question resonated throughout the conference. "*The expectation gap is crucial here*" says De Ridder. For example, there are general rules and standards for estimating materiality, but a part of it is professional judgment. The service that we deliver at this moment does not address all of our stakeholders' questions. Hence, there needs to be a dialogue between the profession and the users to understand what each of them expects and as to what audit quality actually is. This dialogue helps the audit profession to innovate and create new products that fit the wishes of the outside stakeholders better.

During the discussion, Bos was asked how the profession can create more added value for investors. He responds by giving the example that investors do not really understand the concept of materiality. Another issue is key-audit matters. Investors are interested in different key-audit matters than those that are currently included in the audit opinion. "*We sometimes observe that the audit professionals do not flag things that hook into material issues that are interesting to us as investors*". For example, there are always several key-audit matters on goodwill; however, investors are interested in other matters like the quality of internal control.

"Most of the added value of an audit is in the non-financial information area" (Martijn Bos, Eumedion).

Next Bos is asked whether it helps when audit firms monetize values, such as tailored materiality values. Bos replies that monetization is not the Holy Grail. Moreover, "*we investors are keen to put our own prices on stuff*". According to Bos, most of the added value of an audit is in the non-financial information, like evaluation of internal control quality, integrated reporting, quality of the management team and risk estimations. "*I think that if you are the only audit firm that cannot provide that kind of information in an audit report, your life is limited*". De Ridder responds that it is sometimes difficult for audit firms to provide that kind of information, because things like a management letter often contain confidential and sensitive information. "*And even if you made that letter public, you would not achie-*

ve the right effects. So, how can we find that balance between what you can and cannot say outside?"

"There is much more out there in which we can fulfill a role in providing assurance" (Michael de Ridder, PwC).

Humphrey takes the added value of an audit even further: "*If we take a multi-stakeholder approach, does it not follow that an audit is for a better society? For example, in my country the audit profession took a neutral stance on the Brexit discussion. Why didn't they venture into the political arena? Why can't an audit be more about improving society instead of just assuring financial statements? I think that if we take the stance that an audit is just an audit, it could lead to a very stale discussion, and that is not going to sustain the profession in the future. Particularly since what you are auditing is losing credibility in itself*". De Ridder agrees with Humphrey: "*We provide assurance and assurance has a value in society. There is much more out there in which we can fulfill a role in providing assurance. However, there are people out there who say you cannot even do your financial statements audits properly yet, so do not bother to provide assurance on other things*". Humphrey responds by saying: "*I cannot stand the phrase: an audit is an audit. That is the most anti-innovative phrase you can imagine. It is not only about assurance, but also about advising and commenting. I worry about that split; you cannot do those other things anymore*". Again De Ridder adds that the sector needs to look for that balance. He states that a good example of this balance is the sector management letters that were published by the Netherlands Institute of Chartered Accountants. However, De Ridder is also aware of day-to-day reality: "*Yes, we can do more, but we are also very focused on our clients*".

2 What is good auditing?

"Audit quality is implicitly observed by us. It is circumstantial evidence" (Martijn Bos, Eumedion).

Even in an extended audit rapport it is impossible to see how the audit firm conducted the audit and therefore it is difficult to assess audit quality. Bos is asked how institutional investors perceive audit quality. "*Audit quality is implicitly observed by us. It is circumstantial evidence. Audit quality is a perception*" says Bos. "*We can read the report from the regulator, but the audit quality itself is below the surface*". The investor's perception is influenced by incidents and how auditors present themselves in the public arena. For example: how does the profession respond to the regulator's report? According to Bos, the profession needs to become more transparent and show how they put the public's interests before the interests of the firms themselves and their clients. "*That is evidence of change*", says Bos. He is also astonished that, as far as he knows, only PwC has a global investor liaison. "*We are probably one of your more important stakeholders, so shouldn't you talk to us all the time?*"

Continuing along the lines of the issue of transparency, the next question is raised: "*Long-form reporting has*

existed forever yet, to my knowledge, no US organization uses it. Why?*" It is De Ridder who responds: "*There is probably some reluctance to be transparent because litigating is everywhere. The more you write down the more you expose the firm*". According to De Ridder, it is a balancing act between transparency, managing the risks of the firm and meeting the needs of the stakeholders.

"We have to be careful that we do not start to believe more in the standards than in the quality of practice" (Christopher Humphrey, University of Manchester).

Humphrey adds to the discussion that although everyone talks about the role of audit quality in building trust in society, he just wants to see good auditing. Auditors need to feel free to audit well and more standardization is a barrier that will kill the specificity in reporting. "*We have to be careful that we do not start to believe more in the standards than in the quality of audit practice*".

"*Why does it only happen when there is a rule? And there will be more rules. More rules will be detrimental to our profession*" says De Ridder. A good auditor needs to know all the rules, as well as understand, for example, the board room dynamics and the value creation process of a firm. "*I am convinced that in the end, our product is a very human product because the board wants to trust the person or team that does the audit*". So, how tangible is audit quality? "*You can have an audit approach and technology, but in the end you have to make it understandable, personal and be convincing. The human element. To me, that is a very important element of audit quality. I am sure that the people who buy our services take that into account as well as the fact that you have professional expertise and experience*".

3 How should regulators approach the audit sector?

"The 2014 AFM report really hit us. We thought we were doing well" (Agnes Koops, PwC).

Knechel opens the topic of regulation by noticing that regulators around the world have been "*a bit critical, so to say*". He asks the panelist: "what does the sector need to improve itself and how do they want the regulators to approach them in these times of change?" Koops shares honestly: "*The 2014 AFM report really hit us. We thought we were doing well but we understood from the report that we had to do better*". She states that she feels that everyone within PwC is intrinsically motivated to really improve the quality of audits and, as an organization, they embraced many measures and started working on their culture and behavior. "*We are making progress, but it takes time*". The first point Koops makes about the role of the regulator is that the reports helped the sector. However, the drawback of the reports is the pressure they cause. Koops describes an atmosphere of fear. "*We are trying to learn from our mistakes, but sometimes the tone of our regulator makes you feel really bad*". She advo-

cates a change in the regulator's tone of voice in order to decrease the current amount of fear.

"I sometimes feel that our regulator is a bit over the top" (Michael de Ridder, PwC).

De Ridder supports Koops' observations. "*I sometimes feel that our regulator is a bit over the top*". De Ridder compares the attitude of the Dutch regulator with the attitude of the PCAOB. "*The PCAOB has a different tone of voice, a wider view, takes more aspects into consideration, is subtler and is more professional and constructive*". He applauds the "Dash Board" report issued by the regulator which records changes in the sector. According to De Ridder, this report is very helpful to the sector.

However, Humphrey feels that the regulator does not take the opportunity to balance good and bad news. "*IFIAR's findings always talk about things that went wrong or when there was non-compliance. Opportunities of making good quality audits visible are missed*". He is also astonished about the contrast between the atmosphere in the many policy-makers and regulators' think-tanks and quotes a member of a think-tank: "*the floors are on fire. We are that radical at the moment*". This in contrast with the atmosphere in practice where people have grown accustomed to having the regulator watching over their shoulder. Moreover, there are clear differences between regulators around the world in terms of how they approach the problems. "*It would be great to see which regulative attitude is most effective*".

"We just want regulators to be effective" (Martijn Bos, Eumedion).

Bos: "*We just want regulators to be effective*". He adds that he is aware that the regulations can become counter-productive. For instance, investors already notice more '*cluttering of information*' in the annual report. Information that is demanded by the regulator.

Bos is asked about his concept of corporate governance in light of integrated reporting and decreasing audit fees. The attendee notes that he has "*never seen the investor stand up during a selection process of a new auditor and say to the audit committee: 'do not focus on price but on quality'*". Bos replies: "*Eumedion goes into dialogue with more than 40 companies each year and when we do, we ask questions about the audit fee. Did you select on price?*" Investors worry about the audit quality when they see low audit fees. "*There should be sufficient room for an auditor to dig in if problems arise*". Koops adds that she would feel supported if investors asked the question: '*Is the choice based on quality or on price?*'

Tapping into the discussion about audit fees, Humphrey adds that he feels audit firms should open-up about the commercial side of the audit business, both external (in term of the market) as well as internal (status of the auditor in the firm). He has heard rumors that the firms cannot cover the costs of the audit with the audit business itself and that the firms' audit sections are cross-funded by other firm activities.

4 What challenges does the profession face and what does the future look like?

"What difference did you make as an auditor?" (Martijn Bos, Eumedion).

De Ridder points to the expectation gap as the main challenge for the profession. "*I think there are two pretty tough elements out there: continuity and fraud. What do we do with these two aspects as auditors, what is our responsibility and what is the firm's responsibility? It has to do with managing expectations*". Another challenge he recognizes is the link between the auditor's added value and digitalization. "*How do we embrace digitalization and technology in making our products timelier and accurate, while at the same time proving the statement that in ten years time there will be hardly any need for auditors' opinions?*"

"*I think the major challenge for the audit profession is explaining its added value to stakeholders, like investors and the public*" says Bos. "*What difference did you make as an auditor?*" Bos poses that to the audit profession; the client is a distant anonymous figure. Therefore, the sector needs to communicate more about their added value because otherwise, stakeholders have no way of perceiving the added value.

Humphrey: "*A mix of complexities constraints the intellectual space around which practice can be developed, considered, researched and debated*". The challenge today lies in numerous complexities, such as: can I say this, or not, and to whom? Do I have to worry about legal and liability issues? Another challenge Humphrey identifies is the invisibility of audit quality. "*We use proxies for audit quality and have always assumed that we knew what audit quality was, but it is a big debating point*".

"We have to become more IT savy" (Agnes Koops, PwC).

"*If you look further ahead, audit work will become more interesting. Data analytics will deal with the 'easy' work and you as an auditor only have to pay attention to the interesting things that stand out in the annual report*" Koops expects. She stipulates further that the profession has changed a lot in the last decade. "*Before, you joined a firm, worked in a team and went together to clients. Now the auditor is more of a project manager who outsources work*". In the future, the human recourse regarding planning of an audit will change drastically. Koops theorizes that large uniform teams will be replaced by small diverse teams that consist of people with different backgrounds, like data analytics or project management. One of the attendees asked what type of education prepares students best for the profession. According to Koops, automation is the next step. "*We have to become more 'IT savy'*". We should educate students about the usage of data analytics and other forms of automation in an audit. Additionally, more attention should be paid to behavioral components, because what distinguishes us from data analytics is that we are human. "*We have to bring the human factor to the client*".

To a question about his vision on the future behavior

of auditors, De Ridder answers that auditors need to be conscious of the broader role they have in society. He sees it as his job to "*make my (his) people more aware of this responsibility, and make this responsibility carry a heavier weight in their day-to-day decisions while doing an audit*". It is only possible to achieve this awareness if the tone at the top is right and there is a program that supports this attitude. For example, the firm's educational programs now discuss the broader picture of auditing and how to translate this into day-to-day business? "*I hope that the tone-at-the-top helps employees when they need to have that difficult conversation with a client*". However, how can you measure changes in behavior effectively? That is difficult. De Ridder also explains that having a purpose and values is also discussed with clients. According to De Ridder, a signal of whether it is helpful to have this conversation is: "*how many audit proposals did we actually win whilst being the most expensive proposal?*" Koops adds: "*Our purpose is building trust in society. Our profession matters. The purpose and values help us to do the right thing. I think our people are very proud that we do things differently now*". An example is that if an assignment needs more time, they ask for it, which makes people feel more empowered to increase audit quality. Moreover, she says, the culture is shifting from being internally focused to what is happening around us. "*We could do even better, because sometimes we forget when we are busy with our clients*".

A last thought on the future of auditing comes from Professor Humphrey: "*Earlier Agnes said 'the job of the audit is to enhance trust in society'. If the audit sector is successful we will need less auditing, as auditing is there because we do not trust each other. So, in a sense auditing has a strange future because good auditing then eliminates audits. You could argue that the equilibrium for the audit is the expectations gap*".

5 How to attract future talent?

"*I want to train thought leaders!*" (Christopher Humphrey, University of Manchester).

When Knechel raised the question as to how he could convince a smart student to go into the auditing profession, Humphrey replies he asks three questions:

1. Do you have a passion for it?
2. Do you think you can be a leader?
3. Do you think you can drive the profession forward in a new way of thinking?

"*I want to train thought leaders!*" Humphrey notices that the majority of his students drifted into auditing. "*Many of my students do not have a passion for accounting*". Reading a recent FRC study amongst various audit firms in different countries, Humphrey got the following signals: "*We no longer attract the best students, and when we do, we spend the next few years beating the brightness out of them. Recruitment is really an issue*". This is very worrisome according to Humphrey. He suggests that universities can also assist in changing the students' attitudes. "*Look at how we name our subject: financial accounting 1, 2, 3. That is hardly exciting!*"

"*We have to make sure that our profession remains attractive for the talented*" (Agnes Koops, PwC).

It is, however, not only about attracting talent to the firms but also about retaining talent. "*We have to make sure that our profession remains attractive for the talented*". Koops worries that the increased emphasis on standardization of the profession might lead to an audit to becoming "*just a checklist we need to complete, which does not inspire and challenge new talent to step in. Auditing for a better society does*". ∎

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FAR Research project
The loss of talent: A threat for audit quality

By Isabella Grabner, Judith Künneke and Frank Moers

1 Why is this research important and how does it contribute to practice?

The main priority of the audit industry is to maintain and improve audit quality. While audit quality has been an important topic in both accounting academia and practice, there is still a lack of understanding of what drives audit quality. Given that people are the most valuable asset an audit firm has, we focus on examining the labor inputs as a driver of audit quality. Specifically, we argue that a key threat for audit quality that so far has been largely neglected is the loss of talent across the hierarchy. A well-known problem for audit firms is that they invest enormous resources in new professionals only to have many with talent leave (Patten, 1995; Vera-Muñoz, Ho & Chow, 2006; ACCA & ACRA, 2012). A recent survey by the Association of Chartered Certified Accountants finds that only about 38% are satisfied with their career and only 35% plan to stay beyond three years, with no significant differences across Big 4 and midtier firms (ACCA & ACRA, 2012). Hence, turnover rates in audit firms are exceptionally high, with estimates ranging from 22% to 28% per year (Satava, 2003; Brundage & Koziel, 2010). While audit firms are built around the up-or-out model, which relies on a certain degree of turnover, the question is whether a significant part of this turnover rate includes talented employees that would be valuable to retain. Therefore, understanding the determinants and consequences of potential talent loss within audit firms is key in achieving high audit quality and thus highly relevant to audit firms.

Talent loss occurs when talented individuals trained for a profession are not retained by the organizations that have invested in building up their workers' human capital because this talent is not identified in a timely and/or correct fashion or, in more broader terms, this talent is not managed well. It is critical to stress how we define talent. Our definition of talent is tailored to the major topic that the Foundation for Auditing Research (FAR) attempts to address, i.e., audit quality. Thus, rather than having a very general definition of talent, **we define talent as having the knowledge and skills that are relevant for achieving high audit quality**. Talent loss is incredibly costly for organizations that rely on knowledge workers, because a significant part of these organizations' value consists of intangible assets, i.e., the value of its workers' knowledge and skills. In audit firms, highly trained employees usually leak out after the organization has incurred the major part of the training cost (ACCA, 2012) but also jeopardizing audit quality. Although the loss of talent is a recurring issue that has been recognized by audit firms for decades, systematic evidence on the determinants and consequences of this phenomenon, let alone possible solutions, is still scarce. In addition, a particular point of attention is the loss of female talent, also labeled the "leaking pipeline". There are numerous reasons why employees leave the firm, including talented employees. For example, a better outside option, a personal home situation, different preferences of individuals in terms of work-life balance, etc. While these reasons are important, they are also individual-specific and not under the control of the audit firm. We take an organizational design perspective and focus on a mechanism that is under the direct control of the audit firm, i.e., the performance management and incentive system. We propose that the design of the performance management and incentive system plays a key role in reinforcing or alleviating the loss of talent problem. This is both a novel and important research question; while researchers and businesses alike have undertaken a number of measures to understand or tackle the problem, no attention has been paid to the role of the performance management process, despite it being one of the most influential components of the work environment.

2 Introduction to the research question

Besides the well-known motivational effect of performance management and incentive systems, there are theoretical arguments and some initial empirical evidence that these systems also have attraction and retention effects, which might have an even bigger impact on performance than the motivational effect (Banker, Lee, Potter & Srinivasan, 2001; Ittner & Larcker, 2002). Given this, we argue that a core root of the loss of talent problem, and potentially also of the solution, is the design of performance management and incentive systems, thereby bridging the gap between the performance management, human capital, and auditor competency literatures, which have largely developed independently of each other. In particular, we argue that the degree to which the loss of talent problem can be mitigated heavily depends on what type of information is incorporated in performance evaluation and promotion decisions at different hierarchical levels, as this determines (1) the type of employee behavior being incentivized and rewarded, and (2) the type of people leaving the organization. For example, while emphasizing current job performance in promotion decisions provides incentives to perform well in the current job, it ignores the knowledge and skills needed at the next level and therefore potentially passes over employees who are better suited for the next level and subsequently decide to leave.

In particular, we expect the loss of talent to most likely occur at key career steps that involve a large change in required skills between positions, as the talents necessary and recognized for the current job are not perfectly correlated with the talents needed for the next job (Grabner & Moers, 2013). At these key career steps the Peter Principle, which in its extreme form implies that "people get promoted to their level of incompetence", can occur when the performance management and promotion system does not take the change in skills needed for the next level into account (Grabner & Moers, 2013). The other side of the same coin is that competent people are not promoted and might risk leaking out - the problem that we investigate in this project. While Grabner and Moers (2013) provide evidence on how firms can design promotion rules to avoid the Peter Principle, the results in Bol, Estep, Moers and Peecher (2017) suggest that talent is still often misidentified in audit firms. Therefore, we hypothesize that the loss of talent occurs because performance measurement at lower levels does not adequately capture the expected competencies needed for the next job, therefore misidentifying talent, which consequently leaves the company. This is a key threat to audit quality. As a result, we address the following major research question:

RQ: How does the design of the performance management process mitigate the loss of talent (increase the retention of talent)?

3 What does the literature tell us?

In an audit firm, the people are the most important asset because a significant part of the organization's value consists of the value of its workers' knowledge and skills. In the auditing literature this is labeled auditor competency, where auditor competency refers to the auditor's ability to deliver high audit quality, which includes knowledge and skills (DeFond & Zhang, 2014). Thus, although the audit inputs are labor, capital, and other resources, we focus on the most important component, i.e., labor (cf. O'Keefe et al., 1994), and the management of this component. More importantly, based on prior literature (Baker, Jensen & Murphy, 1988; Bol, Estep, Moers & Peecher, 2017; Borghans, Ter Weel & Weinberg, 2014; Deming, 2015; Gibbons & Waldman, 1999, 2006; Grabner & Moers, 2013, 2017; Gul, Wu & Yang, 2013; Heckman & Kautz, 2012; Heckman, Stixrud & Urzua, 2006; Knechel, Vanstraelen & Zerni, 2015; Kuhn & Weinberger, 2005; Lindqvist & Vestman, 2011; Tan & Libby, 1997; Weinberger, 2014), we identify three (interrelated) characteristics of the audit production function, and the auditing context more generally, that are crucial for managing the labor inputs to achieve audit quality.

1. *Heterogeneity in auditor competencies*
2. *Skills are rank-specific*
3. *Audit quality is a product of team work*

These three characteristics have the following implications.
1. Characteristic 1 → Given the heterogeneity in auditor competency and the uncertainty around it, learning needs to take place, in which the beliefs about individual auditors' competencies are updated based on signals such as observed/assessed performance. Performance management systems are the tools through which this type of information is gathered and managed. This emphasizes the crucial role of the performance management system in managing the labor inputs to audit quality.
2. Characteristic 2 → The determinants of an auditor's individual performance need to be examined by rank (hierarchical level). We know relatively little about what determines auditor performance, and how this differs per rank.
3. Characteristics 1 & 2 → The identification of employees who will be successful at later career stages requires an assessment of competencies that are either not relevant or less relevant in their current rank (see also Grabner & Moers 2013). This observation again signals the importance of the performance ma-

nagement process, and the potential problem of relying on assessments of current performance for promotion decisions. It furthermore indicates the importance of knowing what determines performance at different ranks. More importantly, knowing what matters at higher ranks then triggers the question whether such information is incorporated in career decisions. The key, yet open question with respect to the loss of talent is whether talented auditors are passed over for promotion, and if so, whether they indeed (intend to) leave.

4. Characteristics 1 & 2 → The audit engagement has become a "high-skilled, difficult-to-automate job" that heavily relies on human interaction. Such jobs increasingly require social skills, which are based on tacit knowledge (Deming, 2015).[1] Over the last decade, the economics literature has documented the growing importance of "non-cognitive" skills, including social skills and leadership skills, relative to cognitive skills (Kuhn & Weinberger, 2005; Heckman, Stixrud, & Urzua, 2006; Lindqvist & Vestman, 2011; Heckman & Kautz, 2012; Borghans, Ter Weel & Weinberg, 2014; Weinberger, 2014). This suggests that tacit knowledge has also become more important in auditing at all ranks. Consistent with this conjecture, Bol et al. (2017) find, using recent data, that audit firms to some extent start to also value tacit knowledge in relatively inexperienced auditors. While this confirms the importance of tacit knowledge and social skills in auditing, even at lower ranks, we know relatively little about their antecedents.

5. Characteristics 1 & 2 → Deming (2015) shows that the percentage of women being employed in social skill-intensive jobs has increased significantly over the last 30 years. This suggests that there are gender differences in social skills and specifically that females have a comparative advantage in social skill-intensive jobs. This social skill differential is of fundamental importance to the auditing industry. While entry-level male and female auditors are hired at an equal rate, women leak out at a rate two or three times faster than men once they have reached the mid-career manager level, resulting in a continuously low percentage of female partners (e.g., PwC, 2008). Audit firms struggle with the "leaking pipeline", i.e., the disproportionately high loss of female talent up the hierarchy, and face pressure from the public to address the problem. Maybe even more important than the external pressure is the above observation that females might have skills that are crucial for audit quality, which makes the leaking pipeline a threat to audit quality. There is limited empirical evidence of the (importance of the) social skill differential in general, and specifically in the auditing context, an important gap that this project intends to fill.

6. Characteristic 3 → In a team production setting the question arises whether team composition matters. Of particular importance here is whether the impact of the knowledge and skills of an individual auditor on audit quality is inhibited or strengthened by the knowledge and skills of other auditors on the team. Having this insight is crucial for managing audit quality in general, but also for the information value of individual performance assessments. Updating one's beliefs about an individual auditor's competencies is difficult when his/her potential is positively or negatively affected by the other team members. Little, if anything is known about the relevance of team composition in an auditing setting and whether an *individual* auditor's performance (assessment) is affected by who is on the team.

4 Key messages

Our project will provide insights into:

1. What personal characteristics, knowledge, and skills of a manager contributes to audit quality, i.e., what the definition of talent is within the audit industry;
2. The extent to which the performance management system affects the loss of talent, and female talent in particular, across the hierarchy; and
3. To what extent team composition affects performance and the development of talent.

Although we have no answers to these questions yet, we expect that the relevance of some of the knowledge and skills that increase audit quality (point 1) might be insufficiently and/or inadequately taken into account when evaluating the performance of staff and seniors (point 2). This implies that a mechanism that is under the direct control of the audit firm is one of the causes of the loss of talent. Our results thus provide insights into how the performance management system can be redesigned to limit talent loss as much as possible. We further expect, given the team nature of the auditing function and that people are affected by their peers, that the composition of the team can strengthen or weaken the development of individuals (point 3). These results provide insights into making well-informed staffing decisions that maximize individual and team performance.

5 Possible implications for practice

Undoubtedly, the development and retention of talent is a key concern of audit firms. This is best reflected in the strategic importance each audit firm puts on talent management, as documented by most audit firms' business models. Some audit firms even classify the retention of talent as one of the key risks where they can improve its focus, including more resource allocation to this area of highest impact to the organization (see e.g. the websites of each of the Big4 audit firms).

We focus in our project on a mechanism for minimizing the talent loss that is **under the direct control of the audit firm, i.e., the performance management and incentive system**. As stated before, there are numerous reasons why employees leave the firm like a better outside option or a personal home situation, but all these reasons are individual-specific and not under the control of the audit firm. Thus, the audit firm can try to deal with these reasons, but not influence them. The performance management and incentive system is, however, under the direct control of the audit firm, and the way it is designed has important consequences for the motivation and retention of different types of employees. Our project provides evidence of the extent to which the performance management and incentive system in place affects talent loss and why this is the case. For example, the relevance of some of the knowledge and skills that increase audit quality might be insufficiently and/or inadequately taken into account when evaluating the performance of staff and seniors, which potentially provides the wrong signal of the ones who are more or less talented. **Our results thus provide insights into how the performance management and incentive system can be redesigned to limit talent loss as much as possible.** Consequently, our results will provide organizations in general, and audit firms in particular with guidelines to take action to tackle the problems. More concrete:

- The project increases our understanding of the main cognitive abilities, skills, etc. that drive audit quality and whether these drivers are adequately captured in the current performance management and incentive system. These insights will allow audit firms to reconsider their performance management practices and trade-off the benefits of their current systems with the costs these systems create with respect to the loss of talent in general, and the leaking pipeline in particular, and adjust them accordingly.
- A better understanding of the determinants of auditor performance at different hierarchical levels, as well as the root of performance differences between (male and female) auditors gives audit firms the opportunity to reconsider their promotion practices. This helps them mitigate the loss of talent due to the misidentification of talent triggered by the performance management and incentive system in place. Similarly, the results will help audit firms to identify the employee types that are most likely to become partners, and even more important, the characteristics of highly talented auditors (in terms of audit quality) that risk to leak out to start a successful alternative career. These insights allow audit firms to adjust their recruiting practices, and develop strategies to retain the group of "voluntary terminators".

- With respect to team composition, our results will allow audit firms to make well-informed staffing decisions that maximize individual and team performance, put management attention to those projects that for some other reasons cannot be staffed in the optimal manner, and manage high-potentials by putting them in "the right team", and thus make it more likely to retain them.

While we have focused our discussion on the implications of our results for audit firms, they also apply to any other type of organization that heavily relies on human capital and/or teamwork, such as, but not limited to, other professional service firms (e.g., consulting or legal services), financial services (e.g., banking and insurance), or creativity-dependent firms (e.g., advertising and media).

In even more general terms, our theoretical and empirical contributions to the fields of accounting and economics will lead to a better understanding of the role of performance management and incentive systems in the attraction and retention of talent, which will be of interest to decision makers in the corporate world. We will provide insights into what features of performance management and incentive systems are most crucial for employees' career choices and what the consequences are of neglecting these issues. These insights will emphasize the benefits of integrating performance management and human capital management – company functions that from previous experience are often working in isolation – and can trigger changes in corporate performance management and promotion policies and maybe even changes in organizational structures in firms that neglect this integration. Given the well-known problem of the Peter Principle triggering the loss of talent, and the significant costs to firms that face this problem, the insights from our project contribute to solve one of the trickiest problems of today's human capital managers: The identification of talent and maybe even more important, their retention. ■

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Notes

1 Tacit knowledge is a form of procedural knowledge, i.e., "how to" rules, skills, and strategies, that people acquire, often subconsciously, from daily social learning experiences (Bol et al., 2017). Tacit knowledge is different from technical knowledge in that it is difficult to verbalize and typically not acquired from formal instruction. Tacit knowledge is assumed to make people better at managing themselves, managing others, and managing socially complex tasks (Hedlund & Sternberg, 2000; Sternberg, 1999).

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Dialogue

By Julia Wijnmaalen

"The most important input in audit firms are the people" (Frank Moers).

The turnover rate is exceptionally high in the audit sector compared to other industries. Although talent loss is an issue that firms are struggling with for over a decade, professor Moers poses several reasons why this research topic remains relevant. For one, the profession is changing. Developments such as more automation change the profession and require different skillsets. These changes make the profession less attractive, and if less people are attracted to the profession the high turnover rate becomes more problematic than it was before. Another reason for this research is that the people component is crucial in an audit, as is the need for further understanding the link between input (people) and output (audit quality). Moreover, nowadays talented people do not just transfer from one firm to another firm; they leave the profession all together. This trend is underlined by KPMG assurance leader and FAR board member Egbert Eeftink. In his closing remarks he states: "*A key issue we face more today than 10 years ago is the competition for talent, and the skills required because of the automation of audit work*". Another conference attendant attests to the brain drain the industry is facing: '*students right out of college choose to work outside the industry*'. Another attendant underlines this statement by sharing that more than 40% of Dutch CPA's do not work in audit firms.

Pursuant, an attendant asked Moers for advice: a dilemma the sector is struggling with is the balance between learning and sanctioning. "*Nowadays the focus is more on sanctioning (fueled by tightened regulation) instead of stimulating learning, with as a consequence that we lose talent. What can we do?*" Moers replies that sanctioning indeed hinders learning, and that talented people focus on learning. Hence, Moers expects that a focus on sanctioning creates an environment that might push talented people out of the profession.

Performance management systems influence whether or not talent is identified. For example, the value of non-cognitive skills is not always recognized in individuals. Consequently, it happens that both the 'wrong' individuals are promoted as well as that the individuals whose skills are not recognized eventually leave. Moers notes that "*talent decision making may currently be affected by incomplete or inaccurate information systems*". In the discussion it becomes clear that there are differences between firms. One of the attendants points out the importance of situational characteristics: "*Are you going to talk to people? Because the institutional context influences how individuals behave [...] you have different examples of different firms*". Moers replies: "That is also why this platform between practice and science is so important so that we get the context right". Another attendant shares that within PwC USA employees need to clearly demonstrate they are ready for the next job level. "*I remember that I had many talks about non-cognitive skills with my performance coach*". So according to him it hardly occurs that people are promoted who are not ready. Since the research has a gender-angle an attendant asks how Moers is going to control for other reasons why women leave, reasons such as the work-life balance. Moers replies that the research is not so much about men versus women, it is about talented individuals leaving the organization. Misidentified talent. According to him reasons like the work-life balance fall under individual-specific reasons for leaving. However, one of the conference attendants points out that several of those individual-specific reasons might not be gender neutral. For example, women might not have another option to leave, or maybe it is not very stimulating to be at the top of an auditing firm as a woman. Hence the question is raised whether individual-specific reasons for leaving a firm are the same for men and women. ■

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FAR Research project Professional Skepticism: A Trending Concept in Need of Understanding

By Kris Hardies and Sanne Janssen

"The need for professional skepticism in an audit cannot be overemphasized" (Prof. Arnold Schilder, IAASB Chairman, 2012).

1 Why is this research important and how does it contribute to practice?

Regulators and standard setters emphasize professional skepticism as a key input to audit quality (e.g., AFM, 2014; PCAOB, 2015; IFIAR, 2015; IAASB, 2015). Indeed, a global recurring theme in audit inspection findings is instances in which auditors did not appropriately apply professional skepticism in their judgments and actions (IAASB, 2015). For example, IFIAR concluded from its 2014 Survey of Inspection Findings that: "*A factor underlying many audit deficiencies is insufficient exercise of professional skepticism during performance of the audit*" (IFIAR, 2015, p. 3). Hence, "*IFIAR has suggested that enhanced professional skepticism by auditors will contribute significantly to improve the quality of the audit and that firms should prioritize efforts in this area*" (IAASB, 2015, p. 12).

While the importance of professional skepticism is undisputed, our understanding of the consequences and drivers of professional skepticism is limited. Hence, the main idea of the Foundation for Auditing Research (FAR) research project is to broaden our understanding of the causes and consequences of professional skepticism. Specifically, we aim to provide insight into (a) the nature of professional skepticism (i.e. to what extent do individual characteristics such as personality and experience and situational characteristics such as various organizational conditions, tone at the top and time budget pressure matter); (b) the extent to which professional skepticism is a *team*-level factor (i.e. is optimizing professional skepticism a matter of put-

ting the most skeptical people in the same audit team or not); and (c) the (intended and perhaps unintended) consequences of professional skepticism (i.e. is professional skepticism effective and efficient in terms of audit quality). The outcomes of this research project are expected to be of interest not only for academics but should also be informative for audit firms as well as regulators and standard setters. For example, the results of this project might help audit firms in selecting and training their people, in the composition of their engagement teams, and the design and control of their organizational conditions (e.g. evaluation and compensation).

2 Introduction of the research question

Professional skepticism is definitely not a new theme, but it has rapidly increased in importance over the past decade(s). Reference to the concept of professional skepticism before the 1990s is close to non-existent. The first reference in US auditing standards to the concept of professional skepticism dates from the late 1980s. During the 1990s there was increased attention for professional skepticism both by regulators and standard setters (e.g. GAO, 1996; AICPA, 1997 (SAS No. 82); IAASB, 1998 (ISA 240)) as well as by academics (e.g. McMillan & White, 1993; Shaub, 1996), but professional skepticism only started to get real attention after the turn of the century (due to the unraveling of a series of high-profile accounting scandals including Enron and WorldCom); within important practitioner journals like *CPA Journal* and *Journal of Accountancy* professional skepticism got linked to audit failures (Carmichael & Craig, 1996), SEC enforcement actions (Beasley et al., 2001), and malpractice claims against auditors (Anderson & Wolfe, 2002). Between 2000 and 2010, academics increased their focus on pro-

fessional skepticism (e.g. Nelson, 2009; Rennie et al., 2010; Hurtt, 2010). Only in more recent years, however, professional skepticism became the trending topic that it is today. After the financial crisis, regulators and standard setters throughout the world devoted significant attention to the issue of professional skepticism. For example, in June 2010 the Financial Services Authority (FSA) and the Financial Reporting Council (FRC) issued a discussion paper which questions whether the auditor has always been sufficiently skeptical. In December 2012, the PCAOB issued a staff audit practice alert on professional skepticism. In December 2015, the IAASB solicited comments on their project *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*. This increased attention to professional skepticism by practitioners is also reflected in the academic attention devoted to the subject: more than half of the research (62%) ever published on professional skepticism was published between 2013 and today (only 4 studies were published before 2000, and 6 studies have already been published in 2017).

3   What does academic literature tell us

Despite its alleged importance and popularity both among academics and practitioners, the concept of professional skepticism is in fact not well understood. Standard setters typically define professional skepticism as *an attitude that includes a questioning mind and a critical assessment of audit evidence* (ISA 200; AS 1015). Many academics view professional skepticism as an attitude (i.e. as a *state*) (e.g. Shaub, 1996; Nolder & Kadous, 2017; Robinson et al., 2017). However, academics have also defined professional skepticism in terms of (relative) stable differences between individuals (i.e. as a *trait*) (e.g. Hurtt, 2010; Quadackers et al., 2014). Importantly, professional skepticism is an important *input* to auditors' judgment and decision-making and is thought to be of value because it enhances audit quality (e.g. Nelson, 2009; IAASB, 2015). Hence, professional skepticism should be apparent from the behavior displayed by the auditor. For example, if an auditor maintains professional skepticism throughout the audit, this should be reflected in "a heightened assessment of the risk that an assertion is incorrect, conditional on the information available to the auditor" (Nelson, 2009, p. 1). As such, professional skepticism could be related to, for example, increased fraud detection, lower levels of earnings management, lower materiality levels, more frequent audit adjustments, less reliance on management explanations and evidence.

3.1   Professional skepticism as a trait

As indicated above, research on professional skepticism is relative recent, but has seen a rapid expansion over the last few years. Most of this research has ten-

ded to treat professional skepticism as a trait. Traits refer to individual characteristics which are generally unaffected by the environment and consequently relatively stable. As a trait, professional skepticism can be understood as "the propensity of an individual to defer concluding until the evidence provides sufficient support for one alternative/explanation over others" (Hurtt, 2010, p. 151). If professional skepticism is a trait, this means that within every individual, there is some baseline level of professional skepticism that the individual is willing to extend to nearly all those situations/engagements in which the individual interacts. In this context, some authors also understand professional skepticism as the opposite of trust (Shaub, 1996), being the propensity to trust (nearly all) those with whom one interacts and a general tendency to make positive attributions about others' intentions (Rotter, 1954, 1967).

Drawing on this conceptualization of professional skepticism as a trait, measured by the Professional Skepticism (PS) Scale developed by Hurtt (2010), Hurtt et al. (2008) experimentally find that auditors who score high on the PS Scale detect more contradictions in working papers and generate more alternative explanations for management assertions. Similarly, Quadackers et al. (2014), using the inverse of trust to measure professional skepticism, show that less trusting auditors are more likely to arrive at skeptical judgments in an audit task. This finding mirrors earlier work in the field which found that less trusting auditors pay more attention to instances of aggressive financial reporting in financial statements and, as a result, are more likely to arrive at judgments of intentional misstatement (Rose, 2007).

Besides drawing on psychometric measures such as the PS Scale developed by Hurtt (2010) or the Interpersonal Trust Scale developed by Rotter (1967), researchers have investigated the effect of professional skepticism by investigating how management reacts to changes in auditor behavior that are indicative of an increase in auditor skepticism such as a change in audit procedures. For example, Chen et al. (2012) show experimentally that managers expect less earnings management to occur if they are made aware of the fact that auditors changed the nature of evidence collected toward more probative evidence. Collectively, these studies suggest that professional skepticism, whether operationalized as a trait or inferred from skeptical actions, has consistently been linked with beneficial audit outcomes such as deterring earnings management on part of the client or more skeptical judgments and action on part of the auditors.

3.2   Professional skepticism as a state

In addition to being a trait, professional skepticism

can also be understood as an *emergent state* (Grohnert et al. 2017; Nolder & Kadous, 2017; Robinson et al., 2017). Emergent states refer to cognitive, motivational, and affective states that are dynamic and vary as a function of situational characteristics as well as inputs, processes, and outcomes (Marks et al., 2001). If professional skepticism is a state, this means that professional skepticism can be understood primarily as an attitude which can develop over time (or very quickly) based on situational characteristics and need. This also implies that professional skepticism is not just an input, but could be a proximal outcome as well depending on the context (see Marks et al., 2001). For example, professional skepticism may be viewed as an input to fraud risk assessment, but may also be viewed as a proximal outcome of the interaction a junior team member has with the audit partner (e.g. during fraud brainstorming). Most importantly, this means that professional skepticism can be enhanced or impeded due to specific interactions (e.g. due to interaction with an audit partner that heavily stresses the importance of professional skepticism) or due to specific organizational conditions (e.g. due to severe time budget pressure).

In the existing literature, this aspect of professional skepticism as an emerging state is covered by studies that either investigate how situational characteristics located at the level of the audit/client firm or auditor characteristics, such as experience and expertise, enable or constrain the exercise of professional skepticism. Regarding situational characteristics, there is a relatively strong consensus in the empirical literature that they can constrain or facilitate an auditor's exercise of professional skepticism. These studies can be broadly classified into those investigating situational characteristics at the level of the audit firm or audit team, and those considering factors in the client environment. Regarding the internal environment of the audit firm, Nelson et al. (2016) show that auditors who perceive their team leader to be more team-oriented are more likely to speak up and raise audit issues (i.e. engage in skeptical actions). Similarly, it has been shown that auditors whose audit partner stresses the importance of professional skepticism are more efficient and effective in the identification of relevant fraud risk s as well as in their choice of relevant audit procedures (Carpenter & Reimers, 2013). Partners can further trigger an increase in professional skepticism by highlighting that client management believes there to be a low risk of fraud (Harding & Trotman, 2017). With regard to the external client environment, prior research has found that auditors confronted with either a weak control environment or overly optimistic management assertions arrive at more skeptical judgments and engage in more skeptical actions (Quadackers et al., 2009; 2014; Feng &

Li, 2014). In contrast to the relatively consistent findings regarding situational characteristics at the audit team and client level, findings related to the role of auditor experience and expertise on the exercise of professional skepticism are mixed. On the one hand, studies such as Rose (2007) find a direct, positive effect of (fraud) experience on the likelihood of arriving at a skeptical judgment regarding a potential misstatement. On the other hand, Grenier (2017) finds that non-industry specialist auditors are, in general, more skeptical than their specialist colleagues, calling into question the value of industry training and specialization from an audit quality perspective.

3.3 Interaction between trait and state

A potential reconciliation of these contradictory findings lies in the detailed study of the interactions between trait professional skepticism and the situational characteristics that promote professional skepticism as an emergent state (e.g. Grohnert et al., 2017). For example, Quadackers et al. (2014) find that auditors exhibiting a low level of dispositional trust will issue more skeptical judgments if the client has a weak internal control system compared to an auditor exhibiting high levels of dispositional trust. Consequently, it seems that auditors exhibiting a high level of trait professional skepticism are more likely to be triggered by situational characteristics that influence professional skepticism as an emergent state. There is thus considerable value in investigating how trait professional skepticism can potentially be impeded or facilitated by situational characteristics that are associated with triggering professional skepticism as an emergent state. Therefore, researchers have concluded that professional skepticism has both a trait and a state component. Some people might be "professional skeptic" (trait) (i.e. have an inherent tendency towards professional skepticism), but nevertheless on a specific occasion be "convinced" (state) easily by the evidence presented by management (i.e. be in a *state* of believing), which makes them "fail to demand" (behavior) more proof for a certain assertion. Overall, research indicates that traits interact with different factors to create many emotional states, and the temporary ways of being or feeling affect our behavior (modelled in Fig. 1). This implies that (a) different people will react differently (i.e. behave differently) to different situational cues, but also that (b) situations will have a different effect on behavior depending on the characteristics (e.g. traits) of people.

4 Key message(s)

The literature on professional skepticism has rapidly been increasing over the past few years. Despite some excellent theoretical work in this area (Hurtt, 2010; Robinson et al., 2017; Nolder & Kadous, 2017)

Fig. 1   Conceptual Framework
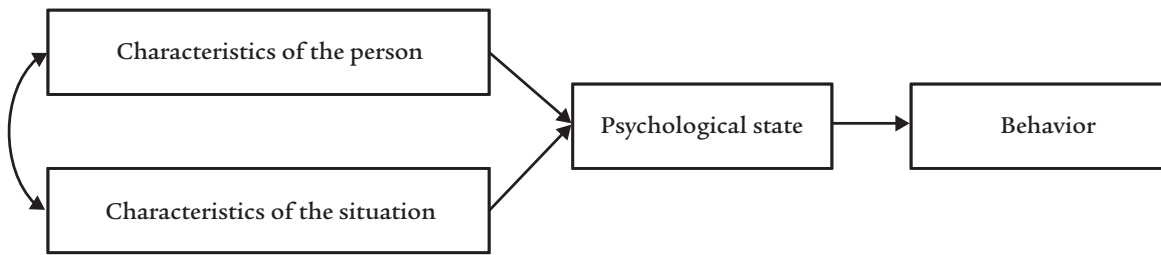
and the publication of a number of review studies on the subject matter (Nelson, 2009; Hurtt et al., 2013), our understanding of professional skepticism remains limited and underdeveloped due to the lack of prior research to simultaneously consider the impact of both personal and situational characteristics and the intermediating role of psychological states. Although prior research suggests that professional skepticism should be understood as both a trait and state concept (i.e. professional skepticism is the outcome of both stable, enduring features as of contingent factors), *the relative importance of personal and situational characteristics remains unknown*. Additionally, we have no systematic evidence on the importance of *various situational characteristics* that allegedly could threaten the maintenance of professional skepticism during an audit (e.g. various organizational and environmental conditions such as tone at the top, commercialization, quality control procedures, promotion and compensation processes, client importance). We also lack a thorough understanding of the *individual antecedents of professional skepticism* (e.g. is professional skepticism as a trait associated with certain socio-demographic factors, experience, motivation, or personality). Studies on professional skepticism so far have also focused solely on individual auditors, ignoring the fact that audits are performed by teams of individuals. It, therefore, remains unknown to which extent different individuals within the audit team affect professional skepticism on the overall audit engagement. Hence, we currently do not know *whether it is necessary for all members to maintain professional skepticism* throughout an audit to ensure high audit quality. Finally, the consequences of professional skepticism on various audit processes and audit outcomes are badly understood. It is assumed that professional skepticism fosters audit quality, but it is unclear *which elements of the audit process are affected (the most) by professional skepticism*. For example, does professional skepticism affect any of the following elements: materiality levels, audit planning, fraud brainstorming, risk identification, risk assessment, audit testing, the evaluation of identified material misstatements, the audit reporting process? Additionally, we do not know whether there exists an optimal level of

professional skepticism, that is how professional skepticism affects audit efficiency and not just effectiveness. The objective of our FAR project is to advance our understanding of these important questions. In particular, Fig. 2 reflects the following three research questions that we will address:

1. What is the profile of individual auditors' professional skepticism across ranks (partner, supervisor, other members of the team), and collectively as a team? Further, what is the association between team leadership skepticism profiles and subordinate profiles?

On the basis of research question 1, we aim to provide evidence on the individual antecedents of professional skepticism and on the extent to which different individuals within the audit team affect professional skepticism on the overall audit engagement.

2. What is the association between the professional skepticism profile of the partner and other team members on the audit process and outcomes (e.g., audit pricing, audit planning and production, and audit quality)?

The purpose of research question 2 is to advance our understanding of the relationship between professional skepticism and audit processes and outcomes. We aim to provide evidence on which elements of the audit process are affected (the most) by professional skepticism and on the necessity for all members to maintain professional skepticism throughout an audit to ensure high audit quality.

3. What is the impact of organizational conditions on the relationship between professional skepticism (of the partner and other team members) and the audit process and outcomes?

On the basis of research question 3, we aim to provide evidence on the relative importance of various personal and situational characteristics. Further, the purpose is to advance our understanding of the relationship between the different elements of the audit process and professional skeptical behavior.

5   Possible implications for practice

By addressing these research questions, our FAR project will help audit firms to understand variation in the professional skepticism profiles across partners, super-

Fig. 2 **Outline FAR Project**
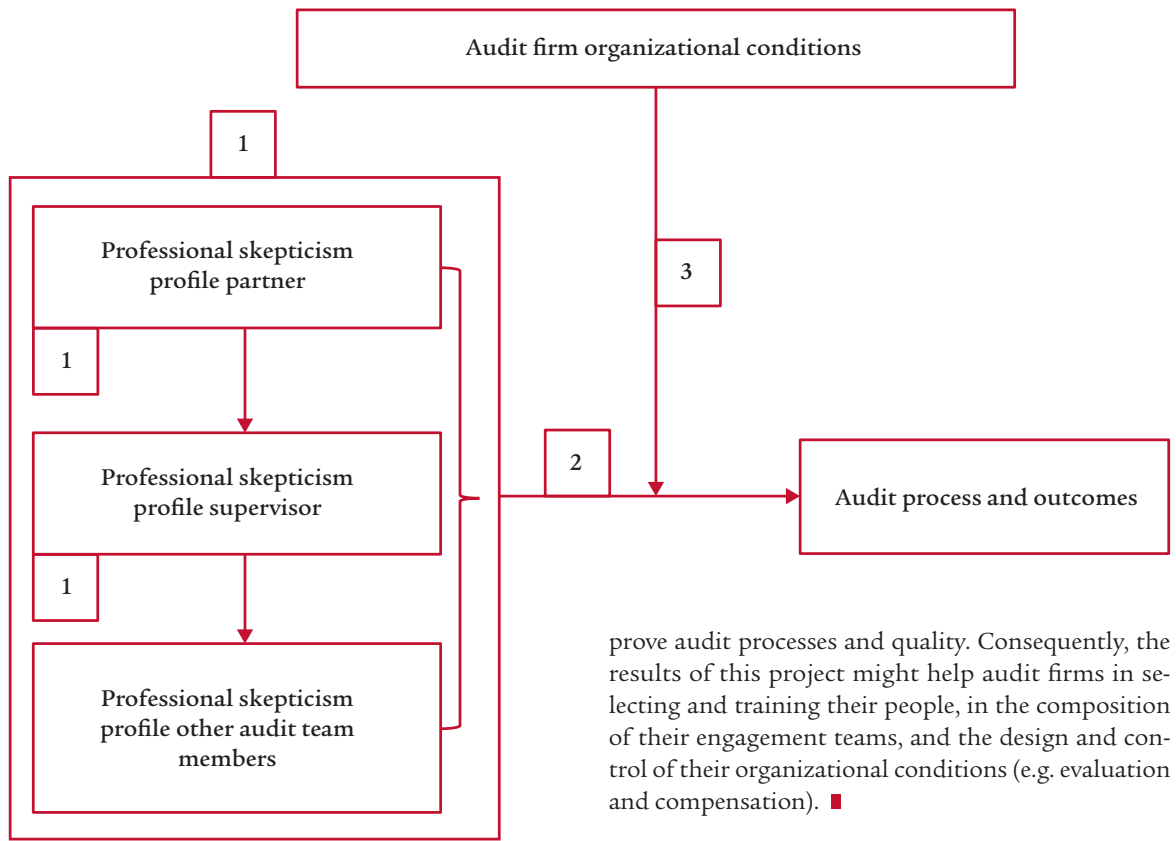
prove audit processes and quality. Consequently, the results of this project might help audit firms in selecting and training their people, in the composition of their engagement teams, and the design and control of their organizational conditions (e.g. evaluation and compensation). ∎

visors, and other engagement team members within the firm, across offices, and across firms; similarities or differences between team leadership skepticism profiles versus subordinate profiles. Furthermore, it will provide insights to audit firms on the role of the professional skepticism profile of the partner and other team members on audit processes and quality-related outcomes. Finally, it will provide insights on organizational conditions that may help the audit firm to im-

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Notes

[1] According to a study by Beasley et al. (2013), insufficient levels of professional skepticism were amongst the top reasons for SEC sanctions against auditors over the period 1998–2010 related to instances of alleged fraudulent financial reporting by US public companies (cited in 49 of the 81 cases).

[2] SAS No. 53 (The Auditor's Responsibility to Detect and Report Errors and Irregularities, 1988)

[3] Although not the focus of this paper, a lot of discussion on professional skepticism focusses on the question whether professional skepticism needs to be understood from a "neutral" or a "presumptive doubt" perspective. The neutral perspective is most in line with current audit practice and standards (Aschauer et al., 2017) and implies that the auditor assumes that management is neither honest nor dishonest, but rather keeps in mind that fraud (or errors) can be present. Conversely, the presumptive doubt perspective assumes some dishonesty unless data indicate otherwise (e.g. Bell et al., 2005; Nelson, 2009; Shaub, 1996). Under the latter perspective, professional skepticism is the opposite of trust.

[4] Regulators and standard setters as well as the popular press have claimed that professional skepticism could be affected by a diverse set of organizational conditions and other situational characteristics such as a firm's quality control systems (including the tone at the top, performance, promotion, and compensation processes), workload and time budget pressures, incentives to maintain client relationships and avoid conflicts with management, identification with the client and trust in management, and the nature and volume of non-audit services (e.g. Richards, 2016; PCAOB, 2012; FRC, 2012). There exists a reasonable amount of research on the impact of organizational conditions and environmental factors on various aspects of the audit

process and audit quality. Especially the role of non-audit services has attracted a great deal of researcher attention (for an overview, see Sharma, 2014), but also other factors such as audit time pressure and audit partner busyness (Goodwind & Wu, 2016; Malone & Roberts, 1996), the degree to which auditors identify with their client versus their identification with the audit profession (Bamber & Iyer, 2002, 2007), the strength of

the audit firm's internal quality control and review system (e.g. Malone & Roberts, 1996), and the audit firm's internal error reporting climate (Gronewold & Donle, 2011; Gold et al., 2014) have been investigated in the literature. The role of such factors in relationship with professional skepticism has, however, received scant attention from researchers to date. Some of the notable exceptions highlighted in this paper include in-

vestigations on the role of partner communications on auditor professional skepticism (Carpenter & Reimers, 2013; Harding & Trotman, 2017), partner characteristics on the likelihood that audit team members will speak up and raise audit issues (Nelson et al., 2016), and the influence of the clients control system on skeptical judgments (Quadackers et al., 2009, 2014).

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Dialogue

By Julia Wijnmaalen

"Do we really know what professional skepticism is?" (Kris Hardies)

Assistant-Professor Hardies started by extending an invitation to the audience to share their insights from practice and to come up with suggestions. *"We are still setting up the data collection, so we can still adjust the research design."*

The topic whether professional skepticism needs to be understood from a "neutral" or a "presumptive doubt" perspective really triggered the audience. *"Can't you be neutral to the client and doubtful towards the evidence?"*, one attendee asks, *"are they really mutually exclusive in an audit?"*. According to Hardies, the two perspectives have not been discussed together in prior studies. It is always about one or the other perspective. *"Maybe you can. We need to think about it"* Hardies replies. Another conference attendee adds: *"We do not say that we are either neutral or skeptical, but we talk about an enhanced professional skeptical situation"*. A different member of the audience poses that the starting point of an audit is always data collection in line with the standards and therefore it is a neutral process. Hardies agrees that auditing standards are more in line with the neutrality perspective, but an important question is what will happen next after the relevant data has been gathered? *"How are you going to respond? Neutral or more skeptical?"* Egbert Eeftink, KPMG assurance lead and FAR board member shares this view in his closing remarks: *"I think that here it is neither one or the other. We cannot be fully neutral as we all operate from our own personal model of the world. And always working from a mindset of presumptive doubt impairs our ability to build reasonable relations with client personnel"*.

Personal and situational characteristics are both important for professional skepticism. Hardies emulates: *"Some people might be more skeptical from a personality point of view, but in a certain situation they might feel that there is less need to be skeptical. Then they demand less evidence, so they show less professional skeptical beha-*vior". However, it is interesting to see how these two variables interact. What is the impact of organizational conditions and other situational characteristics, like the tone at the top, performance management systems and organizational culture? Hardies answers: *"Obviously there are many different things that could influence whether or not someone shows professional skeptical behavior"*. The discussion on situational characteristics reminds one of the conference attendees of the terms: subjective probability and the availability of a heuristic technique. It is not only the facts that influence your perception of a certain risk. A recent experience, for instance, can inflate your estimation of that risk. Since a skeptical auditor is often the bearer of bad news, that person needs to be courageous to speak out. Hence, *"courage seems, to me, to be an important personal characteristic"*. Eeftink also touches upon the courage-part of professional skepticism in his closing remarks: *"Professional skepticism requires courage. It is not only about having a questioning mind and being able to find errors. It is also about the competence to address such issues and to escalate if necessary"*. According to Hardies moral courage is an important characteristic of professional skepticism. Moral courage is a trait, which encourages auditors to take skeptical actions based on their judgements. The Professional Moral Courage Scale (Sekerka et al., 2009) will be used to measure skepticism traits in the FAR project. ∎

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FAR Research project
The effects of multiple team memberships on individual auditors' performance

By Reggy Hooghiemstra, Floor Rink and Dennis Veltrop

1 Why is this research important and how does it contribute to practice?

Auditing involves a process in which an engagement team, consisting of assistants, seniors, managers, and one or more audit partners, applies a series of sequentially performed procedures and decisions with the aim to collect sufficient competent evidence regarding the client's financial reporting process and financial statement assertions (e.g., Trotman, Bauer & Humphreys, 2015; Knechel, Vanstraelen & Zerni, 2015; Francis, 2011; Bik, 2010; Pierce & Sweeney, 2005). Teamwork, or how individuals within engagement teams carry out their work, is therefore of crucial importance for audit quality.

Within audit firms it is common practice that assistants, seniors, managers, and audit partners are members of *more than one* engagement team at the same time and thus typically hold *multiple team memberships* (hereafter referred to as MTMs, e.g., Lopéz & Peters, 2012; Agoglia, Brazel, Hatfield & Jackson, 2010; Bik, 2010; Viator, 2001).
The idea that auditors hold MTMs means that they are concurrently members of several engagement teams in a given period of time (O'Leary, Mortensen & Wooley, 2011). Even in a single workday, auditors may be working on a number of different tasks and may be interacting with a multitude of members of different teams (*cf.* Bertolotti, Matterelli, Vignolli & Macrì, 2015). This has important, to date unacknowledged, implications for understanding what drives an individual auditor's job outcomes, the overall effectiveness of the engagement teams involved, and ultimately, audit quality. Specifically, from the literature on MTMs we know that this way of organizing work comes with certain costs as well as benefits to the individual, the team and ultimately the organization. For instance, while MTMs may create opportunities in terms of increased learning possibilities and better information exchange, it also may come with increased switching costs and higher workload.

The main contribution to practice is that we discuss implications of MTMs for auditing practice to get a better idea of why some auditors are likely to struggle, while others thrive in such a working environment. That is, we will reflect on how and under what conditions working in MTMs affect auditors' job performance.

2 Introduction of the research question

While insightful, research in the auditing domain seems to be based on the idea that auditors are part of one team in which all members work on a single engagement and share responsibility for the attainment of a high-quality audit (e.g., Bell, Causholli & Knechel, 2015). However, it is important to realize that such a team model does not align with reality of how audit work is organized.
As indicated *multiple team memberships* is the predominant way in which work within auditing firms are organized. The omnipresence of MTMs in audit firms and a current lack of understanding of how working in multiple teams simultaneously affects the performance of auditors renders it crucial to reflect on the effects of working in MTMs within audit firms. As this paper discusses some of the most pressing issues related to working in MTMs in audit firms, the outcomes contribute to existing knowledge on key drivers of audit quality (e.g., Christensen, Glover, Omer & Shelley, 2015; Bell et al., 2015; De Fond & Zhang, 2014; Knechel, Krishnan, Pevzner, Shefchik & Velury, 2013; Fran-

cis, 2011, 2004). Also from a practical point of view, having insights into the effects of MTMs is crucial as both audit firms and regulators indicate that audit firms' employees have a crucial role in securing high-quality audits. For instance, the NBA-report *In the public interest* (2014, p. 35) notes that "[t]he quality of the people within an accountancy organization is one of the, if not the most, important defining factors for the quality of the organization and the quality of the audits carried out". At the same time recent transparency reports of Dutch audit firms indicate that recruiting and retaining qualified staff poses a real challenge to audit firms (e.g., KPMG, 2016). One key reason for this is that individual auditors often suffer from a high work load and tend to experience lack of work-life balance.

Therefore, the overall aim of this paper is to reflect on *how* and *under what circumstances* working in MTMs are likely to affect individual auditors' job performance.

3 What does the academic literature tell us?

3.1 Auditors as a key audit quality dimension

Following the seminal work of DeAngelo (1981), audit quality has been defined as the joint likelihood that an auditor will discover and report material misstatements. Both auditor's competence and effort levels determine the likelihood that s/he discovers a material error (e.g., Bell et al., 2015), while the likelihood that a discovered error will be reported by the auditor is affected by the auditor's independence vis-à-vis the client (e.g., De Fond & Zhang, 2014). Various academic reviews of the literature on audit quality (e.g., Trotman et al., 2015; De Fond & Zhang, 2014; Knechel et al., 2013; Francis, 2011, 2004) suggest that employees working at audit firms are a key determinant of audit quality. Evidence from interviews with and surveys among audit partners and staff (Christensen et al., 2015; Persellin, Schmidt & Wilkins, 2015; Westermann, Bedard & Earley, 2015) also suggests that engagement team members perform a pivotal role in securing high-quality audits. For instance, one of the interviewees in the Christensen et al. (2015, p. 17) paper clearly emphasizes employees' pivotal role by stating that "audit quality is driven by the individuals". In practice, a large number of professional organizations and regulatory bodies (e.g., NBA, 2015, 2014; CAQ, 2014; IAASB, 2014; PCAOB, 2014) acknowledge the key role of audit firms' employees in securing high-quality audits. The IAASB (2014), for example, states that "[a] high quality audit is likely to have been achieved by an engagement team that [...] was sufficiently knowledgeable, skilled, and experienced and had sufficient time allocated to perform the audit work". In a similar vein, the PCAOB listed "workload pressures" as a potential root cause for the deficiencies they revealed in the re-

cent past.

At the same time, however, it is alarming that staffing issues are on top of the list of concerns for audit firms of all sizes because both finding *and* retaining qualified staff appears to be problematic (Drew, 2015). This finding reflects significant changes in the work environment of the audit profession, and supports other research showing not only that auditors at all levels perceive their workload to be high (Persellin et al., 2015), but also that they have become more eager to maintain a better work-life balance (e.g., Westermann et al., 2015; Johnson, Lowe & Reckers, 2012).

3.2 Multiple team memberships in audit firms

In an attempt to use scarce human resources as efficiently as possible, audit firms rely on dynamic teams where memberships are frequently shared, shifted and dissolved (López & Peters, 2012; Bik, 2010; Pierce & Sweeney, 2005). In practice this means that auditors hold multiple team memberships, meaning that they are simultaneously members of several engagement teams in a given period of time (O'Leary et al., 2011). Following O'Leary et al. (2011) MTMs can be decomposed into two dimensions: the number of simultaneous team memberships and the variety between team memberships. Both dimensions are relevant in the auditing context. The number of simultaneous team memberships represents the number of distinct engagement teams that an individual belongs to at a given time point; for instance in a certain month during the busy season an individual senior may be working on 6 different engagements simultaneously. The variety between team memberships reflects the teams' similarity in terms of tasks, roles and team characteristics (O'Leary et al., 2011). For instance, while a senior may be the acting manager on one engagement (involving a small(er) firm), s/he may actually mostly be conducting field work on another engagement (involving a large(r) firm).

4 Key message - The countervailing perspectives on the effects of MTMs

Within the MTM-literature two perspectives have emerged to account for the relationships between MTMs and individual performance, namely: the *demand perspective* and the *resource perspective*.

The *demand perspective* emphasizes the negative aspects of belonging to multiple teams simultaneously; aspects that are likely to lead to strain and exhaustion. Scholars suggest that there are two reasons why MTMs pose demands on employees. First, they have to deal with increased *task-related demands*, including time-schedule conflicts (Zika-Viktorsson, Sundstrom & Engwall, 2006), diverging work demands, and switching costs (e.g., Van de Brake, Walter, Rink, Essens & Van der Vegt, 2015; O'Leary et al., 2011; 2012). For example, employees that

work on multiple teams simultaneously have to relocate their work activities more often, have to spend more time on catching up with work done in their absence, and need to shift more regularly between tasks compared to employees that predominantly work in one team only (Pluut, Flestea & Curşeu, 2014; O'Leary et al., 2011). Obviously, some of these issues become even more pressing when the variety in the teams is higher. For instance, higher variety not only means that a greater amount of information must be managed (O'Leary et al., 2011), it also means that the individual employee needs more time and effort to adjust to the different roles and "spheres" in the teams. Also at the team level, the presence of MTMs can also hamper performance as most team members need to coordinate their efforts with the other teams to which they belong (O'Leary et al., 2011) in an attempt to reduce the amount of time that team members do not synchronously work on the same team (i.e., "temporal misalignment") (O'Leary et al., 2012).

Second, working in an MTM-environment can come with increased *social demands* for individual auditors. By nature, engagement teams are episodic implying that memberships are frequently shifted and dissolved (e.g., Bik, 2010). In this environment it is more difficult to develop socially-integrated teams in which individual members feel "psychologically linked to others in a group" (O'Reilly, Caldwell & Barnett, 1989, p. 22). Scholars have suggested that it is relatively complicated to build relationship stability and continuity in an environment in which employees mostly work in multiple teams simultaneously (Van der Vegt, Bunderson & Kuipers, 2010) and, hence, see each other relatively infrequently. This also means that individual members of an engagement team have to spend more time and effort to socially familiarize themselves with other team members. A lack of stability and continuity in interpersonal relationships makes it more difficult to develop trust among team members that would help to minimize intragroup conflict and fosters team-oriented efforts (Mortenson et al., 2007; Van der Vegt et al., 2010; O'Connor, Gruenfeld & McGrath, 1993). Arguably, teams that are less socially-integrated are more likely to perform their work as a mere collection of individuals rather than as a coherent group with common interests (cf. Van der Vegt et al., 2010). This means that more efforts are needed to coordinate individual work, information, and knowledge to effectively accomplish the team's objectives.

Obviously, the abovementioned task-related and social demands associated with MTMs can pose a threat to an auditor's job performance that may jeopardize audit quality (e.g., Persellin et al., 2015; López & Peters, 2014; Agoglia et al., 2010; Jelinek & Jelinek, 2008; Sweeney & Summers, 2002). Supportive evidence for this notion stems from a large-scale survey study by Persellin et al. (2015). Although not focusing on MTM per se, this study does show that auditors' perceptions of their levels of workload are relatively high and strongly related to perceived audit quality. That is, an overwhelming majority (87 percent) of the respondents indicated that their high workload endangered audit quality. Moreover, the majority of respondents indicated that "deadlines and staff shortage are the biggest drivers of workload pressures" and, hence, lower audit quality because these pressures lead to "(1) compromised audit procedures (including taking shortcuts); (2) impaired audit judgment (including reduced professional skepticism); and (3) difficulties in retaining staff with appropriate knowledge and skills" (Persellin et al., 2015, p. 4).

Importantly however, the *resource perspective* highlights that MTMs can also bring important benefits to individual job performance. Scholars highlighting the positive side of MTMs stress that belonging to multiple teams simultaneously could potentially trigger engagement and learning opportunities. Working in different teams, and especially when team variety is high, help improving learning as an individual belonging to those teams is likely to be exposed to different working methods, ideas, insights, information, etc. Moreover, as working in MTMs usually leads individuals to make more careful choices about how to spend their time it may motivate employees to adopt more efficient ways of organizing their work (Van de Brake et al., 2015; Chan, 2014; O'Leary et al., 2011). Lastly, concurrently belonging to multiple teams makes unique information and new network relations accessible to individuals that would not be available otherwise (Lin, 1999). This information and network advantage facilitate actions that may increase individual and team performance (e.g., O'Leary et al., 2011; 2012).

5 Practical Implications

So far we have addressed two contrasting perspectives on MTMs. The basic message from this review of the literature is that working in multiple teams concurrently can be a double-edged sword. Therefore, in the remainder of this paper, we will reflect on the implications of MTMs for auditing practice to getter a better idea of why some auditors are likely to struggle, while others thrive in such a working environment. That is, we will reflect on how and under what conditions working in MTMs affect auditors' job performance.

5.1 Inverted U-shape relationship

It is likely that there is an inverted U-shape relationship between on the one hand job performance and, on the other, the number of simultaneous team memberships as well as the variety between team memberships. This means it is likely that job performance initially improves as the number of simultaneous team memberships

increases or when team variety becomes larger because individual employees are likely to adopt more efficient working methods and are able to learn from the teams s/he is member of. However, it also means that, inevitably, there is a point at which the costs outweigh the benefits and, hence, after which job performance deteriorates. In this respect, O'Leary et al. (2011, p. 467) note "[a]s individuals take on larger numbers of teams, each additional team exacerbates the division of people's attention and slows their reengagement with any one team's work". In a similar vein, they note that after some point higher team variety is associated with greater job scope and complexity which likely leads to high levels of strain which will reduce job performance.

In an auditing context this may mean that when an individual auditor is member of a certain number of engagement teams on which s/he works simultaneously, adding one additional engagement to his/her portfolio and/or increasing the variety of teams would be detrimental to his/her performance. Specifically, it is likely that, in order to cope with the increased work load and due to an increased feeling that the job cannot be done in the allocated time (Persellin et al. 2015), the individual auditor will more likely take shortcuts while performing audit procedures (Sundgren & Svanström, 2014) and that his/her audit judgment may be impaired. Obviously, such practices increase the possibility that existing problems will be overlooked (Persellin et al., 2015; Caramanis & Lennox, 2008), which ultimately harm audit quality.

Also learning effects may diminish when the number of simultaneous team memberships increases beyond a certain point or when team variety becomes too great. For instance, when variety is high the diversity of inputs and information from team members becomes so varied that it becomes "unlikely to trigger any additional learning" (O'Leary et al., 2011, p. 470). Similarly, being on too many teams simultaneously leads to increased time pressure and doesn't allow individuals to reflect on the experiences gained on the different teams and to learn from those experiences. For instance, this may imply that a senior doesn't learn on the job and benefit from the experiences and instructions from the more senior people on the engagement. Hence, this would for instance imply that the senior wouldn't be in a position to acquire skills beyond the general training he/she received. This is alarming as auditing essentially involves on-the-job learning, or "a professional "apprenticeship", in which more experienced colleagues provide guidance on how a less experienced employee should perform a task. Through this process, the apprentice is expected to learn how to translate knowledge of his/her "craft" into practice" (Westermann et al., 2015, p. 864).

Taken together, this means that there is some optimal level of the number of simultaneous team memberships and variety between team memberships at which auditors likely thrive in an MTM-environment. It also means that to allow learning it may be important to either incorporate brief breaks (for instance of half a day) between engagements and/or to minimize the extent to which deadlines on different audit engagements culminate at one date.

While the above-mentioned saturation or inflexion point will ultimately pose limits on the number of simultaneous team memberships and/or variety between team memberships, there are some indications in the literature that individual-level characteristics in general and organizational tenure helps to alleviate the negative effects of MTMs.

5.2 The effects of organizational tenure

In terms of individual-level characteristics it seems that how individuals go about achieving their goals is likely to help explaining how individual auditors cope with MTMs in general and the task-related demands in particular. One crucial characteristic is the auditor's organizational tenure. *Organizational tenure* reflects an auditor's total time employed at an audit firm (cf. Conway & Coyle-Shapiro, 2012). In line with the literature about organizational socialization (e.g., Ashforth & Saks, 1996; Chatman, 1991), higher levels of tenure captures (a) greater task familiarity, (b) improved understanding of the firm's work processes, procedures, and regulations, and (c) better awareness of the firm's implicit norms and values (Van de Brake et al., 2015; Gregersen, 1993). These work experiences may also be relevant when coping with the *task-related* demands of MTMs, because they strengthen an auditor's ability to work effectively on multiple and varied tasks within the audit firm.

Auditors with lower organizational tenure need to spend substantial time and energy on learning the task requirements and implicit norms of each of their engagement teams (Ashforth & Saks, 1996). Although this learning process is an essential element of working at an audit firm (Westermann et al., 2015), it may also cause these auditors to experience switching costs and high work pressure because they are not yet familiar with the organizations' rules, regulations, and procedures for task accomplishment (e.g., O'Leary et al., 2011). Hence, in the context of high MTM, it can be expected that auditors with low organizational tenure may lack the experience vital for adapting to multiple simultaneous team activities (Van de Brake et al., 2015; O'Leary et al., 2011) and will, therefore, be vulnerable to the associated task-related demands.
Auditors with higher organizational tenure, on the

other hand, are likely to be familiar with the tasks requirements set within the different engagement teams and to have a thorough understanding of the norms that govern interaction within these teams (Van der Brake et al., 2015). That is, it can be expected that auditors with higher organizational tenure will find it easier to predict how a wide variety of teams will respond to their task contributions and will adapt their work behaviors more easily if needed (Weick, Sutcliffe & Obstfeld, 2005). Consequently, these auditors may be less susceptible to the negative (demand) consequences of MTM. Accordingly, it is likely that the effects of MTM's task-related demands on auditor's job performance are stronger for auditors with lower organizational tenure than for auditors with higher organizational tenure.

In practical terms this could mean that the phase in an auditor's career is an important factor that explains how MTMs affects auditor effectiveness. This may solve the puzzle that while auditors in the early phases of their career probably learn and develop most from being on many different engagement teams, they also struggle the most with having to switch between those teams. Hence, this also would suggest that audit firms need to take organizational tenure into account when deciding on the number and/or variety of team memberships. For instance, audit firms could consider measures specifically attuned to early career auditors in terms of:

a. the training auditors in their early phases receive (e.g., to include a session on multi-tasking/MTMs as part of the introduction program);
b. staffing/planning decisions (e.g., optimal number of teams an auditor can be part of simultaneously depending on her career phase, how costs or efforts of switching between teams can be minimized, and how such switching costs can be incorporated when evaluating staff).
c. to allow for real learning on the job, it may be important to incorporate some reflection time between engagements especially for the less-tenured staff members.

6 Conclusions

Working in multiple engagement teams simultaneously is at the heart of how auditing firms organize their employee activities. As such, individual auditors are members of more than one engagement team at the same time (i.e., occupy multiple team memberships, or MTMs). Yet when attempting to improve the performance and work conditions of individual auditors, to date audit firms seem to rely primarily on traditional measures (e.g., individual learning trajectories and personal goal setting) that do not take this overarching, multiple team membership perspective into account. Adopting the MTM-lens is crucial in an auditing context as it specifies the unique job demands that individual auditors experience when shifting between multiple engagements. In this paper we have provided some initial thoughts that may provide ideas about how to (re)organize individual work within audit firms in order to allow all employees to thrive within such an environment. ■

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Dialogue

By Julia Wijnmaalen

"Workload pressure is a root cause of drops in audit quality." (Reggy Hooghiemstra)

The discussion starts with the following question: "*How many different engagements are you currently working on?*" A conference attendee answers: "*I see associates who have 30-40 different clients*". This way of working in auditing firms is the topic of Hooghiemstra et al.'s research: What do auditors experience when they work in all these different teams and what is the effect on audit quality? "*In the end, regarding the audit, it boils down to good people. Quality depends on good people and people need time to learn, also if they are talented*". This statement triggers another conference attendee: "*When you say 'people's qualities', what do you mean? Knowledge of course, but also certain personal characteristics? Such as courage and professional skepticisms?*" According to Hooghiemstra, as well as a basic level of knowledge and interest in auditing, personality plays an important role. For instance, are you a person who takes or avoids risks?

"*Workload pressure is a root cause of drops in audit quality*". In this respect Hooghiemstra notes that workload is not only about the number of tasks, but also about the different kind of tasks. If you are working on many different types of engagements, the workload is perceived to be much higher as people have to switch simultaneously between different types of jobs and knowledge. One of the attendees points out that she believes personality also determines how workload pressure is handled. Hooghiemstra agrees and adds that the way you handle workload pressure is also linked to tenure. It is probably easier to switch between jobs if you have more experience. Another attendee does not think that being a member of multiple teams has an equal impact on the performance during each individual audit engagement. "*If I am allocated more time for an engagement, I am able to work at a steadier pace than on some other engagement where I have less time*". Hooghiemstra agrees that this is an important feature, but he also points out that "*in the end, it does not really matter from the regulator's or audit organization's perspective, because they look at the entire level of quality*".

The number of questions raised by the audience signposts the relevance of the research topic. Many attendees propose to include variables that they believe influence the relationship between audit quality and multiple team membership. For example, one attendee embellishes on the difference between planned and unplanned multi-team membership. "*For example, it often happens that the client is late with something and that the individual has already started on another engagement. This might then lead to even more stress*". Another attendee adds that the composition of the team matters. "*I can imagine that a team becomes more effective if the team members have worked with each other before or if they have been working with each other for a longer period of time. This might mitigate some of the negative effects*". One of the conference attendees responds by sharing the results of new research on this particular issue conducted in Australia on the effect of the length of time people have been working together on the level of audit quality. The results indicate that familiarity is a good thing, as it leads to more efficiency and higher audit quality. Another question is about the dependent variable: What is audit quality? A conference attendee notes that the team might think that they did well and worked nicely together, but from a compliance perspective they might not have done a good job, and/or the firm might not be happy with the hours the team spent. "*So from whose perspective do you measure audit quality? And how do you get that data?*" Hooghiemstra replies that researchers indeed struggle with this point, as they have to work with the data available within the firms. He also explains that the research focus is on the team climate and not whether team members are happy. An example of a team climate element is whether it is appreciated if an assistant speaks-up or not.

A conference attendee notes that a distinction needs to be made between short and long term effects. Yes, in the short-term, it is good to work in a team with people that you know and worked with before. However, in the long-term, you potentially learn and improve more if you work with multiple teams and projects. "*Even after 20 years I prefer to only focus on one project and yet it is better for me to focus on more than one project because it makes me into a better auditor, as I gain knowledge from different fields and industries*". Hooghiemstra agrees that there are two sides to the story when it comes to multiple team memberships. On the one hand, one has the resource effect: multiple team memberships make employees work more efficiently and provide the opportunities to tap into other people's knowledge and the knowledge is spread among the teams. On the other hand, one sees a demand effect: the workload is high, employees need to familiarize themselves with different teams, and so on. "*We expect an inverted U-shape relationship between number and variety of teams an employee is a member of, and performance. Initially, performance goes up; however, at some point, this effect will decrease, and the performance will go down negatively thereby affecting audit quality*". ■

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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 dynamic. 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 audit 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 & Raveendran, 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 this result, such as the need to adapt group auditor instructions at the component level or better align work performed for group purposes with statutory audit requirements. Second, while earlier findings suggest that tacit coordination (i.e., leveraging/developing common ground between team members) considerably reduces challenges on group audits, little is known about factors influencing staffing at the component audit level and feasibility of such an approach (Downey & Bedard, 2017). We therefore seek to provide insight into key

drivers of staffing and challenges experienced in this phase of the component audit. In investigating the effectiveness of the third strategy, ongoing communication (i.e., the development and use of communication channels, as well as the content and ease of communication), we seek to provide insight into the direction, communication, and supervision provided by the group auditor, as well as the nature, timing, and extent of the group auditor's review of component audit work.

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

▪1 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.

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Dialogue

By Julia Wijnmaalen

"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 processes".* 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 U.S. 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, theis 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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