

FAR Conference 2019: ‘Evidence informed policy making for the future of the auditing profession’

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In June 2019, the fourth conference of the Foundation for Auditing Research (FAR) has been held. The theme of the conference was ‘Evidence informed policy making for the future of the auditing profession’. Professor Willem Buijink (Open Universiteit and FAR Academic Board member) chaired nine plenary sessions, spread over two days. In this article, the focus will be on the keynote speeches by Robert Knechel (University of Florida and Academic Board Member of FAR) and Miguel Minutti-Meza (University of Miami) and on the panel discussion regarding the theme of the conference.¹

1 Summary of the keynote speech by Robert Knechel: ‘The Future of Assurance: Reclaiming the Economic Imperative of the Auditing Profession’

Robert Knechel covered four topics in his 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.

1.1 Auditing (Assurance) in a risky world

According to Knechel, part of the auditing definition is ‘an economically motivated professional service designed to reduce information risk’, which is forgotten too often. Sometimes this gets lost in scandals, regulatory interventions and defensiveness. Knechel strongly believes that auditing and financial reporting occur in an ecosystem, with many moving interdependent players. Participants have to collectively produce the financial report. It doesn’t happen in isolation. Also, the audit is inherently a cooperative exercise: to audit means to interact with the client. And interactions influence attitudes. This means that the objectives of some participants in the network

will align with the auditor’s objectives, while others will not, and this can change over time. The key is that professional skepticism is most critical when objectives do not align. 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.

1.2 The subject matter of auditing/assurance

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. 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. And whether the audit firms can do it. These ideas lead to the concept of a multidisciplinary firm. This concept has become somewhat loaded. Will it 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 auditors to do more.

1.3 The quality of assurance

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. At the other extreme (very high competence and independence), there still will always be a residual risk in an audit. However, research evidence shows that audit risk is very low on the vast majority of audit engagements. The two remaining conditions are more interesting to talk about: low competence and high independence versus high competence and low independence. Regulation pushes the audit into the area of high competence and high independence. But

nothing goes up forever. 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, a too high 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.

1.4 The regulation of assurance

Knechel participated in a study in Australia where the researchers spoke to regulators, standard setter, accounting firms and audit committees. They 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.

But why would people behave counter to what the goal would be? Well-established theories in economics and psychology 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.

2. Summary of the keynote speech by Miguel Minutti-Meza: 'Insights and limitations of academic measures of audit quality'²

According to Minutti-Meza, there are four important limitations to the current research approach. The first limitation can be found in the 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 the auditor to observable 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 more often 'the bad apple' than the auditors.

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.

The third limitation is that we 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 on examining the plane's processes and find the direct causes of the problem? Analogously, we cannot 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 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 sad. Finally, audit fees are both a process and an outcome variable. It is only an indicator of audit quality, it doesn't have the burden/barrier of proof in court.

There are several possible actions that researchers can take. For example, they 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, etcetera. Another example is that we can focus on audit processes and identifying 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. Additionally, Minutti-Meza offered three sets of fixes for audit quality problems: typical easy fixes, very difficult theoretical fixes and 'somewhat difficult' but meaningful process fixes.³

3. 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), Barbara Majoor (Dutch Authority for the Financial Markets and Nyenrode) and Mark Peecher (University of Illinois).

3.1 Perspective of a rule-maker: Arnold Schilder

The IAASB has some history with taking research on board. The best example probably is audit reporting, which started with the question what needs to be done 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.

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. So, there is a tension. The best thing that can be done, collectively, is to look forward in a timely way. What is coming up on the agenda?

It is difficult to draft standards which are completely evidence-based. But the whole process is organized to integrate the basic idea underlying the evidence-based approach. Drafting standards is not done by the board on its own. It includes consultation, listening to regulators and practitioners and standard setters. That may not be fully evidence-based, but it certainly is somewhere in the middle. In the end, it is about bridging the gap between theory and practice. The accessibility of research to standard setting boards is important. One of the suggestions in Leuz (2018) is that one step could be a sequence of surveys asking what comprises the set of policy-relevant results that are well understood and reliably estimated. It is extremely helpful to bring that information together.

3.2 Perspective of an oversight authority: Barbara Majoor

The idea of evidence-based regulation is valuable. However, we're not there, yet. There are problems, which are clearly described in Leuz (2018). Particularly in the auditing environment, many factors influence the impact of each regulatory measure. Think, for example, about

political pressure and conflicting aims of regulation. It is difficult to isolate and measure the effects of the impacting factors. Furthermore, an important issue is how we can get the right data. This holds especially for pre-implementation of regulation, but also for post-implementation review of the effects of regulation. From that perspective, the approach of the *Commissie Toekomst Accountancysector* (CTA) is promising. They try to gain a clear picture of the relevant issues based on various inputs. They use science in an exploratory way, to analyze possible quality measures. For example, they used the AFM-report as input. It provided them with information on alternative business models, which stimulated further thought regarding possible suggestions. This is a good example of how academic evidence can be used in making policy recommendations.

Hence, evidence-based regulation is a good thing. However, 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 further improving dialogue and developing research.

3.3 Perspective of a researcher: Mark Peecher

We should strive for, in the spirit of Leuz's point, practitioner (including standard setters and regulators) informed audit research. But 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 starting in a number of US 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). That is an important part of the ecosystem. However, 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 academics have to be informed about the environment that they are researching. This would mean that academics have to talk to real life practitioners, regulators or standard setters before they dive into the research. Another positive movement is that universities in the US are hiring more and more clinical professors, who combine practice and academia and who have a different view at this. Another thing we can do is to mentor and to encourage young scholars.

3.4 Panel discussion

During the panel discussion, a major 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, again the importance is stressed of bridging the gap between academia

and practice. It was stressed 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’.

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Noten

1. There will be a separate publication in which all presentations are described in more detail. The publication will be made available via the FAR website: <https://foundationforauditingresearch.org/en/>
2. Miguel Minutti-Meza 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.
3. These can all be found in the more detailed conference report that will be published on the FAR website.

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