

"The worse the numbers, the more flowery the language"

Expectations vs. reality in auditing

Prof. Dr. Peter Leibfried from the University of St. Gallen and **Philipp Hallauer**, Head of National Quality & Risk Management, KPMG Switzerland, discuss challenges and risks in audit.



As the flagship of corporate reporting, the annual report should present a company's figures – and thus its situation – clearly, transparently and in a way that allows comparison. The auditor is responsible for examining whether the underlying financial reporting standards have been properly applied, and for assessing the company's ability to continue as a going concern. However, there are often misunderstandings or differing expectations on the role and purpose of an audit. The expectation gap is as old as the audit industry itself. Recently, though, negative headlines have been popping up more frequently in the media again. Has the audit business grown riskier? Are even more rules and laws needed? Or will digitalization and big data eventually straighten things out?

Prof. Dr. Peter Leibfried Has the audit business grown riskier?

Philipp Hallauer The audit business has always been inherently risky. Some of the key factors include the role of governing bodies, joint and several liability plus the fact that we aren't present at our clients' place of business all year round. Added to those are new factors like the momentum of transformation, swift advances in technology and a rise in cross-border regulations. At the same time, the media and the general public are taking a growing interest in our work as well. I think it's safe to say that our business has grown riskier.



[Left] **Philipp Hallauer**, Head of National Quality & Risk Management, KPMG Switzerland
[Right] **Prof. Dr. Peter Leibfried**, Institute of Accounting, Control and Auditing, University of St. Gallen



«You can actually only ever be absolutely independent if you're willing to give up or lose an engagement under certain circumstances.»

Prof. Dr. Peter Leibfried How do you deal with the expectation gap – the mismatch between expectations of the public, the media and other stakeholders, and the reality of your profession?

Philipp Hallauer As a matter of fact, the expectation gap is something that I've been dealing with for around 30 years. It's directly linked to trust, which lays the foundation and is actually a prerequisite for the proper functioning of both the capital market and our economy. Every individual player in the business cycle needs to be able to trust our work. We need to deliver what they have every right to expect of an audit. If there's a gap, auditors have both the responsibility and ability to close it. On the other hand, there's also an expectation gap in terms of how our role is perceived by the wider public, which occasionally confuses us with a compliance officer who's responsible for identifying each and every irregularity and thinks we're a guarantee for the company's long-term survival. Of course, we can't possibly satisfy these kinds of expectations within the scope of our legal mandate. Some clarification work definitely needs to happen and the industry, the authorities, politicians and, last but not least, the media have a responsibility to do it. All these groups can provide greater clarity and ensure a better understanding of the matter.

Prof. Dr. Peter Leibfried The zeitgeist is trending heavily toward wanting "greater certainty," "more control" and "safeguards against everything." Aligning these expectations with the reality of an audit is quite difficult, isn't it?

Philipp Hallauer You're right about that. In today's world, it's all about preventing accidents and surprises wherever possible. And if something does happen, there always has to be somebody to blame. But this attitude underscores

just how important and relevant our profession is. We can use new audit methods, new approaches and spend more time on the audit to close many of those gaps between expectations and reality. Society's general attitude toward absolute certainty and control, though, needs to be addressed by other bodies because in the business world, mistakes will always happen and companies will actually fail from time to time.

Prof. Dr. Peter Leibfried Compared to the past, to what extent do cultural differences within a company or the considerably more dynamic shifts in companies' social structures now play a role in employees' risk-related conduct?

Philipp Hallauer The social bond between employees and their employers isn't what it used to be 50 years ago. Global mobility is one contributing factor. That has an impact on the risk-related conduct – and misconduct – of employees and members of upper management, in particular. Since their sense of loyalty isn't as strong, they're of the opinion that they can simply continue their journey elsewhere if anything goes wrong. This culture is much more pronounced in the English-speaking world, particularly since failure doesn't have as much of a negative connotation there. At the same time, and as a direct result, the regulatory burden in the US is much heavier than it is in Europe. But here, too, we're well on our way to catching up...

Prof. Dr. Peter Leibfried Will today's audit methods be replaced by a real-time audit process?

Philipp Hallauer That's actually being discussed in the industry and it would be an extremely interesting approach. Processing all the complexities of a

global corporation in real time is no easy task, though. Let's just wait and see where innovation takes us on that topic.

Prof. Dr. Peter Leibfried What role does independence play in terms of the quality of audit services provided?

Philipp Hallauer Independence is a key prerequisite for external audits. If independence cannot be guaranteed, the auditor loses credibility and the trust of every stakeholder, regardless of how well the audit was carried out. Balance sheet readers put their faith in the fact that we reached our opinion neutrally and objectively. That's precisely why an extensive set of rules exists, both at the national and international level, and it's our job to use the tools at our disposal – including a multitude of processes, controls, training and communication – to ensure a company's compliance with those rules. The fact that not all stakeholders share the same understanding of independence doesn't exactly make matters any easier...

Prof. Dr. Peter Leibfried Can an auditor's independence ever be guaranteed 100 percent?

Philipp Hallauer You can actually only ever be absolutely independent if you're willing to give up or lose an engagement under certain circumstances. Of course, that's just the worst-case scenario, but ultimately it's about an auditor having a mindset or professional sense of ethics that gives them the strength to firmly stand up to a large, important client with resolve and explain why a certain situation has become untenable. Not only do they have to meet the requirement of "independence in fact" but also that of "independence in appearance" because if anybody even questions whether an auditor is actually independent or not, that auditor's credibility – and the trust placed in them – is on the line.

Prof. Dr. Peter Leibfried Splitting the Big Four up into separate audit and advisory firms in order to eliminate potential conflicts of interest and financial dependencies is discussed on a regular basis. Do you think that solution makes sense?

Philipp Hallauer So far, the audit-only concept hasn't been implemented anywhere but it's being discussed again in the UK. I'm skeptical about the whole idea and am not alone in the industry. Even the EU, which seems to impose new regulations left and right otherwise, made a conscious decision to reject the idea of separating audit and non-audit services following the 2008 financial crisis. Our services are based on a multidisciplinary model. Our clients expect teams with a broad range of skills and expertise.

Prof. Dr. Peter Leibfried How important is the role of specialists in audit?

Philipp Hallauer The high demands placed on audits carried out in accordance with today's standards don't only call for well-trained auditors but also IT specialists, forensic experts, tax experts, pension fund specialists, legal professionals, etc. In a scenario with pure audit firms, it's unrealistic to believe that this kind of company would be able to recruit and retain a large enough number of such high-quality specialists.

Today's multidisciplinary business model, which permits the use of in-house specialists for audit clients and enables firms to offer advisory clients the entire range of services, is more sustainable. It not only lets audit teams benefit from the extensive experience of highly motivated specialists, but also calls for a culture that focuses on the quality

of audit services, a culture where an awareness of the public's interest in our work is ingrained into every single employee.

Prof. Dr. Peter Leibfried When it comes to regulations, should Switzerland start taking more of a cue from developments in the EU or even the UK?

Philipp Hallauer I'm against regulatory expansion. When it comes to audits and accounting, Switzerland has always adopted international norms, which are currently quite extensive, or aligned its own standards with those norms. To me, it seems much more important for an institutionalized exchange to take place between our industry, the relevant authorities and politicians aimed at further strengthening not only their understanding of audits but also the quality of those audits in the process.

Prof. Dr. Peter Leibfried What specifically is KPMG doing to strengthen the quality of audit services as well as confidence in the audit profession in Switzerland?

Philipp Hallauer Since audits are a global product, KPMG has launched several different initiatives at the global level. We're heavily involved in these initiatives, with one central measure being the introduction of a comprehensive quality management system. This is based on the new International Standard on Quality Management 1, or ISQM 1. Another is the implementation of new audit software that uses a defined workflow to ensure that auditors address every relevant aspect of an audit. Big data and digitalization now also play a role in our work. We're seeing data analytics increasingly penetrate our audit work,

thereby enabling us to automate routine tasks and spend more time focusing on our discretionary scope.

Prof. Dr. Peter Leibfried Major investments in quality assurance and the digitalization of audit tasks are squeezing margins. What does that mean in terms of competition?

Philipp Hallauer These investments should ultimately help us perform our work not only better, but also in a more targeted, more efficient way. But of course they also come at a price. At any rate, the continued professionalization of clients' audit committees has also brought with it a realization that audits generate enormous added value and that investments in auditing can enhance this even further.

Philipp Hallauer How is digitalization affecting the scientific methodology used at the KPMG Chair of Audit and Accounting at the University of St. Gallen?

Prof. Dr. Peter Leibfried Digitalization is fundamentally changing academic work! In the past, students might have read around 30 annual reports for a master's thesis and evaluated these reports based on some sort of criteria. For a Ph.D. thesis, they might have scoured 100 or 300 annual reports. Nowadays, students program an algorithm capable of analyzing the entire text of 500 annual reports in three seconds. They also conduct linguistic evaluations that lead to conclusions like "the worse the numbers, the more flowery the language". It's something we've always suspected, but now we have scientific proof. That's the new world of analytical science for auditing and accounting.

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