

Opportunities to Improve Audit Practice: Partnering with Academic Researchers

W. Robert Knechel, Director
International Center for Research in Accounting and Auditing

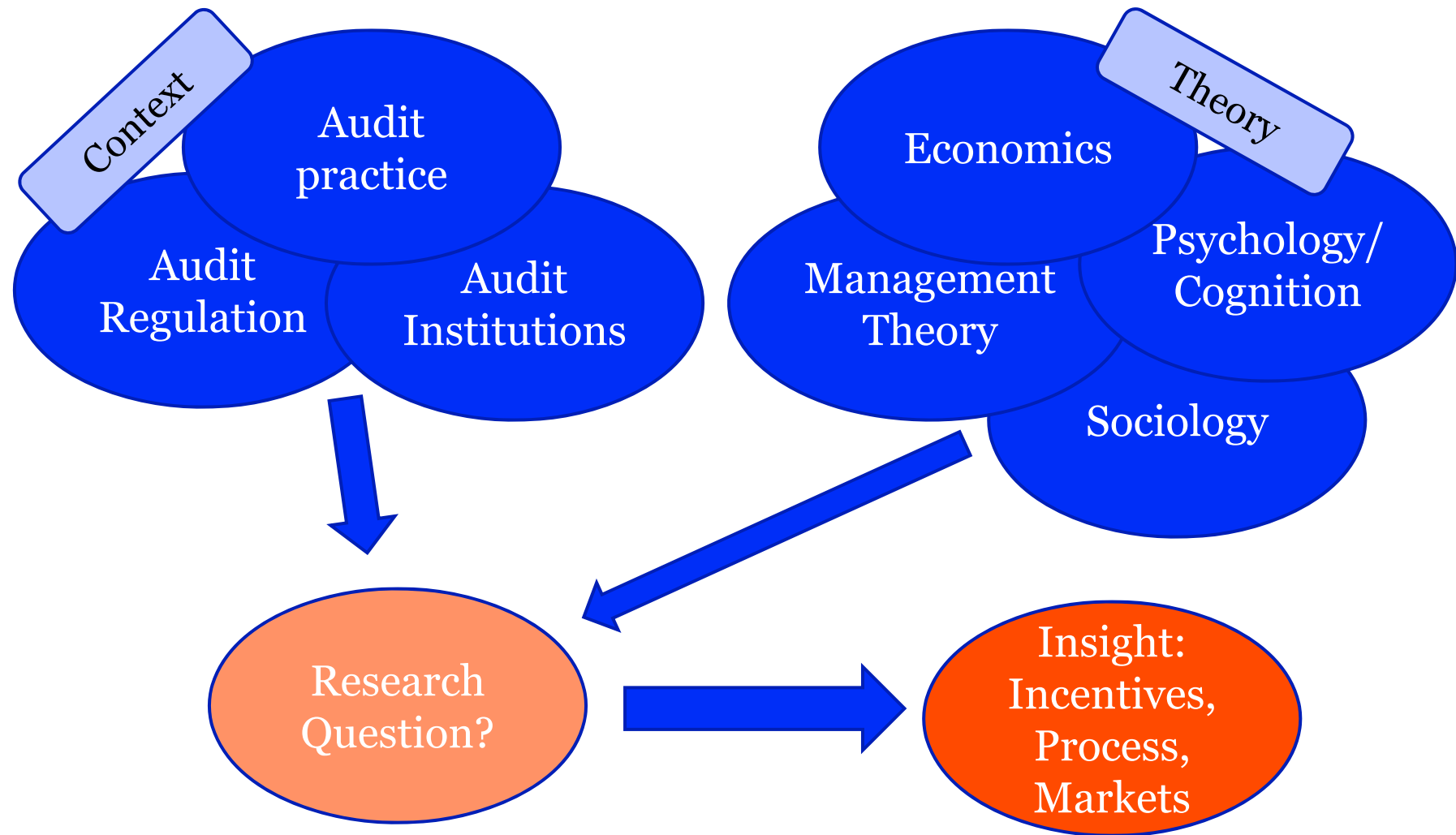


THE UNIVERSITY OF AUCKLAND
BUSINESS SCHOOL



Maastricht University

Audit Research: A Little History



Some Context: Are Audits Effective?

- Anecdotal evidence: Enron, Worldcom, Ahold, Parmalat, etc.
 - Empirical evidence (US):
 - 1995—2002: 55% of bankrupt firms did not receive a going concern report (1.26% of firms went bankrupt).
 - “Audit failures” occur at rate of about 1 per 1,000 for publicly-traded clients.
 - “Audit failures” comprise <0.1% of aggregate client sales.
 - Audits are generally a bargain:
 - Fees are about 0.4% of client sales (0.1%-3.0%).
 - In 2006, the average US audit fee was 58% of total CEO compensation (22% in 2001).
- ***Ultimately, the purpose of audit research is to improve the quality of audits***

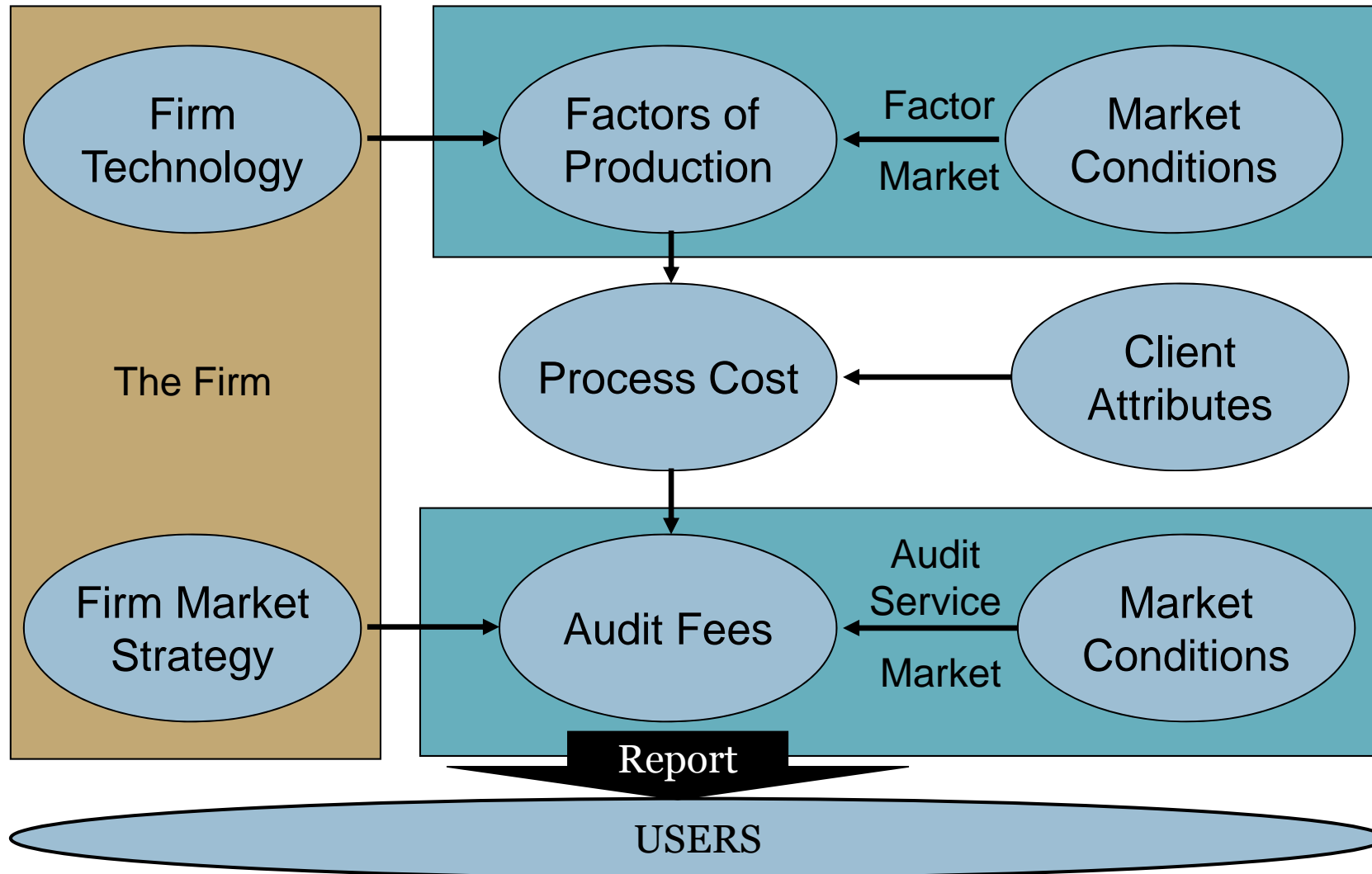
Audit Quality Today

- “[There was] not enough control on what the bank’s were doing. We need good external control, specifically, auditing.” (Pierre Delsaux, European Commission, 2009)
 - “Audit quality starts with users’ expectations. That is the benchmark for determining the quality of an audit.” (Arnold Schilder, Chairman, IAASB, 2009)
 - “We do not need to define audit quality. People know what it is.” (Martin Baumann, Chief Auditor, PCAOB, 2009)
 - “[The SEC has] heard complaints about auditors overauditing in part because they fear that PCAOB inspectors would otherwise find their audits insufficient.” (Annette Nazareth, SEC Commissioner, 2007)
- **Audit quality is not at the level that investors, stakeholders, and regulators would like to see. *Can research help?***

A Research Framework: Some Assumptions

- The quality of the audit is not independent of the quality of financial reporting standards.
- The outcome of the audit is ultimately *unobservable*.
- The quality of the audit is inherently *uncertain* and *idiosyncratic*.
- The audit can not produce zero risk (perfect assurance).
- The quality of the audit is inherent in the audit process.
- The audit is a form of professional service subject to extensive judgment and expertise.
- Standards do not replace sound professional judgment.
→ *The issue of standards is one of the great open questions in current research!*

Auditing: What Do We Know from Research?



What Do We Know about *Users*?

Know:

1. The market values Big 4 and industry specialists over other auditors.
2. Big 4 auditors “appear” to have better audit quality *on average*.
3. Auditor switching does not lead to more lenient auditing *on average*.
4. Good Corporate Governance increases audit demand.

Don't Know:

1. How do changing client circumstances affect auditor changes?
2. What are benefits of an audit in small, non-listed markets?
3. Do stakeholders really perceive differences across firms (within size) or across different measures of industry specialists?

Report

USERS

What Do We Know about *Market Conditions*?

Know:

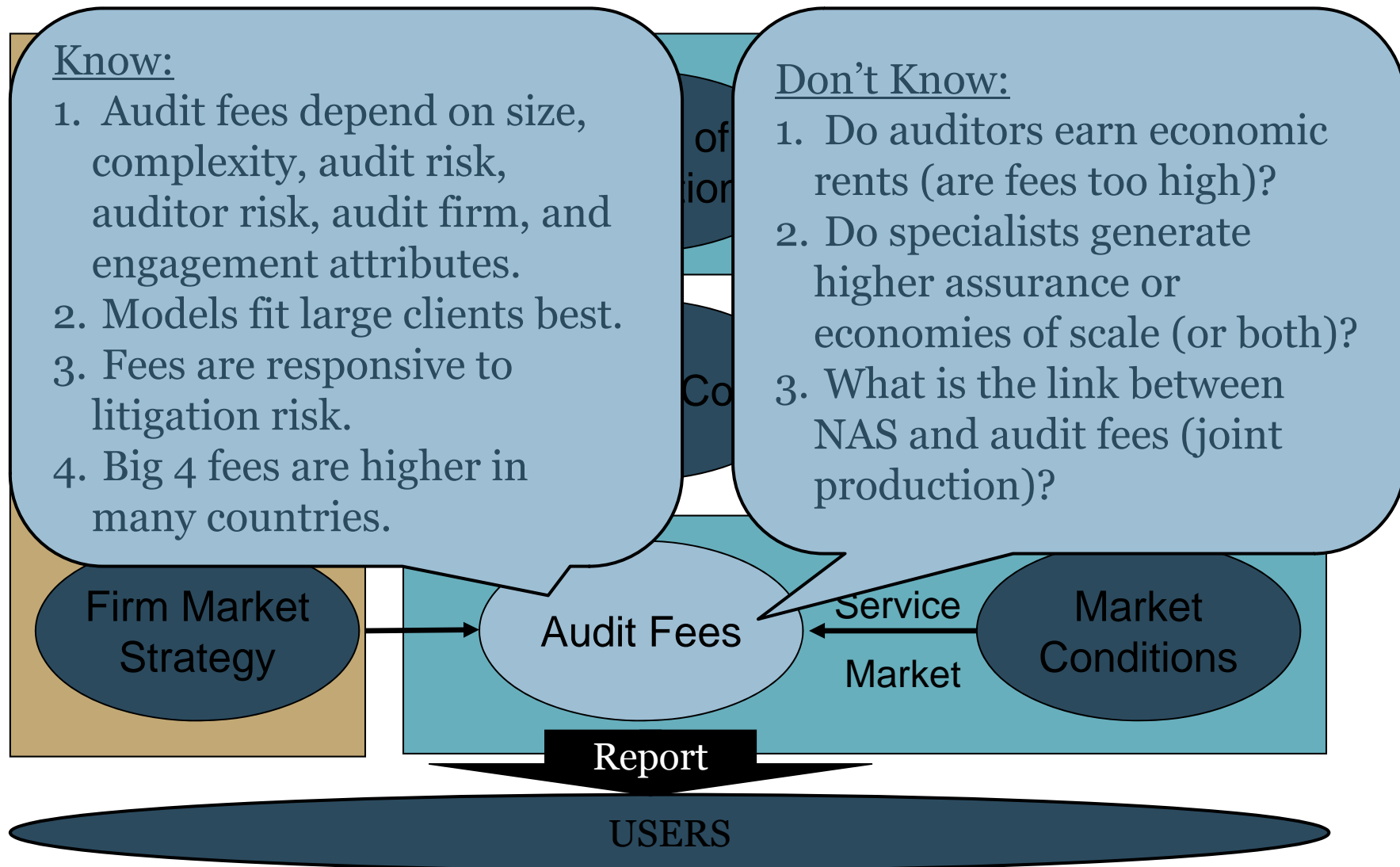
1. Auditors are clearly influenced by economic incentives.
2. Markets appear to be competitive, i.e., cartel pricing does not apply.
3. Big 4 and non-Big 4 firms have different types of clients.
4. Fees increased dramatically after SOX, but reasons are interesting.

Don't Know:

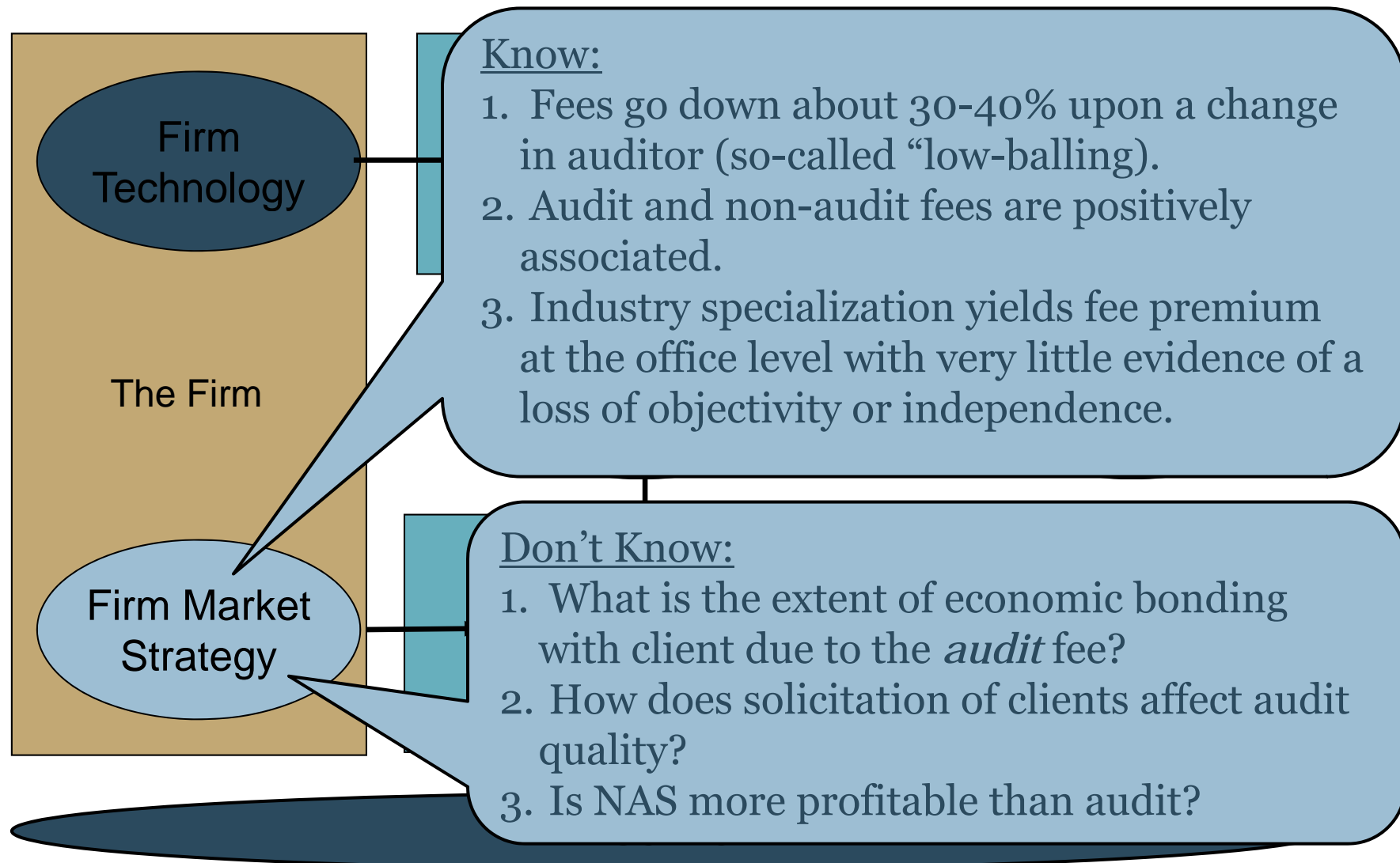
1. Is the Big 4 too concentrated?
2. How does regulation affect competition?
3. Still do not really understand the effect of mergers and collapse of Andersen on the audit market (scale vs fees).

Market
Conditions

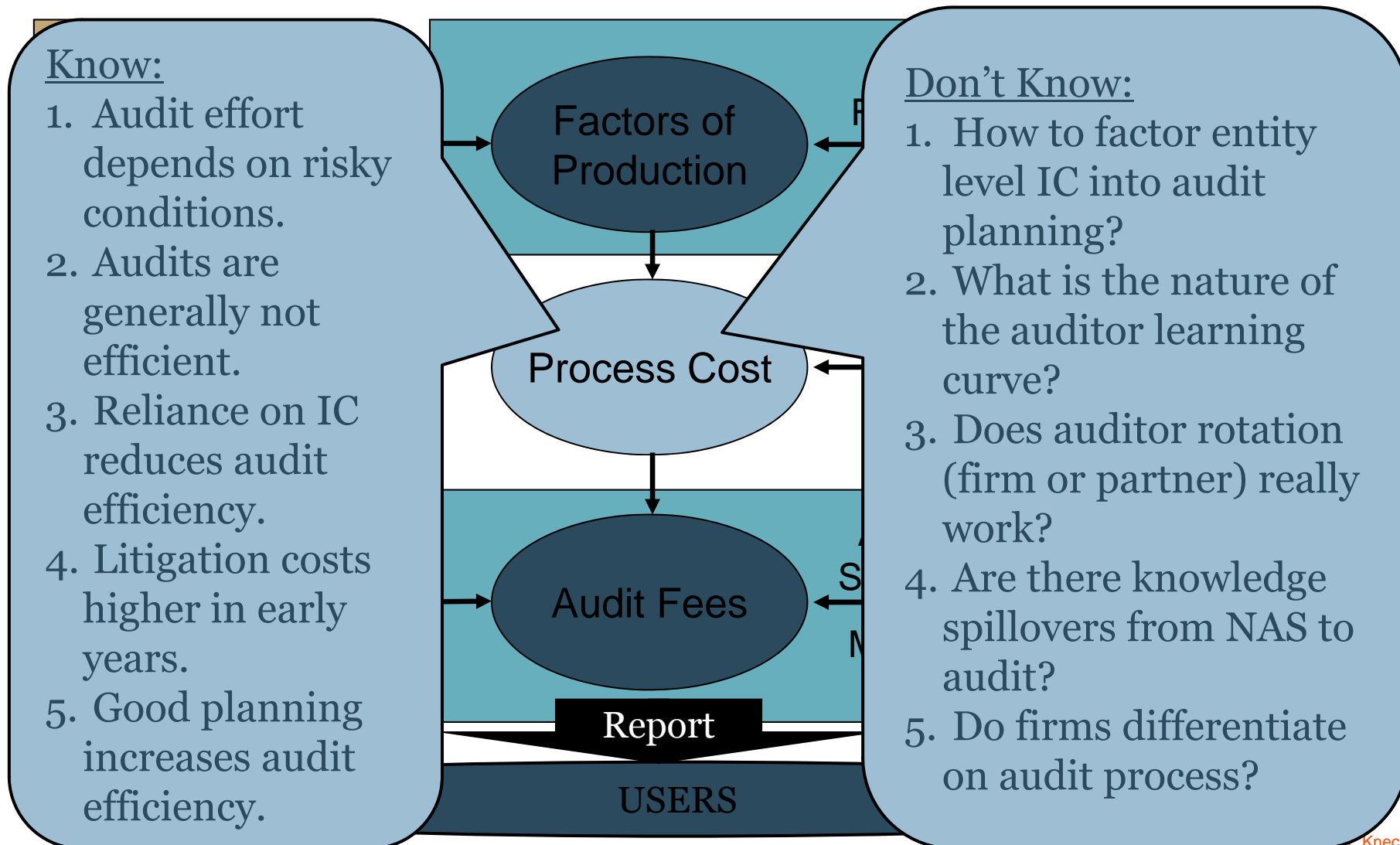
What Do We Know about *Fees*?



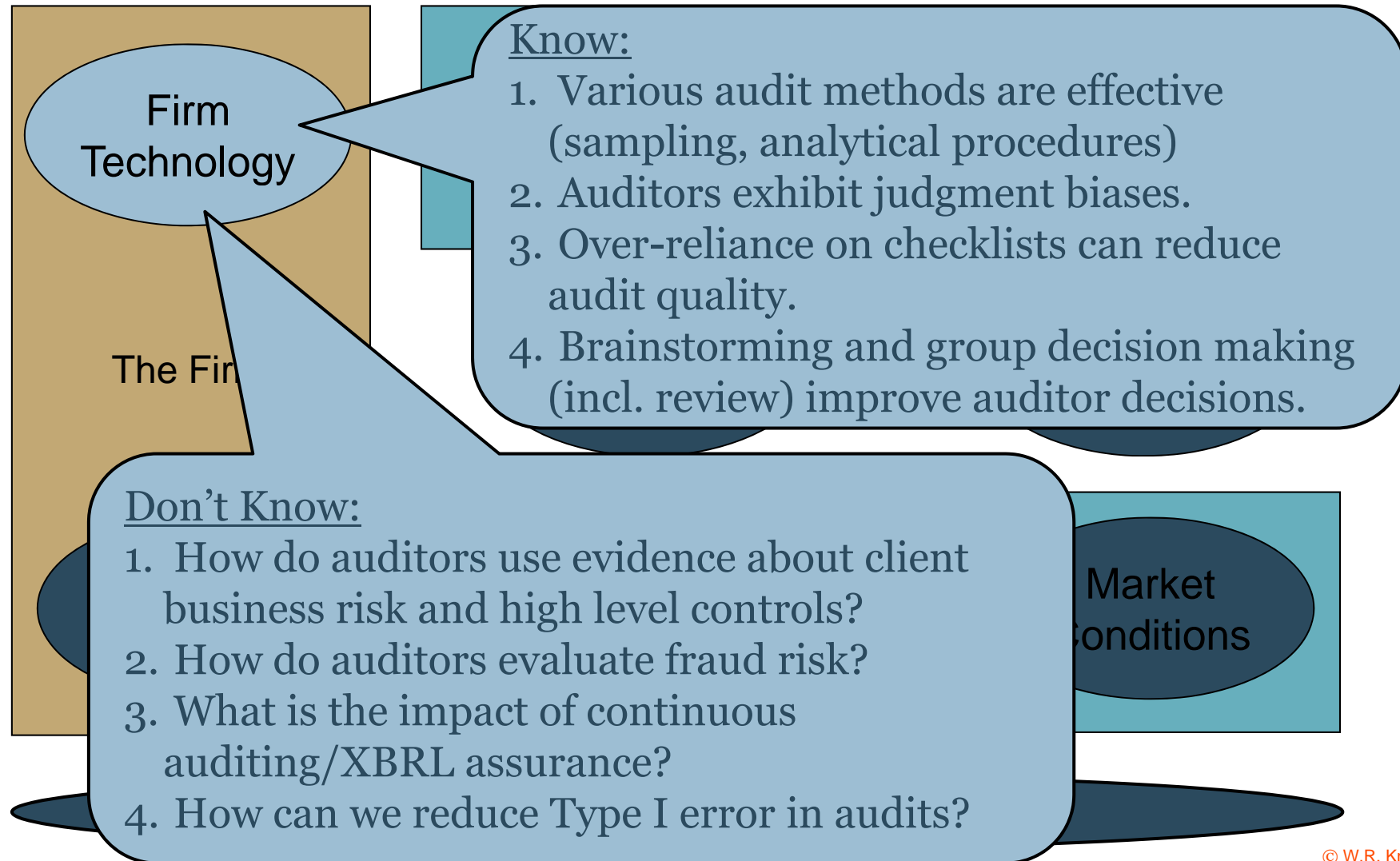
What Do We Know about *Marketing*?



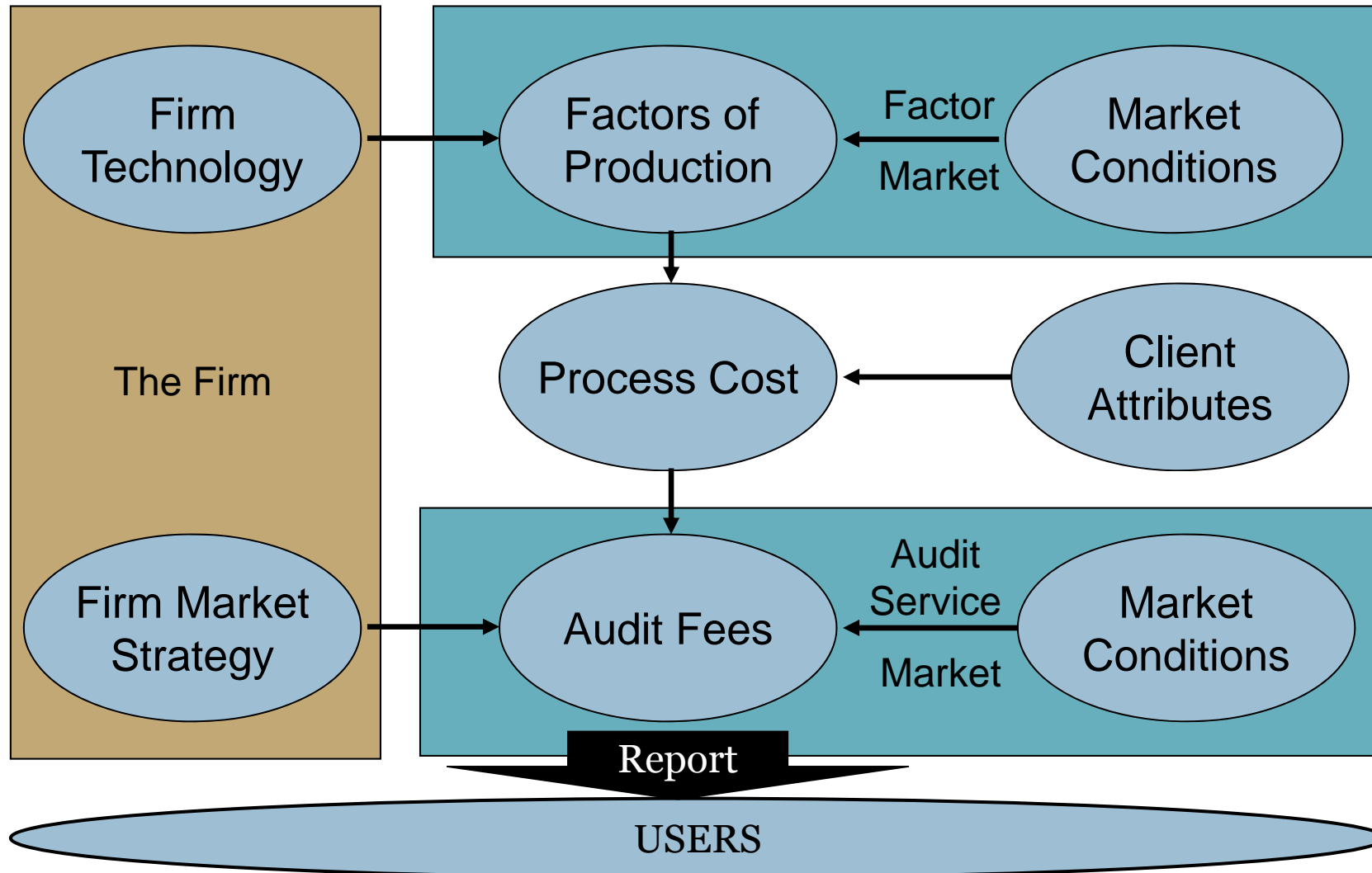
What Do We Know about *Costs/Production*?



What Do We Know about *Audit Methods*?



Auditing: What Do We Know from Research?



Standards and the Audit Process

- Standards promote standardization and routineness.
 - May cause the oversight of important risks or warning signs about client behavior.
 - May result in “defensible” procedures rather than “effective” procedures.
- BUT ... Audit outcomes are unobservable, uncertain and idiosyncratic.
- QUESTION: Is there an inherent conflict between reporting standards that require more judgment (FMV, ICOFR) and audit standards that increasingly constrain the auditor’s process?

→ Auditor judgment is not a limitation of the audit process, it is a necessity and asset.

Comments on Research and Audit Standards

- We know very little about the role of auditing standards in audit quality.
 - Preliminary theoretical evidence suggests that excessively precise standards undermine audit quality as much as excessively loose standards.
 - Some empirical evidence that standards that increase the minimum requirements of the audit also increase costs (fees). ← *No surprise here.*
- No evidence yet available as to whether the increased costs lead to improved quality.
- No evidence about variations in the application of standards in spite of increase in audit inspections.

What Makes an Audit Different?

Attribute	Manufacturing	Services	Professional Services?
Output	Product	Asset-based service	Knowledge-based service
Outcome	Possession	Specific result	Uncertain result
Nature of service	Incidental	Standardized	Idiosyncratic
Resources	Capital and labor	Labor and capital	Labor
Pricing	Product demand based	Service demand based	Time based
Productivity	Resource mix	Resource mix	Labor mix
Performance evaluation	Customer satisfaction I/O balance	Customer satisfaction Capacity balance	Stakeholder satisfaction Capability balance

What Makes an Audit Different?

Attribute	Manufacturing	Services	Professional Services?
Output	Product	Asset-based service	Knowledge-based service
Outcome	Possession	Specific	Uncertain result
Nature of service	Incidental	Standardized	Idiosyncratic
Resources	Capital and labor	Labor and capital	Labor
Pricing	Product demand based	Service demand based	Time based
Productivity	Resource mix	Resource mix	Labor mix
Performance evaluation	Customer satisfaction I/O balance	Customer satisfaction Capacity balance	Stakeholder satisfaction Capability balance

Decomposing the “Net Benefit” of an Audit

$$\frac{B}{F} = \frac{B}{O_c} \times \frac{O_c}{O} \times \frac{O}{I} \times \frac{I}{C} \times \frac{C}{F}$$

**outcome
desired
according to
client needs
and goals**
**Audit firm internal
configuration to
produce outcome
desired**
**Market
influenced
markup??**

- where:
- B = Benefit of service to consumers/stakeholders
 - C = Cost of service
 - O_c = Outcome of the service in terms of consumer need.
 - O = Output of the service
 - I = Inputs to perform/produce the service
 - C = Cost of producing service
 - F = Price (fee) for service

Decomposing the “Net Benefit” of an Audit

$$\frac{B}{F} = \frac{B}{O_c} \times \left[\frac{O_c}{O} \times \frac{O}{I} \times \frac{I}{C} \right] \times \frac{C}{F}$$

**outcome
desired
according to
client needs
and goals**
**Audit firm internal
configuration to
produce outcome
desired**
**Market
influenced
markup??**

- where:
- B = Benefit of service to consumers/stakeholders
 - C = Cost of service
 - O_c = Outcome of the service in terms of consumer need.
 - O = Output of the service
 - I = Inputs to perform/produce the service
 - C = Cost of producing service
 - F = Price (fee) for service

Decomposing the “Net Benefit” of an Audit

$$\frac{B}{F} = \frac{B}{O_c} \times \left[\frac{O_c}{O} \times \frac{O}{I} \times \frac{I}{C} \right] \times \frac{C}{F}$$

**outcome
desired
according to
client needs
and goals**
**Audit firm internal
configuration to
produce outcome
desired**
**Market
influenced
markup??**

- where:
- B = Benefit of service to consumers/stakeholders
 - C = Cost of service
 - O_c = Outcome of the service in terms of consumer need.
 - O = Output of the service
 - I = Inputs to perform/produce the service
 - C = Cost of producing service
 - F = Price (fee) for service

Decomposing the “Net Benefit” of an Audit

$$\frac{B}{F} = \frac{B}{O_c} \times \boxed{\frac{O_c}{O} \times \frac{O}{I} \times \frac{I}{C}} \times \frac{C}{F}$$

**outcome
desired
according to
client needs
and goals**
**Audit firm internal
configuration to
produce outcome
desired**
**Market
influenced
markup??**

- where:
- B = Benefit of service to consumers/stakeholders
 - C = Cost of service
 - O_c = Outcome of the service in terms of consumer need.
 - O = Output of the service
 - I = Inputs to perform/produce the service
 - C = Cost of producing service
 - F = Price (fee) for service

Decomposing the “Net Benefit” of an Audit

$$\frac{B}{F} = \frac{B}{O_c} \times \left(\frac{O_c}{O} \times \frac{O}{I} \times \frac{I}{C} \right) \times \frac{C}{F}$$

**outcome
desired
according to
client needs
and goals**
**Audit firm internal
configuration to
produce outcome
desired**
**Market
influenced
markup??**

- where:
- B = Benefit of service to consumers/stakeholders
 - C = Cost of service
 - O_c = Outcome of the service in terms of consumer need.
 - O = Output of the service
 - I = Inputs to perform/produce the service
 - C = Cost of producing service
 - F = Price (fee) for service

Decomposing the “Net Benefit” of an Audit

$$\frac{B}{F} = \frac{B}{O_c} \times \frac{O_c}{O} \times \frac{O}{I} \times \frac{I}{C} \times \frac{C}{F}$$

**outcome
desired
according to
client needs
and goals**
**Audit firm internal
configuration to
produce outcome
desired**
**Market
influenced
markup??**

- where:
- B = Benefit of service to consumers/stakeholders
 - C = Cost of service
 - O_c = Outcome of the service in terms of consumer need.
 - O = Output of the service
 - I = Inputs to perform/produce the service
 - C = Cost of producing service
 - F = Price (fee) for service

Challenges to Joint Research

- Developing trust, respect, credibility and communication.
- Understanding relative strengths and skills.
 - Research training and terminology (scholarly rigor).
 - Practical (mundane) reality.
- The nature of “interesting” issues/questions.
 - Macro level policy questions → not firm specific.
 - Micro level production questions → efficiency and effectiveness.
- Planning horizon and the need for results.
- Conflicting incentives regarding the openness of results.
 - Researcher: Publication in academic journal
 - Practitioner: Source of competitive advantage



Opportunities of International Research

- Much of the existing research is from the USA/UK/Australia/Canada/NZ.
- The theory (auditing, economics, psychological) does not change for other countries, just the manifestation of the theory.
- Differences across countries provide a wealth of research opportunities:
 - Agency issues (incentives)
 - Institutions
 - Regulation
 - Factor market
 - Firm policies and culture.

Improving the Dialogue

- “Educate” academics to the nature of practice, regulation and professional challenges.
 - Include academics in firm training on current topics.
 - Share audit methods with academics.
 - Invite academics to participate in a practicum.
- “Educate” practitioners to the nature of audit research.
 - Firms can send representatives to conferences.
 - Firms can invite academics to speak to firm personnel.
 - Include academic input in regulatory discussions and advisory groups.
- Jointly encourage talented staff into academia as an alternative career path.
- Pay attention to the firm’s supply chain!

Working Together

- Brainstorm research questions of mutual interest.
- Discuss appropriate research methods (experimental, survey, field-based, archival).
- Define the data to be provided and how it is to be obtained.
 - *Data is often the key and most difficult issue!*
- Determine the appropriate *quid pro quo*.
 - It is common for the research team to produce two reports: (1) an internal (confidential) report for the firm's use and (2) an external report for potential publication.
- Rules of engagement:
 - Strict confidentiality by academic.
 - Submit papers for review by accounting firm.
 - Avoid capricious limits on what can be published.



Conclusion

- An audit is a judgment process made more complicated by the fact that audit quality can not be clearly defined, accurately measured, or routinely observed.
 - Audit quality is infused in process quality.
 - Research can help to improve audit quality in a macro sense (policy, regulation) or micro sense (procedures, production).
 - Firms, academics and regulators have a mutual interest in expanding the insight that good research can bring to the audit.
- *The obstacles to effective partnering on research, while serious, are often inflated.*

Thank you!

