

Aan: Commissie Toekomst Accountancysector

Breukelen, 24 oktober 2019

Geachte commissieleden,

Wij hebben kennis genomen van uw voorlopige bevindingen en maken graag van de gelegenheid gebruik om daarop te reageren. U heeft een gedegen analyse uitgevoerd van de accountancysector en stelt naar aanleiding daarvan verschillende maatregelen voor. In onze reactie beperken wij ons tot uw taak om advies uit te brengen over “de mogelijkheden tot optimalisatie van de huidige structuur van de accountancysector” (artikel 3, lid 2a van de Instellingsregeling).

Hoewel u diverse mogelijke structuurwijzigingen heeft onderzocht en beschreven, komt u tot de conclusie dat er onvoldoende wetenschappelijk bewijs is om te komen tot een fundamentele hervorming van de sector. Door middel van deze reactie willen wij u informeren over een alternatief structuurmodel dat wij hebben uitgewerkt in een wetenschappelijk artikel. In de uitwerking van dit model hebben wij inzichten meegenomen van meer dan 100 deelnemers aan 20 stakeholderdialogen die wij afgelopen jaar hebben gevoerd in Nederland. In het interview in de uitgave van september 2019 van het magazine [Accountant](#) kunt u meer lezen over de wijze waarop dit alternatieve model tot stand is gekomen.

Zoals u in uw voorlopige bevindingen hebt vastgesteld, wordt de accountant in de huidige structuur ingehuurd en betaald door de controlecliënt en niet door het maatschappelijk verkeer (112). Dit leidt tot commerciële druk bij accountants, wat op gespannen voet kan staan met de uitoefening van de publieke taak van accountantscontrole in het maatschappelijk belang (267, 271). Het is precies deze spanning die verontwaardiging oproept bij maatschappij en politiek. Daarom is het nu een goed moment om na te denken over herijking van dit model. Dat de effectiviteit van oplossingen (nog) niet is bewezen hoeft geen belemmering te zijn om te werken aan herstel van vertrouwen in de accountancysector met een innovatief model. Het huidige model heeft immers ook voor- en nadelen en heeft lange tijd gefunctioneerd.

Via deze openbare consultatie bieden wij u graag een uitgewerkt alternatief model aan waarin commerciële prikkels zoveel mogelijk zijn verminderd en tegelijkertijd de kracht van de huidige structuur zoveel mogelijk wordt benut. In bijlage 1 vindt u een factsheet met een overzicht van de belangrijkste kenmerken van dit model en in bijlage 2 vindt u het artikel dat ten grondslag ligt aan deze factsheet. Dit artikel is tevens te raadplegen op [ResearchGate](#). Vanzelfsprekend zijn wij bereid om met u in gesprek te gaan over dit alternatieve structuurmodel.

Met vriendelijke groet,

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Bijlage 1: Factsheet alternatief structuurmodel

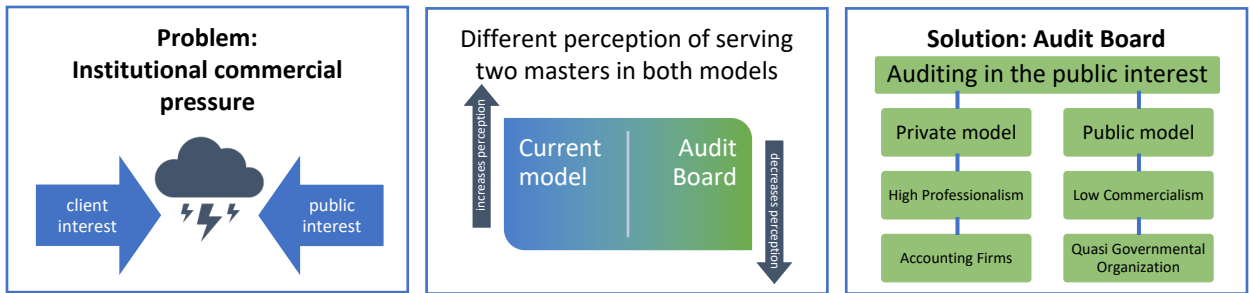
Bijlage 2: Artikel ‘Auditing in the Public Interest: Reforming the Profession by Building on the Strengths of the Existing Accounting Firms’

FACTSHEET

Auditing in the Public Interest: Reforming the Profession by Building on the Strengths of the Existing Accounting Firms

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Gregory M. Trompeter (University of Central Florida) – September 2019
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This factsheet provides an overview of the key characteristics of an alternative solution to the current model of auditing. To minimize the perception of serving two masters we propose a quasi governmental organization – an Audit Board – that is an expert in auditing and reduces the problem of institutional commercial pressure. This proposal is based on our critical thinking and insights from 20 stakeholder dialogues with over 100 participants in the Netherlands.

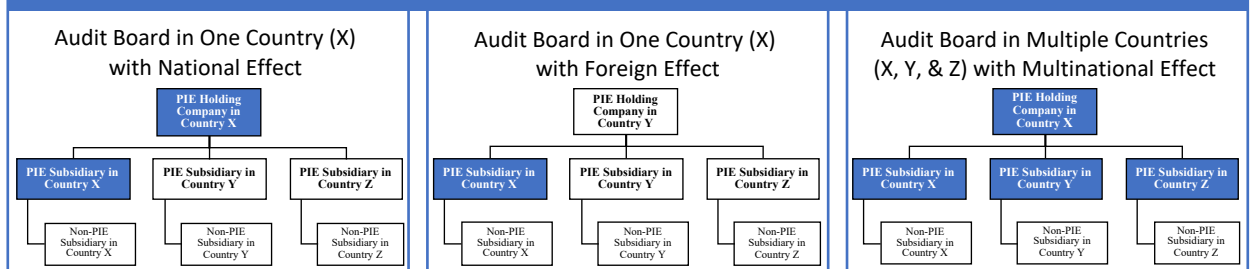


Audit Board

Focus on statutory audits of Public Interest Entities (PIEs)
Legal flexibility of PIE-scope by country
Audit Schedule comprising risks, controls & financial indicators
Internal Audit role in evaluation of Audit Schedule
Existing Accounting Firms conduct component audit work and non-mandated audits

Staffing & HR	Knowledge Sharing	Funding and Governance	Role of the Regulator
Permanent staff Fellows (3-5 yrs) Hire specific skills (e.g. IT, tax, forensic) Intrinsically motivated environment Public interest appraisals	Open source audit methodology Open access audit engagement database for research Academic Fellows Knowledge spillover from fellows	Audit fee without negotiation Executive Committee for day-to-day operations Trustee Committee for public interest oversight Separation of owner, manager and employee roles	Inspections throughout audit engagement Separation of inspections from enforcement Licensing of permitted Accounting Firms for component audits

Three Illustrative Examples of the Audit Board



These figures show the group structure of a multinational PIE with a holding company, PIE subsidiaries in the countries X, Y, and Z, and non-PIE subsidiaries in each country. The involvement of the Audit Board is indicated by blue entities, whereas the involvement of the existing accounting firms is indicated by white entities.

Auditing in the Public Interest: Reforming the Profession by Building on the Strengths of the Existing Accounting Firms

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Auditing in the Public Interest: Reforming the Profession by Building on the Strengths of the Existing Accounting Firms

ABSTRACT: Due to audit quality concerns on the part of regulators and investors, accounting firms may need to re-evaluate their business model. Rethinking the current structure is important because it is difficult to observe audit quality and to differentiate between functional and dysfunctional commercial incentives of accounting firms. Consequently, it is hard for regulators to determine, and for auditors to demonstrate, whether the profession is acting in the public interest. In this essay, we argue why the current model may be suboptimal and offer thoughts on what may be a more sustainable alternative – from a public interest perspective – to the *status quo*: An Audit Board. This Audit Board is conceived as a quasi-governmental organization that would conduct financial statement audits for public interest entities. We envision an organization consisting of a core permanent staff of experienced audit experts that is complemented by fellows drawn from the existing accounting firms who take a job at the Board for a certain time period. We presented our proposal to various stakeholders (19 sessions with 108 attendees) to promote debate and to refine our thinking. Our proposal is relevant for regulators in their efforts of motivating auditors to act in the public interest. It would create an entity that is expert in auditing but avoids many of the independence problems faced by for-profit accounting firms. While this proposal certainly deviates from the current model, we hope that it will spark good conversations that may lead to rethinking of the *status quo*.

Keywords: Business model; Commercialism; Stakeholder dialogue; Professionalism.

1. INTRODUCTION

The accountants were part of 'the system' when they should have been standing outside it, monitoring it rather than indulging it (Brooks, 2018, p. 129).

Audit regulators around the world, represented by the International Forum of Independent Audit Regulators (IFIAR, 2018), make the ongoing and recurring observation that accounting firms fail to achieve an acceptable level of audit quality and that improvements in audit quality are needed.¹ One major concern is that the for-profit accounting firms' commercial interests may interfere with their obligation to act in the public interest. Whereas the definition of the public interest is found to be elusive, ambiguous, and diverse (Dellaportas & Davenport, 2008; Paisey & Paisey, 2018), accounting firms have a clear economic interest to keep their monopoly on statutory audits (i.e., financial statement audits) by claiming that they act in the public interest (Baker, 2005; Church, Jenkins, & Stanley, 2018; Edgley, Sharma, & Anderson-Gough, 2016; Holm & Zaman, 2012; Sikka, 2009a). However, institutional factors at the firm and engagement levels – in this essay referred to as commercial incentives – can make it difficult for auditors to convince society that the public interest has been served. Therefore, regulators around the world such as the Public Company Accounting Oversight Board (PCAOB, 2017), the Financial Reporting Council (FRC, 2018), and the Dutch Authority for the Financial Markets (AFM, 2018b) are rethinking the current business model of accounting firms.

A fundamental inconsistency in the system of auditing is that for-profit organizations conduct mandatory audits in the public interest. In this context, auditors are paid by their clients (i.e., corporate management), whereas the ultimate clients are corporate shareholders.² As a

¹ We use the term accounting firms rather than audit firms because auditing services account for less than 50 percent of total income in many of these firms (Brooks, 2018; Hanlon, 1996; Malsch & Gendron, 2013).

² Clients could be (1) companies; (2) corporate management; (3) corporate shareholders; (4) the audit committee; and (5) society. In this essay, we primarily focus on corporate shareholders as the ultimate clients of auditors and use these specific terms to indicate which element of the client we refer to.

result, the public interest may not be always and completely aligned with the accounting firm's private interests. Furthermore, the quality of auditing services is hard to measure, as auditing is a credence good where the outcome of the audit process (i.e., level of assurance) is unobservable (Causholli & Knechel, 2012; DeFond & Zhang, 2014; Knechel, 2016; Knechel, Krishnan, Pevzner, Shefchik, & Velury, 2013a; Power, 1997). For example, Power (1997) argues that it is striking that auditors are inspected in terms of the audit process because the outcome is obscure and difficult to measure, creating problems in assessing whether auditing serves its purposes and succeeds or fails. This public-private interest tension creates an environment in which accounting firms may have incentives to innovate on efficiency to increase profitability, but potentially lower incentives to innovate on effectiveness to improve audit quality. Therefore, there are calls to consider fundamental reforms to increase auditors' emphasis on the public interest (e.g., Bazerman, Loewenstein, & Moore, 2002; Bazerman & Moore, 2011; Bazerman, Moore, Tetlock, & Tanlu, 2006; Dirsmith, Covalleski, & Samuel, 2015; Moore, Tetlock, Tanlu, & Bazerman, 2006; Sikka et al., 2018).

In this essay, we question the current system in which statutory audits of public interest entities (PIEs) are conducted.³ In addition to the for-profit nature of accounting firms and unobservability of audit quality, we acknowledge two somewhat inter-related factors related to the structure of accounting firms that make it a challenge for auditors to act in the public interest: (1) consulting departments within accounting firms and (2) audit partner profit sharing.⁴ These factors are related to generating, sharing, and increasing profits.

³ According to Directive 2013/34/EU of the European Parliament and of the Council, public interest entities are listed companies, credit institutions, insurance undertakings, or companies designated by member states as PIEs, for instance undertakings that are of significant public relevance because of the nature of their business, their size, or the number of their employees. In our essay, we rely on this general PIE definition and develop a policy proposal that has the flexibility to be adapted based on the specific definition a country is using.

⁴ The United Kingdom's Competition and Markets Authority (CMA, 2018) examines structural problems in the broader market for audit services (as opposed to problems related to the structure of audit firms). The CMA provides

The first factor – the resurgence of consulting departments in accounting firms – provides greater potential to create a culture of commercialism to the detriment of professionalism (Bazerman, Morgan, & Loewenstein, 1997; Brooks, 2018; Hanlon, 1996; Holm & Zaman, 2012; Malsch & Gendron, 2013; Meckfessel & Sellers, 2017; Sikka, 2009a; Wyatt, 2004).⁵ As noted by Malsch and Gendron (2013, p. 870), this consolidation of commercialization might create “a conflict between commercial innovators and guardians of the professional tradition.” Further, as auditing is a credence good, society cannot distinguish between functional commercialism (e.g., investing in R&D to develop more effective technology and new audit methodology to deliver higher quality audit services at lower costs) and dysfunctional commercialism (e.g., cost cutting that leads to higher profits at the expense of high quality audit services).

The second factor is the potential for the structure of audit partner profit-sharing plans to provide incentives to focus on commercial success and short-term profitability (Coram & Robinson, 2017; IAASB, 2014; Knechel, Niemi, & Zerni, 2013b). For example, Knechel et al. (2013b, p. 350) find that in three Big Four firms, “gaining clients is clearly related to an increase in compensation.” To the extent that this focus on commercial success and short-term profitability pre-empts or crowds out a partner’s concern for audit quality, the structure of partner compensation schemes may prove problematic.

After providing our critique to the *status quo*, we explore a new model – labelled as the Audit Board – to mitigate the adverse effects of commercial incentives in the current model and

five issues related to the structure of the market for audit services: (1) selection and oversight of auditors; (2) competition and choice in the audit market; (3) barriers to expansion facing challenger firms; (4) resilience of audit firms; and (5) firm structure and the culture of multidisciplinary firms. While we recognize each of these important issues, our focus is at the engagement and firm levels. Thus, the fifth CMA issue is most relevant for this essay.

⁵ We define commercialism as a mindset in which profitability, market-share, and other measures of commercial success dominate professional requirements. Further, we define professionalism as a mindset in which goals related to achieving, or even surpassing, professional requirements (i.e., audit quality, independence) are of priority and dominate commercial success.

to more optimally focus on the public interest perspective. The Audit Board takes the responsibility of conducting statutory audits that are mandatory for certain PIEs. Our proposal can be adapted to fit the preferences or dictates of local regulators. That is, in one country or region, it could be dictated that all PIEs must be audited by the Audit Board, whereas another jurisdiction could dictate that the Audit Board provide audit services for only a segment of companies (e.g., only the largest PIEs, only financial services entities, only organizations with multinational operations, etc.). This flexibility of implementing the Audit Board differently in different countries is important because various stakeholders (e.g., Big Four firms, regulators) might have subtle power differences (Malsch & Gendron, 2011).

We envision an Audit Board that employs a core permanent staff of full-time, highly qualified, and well-paid audit experts who would provide continuity to the audit teams. Further, the core Audit Board staff is complemented by professional staff (Audit Board fellows) from the existing accounting firms. These Audit Board fellows gain access to the best technology and best practices related to the audits of challenging companies.⁶ After a three to five year fellowship, these professionals take this experience back to the existing accounting firms where they can apply their acquired knowledge to the audit engagements conducted by these firms (e.g., statutory audits of large non-PIEs, component audit work for international parent companies). Alternatively, fellows can stay within the Audit Board as a permanent staff to focus on auditing in the public interest. The Audit Board uses and develops open source audit methodology and conducts audits in multidisciplinary teams based on an objectively predetermined fee that is high enough to facilitate audit quality. Further, the Audit Board provides no consulting services. In

⁶ This approach of Audit Board fellows may be similar to the practice fellowship programs as used by the Financial Accounting Standards Board (FASB), the PCAOB, and the Securities and Exchange Commission (SEC) in the US (Krische, Martin, & Wilks, 2013).

our proposed model, external inspections are conducted by the regulator after finishing each phase of the audit rather than providing a single, overall ex-post review. Finally, a Trustee Committee with representatives of the public interest is responsible for maintaining internal oversight and overseeing the scope of statutory audits. Overall, the purpose of the Audit Board is to serve the ultimate client (i.e., corporate shareholders) rather than corporate management. Consequently, our model removes many of the commercial incentives from the audits of certain PIEs (e.g., large, sensitive, or even all PIEs – depending on the dictates of local regulators).

To expand our understanding of the potential strengths and weaknesses that our proposed Audit Board model would present, we started conversations with relevant stakeholders in the Netherlands. Our goal was to promote dialogue and debate about the Audit Board model and to examine its feasibility. We presented our proposal to various stakeholders in 19 stakeholder dialogues with 108 attendees, ranging from inside the auditing profession (e.g., auditors from Big Four and non-Big Four firms) to outside the profession (e.g., corporate shareholders, members of parliament). These stakeholder dialogues provided critical insights about attracting people, the role of the regulator, practical issues related to global audits and international networks, auditor legal liability, innovation regarding audit methods, and issues related to competition. We used these insights to refine our thinking and modify our model as proposed in this essay.

Our discussion on reforming the auditing profession is timely and relevant for regulators and professionals. That is, in developing a model that builds on the strengths of the profession and removes certain commercial incentives, we contribute to recent initiatives to rethink the current business model of accounting firms (e.g., AFM, 2018b; FRC, 2018; PCAOB, 2017).⁷ As

⁷ Prior work has presented models to reform the profession (see AFM, 2018b; CMA, 2018; Sikka et al., 2018). These present (predominantly) stand-alone remedies without considering international effects. What distinguishes

such, our essay contributes to the current debate on the future of the profession in the UK and the Netherlands (Brydon, 2019; CTA, 2019). Our proposed model of the Audit Board is an alternative to the calls of breaking-up accounting firms into separate consulting and audit-only firms (Marriage, 2018a, 2018b). Furthermore, our model has the flexibility to vary by regulatory jurisdiction because each regulator can dictate which companies need a statutory audit by the Audit Board. Overall, our model retains the advantages of multidisciplinary audit teams (e.g., considering multiple perspectives), and removes – for at least a subset of companies in the market for audit services – the commercial incentives that would still exist in audit-only firms.

The remainder of this essay is as follows. Section two describes the fundamental inconsistency in the system of auditing. Section three discusses two factors in the current business model of accounting firms that may hinder auditors from acting in the public interest. Section four proposes our alternative model to reform the auditing profession. Section five provides the results of our stakeholder dialogue. Section six concludes the essay.

2. THE FUNDAMENTAL INCONSISTENCY IN THE SYSTEM OF AUDITING

The current system of auditing creates tension between commercial and professional/public interests (Bazerman et al., 1997, 2002, 2006; Brooks, 2018; Gendron, 2002; Harris, 2016; Sikka, 2009b; Sikka, Filling, & Liew, 2009; Spence & Carter, 2014). Traditionally, the audit of financial statements relies on the public demand for an independent monitor in principal-agent relationships and the free market supply of auditing services by for-profit accounting firms. The institutionalisation of this monitoring role has evolved into a system of globally and generally accepted statutory audits of public interest entities, such as listed

our essay from previous work, is that we propose a somewhat more detailed solution with a focus on multinational group audits. Overall, our goal is not to provide a broad range of potential solutions and to compare pros and cons of each solution, but to provide an extensive description of the structure and organization of one solution.

companies. In addition, several jurisdictions also have statutory audits for large private companies.⁸ The basic assumption behind the independent monitoring role is that auditors mitigate the traditional agency conflict between owners and managers of companies. However, as currently designed, the structure of accounting firms and the nature for audit services involves its own agency problem. Specifically, for-profit accounting firms have incentives to appease corporate management that pays the audit fees (Brooks, 2018; Church et al., 2018). Thus, this system of an independent monitor in a for-profit accounting firm seems like a form of schizophrenia because auditors have to balance between professionalism and commercialism (Dirsmith et al., 2015; Malsch & Gendron, 2013). In essence, auditors risk being the servant of two masters.

Although the monitoring role of auditors requires a focus on the public interest, the audit is a credence good where it is difficult for an outsider to observe differences in audit quality. This can lead to an expectations gap where the level of expertise, the effort expended, and the assurance provided by the auditor are not observable to users (Franzel, 2016). Furthermore, there is no universally accepted definition of audit quality as generally accepted global measures of audit quality have proven elusive and different stakeholders have different views (Aobdia, 2019; DeFond & Zhang, 2014; Francis, 2011; Gaynor, Kelton, Mercer, & Yohn, 2016; Knechel et al., 2013a; Palmrose & Kinney, 2018). These circumstances lead to the following problems: (1) auditors have conflicting incentives that may lead to reduced audit quality; (2) the quality of auditing is difficult to define; and (3) even if one could observe “auditors in action”, it is difficult to determine the level of audit quality as it has proven difficult to measure. Thus, the system is

⁸ For example, in the European Union, audits are required for medium-sized and large entities that exceed at least two of the three following criteria for two consecutive years: balance sheet total € 4 million, net turnover € 8 million, and an average number of 50 employees during the financial year (FEE, 2016).

one where the public must trust auditors to provide high quality services – which cannot be observed or measured. Therefore, one can argue that changes are needed in the system of auditing to guard against the possibility that auditors will not act in the public interest.

In the current system of auditing, regulators potentially exacerbate the audit expectations gap. That is, inspections of audit engagements predominantly focus on the assessment of whether audits are compliant with auditing standards. This is just one of the multiple aspects of audit quality, such as the absence of material misstatements, the completion of all tasks required by the firm's audit methodology, the compliance with professional standards, or the avoidance of economic problems for a company (Knechel et al., 2013a).⁹ Further, these audit engagement inspections are conducted *after* the auditor's opinion is issued, which makes it impossible to enhance audit quality during the course of an audit engagement. Despite the current inspections of regulators, ongoing corporate failures result in the public outcry: "Where was the auditor?" (e.g., Carillion, Imtech, Steinhoff). Thus, it is important to also consider the role of the regulator from a public interest perspective when reforming the current structure.

Despite all the efforts of accounting firms to improve audit quality in response to the audit inspection reports of regulators, reports from regulators all over the world demonstrate that audit quality must increase substantially (e.g., FRC, 2018; IFIAR, 2018). Potential root causes for the shortcomings are corporate management who select auditors based on price rather than quality, auditing standards and regulatory inspections that contribute to a tick-the-box approach, and audit approaches that emphasize formalization rather than professional judgment and scepticism (Carcello, 2008; CMA, 2018; Moore et al., 2006; Westermann, Cohen, & Trompeter,

⁹ A related problem with the narrow focus on compliance with standards is the increasing number of rules and regulations with multiple open norms that can be interpreted in multiple ways.

2019).¹⁰ Moving the most important audits from the existing accounting firms to the Audit Board is likely to at least partially mitigate these concerns. That is, our model mitigates or removes certain dysfunctional commercial incentives and – to the extent required by relevant, local regulators – places the monitoring role of auditors outside “the system.” Thus, reforming the profession by introducing the Audit Board has the potential to mitigate the fundamental inconsistency in the current system of auditing.

3. COMMERCIAL INCENTIVES IN THE CURRENT STRUCTURE OF ACCOUNTING FIRMS

In this section, we describe two factors in the current business model of accounting firms that provide tension between commercialism and professionalism: (1) consulting departments within accounting firms and (2) audit partner profit sharing.¹¹ As auditing is a credence good and these commercial incentives could be either functional or dysfunctional, stakeholders cannot determine whether auditors have served the public interest.

3.1 Consulting Departments within Accounting Firms

Although consulting has been an integral part of the public accounting business model for decades, there has always been an uneasy and potentially conflicting relationship between the auditing and the consulting groups within an accounting firm (Meckfessel & Sellers, 2017; Suddaby, Gendron, & Lam, 2009; Sikka, 2009a). Of central concern is the possibility that an auditor will sacrifice audit independence in order to maintain good relations with corporate management and access to a steady flow of profitable consulting work. In essence, the financial

¹⁰ The potential risk of corporate management selecting auditors based on price rather than quality could be partially mitigated by a strong and independent audit committee.

¹¹ In the initial version of our essay, we had a third factor: human capital challenges. Based on the insights received in our stakeholder dialogues, we dropped this factor because the Audit Board is primarily focused on mitigating tension between commercialism and professionalism. Mitigating human capital challenges is not the primary focus of our essay and is a potential area for future critical research.

statement audit has the potential to become a loss-leader that allows the consulting group of the accounting firm to get a “foot in the door” and gain access to consulting engagements.

Beyond the threat to independence, there is a general concern that consulting, which has the potential to generate greater profits than auditing, can change the culture from one of maximizing audit quality to one of maximizing profitability (Bazerman et al., 1997; CMA, 2018; Meckfessel & Sellers, 2017; Spence & Carter, 2014; Zeff, 2003a, 2003b). This concern might be driven by the specific type of mindset consultants have. That is, consultants are engaged for a job to maximize the fee and then, when the job is over, search elsewhere to generate more business. This has the potential to lead to a very “one-off”, transactional type of relationship between the consultant and corporate management. However, in the auditing environment, the relationship is, at least theoretically, built on the basis of longer-term trust. The auditor, as a professional, will not take advantage of corporate management and will provide a sufficiently high quality of service to merit being hired on an ongoing basis.

A problem can potentially arise in a partnership when the consulting group generates significantly greater profits on a per-partner basis (perhaps in part because the consulting group does not face the compliance and regulatory costs that the auditor faces). It is possible that the audit partners will be pressured to “pull their weight” and generate similarly large profits. In an environment where fee increases may encounter objections from corporate management, auditors may face the prospect of taking on riskier companies or cutting corners on audit engagements to enhance profitability (at the expense of audit quality). Thus, the current business model of accounting firms has the potential risk of focusing too much on consulting services, which might enhance commercialism in the audit function. This increasing focus on consulting services might

be an adverse effect of the current system where the accounting firms need these highly profitable services to cover the increasing compliance costs on auditing services.

3.2 Audit Partner Profit Sharing

The risk of serving two masters also arises in audit partner profit sharing because the current profit-sharing plans have both commercial incentives (e.g., profitability) and professional incentives (e.g., audit quality). That is, accounting firms have sophisticated performance measurement systems to measure and reward the individual contribution of audit partners in an attempt to discourage shirking (Burrows & Black, 1998; Coram & Robinson, 2017; Fu, Carson, & Simnett, 2015; Knechel et al., 2013b). However, from an agency perspective, these performance-based incentives potentially motivate audit partners to focus on self-interest rather than the best interests of corporate shareholders and society (Eisenhardt, 1989; Shapiro, 2005).

Although the specific structure of certain audit partner profit-sharing schemes might be a salient factor that hinders audit partners to act in the public interest, very little research has been done in this area. Some studies show a negative effect on audit quality when profit sharing is based more heavily on variable (vs. fixed) compensation or on local office performance rather than national firm performance (Ernstberger, Koch, Schreiber, and Trompeter, 2019; Trompeter, 1994), while others show an interaction between profit-sharing plans and client size (Carcello, Hermanson and Huss, 2000; Liu and Simunic, 2005).

In a recent experimental study, Van Brenk, Majoor, and Wright (2019) show that it is the interplay of the type of profit-sharing plan, level of client importance, and auditor reinforcement sensitivity that influence audit quality. Their findings show that audit quality is the highest (lowest) when audit partners have firm-based profit sharing (partner-based profit sharing), client importance is low (high), and reinforcement sensitivity is high. Thus, even when accounting

firms use profit-sharing plans based on firm performance, audit partners still face incentives to serve corporate management when client importance is high. The logic behind this finding is that gaining or losing large companies has a bigger impact on audit partner compensation than gaining or losing small companies. Consequently, while the audit-only model (i.e., forbidding accounting firms from providing consulting and tax services in an effort to enhance the focus on auditing and audit quality) removes the commercial incentives related to non-audit services as discussed previously, commercial incentives still remain due to the for-profit-entity nature of these firms.

4. MOVING THE PROFESSION FORWARD WITH THE INTRODUCTION OF AN AUDIT BOARD

4.1 Our Perspective on the Profession

Before we introduce our model of the Audit Board, we first provide our perspective on the current model of auditing in the public interest. Then, after challenging the assumptions and taken-for-granted beliefs of current practices, we present what we believe to be a relatively novel approach to address weaknesses in the current model (see Alvesson & Deetz, 2000; Delbridge, Suddaby, & Harley, 2016; Gabriel, 2016; Gendron, 2018a, 2018b; Weick, 1989).

In this essay, we present an alternative to the market-based and bureaucratic-based approaches as explained by Freidson (2001). A central problem with the market approach to auditing is that, as a credence good, it is difficult for society to assess the quality of the services being received. Consequently, there can be a tendency to revert to relatively easy (but not necessarily accurate) methods to assess quality such as relying on the audit opinion type (e.g., unmodified) or the identity of the auditor (e.g., Big Four). Further, this inherent difficulty of assessing quality can lead to an overemphasis on the cost of the service, which can appeal to the

profit-making incentives of accounting firms (Brooks, 2018; Wyatt, 2004; Zeff, 1987, 2003a, 2003b). As such, it is not clear that the market-based approach serves the public interest.

Alternatively, as Freidson (2001) argues, one could focus more on a bureaucratic approach where hierarchical control is central. However, in bureaucracy, there is typically a concern over lack of incentives. In particular, the hierarchical control may weed out incentives to perform services efficiently and to innovate. This can harm audit quality as improvements in methods and technology are slow to be incorporated into the audit process.

Given the issues related to these two structures, we propose the Audit Board as a model that avoids some of the problems presented by market control and bureaucratic control (see Freidson 2001). In developing our model, we view the monitoring role of an independent auditor as an important part of the agency framework to mitigate agency conflicts between corporate management and corporate shareholders (Eisenhardt, 1989; Shapiro, 2005). Further, we believe in multidisciplinary audit teams, corporate governance, regulation to guide accounting and auditing standards, knowledge spill-overs, innovation incentives, and reputation and litigation concerns to improve audit quality. We think it is important to acknowledge these strengths of the current model as much as possible when reforming the auditing profession. If properly designed, we believe that the Audit Board could mitigate the market-based issues related to a more commercially focused auditing profession as well as the bureaucratic-based issues related to the lack of incentives to promote efficiency and innovation.

As described previously, we argue that the current model may be viewed as flawed because the existing accounting firms have strong incentives to generate, share, and increase profits. Consequently, auditors face significant tension between commercial and public interests, which may not be sustainable in the long-term. Minor reforms, such as strengthening rotation

requirements or increasing transparency obligations, are not likely to repair trust in the auditing profession because auditing is a credence good where it is difficult to demonstrate that the public interest has been served. Specifically, given that it is difficult to measure audit quality (and changes therein) minor tinkering will not necessarily lead to an observable improvement in audit quality. Therefore, we propose that major reforms may be required in rethinking the structure of auditing in the public interest and to make the profession attractive in the long-term. As such, our model of the Audit Board clearly departs from the *status quo*, but has been developed as a sustainable alternative to the current model. We argue that such a clear departure from the current norm may be necessary, because even if minor mechanistic changes result in small improvements in audit quality, society may not notice, because it will be difficult to demonstrate given the problems with measuring audit quality. Thus, even if such mechanistic tinkering did marginally improve audit quality, it may not restore/enhance the public's trust in the profession.

4.2 Audit Board for Statutory Audits

The most prominent component of our alternative model is that relevant local regulatory agencies determine that certain classes of companies (e.g., all public companies, all PIEs, large or risky or high-profile companies) must have their financial statements audited by the Audit Board rather than the existing accounting firms. We propose that the Audit Board is in charge for about 15 to 20 percent of the statutory audits with a specific focus on PIEs given their relatively large economic impact and risk to society (i.e., too-important-to-fail type of companies).¹² In the

¹² Our proposed model of the Audit Board provides a generic structure for the system of auditing. As such, this model has the potential to serve as a worldwide solution for a worldwide problem. Based on institutional differences, preferences, and power differences among countries, each country has the flexibility to determine the specific set of entities that needs a statutory audit by the Audit Board. For example, national regulators may choose to require, at the extreme, that the Audit Board audits 100 percent of the PIEs that are registered under the local jurisdiction. In the Netherlands, this would create an Audit Board market share of 16 percent because the fee for statutory audits of PIEs is € 133 million on a total of € 807 million for the whole statutory audit market (AFM, 2015). Alternatively, local regulatory agencies could require, for example, that the Audit Board audits all financial institutions and the largest 15 percent of industrial companies.

next section, we provide some illustrative examples of implementing the Audit Board in multinational group audits.

Implementing the Audit Board does not mean that the existing accounting firms are out of business. As noted above, depending on local regulatory dictates, these firms might still be in charge of a significant portion of the market for audit services. That is, these firms conduct statutory audits of certain large companies – which represents a significant portion of the entire statutory audit market (i.e., 80 to 85 percent) – but not for the very important companies that have a public interest. Further, the auditor’s ability to continue offering tax and consulting services will remain separately and survive within the existing accounting firms. As non-PIEs tend to be smaller than PIEs, non-PIEs have less power over their auditors and a lower potential economic impact in case of scandals related to low audit quality. Therefore, our proposed model of the Audit Board is primarily focused on the PIE-market. As such, we provide a sustainable solution that addresses the barriers in the current system of auditing that hinder auditors to act in the public interest.

As currently envisioned and further illustrated in section 4.3, we rely on the principle that audit opinions of mandated PIEs – both at the group and component levels – are signed by the Audit Board in which the mandated PIE is located. Thus, assume for example, a Big Four firm is conducting the audit of a North American global entity that has a significant component in the Netherlands. If this Dutch significant component is not a separately identified PIE, then neither the component audit work nor any related statutory audit work would need to be done by the Audit Board. However, if the Dutch component is a listed company in the Netherlands and subsequently identified as a mandated PIE, then the *component* audit work for the group audit could be done by whomever corporate management and the group auditor choose: a local

affiliate of the Big Four group auditor, an unaffiliated accounting firm, or the Audit Board. However, the company is required to engage the Audit Board to conduct the *statutory* audit because the audit opinion needs to be signed by the Audit Board in the Netherlands. This distinction between component and statutory audits is important based on timing differences, because component audit work is concentrated in the busy season, whereas statutory audit work can be spread over a longer time period. Similarly, for Dutch multinationals, the group audit opinion would need to be signed by the Audit Board. Corporate management and the Audit Board could agree on who would conduct the audit of significant components around the world, but since the group audit opinion is being signed in the Netherlands, the group audit must be coordinated by the Audit Board. Thus, in our proposed model, the existing accounting firms still have an important role in conducting component audit work for multinational group audits. As such, these firms have an incentive to provide fellows to the Audit Board to acquire relevant additional knowledge to audit this type of large and complex companies.

Based on criteria that would be determined by relevant regulatory agencies, it would be made clear which companies require a statutory audit to be conducted by the Audit Board. The Audit Board maps, in cooperation with corporate management and the audit committee, the required components of the audit engagement, which will be summarized in an audit schedule. This audit schedule lists significant risks, internal controls, and financial indicators that serve as input factors for an initial audit budget and planning. In our proposed model, the internal audit function of a mandated PIE can play a role in evaluating the audit schedule. This schedule may also serve as the basis for pre-determining the audit fee, which will be based on a formula that has been approved by the relevant regulatory body. As the total audit engagement fee is based on a pre-determined formula and not subject to auditor-client negotiations, traditional commercial

incentives are reduced or removed from the audits conducted by the Audit Board. Audit hours that exceed budget as a result of unforeseen, incidental, or first-time-occurrence events are charged next year, like premiums for loss assurance contracts are dependent on insurance costs.

Based on estimates in the audit schedule, permanent audit experts from the Audit Board will select the most appropriate and most skilled professionals to compose multidisciplinary audit teams to effectively match demand and supply for audits in the public interest. The audit team will be comprised of a core of permanent Audit Board auditors that will be complemented by a group of Audit Board fellows who leave their accounting firm and take a job with the Audit Board for a pre-determined number of years. The Audit Board takes the liability risk for the audits that they conduct.

4.3 Illustrative Examples of the Audit Board

Our alternative model of the Audit Board can be implemented on a country-by-country basis. In this section, we provide three illustrative examples of the Audit Board with different effects, graphically represented in Figure 1: (1) Audit Board in one country with a national effect (Panel A); (2) Audit Board in one country with a foreign effect (Panel B); and (3) Audit Board in multiple countries with a multinational effect (Panel C).

<< Insert Figure 1 about here >>

In the first illustrative example, the Audit Board is implemented in country X and is in charge for providing the group audit opinion to the financial statements of a PIE holding company in country X. In this situation, the group engagement team includes the permanent staff and fellows of the Audit Board in country X. The statutory audit work of PIEs in country X is also conducted by the Audit Board in country X, whereas the audit work of non-PIEs in country X and both PIEs and non-PIEs in other countries is conducted by the existing accounting firms.

All component auditors for the group engagement will report their findings to the group audit team of the Audit Board in country X. This alternative model creates a national effect because the PIEs in country X are audited by audit teams of the Audit Board. Compared to the current system of auditing, this alternative model decreases the level of commercialism.

The second illustrative example relates to the situation where the Audit Board is implemented in country X and is involved in the statutory audit of a PIE subsidiary from a holding company in country Y. As such, the audit team(s) of the Audit Board will report the audit findings to the group engagement teams of the existing accounting firms in foreign countries. This alternative model creates a foreign effect because the decrease in the level of commercialism is realized at the component level of a foreign holding company rather than at the group level. If this model conflicts with accounting firm's policies that require a Big Four firm to conduct the component audit, the component audit work can be conducted by accounting firms but the statutory audit work need to be conducted by the Audit Board. In essence, if an audit opinion is being signed on a domestic PIE, the audit must be conducted by the Audit Board.

Finally, the third illustrative example creates the strongest effects in terms of decreasing the level of commercialism. In this situation, the Audit Board is implemented in multiple countries. The audit teams of various Audit Boards communicate and cooperate when involved in the audit of group financial statements. As such, there is a focus on the public interest in multiple components of international companies. This alternative model of the Audit Board in multiple countries provides a regional or global mechanism to solve the trans-national problem of independence in the current system of auditing. Table 1 provides an overview of the key characteristics of the three illustrative examples as discussed in this section, compared to the key

characteristics of the current system in which audits are conducted by the existing accounting firms.

<< Insert Table 1 about here >>

A potential adverse effect of implementing the Audit Board in some – but not all – countries in the world is regulatory competition, which means that corporate management might strategically move companies to countries where no Audit Board is implemented. This again clearly shows the need for a worldwide solution to the problem of commercial incentives in the current structure of PIE statutory audits as standard setting, regulating, and auditing take place in a global market structure (Carson, 2014; Dirsmith et al., 2015; Fogarty and Rigsby, 2010). Therefore, we suggest an international organization of Audit Boards – like the International Organization of Securities Commissions (IOSCO) – in which all Audit Boards cooperate to mitigate this adverse effect. Furthermore, it is important that independence requirements between the PIE and non-PIE audit markets are the same to mitigate the incentive for regulatory competition between these two segments.

4.4 Staffing and Human Capital Development within the Audit Board

As currently proposed, the Audit Board employs a permanent staff of full-time, highly qualified, and well-paid audit experts who have clearly lower commercial incentives than in the current model. It is their duty to compose multidisciplinary audit teams with Audit Board fellows from different firms and disciplines to conduct audits in the public interest. We suggest a system of Audit Board fellows in which auditing professionals leave their accounting firm and take a position with the Audit Board for a considerable time span (e.g., three to five years).¹³ After this

¹³ An alternative system of staffing Audit Board fellows is that the existing accounting firms rent or loan professionals to the Audit Board. In this situation, the firms will be reimbursed with a fixed predefined hourly rate for audit hours of their staff spend as Audit Board fellows. However, accounting firms then still have an economic

fellowship, professionals would be free to go back to their respective accounting firm where these auditors disseminate their knowledge to other audit and consultancy engagements throughout the firm, or stay within the Audit Board as a member of the permanent staff. Such fellowships contribute to the knowledge and understanding of the complexity of the current accounting and auditing environments (Krische et al., 2013). In addition to these fellows, the Audit Board has the responsibility to hire other professionals with specific skills that are needed to conduct the audits (e.g., IT, fraud, tax specialists).

We propose a composition of the Audit Board that consists of 75 percent permanent staff (mainly audit partners and senior managers) versus 25 percent fellows from the existing accounting firms (mainly managers and staff).¹⁴ As such, this proposed composition turns around the pyramid model as currently used in auditing practice (Hermanson, Houston, Stefaniak, & Wilkins, 2016; Pierce & Sweeney, 2005). Revising the rapid staff turnover model is important to guarantee continuity in audit teams, create a long-term organization culture focused on the public interest, and mitigate vulnerability of the Audit Board.

Our proposed model of the Audit Board can be designed to be attractive for both accounting firms and auditing professionals. It is attractive for accounting firms because their risk profile will be lower when several high-risk companies are audited by the Audit Board. Further, it is attractive for accounting firms to take back auditing professionals after a fellowship at the Audit Board to enhance knowledge of the latest tools and methodology of auditing large and complex international companies. For auditing professionals, the Audit Board is an attractive

incentive. Therefore, we suggest the system in which professionals leave the accounting firm and are paid by the Audit Board.

¹⁴ The Dutch regulator (AFM, 2018a) employs 642 people of whom 389 are regulators (61 percent) and 253 supporting staff. Thus, the majority has a senior role. Further, the House of Representatives in the Netherlands has 150 members that partly rotate after elections and 575 civil servants to support. As such, each member has three supporting staff to guarantee continuity.

organization to work for when they are intrinsically motivated in auditing in the public interest rather than in the commercial aspects inherent to a higher position in the existing accounting firms. An Audit Board fellowship is attractive for these professionals because they gain access to the best technology and the best practices to audit the largest (and/or potentially the riskiest or most complex) companies. Further, they work with highly qualified audit experts and professionals from different firms in different countries. These Audit Board fellows bring this knowledge back to the accounting firms, which can be applied to, for example, smaller PIE or non-PIE audits and consulting services to all types of companies.

We suggest to implement an appraisal system for Audit Board fellows that motivates these professionals to improve audit quality and serve the public interest. The permanent staff of the Audit Board is responsible for these performance evaluations. Taking back Audit Board fellows (i.e., after finishing their fellowship) with poor audit quality evaluations, would provide an important signal regarding the tone at the top of the accounting firm. As such, Audit Board fellows have a strong incentive to excel on audit quality when they prefer a career as an auditor in an accounting firm.

4.5 Knowledge Sharing by the Audit Board

As the Audit Board is primarily focused on serving the public interest, they have an important responsibility for the accumulation of knowledge on audit quality. For that purpose, the Audit Board will manage an audit engagement database, including planning and actual data from audit engagements performed. This data will be uploaded and centrally stored at the Audit Board to enable real time engagement quality monitoring. Further, this data will be shared with academics – in university partnerships – to jointly work on the further improvement of the audit methodology and tools as used by the auditing profession. More specifically, the Audit Board

supports academics to join as a fellow, learn from current practice, and conduct research. As such, this collaboration has the potential to create a safe learning environment, to share best practices, and to enable and support innovation in audit methodology.

The permanent staff and fellows (both practice and academic fellows) of the Audit Board are responsible for developing up-to-date open source audit methodology based on the international auditing standards. As this staff comes from multiple accounting firms, a diverse range of perspectives is taken into account when developing and practising the audit methodology of the Audit Board. The knowledge on audit methodology and audit quality as accumulated under supervision of the Audit Board will be made available to society based on an open source methodology. Consequently, this open source platform expands the possibilities for innovation because software firms could develop applications that might be helpful in enhancing efficiency and effectiveness of audit methodology. The accounting firms can benefit from this knowledge to enhance their methodology and tools. This is relevant because the existing accounting firms will remain active in the market for audit services. Further, the fellowships of auditing professionals might also create knowledge spill-overs to the consultancy engagements accounting firms provide to companies. Thus, it is clearly in the interest of accounting firms to contribute by rotating their professionals with the Audit Board.

4.6 Funding and Governance of the Audit Board

The main funding of the Audit Board is based on budgeted audit hours and a fixed fee per hour, being paid by corporate management of the mandated PIEs. Budgeted audit hours are determined based on the company's size, risk, complexity, internal controls, and previous year's unexpected audit issues. As rates are fixed and hours are determined based on objective criteria (i.e., pre-determined formula), commercial incentives and negotiation on audit budgets are – to a

large extent – removed from the most important audits. Further, unexpected audit issues exceeding the budget of the current year will be built into next year’s audit fees. This would be analogous to insurance companies where the premium of the next year is based on losses or charges in the current year.¹⁵ As a result, the audit experts at the Audit Board can more fully focus on serving the public interest because the acquisition of new business and discussions about fees for additional work are no longer embedded in a system where both corporate management and the accounting firm have incentives for profitability.

As the main purpose of the Audit Board is to fulfil its legal obligation to conduct specific, pre-determined audits and to serve the public interest, the governance needs to be embedded in a multi-stakeholder dialogue outside the commercialism that is inherent in the existing accounting firms. Therefore, the Audit Board needs to be a separate not-for-profit organization that is neither affiliated with the government nor the accounting firms, where its activities fall under administrative law. As such, the Audit Board is a quasi-governmental organization. This is consistent with the view that statutory audits need a position separate from the market and the state to increase independence and avoid political interference (Fogarty & Rigsby, 2010; Guthrie, 1992; Lyall & Perks, 1976).

The governance structure of the Audit Board consists of two separate committees: Executive Committee and Trustee Committee. The Executive Committee is responsible for managing the daily activities of the Audit Board and is composed by an executive director, HR director, finance director, and research director. These directors need not be practicing auditors. We envision the Executive Committee as one that runs operations and finances of the Audit

¹⁵ Charging for unexpected audit issues in the next year might be organized at the individual company level, but can also be designed at the level of the whole portfolio of mandated PIEs.

Board, but does not take part in the conduct of audits. This is analogous to hospitals that are managed by individuals with strong management backgrounds, but are not necessarily doctors.

The Trustee Committee is responsible for monitoring the public interest perspective of the audits conducted by the Audit Board and is composed by a mix of relevant stakeholders. Potential stakeholders include representatives from the professional bodies of accountants, banks, industry associations, regulators, investors, stock exchanges, and tax authorities. A Nomination Committee within the Audit Board – composed by auditors, users, preparers, and regulators – will nominate the trustees representing these stakeholders, after which the Trustee Committee will appoint them. Given the quasi-governmental nature of the Audit Board, the Minister of Finance needs to ratify the nominations of the Trustee Committee. The Trustee Committee will appoint the directors of the Executive Committee. Figure 2 shows an organogram, representing the main relationships within the Audit Board.

<< Insert Figure 2 about here >>

We propose a governance structure within the Audit Board that consists of two separate committees composed by a broad range of stakeholders outside the auditing profession. This structure is important to address subtle power differences between the existing accounting firms and the proposed Audit Board. As shown by Malsch and Gendron (2011), staffing regulatory organizations with experienced auditors from the accounting firms can result in influencing everyday decisions within this regulatory organization as a result of being internalized to the commercial setting of accounting firms. Since we propose a permanent staff of highly experienced auditors – that come from the existing accounting firms – it is important to have a strong internal oversight to monitor the public interest perspective. Overall, the proposed governance structure of the Audit Board separates the roles of owner (Trustee Committee),

manager (Executive Committee), and employee (audit experts). Whereas audit partners combine these roles in the current system – potentially creating independence issues, our proposed model separates these roles of manager, owner, and employee given that the Audit Board is not a partnership.

Members of the Trustee Committee conduct stakeholder dialogues to consider the public interest, to learn about threats that are relevant, and to refine the scope of the audits conducted by the Audit Board. As such, this multi-stakeholder approach creates flexibility and transparency in agreeing on the scope of the audit (e.g., by modifying the formula that is applied as the basis for pre-determining the audit fee), which is an important advantage compared to the current model.¹⁶ For example, agreement on the extent to which auditors focus on fraud has the potential to decrease the expectations gap. In this role, the Trustee Committee is overseeing – not conducting – the audits of the Audit Board. Furthermore, the Trustee Committee plays an important role in mitigating the adverse effects of removing competition from the mandated PIEs that need an audit opinion by the Audit Board. This lack of competition potentially creates the threat of inefficiency, perhaps related to the quasi-governmental or bureaucratic nature of the Audit Board.¹⁷ By discussing the scope and budget of the audit with the audit team, the Trustee Committee has the ability to address any inefficiencies on a timely basis.

Whereas in the current system of auditing the audit committee of companies has an important role in selecting the audit partner and accounting firm, this choice is mitigated in our

¹⁶ This multi-stakeholder approach is consistent with the way auditing standards are developed and implemented. However, where auditing standards are universal across audit engagements, the Trustee Committee in our proposal has the opportunity to tailor the audit approach for each individual audit engagement.

¹⁷ Since the regulator has representatives in the Trustee Committee, the regulator's perspective can be taken into account when eliminating inefficiencies in auditing standards. For example, in the United States, when companies complained about Auditing Standard No. 2 requiring too much time (and being too costly), the SEC imposed on the PCAOB to modify this standard (resulted in Auditing Standard No. 5). Accordingly, the Trustee Committee can initiate the revision of auditing standards based on stakeholder dialogues.

proposed model of the Audit Board. As noted in section 4.1, we believe in the strengths of the current system where audit committees have an important internal oversight role. Therefore, we propose a system in which the Trustee Committee nominates two audit partners from the permanent staff of the Audit Board to be in charge of the audit of a mandated PIE. In composing these nominations, the Trustee Committee considers independence requirements such that team members have no relationships with corporate management, the audit committee, and/or component auditors. Subsequently, the company's audit committee is responsible for selecting the audit partner who they think has the best fit with the organization.

4.7 Role of the Regulator

We view the role of the regulator as one of enhancing audit quality during the audit (i.e., before the audit opinion is issued). Therefore, we include the role of the regulator in our alternative model of the Audit Board as part of our design to reform the business model of PIE statutory audits. The regulator's perspective might be an important factor in stimulating a public interest mindset. Instead of conducting ex-post inspections of audit engagements, we propose that the role of the regulator is integrated with the audit engagements conducted by the Audit Board. For example, after finishing the planning phase of the audit, the inspectors conduct a review and provide feedback to enhance the quality of the audit. This proactive rather than reactive role of the regulator contributes to in-system quality and a multi-stakeholder perspective for the most important audits. As such, these in-system inspections by the regulator are like quality controls during production processes that are conducted to decrease sunk costs.

Integrating the role of the regulator in our Audit Board model does not mean that the existing regulators (e.g., AFM in the Netherlands and PCAOB in the US) are out of business. These organizations continue to exist and – with respect to audit oversight – will primarily focus

on enforcement related to organizations that conduct audits (i.e., existing accounting firms and the Audit Board). Sanctions of the regulator will be directed to the Audit Board rather than individual audit partners because publicly sanctioning auditors is unlikely to contribute to the safe learning environment of the Audit Board. Consequently, sanctions against the Audit Board are discussed in the Executive Committee and Trustee Committee and are likely addressed by revising the internal quality control procedures. The enforcement role of the regulator is important because audit quality threats are likely to persist (e.g., due to psychological biases), even when commercial incentives are mitigated by implementing the Audit Board as proposed in this essay. Further, the existing regulators might play a role in intervening with differences in opinions between the audit team of the Audit Board and the regulators' inspectors on the audit engagement.

To enhance competition and efficiency in the audit market of mandated PIEs, the existing regulators might play a role in licensing accounting firms to conduct audit work for companies where the Audit Board is the group auditor. As such, the regulators are able to assess the quality and expertise of these firms required to conduct audits of large and complex international companies. Corporate management and audit committees can select component auditors from this list of licensed accounting firms. This licensing approach provides benefits compared to the current system where internal firm policies require that the majority of assets in multinational group audits are audited by member firms. That is, there is the potential for more competition between accounting firms with respect to conducting audit work at the component levels and there is more efficiency as a result of the opportunity to use the open source audit methodology as developed by the Audit Board (see section 4.5).

In the non–Audit Board audit market, the regulator is responsible for making license agreements with the existing accounting firms to conduct statutory audits in the non–Audit Board market. In this model, regulatory agencies might choose to remove commercial incentives or just accept auditor commercialism for these types of audit engagements. Solutions to remove these incentives are to set audit fees or assign audit engagements to accounting firms. Further, the regulator continues to conduct ex-post inspections on audit engagements conducted by the accounting firms.

5. STAKEHOLDER DIALOGUE TO ASSESS THE FEASIBILITY OF THE AUDIT BOARD

5.1. Stakeholder Dialogue Approach

We presented our proposed Audit Board model to various stakeholders throughout the Netherlands. During these presentations, stakeholders offered their thoughts on the feasibility of implementing the Audit Board. Consistent with Weick (1989), presentations to stakeholders resulted in scenarios that were similar to thought experiments to assess the plausibility of our developed policy proposal. Based on the research team’s personal network within the profession, we contacted relevant stakeholders in the Netherlands by phone and/or email to request meetings to explain and discuss our proposal.¹⁸ This has resulted in 19 dialogue sessions to date. These sessions took place from January to July 2019, were all chaired by the two authors from the Netherlands, and had a length from 30 minutes to 1.5 hours. One hundred and eight (108) stakeholders attended these presentations.

Attendees in our presentations cover a broad range of different stakeholders. These stakeholders include executive board members from accounting firms (both Big 4 and non–Big

¹⁸ We had frozen our essay before we started the stakeholder dialogue and sent this version of the essay to attendees in advance.

4), audit partners, managers, and strategy consultants from accounting firms (both Big 4 and non-Big 4), board members of the Dutch professional body of accountants (NBA), members of the young professionals group related to the professional body of accountants, shareholders, members of a committee within the Confederation of Netherlands Industry and Employers, regulators, members of the accountancy monitoring committee (MCA), government auditors, policy officers from the Treasury Department, members of parliament, and a class of executive MBA students.¹⁹ Based on the nature of these stakeholders, we classify them as being internal versus external to the auditing profession and as having direct versus indirect influence to improve the auditing profession. For example, accounting firms are classified in the internal/direct quadrant, whereas MBA students are classified in the external/indirect quadrant. Figure 3 provides a graphical representation of all types of stakeholders in these four quadrants.

<< Insert Figure 3 about here >>

We structured the stakeholder dialogues by, first, presenting the key elements of the Audit Board model based on three slides (as provided in the Appendix). In our introductory comments, we invited attendees to feel free to interrupt and to ask questions or provide comments. In addition, during the later dialogue sessions, we posed questions to the stakeholders that were based on what we learned from previous dialogues. During these sessions, one author presented the proposal while the other took detailed notes of the questions asked and the insights that were provided.²⁰ Stakeholder dialogues were not taped in order to increase the likelihood that attendees would feel free to speak openly about critical issues regarding both the current

¹⁹ The MCA was established by the Netherlands Institute of Chartered Accountants (NBA) in 2015 to monitor the implementation of the 53 measures to improve the quality, behavior, and culture in the auditing profession.

²⁰ The session with the executive MBA students was a bit different than the other stakeholder dialogues because only one of the authors was present in this session and the students did not receive the essay in advance.

model (i.e., current practice with profit-oriented accounting firms) and our proposed Audit Board model.

Subsequently, one of the authors analysed the notes from each of the dialogue sessions to identify the most significant themes that are relevant to implementing the Audit Board proposal. This analysis was reviewed and discussed by the author team to determine which insights and concerns to include in refining the Audit Board model presented in this manuscript. In summary, these stakeholder dialogues have provided critical insights that have led to significant modifications and refinements to our proposed model. This iterative process of presenting the model, receiving feedback and insights, and presenting it again has clarified our thinking and led to an enhanced version of the proposed model of auditing in the public interest.

5.2 Insights from the Stakeholder Dialogue

Based on our stakeholder dialogues, we find that the most salient elements of our proposed model are: (1) attracting people; (2) the role of the regulator; (3) practical issues related to global audits and international networks; (4) auditor legal liability; (5) innovation regarding audit methods; and (6) issues related to competition. We discuss each of these items separately in this section. In each subsection, we indicate what we learned from our stakeholder dialogues and how these conversations have led to a revision of the Audit Board model.

5.2.1 Attracting people

In the current system, it is already a challenge to attract and retain the best and brightest people. Attendees in our stakeholder dialogues raised both advantages and disadvantages of our proposed model with regard to attracting people. They indicated that the Audit Board model might be less attractive for auditing professionals as a result of specializing in statutory audits of PIEs. That is, people have no opportunity to switch between PIE and non-PIE engagements or

between auditing and consulting, creating less diversity in the type of work professionals are involved in. Further, a mandatory fellowship for everyone who wants to become an audit partner combined with the Audit Board focusing on all PIEs, might not be successful in attracting people who are intrinsically motivated to serve the public interest. In this case, accounting firms might not provide their best professionals for a fellowship and are not likely to be interested in taking back Audit Board fellows when the business of these firms is limited to non-PIE statutory audits, tax, and consulting. On the other hand, attendees indicated that a lot of auditors are primarily motivated by auditing in the public interest rather than consulting work and generating new business. In addition, stakeholders suggested that the younger generation is likely to be interested in such a fundamental change of the profession where they have a real opportunity to serve the public interest.

Based on these insights from stakeholders, we revised our proposed model by cutting the link between providing fellows and receiving a license for statutory audits of non-PIEs and removing the mandatory element of a fellowship before getting promoted to the audit partner level within accounting firms. Further, we clarified the important role that existing accounting firms play in auditing large companies and significant components of multinational group audits. Finally, we removed human capital challenges as a factor in the current business model that generates tension between commercialism and professionals (i.e., cyclical nature of hiring people) because our conversations in the stakeholder dialogue refined our thinking and suggested that these challenges are less likely to be mitigated by implementing the proposed Audit Board.

5.2.2 The role of the regulator

Stakeholders offered multiple, often conflicting, insights regarding our proposal of integrating the role of the regulator in the Audit Board. Several attendees indicated that this

might create conflicts of interest for the regulator when they are involved in the auditing process. That is, when being involved during the audit, the regulator is part of the system and carries part of the liability. Further, external inspections are an audit quality incentive in the current system that might be removed when the role of the regulator is integrated within the Audit Board. Stakeholders also raised the issue of timeliness, indicating that regulatory inspections take a lot of time and might hinder the auditors from providing the audit opinion on time. On the other hand, however, stakeholders indicated that real-time regulatory inspections can be integrated in the auditing process in the same way as internal inspections are conducted.

Based on these insights from stakeholders, we revised our proposed model by allocating the role of the regulator into two separate components: (1) inspections (which would be handled internally by the Audit Board) and (2) enforcement (which would be addressed externally by the regulator). As such, regulatory inspections are part of the audit process (similar to internal inspections in current practice), whereas the Audit Board still has an audit quality incentive based on the potential risk of being enforced by the regulator.

5.2.3 Practical issues related to global audits and international networks

An important advantage of the current system is that large accounting firms have an international network to serve multinational companies. Some stakeholders suggested that a European or worldwide implementation of the Audit Board is needed – although complex – in order to be effective. The reason is that revising the system in just one country creates a lot of issues in the context of multinational group audits. For example, it might provide regulatory competition to companies or create tension within accounting firms when some member firms have no business in statutory audits of PIEs. Overall, our stakeholder dialogue reinforced our thinking that it is necessary that the Audit Board model needs to be sufficiently flexible such that

different jurisdictions could choose to implement the model in various ways (or not at all) without impeding the ability to conduct global audits. Furthermore, we refined and clarified the role of the Audit Board in the context of global audits.

5.2.4 Auditor legal liability

Several stakeholders raised questions about the liability within the Audit Board. Whereas audit partners have incentives to mitigate liability risk in the current system, these incentives might be removed in our proposed model where statutory audits of certain companies are mandatorily conducted by one predefined agency. That is, shareholders have no possibilities to fire and/or claim auditors when there are issues in the audits conducted by the Audit Board, creating a suboptimal environment compared to current practice. On the other hand, stakeholders suggested that liability risk can be shared by implementing the Audit Board in multiple countries. Overall, we argue that the Audit Board could purchase professional liability insurance just like other accounting firms. However, in an effort to better address the issue of auditor legal liability, we have used the insights gained from our dialogue sessions to enhance and clarify our proposed model with respect to the corporate governance structure and legal responsibility.

5.2.5 Innovation regarding audit methods

With respect to innovation, the discussion was mixed and very interesting. One concern expressed by our stakeholders is the possibility that the Audit Board would have low incentives to innovate as it is a quasi-governmental organization that is likely to be risk averse. Interestingly, in our dialogues with governmental auditors, attendees indicated that most of their innovations came from former Big 4 professionals. Providing a more nuanced insight, some senior auditors from accounting firms argued that the current model provides them with incentives to innovate, whereas some young professionals indicated that innovation in the

auditing profession is restrained by the regulator who is focused on compliance to current standards.

Stakeholders indicated that there is potential for innovation in the Audit Board based on the proposal's dictate that the Audit Board develop, use, and offer to the profession open source audit methodology. This could allow for significant innovation on the part of third parties who could develop, for example, cutting edge technology that could be incorporated into the Audit Board's open source tools. Overall, based on these discussions, we have modified and clarified our proposed model to better explain that, while the feedback was not uniform, there is the possibility that the Audit Board could be as innovative as (or more innovative than) the current accounting firms.

5.2.6 Issues related to competition

Finally, stakeholders raised the issue of a lack of competition when certain companies need to be audited by one Audit Board. They clearly indicated a lot of potential adverse effects of creating a monopoly for statutory audits of PIEs, such as lower efficiency, higher bureaucracy, higher costs, less timely audit opinions, and lower audit quality. We have addressed this issue by clarifying the enhanced role of the company's audit committee in selecting the audit partner from the Audit Board, the Trustee Committee in conducting stakeholder dialogues to monitor the public interest perspective, and the regulator in licensing accounting firms to conduct component audit work.

5.3 Conclusions from the Stakeholder Dialogue

In refining our thinking in the development of our proposal, and this essay, the stakeholder dialogues were crucial. They provided us with relevant insights into advantages, pitfalls, practicalities, and feasibility of implementing the Audit Board. In essence, they caused

us to engage in a series of thought experiments where we, along with our dialogue attendees considered “what if” scenarios that led us to reinforce, delete, or in some other way, modify our thinking and, in turn, our proposed model. Our conclusion based on the stakeholder dialogue is that there is potential for such a fundamental reform of the auditing profession. However, the issues raised – in particular, the world of multinational group audits – are complex, indicating that further discussion/research is likely needed to examine potential implications.

At the end of each stakeholder dialogue, we asked all attendees to answer the question “What is the likelihood that the Audit Board model will be accepted by (1) current partners and (2) future partners?” on a fully labelled scale from 1 (*extremely unlikely*) to 5 (*extremely likely*). On average, responses indicated a mean score (standard deviation) of 1.85 (0.71) for the current partners and 3.24 (1.03) for the future partners.²¹ Thus, stakeholders believe that it is more likely that the future generation of audit partners will be willing to accept such a fundamental reform of the auditing profession rather than the current generation of audit partners.²² Interestingly, as shown in Figure 3, the difference between these two questions tend to be larger for the stakeholders in the quadrant of external involvement in the auditing profession and indirect influence to improve the auditing profession compared to the insiders who have direct influence (i.e., accounting firms, professional body of accountants, young professionals). Thus, outsiders who have indirect influence believe that the future partners are more likely to accept such a fundamental reform of the profession than the current partners.

²¹ We conducted a paired-samples *t*-test to examine the mean differences between these two groups. Findings (not tabulated) show that these means are significantly different ($t_{100} = -14.358$; $p < 0.001$). Inferences remain unchanged when we include the 23 conference attendees who answered these questions after presenting our essay at the 29th Auditing & Assurance Conference in Birmingham.

²² Of course, it is not clear whether they believe that the future partners would be more likely to welcome the changes. It is also possible that if the Audit Board was adopted, then future partners would eventually accept the new model because that will become the *status quo*, and eventually, if one were to venture sufficiently far into the future, the Audit Board model would be accepted because it would be the only model ever known by the population of current partners and business executives.

6. CONCLUSIONS

Auditors encounter significant pressure to reform their business model and to act in the public interest (e.g., AFM, 2018b; CMA, 2018; Marriage, 2018a, 2018b; PCAOB, 2017). Relying on academic literature and several recent reports, we show in this essay why it is very difficult for the auditing profession to respond to these calls and to address the audit quality concerns as observed by audit regulators. As the existing accounting firms are for-profit organizations with large consulting departments, these firms face conflicts between commercial success (i.e., commercialism) and professional requirements (i.e., professionalism). Potential solutions such as audit-only firms, allocating audit engagements to accounting firms, or joint audits are not sufficient to remove commercial incentives. Further, breaking-up the existing accounting firms into audit-only firms and consulting firms provides serious limitations to compose multidisciplinary audit teams because audit teams cannot bring in their consulting counterparts (e.g., fair value expertise, IT auditors, tax specialists). Therefore, a more drastic and innovative solution may be needed to improve independence and repair public trust.

We provide a potential solution for this problem by introducing an Audit Board that builds on the strengths of the existing accounting firms. That is, the Audit Board is a separate not-for-profit organization outside the existing accounting firms that is responsible for the most important statutory audits in a certain country. A permanent staff of audit experts will hire Audit Board fellows from the existing accounting firms and professionals from other organizations to compose multidisciplinary audit teams. Overall, this alternative model removes the weaknesses of the current system (e.g., commercial incentives) and builds on the strengths of the existing accounting firms (e.g., multidisciplinary teams). The effectiveness of our alternative model can be tested by implementing the Audit Board in a single country (or a single market segment) and

examining actual and perceived implications on audit quality, and/or by artificially testing the implications on audit quality and audit fees in a behavioral economics lab.

Although this essay provides a description of a solution to the ongoing and recurring observation of independence issues, we acknowledge limitations to our proposed model of the Audit Board. First, our essay does not consider the potential revisions that are needed in the current international legislation on statutory audits. Second, by specifically focusing on commercial incentives and the public interest at the firm and engagement levels, we rarely consider factors at the market level, such as the demand function (i.e., selection of auditors) and competition among firms. Third, our proposal might be viewed as controversial as it requires an extensive modification of the current market for statutory audits of PIEs, whereas alternative solutions – such as (1) breaking-up accounting firms into audit-only and consulting firms; (2) allocating companies to accounting firms and setting fees by the regulator; or (3) conducting statutory audits by a government agency – might be easier to implement. However, these alternatives still have dysfunctional commercial incentives to serve corporate management or lack functional commercial incentives to serve society. That is, audit-only firms still might face excessive price competition to the detriment of audit quality, whereas allocating companies to accounting firms and creating a government audit agency might remove innovation incentives for efficiency and effectiveness, consistent with the concerns as discussed by Freidson (2001). Therefore, we think the Audit Board has the potential to reform the profession in a good way.

We enjoyed the critical thinking when developing an alternative model for statutory audits of PIEs and presenting it at several stakeholders. As such, we embraced the challenge to leave the audit stakeholders optimistic for the future by providing novel ideas for a fundamental change (Gendron, 2018a; Humphrey, Canning, & O'Dwyer, 2018). We hope that this essay

generates good conversations about auditing in the public interest and a sustainable solution for an attractive profession.

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APPENDIX

Slides Used in Stakeholder Dialogue

Barriers for Auditors to Act in the Public Interest

Reforming the Business Model is needed to address problems that may arise from auditors' commercial incentives. Auditing is a credence good: society cannot distinguish between functional & dysfunctional commercialism.

Resurgence of Consulting in Accounting Firms	<ul style="list-style-type: none">• Central concern: Auditor independence ⇔ Good client relations• Potential tension in partnership: Profitability of Consulting ⇔ Profitability of Auditing• Potential conflict in organization: Maximizing Profits ⇔ Maximizing Audit Quality
Structure of Audit Partner Profit Sharing	<ul style="list-style-type: none">• Serving two masters: Commercial Incentives (profitability) ⇔ Professional Incentives (audit quality)• Performance-based incentives might lead to Audit Partner trade-offs: (1) Self-Interest ⇔ Interest of the Profession; (2) Long-Term investments in audit methodology ⇔ Short-Term financial optimization
Human Capital Challenges	<ul style="list-style-type: none">• Appropriate staffing & realistic budget ⇔ Low(er) audit fees• Cyclical hiring process: Long-Term HR development ⇔ Short-Term filling the HR-gap• Decreasing long-term career attractiveness: more demanding (compliance), less appealing (e.g. longer education)

4

Audit Board Model (1)

Critical Perspective on the Profession	<ul style="list-style-type: none">• Independent auditors are important to mitigate agency conflicts between companies and stakeholders• Strengths of the current model: multidisciplinary teams, competition, regulation, knowledge spill-overs, reputation and litigation concerns to improve audit quality• Major reforms required to mitigate tension between commercial and public interests
Audit Board for Statutory Audits	<ul style="list-style-type: none">• Primary focus on PIE-market• Statutory audits of PIEs by the Audit Board; "PIE" can be defined differently in different jurisdictions• Existing accounting firms focus on tax and consulting services and on audit services to non-PIEs
Audit Schedule and Fee	<ul style="list-style-type: none">• Audit schedule with Significant Risks, Internal Controls, and Financial Indicators for budget and planning• Audit engagement fee is fixed and based on a formula approved by the regulator• Multidisciplinary audit team of permanent staff, complemented with Audit Board Fellows (rotations from firms)

5

Audit Board Model (2)

Staffing and Human Capital Development	<ul style="list-style-type: none"> 75% permanent staff of full-time, highly qualified, and well-paid audit experts 25% Audit Board Fellows on rotation from accounting firms for 3 to 5 years and additional professionals with specific skills (e.g. IT and fraud specialists) Appraisal system for Fellows: excellent audit quality evaluations required before being promoted to an audit partner Accounting firms that provide Audit Board Fellows receive a license for non-PIE statutory audits
Knowledge Sharing by the Audit Board	<ul style="list-style-type: none"> Audit Engagement Database to enable real time audit quality monitoring Fellowship for academics to create safe learning environment and support innovation in audit methodology Open source audit methodology based upon multiple perspectives of Audit Board staff and fellows (available for all licensed accounting firms)
Funding and Governance of the Audit Board	<ul style="list-style-type: none"> Funding based on budgeted hours and a fixed fee per hour (unexpected issues built into next year's fees) Separate not-for profit organization neither affiliated with government nor accounting firms Strong internal oversight by Board of Trustees with stakeholder representatives (e.g., professional bodies of accountants, banks, regulators, investors, stock exchange and tax authorities with a majority of votes for public interest stakeholders)
Role of the Regulator	<ul style="list-style-type: none"> Role of the regulator is to enhance audit quality during the audit, before the audit opinion is issued Integration of regulator within the audit engagement; inspection after finishing each phase Traditional role of the regulator remains for non-PIE statutory audits

7

Note. These three slides are used in each stakeholder dialogue to present the key elements of our proposed Audit Board model.

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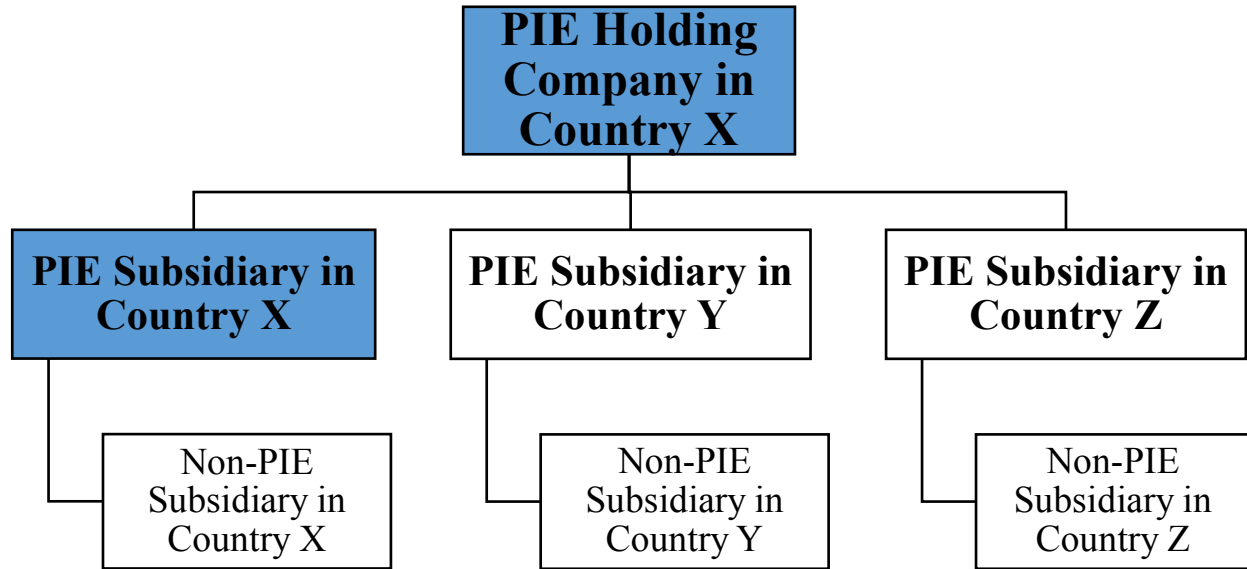
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FIGURE 1

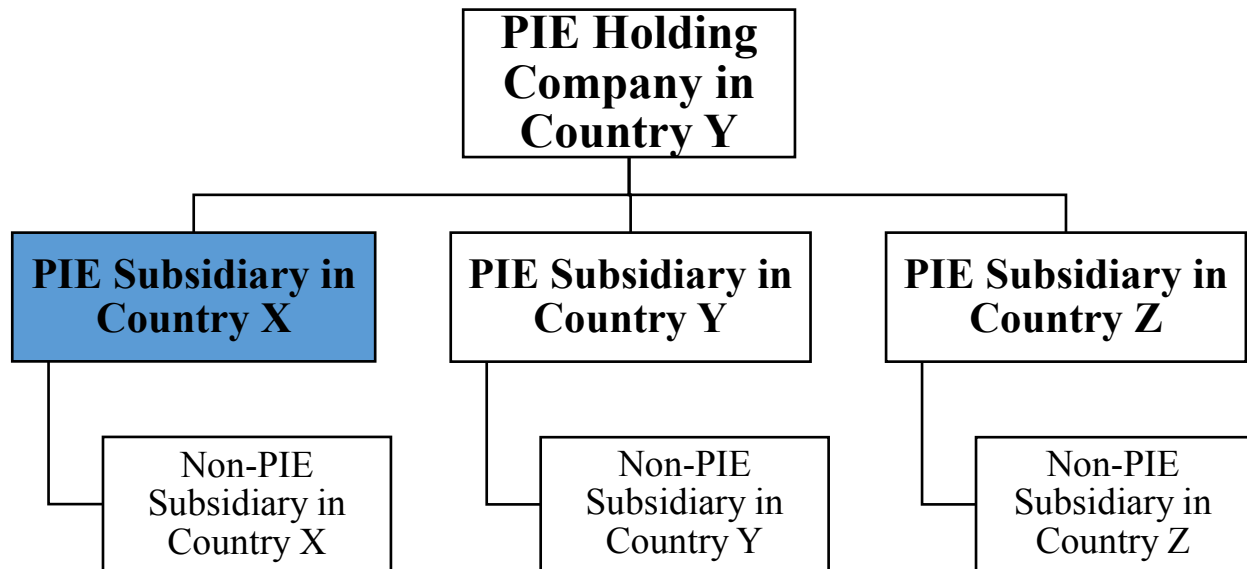
Three Illustrative Examples of the Audit Board

Panel A: Audit Board in One Country (X) with National Effect



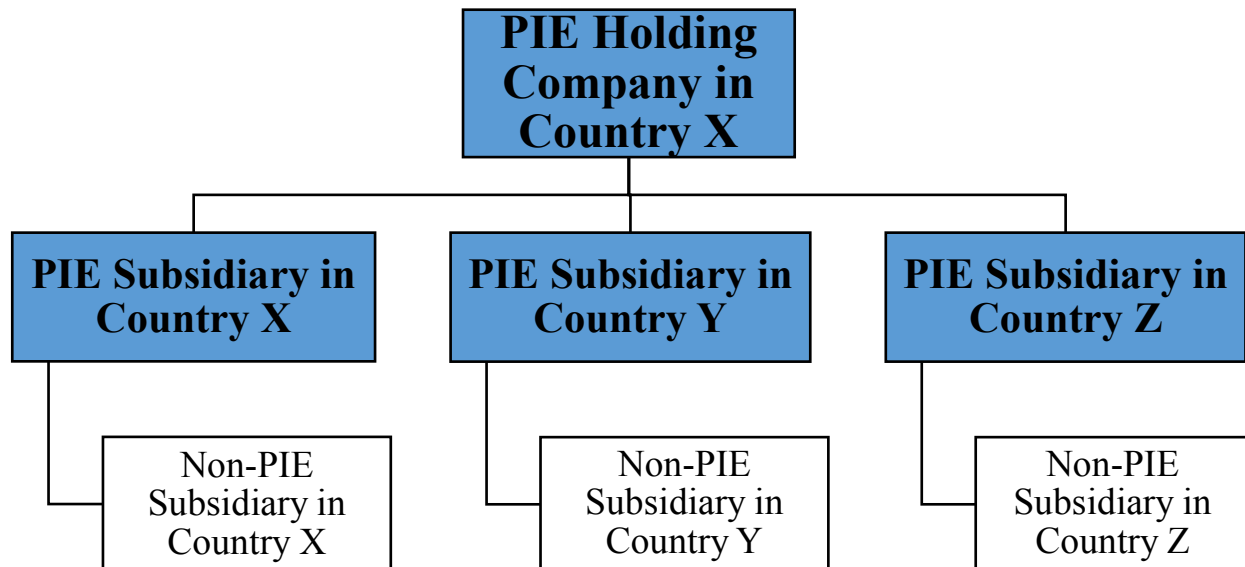
Note. This figure shows the group structure of a multinational PIE with a holding company in country X and PIE subsidiaries in the countries X, Y, and Z. Further, each PIE subsidiary has a non-PIE subsidiary. The Audit Board is implemented in country X, meaning that the Audit Board is in charge as group auditor for the PIE holding company in country X and component auditor for the PIE subsidiary in country X. The involvement of the Audit Board is indicated by blue components, whereas the involvement of the existing accounting firms is indicated by white components.

Panel B: Audit Board in One Country (X) with Foreign Effect



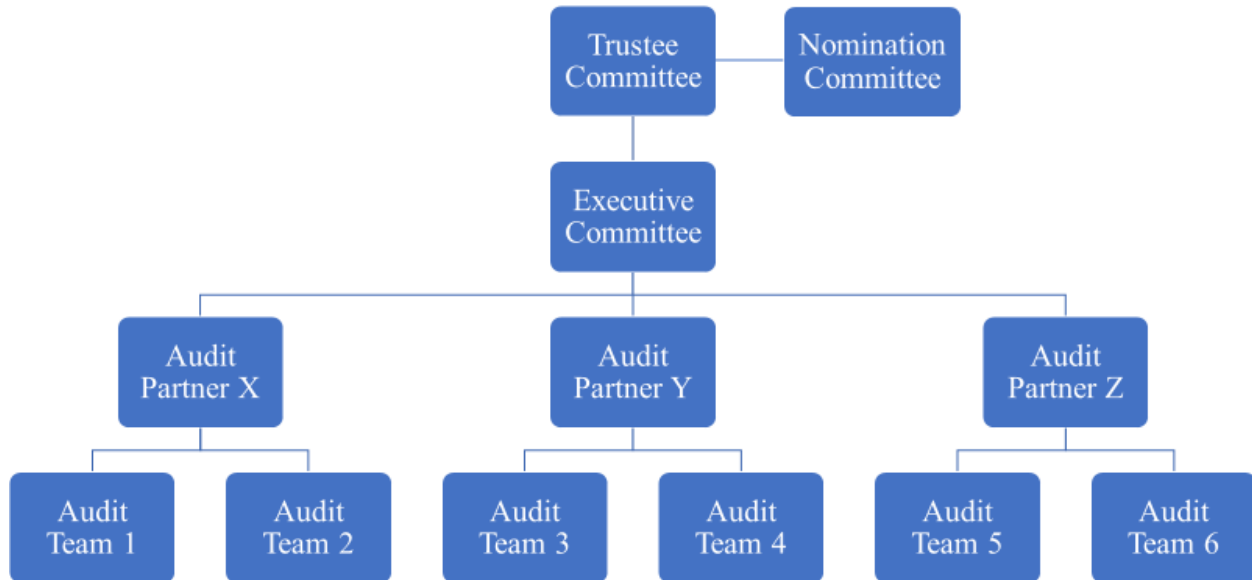
Note. This figure shows the group structure of a multinational PIE with a holding company in country Y and PIE subsidiaries in the countries X, Y, and Z. Further, each PIE subsidiary has a non-PIE subsidiary. The Audit Board is implemented in country X, meaning that the Audit Board is in charge as component auditor for the PIE subsidiary in country X. The involvement of the Audit Board is indicated by blue components, whereas the involvement of the existing accounting firms is indicated by white components.

Panel C: Audit Board in Multiple Countries (X, Y, and Z) with Multinational Effect



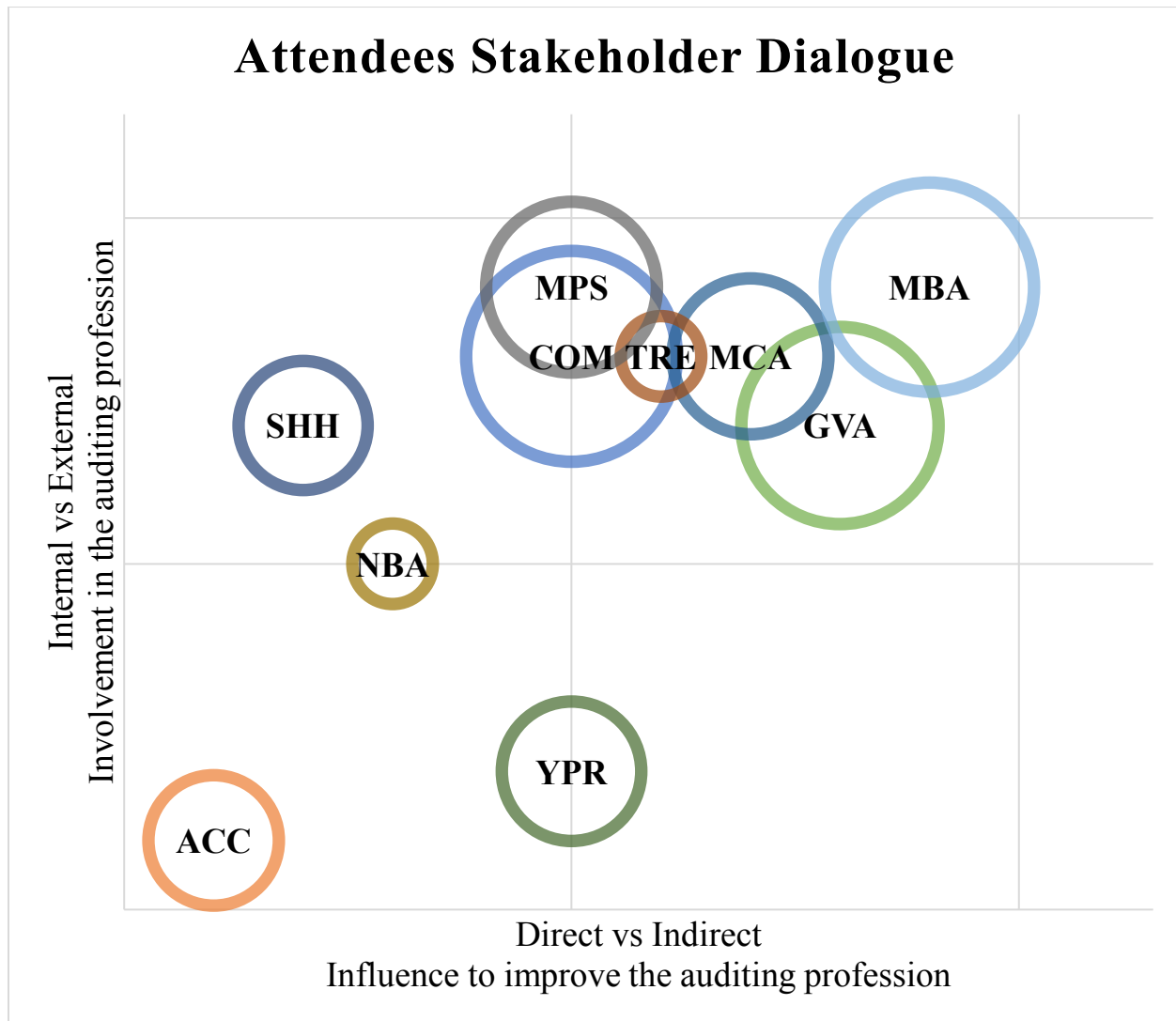
Note. This figure shows the group structure of a multinational PIE with a holding company in country X and PIE subsidiaries in the countries X, Y, and Z. Further, each PIE subsidiary has a non-PIE subsidiary. The Audit Board is implemented in countries X, Y, and Z. The Audit Board in country X is in charge as group auditor for the PIE holding company in country X and component auditor for the PIE subsidiary in country X. The Audit Boards in countries Y and Z are in charge as component auditor for the PIE subsidiaries in countries Y and Z, respectively. The involvement of the Audit Board is indicated by blue components, whereas the involvement of the existing accounting firms is indicated by white components.

FIGURE 2
Organogram of the Audit Board



Note. This figure shows the basic organogram of the Audit Board. The Nomination Committee nominates the trustees representing relevant stakeholders from the professional bodies of accountants, banks, industry associations, regulators, investors, stock exchanges, and tax authorities, after which the Trustee Committee appoints the trustees. The Trustee Committee appoints the Executive Committee (representing an executive director, HR director, finance director, and research director). Audit partners are responsible for managing several multidisciplinary audit teams.

FIGURE 3



Note. This figure shows a classification of stakeholders from our stakeholder dialogue in four quadrants: (1) the left/lower quadrant represents stakeholders who have internal involvement in the auditing profession and direct influence to improve the auditing profession; (2) the left/upper quadrant represents stakeholders who have external involvement in the auditing profession and direct influence to improve the auditing profession; (3) the right/lower quadrant represents stakeholders who have internal involvement in the auditing profession and indirect influence to improve the auditing profession; (4) the right/upper quadrant represents stakeholders who have external involvement in the auditing profession and indirect influence to improve the auditing profession. A larger size of the ring represents a greater likelihood that the Audit Board model will be accepted by future rather than current partners (see section 5.3). ACC = accounting firms; YPR = young professionals; NBA = professional body of accountants; SHH = shareholders; MPS = members of parliament; COM = companies; TRE = treasury department; MCA = accountancy monitoring committee; GVA = government auditors; MBA = MBA students. Regulators (external/direct quadrant) are missing in this figure because this was the first stakeholder dialogue in which we did not ask the two questions about the likelihood that the Audit Board model will be accepted.

TABLE 1

Key Characteristics of the Illustrative Examples of the Audit Board

Key Characteristics	Current Situation	Audit Board in One Country, with		Audit Board in Multiple Countries, with
		National Effect	Foreign Effect	Multinational Effect
		<i>Figure 1, Panel A</i>	<i>Figure 1, Panel B</i>	<i>Figure 1, Panel C</i>
a. PIE holding company in	Country X	Country X	Country Y	Country X
b. Audit Board in	N/A	Country X	Country X	Countries X, Y, and Z
c. Audit of PIE group financial statements: 1. Core audit team comprises auditors from 2. Design and execution group audit by 3. Instruction of component auditors by 4. Issuance auditors' opinion PIE holding company by	Existing accounting firm in country X	Audit Board in country X	Existing accounting firm in country Y	Audit Board in country X
d. Statutory audit of:				
1. PIE subsidiaries	All countries: Existing accounting firms	Country X: Audit Board Other countries: Existing accounting firms	Country X: Audit Board Other countries: Existing accounting firms	All countries: Audit Board
2. Non-PIE subsidiaries	All countries: Existing accounting firms	All countries: Existing accounting firms	All countries: Existing accounting firms	All countries: Existing accounting firms
e. Component audit of PIE and non-PIE subsidiaries	All countries:	Country X:	Country X:	All countries:

	Existing accounting firms	Audit Board or existing accounting firms Other countries: Existing accounting firms	Audit Board or existing accounting firms Other countries: Existing accounting firms	Audit Board or existing accounting firms
f. Potential impact on perceived tension between commercialism and professionalism	High	Medium	Medium	Low

Note. This table shows whether the Audit Board or existing accounting firms are in charge at the group and component levels in the different scenarios of the Audit Board as graphically represented in Figure 1, being compared with the current situation. Further, it shows the potential impact on the perceived tension between commercialism and professionalism in the country (or countries) where the Audit Board is implemented.