FAR Conference 2020

Report of the fifth international conference
of the Foundation for Auditing Research

FOUNDATION FOR
AUDITING
RESEARCH

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This report contains the summaries of the presentations and keynote speech held at the first online conference of the Foundation for Auditing Research (FAR). The summaries in this conference report should not be viewed as a formal research publication. The report should be read as an account from an audience member's perspective.

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An introduction to the first online FAR International Conference

The fifth annual FAR Conference was held on Monday June 22, 2020. As a result of the circumstances, the event took place in an online, Covid-19-proof setting. Still, almost 200 participants from all over the world registered for this virtual meeting. About 50 percent of these were academics. The other 50 percent consisted of students, practitioners, regulators and government officials. This strengthens our belief that a broad group of stakeholders appreciates the work of our Foundation.

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The theme of the conference was intentionally broad: 'academic and practitioner insights into audit quality'. This theme seamlessly fits with FAR's main purpose, which is facilitating knowledge development and knowledge dissemination concerning audit quality.

The presentations provided a representative cross section of current FAR projects, in which knowledge is created as well as shared. During five sessions, researchers from Canada, the Netherlands, Switzerland and the USA presented their FAR research findings and their views on current issues.

Wim Gijselaers discussed his FAR research (with Therese Grohnert and Roger Meuwissen) on human capital formation, through the learning behavior of audit teams within audit firms, and audit quality.

Anna Gold and Tammie Schaefer presented the preliminary results of their FAR survey and experiment concerning audit committees support for the auditor and its effect on auditor skepticism.

Marshall Geiger's presentation was the keynote presentation of the conference. He reflected on going concern opinions in the time of Covid-19. He did this against the background of his major recent going concern literature review that he conducted for FAR with Anna Gold and Philip Wallage (https://foundationforauditingresearch.org/files/papers/a-synthesis-of-research-on-auditor-reporting-on-going-concern-uncertainty.pdf).

Jean Bédard presented the findings of a literature study (with Nadine Glaudemans, Mieke Jans, Mathijs van Peteghem, Annelies Renders, Caren Schelleman and Lei Zou). This study took place in preparation for their FAR research project relating client internal control (over financial reporting) to the quality of financial reporting and the audit.

Alain Schatt presented an insightful overview of research findings related to mandatory joint audits (a study with Jean Bédard), of which the conclusion was: do not make joint audits mandatory.

In this booklet, we proudly present the summaries of these five conference presentations. At the end of each article, a selection is included of three Q&A's from the Q&A sessions that took place after each presentation. The summaries also include links to the conference presentations and the follow-up podcasts.

We hope you will enjoy reading the summaries and viewing the presentations and Q&As, and we are looking forward to meeting you again, hopefully 'in the flesh', next late Spring 2021.

Prof. dr. Olof Bik RA
(Academic Board Member and Managing Director FAR)

Prof. dr. Jan Bouwens
(Academic Board Member and Managing Director FAR)

Prof. dr. Willem Buijink
(Academic Board Member FAR and Conference Chair)

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[1] *Note that for reasons of brevity, the complete references of the papers referred to in the text are not included in the summaries, but can be found in the papers of the research teams.*

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Moving audit teams forward:

designing firm environments for sustainable learning from errors

Presented by:
Wim Gijselaers, co-authored by Therese Grohnert and Roger Meuwissen (all affiliated with the School of Business and Economics, Maastricht University)

Abstract
Educational researcher Wim Gijselaers and his team members investigated the relationship between the human capital of audit firms and audit quality, particularly through the learning behavior of audit teams. The team learning angle offers valuable opportunities, in addition to investments in, for example, technology and external inspections. An analysis of the existing research at the organizational level shows that particularly organizational culture and working conditions have an effect on team learning behavior. At the team level, team composition is only of conditional importance for success. So-called 'constructive conflict' (exchanging and discussing different opinions) and regularly reflecting on what is happening and what the consequences are going to be ('reflexivity'), are most often mentioned as being essential ingredients for an effective team. This especially holds for teams under time pressure. At the individual level, questionnaire results indicate, among other things, that younger auditors experience more directive leader behavior as a stimulus for their learning behaviors. The leadership style also seems to be more important than the personality traits of the leader.

According to Gijselaers, it is important that researchers and auditors invest in a sound sustainable relationship. This way, each other's 'languages' will be better understood and it will enable a focus on common goals. This can be done, for example, by having auditors actively participate in the development of research questions.

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Pilots and auditors

I'm a passionate 737 simulator pilot. In this simulated world, I am the captain, flying the plane on my own. It takes many hours of practice to land safely under various conditions. In this simulator, I am doing this on my own to achieve optimal performance. In the real world of aviation, both flight crew and cabin crew are responsible for ensuring that a flight is safe, comfortable and on time. Moreover, cabin crew and flight crew don't work in isolation. They both work for a company that operates in a highly competitive and regulated, specific environment. I wondered: what if inspection bodies require aviation industry to do more to understand and address shortfalls in performance? What could be done?

The classic answer is to start improving technology. They also did that in the aviation industry. Technology helped substantially, until they found, somewhere in the 80s, that more technology was not necessarily correlated with improved performance. Then, they started to improve safety procedures. Inspection became more important and the incentives to work safely were crucial. However, after a while, the marginal returns of those measures decrease to nearly zero.

Then, what's left is human capital: the importance of the people who are working there and the way they learn every day. That idea made us think that we could start looking at the audit in a different way and also move auditing research into a new direction.

Human capital and learning in auditing

What if reports by inspection bodies (AFM, IFIAR, MCA) consistently emphasize that audit firms need to do more to understand and address shortfalls in audit quality? The obvious answer would be that they could invest in technology, safety, inspection and incentives, like in the aviation example. But we decided to focus on the importance of human capital. Human capital consists of the people who are working in the firm. We would like to know whether human capital is related to audit quality, by taking a typical perspective. We want to know the way people learn in their everyday work, and whether it helps them to reflect and to adapt to a changing world and to address the shortfalls in audit quality.

That's our basic story. The question we want to answer is: what are the drivers and behaviors that enable learning. These can be used as a response to challenges and errors that the audit firms are facing, given the negative oversight reports and given the allegations being made.

We studied this question at the firm level, the team level and the individual level. We conducted a literature review, interviews and surveys. The research methods differ for every level. The focus was on identifying the drivers which enable team learning behavior. Looking at the teams, we identify team learning behaviors that enable responses to challenges and errors. And how individual behaviors can help the team to respond to challenges and errors, to help team functioning.

Drivers enabling team learning behavior at the firm level: literature review

Our meta-analysis of the literature implied an initial identification of 3,151 studies of which 50 studies were selected, including 4,778 teams.[1] The professional work contexts were related to healthcare, law, higher education and aviation. These are all contexts that are imperfectly predictable and subject to constant change (like in auditing), and included: product development, high-tech production, R&D, financial services, and IT development.

Looking at studies on professionals in work-based team settings, we wanted to know what the drivers are that determine the behaviors. Team learning behavior is about whether or not a team can adapt to the challenges being faced. Looking at the main findings, for the firm level, we identified four drivers that determine team learning behavior: tone at the top, infrastructure, firm culture and job resources.
The first driver we found is tone at the top. We found a relatively low, but positive effect of tone at the top on the way teams learn. Features that showed up were messages given by the top, demonstrated leader behaviors and the authenticity in their behavior. If the leaders say A, but demonstrate B, that is interpreted as non-authentic behavior, which has a negative impact.

[1] *Nellen, L., Gijselaers, W.H., & Grohnert, T. (2020). A meta-analytic literature review on organization- level drivers of team learning, Human Resource Development Review, 19(2), 152–182.*

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The second important element was infrastructure, which is about the procedures within the companies related to the knowledge management systems and the HR practices.

More importantly, we found that the firm culture has a positive effect, in terms of the firm values they expressed. The attention that is paid to learning processes, whether or not they endorse innovation and how they deal with their error management. For example, is there a shame/blame culture or is there a culture in which errors are analyzed to find the roots and causes and what can be done about it in the near future? The most important finding was whether job resources, in terms of support, time and budget, were supporting the work conditions. There was one set of robust findings, which were found for firm culture and job resources. Here, all findings pointed in the same direction.

There was a second set with less robust findings, where findings depended on the circumstances or context of the studies.

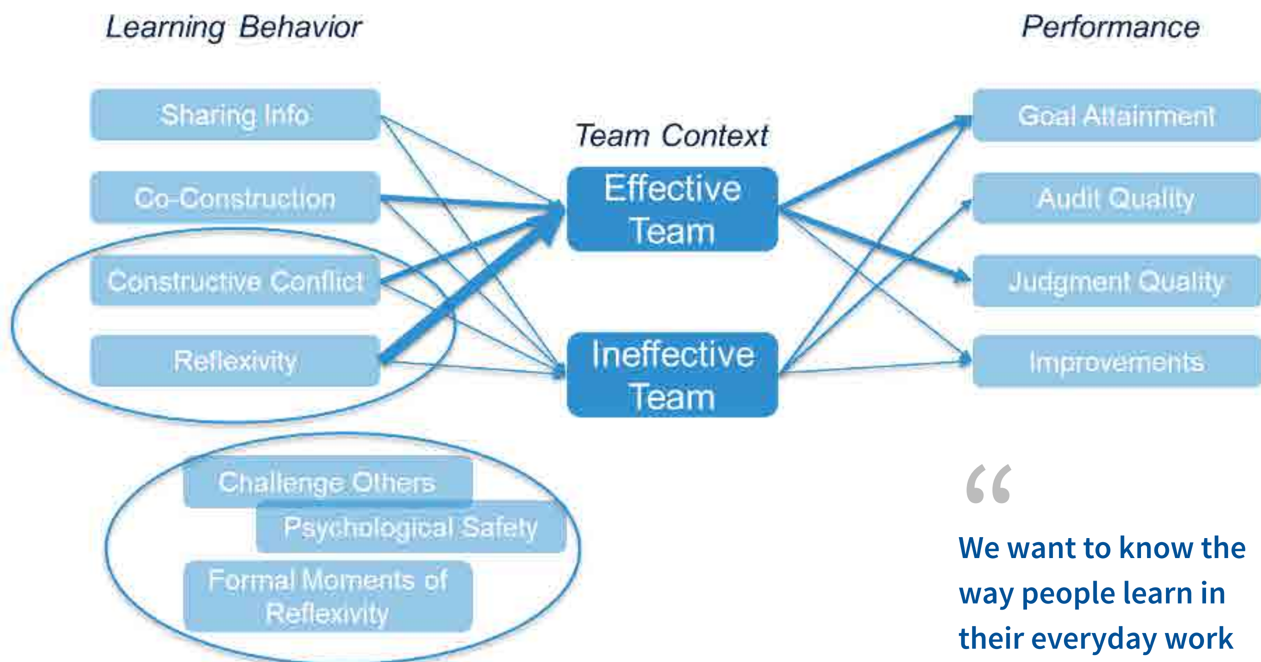
These four drivers influence the way professional teams work. They also seem quite obvious. The good thing is that they are all under direct control of firm management. They supplement the hard side of regulations and procedures. But it is no rocket science.

> **The most important finding was whether job resources were supporting the work conditions**

Team learning behaviors at the team level: interviews

At the team level, we subsequently looked at how leaders influence and cooperate with their teams. We wondered what is required from leaders to enable the work of their teams. For this, we used interview methods. We asked participants to think about critical incidents which happened in your team and provide an example of an effective and an ineffective audit team. We then asked about the team characteristics and tasks, drivers of good versus insufficient performance and when teams learn from their work.

We got a series of beautiful stories from different perspectives. We interviewed 6 partners and directors, 9 managers, 8 seniors and 6 juniors, until we reached a level of saturation, meaning that an extra interview does not lead to additional information anymore. Then we analyzed the interview transcripts. We visualized the 'co-occurrences' in the results, as depicted below. The width of the arrows represents the strength of the relationship.



> **We want to know the way people learn in their everyday work**

Here, you can see what makes an effective versus an ineffective team, as experienced by the participants. In terms of performance, we asked the participants about performance, as indicated by goal attainment, audit quality, judgment quality and improvements. We looked at the way teams work, particularly at sharing information, co-construction, constructive conflict and reflexivity.

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When people were describing the way they shared information and how that connected to team effectiveness, we found that sharing information does not make difference in predicting effectiveness.

However, we found differences for co-construction. Co-construction means 'I'm saying something and then someone responds to what I'm saying', which increases knowledge, because we are constructing upon each other's knowledge. This building-up-process makes a difference in effectiveness.

A more important finding was related to constructive conflict. Constructive conflict means 'I'm saying something and then someone shares a different view on what's happening'. It concerns the right to agree to disagree. It results in a lively debate. The data constantly showed that effective teams involved that kind of behavior three times more than ineffective teams.

The final result was about reflexivity, making a real difference for a team being effective or ineffective. Reflexivity was mentioned four times more than the other factors in differentiating between effective teams versus ineffective teams. Reflexivity means reflecting on the consequences for the near future.

When describing the behaviors of an ineffective team, reflexivity was mentioned as often as sharing information. But concerning effective teams, reflexivity was mentioned at least four times more often.

So, in general, the two most important behaviors differentiating between effective and ineffective teams are constructive conflict and reflexivity. Regarding performance, effective teams are related to goal attainment and judgment quality more often. It is important to note that challenging others requires psychological safety. Furthermore, effective teams built in formal moments of reflexivity.

Individual behaviors helping the team: interviews and surveys

The third level of our study pertains to the individual level. The question was: which individual leadership behaviors and beliefs effectively enable learning behavior at the team level, as a response to challenges and errors? We studied this with a survey. The survey was based on the 'classic' leadership equation. This equation states that team learning is dependent on: reflexivity (a facilitative process that can be planned to reflect on the work people do); welfare, vulnerability and invitations to contribute (empowering leader behavior); and clear goal setting by the leader (directive leader behavior).

In the survey, 246 auditors participated (ranging from the junior to partner level) from two Big Four firms and one mid-tier firm.

We asked them to rate directive leader behavior (focus on goals) when they were thinking about an audit team they worked with in the past. And particularly how their behavior could be characterized in terms of team learning behavior. We found two distinctive responses regarding the directive leader behavior. One typical response was that an increase in directive leader behavior basically doesn't show a connection with team learning behavior. The second typical response was that there was a clear relationship between increase in directive leader behavior and team learning behavior. Partners were not that responsive to directive leader behavior. They don't like that kind of behavior. However, it was interesting to see that auditors at the associate level seem to appreciate directive leader behavior: they state that team learning behavior increases with directive leader behavior. Young people seem to be much more in favor of structure.

Then we asked the participants in the study about empowering leadership (focus on welfare, vulnerability and invitation). The good news is that the partners now seem to prefer empowering leadership: it is associated with more team learning behavior by them. This relationship is similar for the associates and (senior) managers.

What do we learn from all this? Depending on the level an auditor has within the firm, they have a different view on what contributes to team learning behavior. It is related to the hierarchical position within the firm. You can imagine that the higher positioned auditors need a different line of support than the less experienced auditors. You can train and prepare people for that. In my opinion, that sounds like good news.

Reflections on the research project

I would like to share a couple of reflections concerning our research project and the way FAR might develop further in the future.

The first reflection I would like to make is that as a research team you should create strong partnerships with practice. You have to invest in a longstanding relationship with the audit firms. You should build mutual trust and work on shared goals.

We found that sharing information does not make a difference in predicting effectiveness

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Research should adapt to the issues which are raised by practice, and frame those into academic research questions. And vice versa. This requires understanding each other's language. The second lesson we learned was that you should engage in elaborating research questions together. That increases the commitment for both parties.

The third lesson was that it is important to follow-up after the project has been done and build long-term relationships through 'clinical' research. There is a parallel with healthcare. In healthcare, bio scientists are working together with clinicians. You could say that the practicing auditors are the clinicians. We strongly endorse working together with practicing auditors. We are convinced that in the long run the benefits are so much higher than if you would just operate at a basic research level.

The Q&A-session at the end of the presentation was led by Fabian Klar of BDO. *Three selected Q&A's are included below.*

1. **Reflexivity is a big issue for auditing standard setters and it is implemented into the standards. Is it possible to stimulate reflexivity via the standards?** 'This goes back to my story about aviation. When safety in aviation needed to be improved, they found out that people don't necessarily adhere to safety procedures, because these are not 'owned' by them. Many of the audit procedures are not developed by the firms themselves. Auditors are stakeholders in the process, but often it is crucial for professionals that they are the owner of the solution.

   According to me, the obvious answer is this is typically something the firm should endorse, on top of the technology and the importance of procedures. My experience is, that after two or three years, slowly the audit team behavior will change. Introducing moments of reflexivity, should be done by the firm. As a side fun fact: we conducted a study several years ago, where we put audit teams in a simulation setting and we gave them a very complicated case. Some teams got a two-minute pre-check before they started analyzing the case. We called that the 'before action reflection intervention'. The teams with these extra two minutes (and a half-way moment of reflection) showed a substantially better performance than the teams without these reflection moments.'

2. **You said that sharing information only has a weak link to discriminating between effective and ineffective teams. Does that imply that team learning only takes place at the individual level?** 'No. When you look at teams and the way they exchange information, if they stay at the information sharing level only, you get a shallow discussion. The important difference between effective and ineffective teams is whether the receiver of information, for example, disagrees with the conclusions drawn based on the numbers. The views may differ and should be expressed. Information should be valued, evaluated and judged.'

3. **So, do certain auditors work better together?** 'Well, no. There is an analogy with soccer teams. If you have Messi on your team, the team will probably win? Not necessarily. Many studies examined whether performance can be predicted from team composition. Research shows there is no correlation between team composition and team performance. The effectiveness depends on whether the team, given the composition, has the capacity to perform. That implies that people can be trained for different roles. You can train them to collaborate. Also, in soccer teams, you don't want individual stars only. Furthermore, is leadership and team work mainly about attaining goals, or also about a tool to help develop the members within the team and the company.'

Additional Q&A's were asked during a follow-up podcast: *https://foundationforauditing research.org/en/news/farview-9-with-prof-wim-gijselaers/*

For more information regarding the project, please refer to: *https://foundationforauditing research.org/en/research-publications/projects/2016b03-moving-audit-teams-forward-a-designing-firm-environments-for-sustainable-learning-from-errors-prof-dr-gijselaers/*

Can audit committee support improve auditors' application of professional skepticism?

Presented by:
Anna Gold (VU Amsterdam & NHH) and Tammie Schaefer (University of Missouri, Kansas City). Co-authors are Joseph Brazel (North Carolina State University) and Justin Leiby (University of Illinois)

Abstract
Anna Gold and Tammie Schaefer discussed the preliminary results of their survey and experiment concerning the support of audit committees and its effect on auditor's skepticism. The survey showed that most responding auditors experience support from the audit committee on more than half of their engagements. However, lower level audit staff does not directly interact with audit committees.
The experimental results show that audit committee support can be effectively communicated to the audit team via the audit partner, leading to more skeptical action (but not judgment). This indirect communication via the partner is not only more effective, but also less costly than direct communication between the audit committee and the teams (given the geographical spread of the team members).

Motivation and research approach: survey and experiment
It is generally accepted that auditor's professional skepticism is important for audit quality. But heightened skepticism may also lead to costs, such as budget overruns and potential conflicts with client management. Furthermore, a potential inefficiency is the risk of false positives. This happens when cues or red flags suggest misstatements, but upon further investigation, appear to reflect non-errors. Prior research has repeatedly found that auditors who walk the extra mile of being skeptical, may face punitive actions by their superiors, rather than being rewarded for it. In such cases, audit quality can be at risk.

If these (anticipated) costs inhibit auditor skepticism, it is possible that audit committee support could alleviate such concerns

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and motivate the adequate application of skepticism on audit engagements. In our study, we examine the potential influence of audit committee support on auditor skepticism by holding a survey, among 104 auditors of varying ranks at the eight largest US firms and one Dutch Big4 firm. We wanted to find out more about the current state of audit committee support, about whether auditors actually experience such support, and what form that support might take. In addition, we conducted an experiment among audit seniors at multiple firms in the Netherlands.

Current state of audit committee support
In our survey, we asked open-ended questions, resulting in a rich data set. For example, we asked respondents to indicate what percentage of their engagements they would describe as having a supportive audit committee. We see quite a bit of variation in the experienced support. However, most respondents indicate that more than half of the engagements have a supportive audit committee (61.4 percent). We also solicited which audit team members have direct interaction with the audit committee. It is not surprising that direct interactions with the audit committee are typically relegated to the audit partner (indicated by 98.1 percent of the respondents) or to the upper level of engagement team management (director: 67.3 percent; senior manager: 67.3 percent). While low levels of interaction between audit seniors and staff and audit committee members are unsurprising, it was interesting to note the relatively low interaction percentage for audit managers (25 percent).

Indirect communication of audit committee support to the audit team
Given the expectation of a lack of direct communication between the audit committee and the lower levels of the engagement team, we asked on what percentage of their engagements the audit partner or manager had explicitly communicated the audit committee's support to the entire engagement team. We viewed this as an alternative, indirect way of communicating audit committee support to the team. Participants indicated that such support was conveyed, on average, on 43.8 percent of audit engagements.

The following quote from a US audit manager who participated in the study gives an example of how this occurred:

'During an audit committee meeting, we reported various findings and deficiencies that had been discovered during the audit. These findings had been discussed with management prior to the meeting, and management had disagreed with several of them, leading to some tense moments. However, during the audit committee meeting, certain committee members were very receptive to the findings and reiterated just how important it was for management to address these items in a timely manner. They also complimented the thoroughness of the audit to find these items and voiced their pleasure with the team. Due to the significant level of stress and hours put into the engagement, the manager and partner informed the rest of the engagement team of the positive comments. The team was very happy that their efforts were appreciated by the audit committee, as it seemed they had not been by management. In subsequent engagements, it seemed that the team was even more thorough and were not as affected when management disagreed with a finding/deficiency.'

This quote provides an illustrative example of how support can be communicated by the manager and partner; but it is also informative in other regards. It shows how this support can mitigate disagreement with management, how the audit committee tries to find common ground, and even how the audit team is given new energy through the shown support.

Direct communication of audit committee support to the audit team
It is possible, in some cases, that a member of the audit committee directly expresses the audit committee's support to the entire engagement team. However, participants indicated that such support was directly conveyed, on average, in only 13.3 percent of audit engagements. Hence, it is quite uncommon. When we asked how the support was directly conveyed and if there was any effect on the audit, one participating audit senior from the US said:

'The audit committee member stopped by the team's conference room to wave and yell "you guys are doing great!". Although this was a very brief moment, it was nice to get some positive encouragement from other parties. At another client, we sometimes received a basket of goods from the AC as a means of gratitude for the audit.'

This shows that support can be effective and useful. On the other hand, on average, participants indicate that there is no mention of audit committee support conveyed to the engagement team on 41 percent of the engagements. This percentage is highest for audit seniors.

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How audit committees can show support
In an open-ended question format, we inquired how audit committees show support. The top 3 responses can be categorized into: openness, cooperation and appreciation. Concerning openness, participants mentioned an open dialogue between audit committee and audit team, a continuous availability of the audit committee for the auditor (the committee takes time for auditor), and interactions outside of formal meetings without management being present. Regarding cooperation, the audit committee can stress to management the importance of cooperation with auditor. Thirdly, pertaining to appreciation, the audit committee can appreciate the audit role, is genuinely interested in the auditor's work, and trusts the auditor's skills. It is particularly impactful when such appreciation is expressed in front of management.

Hence, the common theme regarding support is the role of the audit committee in acknowledging the value of the audit and in insulating and supporting the auditor when tensions with management are present. As a side note, it was surprising that relatively few respondents mentioned the audit committee's role regarding alleviating audit fees/budget overruns.

How do audit committees affect professional skepticism?
We were interested in how audit committees can ultimately affect professional skepticism. Almost half of the respondents (45.3 percent) indicated that audit committees have no impact on the professional skepticism of engagement teams. This may be due to a lack of conveyance of support. When audit committees did affect professional skepticism, this typically concerned the scope of the audit/substantive testing phase of the audit and, to a lesser extent, the risk assessment phase.

We also asked for observed best practices regarding audit committee support. The top responses relate to openness, mediating management conflicts and insulating auditor from management pressure, and the sharing of insights by the audit committee.

Conclusions of the survey study
The main conclusions of the survey study are:

- Experiences with audit committee support vary substantially and ways in which audit committees support teams are multifaceted.
- Audit committee support may not actually be trickling down to the lower levels of the engagement team (this might explain why some respondents don't see an effect on skepticism).
- Openness and availability are key forms of support.
- Audit committees are important in insulating the audit team from conflicts with client management.
- Audit committee support is most likely during the substantive testing phase of the audit.
- Unexpectedly, additional fees were not mentioned as an important form of support.
- These insights helped us develop our experiment where we examine:
  - o Does audit committee support affect auditor's professional skepticism?
  - o Does it matter who conveys the support (partner or audit committee chair)?
  - o Is the effect of support contingent on client management's attitudes (good versus poor)?

Preliminary results of the experiment
Based on the findings of our survey, we predicted that poor management attitude can inhibit professional skepticism, since auditors scale back professional skepticism in order to avoid social mismatches, straining client relations, etc. So, our first hypothesis is: auditors are less likely to exercise skepticism when management has a poor attitude (versus a good attitude). We are looking at management attitude, because we thought audit committee support might be particularly important in cases of poor management attitude.

We also contemplated, leading to our second hypothesis, that the effect of poor management attitude on skepticism can be reduced when audit committee support is communicated to the audit team. Our main research question was: if communicating audit committee support 'works', does it matter who communicates the support? More specifically, is support communicated by the audit chair more effective than support conveyed by the audit partner?

Experimental design
We conducted a so-called 2 by 3 between-subjects experiment. First, we made slight changes in the materials to convey different

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management attitudes, either good (management is pleasant and friendly) or poor (disrespectful and unfriendly). The second variable in the experiment was audit committee support. There were three different levels: either the audit committee chair directly conveyed support, the partner conveyed support or no support was conveyed. This manipulation was driven by the survey results regarding best practices of audit committees indicating support.

Manipulation of audit committee support
In both the audit committee chair and the partner conditions, the case provided to the participants described either the chair or the partner entering the meeting room. The information communicated was the same in both settings.

The issues we stressed were that the audit committee: (1) acknowledge responsibility of the audit committee to protect investors via the audit; (2) have stressed importance to management and encouraged timely responses; (3) mention importance of supporting audit team if disagreements with management arise; (4) would consider additional fee for justified budget overruns; (5) will check in with the audit team (committed to open lines of communications). And in both cases the team was thanked for their effort. In the no-support condition, we still mention that the partner has a meeting with the audit committee and then holds an engagement team meeting, where it is announced that the audit committee meeting went well and the audit committee thanks everyone for their hard work and commitment. And the partner thanks the team for their time.

Participants and task
The experiment was conducted with 184 practicing auditors of various audit firms. The participants on average had 58 months of experience, in various industries. On 71 percent of their engagements no audit committee support is expressed, on average. We had them assume the role of an audit senior and conduct an analytical procedure over a sales account task. They had to calculate an expectation and determine whether additional work was necessary.

Measures of professional skepticism
Prior research has shown that skeptical judgments and actions don't always line up. For skeptical judgment, we were looking to see whether auditors recognized the fraud red flag that we seeded in the materials. We measured whether they noticed the inconsistency between non-financial measures and revenue growth. If they noticed the inconsistency, that was indicative of their skepticism. Skeptical action was measured with an aggregate measure which was broken down into whether they would be approaching management or would ask and follow-up with their manager.

The good news is that auditors recognize the fraud red flag, across conditions. However, the actions they take show differences. The main dependent variable (a 0/1-variable) indicating presence or absence of skeptical action, shows quite a big difference in skeptical action between the no-support setting and the 'partner conveys' setting. When we look further into whether they choose to further inquire with management or inform their manager, that difference is most pronounced in whether or not they are going to approach management. If management has a bad attitude, they are much less likely to engage in skeptical action. However, if the partner conveys support, then that goes up and they are more likely to act skeptically.

Take-aways
There is a disconnect between auditor skeptical judgments and their skeptical actions. Auditors overall do recognize there is a problem, but they don't always follow up on that. An easy intervention of a supportive audit committee, where the partner communicates support, seems to increase skeptical action. The costlier intervention of having the chair communicate does not seem to do a better job.

It is interesting that auditors generally responded positively to the audit committee chair communicating the support directly. They self-reported higher motivation and higher effort when the chair communicated, as compared to when the partner communicated. But that did not translate into actions. We found that auditors were more skeptical from an action standpoint when the partner was doing the communicating. These experimental findings are supported by auditors' responses to the survey. One respondent says that it seems like a decent idea that the audit committee chair would directly communicate their support. However, it would be quite impractical on larger engagements, especially to the extent that teams are dispersed geographically.

The good news is that auditors recognize the fraud red flag

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The Q&A session at the end of this presentation was led by Rick Dekker and Marnix Pouw of Deloitte. After the conference an additional Q&A-podcast was organized. Three selected Q&A's are included below.

1. **Is it possible that a management with poor attitude influences the appointment of audit committee members who are less likely to support professional skepticism by auditors?** Tammie: 'There is clearly evidence in the literature that, despite independence regulations, there is involvement by management in the oversight of auditors. So, it is possible that management teams with certain attitudes might be more or less likely to have supportive audit committees. One thing that we can note, based on our current project, is that communications about support to the audit team (especially when they are made by the partner) seems to matter. In our experimental condition, where there's no support communicated and management has a bad attitude, we see the least amount of skeptical action.'

> **Auditors who walk the extra mile of being skeptical may face punitive actions by their superiors**

2. **The frequency, timing and proactiveness of audit teams communicating with audit committees vary in practice. Does your study give any indications of what audit teams could do in creating the best conditions to stimulate professional skepticism in the audit?** Tammie: 'One of the takeaways from our experiment was that communications from the partner to the team were just as, or in some cases more, effective than having those come from the audit committee chair. We also found that the audit committees can show their support by being open, involved and sharing their insights with the audit team. Additionally, we had multiple individuals mention providing a reminder that the audit team is serving and protecting users of the financial statements. That way it redirects their focus from pleasing management to protecting the users. To the extent that these are things that could be communicated early, and perhaps even regularly, to the audit team, it seems like those communications might be quite impactful to the audit.' Anna: 'Sometimes it may also be the case that the audit committee is not actually aware of the added value they can provide. Maybe audit committee members are not always sure how they can provide that support that would be perceived as useful by the audit teams. Some communication could probably be improved towards the audit committee, to give them an idea of how they could be helpful and supportive.'

> **Is support communicated by the audit chair more effective than support conveyed by the audit partner?**

3. **Do differences between engagement partners and lower level auditors affect your survey results?** Anna: 'We see in the closed questions that experience with audit committees and audit committee support varies a lot, depending on the rank people have. In the survey, this explains why we get relatively more insightful responses from managers and partners. They can base their responses on their own experiences. However, I was pleasantly surprised by the insights that were given by less experienced auditors. They offered suggestions on how they could potentially provide support. In addition, the experiment that we did was with those less experienced seniors, which was very useful, because you can actually test conditions on people's judgments that they would not be exposed to in the real world.' Tammie: 'In the experiment, we noted that the less experienced seniors seem to be the most impacted by the partner communicating support.'

For more information regarding the project (including the follow-up Q&A-podcast), please refer to: *https:/foundationforauditingresearch.org/en/research-publications/projects/2018b04-how-can-audit-committee-support-improve-auditorsa-application-of-professional-skepticism-prof-dr-gold/*

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Keynote speech:
Some thoughts on the Going Concern Audit Opinions in the age of COVID-19

Presented by:
Marshall Geiger (University of Richmond, USA)

Abstract
The keynote speech by Marshall Geiger was very topical. He discussed going concern opinions in the context of the COVID-19 era. Geiger presented an impressive 7-slide timeline with the pandemic events and their economic impact. Our current period has been named the biggest peace time recession in almost 100 years. In that regard, it is remarkably positive that audit standards and regulations on going concern appear to be very robust. This doesn't make the current COVID-19-guidance superfluous, but it does indicate that going concern regulation is sound.

A COVID-19 timeline
To set the scene, Geiger sketched a quick walk down 'COVID-19 memory lane'.

2019 was a great year. World stock markets were performing pretty well. General global economic outlook was fairly bright (although the Brexit needed to get resolved and there were trade tensions between US and China). Going Concern Modified Opinions (GCOs) from auditors in the U.S. were at a 10-year low, reflecting relative broad business financial health globally (Audit Analytics 2020).

The fundamental underlying approach to going concern issues is sound, even when extremely stress tested

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Then we entered 2020. After a smooth start, things got messy pretty quick. Here are some selected headlines from the WSJ/CFO Journal and Financial Times:

10 February:	Smaller US firms struggle to get workers despite strong job market.
13 February:	Global central bankers adopt cautious outlook on Coronavirus.
14 February:	White House proposes to fold PCAOB into SEC, which didn't get a lot of attraction.
25 February:	Global stock markets slide as the virus spreads in Europe.
4 March:	Death toll in US rises to 11 as virus spreads in California & New York.
13 March:	Dow suffers its worst day since the crash of 1987.
24 March:	Companies like FedEx, GE, Starbucks, American Eagle & Zillow withdraw guidance due to uncertainties surrounding Covid-19.
27 March:	US passes $2.2 trillion CARES Act for Covid-19.
5 April:	Boris Johnson admitted to hospital with Covid-19.
9 April:	SEC urges companies to be transparent in their Covid-19 disclosures.
15 April:	World economy forecast to contract 3.0% in 2020; US personal tax filing due date moved to 15 July.
16 April:	Citigroup increases loan loss reserve from $278 million to $4.92 billion, a massive increase of about 1,700 percent!
17 April:	US jobless claims now at 22 million in 4th week of shutdown.
21 April:	US crude oil price goes negative for the first time in history. There was no space to store the oil.
22 April:	Over 18 million workers in Europe idled.
27 April:	France, Spain, Italy and US move to ease lockdown restrictions and Boris Johnson's first day back on the job.
28 April:	HSBC profits are half normal and loan loss provisions increase by a mere 400 percent.
30 April:	The US economy shrank 4.8 percent in the first quarter of 2020. And Royal Dutch Shell cuts dividend for first time since WWII.
4 May:	European and US banks book more than 50 billion dollars in loan losses in the first quarter of 2020. Exxon/Mobil posts first quarterly loss in 30 years.
5 May:	Global deaths from Covid-19 top 250,000.
6 May:	WSJ publishes the article "Going Concern opinions may be poised for a comeback".
7 May:	The European Commission estimates contraction at 7.75 percent of GDP so far for 2020 (it was 4.5 percent in the global financial crisis in 2007/2008).
13 May:	The US Fed Chair Powell says that more measures may be necessary to prevent long term damage.
18 May:	India extends the lockdown. Finance Minister suspends bankruptcy cases for up to 1 year.
22 May:	Financial statement fraud risk increases due to Covid-19 (ICFR disruptions and market pressure).
28 May:	US number of jobless claims hit 40 million.
1 June:	UK banks warn up to 50 percent of the Covid-19 loans may default, with hundreds of thousands of failed businesses in the UK alone.
8 June:	Germany reports historic 18 percent tumble in output in April – largest on record.
9 June:	World Bank expects global economy to shrink by 5.2 percent. US Fed expects 6.5 percent US contraction for 2020. US Stocks erase 2020 losses (Nasdaq goes over 10,000 for the first time in history, the stock market regains all of the lost ground).
11 June:	Global stocks fall amid gloomy employment outlook.
12 June:	The UK economy shrinks by 20 percent in April.
15 June:	Global equity markets sink amid surge of Covid-19 cases in US and China.
16 June:	Global equity markets rally on hopes of fresh US stimulus measures. US retail sales were up 18 percent in May.
17 June:	Bank of England forecast to unleash at least £100 billion in extra stimulus. UK public debt is greater than 100 percent of GDP.
18 June:	More than 45 million people in US have filed for unemployment.

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Future and recovery

An important question is what the immediate business future will look like? And what will the shape of the recovery curve look like? Will it follow a V-curve, a U-curve with a flat bottom, a W-curve with two dips, an L-curve with a flat line after a decline or will it be an infinity loop that will go up and down for a long time? According to Geiger, the last one will probably be the closest to the truth.

What do the experts think? Mike Wilson, Morgan Stanley's chief investment officer, said in the Financial Times of June 3 2020: *'Historically, economies frequently experience a V-shaped recovery after a recession. The severity of this particular recession, combined with the unprecedented policy response, makes it unlikely we will see anything but a V-shaped recovery this time.'*

Erik Nielsen, UniCredit's chief global economist, stated in the same Financial Times article: *'Attempting to forecast the economic effects of the lockdown is truly a fool's game. Never before have we seen a man-made recession of this scale, nor have we seen policy responses of this magnitude to cushion the impact on people's livelihood. On balance, however, I expect the biggest peacetime recession in almost 100 years.'* These are just illustrative of the disparity of opinion among the experts. If they don't know, who will truly know?

Implications for the auditor

What will business look like after the 'new normal' is established? And what does this mean for auditor's and their opinions with respect to going concern uncertainty? Looking at the plethora of new COVID-19 practice guidance issued by just about every public and private auditor regulatory body, as well as association of public auditors, evidently it means pretty much exactly the same thing after COVID-19 as it did before COVID-19. There is essentially nothing new regarding regulations, standards or the responsibility of auditors in the COVID-19 guidance, that was not in place prior to the COVID-19 pandemic. With the exception of deferring the implementation of some already adopted auditing and financial reporting standards.

This indicates that we believe the fundamental underlying approach to going concern issues is sound, even when extremely stress tested.

The 'new' guidance reminds us to be diligent auditors and follow the existing standards. It also reminds us that this is especially difficult right now, but that the world is very interested and will be watching.

Geiger still finds most of the added guidance helpful, as it focuses discussion on the difficult issues involved in determining whether a GCO is appropriate. It provides a more explicit detailed discussion of audit evidence to consider when deciding the appropriate reporting on going concern uncertainties. And it is helpful both in determining the appropriateness of a GCO, as well as appropriate use and disclosure in the accompanying KAMs/CAMs (Key Audit Matters/Critical Audit Matters) and emphasis of matter paragraphs.

It is interesting that the ICAEW in the UK issued guidance for investors on how to interpret auditor GCOs and related disclosures, especially with the expected increase in the number of GCOs, and going-concern-related KAMs/CAMs and emphasis of matter paragraphs investors are likely to encounter. [1] Geiger thinks it is noteworthy, to educate investors and other non-sophisticated auditing people on what an audit is and what these going concern opinions are actually trying to say. It is a good thing.

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[1] *See: https://www.icaew.com/insights/viewpoints-on-the-news/2020/apr-2020/coronavirus-understanding-audit-reports*

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COVID-19 decision making resembles GCO

Geiger's favorite newspaper quote from the pandemic is: *'When responding to questions regarding the country's response to the pandemic, Dutch Prime Minister Mark Rutte replied that:*

1) All decisions have been made with the scientific insights available at that moment.
2) 'In crises like this, you have to make 100 percent of the decisions with 50 percent of the knowledge, and bear the consequences.'

This was published in the Dutch Financial Times on 12 March 2020.[2]

Isn't this exactly the issue auditors are faced with regarding going-concern uncertainties? You base decisions on known facts and circumstances at the time. You have to make 100 percent of the decision with only 50 percent (or less) knowledge of the course, or even possibility, of future events. And you bear the consequences of the decision. Even if a client company's business seems to be going well, what do you do when they radically change business models? How do you assess their preparation for future business disruptions? How can you ensure properly recorded financial statements, with all the required estimates and value analyses? How can you look past the immediate 2-3 months all the way to a year out? How can you decide when to do the 'going concern review'? How can you help clients to properly account for any government aid received? These (and a host of others) are not trivial issues.

Covid-19-Related GCO research questions

Prior research has generally found that an increase in GCO rates increases type I 'error' rates (GCO without subsequent failure) without much decrease in type II 'error' rates (failures without a prior going concern opinion). An important question is: will the inevitable increase in GCOs due to the pandemic result in a similar pattern? Or will there simply be more business failures in the next few years leading to a decrease in type I 'error' rates?

Also, how does one assess the accuracy of 2019 audit reports? Can the non-GCOs in 2019 for failed businesses in 2020 be considered type II errors? Will GCOs be 'overused', possibly as a way to limit legal liability? Will GCOs be 'underused' in hope of reducing the self-fulfilling prophecy? In arriving at the GCO decision, will the same audit evidence be obtained and evaluated? If not, what is added and removed? And will that evidence get the same weight in GCO decisions as before? So, in essence: do the former GCO decision models hold in the pandemic, or post-pandemic period? Do we look at the same things and are we giving them the same weights?

Do audit firms change their internal processes for GCO evaluation? If so, how? Are these short-term or long-term changes? What specific additional work, if any, do auditors require of their clients to support evidence of going concern viability? How do auditors use KAMs/CAMs to report going concern uncertainties during the pandemic? Do these disclosures differ compared to the pre-/post-pandemic period?

Do auditors issue more qualified opinions or disclaimers of opinion related to issues associated with going concern uncertainties during the pandemic? How often are going concern uncertainties mentioned in the interim financial statements and review reports? How does this compare to pre-/post-pandemic periods? How are GCOs related to specific financial statement items (i.e., intangibles, cash flow from operations, etc.)? How are GCOs related to non-financial statement items like: ownership type (institutional investors/family/etc.), institutional setting (country/legal environment, etc.), supply-chain resilience, outside guarantors and industry differences?

Importantly, how do auditor characteristics like experience levels (partner, team), industry expertise (partner, team, office), tenure with the client (partner, team, office), perceptions of the self-fulfilling prophecy (partner, team), willingness to challenge client management/ professional skepticism (partner, team), confidence (partner, team) and other traits and characteristics? How do they manifest in differences in evidence evaluation, GCO issuance rates and 'error' rates during the pandemic compared to the pre-/ post-pandemic period? Most importantly, what are the "new" or "heightened" issues faced by auditors actually making GCO decisions during these times?

What do you think?

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[2] *See: https://nltimes.nl/2020/03/12/everyone-stay-home-sick-many-events-banned-dutch-government-tightens-coronavirus-rules*

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The Q&A-session at the end of the presentation was moderated by Anna Louwerse of PwC. An additional Q&A-podcast was held. Three selected Q&A's are included below.

1. **To what extent do auditors consider potential future government interventions, for instance from a central bank, when making a going concern decision?** 'I think that auditors will have to consider that more, just because it's much more pervasive and many businesses have depended on the government interventions to survive. We now know how to account for that. The real difficulty is going to be trying to figure out whether there's going to be another wave of government help and how much the clients will be able to benefit from that. It's certainly going to be part of the business landscape. It may be critical for some businesses literally to stay alive and for other businesses it might just mean that they fare better than they would have without it.'

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There is essentially nothing new regarding regulations, standards or the responsibility of auditors in the COVID-19 guidance

2. **How can investors' and other stakeholders' confidence be restored with the help and coordination of different regulatory agencies?** 'I do applaud efforts like the ICAEW, to come up with a publication that addresses going concern issues for users of financial statements, not necessarily for people in the financial reporting environment. So, education is one of those pieces, but you can't educate everyone. Regulators need to be flexible with their oversight. These are unprecedented times, so there needs to be some documented professional judgment and some leniency when it comes to what actually happens down the road. It is already very hard to predict in calm times, let alone now. But we can't just issue going concern opinions to everyone's financial statements, because of the time. There has to be some professional judgment. That would bolster the usability and benefit to stakeholders and can increase the confidence in going concern opinions from auditors.'

3. **To what extent will COVID-19 GCO bring real information value to, for example, investors? Is the majority subject to a lot of boiler plate wording?** 'It has a chance to bring some real value to investors, but I also think that auditors aren't the only player in this system. A lot of that's going to come from management and their reporting disclosures and then the auditors ensuring that those disclosures are robust and informative regarding the business and the business' particular circumstances. I hope that some of that individualism would be reflected in some audit reports, but we probably also see a lot of similar language since a lot is about general uncertainty and disruption across multiple sectors. You can't really be too specific about some things because it's just a broad brush of issues that are concerning or uncertain. But you also have to realize that the auditors have already made sure that the client's disclosures are robust and informative. Boilerplate language then is not necessarily problematic.'

For the video and slides of the presentation, please refer to:
https:/foundationforauditingresearch.org/en/news/far-online-conference-22-june-2020-summary-and-videos/

Additional Q&A's were asked during a follow-up podcast:
https:/foundationforauditingresearch.org/en/news/farview-8-with-prof-marshall-geiger/

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How does one assess the accuracy of 2019 audit reports?

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Current knowledge on internal control:

a literature review

Presented by:
Jean Bédard (Laval University). Co-authors are Nadine Glaudemans, (Maastricht University), Mieke Jans (Hasselt University), Mathijs van Peteghem (Maastricht University), Annelies Renders (Maastricht University), Caren Schelleman (Maastricht University) and Lei Zou (University of New South Wales)

Abstract

Jean Bédard presented a literature study on the relationship between internal control (over financial reporting) and the quality of financial reporting. That relationship is important because the auditor can make use of the client's internal control system when planning the audit. The project team examined which factors influence the internal control quality of an organization, how this subsequently affects the work of the auditor (and the judgments regarding the internal control quality) and ultimately, among other things, the quality of the financial reporting and market responses. Previous research has shown that the quality of internal controls is positively linked to, for example, the independence and expertise of the audit committee. Bédard stated that labeling limited control as an 'internal control weakness' does not necessarily lead to errors in the financial reporting. At the same time, not reporting weaknesses also does not mean that errors will not occur.

Prior research shows that if a material weakness is reported, for example, the quality of financial reporting and the efficiency of investments will be lower. Also, the audit fees will be higher in the case of reported material weaknesses, since the auditor will have to do more work. Moreover, auditing has a positive effect on finding and reporting material weaknesses by clients.

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Background

The main objective of the FAR project for which this literature review has been performed, is to look at what factors influence the auditor's evaluation of client internal control quality. In addition, the effect of auditor evaluation of internal control quality on the audit procedures is studied. Furthermore, the study includes the influence of the perceived client internal control quality and subsequent audit procedures on financial statements adjustments.

Internal control is not a new topic. In the 1970s, there were quite a few audit failures and as a result internal controls received a lot of attention from the U.S. Congress, regulators and the business press. The FCPA (the Foreign Corruption Practices Act) required companies to have a system of internal controls in place. In the same time period, as a result of rapid technological change and competitive pressures, audit firms were interested in research that could make the audit more effective and efficient.

An important research project resulted in Mock and Turner's AICPA Monograph – Internal accounting control evaluation and auditor judgment (1981). The study examined auditor judgment in the evaluation of internal controls. Mock and Turner found significant variability in decisions, processes, recommendations and interpretations of internal controls. Based on the study, Peat, Marwick, Mitchell & Co (now KPMG) developed the SEADOC approach for evaluating internal controls (System Evaluation Approach, Documentation of Controls) in 1983.

In the mid 90s, KPMG abandoned this approach and moved toward the Business Management Process (BMP). After the business failures after the year 2000, they moved away from BMP and back to the importance of the internal controls, following SOx 404.
During his work as a practicing auditor, Bédard found that it was very difficult to evaluate internal controls and recognize the impact of internal control evaluation on the required audit process.

Internal control definitions

The COSO-definition of internal control is 'a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance'. In fact, this COSO-definition developed a new view of internal control. It was about more than only control activities. It moved towards recognizing the role of management and the audit committee on internal control. So, it moved away from the role of the auditor.

In addition, according to the PCAOB (2004), internal controls over financial reporting (ICFR) are defined as 'reasonable assurance about the reliability of a company's financial reporting and its process for preparing and fairly presenting financial statements in accordance with GAAP'.

The COSO-definition developed a new view of internal control

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Research on ICFR: drivers of ICFR (non)quality
Internal control research looks at the impact of the internal control system on the financial statements and at the determinants of the quality of the internal controls. In general, previous research has looked at the disclosure of material weaknesses after the evaluation of the internal control system by management and by the auditor, mainly in the US.

The material weaknesses of interest will have an impact on the quality of the financial statements. The definition of a material weakness is: 'a deficiency, or a combination of deficiencies, in ICFR (internal control over financial reporting), such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis'. It is a difficult judgment to make, because there is a reasonable possibility that the material misstatement will not be detected or prevented. It doesn't mean that there actually is a material error in the financial statements.

Specific ICFR research has studied the drivers of weaknesses in internal controls over financial reporting. Areas studied are: firm operations, executives, audit committee and board of directors, which are discussed next.

ICFR-drivers: firm operations
With regard to firm operations, various factors may affect the quality of internal controls. Complexity, diversification and financial distress show a positive relationship with internal control quality. They result in higher risk of a weak internal control system. Higher firm size, age of the company and need for external capital result in a higher probability that the internal control system will of quality. Some studies also found a negative impact of data breaches on internal controls, besides their impact on the ICFR.

ICFR-drivers: executives, audit committee and board of directors
The drivers related to executives, audit committee and board of directors were recognized by the COSO-framework. Research found an association between CEO characteristics (age, gender, tenure), CEO incentives (ownership, social capital) and CFO characteristics (expertise) and incentives (ownership) on the one hand and internal control quality on the other hand. Interestingly, the influence of the CFO characteristics is higher than that of the CEO characteristics.

Concerning the audit committee, independence (compensation, equity held, CEO/CFO ties, rules defined by exchanges), competence (accounting expertise, supervisory) have an impact on internal control quality: more independence and competence are associated with a lower likelihood of a material weakness. Size and activities of the audit committee have a smaller impact.

Finally, the independence and size of the board of directors as a whole influence internal control quality, but less than the audit committee.

The impact of disclosure of material ICFR weaknesses
Research studies also considered the impact of the disclosure of material ICFR weaknesses on financial statements quality, firm operations, audit and market response.

In terms of financial statements quality, it can be expected that a good system of internal controls is associated with better financial statements quality. So, a disclosed internal control weakness should reduce financial statements quality. In general, that is what studies find, in terms of abnormal accruals, meeting or just beating analysts' earnings forecasts, restatements and forecast accuracy.

In terms of firm operations, one may think that a weak internal control system over financial reporting could be also be an indication of weak control over the other parts of the operations. Research shows that a material weakness is related to lower investment efficiency, higher inventory turnover ratios and more inventory impairments. There is also a reduction in investments, in particular the risky components.

Concerning the audit, a material weakness leads to higher audit fees (due to increased work) and longer audit report lags. Finally, a reported material weakness leads to a market reaction; cost of equity, credit and loan spreads are also influenced, but the results are mixed.

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Auditor and ICFR
The auditor uses the internal controls for the financial statements audit. In Japan and the US, the auditor also uses it for an explicit audit opinion concerning the ICFR.

Researchers have studied reliance on internal controls and the effect on substantive procedures. They find that there is some reliance on internal control and that there is a link to the substantive testing. However, as mentioned, there is significant variability in decisions, processes, recommendations, and interpretations of IC. So, the effect is not necessarily as strong as one might think. Also, research shows that the audit decision regarding internal controls depends on the auditor's competence (experience, training, knowledge): when an auditor is more competent there is a better evaluation of internal controls and the audit program will be more adequately adjusted.

Other areas of research have studied, for example, the role of IC documentation, managers interaction with auditors (concerning negotiation about the identification of the weakness and its disclosure), non-audit services (there is no real impact on disclosure), and whether there is better detection/disclosure of material weaknesses when ICFR is audited (when audited there is a higher likelihood of detection and disclosure).

Conclusion and future research
It can be concluded that a lot of research on internal controls has been done since the 1970s. It has been particularly popular after SOx 404, due to increased data availability. The findings show an impact of internal control quality.

What would be interesting to study next? First of all, it is important to examine the interrelation between the various actors (management, board, auditors) with regard to the evaluation of the quality of internal control systems and the identification/reporting of material weaknesses. Furthermore, new tools for IC evaluation can be studied (e.g. data analytics).

Concerning disclosed internal control weaknesses, first it is important to realize that the absence of disclosed weakness not necessarily implies that the internal control system is appropriate. There might be undisclosed weaknesses or the weaknesses were corrected. To examine these possibilities, non-public data about IC quality (both from companies and audit firms) are required. Another question is whether ICFR should be audited, like in Japan and the US. If yes, at what frequency? What is the cost-benefit of this?

Most of the studies in this field are done in the US, but the US is only one of the 195 countries in the world. Other countries need to be studied as well, to get a better understanding, for example regarding the impact of culture.

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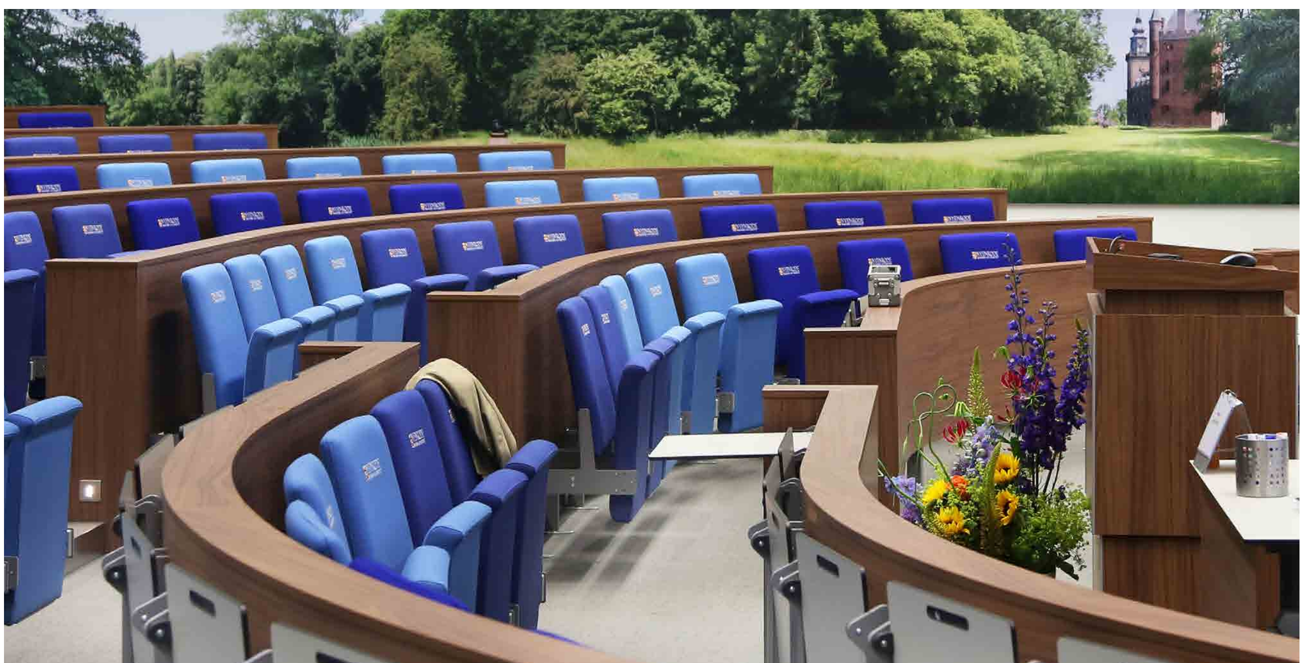
Complexity, diversification and financial distress show a positive relationship with internal control quality



The Q&A-session at the end of the presentation was led by Emiel Koolstra of Mazars. Three selected Q&A's are included below.

1. **Should auditors become stricter in their communication concerning internal controls?** 'To my knowledge, auditors don't communicate much to investors regarding the internal controls. There is communication in the US concerning the audit report on the internal control system, but in the rest of the world there is almost nothing. Some companies will communicate information, for example in Canada, where companies have to provide an opinion regarding their own internal control system, but the auditor is not involved. So, should the auditor provide more information? I think it's probably related to what we will see with the KAMs in the audit report. Maybe the auditor can communicate why he's not using a mixed approach to testing and just uses substantive tests, whether there was a material weakness in the system and he had to change the audit program accordingly.'

2. **When auditors cannot rely on internal controls, the audit opinion has a different assurance and predictive value than in situations where they can rely on effective internal controls?** 'In the past, reliance on internal control was like a business decision for the auditor: is it costlier or less costly to rely on internal control or not? With the changes in the internal control system within the accounting system, it is more difficult not to have some degree of reliance on the internal control system, because all the data that is entered there went through a computerized system. So, if you don't have the adequate control for the data entry, how can you perform substantive procedures on data that is now on the computer system and not on paper, like it was in the past? Some degree of reliance is necessary. Probably the response to the question is: it depends on the type of weakness that you have in the internal control system and if it's more in terms of IT-problems. Then, it may have an impact on the quality of your substantive procedures, if you cannot rely on outside source of data in this case.'

3. **Often internal control frameworks are very elaborate. How do you view reporting on a more concise set of internal controls with a focus on the key risks?** 'Companies currently have to disclose their key business risks. In Canada, they can provide more or less information about the way they control these risks. Should we do the same thing with the internal control system for the financial statements? What are the key risks there and what controls does the company have in place for this? That could be an extension of the disclosure concerning the internal quality of companies. I'm not sure whether there's a demand for this. I think that's something that should be examined.'

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It can be expected that a good system of internal controls is associated with better financial statements quality

For more information regarding this FAR research project, the conference presentation and the follow-up Q&A session, please refer to:
https:/foundationforauditingresearch.org/en/research-publications/projects/2017b03-auditor-judgment-on-internal-control-quality-and-audit-quality-prof-dr-bedard/

Economic consequences of (mandatory) joint audits:
the joint audit does not (yet) offer clear benefits

Presented by:
Alain Schatt (University of Lausanne, Switzerland). Co-author is Jean Bédard (Laval University, Canada)

Abstract
Alain Schatt presented a literature review on the use of joint audits in France. The use of joint audits has recently been brought up in the Netherlands, as a result of the publication of the 2018 AFM report 'Kwetsbaarheden in de structuur van de accountancysector' ('Vulnerabilities in the structure of the accountancy sector'). Schatt elaborated on the potential economic consequences of the joint audit in terms of market concentration, audit costs and audit quality. As also concluded in the AFM report, the current approach to the joint audit in France is not working as desired. In practice, the joint auditors simply divide the audit work and the smaller parties perform the easiest part. 'Voluntary joint audits actually don't exist', says Schatt. This makes sense, he thinks, since overall, audit research hasn't found evidence that joint audits have a positive effect on audit quality, but audit fees are higher. He concludes that there are no clear benefits of a joint audit, in the current applications. Further research should show whether and how the joint audit model could contribute. That is also a recommendation in the recent report of the Commissie toekomst accountancysector ('Committee on the future of the accountancy sector').

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Mandatory joint audit and possible consequences
A mandatory joint audit entails that companies must appoint two different audit firms, which share the total audit work and both sign the audit report. Joint audits exist in France since 1966. The joint audit was also mandatory in Denmark until 2005 and in Canada until 1991 (for banks). It is interesting that some regulators and authorities suggested a broad introduction of joint audits in Europe, as also stated by the European Commission in the Green Paper entitled 'Audit Policy: Lessons from the Crisis', in 2010.

In the Netherlands, the topic has recently been discussed by the Dutch Authority for the Financial Markets (the AFM), in their report 'Kwetsbaarheden in de structuur van de accountancysector' ('Vulnerabilities in the structure of the audit sector'), as published in November 2018. This leads to the question whether mandatory joint audits should be introduced in other countries than France, or whether France should abandon joint audits.

Our project tries to provide some answers to this question by analyzing the economic consequences of mandatory joint audits. We particularly look at three potential (economic) consequences of joint audits: (1) audit market concentration (do joint audits lead to lower market concentration?); (2) audit quality (do joint audits lead to higher audit quality?); and (3) audit fees (do joint audits lead to lower audit fees?).

Hence, we try to understand whether joint audits break the oligopolistic market and lead to a better price-quality ratio of audit services for clients, or not.

> “
> **We try to understand whether joint audits break the oligopolistic market**

The impact of joint audits on market concentration
The first important question is whether mandatory joint audits decrease the market concentration of the Big Four audit firms, which is a key objective of regulators. Regulators often consider that the concentration of audit services offered to listed companies has become too high over time: the market share of the Big Four firms for listed companies exceeds 90 percent in most of the European Union member states (i.e., the audit market is an oligopolistic market). The idea is that a decrease in the market share of Big Four firms would lead to the fact that listed firms would 'automatically' demand more audit services from smaller/local audit firms.

The European Commission stated that joint audits *'should be developed further to dynamise the market to allow mid-tier non-systemic firms to become active players in the market segment of the audits of large corporations, which until now has*

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proven elusive. To encourage the emergence of other players and the growth of small and medium sized audit practices, the Commission could consider introducing the mandatory formation of an audit firm consortium with the inclusion of at least one non-systemic audit firm for the audits of large companies' (European Commission, 2010; p.15-16).

But why should market concentration be limited, theoretically? This notion is based on the idea that an oligopolistic market is associated with lower competition. However, we know that this idea does not necessarily hold true. Francis, Michas and Seavey (2013) adopt a cross-country perspective (including 42 countries) and report that the Big Four country-level market share is positively associated with earnings quality.[1] Furthermore, the disequilibrium in market shares among the Big Four (i.e., intra-Big Four concentration, as proxied by so-called Herfindahl indices) is negatively associated with earnings quality. Such findings suggest that joint audits contribute to earnings quality, if it really leads to more competition between the Big Four, and not if it simply attenuates the global Big Four position.

Another argument of regulators is that the market share of Big Four firms leads to a high systemic risk, which can lead to market disruption if one of the Big Four firms fails. The question then is whether joint audits would reduce the systemic risk. However, the reduction of systemic risk depends on the development of large non-Big Four firms (second-tier) and these don't exist in practice at this moment.

From a more practical viewpoint, joint audits may have a different impact on market concentration, when concentration is measured based on number of clients as compared to audit fees. For two reasons, the results may change significantly - in a context of mandatory joint audit - when audit fees (instead of the number of clients) are examined. First, the Big Four firms may audit the largest companies (paying higher fees), because small audit firms lack the operational resources to audit large firms (i.e., production constraints). Second, for a given audit client, the Big Four firms may appropriate a greater proportion of the fees when the second auditor is a non-Big Four firm (this reflects joint-audit imbalance). Thus, Big Four also capture a very large part of the audit fees paid by public firms, even in a context of joint audit that allows smaller audit firm to audit some public firms.

What does academic research teach us about the effects of joint audits on market concentration, looking at results from the academic literature on joint audits in France? When we use the number of clients as a measure of concentration, the French audit market seems less concentrated than other European markets (the Big Four firms conduct a significantly lower percentage of audits). However, if the percentage of fees paid to Big Four firms in France as a concentration measure, concentration is nonetheless quite similar to that paid in other countries.

With support of the Foundation for Auditing Research, we have collected additional evidence for the French market regarding the period 2002-2017. Our sample includes French companies listed on the Paris Exchange (Euronext), with annual reports available on the AMF-website (L'Autorité des marchés financiers) or on company websites. For about 10,000 audited companies, we find that the market share of the Big Four firms and the next two largest firms has increased between 2002 and 2017. For the Big Four firms only, the market share in terms of number of clients was 46 percent in 2002 and 55 percent in 2017, meaning that the market share of small firms declined. For audit fees, Big Four took 76 percent in 2002 and 82 percent in 2017. In 2017, the small firms only had 3 percent of the audit fees. So, even in the context of mandatory joint audit, Big Four firms had huge market shares, particularly in terms of audit fees.

If we look at the pairs of auditors in the joint audits, almost 60 percent of the companies are audited by a pair composed of a Big Four firm and a non-Big Four firm. Joint audits imbalance is greater for this type of dyad: Big Four capture a large part of the fees here. We also see that the proportion of companies audited by two Big Four firms has increased (from 17 percent to 26 percent). These results suggest that the market is really concentrated and that market share of the Big Four firms increased in the examined period.

> **The question then is whether joint audits would reduce the systemic risk**

[1] *During his presentation, professor Schatt used quite a few academic references. Please consult the related practice note for details (see link at the end of this article). For reasons of brevity, the detailed references are not included here.*

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The impact of joint audits on audit quality

An important issue is whether mandatory joint audits increase audit quality (and, therefore, earnings quality). Audit quality is generally defined as the joint probability that an auditor will detect and subsequently report a breach in financial reports (DeAngelo, 1981). Joint audits may be associated with more knowledge/ competencies (resulting in a higher probability of detection of a breach), and greater independence (resulting in a higher probability of reporting of a breach) because it is easier for two auditors to resist managerial pressure (Francis et al., 2009).

A question that can be asked is whether shareholders require a higher audit quality. That depends, for example, on the presence of macro and micro mechanisms that curb opportunistic behavior of managers (i.e., earnings management). And what is the price that needs to be paid for higher quality? Another issue is the measurement of audit quality. Currently, only 'imperfect' measures are used in the academic literature, such as abnormal accruals, going-concern opinions and restatements, as noted by Ratzinker et al. (2013) and DeFond and Zhang (2014). Better measures are needed, but this requires the collaboration of audit firms.

So, what does academic research teach us about the effects of joint audits on audit quality, looking at results from the academic literature on joint audits in France? Audit quality (captured by earnings reliability metrics) is not higher in France than in other European countries. Hence, the idea that four eyes are better than two is not true in French auditing practice.

The impact of joint audits on audit fees

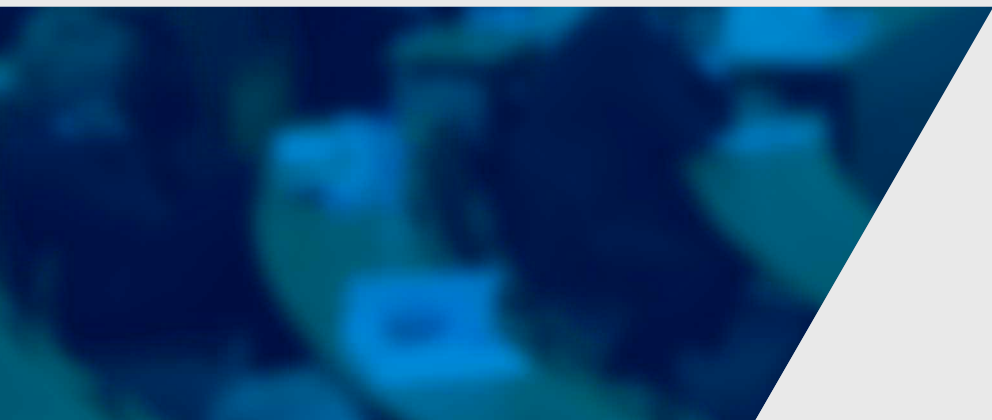
The last key question is whether mandatory joint audits decrease audit fees. Economic theory predicts lower prices for audit services, if joint audits favor competition. However, the coordination costs between the two auditors, as well as the burden created by the cross-review may increase audit fees. Even if audit quality would increase, it is unclear whether shareholders want to pay more audit fees, as discussed.

Results from the academic research on the joint audits in France show that audit fees are significantly and substantially higher in France than in other European countries.

The impact of joint audits on the auditors

It is interesting to analyze whether the impact of joint audits on market concentration is sensitive to the specific combination of audit firms working on the joint audits. The choice of the pair of auditors is not random. Ownership structure is a key determinant of the presence of one or two Big Four firms. Empirical studies suggest that the probability of having at least one Big Four firm is higher for firms with diffuse shareholding.

The specific use of two Big Four firms increases with the presence of institutional investors (Francis et al., 2009), but decreases in the presence of family shareholding (Marmousez, 2012). So, the choice is driven by agency costs. Empirical research does not support the idea that the pair of joint audit firms overall influences audit quality. However, in their study focusing on impairment of the goodwill, Lobo et al. (2017) document that firms audited by a Big Four firm and a non-Big Four firm are more likely to book an impairment and book a larger impairment than firms audited by two Big Four firms (when low-performance indicators suggest a greater likelihood of impairment).



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Regarding audit fees, several studies find that the presence of at least one Big Four audit firm increases audit fees. Furthermore, more balanced work between joint audit firms enhances the audit fees.

Summary of the academic literature from France
The French audit market, where mandatory joint audits exist since 1966, is less concentrated in appearance than other audit markets. When one focuses on the number of clients, that is. However, the level of concentration is effectively not very different in France (in comparison to other European countries), when one focuses on audit fees.

Overall, audit/earnings quality is not better in France than in other European countries, and it is not sensitive to the pair of auditors (e.g., two Big Four firms vs. two non-Big Four firms), which is probably due to the fact that different pairs of auditors are in charge of different clients (i.e., two Big Four firms audit larger and complex companies). Furthermore, higher audit fees are charged by auditors in France, in comparison to other European countries. And the amount of audit fees is sensitive to the pair of auditors (i.e., higher audit fees are charged when Big Four firms are hired).

Ownership structure is a key determinant of the presence of one or two Big Four firms

Two other relevant studies
Before answering the initial question whether joint audits are effective and efficient, two studies from the UK and Denmark are relevant.

A very interesting 'simulation' conducted by Guo et al. (2017) suggests that the introduction of joint audits in the UK would significantly increase audit fees and decrease consumer surplus, which is not good news. Second, findings based on Danish data (Holm and Thinggaard, 2014, 2018; Lesage et al., 2017) suggest that the abandonment of mandatory joint audit increases audit market concentration (i.e., higher market shares of Big Four firms), because only a few Danish firms voluntarily adopt joint audits (i.e., non-Big Four firms are not hired anymore as the second auditor). However, it has no significant impact on audit quality and it leads to a significant decrease of audit fees. This is ultimately good news for investors.

Implications of the literature review
The general conclusion from existing research is that joint audits should be abandoned in France and should not be introduced in a similar fashion in other countries. For investors, it is relevant that the French experience shows that mandatory joint audit is not necessarily an efficient system (i.e., the quality-price ratio is low). Audit quality is similar but at a higher cost (i.e., more audit fees), when French firms are compared to other European firms.

For auditors, it is important that the French experience shows that mandatory joint audit provides some financial advantages. Big Four firms can charge higher audit fees and non-Big Four firms may have access to (medium) public companies. For non-French regulators, it is difficult to compare their situation with the French experience, because many other 'rules' (or regulations) interact with joint audits. For example, in France six-year audit contracts between auditor and client are signed.

The auditor cannot be fired during this period. So, it is important to note that the institutional context is relevant: specific rules may substitute or complement the joint audit system in France. In other words, joint audits may have different consequences in other countries.

The general conclusion from existing research is that joint audits should be abandoned in France

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The Q&A-session at the end of the presentation was chaired by Lucas Conijn of EY Young Professionals. There was also an additional follow-up Q&A. Three selected Q&A's are included below.

1. **How is the work divided between the joint audit firms?** 'There is no research evidence on this, but it is a key question. That is the responsibility of the audit committee. Basically, when the joint auditors are a Big Four and a non-Big Four firm, the Big Four firm decides on who is doing what, for practical reasons. When you audit large group companies, the small auditor firms cannot go abroad and it is difficult for them to do complex tasks, for example. Small firms have less resources and do the 'easier' part of the work. But we need more research on these topics.'

2. **What would your advice be to the AFM on adopting mandatory joint audits?** 'I would advise to not adopt a mandatory joint audit. I see from the studies in France and Denmark that the costs of joint audits are high, without seeing clear benefits. But, to be honest, we use imperfect measures of audit quality. If one can prove that joint audits improve audit quality, by using different measures of quality, the situation will change. But for now, I would say: don't use joint audits. As mentioned, after leaving the mandatory joint audit in Denmark, audit fees decreased while maintaining the same level of audit quality.'

3. **To what extent do joint audits have any impact on and/or increase audit quality?** 'The key idea of the joint audit is that four eyes are better than two eyes. However, audit firms doing a joint audit usually split the work load. It would probably take too much time to duplicate all audit work, which would also be costly. Therefore, the four eyes principle is not effectuated in practice. This might cause the fact that academic research is unable to detect higher audit quality in French joint audit system, as was also the case in Denmark. However, as stated earlier, the audit quality measures used by researchers are imperfect. Results might change if other measures would be used.'

For more information, please refer to the related FAR practice note:
https:/foundationforauditingresearch.org/files/joint-audit.pdf

For the video of the conference presentation, see:
https:/foundationforauditingresearch.org/en/news/far-online-conference-22-june-2020-summary-and-videos/

For the follow-up Q&A podcast, see:
https://www.youtube.com/watch?v=avFLqTC2_mw

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