



30 October 2020

Mr Willie Botha  
Technical Director  
International Auditing and Assurance Standards Board  
International Federation of Accountants  
6<sup>th</sup> Floor  
529 5<sup>th</sup> Avenue  
New York, NY, 10017

**Re: Comment Letter on IAASB Exposure Draft ED ISA 600 'Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)'**

The Auditing and Assurance Standards Committee of the Accounting and Finance Association of Australia and New Zealand (AFAANZ) is pleased to comment on the International Auditing and Assurance Standards Board's Proposed International Standard on Auditing 600 'Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)'.


AFAANZ is the peak regional academic accounting and finance association, and counts among its membership the region's leading and emerging accounting and finance researchers. The Auditing and Assurance Standards Committee is an ad-hoc committee under the governance of AFAANZ's Auditing and Assurance Special Interest Group, formed to give a voice on standard setting deliberations to the academic research literature.

The views expressed in the comments that follow are those of the undersigned Committee members and do not necessarily reflect the official position of AFAANZ. While the views expressed represent a consensus view of the Committee, they do not necessarily reflect the individual views of every member.

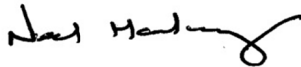
We limit our comments to the questions for which we are of the view that the extant academic research may meaningfully contribute to deliberations. Specifically, we comment on Questions 1, 2, 3, 8 and 12.

If you have any questions on our submission, please contact either of the Committee Co-Chairs (Noel Harding – [n.harding@unsw.edu.au](mailto:n.harding@unsw.edu.au) or David Hay – [d.hay@auckland.ac.nz](mailto:d.hay@auckland.ac.nz)).

Yours Sincerely\*,



Paul Coram  
University of Adelaide



Noel Harding  
UNSW Sydney



David Hay  
University of Auckland



Jahanzeb Khan  
Deakin University



Ashna Prasad  
Monash University

\* All signed in their capacity as members of the AFAANZ Auditing and Assurance Standards Committee.

## Auditing and Assurance Standards Committee of AFAANZ comments on ED ISA 600

We begin by commending the International Auditing and Assurance Standards Board (IAASB) for their work on this project. Group audits, including (but not limited to) working with component auditors, present considerable challenges to the achievement of audit quality and the effective and efficient operation of domestic and global capital markets. Growing industry and geographic diversification (including but not limited to ongoing globalisation) are increasingly testing auditors' ability to coordinate geographically dispersed work teams while leveraging the benefits of local knowledge and experience. Regulators continue to express concerns with the conduct of group audits (e.g., IFIAR 2020). Academic research suggests that the extent to which component auditors are involved in a group audit is associated with negative audit quality outcomes (e.g., Carson et al. 2019; Burke et al. 2020; Downey and Westermann 2020) and highlights that investors negatively react to the use of component auditors (e.g., Hux 2020; Impink et al. 2020; Demek et al. 2020). The work of the IAASB in this area is, therefore, very timely, and very much in the public interest.

Research, adopting a range of validated methodological approaches, has focussed on factors relating to audit quality in a group audit setting. It is with reference to this research that we comment on several questions for which input has been sought.

Overall, we believe that the proposed amendments to the standard will result in improved group audit quality. However, we feel, based on findings in the extant academic research literature, that further improvements in the public interest can be incorporated into the final standard. In summary, we feel that the current drafting of the proposed standard;

- i. does not adequately support the development of a team identity involving all members of the group engagement team working collaboratively towards a common goal of group audit quality;
- ii. presents a potentially detrimental authoritative tone in which responsibility for addressing cultural differences disproportionately rests with component auditors;
- iii. may encourage over-reliance on standardised network quality management policies and procedures;
- iv. gives insufficient recognition of the group audit challenges that exist independent of the use of component auditors;
- v. can be elaborated on to highlight challenges in exercising an appropriate level of professional scepticism in a group audit setting;
- vi. can be elaborated on to more effectively recognise the cultural factors that a group engagement team must contend with;
- vii. can provide further application material to help the group engagement team to apply ISA315 in a group audit setting; and
- viii. may inappropriately prohibit reference to component auditors in the auditor's report.

We expand on these points below.

**Question 1 With respect to the linkages to other standards:**

- (b) Does ED ISA 600 sufficiently address the special considerations in a group audit with respect to applying the requirements and application material in other relevant International Auditing Standards, including proposed ISA220? Are there other special considerations for a group audit that you believe have not been addressed in ED ISA 600?**

Extant research points toward a number of important group audit special considerations that have not been adequately captured in the proposed standard.

Organisation Theory (e.g., Puranam and Raveendran 2012) points towards reciprocal (mutual) predictability of action as an important factor in minimising coordination difficulties among agents who may be evaluated on the basis of a combined output (in a group audit setting, the group engagement partner is responsible for the conclusions drawn on the basis of the work completed by others such as component auditors). Research in auditing highlights the importance of a team / shared identity working towards a common goal in facilitating reciprocal predictability and minimising coordination and communication issues (Downey and Bedard 2019; Downey and Westermann 2020). Audit offices put effort into developing a common identity and a commitment to office-wide quality that facilitates predictable behaviour and an environment within which direction, supervision, and review are most effective.

Component auditors, coming from different offices, do not always subscribe to this team identity, thereby detracting from reciprocal predictability, exacerbating coordination concerns, and reducing the effectiveness of component auditor's work (Downey and Bedard 2019; Downey and Westermann 2020). This is relevant, not only for group audits involving component auditors, but for all group audits. Fostering a team identity is important for all distributed teams, even teams from the same office (Downey et al. 2020). **We recommend that paragraph 4 be expanded so as to set the tone in facilitating, through the efforts of the entire group engagement team, a team identity with a common goal.** The Explanatory Memorandum notes that when component auditors are involved, they are an integral part of the engagement team. The proposed standard, however, does not effectively reflect this sentiment. The group engagement partner, and those to whom responsibility is assigned, play a critical role in fostering a synergistic team identity. For example, Nelson et al. (2006) highlight the importance of team-oriented leadership in encouraging effective communication within audit teams. We further **suggest that the application material associated with paragraph 12 be expanded to recognise the importance of leadership in emphasising and supporting a team identity working towards a common goal.**

While we agree with the assignment of ultimate responsibility to the group engagement partner, we feel that the proposed standard presents too much of an authoritative tone that likely exacerbates an already insufficient sense of accountability and responsibility among component auditors (Downey and Westermann 2020). We feel that the proposed standard does not assign sufficient responsibility to the group engagement partner and their local office engagement team for facilitating and working within an environment in which communication

and coordination challenges are minimised. Engagement resources, and group audit quality, are not only a function of the competence and capabilities of component auditors (paragraphs A41-A44 detail considerations in this regard), but also the competence and capabilities of the group engagement partner (and those to whom responsibilities are assigned) who will be directing, supervising and reviewing the work of component auditors. Downey and Westermann (2020) suggests that communication and coordination challenges in a group audit are accentuated by an ethnocentric approach where component auditors are expected to yield to the culture of the group auditor. Research suggests that group audit quality is likely improved when the group engagement partner, and others who will be directing, supervising and reviewing the work of component auditors, take an ethno-relativist perspective, putting themselves in the position of the component auditor and, in doing so, better understand the cause of and solution to coordination challenges. With this in mind, **we recommend that paragraph 21 be expanded to require the group engagement partner to determine that the members of the group engagement team who will be directing, supervising and reviewing the work of component auditors have the appropriate competence and capabilities to work collaboratively and effectively with the component auditors. Application and explanatory material in this regard can also be included to highlight particular competencies unique to group audits such as group audit experience and country-specific experience**, both of which research has shown to be associated with higher audit quality (Gunn and Michas 2018).

While we recommend that paragraph 21 is expanded to include all members of the group engagement team, and not just component auditors, we do not wish to detract from the importance of competent and capable component auditors in that research (Burke et al. 2020) highlights that competent component auditors can mitigate other quality threatening characteristics of involving component auditors (e.g., culture and language difficulties). However, we note research highlighting that auditors are often overconfident in their colleagues' knowledge (Tan and Jamal 2001; Han et al. 2011). Research undertaken with a view to understanding and improving auditor assessments of their colleagues' competence (Harding and Trotman 2009) highlights the importance of knowing the average competence and capabilities of auditors within 'natural' categories such as hierarchical level in making well-calibrated assessments of their colleagues' competence. Since research suggests that auditor competence and capabilities may not be consistent across national boundaries (Downey and Westermann 2020), we **recommend that an additional bullet point be included under dot point 4 in paragraph A42 to include a consideration of whether the group engagement team and component auditor share common recruitment and promotion policies.**

With regard to the consideration of network quality control requirements, research points towards the care that needs to be exercised when relying on a network firm's quality controls. Carson et al. (2019) suggest that audit quality concerns are associated with the use of both network and unaffiliated component auditors, and Downey and Westermann (2020) highlight that quality management may not be consistently applied across global networks. While these concerns are likely to be most pronounced across cultures (Bik and Hooghiemstra 2018), research highlights that inconsistent application of network firm quality control procedures may still be a problem in circumstances when cultural differences are not as

pronounced (Barret et al. 2005) and within nations (Beck et al. 2019). We, therefore, **recommend that the points expressed in paragraph A40 not be expressly limited to circumstances when component auditors are not from the same firm** as there may be differences in quality management, independent of whether the component auditor is from the same firm or not. Similarly, **we recommend that commentary in paragraph A44 on the potential for the group engagement partner to rely on network requirements be qualified with the need to consider how consistently network requirements are likely to be applied.**

With regard to engagement performance (i.e., paragraph 23), we concur with the tenet expressed in paragraph A51 that the engagement circumstances (e.g., geographic dispersion of engagement team members) and not only the group entity's circumstances (e.g., assessed risk of material misstatement), should be considered when determining the nature, timing and extent of direction and supervision of component auditors and the review of their work. Paragraph 23, however, refers only to circumstances of the group entity without reference to engagement circumstances. **We recommend that paragraph 23 be expanded to include a requirement for the group engagement partner to take into account engagement circumstances.** This will direct due attention to paragraph A51.

With reference to the engagement circumstances that may be considered by the group audit partner, research highlights a number of circumstances in addition to those presently noted in paragraph A51 (i.e., the competence and capabilities of component auditors, location of engagement team members). Research identifies the following considerations associated with audit quality that we believe the group audit partner should also be mindful of; the extent to which component auditors are involved in the group audit (Burke et al. 2020), cultural and language difficulties (Sunderland and Trompeter 2017; Burke et al. 2020; Downey and Westermann 2020; Saiewitz and Wang 2020), component auditor concurrent commitments and priorities (Downey and Westermann 2020) and socio-cultural norms (Downey and Westermann 2020).

Finally, with regard to two-way communication between the group engagement team and the component auditor, and with reference to research highlighting that reciprocal predictability is an important factor in minimising coordination difficulties in a group audit setting (Downey and Bedard 2019), we feel that the emphasis in paragraphs 43 to 45 is inappropriately limited to issues directly impacting the group auditor's conclusions, with insufficient emphasis on promptly communicating coordination challenges that may threaten group audit quality. **We recommend that paragraph 44 be expanded (or an additional paragraph added) requiring the engagement team to request the component auditor to also communicate matters relevant to the efficient and effective conduct of the group audit.**

**Question 2. With respect to the structure of the standard, do you support the placement of sub-sections throughout ED ISA 600 that highlight the requirements when component auditors are involved?**

We are concerned that some of the references to issues relating to component auditors (both specific sub-sections and general sections) are not unique to component auditors and are

relevant to group audits, irrespective of whether a component auditor is used or not. While research suggests that the audit quality concerns in group audits are likely to be more pronounced when component auditors are used (e.g., Carson et al. 2019), there are quality threatening coordination and communication issues that exist independent of whether or not component auditors are used (Hanes 2013). For example, research on distributed teams from the same office (i.e., not component auditors) highlights communication challenges and a lack of shared identity in such settings (Downey et al. 2020). Our concern is that too much emphasis on component auditors may inadvertently contribute to an incorrect belief that the requirements, application and other explanatory material is not relevant when component auditors are not involved. **We recommend that a careful review be undertaken of provisions in the proposed standard that are currently focussed on component auditors to determine whether they address unique issues appropriate only when component auditors are used, or more generally applicable to a group audit.**

**Question 3. Do the requirements and application material of ED ISA 600 appropriately reinforce the exercise of professional scepticism in relation to an audit of group financial statements?**

The exercise of an appropriate level of scepticism is a challenge that confronts auditors performing all audits, not just group audits. We note that improvements introduced in ED-ISQM1 and ED-ISA220 will help auditors meet the requirement to exercise an appropriate level of scepticism in all audits, including group audits. We do note, however, a number of unique characteristics of group audits for which academic research highlights opportunities to improve the proposed standard to reinforce the exercise of professional scepticism in relation to an audit of group financial statements.

Research highlights that, with reference to how their actions may be evaluated by superiors, auditors may be reluctant to act on their questioning mind as the additional work will incur additional costs but may not (and most likely will not) result in the identification of a misstatement (Brazel et al. 2016; Brazel et al. 2019). This impediment to the exercise of an appropriate level of professional scepticism is termed an 'outcome effect', and may be more pronounced in work undertaken by component auditors. Fee negotiations between the group and component auditor, the specificity with which the group auditor directs what needs to be done by the component (often taking the form of an agreed upon procedures engagement) and the extent to which the component auditor feels a sense of accountability to the group auditor (Downey and Westermann 2020), all lead us to question how sceptical enquiry will be perceived by the component auditor, and the threat that this may pose to the appropriate exercise of professional scepticism in the audit of group financial statements.

With this in mind, **we recommend that paragraph A9 be expanded to explicitly recognise the increased threat from outcome effects in the exercise of an appropriate level of professional scepticism by component auditors.** We further recommend that paragraph A51 include an acknowledgement that the nature of the direction of component auditors' work can be tailored to take into consideration a need to build in a degree of flexibility that does

**not overly restrict the nature timing and extent of the procedures component auditors perform, and allows them the flexibility to act on their questioning mindsets.**

We note that our comments under Question 1 as they relate to the importance of supporting a team identity and concerns around the authoritative tone in assigning responsibility to address communication and coordination issues, and our recommendations as to changes to the standard that may ameliorate some of the threats to group audit quality, are also relevant here. Research has shown that a supportive partner style and team identity salience are important determinants of the level of professional scepticism exercised by auditors (Stevens et al. 2019).

A large body of research highlights that culture can, and often does, impact auditor judgments (see Nolder and Riley 2014 for a review of this literature) and the exercise of professional scepticism is not immune to the influence of culture (e.g., Saiewitz and Wang 2020; Khan and Harding 2020). We concur with the explicit recognition of cultural influences in paragraph A9. However, **we recommend that given the impact of national culture on audit judgments, consideration be given to including an appendix to the proposed standard detailing considerations relating to culture in a group audit setting.**

Finally, concerning the impact of cultural differences on auditor scepticism, we note research finding that making auditors aware of the different cultural mindsets can reduce the effects of culture on the exercise of professional scepticism (Saiewitz and Wang 2020), providing additional support for our **recommendation that paragraph A51 be further expanded to reinforce the need to be mindful of cultural differences in tailoring the nature of direction, supervision and review.**

**Question 8. Will the risk-based approach result in an appropriate assessment of the risks of material misstatement of the group financial statements and the design and performance of appropriate responses to those assessed risks? In particular, the AUASB is interested in views about:**

- (b) Whether the interactions between the group engagement team and component auditors throughout the different phases of the group audit are clear and appropriate, including sufficient involvement of the group engagement partner and group engagement team?**

Paragraph A42 specifies that “In determining whether component auditors have the appropriate competence and capabilities to perform the necessary procedures at the component for purposes of the group audit, the group engagement partner may consider matters such as:

...

“The consistency or similarity of language and culture”

[among many others]

There are other references to culture elsewhere in the proposed standard. However, while the proposed standard mentions cultural differences, it does not explain the risks



involved. These are extensive. There is a substantial body of research showing that, for example, auditors brought up in certain cultures may approach the exercise of scepticism differently and may vary in the way they question and challenge management; or that they rate risk differently. Auditors may make different materiality assessments depending on their cultural background. Nolder and Riley (2014) summarise the literature examining the effect of culture on auditor judgments. Other studies have shown that compliance with an audit firm's global policy varies depending on culture (Bik and Hooghiemstra 2018). Research also shows that modified audit opinions are more likely to occur in some cultures than others (Chen et al. 2017).

Given the importance for group audit quality of recognising and responding to differences in national culture, we **recommend that an additional appendix to the proposed standard be drafted detailing the considerations relating to culture in a group audit.**

**(c) What practical challenges may arise in implementing the risk-based approach?**

Extant ISA315 paragraph A186 reinforces the requirement that inherent risk is to be assessed independent of control risk. Research suggests that auditors may struggle to deal with the interdependencies between inherent and control risk (Messier and Austin 2000; Miller et al. 2012), and this has the potential to be incrementally challenging in a group audit setting. Paragraph 31, referring to ISA315 requires the group engagement team to assess the risk of material misstatement of the group financial statements *based on the understanding obtained in paragraph 24*. Paragraph 24 includes both inherent risk and control risk considerations, thereby blurring the requirement, as expressed in ISA315, to identify risk of material misstatement before consideration of any related controls. **We recommend that additional application and explanatory material relating to paragraph 31 be included to reinforce the expectation that risks of material misstatement are identified before consideration of any related controls.** In this regard, wording similar to ISA315 paragraph A186 could be employed.

We also note, with reference to the extant literature, the challenges in recognising and responding to risks arising from quantitatively non-significant components and qualitative factors (Graham et al. 2018; Backof et al. 2020). Graham et al. (2018) suggest that statistical sampling principles can be applied to achieve additional comfort when selecting non-significant components for which audit procedures will be performed. **We recommend that additional explanatory and application material relating to paragraph 33 (under scoping of a group audit – currently paragraphs A86 to A90) be included to recognise the potential for sampling (and the provisions of ISA530) to be employed in terms of scoping-in smaller non-significant components in order to manage audit risk.** Backof et al. (2020) show that requiring group auditors to separately consider and document quantitative and qualitative risk factors (rather than taking a holistic approach) resulted in auditors being more sensitive to qualitative risk factors. With this in mind, **we recommend that paragraph A78 be expanded to recognise that the group engagement team considers both quantitative and qualitative risk factors.**

**Question 12. Are there any other matters you would like to raise in relation to ED ISA 600?**

Although not the subject of an explicit question, extant research speaks to the veracity, in paragraph 52, of prohibiting reference to a component auditor in the auditor's report, and we make the following comments.

The prohibition in paragraph 52 on referring to a component auditor seems at odds with the increased transparency reflected in recent changes to the auditor reporting landscape. In a review of the research, Mock et al. (2013) concluded that "Users desire more information about the auditor, the audit, the financial statements and aspects of the entity that are relevant to the financial statements" (p.345). Christensen et al. (2016) similarly find that investors focus more on audit inputs and process than outputs when considering audit quality. Component auditors play a significant role in the conduct of group audits and research (Hux 2020) shows that knowledge of component auditor use in an audit impacts investor perceptions of audit team trustworthiness and financial statement reliability.

The U.S. PCAOB deliberated over whether to require disclosure of component auditors outside or as part of the auditor's report, ultimately deciding on disclosure in Form AP, but permitting audit firms to voluntarily report this information in an appendix to the auditor's report (PCAOB 2015). In stakeholder engagement, investors expressed a preference for the information to be included in the auditor's report (PCAOB 2015), and research examining the interplay between mandatory reporting and additional voluntary disclosure highlights that voluntary disclosure can reduce negative perceptions of audit quality when component auditors are used (Demek et al. 2020).

We further note research suggesting that potential adverse effects of disclosing component auditor usage may not materialise. While disclosing component auditor use could unintentionally reduce audit quality as auditors feel less accountable, research in the U.S. on lead auditor decisions to accept or decline responsibility for component auditor work finds no evidence that audit quality falls when the lead auditor declines responsibility (Mao et al. 2020). Responding to concerns of the PCAOB that disclosing component auditor use may increase liability of the lead auditor, Demek et al. (2020) find that voluntary disclosure of component auditor use in the auditor's report does not increase investor perceptions of blame and liability to the group auditor following a restatement.

While the research literature does not allow us to comment on whether disclosure of component auditor use should be a requirement, and if so, whether that disclosure should be through the auditor's report or some other reporting mechanism, we feel that the prohibition on referring to component auditors overly limits auditors' options in drafting Key Audit Matters as required by ISA701 and broadly limits the auditor's ability to increase transparency. We, therefore, **recommend that paragraph 52 be amended so as to state that the auditor's report on the group financial statements may refer to a component auditor. If the auditor does refer to a component auditor, the auditor's report shall include that the reference does not diminish the group engagement partner's or the group engagement partner's firm's responsibility for the group audit opinion.**

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