How should the auditors be audited? Comparing the PCAOB Inspections with the AICPA Peer Reviews

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Abstract
In their investigation of the new PCAOB Inspections, Lennox and Pittman [Lennox, C., Pittman, J., 2009. Auditing the auditors: evidence on the recent reforms to the external monitoring of the audit firms. Journal of Accounting and Economics, forthcoming] address one of the most important and controversial features of the recent shift from self-regulation to government regulation in the US audit markets. In this paper I attempt to place their investigations into the broader auditing and regulatory literature, critique what we learn and do not learn from their analysis, and make suggestions for future related research.

1. Introduction
Studying the consequences of the new PCAOB Inspections is important for several reasons. One is that the PCAOB Inspections potentially impact auditors’ incentives. This is important because high-quality auditing is necessary for well-functioning capital markets and auditors’ incentives play a critical role in assuring high-quality audits (Watts and Zimmerman, 1986). While the auditor incentives most commonly associated with audit quality are litigation and reputation concerns, oversight mechanisms used to monitor the profession are also likely to impact auditors’ incentives. Currently, however, little is known about the effectiveness of these mechanisms, or how they may affect audit quality. Thus, an investigation of the new PCAOB Inspections potentially provides insights into an important feature of the US audit markets that is not well understood.

Another important reason for studying the new PCAOB Inspections is that they are a central feature of the shift to quasi-governmental regulation of the US auditing industry.1 The PCAOB’s creation is a consequence of The Sarbanes-Oxley Act of 2002 (SOX) and represents an end to over 50 years of self-regulation in the US auditing industry. The importance of the
inspections in the PCAOB’s efforts to reform the US auditing profession is revealed in the following quote from a PCAOB member:

Inspections is [sic] the Board’s core function [and] the fundamental tool Congress gave the Board to restore public confidence in audited financial reporting. (PCAOB, 2005)

Finally, studying the shift from the old AICPA Peer Reviews to the new PCAOB Inspections is potentially interesting because it represents a trade-off of expertise for independence. This is interesting because this trade-off is a central feature in long-standing debate between self-regulation and government regulation (e.g., Stigler, 1971; Peltzman, 1976). Traditionally, this trade-off arises because government regulators, while more objective than self-regulators, generally have less industry expertise. In contrast, self-regulators, while more expert than government regulators, are less objective. In the case being studied here, the PCAOB Inspectors are forbidden from being active auditing professionals, and the AICPA Peer Reviewers are practicing auditors. Thus, an interesting aspect of Lennox and Pittman (2009) is that it potentially provides empirical evidence on a long-standing debate in the economics literature.

For all of the above reasons the analysis in Lennox and Pittman (2009) is a worthwhile attempt to better understand how institutional arrangements to monitor auditor behavior impact audit quality in the US capital markets. It is a monumental challenge to organize and interpret the disparate and complex disclosures provided in the Inspection and Peer Review reports. The authors have met this challenge by designing and implementing creative and rigorous tests that yield insightful results. As a result, the paper makes a unique and valuable contribution to the auditing and regulation literature. Like all research, however, the paper also has its limitations, and the following sections discuss what I believe are some of the more relevant limitations.

2. What can be concluded from investigating the “information value” of PCAOB Inspections?

2.1. Does lack of “information value” mean the PCAOB Inspections are ineffective?

The central research question in Lennox and Pittman (2009) asks whether the new PCAOB Inspections provide “information value” to audit market participants. The reports are defined as having information value if audit market participants, on average, switch to audit firms that receive favorable reports, and away from audit firms that receive unfavorable reports. This is an important issue because prominent commentators argue that the PCAOB Inspections should be informative to audit clients.2 In addition, prior literature finds that the old AICPA Peer Reviews had information value (Hilary and Lennox, 2005). Thus, the paper’s research question is well motivated and interesting. In answer to its central question, the paper finds that the PCAOB Inspections do not have information value. The analysis also identifies two reasons why the Inspection reports are not informative: (1) they do not provide an overall “opinion” on the quality of the auditing firm, and (2) they do not disclose information about the audit firm’s quality control systems. This contrasts with the AICPA Peer Reviews, which include both of these disclosures.

Finding that the PCAOB Inspections lack information value, however, does not necessarily mean they do not fulfill their intended purpose. Section 104 of SOX, which mandates the Inspections, states they are meant to “assess compliance” of public accounting firms with the requirements of SOX, the PCAOB, the SEC, and professional standards. It does not require the Inspections to achieve this objective by being informative, as defined by the authors. Further, the PCAOB does not claim that the Inspections are meant to be informative, and instead simply states:

Overall, the inspection process is designed to promote ongoing improvements in audit quality of registered firms. (PCAOB, 2008) Emphasis added.

The fact that the PCAOB Inspections fail to provide information value does not mean they fail to improve audit quality. Is it possible that PCAOB Inspections improve audit quality even though their Inspection reports lack information value? While this is ultimately an empirical question, I believe it is possible. For example, if the PCAOB Inspectors develop a reputation for being much tougher than the Peer Reviewers, they may provide audit firms with ex-ante incentives to increase audit quality. This is consistent with allegations that the PCAOB Inspectors are overly critical in second-guessing auditors’ judgments (Farrell and Shabad, 2005). In addition, unlike the Peer Reviewers, the PCAOB Inspectors are able to take actions against errant auditors that can result in large penalties. These actions can include notifying the SEC of auditor transgressions, notifying the Justice Department of possible criminal violations, and disciplinary proceedings by the PCAOB itself (PCAOB, 2008).3 If the PCAOB Inspectors hold the auditors to stricter standards and are able to impose costly penalties, auditors will have incentives to improve audit quality in anticipation of the Inspections. This also means that we

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2 For example, the authors note that Michael J. Cooke, former Chairman of Deloitte, has stated that it is important for the PCAOB Inspections to provide information to audit market participants about audit quality.

3 The size of the penalties resulting from PCAOB disciplinary actions can be large. For example, the PCAOB reported that during 2007 they settled nine disciplinary proceedings, with penalties including a $1 million fine and the barring of several individuals and firms from practicing public accounting (Public Company Accounting Oversight Board, 2007).
may observe the PCAOB reporting numerous audit weaknesses and imposing costly sanctions against auditors, even though the average level of audit quality has improved. I am not suggesting that the PCAOB Inspections have improved audit quality. Rather, I am pointing out that this question is not directly addressed in Lennox and Pittman (2009). Providing ex-post information on cross-sectional differences in audit quality (i.e., “information value”) is just one possible channel through which the PCAOB Inspections may benefit the audit markets. Another possible channel is to provide ex-ante incentives by having stricter standards and imposing harsh penalties.

2.2. What do we learn about regulatory regimes from studying the information value of the PCAOB Inspections?

As noted above, the replacement of the Peer Reviews with the PCAOB Inspections results in a classic trade-off of expertise for independence. The paper’s investigation, however, does not directly address whether this trade-off may be a factor that helps explain the lack of information value in the PCAOB Inspections. Thus, the paper does not provide insights into one of the most salient and interesting features of the switch from self-regulation to government regulation. While this limits what we learn from the study about regulatory regime changes, I hesitate to be too critical. Given the numerous and complex differences between the Peer Reviews and the PCAOB Inspections, it is not immediately obvious how one would go about teasing out the effects of expertise versus independence. Rather than being a criticism of the paper, the point of this observation is to simply lament the fact that the institutional setting is not more conducive to investigating one of the big picture issues of self-regulation versus government regulation.

2.3. Lack of evidence or lack of association?

The paper’s conclusions are based on the absence of finding an association. Specifically, because there is no significant association between the content of the Inspection reports and subsequent auditor choice decisions, the authors conclude that the Inspection reports are not informative. A danger in drawing this conclusion, however, is that the lack of evidence of an association is not necessarily evidence of a lack of association. In particular, a lack of a statistical association can be caused by deficiencies in the research design or a lack of statistical power. Lennox and Pittman (2009), however, employ a well-directed and rigorous research design and the analysis does not appear to suffer from low statistical power. As such, it is reasonable to expect that the study would reveal a significant association if such an association existed. Thus, while we can never formally accept the null hypothesis of no association, the paper is sufficiently rigorous that the authors are justified in concluding that the PCAOB Inspections lack information value.

3. Why are the PCAOB Inspections less informative than the Peer Reviews?

The paper’s primary conclusions are based on comparing events that occurred before SOX, with events that occurred after SOX. Specifically, the paper finds that the pre-SOX Peer Reviews are informative, while the post-SOX PCAOB Inspections are not. A potential threat to the validity of such a comparison is that omitted correlated variables may confound the comparison. In this section I discuss the variables that potentially confound the comparison and assess how the authors have dealt with these threats.

3.1. Did the quality of financial reporting improve after SOX?

If financial reporting quality improved after SOX, the PCAOB Inspections are likely to report less egregious weaknesses, which, in turn, are likely to have less information value. The most compelling reason to believe that financial reporting quality improved after SOX is that auditors’ and managers’ incentives are likely to have changed after SOX. For example, SOX increases criminal penalties imposed on managers for financial misconduct, and PCAOB Inspectors are able to report errant auditors and their clients to the SEC and the Justice Department (Palmrose, 2006). Thus, there are reasons to believe that auditors and managers have stronger incentives to improve auditing and financial reporting quality after SOX.

There is also empirical evidence that suggests auditing and financial reporting quality may have improved after SOX. For example, Cohen et al. (2008) report that earnings management declined after SOX and Lobo and Zhou (2006) find that auditors appear to be more conservative after SOX. In addition, many client firms delisted or went “dark” after the adoption of SOX (Engel et al., 2007; Leuz et al., 2008). Since this research suggests that the firms that delisted or went dark had poorer financial reporting quality, their withdrawal is likely to improve the average financial reporting quality after SOX.

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4 Lennox and Pittman (2009) find that the PCAOB reports are uninformative in spite of the fact that they reveal audit weaknesses. Their evidence convincingly suggests this is because the reports fail to disclose the type of information that gave the AICPA review reports information value, such as quality control weaknesses and an overall opinion. As I discuss later, other factors also potentially contribute to making the PCAOB Inspection reports uninformative, such as the lack of representativeness of the disclosed weaknesses.

5 In this regard, the PCAOB Inspections may be similar to the incentives provided by the threat of litigation and loss of reputation, which also provide ex-ante incentives to improve audit quality (Palmrose, 1988; Weber et al., 2008).
The authors partially address this issue by testing whether audit quality appeared to improve after the inception of the PCAOB Inspections. Specifically, they regress the incidence of restatements on the number of weaknesses reported in the PCAOB Inspection reports during the period 2005–2007. If audit quality improved after SOX, the authors expect the association between the restatements and the number of weaknesses to diminish over time. The analysis finds that the association does not diminish over time, and the authors conclude that audit quality did not progressively improve during the 2005–2007 period.

While the paper’s analysis of restatements is informative, it does not conclusively address whether implementation of SOX coincided with an upward shift in financial reporting quality. One limitation of the analysis is that it does not compare audit quality before and after SOX. Another limitation of the analysis is that post-SOX restatements may be a poor indicator of the seriousness of the weaknesses identified in the Inspections. This is because restatements after SOX may be mechanically related to the weaknesses found during the PCAOB Inspections. A mechanical association is suspected because the PCAOB Inspectors are allegedly under pressure to identify weaknesses, and to push for restatements related to those weaknesses (Farrell and Shabad, 2005). This is consistent with Scholz (2008), which reports a sharp increase in the number of restatements after SOX and a sharp decline in the market reaction to restatement announcements. This is also consistent with an SEC report, which concludes that many of the post-SOX restatements may have little impact on firm value because they result from confusion over the interpretation of new accounting standards (SEC, 2008). Thus, examining the association between restatements and the number of weaknesses identified by the PCAOB Inspectors may not be a reliable indicator of whether financial reporting quality changed during the period examined.

While it remains an open question whether the effects of improved financial reporting quality are partially responsible for the paper’s findings, it is also important to point out that this potential problem is unlikely to completely explain the paper’s results. Specifically, the paper does find that the Peer Reviews performed during the post-SOX period were informative, albeit less informative than the Peer Reviews performed during the pre-SOX period. This suggests that there is at least some degree of variation in audit quality in the Post-SOX period. Thus, the authors are reasonable in concluding that if the PCAOB Inspections provided the appropriate disclosures, audit market participants are likely to find them informative.

3.2. Are the weaknesses identified by the PCAOB Inspections representative?

The PCAOB explicitly targets their Inspections toward examining the riskiest auditing issues among the riskiest clients. As explained in a recent PCAOB Annual Report:

Our inspection teams, therefore, identify audits for review based on an assessment of the relative risks of misstatements or audit deficiencies. The teams further maximize the effectiveness of inspections by focusing on aspects of those audits most likely to pose the most challenging issues. (PCAOB, 2008)

This approach seems appropriate if an objective of the PCAOB Inspections is to detect and punish errant auditors. However, a consequence is that the weaknesses reported in the PCAOB Inspections are unlikely to be representative of the auditor’s client base or the average audit quality provided by the auditor. If audit market participants understand that the weaknesses identified in the PCAOB Inspections are not representative, they may not find the information useful in making auditor choice decisions. Thus, while the paper attributes the lack of information value to the limited information disclosed in the PCAOB Inspection reports, a contributing factor may also be their lack of representativeness.

3.3. Are the weaknesses identified by the PCAOB Inspections trivial?

A common criticism of the PCAOB Inspections is that they are too detailed-oriented and as a result tend to identify trivial and inconsequential audit weaknesses. As one commentator put it,

…no issue is too small to be the subject of PCAOB scrutiny. (Farrell and Shabad, 2005)

This is consistent with the widespread concern that PCAOB Inspectors are under pressure to identify and report weaknesses. It is also consistent with the fact that the most common deficiencies in the area of auditor independence that were discovered in the PCAOB’s inspections of small audit firms during 2004–2006 involved the preparation of client’s footnotes and cash flow statements (PCAOB, 2007, p. 16). While the preparation of footnotes and cash flow statements for small public clients is technically a violation of SOX’s ban on providing non-audit services, the severity of such violations seems relatively minor.

The authors address whether a decline in severity of the reported weaknesses explain their results by performing additional analysis. Specifically, they examine whether information value is associated with relatively more serious weaknesses. They find that audit market participants are not informed by the reported weaknesses, irrespective of their severity. While this analysis provides some comfort that trivial weaknesses do not explain the lack of information value in

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6 Recall from Lennox and Pittman (2009) that the AICPA Peer Reviews continue to be required post-SOX for audit firms that voluntarily join the AICPA. Thus, the paper is able to observe AICPA Peer Reviews both before and after SOX.
the PCAOB Inspections, it does not entirely rule out this alternative explanation. In particular, there is likely to be variations in severity within the severity categories used by the authors. For example, consider the category labeled NO_TEST, which captures weaknesses in which the auditor fails to perform a required audit test. Failure to perform a test that has a high probability of discovering a material misstatement is likely to be viewed as more severe than failure to perform a test that has a low probability of discovering a misstatement. The concern is that the inspection reports may include a large number of trivial weaknesses. If audit market participants are unable to discern the trivial weaknesses from the consequential weaknesses, they may essentially view the Inspection reports as noise. This, in turn, would help explain why the PCAOB Inspection reports lack information value.

4. Future research

The paper investigates some important issues with respect to the PCAOB Inspections, but also leaves some important questions for future research. One important question that remains unanswered is whether the PCAOB Inspections are likely to impact audit quality in the US audit markets. While the paper addresses whether the PCAOB Inspections influence the behavior of audit market participants, it does not address whether the Inspections influence the behavior of auditors. This is a potentially fruitful area to explore since there are many reasons to suspect that the Inspections may well impact auditor behavior. For example, Read et al. (2004) report that 47 small audit firms ceased auditing public clients during the period immediately following the passage of SOX. Follow-up questionnaires revealed that concerns about the PCAOB Inspections were the auditors’ primary reasons for exiting the industry. Among other things, this suggests that the PCAOB Inspections may result in consolidation in the auditing industry. The impact of this consolidation on audit quality, however, is uncertain.

Another unanswered question is whether the trade-off between expertise and independence, that accompanies the shift to government regulation, impacts the average level of audit quality in the US audit markets. While teasing out these effects presents a non-trivial challenge, the potential contribution to the audit markets literature, and the wider literature on regulatory economics, is substantial.

5. Summary

In their thoughtful and rigorous investigation of the new PCAOB Inspections, Lennox and Pittman (2009) address one of the most important and controversial features of the recent shift from self-regulation to government regulation. Their evaluation of the transition from Peer Reviews to PCAOB Inspections, and their comparison of the information value across the two monitoring mechanisms, provides valuable and important insights about the factors that are likely to inform market participants about audit quality. Going forward, the paper also provides a strong foundation for future research that will help us further understand the recent and profound change in regulatory oversight in the US audit markets.

References