FAR Conference 2019

Report of the fourth annual conference of the Foundation for Auditing Research

FOUNDATION FOR AUDITING RESEARCH

Inhoudsopgave

Colofon

This report contains the summaries of the presentations and key note speeches held at the fourth annual 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 fourth FAR International Conference

The fourth annual conference of the Foundation for Auditing Research (FAR) was held in June 2019. The theme of the conference was ‘Evidence-informed policy making for the future of the auditing profession’. Therefore, the central question during all the presentations of this conference was: how can evidence-based auditing sector policy making be implemented? We are happy to offer you this conference report, which summarizes the keynote speeches and the FAR project presentations of preliminary research findings.

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The 2019 FAR Conference audience was mixed, as usual. The 157 persons audience consisted of auditing academics (43 percent) and auditing practitioners (41 percent), and participants from various other stakeholders: auditing regulators, the auditing oversight body and the Dutch professional body.
This diversity of the participants demonstrates the broad, and still growing, interest in auditing research and its practical applications.
Furthermore, the discussions during the conference underlined the uniqueness of the FAR-initiative within auditing research, which aims to provide access to a wealth of internal audit (firm) data.
The conference program consisted of nine plenary sessions, spread over two days. There were three keynote speeches by Miguel Minutti-Meza, Robert Knechel and Murray Barrick. Furthermore, there were six presentations discussing FAR projects in various development stages. During the FAR project presentations FAR project teams presented and discussed preliminary research results.

The FAR research and FAR conferences focus on studying auditing, mainly in The Netherlands, with potential implications across its borders, of course. The research and conferences pertain to both audit policy making and audit firm management. The theme of the 2019 conference was 'evidence-informed policy making for the future of the auditing profession'. Given the extensive and still growing regulatory activity with regard to the auditing sector in the EU, the US and elsewhere, it is indeed appropriate to explicitly consider how policy making takes place in the auditing sector, and how it ultimately affects audit quality.
Auditing researchers will, obviously, advocate careful theory and research evidence-based policy making here, both with regard to the formulation of policy and the evaluation of the audit quality effects. This is also a central goal of FAR.

Therefore, the central question during all the presentations of this fourth FAR conference was: how can evidence-based auditing sector policy making be implemented? Indeed, given that the goal of all this regulatory activity is to improve audit quality: can this be expected to happen; does this indeed happen? The panel discussion summary in this report discusses these questions in more depth.

We would like to underline Willem Buijink's attempt, in his introductory remarks at the start of the conference, to 'bring home' the personal nature of the ultimate aim of regulatory activity with regard to the auditing sector, which is: to affect audit quality'. He focused on the Dutch case. Annually, there are 20.000 statutory audits in the Netherlands, of which about 14.000 involve for-profit corporations. There are 900 PIEs and 85 Dutch listed companies. There are only a small number of PIE audit firms and about 270 licenced audit firms in total. There are 1800 statutory auditors that can be engagement auditors. They carry out the 20.000 audits. There must be 20.000 CFO's and, at least, 900 PIE audit committee chairs, also directly involved in 20.000 audits. These people 'create' audit quality. This links auditing sector policy directly to individuals. Importantly, note also that, these days, we in fact know exactly who all these individuals are! Not only in the Netherlands.

We hope you will enjoy reading these impressions from the 4th International FAR Conference.

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(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)

[1] *MAB already published a brief summary of the 4th annual FAR conference in the 9/10 issue of 2019. MAB is an open access journal, the previous special FAR conference issues and the 2019 FAR conference summary are all readily accessible via: https://mab-online.nl/.*

Panel discussion:
The value of evidence-informed policy making for the future of the auditing profession

Panel members:
Arnold Schilder, Barbara Majoor and Mark Peecher

Panel chair:
Willem Buijink

Panel on the theme of the conference
The theme of the conference was 'Evidence informed policy making for the future of the auditing profession'. This theme is closely related to the purpose and mission of the FAR. Earlier work on evidence based and/or evidence informed policy making in accounting and auditing has been published, for example, by Bik and Bouwens (2018), Buijink (2006) Leuz (2018) and Salterio et al. (2018). In his article, Leuz (2018) notes that research in accounting has a very low impact on practice. However, he sees an important role for 'evidence informed policy making'. This requires extensive investments into the research infrastructure, ranging from data generation to the aggregation and transmission of research findings. According to Leuz, the biggest challenge is to overcome the lack of data that is necessary to conduct policy-relevant research.

The panel members who discussed this important theme were Arnold Schilder (Chair of the International Auditing and Assurance Standards Board, at the time of the conference), Barbara Majoor (Dutch Authority for the Financial Markets and Nyenrode) and Mark Peecher (University of Illinois).

Perspective of a standard-setter: Arnold Schilder
Currently we have a consultation on the IAASB's strategy and work plan. One of the things we consider is the recognition of the importance of a

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more explicit research phase at the beginning of a project, before we decide on projects for new standards. Maybe FAR could contribute to the IAASB outreach to indicate that they are interested in a dialogue to discuss their potential help in organizing such a research phase. I'm certain it will be well-received.

The IAASB has some history with taking research on board. The best example, I believe, is auditor reporting. That started with the question what we need to do to help users of auditor reports to better understand the audit and the financial statements subject to audit. The IAASB, together with the AICPA, commissioned research to four research groups from all over the world. In my first year as Chair, in 2009, we received the conclusions and re-commendations of these four groups. The basic message was quite simple: users would like to hear more from the auditors than just the auditor's opinion to the financial statements. And that is only one example.

> "Discussions in the Monitoring Group also often indicate that we should move faster

We also organized presentations to the board concerning professional skepticism. Also, here I found it important to plead for some kind of link between research and standard setting. The starting point is of course: you shouldn't draft standards out of the blue, it should also be evidence based. That makes sense. At the same time, this is not an easy task. One of the reasons is that research takes time, and often there isn't much time.

As an illustration, today we received a comment letter from the Committee of European Auditing Oversight Bodies (CEAOB). They commented on our strategy, including the research part: *'While we acknowledge the importance of information-gathering and research to inform the IAASB's activities, there is a risk that unless such activities are time bound and subject to appropriate controls they could delay the IAASB's work rather than enhancing it. The process may become overly focused on research activities rather than actual outcomes. We encourage the IAASB to define clear targets with actual tangible outcomes, as well as the expected time for delivery.'* This kind of comments is not incidental. Discussions in the Monitoring Group also often indicate that we should move faster. So, there is a tension.

The best thing we, collectively, can do is to look forward in a timely manner. What is coming up on the agenda? We need a two-to four-year time horizon.

Leuz stresses the importance of post-implementation reviews. We have done this in the past with the Clarity ISAs. We will also discuss post-implementation reviews for the new auditor reporting, the key audit matters. We should do that two years after the standards became effective, which has not yet happened in the U.S. Key audit matters are very useful, but in the U.S. that is not visible, yet. But it is an important question in what cases key audit matters are more helpful or less helpful. Janine van Diggelen, when she was the IFIAR chair, emphasized the importance of entity specific key audit matters. Every year you have to make a unique story, without automatic repetition. Some auditors are really good at this. In the U.K., there were awards for the most innovative and insightful audit reports. That resulted in an unexpected compliment for this initiative from the investor side. But, is that still the case? And, of course, we want to know whether the more specific an auditor is, this is also more helpful to investors? Auditors have to help explain the reality behind the numbers. How can auditor reporting be most helpful? We will

examine that. So maybe we can start discussing research projects on this.

And there is more. ISA 540 on the audit of accounting estimates is now revised and needs to be implemented. In the meantime, we provide implementation guidance, more than we did in the past. Research may help in informing this implementation guidance. We also have new and revised standards for quality management out for comment. There is a fundamental shift in the approach to quality control from compliance and backward looking to a more comprehensive preventative active forward-looking approach.

So, let me get back to the evidence-based part. It is difficult to draft standards which are completely evidence-based. But the whole process is organized to integrate this idea. Drafting standards is not done by the board on its own. It includes consultation, listening to regulators and practitioners and standard setters. I agree that's not fully evidence-based, it is somewhere in the middle. Let me conclude by quoting the conclusion by Leuz: *'The systematic use of academic evidence to inform standard setting, regulation and policy requires substantial investments into the research infrastructure, including the synthesis and transmission of findings. It is not something that policymakers can simply decide to do on their own. Building the necessary research infrastructure takes time and, if taken seriously, evidence-based policymaking requires a concerted and long-term effort by researchers and policymakers.'*

The IAASB is very open-minded in having such a dialogue.

Perspective of an oversight authority: Barbara Majoor
Let me start by saying that in the Netherlands the oversight is provided by an authority, the Dutch Authority for the Financial Markets (AFM), which is not the regulator. The regulator is the Dutch Ministry of Finance. The AFM has no power to make rules. The role of the AFM is to assess compliance with the standards. They are also an agenda-setter with respect to the operation of the financial markets, including the audit.

> "It is good to see the bigger picture. It is all about the question how we get from A to B

My reflections on the topic at hand are based on my experience at the AFM as well as my experience as an academic. It is good to see the bigger picture. It is all about the question how we get from A to B. In 2015, the auditing profession and the auditing firms in the Netherlands concluded together that, based on a number of incidents and critical reports of the regulator on audit quality, that fundamental changes and improvements were necessary concerning audit quality, in order to act more in the public interest. In my view that is point A. There are several ways to get to point B, the point where audit quality will have improved.

In an ideal world, everyone is intrinsically motivated to do the right thing with focus on stimulating the intrinsic motivation, such as culture and tone-at-the-top. It is

important to focus on those things, which are not about rule-making. In the world of auditors, that is not the whole story. A less idealistic world is probably more realistic. And measures might be necessary. This road has been taken in the Netherlands. The Dutch Ministry of Finance has decided that, next to quality enhancing rules, also an oversight body was necessary and also the profession itself came up with 53 measures to improve audit quality. All measures together are addressing the problem. It would be wonderful if we fully understand whether and how the measures influence audit quality.

So, I fully agree with the idea of evidence-based regulation. However, currently we're not there, yet. There are problems, which are clearly described in the article of Leuz. Particularly in the auditing environment, many factors influence the impact of each measure. For example, political pressure or conflicting aims of regulation etc. It is difficult to isolate and measure the effects. Furthermore, an important issue is how we can get the necessary research data. This holds especially for pre-implementation, but also for post-implementation review of the effects of regulation. In that perspective, I find the approach of the *Commissie Toekomst Accountancysector* (CTA) promising. They try to get a clear picture of the relevant issues, based on various input. They use science in an exploratory way to analyze possible quality measures. A recent AFM-report, for example, was input for them in an exploratory way. It provided them, for example, with information on alternative business models. They used those for further thinking regarding possible suggestions. This is a good example of how academic evidence can be used in making policy recommendations.

To conclude, I think evidence-based regulation is a good thing to strive for. We should discuss how this can be improved. But if we don't know all the effects of regulation that does not mean that no action should be taken. We should improve developing insight pre- and post-implementation. Therefore, we have to work on improving dialogue further and develop research. Topics could be audit firm rotation, key audit matters, partner signing but also soft measures like cultural changes in audit firms, and effects of the focus on professional judgment and public interest. We can start with doing research on the post implementation of these measures.

Perspective of a researcher: Mark Peecher

During the recent Center for Accounting Research & Education conference of the University of Notre Dame, one of the most encouraging things I saw was that SEC-commissioner Robert Jackson with so much enthusiasm started quoting academic studies. This suggests that the SEC is actively finding relevant academic research to help with policymaking. One of the things he affirmed was the value of experimental research concerning audit judgment processes. Since we're not living in a perfect world, random assignment and experimentation can be very helpful for policymakers. We talked about archivally informed behavioral research and behaviorally informed archival research. We should really strive for, in the spirit of Leuz's point, practitioner (including standard setters and regulators) informed audit research. A big current threat to high quality audit research, according to me, is research of auditing by people who have done financial reporting research who may not even understand financial reporting really well, are suddenly doing audit archival work. They don't understand the institutional context. There is a lot of research like that. There is a very clear appetite for evidence-informed work, at least in the Netherlands, but now also in the U.S., with the new leadership at the PCAOB. They ask for academics to come and present their work. That is a positive sign.

> "How do we get to an ecosystem with an infrastructure to help regulators and standard setters have evidence-informed audit standard setting and regulation?

How do we get to an ecosystem with an infrastructure to help regulators and standard setters have evidence informed audit standard setting and regulation? Several things come to mind. One of the things I start to see in a number of U.S. universities is a new performance metric that is called 'engagement'. Under this umbrella the key point is having face time with leading practitioners in auditing (but also in other fields, like marketing). This encourages doing research that we talk about here. The way that academics have mainly been rewarded historically has been publishing papers and talking to other academics. With 'engagement' being explicitly rewarded, there is going to be even more reason to start interacting with professionals. That is an important part of the ecosystem. But until today, this FAR

conference is a very positive outlier in the extent to which practitioners and academics interact.
Another way to achieve our goal is to change the research production process, so that you have to be informed about the environment that you're researching. This would mean you have to talk to real life practitioners, regulators or standard setters before you dive in. Another positive movement is that we are hiring more and more clinical professors, who have a different view at this. The last thing we can do is mentor and encourage young scholars and stimulate ideas that are informative for practice and regulators. We already have conferences that only accept papers by non-tenured professors. That is good for improvement of the infrastructure.

Key points from the discussion: Q&A
During the panel discussion, a clear case was made for tearing down the walls between experimental and archival research silos and for using alternative research methodologies. Regulators, standard setters and policymakers care less about the methods and instead focus on the answers to policy questions. We should find ways to organize research and conferences around topics and policy questions, bringing together scholars from different fields using different methods.

Furthermore, during the discussion, the importance was stressed of bridging the gap between academia and practice. It was emphasized that conferences like the FAR conference are necessary to offer practice summaries of research, since most auditors in practice 'hardly ever walk around with research papers in their suitcases'. The communication of researchers needs to be geared more towards practitioners. Also audit firms could set up internal research units to help with this.

Lastly, an important observation was that professionals don't seek to maximize remuneration for their services. They take a reasonable honorarium for their work and they abide by a professional code of conduct. That is very appealing to students. Students want to be part of a profession. If you tell them go maximize profit, that is exactly what most students don't want to do. For a professional, the most important thing is doing the job right. Therefore, it is very important to focus on behavioral aspects and a quality-oriented culture.

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Keynote Speech
Miguel Minutti-Meza:

Insights and limitations of academic measures of audit quality [1]

In his keynote speech, Miguel Minutti-Meza identified four important limitations to the current research approach concerning audit quality. Subsequently, he presented researcher actions and sets of fixes to alleviate the problems. This article contains an edited transcript of his speech.

[1] *Miguel Minutti-Meza (Associate Professor of Accounting at the University of Miami) stresses that the views are his own and do not reflect those of the PCAOB Board or Staff, where he has been an academic fellow for a year.*

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'From existing literature reviews, my own work and conversations with other researchers and auditors, it is clear that practitioners generally understand and apply a tool known as the audit risk model. Actually, the audit risk model is not really a model, but a heuristic tool that we use to teach auditing. Using this model, auditors have to consider inherent risk, control risk and detection risk, which ultimately result in a residual or acceptable audit risk. I believe the multiplication signs in the model don't necessarily make a lot of sense, but the mentioned components arguably result in audit risk as an outcome. In the academic literature, there is an emerging consensus that audit quality and the audit risk model potentially link to audit inputs, process, outputs, and environment. But it is less clear how the audit risk model components relate to client characteristics, audit firm environment inputs, and the audit process leading to audit outputs. Let me provide you with some thoughts on this.

Both inherent and control risk are primarily determined by client characteristics. These client characteristics consist of, for example, size, profitability, losses, 'difficult areas' – like tax, goodwill, fair value -, total accruals and accruals caused by economic events, such as losses.

"

Maybe one day we will understand more about how engagement teams function

After considering client characteristics, we move forward to the audit firm environment. This is the area where most of the research work has been done, mainly as a result of data availability. There has been a development from understanding firms to understanding offices and recently towards partners. And maybe one day we will understand more about how engagement teams function. In general, we have seen papers on Big 4, office size, industry specialists, client portfolios, tenure, and recently on association memberships. But what we would also like to capture are institutionalized entity-level policies and procedures linked to a firm's environment, including hiring and promotion, methodology, templates, and internal guidelines. However, we cannot really observe those. Therefore, most of the auditing research on quality deals with the audit firm environment.

A third major component of the audit is related to the audit process. The topics that have been mainly studied by audit researchers until now are audit fees and partner identities (i.e., their names). But what can you learn from a name? Not much really. What we really want to know is what actions are executed in an individual audit. What expertise, independence, objectivity, and effort were at play?

The last piece of the audit puzzle is the audit output. The audit output is somewhat related to the residual risk in the audit risk model, but there's more, for example the auditor's report text – like going concern opinions and other -, restatements, internal control opinions, lawsuits, market reaction to client's financial information, regulatory inspection failures, client's accruals, and SEC enforcement actions. These are all observable, but what we would like to see is true audit failure. We want to find out exactly what audits are good and bad.

What is the typical research design of audit quality studies? First, there is the mantra: 'no data, no research'. All research is based on available data. We use data from large public databases, which contain observable variables (by construction). The focus is on publicly-traded companies and the best quality data is from the United States, although that is currently shifting a bit. Researchers typically estimate a statistical model, commonly:

OUTCOMES = f(OBSERVABLE MEASURE, CONTROL VARIABLES, e)

For example:
Restatement = f(Big 4, Client size, Client Profitability, e)[2]
Restatement = f(Audit Fees, Client size, Client Profitability, e)

If there is a statistically significant coefficient for a given observable measure or variable, then we conclude that the variable is a determinant of audit quality, for example a Big 4 variable can be associated to restatements and client's accruals.

Limitations
There are four important limitations to this current research approach. The first limitation resides in the strong effect of client characteristics. By focusing intensely on 'controlling away' client characteristics, it can seldom be determined what is the relative magnitude of the 'contribution' of the client versus

[2] *In this example model, restatements are described as a function of: (1) being audited by a Big 4 audit firm or not; (2) the size of the audited company; and (3) the profitability of the audited company. In addition there is an 'error term' (e) indicating the part of the restatements that is not explained by the three variables just mentioned.*

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the auditor to observable outcomes. Take, for example, a restatement. How likely is it that a restatement is caused by the client compared to an audit inefficiency? Research shows that, among all litigation actions against companies, only 20 percent include the auditor as a court defender (Lennox and Li 2019 *When Are Audit Firms Sued for Financial Reporting Failures and What Are the Lawsuit Outcomes?*). Hence, we should move away from research in which client characteristics seem to 'not matter' and are a nuisance for research purposes, towards research in which it is examined whether clients are possibly more often 'the bad apple' than the auditors.

A complex additional issue is that client characteristics also determine the known auditor environment variables. For example, large clients hire large auditors, and large clients are inherently different from small clients. So how can we separate the effect of size from everything else? That is not an easy task. In my own research, after tightly controlling for differences in client characteristics, the Big 4 effect on average client's accruals is 0.9 of the regression estimate and its statistical significance is somewhat debatable (i.e., very difficult to determine). This is narrowly defined as a 'self-selection problem'. By the way, my own papers take this narrow view and possibly need a re-write, too. Separating the client and auditor contribution to financial reporting quality is a complex causality problem that goes beyond self-selection. My guess is that key observable outcomes are highly determined by client characteristics and to a lesser extent by the auditor environment.

The second limitation is that we assume stable 'average' consequences of an audit firm environment. On average, it seems that Big 4, industry specialists, and large offices have comparatively higher quality outcomes. However, these findings do not explain real issues, such as, for example, the correlated audit failures involving Arthur Andersen in the U.S. and increasingly KPMG in the U.K. and other countries. Does this mean that such an audit firm is bad? Not necessarily, it just means that there were some bad audits. But those cannot be identified 'on average' by focusing on the audit firm or its environment. Another reality is that small auditors, with smaller offices, and relatively lower levels of specialization keep gaining market share, even among IPOs, in the U.S. Why would this happen if they were so bad? Once a client picks a firm with certain characteristics, it is very difficult to do anything to change its environment. This is similar to simply hiring a contractor based on brand to build a roof, but never supervising the contractor's actions. Finally, the cost to society of Big 4 and non-Big 4 failures are vastly different - think about number of restatements versus market losses. Who cares only about number of misstatements, if the magnitude is not considered? These average firm environment indicators are useful, but they are also limited.

> "These average firm environment indicators are useful, but they are also limited

The third limitation is that we still know little about the audit process. For example, consider observed, correlated, systemic, and high-cost failures, such as the Boeing 737-MAX crashes. Would we focus on Boeing's large market share, industry expertise, expertise making planes, etcetera to explain and correct the problem? Or instead on examining the plane's processes and find the direct causes of the problem? Analogously, we cannot

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say confidently, based on data, what auditor actions matter the most for quality and why. For example, there is a vague understanding of what audit risk is, typically in audit fee research. 'New' risks keep emerging by simply associating new client variables to audit fees (even 'extreme weather' events). Everything seems to be related to audit risk.

The fourth limitation is that observable audit quality outcomes have 'strange' relationships and difficult interpretations. We do not know exactly how restatements, large accruals, going concern opinions, inspection findings, and other outcomes actually overlap. They are certainly correlated, but very weakly. What causes the low internal consistency? We simply don't know. There is a great deal of research about what accruals and discretionary accruals mean. The best answer is probably that companies with large accruals are a fertile ground for audit mistakes and thus indicate high risk, but it is hard to link them to a level of quality. Accruals are both a client characteristic and an audit outcome. So, how much impact does an auditor have on total accruals? Some, probably. Also, the effect sizes of discretionary accruals are close to meaningless, given that they can hardly be interpreted. More is bad, that is all we can say, which is disappointing. Finally, audit fees are both a process and an outcome variable they are only an indicator of audit quality, which doesn't have the burden/barrier of proof in court.

Actions for researchers

I would like to mention five actions for researchers. Some are mine, some are borrowed, and some may be more important than others:

1. We can move forward from "associations" research, in which one variable is linked to another, one at a time, trying to infer that auditor attribute X is linked to client outcome Y. For example, partner gender and audit fees, partner gender and audit quality, etc.
2. We have to focus on effect magnitudes, relevant ranges, and what they mean. How meaningful is an industry specialist premium of 7 percent of audit fees, when median fees in the U.S. are $500K, and a specialist costs $35K? Why isn't every company hiring a specialist then?
3. Focus on explaining why auditors and clients make some choices (instead of focusing on associations) and whether choices result in optimal (or less optimal) outcomes. Are more fees not always better?
4. We can focus on audit processes and identify which process deficiencies result in bad audits. What exact conditions drive revenue recognition restatements? We should look further than Big 4 versus non-Big 4. Audit committees and regulators want to know how to stop revenue recognition misstatements.
5. Acknowledge the high causal density of some issues, for instance, among small companies, multiple things often go wrong (e.g., restatements, Internal Control Weaknesses, Going Concern Opinions). What is the effect of one variable on another? These effects are difficult to isolate. It is difficult to determine whether a Big 4 auditor helps low-quality clients, over and above their bad conditions. Furthermore, finding or not finding inferences with multiple proxies is not always desirable. Usually for different dependent variables different regressions are run, and the findings are considered to be robust if a coefficient is significant in the majority of the regressions. Of course, that is nice, but it doesn't meet the burden of proof in court.

Three sets of fixes for audit quality problems

From a regulatory viewpoint, there are six typical 'easy' fixes for audit quality problems:

1. Add a layer of regulatory inspections, because making the auditors "feel afraid" should increase audit quality.
2. Take away non-audit services.

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Relying on limited - and some flawed - academic research, anecdotes, and intuition, they should be prohibited.
3. Add independent experts to the audit committee, without clearly defining what expertise is and how exactly it affects the purchase of audit services.
4. Mandate auditor rotation. Every given number of ad hoc years: is 5, 10, 20 okay?
5. Disclose engagement partner names, and Engagement Quality Review partner names etc. This would be the same as requiring Boeing to print the chief engineer's name on the door of every plane. If something goes wrong, then you can blame the engineer. The idea is that liability will take care of quality problems.
6. Mandate disclosure of Critical Audit Matters and Key Audit Matters. But the auditor cannot produce new information due to inherent institutional constrains.

Next to these 'simple' fixes, there are four 'very difficult' theoretical fixes, some proposed by Joshua Ronen *(2010 Corporate Audits and How to Fix Them):*

1. Change the auditor revenue model to government payer, insurance payer, or other.
2. Change the structure of the audit market by imposing ad hoc limits on services and sizes of large audit firms.
3. Hope that mandating two auditors will make little firms grow and add a double layer of safety.
4. Move away from partnerships to other forms of corporate structures for audit firms.

Additionally, there are five 'somewhat difficult' but meaningful process fixes. How about:

1. Understand how audits are a system of overlapping (a) assessments, (b) tests, (c) controls, and (d) conclusions.
2. Understand what exact process has gone wrong in known audit failures, whether issues are systemic, and devise controls to prevent similar cases. Think about ENRON, for example, where there was a problem in the consolidation standards.
3. Develop a systematic approach of trial and error that identifies successful and evolutionary steps to improve the auditor's conclusions (for example, improve Goodwill impairment tests).
4. Use technology and artificial intelligence to process data on audits to find meaningful patterns.
5. Identify how partners' compensation and disciplining mechanisms, internal process controls (quality review) and external controls (inspections) could detect and prevent deficiencies without overlapping.

Key points from the discussion: Q&A

It is said that some discretionary accruals might be more predictive of future cash flows than others. Miguel: 'My view is actually more simplistic than this. Discretionary accruals have a 0.7 correlation with total accruals. So, it doesn't really matter which accruals you use. Now, total accruals happen within firms that don't have a short cash flow cycle. Total accruals happen when you build airplanes, ten years in advance. Total accruals happen when you are a complex company. And complex companies are more error prone. So, more accruals are not necessarily problematic, but they might indicate problems'. A participant mentions that it is known that auditors often don't look really hard at clients that look like every other similar company. If auditors look at things more because they seem out of line, then in fact it is not the case that more accruals are bad. These companies actually may be better than companies that look normal. Miguel: 'Concerning the process, a clarification is in order here. Perhaps we need more research on the process steps. We need to know more about which steps of the process are well-executed and lead to compliance. In the papers on discretionary accruals, we try to find an optimal ratio. I think more can be done on the optimal set of steps, and how they can be improved.' Miguel adds that the audit failure rate is very low. There is no real audit quality crisis. There are less than one percent of critical errors and they are non-correlated. Regulators should be concerned with correlated systemic errors. Furthermore, auditing will only be as good as the quality of the underlying financial reporting system is. Lastly, the important point is made that behavioral researchers already examined many conditions under which an auditor doesn't identify risks and under which they identify patterns etc. We know a lot about the process already. There are more than 400 experiments published in the Top 5 journals.

Fit Matters: Attract, Select & Retain Top Accounting Students

Murray Barrick (Professor at the Department of Management, Texas A&M University) has a deep research experience concerning individual behaviors, job performance and team work. During his presentation at the FAR conference 2019, Barrick shared insights from his study on how fit matters to accounting students when selecting a potential employer. In particular, Barrick discussed the role of person-organization fit during the recruiting process. This article contains an edited transcript of his speech.

Recruiting, fit and choices

'Recruiting is about job choices. Since I am interested in predicting behaviors, my research distinguishes between predicting choices as well as day-to-day behaviors. With recruiting we are interested in the choices about joining one firm or another firm. These choices are going to be predicted by person-organization fit or the match between applicant and employer, as noted in the popular press.

Why do we care about person-organization fit? Well, ask people what they want in a job and fit to the employer is one of the top concerns. For decades, workers have ranked fit as their top priority, above promotions, income, job security, and hours worked. Fit is one of (if not the) dominant consideration when making decisions as to whether to join or leave an organization. Yet, most people feel that fit is

missing in their work. The purpose of the presentation is to help you understand what the 'perfect fit' means to your firm.

Why fit matters to your firm

There is evidence that fit leads to greater engagement, prolonged retention (i.e. less turnover), and a more fulfilling, rewarding career. Hence, both the student and the employer benefit from greater mutual fit. Finding the perfect fit implies that a firm values what its junior associates naturally like to do and are good at doing, thereby creating a virtuous cycle.

I have been engaged in a study with PPA students (professional program in accounting, a Master's Degree) at Texas A&M University. Over 700 students have been studied in the past 3 years. The students start with the program in their junior year of college, in December, and they accept an internship offer during their first semester.

This plays into the misfit notion, because students often select an employer before they fully understand cultural differences between the firms. And at Texas A&M you can only take one internship.

For 95 percent of the students that internship decision turns out to be their employment decision for three years. That is kind of shocking. This phenomenon has also been recently reported in the Wall Street Journal. They report higher levels of anxiety for these students, which often is exacerbated due to the slow response in responding to job applications. A recent finding suggests this generation of applicants may be 'the most anxious' (see American Psychological Association, 2018, Stress in America survey), which has implications for a firm recruiting students. Specifically, if your firm recruits fast and decisively ('we want you!'), that will enhance your effectiveness in accepting your offer. A related notion is that a firm should appeal to the aspirations of the applicants (their hopes and dreams).

We find, for example, that one value under study is security, and accounting students judge security extremely high as a value. One benefit of fit is that if you 'fit in' you feel more security in the job choice. So, emphasizing fit reduces anxiety and provides security. Consequently, as a recruiting firm, it is important to enhance mutual fit to ensure greater engagement and performance.

Results of our study

We studied the recruitment of Texas A&M PPA students by the top 5 firms (who hire 97 percent of the students), and we identified for each student the best fitting employer based on the student's profile values and cultural preferences. As an aside, accounting firms didn't want me to disclose the best fitting firm for each student. Apparently, they are quite nervous about others disclosing the nature of their potential fit to the candidates.

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> The bottom line of research to date is that both students and employers benefit from better fit

The findings show that, when recruited by their best fitting employer, applicants were more likely to: (1) apply to that firm; (2) receive an office visit invitation; (3) receive and accept an employment offer; (4) start the internship with a stronger commitment (more passionate, excited and engaged); and (5) hold strong

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expectations that the work would expose them to fulfill their specific needs and fundamental values.

The bottom line of research to date is that both students and employers benefit from better fit. If your goal is to retain productive employees, one way to do that is through consideration of fit.

The dataset shows compellingly that applicants are attracted to the best fitting firm and they are more likely to be selected by recruiters in that best fitting firm, because when employees are well matched to their employer, evidence suggests they experience optimal psychological reactions, fulfillment, and performance.

But a fit on what?
We looked at two dimensions of fit: work values and organizational culture. Values are guiding principles that influence individual choices. In essence, values are beliefs about what is important in business and life, even how business should be conducted. The 10 values studied have been found to be influential in all types of national cultures and hence, are viewed as universal attributes. These include both moral values (integrity, honesty) but also values about innovation, customer service and quality (dependability), as well as cooperation, attaining accomplishments (achievement), change and adaptation, even beliefs about a more positive future – all are examples of values.

The values can be summarized through a 'dynamic structure of values' perspective. Underlying this structure are the 10 different values. People vary based on these values, but people with similar values lead to a fit with similar companies. There are four 'sets of values'. The first set is 'mastery and competence' (e.g., 'strives for achievement' and 'action-oriented, confident'). The second set is 'openness to change' (e.g., 'values freedom and autonomy' and 'playful spirit to life and work'). The third set is 'status and prestige' (e.g., 'maintain power and dominance' and 'values prestige and pay'). The fourth set is 'relationships' (e.g., 'favors collaboration' and 'strives for meaningful bonds').

Organizational culture can also be described within four sets (following the Competing Values Framework by Cameron and Quinn): (1) hierarchy (e.g., 'favors structure and conformity' and 'stability is important'); (2) entrepreneurial (e.g., 'dynamic and risk taking' and 'values innovation'); (3) market (e.g., 'results-oriented' and 'customer driven'); and (4) clan (e.g., 'communication, teams' and 'tight social networks'). While each is relatively independent, it is possible that organizations can score high on all of them. Recent research suggests firms high on all four culture "sets" are likely to be the most successful organizations.

In combination, both work values (from the individual perspective) and organizational culture (from the organizational view) are determining mutual person-organization fit. Initially, our research question was: 'do you fit to the values, or do you fit to the culture?' Instead, we find similar results for both components. But there was also a third 'element' at play: personal work goals, which function as 'deal breakers'. Examples of deal breakers were: location and career mobility (some like to travel, some do not), pay/benefits (although in the first couple of years pay is similar between firms), as well as personal development opportunities and job security differences between firms.

Previous research has not looked at the best fitting firm and the effect on retaining employees. Typically, we only have data on the company that applicants join. Since 97 percent of our sample students joined one of five audit firms, our research design provides a unique opportunity to rigorously examine this question. For example, for the first time we revealed that only 50 percent of applicants choose their best fitting employer. Why is this not 100 percent? Well, idiosyncratic reasons matter too, like location, 'click' with the recruiter etc. But also, the recruiting itself plays a role. Consider the following anecdote. During recruiting the applicant would go to the office and take the elevator up, the door would open and there is a big party going on. This is going to be fun, the applicant thinks! The applicant accepts the job. When he/she arrives at work, however, the elevator goes down and when the elevator opens, it is like hell down there. This suggests that recruiting, or putting your best foot forward, may lead to a lack of clarity regarding what are the organization's true values and culture. Our findings suggest firms may realize competitive value by better conveying what and who they are.

The results show that those who choose the best fitting employer (assessed by the researchers, based on surveys) do benefit. Better 're-cruitment outcomes' lead to greater satisfaction and more passionate employees who are engaged by the work. It seems that pursuit of the perfect fit is like the 'holy grail': as attaining mutual fit can lead to retaining productive employees.

What factors matter most to fit?
The key question for a job applicant is: do my values match the firm's key values? At A&M, the top

two key values are security and relationships. 65 percent of the students have this profile. Pay and prestige are the next highest values. These values overlap with the four organizational cultures. Firms should consider what their most important values are and clearly convey that to recruits.

Note that if a company wants to increase person-organization fit, the downside is that they will lose some candidates, as they withdraw after perceiving misfit to the firm. Not all firms like that; though realistically misfits are not likely to stay.

What are the steps an audit firm can take to find the perfect fit? They should examine the sources of information they control: is the firm effectively conveying the culture and values? And is the message consistent: from recruiters to hiring managers? Firms should also recognize that if instead they decide to only emphasize positive images, they will attract both fit and unfit applicants.
The challenge is to focus on what matters. How well employees fit with their employer determines whether what they like to do and are good at doing is also valued by their employer. The perfect fit will enable employees to meet their goals and values and experience greater career success, which in turn, should create greater success for them, thereby enabling them to meet their goals.'

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What are the steps an audit firm can take to find the perfect fit?

Key points from the discussion: Q&A

Diversity is also important for the success of a company. How does this relate to the story? Barrick: 'It boils down to the difference between 'fitting in' and 'doing well'. The diversity characteristic has more to do with 'doing well' than with 'fitting in'. Functional diversity relates to who is good at task work? Who's good at team work? Who is good at leadership? Who is good at interacting with the client? Those four functional skills differ. Partners often talk about diversity in teams as critical for their success. That doesn't preclude that all of those functionally diverse people have security as their number one consideration. That is the beauty of focusing on values. Values don't predict day-to-day-performance (doing well) as well as personality traits. However, personality traits don't predict job choices very well (fitting in) either. Values do. They are just different processes, but they can both be managed.'

What are the discrepancies between what people say and what people do, both for job seeker and employer? For example, do employers stick to the values they advertise? Barrick: 'It seems that firms often just want to attract people and get them in the door. This is called the 'fly-paper approach'. Then later on those who are poor fits quit. I encourage people to think about the following. There are many reasons why we end up with only 50 percent of the students accepting the best fitting employer. A primary one is the firm's failure to clearly convey who they are during recruiting. I believe the employers could quite easily get consensus on the top three values and type of culture emphasized by the company. Then consider from the recruiting side: what do we have control over? The answer is: control over the message of how we're conveying our values and culture and how we interact with the students. At A&M we do it the other way around. We tell the students what their scores are on values and help them identify which values and cultures they view as personally important. Than we discuss ways the students can try to find out who they fit best with. In this way, we hope they will make better, more informed job-choice decisions. In closing, I would encourage all to consider different ways to convey your most important values and organizational culture during the recruiting process, to enable candidates that fit well to your firm to accept your employment offer, once extended.'

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Does listening to earnings calls affect assessed misstatement risk or alter audit plans?

Presented by:
Mark Peecher *(Deloitte Professor of Accountancy at the University of Illinois).*

The paper is co-authored by:
Jessen Hobson, Sebastian Stirnkorb and Devin Williams.

The discussant:
Dick de Waard *(Professor of Auditing at the University of Groningen).*

The study revolves around earnings calls. After listening to an earnings call, if the auditors believe that the risk of material misstatement (RMM) is higher than they previously thought, then they are expected to increase the planned substantive evidence collection. The results of the study, so far, show that some of the experimental manipulations fortify or erode this relationship, for actual audits.

Theory and expectations
Auditors prefer that their audit clients are not engaged in fraud (or earnings manipulation). Using motivated reasoning theory as a guide, the researchers predict that this preference causes (subconscious) bias to arise in auditors' beliefs and action plans. The idea is that the phenomenon particularly plays a role when the auditor is on the client's engagement team. Peecher illustrates the point by describing that people in general, for example, do not want to believe evidence that their spouse has been unfaithful or that their own son or daughter has committed a crime. When persons who are socially close do bad things, their propensity to do so escapes.

There is quite a bit of experimental laboratory-research evidence that shows that depending on the likeability of a person their behaviors

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are perceived differently. However, a field experiment is conducted to test this idea within an actual real-life auditing setting, with archival controls and supplemental dependent variables. This is a unique opportunity, through the Foundation for Auditing Research, to test the theory in the real world.

The prediction is that there will be more bias if auditors receive a prompt to be alert for markers that management is engaged in fraud. Why is that the case? Such a prompt makes salient an aversive, preference-inconsistent event triggering motivated reasoning. This is caused by an unpleasant aversive event which is coming to the forefront of the auditor's mind, whereas the regulatory mode would be: let the auditor just look for fraud, and brainstorm about fraud.

There are two prompts being tested in the experiment: a fraud prompt and a cognitive dissonance prompt. The fraud prompt in the experiment requires the participant to pay attention to, and note, any information that could have potential financial reporting implications. Specifically, the participant should pay attention to markers that could indicate instances of earnings manipulation or financial statement fraud. The participant is asked to recall that audit standards state that audits should be planned to provide reasonable assurance that the financial statements are not materially misstated and whether the misstatement(s) are due to error or due to financial statement fraud. Subsequently, the participant is asked to assess the likelihood that the client's (uncorrected) quarterly or annual financial statements will be misstated as a result of earnings manipulation or financial-statement fraud after listening to the earnings call.

The second prompt (the cognitive dissonance prompt) asks the participants to pay attention to, and note, any information that could have potential financial reporting implications. Specifically, they should pay attention to markers that could indicate that client management is experiencing cognitive dissonance during the call. Cognitive dissonance is the negative, uncomfortable emotion a person feels when they are saying something that they know is not true. Those experiencing cognitive dissonance feel uncomfortable, uneasy, and bothered. Participants are asked to assess the perceived cognitive dissonance felt by management as a whole after they have listened to the call.

> "So, the key is to look at markers for fraud, without emphasizing the fraud-word

The prediction is that there will be less bias if auditors receive a prompt to be alert for markers

that management is experiencing cognitive dissonance, while the fraud prompt will result in a higher bias. The idea is that focusing on a marker of fraud without emphasizing fraud (i.e., cognitive dissonance by management) enables auditors to tap their ability to reason objectively and neutrally and to better connect their assessments of risks to evidentiary needs. So, the key is to look at markers for fraud, without emphasizing the fraud-word. This will unlock the capacity for good professional skeptics.

Method

184 auditor participants listened to actual Dutch public company earnings calls. 30 percent of the participants were audit partners, but the sample contains representatives of the full gamma of ranks. The experimental conditions were: (1) no prompts; (2) fraud prompt; (3) cognitive dissonance prompt; and (4) both prompts. The participants made pre-call risk of material misstatement (RMM) assessments and audit plans (e.g., how much work do you plan to do?). Then they listened to the call and made post-call RMM assessments and decided on further actions. 23 control participants were used to examine what happens if the company is not the auditor's own client.

Preliminary observations

On average, about 15 to 20 percent of the participating auditors change risk assessment and/or planned work as a result of the call. After listening to the call, partners most often said they planned to revise the audit plan in any way (about 15 percent as opposed to, for example, about 5 percent by managers). Peecher expected that the people in the trenches would have proposed more changes. Not finding this result might be caused by their feeling that they don't have that much influence on the audit plan?

> "The liar is feeling uncomfortable because he knows he is lying and the auditor should see that

Some preliminary inferential statistics reveal a troubling pattern, suggestive of motivated reasoning when a prompt to be alert for fraud occurs. A prompt to be alert for cognitive dissonance appears to have some newly identified advantages, but only in absence of fraud prompt. In particular, the prompt to be alert for markers of fraud seems to undermine the normative relationship between assessed RMM and planned evidence. Correlations were presented between risks and audit work for all four experimental conditions. Most significant correlations are found for the no-prompt group. But they seem to be relatively low. The correlations concerning the fraud prompt contain many non-significant cells. This is kind of worrying. For the cognitive dissonance prompt, correlations seem to be okay (except for test timing) and correlations are much higher than for fraud prompt. However, the strongest correlation between assessed risk and audit plan is only 0.52. Of course, changes in risk assessment should be integrated in the audit plan. However, the current evidence seems to indicate that where risks change the most, least adjustments in the planning are present.

Discussant remarks: Dick de Waard

Auditors operate in a regulatory environment with a focus on fraud. One of the ideas is that one can see whether someone is lying because of cognitive dissonance. The liar is feeling uncomfortable because he knows he is lying and the auditor should see that. That is a challenging task. Most of the times auditors receive penalties when finding a fraud: loss of the client, litigation if the fraud is discovered too late, or constraining discussions with the audit committees. De Waard confirms that all of this happens, judging from his own experience. Also, whistleblowers are not very popular.

There is quite some discussion on creating a system for incentives to encourage auditors to more actively look for fraud. But maybe this causes the risk of bounty hunting? Couldn't the audit committee play a more prominent role? Too often the audit committee is too close with the CEO and/or the CFO. It may sound somewhat contradictory, but if you know someone better, it easier to discover lies, in my opinion. That becomes difficult for auditors because of the mandatory partner and/or firm rotations. That makes it easier to lie. Also, De Waard believes, the ability to detect a lie is related to age, and not necessarily to being a partner. More focus on fraud will not help us. The main question is: is there still hope? Can training be helpful here?

Key points from the discussion: Q&A

During the discussion, it is noted that the Dodd-Frank Act rewards whistleblowers financially, but excludes the independent external auditors. That is something to think about. Furthermore, it is discussed how auditors in practice can be prompted to look for markers of cognitive dissonance during the audit. Existing evidence shows that middle-aged people are better able to detect lies. More research can and should be done in this area. Another key attention point was the weak link between risks and procedures. Peecher hopes to be able to shed some more light on that, based on the qualitative data. Peecher: 'Maybe we just already put a bit too much work in every audit. There are so many redundant procedures. That's one possible line of thought.'

Does Status Equal Substance? The Effects of Experts' Social Status on the Audit of Complex Estimates

Presented by:
Justin Leiby *(Associate Professor of Accountancy at the University of Illinois).*

The paper is co-authored by:
Anna Gold and Kathryn Kadous.

The discussant:
Ralph ter Hoeven *(Deloitte and University of Groningen).*

People don't do a very good job in assessing expertise. This is an issue across many domains. Leiby illustrates this by quoting Philip Tetlock who wrote two books which basically debunk the idea that acclaimed experts are very good at what they do. These two quotes are: 'The accuracy of an expert's predictions actually has an inverse relationship to his or her self-confidence, renown...' and '…success can lead to acclaim that can undermine the habits of mind that produced the success' (Sources: Expert Political Judgment, 2005; Superforecasters, 2015).

Why is this important for auditing? Well, experts are essential to the audit of estimates. A PCAOB survey showed that on average there were five specialists on large engagements. This number has probably increased. Auditors by definition lack the expertise to actually go and reperform the work of the expert. So, auditors need comfort about the expertise of the specialist. However, competence is unobservable, but assessing it is required.

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Theory and expectations
There are concerns stated by the IAASB and the PCAOB that auditor exercise insufficient care in using the work of experts and in assessing experts' competence. For example, auditors rely on general competence of experts not on issue specific capability. The idea of Leiby and his team is that social status intrudes on assessing expert competence and reliance. The specific question they ask is: does an expert's social status affect assessments of his/her competence and, ultimately, the audit team's conclusions about client estimates?

Social status consists of social rank/standing based on admiration and respect. It is observable, salient and used pervasively to assess unobservable quality. Status is an important substitute in assessing quality, and auditing standards allow competence assessments based on standing among peers, writing books etc.

The researchers have three main expectations:

1. High expert social status inflates perceptions of experts' competence. This increases auditor reliance on high status experts when there is uncertainty.
2. When experts disagree with a client's estimate, auditors rely on expert more when experts' social status is high. This facilitates 'pushing back' on aggressive client estimates.
3. When experts agree with client but offer poor justification, auditors rely on expert more when experts' social status is high. There is overreliance on poor evidence, increased audit risk.

Method
The research team conducted an experiment with 170 Dutch Auditors (from seniors up to partners), through the Foundation for Auditing Research, in which there is a fair value case involving an aggressive client discount rate used to value investment properties. Each auditor receives input from an expert (one of six randomly assigned 'conditions').

Half see a high social status expert, half see a moderate status expert. Each auditor sees one of three expert reports, containing: (1) a strongly justified agreement; (2) a weakly justified agreement; or (3) a strongly justified disagreement.

> "Each auditor receives input from an expert

Intermediate observations
How do the data match the expectations, so far? First, social status increases perceptions of expert competence, across conditions. Second, concerning disagreement, auditors were willing to rely more on experts who disagreed with the client's estimate, when that expert had high social status. This seems like good news. Third, there is no indication that auditors are more willing to rely on

poor arguments when they come from a high-status specialist.

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> Auditors recognize that certifications signal competence, but playing tennis does not

Afterwards, each participant learned one of three new things about the expert. The expert was: (1) a register valuator; (2) a Certified European Financial Analyst; or (3) plays tennis with firm leaders. Particularly the third item should not at all be relevant.

Auditors recognize that certifications signal competence, but playing tennis does not. However, auditors only change assessments of the client estimate in a desirable direction after they learn the expert plays tennis with firm leaders (i.e., more social status information).

The good news is that high expert social status empowers auditors to challenge aggressive client estimates when evidence justifies it. The not so good news is that auditors do not assess expert competence in a manner consistent with how they rely on the expert's input. If anything, higher competence assessments lead to less challenging of estimates.

The researchers offer two preliminary implications of these findings.

First, it may be helpful to separate assessing expert competence from using the expert's input to evaluate an estimate, because expert social status appears harmful for the former but helpful for the latter. Doing so could include centralizing expert competence at the firm level while empowering reliance at the engagement level, or restricting status information from those who assess expert competence. Second, it may be helpful for firm quality controls and possibly for professional standards to consider a broader range of expert characteristics beyond competence, as characteristics like status may have more positive implications for audit quality in some conditions.

Discussion by Ralph ter Hoeven
(Audit Partner at Deloitte and Professor of Accounting at the University of Groningen)

From the presentation by Leiby, it becomes clear that accounting and auditing experts may be part of the problem instead of part of the solution. In the standards, the ISA 220, as part of the quality control framework of firms, firms should have specialized ISA-experts or accounting experts, willing to take up complex issues. Teams should at least have a consultation possibility with these specialists. In many firms, you can call experts if you're not certain whether your client is applying the rules correctly, for example concerning IFRS. An important audit threat is that team members don't consult specialists within the firm. Is that a behavioral issue? Is it because they already gave away their position to the client and don't dare to consult? However, an open consultation culture is important. Consultation is a strength.

This presentation is actually more about ISA 620, the use of experts by audit teams. All auditors have learned its contents. The expert should be from a reputable firm, we should assess the quality etc. It is an important area, including, for example, actuarial valuation, purchase price allocation and valuation of complex financial instruments. What is important here? Audit firms receive reports from well-known experts. But in case of difficult issues, often the company is already consulting external experts, often issuing reports on behalf of the client. The auditor will then often use the firm's internal specialists to review the contents. So, many of the threats that have been presented by Leiby are consequentially diluted, since many parties are involved. But nonetheless, the issues are valid. It would be interesting to check whether a report of the same quality is treated/approached differently by internal specialists when it stems from firms of different reputation. Ter Hoeven shared two best practices of audit partners that were right concerning their doubts about parts of expert reports especially in the application of IFRS: 'This teaches us three things indicating audit quality. First, it shows that partners read the reports. Second, they critically read the reports. And third, they consult our internal specialists.'

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Key points from the discussion: Q&A

Next to the status of the expert, the organization the expert works for might also have a certain status that might reflect on the status of the expert. So, the organizational context might be important. However, Leiby stresses that they studied internal experts to the firm, and not external experts where that might play a role. It was asked whether duration of a relationship with an expert has an influence. Leiby indicates that they can't answer that question. But if someone says that expert X is great, of course that means something and will have an effect. But the effect will/ should weaken over time. Leiby states their study covers an important part of the puzzle in the early stages. The interesting question is posed whether experts can also be blinded by the social status of audit partners? Ter Hoeven says he isn't aware of that. According to him, it is even the other way around: 'If senior staff calls us with a problem, the first question we ask is whether their audit partner knows that they are calling.' Ter Hoeven additionally states that internal experts are working in the technical departments and that it would also be interesting to acknowledge that the status of those departments is not that high within the firms. Leiby recognizes this issue, but remarks that this is more about professional status instead of social status.

Multiple team membership and quality threatening behaviors

Presented by:
Reggy Hooghiemstra *(co-researchers on this FAR-project are Dennis Veltrop, Floor Rink and James Zhang).*

According to Hooghiemstra, current concerns about audit quality can be illustrated by a quote made in 2014 by the chairman of the International Forum of Independent Audit Regulators (IFIAR): 'Too often, auditors sign off on financial statements, even though they have not collected sufficient information to base their judgments on […]. In a high number of audits, we found deficiencies […] also, we do not see an improvement.' Audit workload and time pressure may be among the root causes of these problems.

Several studies have asked practitioners to assess the factors which may impair audit quality. The results of these studies show that the potential impairments are to a certain extent related to staffing issues.

The project team focuses on conducting audits by audit teams. Working in audit teams is one important feature of how work within auditing firms is organized. Quite often auditors work on several engagements at the same time. In this study, the effects of multiple team memberships (MTMs) on so-called 'quality threatening behaviors' are examined. During the presentation, Hooghiemstra provided insights into some of the preliminary ideas and findings of a study the team is working on.

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Defining the key concepts
Quality threatening behaviors are broadly defined as 'behaviors that signal the poor execution of an audit procedure that reduces the level of evidence gathered for the audit'. Quality threatening behaviors usually involve one or more of the following behaviors:

- Reduction of work below what is reasonable.
- Superficial review of client documents.
- Acceptance of weak client explanations.
- Failure to research an accounting principle.
- Failure to pursue a questionable item.
- False sign-off.

MTM relates to the phenomenon that individuals serve on several teams concurrently during a certain time period (in the study the focus is on a three-month window). MTMs are distinct from, yet related to, multitasking. The core difference between multitasking and MTMs is that multitasking broadly refers to engaging in different activities within one team. For example, an assistant initially works on the inventory and then changes attention to doing work on the accounts receivable on the same engagement.

MTMs are the most important element of the way audits are organized. It allows for the most efficient use of personnel. The key research question is: How does multiple team membership affect the extent to which auditors engage in quality threatening behaviors?

Conceptual framework
The main idea is that the higher the number of teams an individual auditor simultaneously serves on, the higher the degree of quality threatening behaviors. Further, the expectation is that there will be an indirect 'channel' via learning. The better individual auditors are able to learn from, for example, prior experiences or on the job training, the better they are in decreasing quality threatening behaviors. If you would combine it with the number of MTM's, you could also imagine that the higher the workload, the less opportunity to actually learn. Ultimately, the expectation is that also via the indirect channel there is a positive impact on the number of quality threatening behaviors.

In addition, the research team examines the impact of resilience, to account for differences between auditors. Resilience means the extent to which an individual is able to bounce back from adverse situations. The literature states that resilience is an important personal resource which explains why some individuals are better able to deal with a high workload than others. Hence, the expectation is that the more resilient an auditor is, given a certain number of MTMs, the better she will be able to learn (a so-called 'moderated mediation').

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In addition, the research team examines the impact of resilience, to account for differences between auditors

From MTM to QTB
There are a number of reasons to expect that a higher number of MTMs is negatively associated with audit quality. For example, in the prior literature, there is some evidence indicating that even at the partner level, the higher the number of clients that have to be managed, the lower audit quality becomes. There can be time-schedule conflicts, switching costs (e.g., relocation and coordination) and an increased workload and time pressure. Furthermore, auditor *busyness* literature finds a negative association between the number of clients and audit quality. Typical for the situation is that the higher the number of different teams that an individual serves on, the higher the effort is that has to be spend on coordination between the teams. Accordingly, it

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is expected that there is a positive association between the number of MTMs and QTB.

From MTM to Learning to QTB
(On the job) learning is a key attribute for auditors. Learning allows for better judgment accuracy and increased professional skepticism. More MTMs leads to reduced learning because time pressure directs attention to critical and immediate tasks and it becomes more difficult to integrate new information. This informs the second expectation the team has formulated at this stage: learning mediates the positive association between the number of MTMs and QTB.

The role of resilience
The expectation is that the relationships above are not the same for all auditors. It may depend on resilience. Resilience refers to the ability to rebound when individuals are in adverse situations. It is an important capacity to cope with workload pressures. More resilient individuals are less likely to stress out in challenging situations. This leads to the last prediction in which it is stated that the mediated relationship between MTMs and QTB via learning is stronger for less resilient auditors.

Research design
Four key measures were used in a survey in which a representative number of auditors participated:

- MTM: 'How many engagements did you serve on during the last three months?'
- QTB: 'How often did you engage in the following behaviors …?'
- Learning, for example measured by asking to what extent auditors agree with the statement: ' I continue to learn more as time goes by'.
- Resilience, for example measured by asking to what extent auditors agree with the statement: 'When bad things happen to me, I try to feel not bad about myself'.

Preliminary observations
On average the participating auditors served on about 9 different engagement teams.
The study suggests that the number of auditors who indicated that they very often resort to the defined quality threatening behaviors is quite low. Compared to prior research, this even is much lower. That is a positive result. The researchers don't find evidence for a higher number of MTMs leading to higher quality threatening behaviors. But the researchers are able to show that resilience matters. The more resilient auditors are, the more they learn from more MTMs. The combination of a high number of MTMs and low resilience is associated with the highest number of the highest level of quality threatening behaviors.

Discussion and implications
The research team finds some evidence that the number of MTMs explains the degree to which auditors resort to quality threatening behaviors. Furthermore, and maybe more important: a large part of the effect takes place indirectly, via reduced learning. Also, an important moderating effect of resilience is present.

A practical implication could be to adapt HR-policies in order to stimulate that resilience is considered to be important. Coaching might help in learning to deal with high-stress situations. Also, attention during on-boarding activities can be geared more toward resilience.

Key points from the discussion: Q&A
A practitioner notes: 'What I learn from this is that looking at behavior is incredibly complicated. But being on multiple teams is something we always consider during evaluations, for example, when looking at the portfolio of partners. If they have more than a preset number of clients, we look at the hours they have supervised, involvement of other partners, etc. So, it's an important point of attention.' Another participant remarks that some team members are exceedingly good at fighting problems. Those are the ones that get assigned multiple times. That is not only about resilience. It is about the special element you bring to engagements, just because you're good. Hooghiemstra: 'We do not examine why people get appointed, but there is research in which it is shown that people who perform better, also in more teams, as a resilient high performer, are also likely to be invited to more teams.'

Auditor Reporting for Going-Concern Uncertainty:

Research Findings and Practitioner Perspectives

Presented by:
Marshall Geiger (University of Richmond), Anna Gold (Vrije Universiteit Amsterdam) and Philip Wallage (Vrije Universiteit Amsterdam and University of Amsterdam).

This is the first FAR research synthesis project. A literature review is a good way to create more awareness among practitioners concerning what is already known from research on factors that appear to affect their decision making, which in the long run may lead to better decision making.

The study comprises three main elements: (1) a review of recent research findings on auditor reporting on going concern uncertainty opinions; (2) practitioner perspectives of research findings and of the difficult issues in practice regarding Going Concern Opinions (GCOs); and (3) future research areas and issues.

The reasons for starting the study
A GCO is one of the most important judgments that auditors make, as it has tremendous impact on markets and clients. GCO issuance also says something about audit quality. Furthermore, it is one of the few observable outputs that vary across engagements. When the FAR-call for projects came out with an interest in

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Marshall Geiger

GCOs, this was a great opportunity to extend an existing literature synthesis in Auditing: A Journal of Practice & Theory, as that covered research until 2012. It was surprising to see that as many as 149 studies have appeared in this area since then. In this presentation, the most important findings from the literature review will be presented.[1]

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Besides reviewing and summarizing the papers, it was decided to organize a focus group meeting with experts from several Dutch audit firms. They reflected on some of the key findings of the literature review and several “hot topics” in the GCO-area were discussed.

In the literature review, three broad categories were used: (1) determinants of GCOs; (2) accuracy of GCOs; and (3) consequences of GCOs.

1. Determinants of GCOs

The determinants of GCOs can be split into client characteristics, auditor characteristics, auditor-client relationship and regulatory oversight.

Some Client Characteristics

In general, clients are more likely to get a GCO if they:

- Have financial statement filing delays (Cao et al., 2016)
- Employ a business strategy of innovation and have a fluctuating product mix (Chen et al., 2017). So, if they are more complex and dynamic.
- Engage in controversial activities related to customers, employees, the environment or the community (Koh and Tong, 2013)
- Are overly optimistic:
  - Have overly optimistic financial forecasts (Feng and Li, 2014)
  - Have over-confident management (Kim, 2017)
  - Report financial results less conservatively (DeFond et al., 2016)
- Have a new CFO (Zaher, 2015; Beams et al., 2016)
- Have a poor work place environment for employees (Huang et al., 2017)
- Fail to remediate internal control deficiencies (Hammersley et al., 2012)
- Have a CEO with friendship ties to audit committee members (Bruynseels and Cardinaels, 2014)

Some Auditor Characteristics

Auditors are more likely to issue a GCO if they:

- Are from a Big N audit firm (Berglund et al., 2018) (Note: there is mixed evidence on this as well)
- Are in a US office that had few type I errors in the previous year (Ahn and Jensen, 2017)

Furthermore, instead of summing up all of the evidence, auditors

[1] *Please refer to the full report, for a complete overview and for the detailed references to the articles mentioned. See: https://tinyurl.com/yx6ff88y.*

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Anna Gold

tend to average the diagnosticity of all the available evidence at the end of a task. Thus, significant evidence against the going-concern assumption gets averaged with milder evidence resulting in a more moderate evaluation than evaluating the significant negative evidence alone (Lambert and Peytcheva, 2017).

Auditor-Client Relationship
GCO issuance increases likelihood of auditor dismissal and dismissals following a GCO are greater when management is more powerful than the audit committee (Kim, 2017).

The failing of a company, without an issued going concern opinion by the auditor, happens more often in the early years of an audit in the US (Read and Yezegel, 2016). There are mixed findings in other countries (Ratzinger-Sakel, 2013; Garcia-Blandon and Argiles, 2015; Chi et al., 2017).

Regulatory Oversight
In the US, annually inspected non-Big N firms issue more GCOs compared to tri-annually inspected audit firms after the start of PCAOB inspections (Litt and Tayni, 2017). Foreign auditors subject to new PCAOB inspections have a significantly higher probability of issuing a GCO (Lamoreaux, 2016). Firms sanctioned by Chinese inspectors issue more GCOs after enforcement actions (Firth et al., 2014). And non-Big N audit offices that have greater awareness of SEC enforcement actions are more likely to issue first-time GCOs (DeFond et al., 2017).

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> The failing of a company, without an issued going concern opinion by the auditor, happens more often in the early years of an audit in the US

2. Accuracy of GCOs
A Type I error is when auditors issue a going concern opinion and the company doesn’t go bankrupt or fail. A Type II error is when a company fails and the auditors haven’t issued a going concern opinion. Are these indicators of ‘errors’/audit quality? A few papers argue that focusing solely on bankruptcy or liquidation as the definition of a ‘failed’ company significantly overstates type I error rates, leading to an understating of the accuracy and quality of GCO reporting, and consequently, understating the value of GCOs to investors and users of the financial statements (Noglar, 1995; Desai et al., 2017; Gutierrez et al., 2017).

In general, the literature finds that increasing GCO rates generally increases type I errors, without significantly reducing type II errors (Blay et al., 2016; Carson et al., 2017; Chu et al., 2018).

Statistical Failure Prediction Models (SFPM - like Altman Z and models of bankruptcy prediction) use public data and are better predictors of company failure than GCOs (Gerakos et al., 2016; Alareeni and Branson, 2017).


Philip Wallage

Auditor Characteristics
There is mixed evidence on whether Big N firms are more accurate than non-Big N auditors (Myers et al., 2014; Blay et al., 2016; Kabir and Rahman, 2016; Berglund et al., 2018). Partner GCO decisions are more accurate if they: have higher IQs (Kallunki et al., 2018 – Sweden Male partners only), have more years of experience, education, and have more industry experience (Che et al., 2018 - Norway).

3. Consequences of GCOs
Receiving a GCO increases a financially distressed company's probability of bankruptcy only by an average of 0.84 percent in the US, suggesting that, in general, auditors and firms do not need to be overly concerned with the prospect of a GCO sending a company into bankruptcy – i.e., the 'self-fulfilling prophecy' hypothesis (Gerakos et al., 2016). However, a first-time GCO increases the company's cost of equity capital by an average of 3.3 to 5.2 percent (Amin et al., 2014). And credit rating agencies typically downgrade the company's credit rating after a first-time GCO (Feldman and Read, 2013; Strickett and Hay, 2015). Furthermore, there are negative share price consequences of a GCO to equity owners (Czerney et al., 2017), which is consistent with prior research.

In general, experienced investors associate type II errors with lower audit quality, and type I errors with higher audit quality (Christensen et al., 2016). And there is a significant negative association between GCOs and subsequent auditor litigation, suggesting that auditors deter lawsuits by issuing GCOs (Kaplan and Williams, 2013).

Some observations of practitioners from our 'focus group' discussion
Discussing a GCO is a really difficult issue concerning judgment, future events, clients etc. However, if such an opinion is not issued and the company goes bankrupt within one year, also the auditor is in trouble. To get more insight into the practitioners' views regarding the findings from the literature review, the six largest Dutch audit firms were contacted and the experts on GCO's were asked to participate in a group discussion. The responses were all positive. The 22 most important findings from the literature review were sent to them beforehand.

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> The 22 most important findings from the literature review were sent to them beforehand

They were also asked to bring to the table the most important issues they experience in practice. Some of these issues were: proper integration of KAMs and GCO disclosures is difficult and subject to differing interpretation; the question whether non-material GC uncertainties should be included as KAM; and the ability of users to tell the difference from material uncertainties. It will come as no

surprise that people did not reach a complete consensus on this.

Consultation with firm GCO-experts appears to be widely practiced. However, there is variance observed in terms of timing (early vs. late in process), and there are concerns about timely involvement. In addition, younger partners tend to consult earlier than older partners. Furthermore, the number of consultations has increased as a result of involving experts in the team.

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> There was also a general interest in developing better statistical models to be used as GCO decision aids

There is recognition that reliance on proprietary information is much stronger than reliance on publicly available information (which might explain some research results). There was also a general interest in developing better statistical models to be used as GCO decision aids (algorithms, for example). And the importance of the client's own GCO-assessment was discussed as being critical to the audit process and to the evaluation of the adequacy of financial statement disclosure.

Some Areas for Future Research

The authors also presented possible avenues for further research:

- Is issuing a GCO a measure of audit quality?
- How does the advent of “Big Data” and advanced analytic techniques improve auditor GCO decisions / enhance the predictive ability of bankruptcy prediction models?
- What are some of the characteristics of the lead engagement partner / audit team members that drive GCO decisions?
- Are there differences between public and private company audits in terms of audit firm, auditor and other effects associated with GCO decisions?
- How do firms integrate GCOs into the new audit reporting formats with CAM/KAMS?
- Use of firm in-house GCO experts and their impact on GCO reporting decisions has yet to be explored in the extant research.
  - o When do these consultations typically take place?
  - o Are reporting decisions more accurate after GCO consultations?
- Researchers must seek to create more realistic models and analyses of actual auditor GCO decision-making. As audit firms specifically document GC consultations (their decisions and rationale), audit firms could provide access to this information in order to accomplish this.

Discussion by Arjan Brouwer (Audit Partner at PwC and Professor of Accounting at Vrije Universiteit Amsterdam)

Research syntheses are an excellent tool for evidence-informed auditing and policy making. Of course, the findings have to be tailored to the Dutch situation. In the overview there are interesting and less interesting findings. The finding that loss-making companies or companies which break the bank covenants get GCO's, or that more intelligent auditors make better decisions are not very exciting. That is almost a given, and confirmed in the literature. However, many researchers have provided relevant insights into the issue and the likely effect of measures aimed at reducing the number of times an auditor fails to issue a GCO whereas the company does go bankrupt within a relatively short timeframe thereafter.

In the current standards, according to Brouwer, a company is either healthy or almost dead. What do the accounting standards say? Accounting standard IAS 1.25 states that there is a going concern basis unless management either intends to liquidate the entity, to cease trading, or has no realistic alternative but to do so. It furthermore states that when management is aware of material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. So, it only applies when there is significant doubt.

It all starts with accounting, not auditing. Basically, what the GCO is about, is pointing the reader of the financial statements to the disclosure of management's going concern expectation. The relevance of that is also depending on the quality of that disclosure. Why are we struggling so much with this? Why do we have so many Type I and II errors? We

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could ask ourselves, what the incentives could be for an audit firm to not issue a GCO, if you know that the company will (probably) go bankrupt. Brouwer's answer would be that there is no incentive. An audit firm has all the reasons to get it right, because in case of problems, they will always go after the auditor.

Also, the literature tells us that auditors and audit firms have many reasons to appropriately issue a GCO: reputation risk, liability risk and other financial risks. However, it appears very hard to identify the companies with significant risk. Incentives to reduce risk seem to result in more conservatism but not in a more accurate identification. Why is it so hard?

In a substantial part of the literature, conservatism is used as a proxy for audit quality. But from an accounting perspective, conservatism doesn't equal quality in auditing terms. If we all become more conservative, it doesn't result in more relevant information. How do we get to better reporting about the risks that a company faces? A relevant question is how the combination of reporting about those risks, governance around it and assurance on it can facilitate better (investor) decision making. Approaching the problem only as an auditing issue will continue to result in disappointment.

Key points from the discussion: Q&A

It was asked whether there exists evidence on the impact of Type I errors. You could say that in making a Type I error, the auditor was too conservative. However, it puts everybody on alert, resulting in less bankruptcies. Geiger refers to a study in the 80's, concerning US data, in which they found that there is no self-fulfilling prophecy for firms that received a going concern opinion (they did not go bankrupt because of that). But auditors were more likely to lose that client. So, the conclusion was that there was a significant cost to auditors for making a Type I error. Similar findings are available from Belgium, where standards became stricter and a decrease in Type II errors has been observed, but also a sharp increase in Type I errors. The consequences for the company were not very positive. As can be expected, the interest rates and employee turnover went up. During the discussion it was mentioned that in the UK a viability statement has been introduced a few years ago, which basically requires every listed company to have a more comprehensive discussion on going concern risks in the director's report (but it's not audited). It is about the viability of their business model and make a prediction of the horizon they deem possible. Also, in The Netherlands this is being discussed.

How do professional skepticism profiles affect audit processes? A sneak peek of preliminary observations

Presented by:
Sanne Janssen *(Open Universiteit and University of Antwerp)* and Ann Vanstraelen *(Maastricht University and University of Antwerp).*

Co-team members:
Kris Hardies *(University of Antwerp)* and Karla Zehms *(University of Wisconsin).*

The research team provided a sneak peek of preliminary observations from their FAR research project on professional skepticism profiles and on how these professional skepticism profiles affect audit processes.

They presented descriptive statistics which are solely based on the survey-data obtained. In the next phase of the project, the survey-data will be combined with proprietary archival data from audit firms to develop and test a more complete research model and control for confounding factors.

Professional skepticism is an important issue for the auditing profession and has received a lot of attention by academics, practitioners, standard-setters and regulators. Regulators and standard setters emphasize professional skepticism as a key input to audit quality and the concept of professional skepticism is pervasive throughout auditing standards. Surprisingly, however, there is relatively limited knowledge and research concerning the drivers and consequences of professional skepticism, and in particular how these affect the audit process.

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There does exist some experimental research on how professional skepticism affects auditor risk judgments. However, how this translates into audit procedures and the audit process is not extensively studied. Therefore, this is exactly the objective of the research project.

As more often mentioned, professional skepticism is an ill-defined concept. There is no clear consensus on what it means and how it should be measured. It is interesting to know what professional skepticism entails. Is it: (a) to have a questioning mind and a critical assessment of audit evidence; (b) to have more doubt about the validity of an assertion than about its invalidity; or (c) something else?

Standard setters typically define professional skepticism as option (a), which is the neutral perspective. Given this perspective, the auditor will collect and evaluate audit evidence to confirm management assertions and to rule out alternative explanations. Option (b) represents the presumptive doubt perspective. This perspective is proposed in the auditing literature. It is most visible in the auditing standards concerning fraud and states that the auditor assumes some level of dishonesty or management bias, until or unless evidence indicates otherwise. Nonetheless, in academic literature, professional skepticism is often defined as option (c). Many academics view professional skepticism as an attitude, a state of mind. Though, professional skepticism is also defined as a trait, a (relative stable) difference between individuals. Further, professional skepticism also may be conceptualized as both a mindset and an attitude which is driven by individual determinants, and by social and situational factors. This is actually the most recent conceptualization of professional skepticism, as put forward in the academic literature by Christine Nolder and Kathryn Kadous. They depict trait skepticism as an individual factor that influences the larger professional skepticism construct.

Conceptualizing professional skepticism as a mindset and attitude allows for it to be malleable to a certain extent. This implies that audit firms can develop methodologies and create organizational conditions to enhance professional skepticism.

> One of the research questions is: to what extent is there variation in professional skepticism profiles among Dutch auditors?

For the purpose of the research project, it is argued that a professional skepticism profile is formed by a combination of individual professional skepticism traits, other personal characteristics and contextual factors.

One of the research questions is: to what extent is there variation in professional skepticism profiles among Dutch auditors? Multiple measures for trait skepticism are used. The Hurtt Professional Skepticism Scale (HPS) is used to measure neutral trait skepticism. The scale includes questions designed to assess whether an auditor has a questioning mind, is willing to suspend judgment, searches for knowledge, has interpersonal understanding, and has autonomy and self-esteem. Professional skepticism is also measured by using the Professional Moral Courage Scale (PMC). Its definition states that auditors vary in their willingness to take skeptical actions and to what extent they are able to make the decision to take actions. Lastly, the reversed score of the Rotter Interpersonal Trust Scale (RIT) is used. It is designed to capture a generalized expectancy of an individual or a group that the word, promise, verbal or written statement of another individual or group can be relied upon. The three different measures are used, because the correlation/factor analyses show that they indeed measure different constructs.

Method

Six FAR affiliated Dutch audit firms participate in the project for which they delivered a sample of in total 342 engagements. 1447 auditors were selected to participate in the study of which 758 submitted a usable response. The sample consists of about 150 partners, 220 managers, 110 seniors and 270 juniors.

Preliminary observations

First, the study shows that the mean score of the partners significantly differs from the other ranks, on all three scales. The results suggest that the partners have a higher neutral skepticism and higher moral courage, while for Distrust the mean score of partners is lower which means that partners have a lower level of presumptive doubt.

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> The team also collected data on other characteristics like gender, age, experience, knowledge, etc.

Also, the participants’ self-perceived level of professional skepticism correlates significantly with the scores on the HPS and PMC scales, but not with the Rotter scale.

The team also collected data on other characteristics like gender, age, experience, knowledge, etc.. For the last three, the observed values increase simultaneously with rank. For gender, however, the number of females decreases when rank increases: 36 percent of juniors is female, and only 8 percent of partners is female. Furthermore, questions on organizational conditions were included in the survey, like professional orientation, perceived quality control and perceived unethical tone at the top. There are differences regarding perceived unethical tone at the top: partners perceive unethical tone at the top significantly lower than other ranks.

Concerning personality characteristics, the results again show a significant difference between the partner and other ranks. On average, partners are more extravert, more conscientious, more emotionally stable and more open and narcistic, but partners are less Machiavellian and psychopathic.

An important goal of the project is to study whether professional skepticism really matters for the audit process. Therefore, there were questions

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included in the survey concerning fraud brainstorming, valuation, and about analytical procedures.

Based on the questions regarding fraud brainstorming, the research team is able to measure fraud brainstorming quality, fraud risk factors, fraud risk responses, etc. Fraud brainstorming quality is relevant as prior literature suggests that higher fraud brainstorming quality leads to more effective audit plans to identify misstatements due to fraud. Fraud brainstorming quality is measured by use of a 21-item measure (e.g., Did a partner lead the sessions? Did specialists attend the session? Was an agenda used?), resulting in a brainstorm quality score where a higher score indicates a higher fraud brainstorming quality.

The researchers looked at the correlation between the trait skepticism scores and fraud brainstorming quality. Auditors with a high score on the HPS and PMC scales show significantly higher fraud brainstorming quality compared to partners with a low score on these scales (split by median). For Distrust, the opposite holds.

Partners with a high score on the HPS and PMC scales experience on average more contribution of the attendees of the brainstorming session(s), have on average more specialist attending the fraud brainstorming session(s) and the preparation of the session(s) and the duration of the session(s) is on average longer compared to partners with a low score on the HPS and PMC scales. Typically for partners with a high score on the PMC scale, the discussion during the fraud brainstorming session(s) is more extensive compared to partners with a low score on the PMC scale. For Distrust, a higher percentage of the partners with a high score on Distrust lead the brainstorming session(s) themselves. Further, the preparation of the session and the duration of the session is on average shorter compared to partners with a low score on Distrust.

For valuation, the question 'to what extent did you resolve the uncertainty about a particular valuation or judgement?' was included in the survey. The results show that auditors with a high score on the HPS and PMC scales, to a larger extent attempt to resolve uncertainties by means of, for example, collecting additional evidence and seeking advice from specialists. For Distrust, no results were found.

Regarding analytical procedures, the question was asked 'to what extent did you use the following analytical procedures for a particular engagement?' (for example: 'I developed formal quantitative expectations for account balances'). Again, the findings show that auditors with high scores on the HPS and PMC scales made more use of the analytical procedures, compared to the low score group. And there was no difference for Distrust.

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> The researchers looked at the correlation between the trait skepticism scores and fraud brainstorming quality

These preliminary observations seem to suggest that professional skepticism is affecting the audit process. The main focus was on trait skepticism, but if professional skepticism is conceptualized as a mindset and an attitude, then professional skepticism does not only have a trait component but also a state component. In other words, professional skepticism is defined by personal characteristics, but also by situational characteristics like tone at the top, client pressure et cetera. The individual traits are going to interact with different factors which are going to create emotional or psychological states which are essentially temporary ways of feeling or being that are going to affect your behavior. Until now, research has not simultaneously considered both personal and situational characteristics and the intermediating role of psychological states on behavior and subsequently on the audit process. This is exactly what will be examined in the next stage of this project.

The outcomes of this research project are expected to be of interest not only for academics but should also be informative for audit firms as well as regulators and standard setters. For example, the results of this project might help audit firms in selecting and training their people, in the composition of their engagement teams, and the design and control of their organizational conditions.

Key points from the discussion: Q&A

The stability of personality characteristics was discussed, particularly that of the skeptical traits. According to Janssen, skepticism has an innate component that is relatively stable over time, and there is a small component which is malleable and can be influenced by training and experience. Vanstraelen added that recent experimental work shows that triggering intrinsic motivation helps increasing the level of skepticism. So, it is malleable to an extent, but auditors will always keep their own personality. When asked, the researchers state that the impact of distrust, as measured by the reversed Rotter scale seems to be limited, and hence that it might not be really beneficial for the audit if an auditor is too distrusting. However, the analyses are preliminary, not considering yet any confounding factors.

Keynote Speech Robert Knechel: The Future of Assurance: Reclaiming the Economic Imperative of the Auditing Profession

Robert Knechel (University of Florida and Academic Board Member of FAR) covered four topics in his keynote speech: (1) auditing (assurance) in a risky world; (2) the subject matter of assurance; (3) the quality of assurance; and (4) the regulation of assurance. This article contains an edited transcript of his speech.[1]

Auditing (Assurance) in a risky world

'This first section is definitional. Many years ago, I started a little game, asking students to define what an audit is. I realized very quickly that you get some really odd answers. I haven't tried this with professionals, but people don't necessarily agree on what an audit is. As an illustration, I have searched for common definitions. Merriam-Webster (on-line) states: 'a complete and careful examination of the financial records of a business or person'. For most of the world this is probably a good definition. The best-selling auditing

[1] *For reasons of brevity, no detailed literature references are included. The references can be found in the article 'Understanding financial auditing from a service perspective' by Knechel, Thomas and Driskill, in Accounting, Organizations and Society (in press): https://doi.org/10.1016/j.aos.2019.101080*

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textbook by Arens et al. defines auditing as: *'The accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria'. I'm okay with that definition, but I have come up with another, more elaborate, definition: 'An economically motivated professional service designed to reduce information risk that relies on the knowledge and skills of experts used in a systematic process that considers the idiosyncratic needs of a client where the outcome is unobservable and subject to market forces and regulatory constraints' (Knechel, 2017).* To parse this out, I would like to focus on three pieces.

The first piece is the critical piece: 'an economically motivated professional service designed to reduce information risk'. I believe that we have forgotten this too often. Auditors have an economic role to play. That is extremely critical. Auditors have a great story to tell the world. Sometimes this gets lost in scandals, regulatory interventions and defensiveness. The second piece is: 'relies on the knowledge and skills of experts' and the third piece is 'subject to market forces and regulatory constraints'.

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> The first piece is the critical piece: 'an economically motivated professional service designed to reduce information risk'

I strongly believe that auditing and financial reporting occur in an ecosystem, with many moving parts. An economic ecosystem is 'a network of businesses and individuals considered to resemble an ecological ecosystem because of its complex interdependent parts'. That kind of fits financial reporting and the role of auditing.

Within the financial reporting and auditing ecosystem we have a number of moving parts. There are many players. We have management, process owners who generate the accounting information, the internal control system, the internal auditors and governance structures. All of these have a role to play in financial reporting. We sometimes forget that. The external auditors overlay these participants and connect all of them. It gives auditors a somewhat dominant role. But who gets blamed if something goes wrong? That is almost always the auditor. But the participants just mentioned have to collectively produce the financial report. It doesn't happen in isolation. There are also investors, regulators and standard setters involved. The question is what the role of the auditors is. If it is simply to fence in the danger of the financial reporting world, is that really a proper description of what auditors do?

The different participants have different knowledge and skills. Some have internal knowledge about the organization, some have external expertise and some have both. It is very important to note that the interactions among the

participants expands expertise for all of them (Power 2003). We learn from each other. That is inherent to, and necessary in, the audit process. We can't watch 'off shore', we have to be in it. The audit is inherently a cooperative exercise: to audit means to interact with the client. And interactions influence attitudes.

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> We learn from each other. That is inherent to, and necessary in, the audit process

Furthermore, auditors more and more become effectively 'embedded' in many clients (cf. ICFR). In the U.S., juniors and seniors are often in the client accounting offices for weeks. They can't be there without being influenced by the people surrounding them. This means that the objectives of some participants in the network will align with the auditor's objectives, some will not, and this can change over time. The key is that professional skepticism is most critical when objectives do not align. But we have to balance that skepticism, and use it when it really matters. But this concern applies to all participants, not just the auditors. Other participants also have to play their role. If they break down, is it the auditor's fault? Can the auditor compensate? We often don't know.

Let me make a potentially controversial statement: expertise can counterbalance economic bonding that might occur in such a setting (cf. the literature on auditor-client negotiations). Who do people listen to? It could be the person with the highest social status, but it often is someone who actually knows more.

The subject matter of auditing/ assurance

People might ask: 'why discuss the subject matter of auditing if we cannot even properly test the financial statements?' If we go back to the idea that an economic reason for auditing exists, the question becomes a bit broader. We live in a world with an information super highway, with lanes containing information concerning ESG/CSR, cyber, forecasts, MD&A, non-GAAP and 10K/10Q. Only the last lane is audited. Users don't know if all the other information is accurate, relevant, reasonable, realistic, true and fair. We don't know, and the markets don't know. People most often don't know what information is audited and what's not. They often simply look at news reports.

We audit GAAP-reports. And we did that in the past. If we start thinking about some of the other sources of information, is it just a distraction from what we are supposed to do (i.e., the statutory audit)? The critical question is whether expansion of the attention of the auditor into a broader universe of subject matter undermines or helps the statutory audit. The answer, to some extent, is already in the standards. In the U.S., internal control needs to be audited because people think that makes the financial statements better. There is a synergy between those two activities. We can go even further. Since the work of the auditor is supposed to be based on deep knowledge of a client, would it be helpful if the auditor would know more about, for example, their ESG and CSR activities? Would that help to understand the risks better? And this can be expanded further. But the question is whether the audit firms can do it. This requires addressing fundamental questions like: what does it mean to assess risks, what is evidence, what is materiality? Do we have the necessary data, training and expertise? These ideas lead to the concept of a multidisciplinary firm. This concept has become somewhat loaded. Will that de-emphasize the audit? Maybe. We need to think about it. We cannot deny the effects of the rapidly changing ecosystem. How do firms have to adapt? And regulation? The immediate challenge is that there are market forces who would really like us to do more. They, of course, want better audits of the financial statements, but they want us to do more. Is that possible, given regulation, for example?

The quality of assurance

Of course, nobody wants auditors to do anything they are not good at. So, what is audit quality? The well-known definition by DeAngelo (1981) is: 'the market assessed joint probability that a given auditor will both discover a breach in a client's accounting system, and report the breach'. Auditors often say error or misstatement instead of breach, but the idea is simple. The auditors have to do two things: they have to know what they are doing, they have to be competent and have knowledge and expertise, and they have to be objective and independent. This leads to discovering and reporting errors.

A couple of questions follow from this. Should the goal be homogeneous outcomes as determined by standards, regulations and auditor (firm) goals? Or should it be broader? What does it mean to be a professional, in that sense? And second, are auditor competence and independence orthogonal (i.e., non-substitutable) traits of a valuable economic service? Competence and independence are two attributes of an economic good that are both desirable. But usually there is a trade-off.

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The more independence and competence, the higher the quality is going to be. If independence is low and competence (knowledge) is low there is no economic value. Even at the other extreme (very high competence and independence), there will always a residual risk in an audit, which is very low, as research evidence shows. The two remaining conditions are more interesting to talk about: low competence and high independence versus high competence and low independence. These are conditions that nobody really wants. How do we avoid these? The answer is: regulation. GAAS rules dictate minimal competence, while independence rules regulate minimal independence. Hence, regulation pushes the audit into the area of high competence and high independence.

But, think about the case where there is an inspection, for example by the PCAOB. If they find deficiencies, they essentially say that it is an individual failure (concerning competence). Of course, it happens, nobody denies that. But it leads to new rules, if it is a systemic problem. For example, how do we deal with valuation experts? So far so good. The potential problem lies in the next step. How often did it happen that someone looked at an individual failure and then concluded that it is a systemic failure? The reaction to that is new regulations. This leads to a negative feedback loop, undermining audit quality. I don't have the answer, it's just a question.

Economists give us a sort of an answer in terms of the law of diminishing marginal returns. For example, auditors have to interact with the client to conduct the audit and, because of basic human nature, that interaction has the potential to undermine some of the auditor's objectivity. If the independence rules are pushed to the limit, this will have an effect on the ability of the auditor to generate the appropriate expertise and knowledge. Hence, too much independence may cause a loss of competence. In short, auditors have to interact with the reporting ecosystem. If you fence that off, it causes potential limitations.

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It is much more complicated than we previously believed. There is an inherent tension between the extent of stakeholder interactions and independence, i.e., participants may have divergent incentives [Nätti, Pekkarinen, Hartikka and Holappa 2014]. Quality depends on expectations and contributions of all participants. So, is there an audit failure or is there an ecosystem failure?

One of the issues we haven't dealt with is whether the nature and appropriateness of cooperation/interaction by the participants within the reporting system has a direct effect on quality. Potential problems include:

- Differential influence/power across participants.
- Participants may fail at their individual role (e.g., deference, distraction, resistance, ignorance).
- Failure to appropriately integrate competencies.
- Inappropriate substitution of competencies.
- Inability to audit "around" low quality participant(s).

Also, standardization does not necessarily lead to quality improvements:

- Standardized output is not always a reflection of quality (i.e., possibly ignoring the idiosyncratic nature of the client, relying on poor observability of outcome, assuming non-zero residual risk) [Sampson and Froehle 2006, Knechel 2013]
- Low quality usually reflects 'gaps' in expectations [Parasuraman et al. 1985; Porter 1993; Humphrey, Moizer and Turley 1992]
- You may have a standardized method, but no standardized application.
- Standardized coordination?
- Efficiencies in scale (diversity of service) versus efficiencies in scope (consistency of process). Is there a need for multidisciplinary practices?

Auditing should not become so standardized that is essentially repeating a ritual from engagement to engagement.

Furthermore, cooperation can increase quality and reduce the effect of economic bonding (independence):

- Presence and integration of redundant competencies is good.
- Increased interaction, both formal and informal, increases trust/effectiveness such as [Havila et al. 2004; Van der Valk and Van Iwaarden 2011]:
  - Auditor/Audit Committee [Cohen, Krishnamoorthy and Wright 2002]
  - Audit committee/Management [Badoloto et al. 2014]
  - Audit committee/Board of Directors [Van Peteghem, Bruynseels and Gaeremynck 2015]

- Knowledge specialization ("knowledge intensity") creates influence ("power") [von Nordenflycht 2010, Sharma 1997, cf industry specialization]
- Co-investments in high quality processes create mutual dependence and trust since investments are not readily transferable [de Brentani and Ragot 1996; Sharma and Patterson 2000, Greenwood et al. 2005]

The regulation of assurance

Okay, lets now discuss 'the regulation of assurance', or a better title might be the 'the law of unintended consequences'. Why don't regulations work out as intended? Let me illustrate this with an example. Our cars are safer today than 15 years ago. But the number of accidents did not decrease. The reason for that is that drivers feel safer and drive more aggressively as a result. Audits are also getting better, but the number of deficiencies found in inspections go up.

We did a study in Australia where we spoke to regulators, standard setters, accounting firms and audit committees. We heard two different viewpoints. The regulators said that more regulation will lead to better audits. The rest of the interviewees indicated they were not so certain about that. They perceived the substitution of compliance for meaningful more substantial audit work. It was based on perception, not on hard core empirical evidence. But it was very clear that there might be a tipping point. Nothing goes up forever.

Why are there unintended consequences? Why would people behave counter to what the goal would be? There are several psychological theories. The Theory of Moral Hazard states that people take more risk if they perceive that others bear the cost of that risk. For example, how might that work with a joint audit? Then, there is the Theory of Self-licensing (or moral licensing): people take more risk if they perceive that virtuous actions balance bad actions. There is also the Theory of Risk Compensation: people alter their behavior in response to the perceived level of risk. And there is the Theory of Resistance Behavior: increased interventions cause the target to resist the limitations. So, well-established theories show why regulation does not always work.

Hence, if we want to think about the economic value proposition of auditing, we need to think about what this ecosystem looks like, what our role is in it and what the appropriate level of regulation might be.

Conclusion

I would like to end with this quote: "We want to measure our contribution more by the quality of the service rendered than by whether we are making a good living out of it … It has been the view of accountants up to this time that their responsibility begins and ends with the certification of the balance sheet and statement of earnings. I maintain that the responsibility of the public accountant begins, rather than ends, at this point."

This was said by Arthur Andersen in 1913 upon the founding of Arthur Andersen and Company. I think this is something we have forgotten. The auditor is not just a cog in the ecosystem!'

Key points from the discussion: Q&A

A participant mentions that within the DNA of every biological cell it is programmed that in certain circumstances a cell of organism can self-destruct. He asks whether auditing can also disappear from the ecosystem? Knechel acknowledges that if certain participants fail then the system may fail and that we're are in a delicate state right now after 100 years of auditing. Further, it is asked how we should communicate with critical stakeholders? Knechel: 'When the system fails, participants will start blaming each other. And auditors are a main target. There is no magic answer here. Understanding the dynamics is the most important. And it is not necessarily a one size fits all situation. The ecosystem can differ per company. We know that a company that pays more audit fees also invests more in internal controls and internal audit. They have an ecosystem that seems to work together to produce better financial statements. If a company wants to reduce audit fees that might hurt the system, it is a potential warning sign.'

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