

# Differences in the Judgements of Experts: Audit Quality from the Perspective of Regulators, Auditors, Audit Committees, and Users

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Ken was inducted into the Australian Accounting Hall of Fame in 2011 and was an ARC Professorial Fellow 2011–2015. In 2018 he received the UNSW Business School Outstanding Research (Inaugural Professorial) Award. In the Australia Day 2020 Honours he was appointed Member of the Order of Australia (AM) for significant service to education, particularly to accounting. He has extensive experience over 40 plus years in both Australia and the US teaching MBAs and providing executive training courses. He has made submissions to recent Government inquiries and appeared before the Parliamentary Inquiry into Regulation of Auditing in Australia. His recent research has considered audit quality and has included audit partners and other audit professionals, Audit Committee Chairs and audit standard setters.

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# Introduction

## The importance of auditing

The Parliamentary Joint Committee on Corporations and Financial Services Inquiry (PJC Inquiry) into the Regulation of Auditing in Australia Final Report clearly recognised the importance of audit: *“In this radically changed environment, independent and accurate external auditing is more critical than ever in helping determine efficient and effective capital allocation.”* (PJC Inquiry Final Report 2020b, p. 1) and the importance of auditor independence in building this trust: *“With regard to auditor independence, both real and perceived, the committee reiterates its view that auditor independence is a key determinant of a robust audit regulatory framework and crucial in the process of building trust, confidence and stability in capital markets.”* (PJC Inquiry Final Report 2020b, p. 2).

Submissions from both Treasury and the Auditing and Assurance Standards Board (AUASB) provide further insights on the importance of an audit: *“Australia’s financial reporting system aims to ensure the market has appropriate, useful information to make efficient and effective decisions about the allocation of resources.”* (Treasury 2019, p. 2) and *“Audit is therefore one element of a broader financial reporting system, but it is significant because it constitutes the principal independent, external check on the integrity and reliability of companies’ financial reporting. It adds credibility to the financial statements prepared by companies, increasing shareholders’ and other users’ confidence in them.”* (Treasury 2019, p. 3). The AUASB in its submission to the PJC Inquiry states *“The purpose of an audit is to enhance the degree of confidence of intended users in the financial report. This is more important than ever due to recent deterioration in public trust in institutions, companies and government. Audit can assist with trust as it adds credibility to the financial report prepared by companies, enhances confidence and lowers the cost of capital by reducing risk to investors.”* (AUASB 2019, p. 1).

The Center for Audit Quality in the US also outlines the importance of audit in building trust and confidence in information via audits and the strong role played by auditors in capital markets *“Investors, lenders, and other users of audited financial statements can more confidently use this information because auditors have provided an independent perspective. This assessment, in other words, builds trust and confidence. Without that trust and confidence, market volatility would likely increase, investors and lenders would likely charge a higher cost of capital for their risk, and fewer funds would be available to fuel business investment and growth. Consistent, reliable, and comparable financial statements underpin robust capital markets.”* (CAQ 2019, p. 10).

The above quotes illustrate the critical importance of trust in financial reports to capital markets. The independence and competence of the auditor are key components of high audit quality that enhances this trust.

## Changes to the audit profession

My review of earlier changes is covered in Trotman (2006). I include the abstract below.

*Auditors today [i.e., 2006] are subject to increased expectations from regulators and the investing public. At the same time, corporations are expanding, transactions have become more complex and there are requirements on auditors to provide much greater levels of assurance related to financial fraud. This paper notes that judgment is the 'cornerstone' of auditing and describes some of the 40 years of research that has considered judgment and expertise. While the literature recognises that 'of course experts make mistakes', there appears to be a growing presumption that this should not be the case for auditors.*

*In many professions, the difficulty of making judgments is recognised. This paper discusses the role of judgment in medicine, the legal system, police investigations and marketing. It is recognised that errors of judgment do sometimes occur in these professions. The question that arises is whether auditors are being held to a higher level of accountability than other professions. This is particularly important where the scope of audits is constrained by the price society is willing to pay for such services. It is suggested that even a well-conducted audit, following all appropriate audit standards, can fail to detect a material fraud in the financial statements, particularly where management has gone to great lengths to cover up the fraud. These considerations are important in an environment where audit standards have the force of law.*

*The concept of cumulative evidence is discussed by reference to the Public Company Accounting Oversight Board (PCAOB) reviews of the Big 4 in the US. It is concluded that any inspection process should be concerned with whether sufficient cumulative evidence has been obtained rather than specific aspects of particular audit tests. The paper suggests that Australian inspection agencies have an opportunity to more fully inform investors than has been the case with the PCAOB, by providing a more even-handed assessment that describes both the good and the bad. The market needs to be aware of not only problems but also enhancements in independence procedures and quality controls and whether the enhanced policies are continuing to work effectively. (Trotman 2006).*

In this paper I update my earlier views by considering recent audit inspection findings, the increasing complexity of financial reports and auditor judgements, why there are differences in complex judgements across all professions, and whether auditors are being fairly evaluated when there are differences between auditor and inspector judgements. I conclude by discussing the views on audit quality by ASIC inspection reports, the PJC Inquiry, investors and audit committees. Then I provide some views on going forward including an evidence-based approach and a broader view of regulatory enforcement and inspections.

# Audit inspections

## Audit inspection findings

What was surprising to me at the time of writing my submission to the PJC Inquiry in 2019 was that the negative findings (deficiency percentage) had remained very constant over the previous four inspection periods despite the continuing references in the inspection reports to lack of professional scepticism and criticism of insufficient evidence, particularly related to revenues, impairments and fair value estimates. The negative findings were of concern to audit firms and had adverse financial consequences for the partners involved. In addition, the firm transparency reports indicate that major changes were taking place within the firms which were expected to reduce the negative findings. However, surprisingly the inspection outcomes did not improve and subsequent to the PJC Inquiry the 'negative findings' have become even greater.

In 2022, the level of negative findings increased to 36% overall (32% in 2021) and 32% for the larger six firms (25% for 2021). This is a significant increase, and the question arises what has changed. ASIC concludes that "*all firms should continue to focus on improving audit quality which in turn should reduce the overall findings*" (ASIC 2022a). For this to happen, I believe it is essential to first understand what the increase in the negative findings means. Such an understanding is important because "*the objective of an independent audit is to provide confidence in the quality of financial reports which is key to confident and informed markets and investors*" (ASIC 2022a). The above level of negative findings does not provide that confidence (AUASB 2019).

What exactly does a deficiency, or a negative finding (as now described by ASIC) mean? ASIC describes this as:

*A negative finding is where, in our view, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement (negative findings). Negative findings from our reviews of audits do not necessarily mean that the financial reports audited were in fact materially misstated. Rather, in our view, the auditor did not have a sufficient basis to support their opinion on the financial report. (ASIC 2022a)*

In fact, this difference between what is 'a negative finding' and 'not finding a material misstatement' caused some confusion to the PJC Inquiry.

*Another area of potential confusion regarding the ASIC audit inspection program relates to the extent to which ASIC finds a material misstatement in the financial statements that requires change. Evidence to the committee indicates that ASIC's financial reporting surveillance program has consistently found that four to five per cent of accounts reviewed require a material change. This is comparable to other major jurisdictions. (PJC Inquiry Interim Report 2020a, para 3.109)*

Consistently across recent inspection reports, ASIC provide similar conclusions such as "*all firms should continue to focus on improving quality which in turn should reduce the overall level of [negative] findings*" (ASIC 2022a). While ASIC, audit firms, the AUASB and the FRC all agree with this focus (see a wide range of PJC Inquiry submissions) including the view that "all firms should continue to focus on improving audit quality", I do not believe this focus will necessarily lead to a reduction in negative findings. In fact, there is evidence that this is not the case. The last two decades have

continually seen improvements by audit firms in quality controls around professional scepticism, firm culture, internal inspections within firms, changes in remuneration practices as disclosed in transparency reports of all the major firms and outlined by the firms in response to ASIC's requests for Root Cause Analysis related to past findings (ASIC 2022b). However, these improvements have not decreased the level of negative findings in recent ASIC inspection reports (ASIC 2022a) even though there is a range of convincing evidence that both internationally and in Australia (see Knechel and Ghandar 2021) that major improvements have occurred.

## The increasing complexity of financial reporting and the implications for inspection reports

For several decades now, I have emphasised the complexities involved in making accounting estimates as part of the process of producing financial reports. This provides challenges for management, directors, audit committees and, in particular, auditors (Trotman 2006; Peecher, Solomon, and Trotman 2013). In particular, the degree to which accounting estimates depend on complex forward-looking judgements has grown in the last few decades and, in particular, recent years including the uncertainty in estimating the future value of assets given the current environment with pandemics and international conflicts (AASB/AUASB 2020; Bauer, Humphreys, and Trotman 2022; Simnett and Trotman 2022).

These challenges were recognised by the PJC Inquiry:

*Several inquiry participants sought to highlight the complexities faced by the preparers of financial reports and, in turn, by the auditors of those financial reports with regard to the valuation and impairment of non-financial assets. The challenges facing auditors in this respect are increasing alongside the changing business environment in which they operate. As touched on in Chapter 1, companies are expanding and operating on an increasingly diverse and global scale. Changing business models have resulted in financial statements that include balances requiring greater professional judgement and estimation (including of future revenues and expenses), which is subject to uncertainty and considerable differences in opinion. (PJC Inquiry Interim Report 2020a, para. 3.66)*

*The AUASB neatly described the challenge of auditing non-financial asset valuations and impairments: Accounting estimates, including the valuation and impairment of assets such as intangibles, are often highly complex, involving high levels of professional judgement. The estimates are often based on complex models that involve forecasting and assumptions about future business performance and events. As a result, the auditing of estimates is very challenging, as it is more difficult to gather sufficient and appropriate evidence for matters that have not yet occurred. (PJC Inquiry Interim Report 2020a, para. 3.67)*

*The non-financial asset valuation and impairment outcomes disclosed in financial reports are generally the product of numerous inputs and assumptions for which there are limited observable data points or that rely on considerable estimation. Small changes in these variables can result in significant variations in outcomes. (PJC Inquiry Interim Report 2020a, para. 3.69)*



In the PJC Inquiry Final Report, it further recognises the contested nature of some professional judgements made by auditors and recommends "... ASIC continually review its audit inspection methodology with the aim of producing reports of greater sophistication and clarity that take into account **the contested nature of some of the professional judgements made by both auditors and ASIC inspectors**" (PJC Inquiry Final Report 2020b, para. 1.7 [emphasis added]).

It is suggested that many users of financial statements are not aware of the complexities of the judgements required to prepare and audit these statements. This level of uncertainty has resulted from emphasis on fair value measurements (FVM) which often involve estimates of future revenue and expenses decades into the future. This is confounded by the heightened focus on climate change events and sustainability reporting. Decisions made by Boards about reductions in future greenhouse gas (GHG) emissions affect the life and valuation of some companies' largest assets. The Chartered Accountants Australia and New Zealand IFRS Survey (2022) has found for a third year running that the impact of adopting IFRS 9, 15 and 16 is still being felt, with the complexity of financial statements being ranked as the most impacted area (CA ANZ 2022).

Extreme uncertainty can exist in financial statements when measured based on fair values where it is difficult to precisely estimate at any point in time the ultimate value of an asset or a liability (Christensen, Glover, and Ward 2012; Peecher et al. 2013; Glover, Taylor, Wu, and Trotman 2019). The true value is often only known when an asset is sold but a present estimate has to be made of its fair value (regardless of whether there is an active market). While estimates may be the best available at a point in time, there is a large range of estimate uncertainty because of the nature, complexity, and lack of verifiable evidence (Glover et al. 2019). Thus, different experts are likely to come to different estimates, and as the complexity of the estimate increases, so does the likelihood of including different variables in determining that estimate. In fact, there have been numerous suggestions that it may not be realistic to provide assurance on a reported point estimate given the level of subjectivity and that no amount of evidence can achieve a higher level of assurance (Glover et al. 2019). In these circumstances, it is not surprising that different experts may come to determine differing conclusions or even, if they come to similar conclusions, may approach the task in different ways (Glover et al. 2019). Examples of such uncertainty can include the need for impairments of assets due to advances in technology, changing consumer preferences, rising inflation, interest rate fluctuations, etc. One of the more recent areas of increased uncertainty relates to sustainability issues including the physical risk of climate change on asset valuation and risks associated with achieving net zero carbon emission targets. For example, a company in a particular industry may have a plan to transition to net zero carbon by 2050. The change may depend on technological advances over the next thirty years.

## Negative findings in inspection reports

Based on increasing complexity, two issues need to be considered. Is it reasonable to expect auditors, or any other professional, never to make an error of judgement and what exactly is an error of judgement? First, when judgements involve future estimates, sometimes across decades, are those estimates an error if the future turns out to be different from what was expected? Or is an error when a professional does not show sufficient professional scepticism or does not collect sufficient appropriate evidence. While the latter appears a more reasonable approach, difficulties arise in determining what is sufficient professional scepticism, is the evidence collected appropriate, is it sufficient and/or has there been adequate documentation. Thus, while it can be clear in some circumstances that there is a deficiency in professional judgements, it is less clear that when two professionals come to different

judgements (e.g., an auditor and an inspector) that there is a deficiency in one of their judgements or which judgement is more appropriate.

Second, the fact that there is a difference of opinion of two experts (two different auditors or an auditor and inspector) does this mean that there is a material misstatement in the financial statements that the auditor has not found?

To explain further, ASIC defines a negative finding as follows:

*A negative finding is where, in our view, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement (negative findings). Negative findings from our reviews of audits do not necessarily mean that the financial reports audited were in fact materially misstated. Rather, in our view, the auditor did not have a sufficient basis to support their opinion on the financial report. (ASIC 2022a)*

Thus, it is clear that a negative finding is not an indication that the financial statements are materially misstated. In the vast majority of negative findings, neither the auditor nor the inspector believes the financial statements were materially misstated, given that the financial statements were not adjusted after the inspection. What it means is that in some aspect of the financial statements, the inspector's judgement is that the auditor did not obtain reasonable assurance that the financial statements were free of material misstatement. That is, the evidence collected, in the inspector's view, was either not sufficient or not appropriate or sometimes it means that the documentation was not considered by the inspector to be both sufficient and appropriate. In this case, sufficient is whether the inspector judges the "audit file should contain sufficient detail for an experienced auditor to understand the work performed and relied on in forming conclusions. Where this detail has not been documented, our presumption is that the work has not been performed." (ASIC 2022a, p. 7). What is considered sufficient documentation is likely to depend on the nature and complexity of the issue as well as the audit and industry experience of the parties involved.

Maybe the above differences could be considered a deficiency/negative finding if it was clear that an inspector was more knowledgeable than other experts about auditing evidence, has more audit experience, has more specific industry knowledge than the auditor, or has greater experience in complex fair value judgements. But there is no evidence that this is the situation and, in fact, very experienced professionals including both senior US audit partners (Glover et al. 2019) and audit committee chairs of large Australian companies (Simnett and Trotman 2022) have suggested this is unlikely to be the case.

# Experts' judgements

## Should we expect all professionals to agree on complex judgements: comparison to other professions

Most professionals including auditors, engineers, judges, lawyers, and doctors face difficult and challenging decisions. In considering the question whether these experts make errors in judgement, it is necessary to consider what is an error of judgement, how do we know when there is an error in judgement (e.g., if two experts disagree does that mean there is an error in judgement), if an error is found to occur what is the cause of the error including whether it was in search and acquisition of evidence, evaluation of evidence, or the timing of when the judgement needed to be made. Below I update some suggestions I made in a report published by the Institute of Chartered Accountants in Australia *Professional Judgment: Are auditors being held to a higher standard than other professionals?* (Trotman 2006).

In most professions there is recognition that making judgements is extremely difficult and there are advantages of having multiple experts make these judgements. Our legal system recognises that courts do not always make the right decision and so the system is set up to include an appeal system and, in fact, a large number of appeals are upheld. Higher appeal courts generally have a large number of judges making the decisions. This system takes advantage of a large literature that provides evidence as to the advantages of group decision making. However, it is noted that while the evidence is that increasing the number of judges improves performance, there is a cost to society in having better judgement accuracy. Similar arguments can be made in medical situations where the most complex judgements are often considered by multiple medical experts. For all professionals, the key point is that when complex judgements are involved, experts do not always arrive at the right decisions whether they are doctors, lawyers, judges, engineers, or auditors. The error rate can often be reduced by adding extra resources (experts), but this increased accuracy does come at a cost. Similarly, audit quality can likely be increased by allocating more resources, but this will also result in a cost to society. Similarly, the accuracy of the inspection programs can be improved with more resources and more accurate extrapolation of samples would occur with larger, more representative selection of samples, but again this increases costs.

The PJC Inquiry summarised considerable academic research on audit quality in Chapter 4 of the Final Report. A key point made in Sections 4.1–4.5 is that audit quality is a function of auditor competence and auditor independence. These sections refer to submissions from Professor Taylor explaining that competence refers to the auditor's ability to appropriately identify problems whereas independence refers to the auditor's willingness to make the appropriate actions to address the problem. Both attributes are necessary for audit quality and cannot have more of one to compensate for the other (Professors Houghton and Jubb PJC Inquiry submission). The key point is that even if issues related to auditor independence are adequately addressed and auditors meet the requirements of having adequate competence, some differences in auditor judgement are to be expected. That is, in all professions when complex judgements need to be made, some experts may base their judgements on different information to other experts and still come to the same conclusion (e.g., a particular medical procedure is selected, a court decision or an auditor's judgement that there are no material

misstatements in the financial statements) based on different quantities and types of evidence and sometimes experts will come to different decisions.

Compared to many other professions, auditors face an additional challenge in that the information presented to them to audit may potentially contain fraudulent information. Users need to recognise that even if an audit is properly planned and performed in accordance with Australian auditing standards, there is still an unavoidable risk that some material misstatements in the financial statements are not detected. The AUASB (2019) outlined the reasons for this inherent difficulty:

- sophisticated and carefully organised schemes designed to conceal fraud;
- deliberate failure to record transactions;
- collusion between parties committing fraud; and
- intentional misrepresentation being made to the auditor.

## Why do experts disagree?

As discussed above, negative findings in an inspection report are generally interpreted by regulators and the press as a deficiency in audits. In fact, it can be a deficiency in auditor judgements and/or processes, a deficiency in the judgements and/or processes of the inspection team, or a difference in professional judgements between two competent groups of professionals due to such factors as the information available at the time of the work, different interpretation of auditing standards, different knowledge/experiences of the two groups and/or different incentives. Peecher et al. (2013) review extensive psychology and neuroscience evidence that shows that disagreements between experts are common even in situations when the experts receive the same information at the same time, and this is more likely as uncertainty and task complexity increase.

Auditing of FVM and other complex accounting estimates is acknowledged as a very challenging and complex area of audit and both Australian and international regulators have reported repeated negative findings in this area over the last decade. Research carried out on the audit of FVMs in the US (see Glover et al. 2019) shows that auditors perceive a gap where inspectors expect more audit testing and evidence than the auditors believe is required by auditing standards (referred to as a 'FVM gap'). Four key areas where this gap occurs are the evaluation of risk, the sufficiency of audit evidence, the precision levels achievable when auditing these FVMs of substantial complexity, and what is the appropriate degree of reliance to be placed on third-party specialists. Glover et al. 2019 suggest this FVM gap can result from:

- substantial subjectivity and uncertainty in complex FVMs with extreme estimation uncertainty;
- the lack of inspector knowledge, expertise and training with respect to FVMs;
- differing roles and incentives of inspectors and auditors;
- a lack of sufficient clear guidance in audit standards on what is sufficient and appropriate audit evidence.

On the last issue, AUASB (2019) state in their submission to the PJC Inquiry that the AUASB has been working with ASIC and audit firms to identify those areas where further guidance is desired to clarify how to interpret the auditing standards. This included clarifying the requirements of updating Guidance Statement 005 *Using the Work of a Management's Expert* in order to address previous ASIC audit inspection findings. This issue becomes particularly complex because there are situations where there are numerous groups of experts: auditors, inspectors, management, and audit committee

members<sup>1</sup>, experts hired by management to inform the valuations in the financial statements, and experts hired by auditors as part of evidence collection on valuations. Given the complexity of some of these future orientated estimates, even if all experts are independent, it is not surprising there are differences in the estimates (consider recent challenges in estimating future interest rates, oil prices, exchange rates, etc.). Auditors are in effect required to inspect the approach and accuracies of estimates from experts hired by both management and the auditor and it is a professional judgement of the nature and extent of this assessment which inspectors in turn review.

It is also likely that the work done by all of the 'experts' referred to above are done at different times, with the inspection process carried out many months after all the other work is complete. Such differences in timing can lead to a hindsight bias. Peecher et al. (2013) describes this situation as follows:

*“Outcome-triggered accountabilities usually entail retrospective assessments of auditors’ judgment processes, and both the salience of and uncertainty surrounding various risk factors can widely change during versus after the audit, especially in volatile economic times. ... Regulators who retrospectively believe a different approach to audit testing would have been better may well be drawing reasonable conclusions, but auditors also may have used a different approach to audit testing, if they had knowledge of changing conditions. Consequently, regulators’ assessment of auditors’ judgment processes may be biased (perhaps unconsciously) by intervening outcomes (e.g., changed economic conditions or large decreases in stock price).”* (Peecher et al. 2013, p. 602)

Discussions of expertise in a range of literatures including psychology and neuroscience suggest that experts often disagree. Mumpower and Stewart (1996) identify the following reasons why expert disagreement is common: different information sets, different ways of combining information, different weighting of information, different thresholds for conclusions and different propensity to be biased (conscious or unconscious). Research in neuroscience suggests that humans reason using idiosyncratic perspectives, based on their specific biological makeup and life experiences. This research concludes that *“The presumption that each of us, if presented with the same evidence, should draw the same conclusions, isn’t consistent with modern neuroscience’s view of brain function”* (Burton, 2010). Such differences in expert judgements become more likely as uncertainty, task complexity, and the number of alternative conclusions increase. In medicine the expectation that experts commonly disagree on appropriate procedures has led to the respectable minority defence to malpractice lawsuits. Court findings in the US note that providing that a physician chooses a *“mode or form of treatment which a reasonable and prudent member of the medical profession would undertake under the same or similar circumstances [they] shall not be subject to liability for harm caused thereby to the patient”* (Hudson and Moore 2011).

There has been much consideration given to what is expected of an expert. Much of this consideration is based on a foundational study by Einhorn (1974) which divides the attributes of an expert between agreement in fact (e.g., consensus between experts, consistency over time) and agreement in principle (e.g., similar weighting, and combining of information). The disagreements between inspectors and auditors appear to be more closely related to disagreements in principle rather than disagreements in fact. The inspection reports refer to negative findings in the sufficiency or appropriateness of audit procedures carried out rather than whether the financial statements were

<sup>1</sup> IAASB (2014) provides a framework for audit quality to illustrate that overall audit quality is impacted by all the participants in the financial reporting chain: auditors, management, those charged with governance, regulators and users.

materially misstated. Of the audit partners in the Glover et al. (2019) study who report that additional audit procedures were performed to remediate the deficiencies identified by inspectors, no partners indicated that the additional procedures resulted in adjustments and/or restatements. Similar points were made in numerous PJC Inquiry submissions by the audit firms that ASIC identified concerns in the inspection reports of their firms did not require a subsequent restatement.

Based on earlier research (Mumpower and Stewart 1996; Weiss and Shanteau 2003; Peecher et al. 2013; Trotman 2019), I outline some reasons why the judgements of two experts are likely to be different for complex judgements. Specific differences between audit partners and inspectors on six dimensions follow: different information sets, different mental models, different ways of combining information, different thresholds for reaching conclusions, different propensity to be biased, and differential variance in judgement. First, timing differences between when an auditor makes a judgement and when an inspector reviews these judgements can result in the salience and uncertainty of a risk factor varying substantially, and therefore auditors and inspectors potentially having different information sets. Second, because of differences in past audit experiences and training, it is likely that auditors and inspectors have different mental models for processing information. For example, inspectors likely see more higher-risk clients because of the selection process of files for review. Third, information can be processed in different ways. For complex estimates, auditors usually gather evidence and then, after evaluating that evidence, make judgements on whether additional evidence is required. This is called 'sequential' processing. On the other hand, inspectors usually see all the evidence that the auditor has documented at once, this is called 'simultaneous' processing. Such differences in processing method can lead to different conclusions. Fourth, audit partners and inspectors may have different thresholds for reaching conclusions about whether a deficiency in audit procedures exists. These thresholds are likely to be affected by incentives, industry knowledge and audit knowledge of the individuals involved. Fifth, such factors as different training, different past roles, and different engagement experiences can all affect the extent of bias, both conscious and unconscious. Finally, time spent on the task can also impact the work completed. Internationally, auditors often complain that they are constrained by budget hours and fee constraints which can be more stringent than those faced by inspectors (Glover et al. 2019). This issue was also raised by some audit firms in PJC Inquiry submissions.

# Audit quality

## Alternative views on audit quality

Defining, measuring and enhancing audit quality has been a central focus of audit regulators (IAASB 2014; AUASB 2019), practitioners (Brydon Report 2019; CAQ 2019), and audit research (see review papers by Libby and Luft 1993; Francis 2011; Peecher et al. 2013; Knechel, Krishnan, Pevzner, Shefchik, and Velury 2013; DeFond and Zhang 2014; Free, Trotman, and Trotman 2021; Trotman, Trotman, and Wright 2022).

The key elements to audit quality, as set out by the IAASB's Framework for Audit Quality (IAASB 2014), focus on inputs, processes, and outputs. Input factors are the resources brought to bear on an engagement by individual auditors, the audit team, and the auditing firm such as ensuring professional staff possess adequate auditing, accounting, and business knowledge as well as strong professional values. Also, sufficient staff and partner time must be devoted to the engagement. Process factors are measures taken to ensure a rigorous audit process and that quality control procedures are put into place to ensure compliance with laws, regulations, and auditing standards. For instance, a firm's audit methodology should be well developed and promote scepticism. In addition, appropriate supervision and review of work is essential as well as documentation of the tests performed. Finally, output factors reflect the reliance that can be placed on the end products of the engagement including the audit opinion and reports to those charged with governance, management, and regulators (IAASB 2014).

The focus of this Framework is also on the financial reporting supply chain (also referred to as the financial reporting ecosystem) which includes auditors, management, those charged with governance, regulators, and users (IAASB 2014; Knechel, Thomas, and Driskill 2020). This financial reporting supply chain operates within a range of contextual factors including auditor regulation and audit standard setting. It highlights the importance of the interactions between various stakeholders in achieving audit quality (auditors, audit committees, management, regulators, and users) (IAASB 2014; Free, Trotman, and Trotman 2021). The significance of the interactions of stakeholders is also recognised in the UK Brydon Report (2019):

*To make the audit itself of better quality and more effective, changes need to be made by those other actors also. Audit interacts with many participants – management, non-executive directors, standards setters, regulators, users of accounts (shareholders and others) – who all need to play their part to create a fully functioning environment. One weak link can undermine all the others... (3.14)*

In Australia, auditing standards are set by the AUASB. The standards are legally enforceable for audits under the Corporations Act 2001. These standards are based on the international standards issued by the IAASB. These standards are continually updated for the increasing complexities of the operations of companies in addition to addressing audit quality issues that are raised through inspection processes and actual/perceived audit failures (IAASB 2019). In Australia, ASIC is responsible for assessing compliance with auditing standards. However, while ASIC inspection reports receive wide attention and extensive publicity, it is noted that 'regulatory inspection findings are but one indicator of audit quality and it is necessary to look more holistically at measuring and assessing audit quality (AUASB 2019).

Here I consider four different perspectives on audit quality. While the ASIC inspection reports portray a negative view of audit quality, the other three perspectives are positive in terms of audit quality in Australia.

- A. ASIC inspection findings
- B. Conclusions of the Parliamentary Inquiry into the Regulation of Audit in Australia
- C. Views of audit committee chairs
- D. Investors' views

## A. ASIC inspection findings

The following is an extract from the executive summary of ASIC's latest Audit Inspection Report (October 2022).

### **Our key findings**

*Our audit file review shows an overall increase in the level of negative findings from 32% last year to 36% this year. The equivalent level of findings for the largest six firms was 32% compared to 23% last year. The largest number of negative key audit area findings continued to relate to the audit of revenue and the audit of asset values and impairment of non-financial assets.*

*As the audit of revenue and receivables, and the audit of asset values and impairment of non-financial assets have historically had large numbers of negative findings, this year our report includes case studies of good practice in these key audit areas.*

*Our detailed findings and case studies are in 'Detailed audit file review findings'.*

*This year we also reviewed the largest six firms' approaches to root cause analysis of negative findings. Our observations and better practice considerations for all firms are included in Report 739 Root cause analysis: Audit firm thematic review (REP 739).*

### **Conclusion**

*All firms should continue to focus on improving audit quality which in turn should reduce the overall level of findings. We also expect audit firms to focus on identifying and addressing root causes of negative findings, developing and implementing action plans to address the identified root causes, and monitoring and revising action plans to ensure they are effective and sustainable.*

*The increase in negative findings is potentially due to our focus on a small number of high-risk audits and higher risk key audit areas within these audits, inclusion of audits of large unlisted entities and the impact of COVID-19 conditions. (ASIC 2022a)*

While the ASIC inspection reports have evolved over time, previous reports contained very similar information. That is, the reporting of a large percentage of negative findings, the need to focus on improving audit quality, and a caveat that the results may be due to the sampling procedures adopted.

## B. Conclusions of Parliamentary Inquiry into the Regulation of Audit in Australia

Overall, the conclusion of the PJC Inquiry on audit quality in Australia was much more positive:

*Notwithstanding the findings of ASIC's audit inspection program, stakeholder perceptions suggest that, while there are opportunities for improvement, overall, the quality of audit in Australia is of a high standard. (PJC Inquiry Interim Report 2020a, para 3.8)*



PJC Inquiry conclusions on audit quality were that:

*While some witnesses expressed fears and some anecdotal evidence was presented during the course of the inquiry, the committee did not receive concrete empirical evidence of systemic issues with audit quality in Australia. That said, several stakeholders proposed improvements to the ASIC audit inspection program to improve its useability and, in turn, help drive improvements to audit quality. One of the key pieces of feedback received was the suggestion that ASIC improve the transparency and utility of its inspection program by grading the findings in its reports according to their severity or significance. Currently, ASIC presents more serious findings such as an unsupported audit opinion, as equivalent to other less significant findings, such as the need to better document audit evidence. (PJC Inquiry Interim Report 2020a, para 3.105)*

As background, I outline below a few extracts of my submission to the PJC Inquiry:

12. *Audit inspections commenced in Australia post CLERP in 2004. Since 2006 ASIC inspection reports have been produced regularly. The most recent ASIC inspection reports for the 18 months to 30 June 2018 find that in 24% of the audit areas reviewed, auditors did not obtain sufficient, appropriate evidence that the financial statements were free of material misstatements. What is surprising is that this percentage deficiency has remained fairly constant over the last four inspection periods, there is constant reference to a lack of professional scepticism and constant criticisms of insufficient evidence related to areas involving impairments and fair value estimates. I believe there have been some very positive changes by the audit profession over the last 20 years. ...*
14. *What does a discrepancy in an inspection report mean? It is generally interpreted by regulators and the press as a deficiency in audits. In fact, it can be a deficiency in auditor judgments and/or processes, a deficiency in the judgments and/or processes of the inspection team or a difference in professional judgments between two competent groups of professionals due to such factors as the information available at the time of the work, different experience and training of the two groups, different incentives, etc. ... (Trotman submission to the PJC Inquiry 2019, pps. 4–5)*

While there were numerous other submissions that discussed the ASIC inspection process, the views of the AUASB are particularly relevant to the above discussion. The AUASB submission noted certain aspects of the ASIC inspection process that clarify what an ASIC audit inspection finding means and the need to consider a broader range of measures of audit quality:

*ASIC is responsible for assessing compliance with the auditing standards and for taking enforcement action where appropriate. It is worthwhile noting that an adverse ASIC Audit Inspection finding can result from;*

- *Deficient audit application;*
- *A difference in professional judgements made by the auditor when compared to the ASIC inspector; or*
- *A difference in interpretation of the Auditing Standards made by the auditor when compared to the ASIC inspector.*

*It is important to note that the ASIC Audit Inspection Program is a risk-based sample focusing on the big audit firms, complex and challenging audits, and more significant or higher risk areas of the financial reports. For this reason, AUASB agrees with ASIC's view that the results cannot*

*be generalised across the entire market, and that the results cannot be compared over time. Also, in any one review period, ASIC perform a small number of detailed inspections relative to the number of listed entity audits a firm conducts, further decreasing the ability to analyse the results across firms and over time. This further supports the need to consider other measures of audit quality which can be monitored over time.* (AUASB submission to the PJC Inquiry 2019, p. 12)

The PJC Interim Report outlined the perceptions of a whole range of stakeholders including the Financial Reporting Council (FRC), Australian Institute of Company Directors (AICD), senior partners from all of the Big 4 and many mid-tier firms supporting the view that on the whole the audit system was working well, and while there is always a need for potential improvement in some areas they were being addressed. A number of factors were used to support this view including surveys of investors and directors and the fact that the ASIC financial reporting surveillance program resulted in very few material changes to net assets or profit of companies. From interviews with stakeholders, it is clear that many see the reporting process as misleading.

Two of the major suggestions for improvements outlined by the PJC Inquiry were: (a) grading of the severity of inspection findings, and (b) adoption of more balanced reporting. Suggestions for the grading of the severity of inspection findings is particularly important as it was not clear whether the deficiency related to inadequate or insufficient audit work or whether it was a matter of the degree to which the inspector found that the issue had been adequately documented. Many of the audit firms in their PJC Inquiry submissions advocated for a severity assessment and CA ANZ recommended that ASIC develop a 'three grade severity scale' for inspection findings.

The other major suggestion was the adoption of more balanced reporting of ASIC findings. My suggestion in my submission to the PJC Inquiry was reported as follows:

*Professor Trotman argued that stakeholders need to be aware of positive findings:*

*There is an opportunity for ASIC to more fully inform investors on audit quality. Capital markets should be given a more balanced assessment that describes both the positive and negative findings...The report could also include an update on new improvements made by the audit firms. The market needs to be aware of these enhancements and whether the policies are continuing to work effectively. Examples of innovative audit procedures and best practice also could be acknowledged so that firms are rewarded for these actions. ASIC has considerable data on the root cause analysis of the deficiencies reported and providing researchers with access to unidentifiable data would likely lead to insights to improve audit quality.* (PJC Inquiry Interim Report 2020a, para 3.55)

Also reported was Professor Robyn Moroney's suggestion, based on her research findings of changing the language used in the report. She referred to the current reporting framework noting that the language used in the reports has a detrimental impact on auditor commitment and turnover intentions.

To ASIC's credit, both suggestions have resulted in changes to the most recent ASIC Inspection Report (Report 743 October 2022) (ASIC 2022a). In this report ASIC includes two case studies that "provide examples of good practice and the nature and extent of work performed on the revenue and receivables key audit area" (ASIC 2022a, p. 12). However, the case study does use generic terms like 'well documented', 'was tested for completeness and accuracy', 'transactions were tested substantially ...'. However, my belief is that an auditor could follow this work plan exactly but there could still be

negative findings if the inspector and the auditor were not in agreement on what they consider is 'well documented', what are 'key controls', what is 'adequate testing of ...', and 'whether the review of ...' was sufficient. Also, while ASIC has changed language used in earlier reports from the words 'negative findings' instead of 'deficiencies'. It is not clear to me that this would, in fact, reduce the negative effects outlined by Professor Moroney.

The third suggestion for improvement by the PJC Inquiry was the publication of individual firm inspection reports. This has now been done by ASIC for a number of years but, again, given the problems of generalising from a very small sample of high-risk audits, the reliability of their rankings is unlikely to be robust and changes over time could be due to changes in relative performance or the problems of extrapolating from a sampling method which was strongly criticised during the PJC Inquiry and in more recent interview data with audit committee chairs (Simnett and Trotman 2022).

In summary, all the evidence that I have seen supports the value of having a robust inspection regime such as the ASIC Inspection Program. However, progress is desirable on clarifying what exactly is a deficiency/negative finding and classifying these negative findings in a more informative way. In addition, while the inspection reports have become clearer on the problem of extrapolating from the high audit risk sample chosen, this is only a partial solution as it has not resulted in changes to how overall results are reported more widely.

### C. Views of audit committee chairs

A number of studies involving interviews with audit committee chairs (ACCs) of large listed Australian companies conclude that audit quality in Australia is of a high quality. For example, Simnett and Trotman (2022) in a Research Report to the AUASB and FRC on the perceptions of audit quality by ACCs in Australia, provide evidence on the overall assessment by ACCs of audit quality of their incumbent auditors (for all 21 ACCs their incumbent auditor was a Big 4 firm). In this study the authors asked ACCs to assess overall quality of their incumbent auditor as *excellent*, *above average*, *average*, or *below average*; 60% assessed audit quality as *excellent* and 40% *above average*. Those that selected *above average* often commented that *above average* is a very high barrier, and their auditors passed this barrier. The 100% response of *excellent* or *above average* was consistent and even stronger than earlier surveys of ACCs conducted by the AUASB in 2020 and 2018 which were 94% and 92% respectively. A common point raised by ACCs was that if their auditor was not at least *above average* they would quickly do something about it including changing audit partner or putting the audit out to tender. Full details of these interviews are reported in AUASB Research Report 9 'Perceptions of Audit Quality by Audit Committee Chairs in Australia' (Simnett and Trotman 2022).

In addition, the above in-depth interviews of 21 ACCs of ASX 300 companies canvassed a range of issues covering audit quality (Simnett and Trotman 2022). The majority of ACCs saw the inspection process as having a range of positive aspects including increased likelihood to improve overall audit quality, providing insights at the time of a tenure process and in discussions with the incumbent partner and sometimes giving an additional layer of comfort to the ACC as part of their decision process. However, there were strong criticisms of some aspects of the ASIC reporting process, including inappropriate generalising from a small sample of high-risk audits to the whole audit population, lack of balance in reporting (i.e., a focus on the negative findings) and determining what a negative finding really means. Some ACCs questioned whether ASIC had the resources and staff to make the complex judgements required for some specialised fair value estimates and that they had more confidence in the experts they hired. Some concerns were raised that while the purpose of the

inspection program was to increase market confidence in financial reporting, the method of reporting often led to the opposite effect.

#### **D. Investors' views**

Several studies have found that investors are confident about audit quality in Australia. For example, CA ANZ's annual retail investor confidence surveys have over four years indicated a high degree of confidence in audited listed company financial reports, and they trust that auditors are performing their role in terms of protecting investor interests.

*Auditors remain the most trusted group, at 51%, when it comes to stakeholders that advance investor protection, followed by regulators with 41%, and analysts and Stock exchanges with 40%. (CA ANZ Retail investor confidence survey 2022, page 10)*

*Confidence in financial information released by publicly listed Australian companies remains high (87%, 2021 91%) with Auditing is well regulated (52%), Auditors act ethically and provide honest and independent third-party scrutiny (45%) and Auditors are highly skilled (40%) as the top 4 reasons for the confidence. (CA ANZ Retail investor confidence survey 2022, page 7)*

Another study conducted by the FRC in conjunction with the AUASB (FRC/AUASB 2019) found that:

*Overall, 93% of professional investors indicated audit quality is "average" or "above". Correspondingly, only 7% indicated audit quality is below average or poor (page 6)*

*Professional investors consider the outputs from the audit, i.e. quality of financial disclosures (rating 3.58/4), reported episodes of fraud within audited companies (rating 3.52/4), and the quality of the information in the auditor's report (rating 3.51/4) as the most important factors that influence their perception of audit quality.*

*Professional investors see a clear link between audit quality and the quality of the financial report, which demonstrates the key role auditors play in contributing to the quality of financial reporting (page 9)*

Relevantly, the PJC Inquiry Interim Report (PJC 2020a) referred to these findings, concluding:

*By providing reasonable assurance of the accuracy of financial reports, audit is integral to enhancing investor confidence and thereby, to supporting the efficient and effective allocation of resources within Australia's capital markets. Audit is therefore a key element of Australia's wider financial reporting framework, and an essential prerequisite to strong economic growth. (PJC Inquiry Interim Report 2020a, para 1.14)*

*Notwithstanding the findings of ASIC's audit inspection program, stakeholder perceptions suggest that, while there are opportunities for improvement, overall, the quality of audit in Australia is of a high standard. (PJC Inquiry Interim Report 2020a, p. 3.8)*

# Going forward

## An evidence based approach

Based on my reading of the PJC Inquiry reports, submissions to the PJC Inquiry, and a range of academic research, below I discuss what I consider to be two key issues facing the accounting profession related to (a) negative findings in inspection reports, and (b) the expectation gap:

- (a) there has been continued high negative findings in ASIC inspection reports and despite extensive resources being injected by the major accounting firms to address these issues, there has been no improvement in the level of negative findings. The reporting of these findings is often misinterpreted with resulting adverse consequences in the confidence in financial reports. Research is needed to address two key issues raised by the PJC Inquiry on the percentage of negative findings in inspection reports.

*ASIC readily acknowledges that, due to the risk-based methodology used, the results of its audit inspection program may not be indicative of the entire audited population of listed and unlisted entities. Indeed, ASIC advises in its Audit inspection report for 2018–19 that ‘great caution is needed in generalising the results across the entire market’ and also, that ‘purely random reviews could result in a different level of findings’.* (PJC Inquiry Interim Report 2020a, para 3.25)

*Further clarifying the approach used in undertaking its audit inspection program, ASIC noted that audits necessarily involve the application of professional judgement, which is subjective. As such, there are some instances where different individuals will reach different judgements on whether the audit work performed is sufficient.* (PJC Inquiry Interim Report 2020a, para 3.29)

In particular, independent research is needed to better understand the ASIC findings:

- i. the generalisability of the results,
- ii. to what extent are the negative findings a difference in judgements between different experts (auditors and inspectors) or are they are a ‘deficiency in judgements’ of one of the experts, and
- iii. what are the most effective ways of addressing the concerns raised?

Requests to conduct such research are often met with a genuine concern about the confidentiality of the information. Audit firms and ASIC handle this confidentiality issue through firm policies, professional and ethical pronouncements, and sometimes confidentiality agreements. The question arises; why it would not be acceptable for researchers, who are members of professional accounting bodies and willing to sign confidentiality agreements, not be trusted to carry out independent research. These issues have been addressed internationally. For example, Taylor (2019) sets out examples of this occurring through the PCAOB, also FARS in the Netherlands has a good track record of providing such data.

- (b) Over two decades ago I chaired an Institute of Chartered Accountants in Australia task force entitled *Financial Audit Report: Meeting the Market Expectations*. The report's executive summary discussed the expectation gap:

*The 'expectation gap' between what the community expects from auditors and what auditors provide has been previously well documented by the profession. Attempts to reduce this gap, by moving community expectations into line with the audit product currently being delivered, have largely failed. Consequently, there appears a strong need to expand the scope of the financial report audit to meet market expectations.*  
(Trotman 2003)

Twenty years later this expectation gap remains and it likely has expanded. The PJC Inquiry Interim Report referred to this expectation gap noting "*the existence of a disconnect between the regulatory requirements of an audit and auditors, and the general public's expectations regarding the functions of an audit and auditors*" (PJC Inquiry Interim Report 2020a, p. 91). While recognising that addressing this expectation gap "*is no simple task ... the committee considers it should be explored to further strengthen trust in the system and better meet users' needs*" (PJC Inquiry Interim Report 2020a, para 5.60), the PJC Inquiry recognised that the expectation gap needs to consider the whole ecosystem of corporate governance and the cost of any proposed policy changes. In particular, extending the scope of the audit will mean that audit firms need to recover the cost of that additional work. The PJC Inquiry also recommended that the Financial Reporting Council oversee a formal review of the sufficiency and effectiveness of reporting requirements for (a) the prevention and detection of fraud, and (b) management's assessment of going concern.

Overseas developments, submissions to the PJC Inquiry from audit firms, and the conclusion of the PJC Inquiry suggests there is an appetite for extending the audit to increase the coverage of both fraud and going concern. However, this suggestion has been contemplated for decades but there has been very little systematic research on the best way to approach the problem. The FRC has "*noted the importance of any changes to the scope of audit being considered in light of sufficient and appropriate evidence. In particular, the FRC advised that any expansion of auditors' responsibilities to specifically consider fraud or misconduct needs to consider the cost and benefits of doing so,*" (PJC Inquiry Interim Report 2020a, para. 5.25).

While the increasing complexities of accounting estimates are acknowledged within the profession, some new 'expectation gaps' are evolving. Research in the US conducted by Glover et al. (2019) find what they describe as a FVM gap. That is, a gap between what auditors perceive as appropriate evidence to conclude on a fair value estimate and what inspectors (PCAOB) believe is required. Glover et al. (2019) report many instances where auditors respond to 'inspection risk' rather than audit risk. That is, they select audit procedures they believe are consistent with what they expect inspectors will require rather than focussing on what they see as audit risk.

# Potential solutions

## A broader view of regulatory enforcement and inspections

My earlier discussion leads to two basic conclusions. First, there is general support for some form of ASIC inspection process as it has a positive effect on overall audit quality. Second, while the ASIC inspection process has continued to report relatively high levels of deficiencies/negative findings and audit firms appear to have responded with well documented improvements in procedures and controls, the deficiency rate/negative findings have not declined. This has led to a range of concerns about the inspection process and, in particular, the method of reporting.

To find a solution to the above, it is suggested that it is time to look more broadly at explicit norms and international best practices that have been developed for regulatory inspections in general as well as some specific professions and industries, that have not been widely explored or established in the area of audit regulatory inspections. For example, OECD Best Practice Principles for Regulatory Policy - Regulatory Enforcement and Inspections provides guidance to policy makers on improving regulatory enforcement and inspections and provides some examples of good practices in this area. In particular, it sets out the following 11 principles that can be considered:

Principle 1 Evidence-based enforcement

Principle 2 Selectivity

Principle 3 Risk-focus and proportionality

Principle 4 Responsive regulation

Principle 5 Long-term vision

Principle 6 Co-ordination and consolidation

Principle 7 Transparent governance

Principle 8 Information integration

Principle 9 Clear and fair process

Principle 10 Compliance promotion

Principle 11 Professionalism

Of particular interest are the use of volume indicators which are currently used by audit regulators who rely on volume and percentages of negative findings as their main measurements of regulatory performance. OECD Regulatory Enforcement and Inspections Toolkit states:

*“Using volume of activities (inspections) or violations detected (and sanctions) as indicators gives perverse incentives to inspecting agencies, since they then have an incentive to achieve low compliance levels, which will give them more volume – and runs contrary to their mission. Performance should be assessed against the achievement of social well-being (safety, health, environmental protection etc.) and, as an intermediate step towards this and a proxy for these goals, against improvements in compliance. It is indispensable that this be defined as a central task and indicator for inspection and enforcement structures.”* (OECD Regulatory Enforcement and Inspections Toolkit Sub-criterion 1.3 page 15)

## Need for research evidence

The above OECD publications on regulatory inspections emphasise the importance of evidence. However, independent research plays a smaller role in regulation decisions than I would expect. For example, while there were a large range of very informative and interesting issues raised in the large number of submissions to the PJC Inquiry, one thing that did surprise me was that compared to other professions (e.g., medicine) there were very few references to systematic independent research. There were numerous suggestions for change, but evidence to support the change was usually anecdotal. There were also many suggestions of 'no need to change' but generally the reasons given for no change were that there was no evidence to support the change. However, when there is not an environment that supports systematic independent research, the 'lack of evidence' argument carries little weight.

Professor Taylor (Taylor 2019) provides an important example of the comparative use of evidence as a basis for regulatory and procedure changes in auditing versus medicine. Taylor argues that *"Fundamentally, there are really only two ways that decisions can be made about the need to create (or remove) regulatory requirements such as those that would impact on the conduct of audits as well as the underlying structure of audit firms and the entire market for audit services. Policy recommendations must either reflect evidence, or alternately they reflect intuition."* (Taylor 2019). However, he identifies numerous examples over the last 20 years of introduction of new regulations and/or calls for further regulatory action based more on intuition than hard evidence. Taylor further gives an interesting medical analogy: *"Using medical science as an example, evidence serves as a basis to decide whether a given medical treatment is an effective intervention in addressing a health issue. Such evidence is viewed as critical because it enables reliable, robust conclusions about causality (i.e., does Drug A represent an effective intervention in treating Disease X). In a similar vein, arguments about the role of non-audit services or the structure of the market for audit services in influencing audit quality are ultimately questions that can either be addressed via evidence, or alternately by intuition. Surely good policy should be evidence-based?"* (Taylor 2019)

To address many of the key issues raised in the PJC Inquiry submissions and the PJC Inquiry Reports, research is needed to inform the debate and move the focus from isolated instances to evidence based on systematic well-designed research. One very positive step in the use of evidence is the AUASB's adoption of an evidence-informed standard setting strategy (AUASB 2019). This document sets out the need for the AUASB to have a robust and transparent evidence gathering process to inform and support decision making including standard setting deliberations and decisions are informed by relevant and reliable evidence. Similarly, both the PCAOB in the US and FARS in the Netherlands have an extensive research program.



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