

XII. Auditing Update: Academic Study and the PCAOB's Report on Engagement Quality Review

A. Introduction

Currently, both the Public Company Accounting Oversight Board ("PCAOB") and the Securities and Exchange Commission ("SEC") are concerned about the quality and the accuracy of audits occurring in the United States.¹ The auditing process itself is extremely important to the economy, because investors are more likely to invest if they have confidence in financial statements.² Recently, notable developments have shed new light on auditing quality.³ First, the results of an academic study conducted in India suggested methods to improve the accuracy of auditor reports.⁴

¹ See Tammy Whitehouse, *PCAOB Plans Rules on Auditing Estimates, Quality in 2014*, COMPLIANCE WEEK (Dec. 10, 2013), <http://complianceweek.com/pcaob-plans-rules-on-auditing-estimates-quality-in-2014/article/324984> (reviewing the PCAOB's progress in making "improvements to auditing standards," and the SEC staff's willingness to help).

² Joshua Ronen, *Corporate Audits and How to Fix Them*, J. ECON. PERSP., Spring 2010, at 189, 189.

³ See Esther Duflo et al., *Truth-Telling by Third-Party Auditors and the Response of Polluting Firms: Experimental Evidence from India*, 128 Q.J. ECON. 1499 (2013). See generally PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, RELEASE NO. 2013-011, OBSERVATIONS RELATED TO THE IMPLEMENTATION OF THE AUDITING STANDARD ON ENGAGEMENT QUALITY REVIEW (Dec. 6, 2013), http://pcaobus.org/Inspections/Documents/120613_EQR.pdf [hereinafter OBSERVATIONS].

⁴ Duflo et al., *supra* note 3, at 1500–02. Michael Greenstone is a Professor of Environmental Economics at the Massachusetts Institute of Technology. *Michael Greenstone: Short Biography*, MIT ECONOMICS, <http://economics.mit.edu/faculty/mgreenst/short> (last visited Apr. 16, 2014). Esther Duflo is a Professor of Poverty Alleviation and Development Economics at Massachusetts Institute of Technology. *Esther Duflo: Short Bio*, MIT ECONOMICS, <http://economics.mit.edu/faculty/eduflo/short> (last visited Apr. 16, 2014). Rohini Pande is a Professor of Public Policy, the Area Chair for Political and Economic Development, a Co-Director of Evidence for Policy Design, and a Director of Governance Innovations for Sustainable Development Group at the Harvard Kennedy School. *Rohini Pande*, HARVARD KENNEDY SCHOOL: JOHN F. KENNEDY SCHOOL OF GOVERNMENT, <http://hks.harvard.edu/about/faculty-staff-directory/rohini-pande> (last visited Apr. 16, 2014). Nicholas Ryan is a post-doctoral research

Although the general applicability of the study is questionable, its findings are likely relevant to United States companies' financial reports.⁵ Second, the PCAOB issued a report on engagement quality, in which the PCAOB discovered that engagement quality reviewers were not catching all the deficiencies of engagement teams,⁶ even though they were tasked to review audit engagements and were qualified to do so.⁷ The report found that even with the implementation of engagement quality reviewers, in one year of inspections, a large number of audit and engagement quality review deficiencies persisted.⁸ This article highlights the importance of audit quality and reviews the various methods by which companies can improve audit quality. Part B presents the background of the audit system and its quality issues. Part C discusses current efforts to improve the audit system. Part D analyzes these efforts and predicts how future audit quality concerns may be addressed.

B. Background

The Sarbanes-Oxley Act of 2002 ("Act") established the PCAOB to manage the auditors of publically traded companies.⁹ The

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⁵ See Duflo et al., *supra* note 3, at 1541; Peter Dizikes, *An Experiment Puts Auditing Under Scrutiny*, MIT NEWS (Oct. 9, 2013), <http://web.mit.edu/newsoffice/2013/experiment-puts-auditing-under-scrutiny-1009.html>.

⁶ OBSERVATIONS, *supra* note 3, at 3–4. The engagement team draws conclusions from the substantial judgments they make during an audit engagement. See PCAOB STANDARDS and RELATED RULES, Auditing Standard No. 7: Engagement Quality Review, §§ 2, 9 (Am. Inst. of Certified Pub. Accountants 2011) [hereinafter Auditing Standard No. 7]; PCAOB STANDARDS and RELATED RULES, Auditing Standard No. 3: Audit Documentation, § 3 (Am. Inst. of Certified Pub. Accountants 2011).

⁷ See Auditing Standard No. 7, *supra* note 6, §§ 1–5.

⁸ OBSERVATIONS, *supra* note 3, at 6.

⁹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750; *Public Company Accounting Oversight Board (PCAOB)*, SEC, <http://sec.gov/answers/pcaob.htm> (last modified Jan. 16, 2013).

Act granted the SEC supervisory power over the PCAOB.¹⁰ Consequently, the SEC must approve all PCAOB rules.¹¹

Large companies hire external firms to audit their financial records.¹² Although the third-party audit system can be successful in certain circumstances, it has undeniable flaws.¹³ Because the company requesting the audit also pays the auditing firm, auditors may feel pressured to give the company favorable results, in order to preserve their jobs.¹⁴ Auditors may be incapable of overlooking biases that incentivize them to report what is in their clients' best interests, notwithstanding their own obligation to report their findings objectively.¹⁵

C. Attempts to Improve the Audit System

Officials at both the PCAOB and the SEC have identified concerns regarding the quality of audits taking place in the United States.¹⁶ Currently, there are two notable developments concerning audit quality.¹⁷ The first is an academic study conducted in India.¹⁸ The second is a PCAOB report on engagement quality review.¹⁹

¹⁰ 15 U.S.C. § 7217(a) (2012); SEC, *supra* note 9.

¹¹ 15 U.S.C. § 7217(b)(2) (2012); SEC, *supra* note 9.

¹² Dizikes, *supra* note 5.

¹³ *See id.* ("But when an auditing firm's revenues come directly from its clients, the auditors have an incentive not to deliver bad news to them.")

¹⁴ *See id.*

¹⁵ *See* Max H. Bazerman et al., *Opinion: The Impossibility of Auditor Independence*, SLOAN MANAGEMENT REVIEW, Summer 1997, at 93–94 ("[T]hey may be unable to overcome cognitive or psychological biases that make them arrive at marginal decisions in the client's favor.")

¹⁶ *See* Whitehouse, *supra* note 1; *see also* Ronen, *supra* note 2, at 195 ("The quality of [auditor] performance is a contentious issue . . .").

¹⁷ *See* Duflo et al., *supra* note 3; OBSERVATIONS, *supra* note 3.

¹⁸ Duflo et al., *supra* note 3.

¹⁹ *See* OBSERVATIONS, *supra* note 3.

1. ***Truth-Telling by Third-Party Auditors and the Response of Polluting Firms: Experimental Evidence from India—an Academic Study by Duflo, Greenstone, Pande, and Ryan***²⁰

The academic study by Esther Duflo, Michael Greenstone, Rohini Pande, and Nicholas Ryan (together, the “Researchers”), sought to pinpoint ways to promote the “accuracy of auditor reporting.”²¹ The Researchers based their study on the “environmental audit system,”²² and “designed and evaluated a modified audit system”²³ for “industrial [plant] pollution levels.”²⁴ The study’s treatment (“Treatment”) included four major steps.²⁵ First, a research team randomly assigned auditors to selected Treatment plants.²⁶ Second, the study collected funds to pay the auditors from a “central pool” of money with a “flat rate” fee that was decided upon beforehand.²⁷ Third, an independent party was assigned to check random samples of the work the auditors completed.²⁸ Finally, the auditors were paid in accordance with the accuracy of their reports, based on random samples of their work checked by the independent party during the second year of the Treatment only.²⁹

The Researchers recorded the results of the Treatment and developed several conclusions.³⁰ First, they concluded that general auditing system for plants likely to pollute at large levels was misleading, since auditors recorded readings of plant pollution “just below the regulatory standard.”³¹ Second, the Researchers found that auditors under the Treatment were more honest and their reports

²⁰ Duflo et al., *supra* note 3.

²¹ *Id.* at 1501, 1507.

²² *Id.* at 1505.

²³ *Id.* at 1507.

²⁴ *Id.* at 1503.

²⁵ *Id.* at 1501.

²⁶ *Id.* at 1501. The Treatment group consists of almost half of the 473 plants that were eligible for the audit because of the amount of pollution they produced. *Id.* at 1508.

²⁷ *Id.* at 1501.

²⁸ *Id.* at 1501, 1509.

²⁹ *Id.* at 1501, 1510.

³⁰ *Id.* at 1501–02.

³¹ *Id.* at 1502.

were thus more accurate.³² This was demonstrated by a decrease in the number of plants that auditors incorrectly recorded “as compliant with pollution standards.”³³ Third, the Researchers concluded that emissions lessened once plant owners realized that “the regulatory authority would receive more reliable audit reports.”³⁴ Thus, overall, the Researchers were able to design a Treatment that successfully improved the overall accuracy of the audit system for pollution plants in India.³⁵

Even though the study focused on auditing compliance with environmental regulations,³⁶ the study’s conclusions may also apply to financial reporting in the United States.³⁷ The Researchers identified a common issue among “all third-party audit markets”—namely, that auditors are presented with a “conflict of interest” and lack proper motivation to report honestly.³⁸ Thus, it is likely that performing a similar treatment in the United States on audits of companies’ financial reports could elicit some measure of positive change.³⁹ However, such change may not be as radically successful as the one in the Researchers’ academic study, as there may be other variables at play in the United States financial system.⁴⁰

2. The PCAOB’s Report on Auditing Standard No. 7: Engagement Quality Review

The PCAOB’s Auditing Standard No. 7 addresses engagement quality reviews.⁴¹ Engagement quality reviews are

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 1501–02.

³⁶ *Id.* at 1500–01.

³⁷ Compare *id.* at 1541 (“Our findings are likely of broader relevance . . .”), with Dizikes, *supra* note 5 (“Still, it is an open question how broadly the current study’s findings can be generalized.”).

³⁸ Duflo et al., *supra* note 3, at 1541 (“We believe that the core problem—that auditors face a conflict of interest, or at least poor incentives to tell the truth—exists in all third-party audit markets.”).

³⁹ See *id.*; Dizikes, *supra* note 5.

⁴⁰ See Duflo et al., *supra* note 3, at 1502, 1541 (“[T]he exact nature of any audit reform will reflect a particular market’s status quo functioning and institutional details.”).

⁴¹ Auditing Standard No. 7, *supra* note 6, § 1.

meant to help improve the accuracy and quality of audits by identifying incomplete and incorrect audit opinions.⁴² An engagement quality reviewer's assessment of an engagement team's work also helps protect investors.⁴³

Every audit engagement must be accompanied by an engagement quality review.⁴⁴ Auditing Standard No. 7 requires an engagement quality reviewer to "evaluate the significant judgments . . . and related conclusions" of the engagement team, in the course of "forming the overall conclusion on the engagement and . . . preparing the engagement report."⁴⁵ Engagement quality reviewers must meet certain qualifications.⁴⁶ To be eligible to become an engagement quality reviewer, one must: (1) "be an associated person of a registered public accounting firm," unless the reviewer's firm conducted the engagement report, in which case he or she "must be a partner" or comparable position, or separate from the firm,⁴⁷ (2) be objective,⁴⁸ (3) be independent from the firm,⁴⁹ (4) have integrity,⁵⁰ and (5) be competent in "accounting, auditing, and financial reporting."⁵¹ Engagement quality reviewers assess an engagement team's major decisions to see if they properly lead to the team's conclusions.⁵²

The PCAOB issued a report on Auditing Standard No. 7, evaluating the implementation of engagement quality reviews.⁵³ The PCAOB concluded that most firms had trained their employees on Auditing Standard No. 7 and began incorporating the requirements of the standard into their procedures and practices.⁵⁴ However, a

⁴² See OBSERVATIONS, *supra* note 3, at 1; Press Release, Public Company Accounting Oversight Board, PCAOB Issues Report on Implementation of Auditing Standard on Engagement Quality Review (Dec. 6, 2013), http://pcaobus.org/News/Releases/Pages/12062013_EQR.aspx.

⁴³ Press Release, Public Company Accounting Oversight Board, *supra* note 42.

⁴⁴ Auditing Standard No. 7, *supra* note 6, § 1.

⁴⁵ *Id.* § 9.

⁴⁶ *Id.* §§ 3–8.

⁴⁷ *Id.* § 3.

⁴⁸ *Id.* §§ 4, 7.

⁴⁹ *Id.* §§ 4, 6.

⁵⁰ *Id.*

⁵¹ *Id.* §§ 4–5.

⁵² *Id.* § 9.

⁵³ OBSERVATIONS, *supra* note 3, at i.

⁵⁴ *Id.* at 3.

survey of audits revealed audit deficiencies where an engagement quality reviewer either did evaluate or was supposed to have evaluated.⁵⁵ Chairman of the PCAOB, James R. Doty, describes audit deficiencies as situations where “the auditor left insufficiently audited an aspect of the financial statements that could include an undetected material misstatement.”⁵⁶ Thus, the PCAOB discovered that engagement quality reviewers did not perform their jobs correctly, and that, specifically, they failed to appropriately evaluate the engagement team’s important judgments used to generate their final conclusions.⁵⁷

In their report on engagement quality review, the PCAOB discussed possible causes of engagement quality reviewer non-compliance and potential solutions for these issues, so that firms could better implement the standard.⁵⁸ Likely causes include the failure of the engagement team to record information pertinent to comprehending the conclusions in the engagement completion document,⁵⁹ and the possible lack of time spent by the engagement quality reviewer.⁶⁰ Possible solutions include confirming the engagement quality reviewer is suitable for the position,⁶¹ giving engagement quality reviewers in firms an appropriate amount of time to conduct their reviews,⁶² and ensuring that engagement teams record an appropriate amount of information so that an engagement quality reviewer can comprehend the conclusions of the engagement team.⁶³ The PCAOB states in its report that “[a]ll registered firms should review this report and consider whether the types of deficiencies that the Board’s Inspections staff has observed related to

⁵⁵ *Id.*

⁵⁶ James R. Doty, Chairman, The Role of the Audit in the Global Economy, Speech at the ICAS Aileen Beattie Memorial Lecture (Dec. 10, 2013), http://pcaobus.org/News/Speech/Pages/04182013_ICAS.aspx.

⁵⁷ OBSERVATIONS, *supra* note 3, at 3–4.

⁵⁸ *Id.* at 5–7.

⁵⁹ *Id.* at 5. The engagement completion document must be used by an auditor to “identify all significant findings or issues.” PCAOB STANDARDS AND RELATED RULES, Auditing Standard No. 3: Audit Documentation, § 13 (Am. Inst. of Certified Pub. Accountants 2011).

⁶⁰ OBSERVATIONS, *supra* note 3, at 6.

⁶¹ *Id.* at 7.

⁶² *Id.*

⁶³ *Id.*

[Auditing Standard] No. 7 could manifest themselves in their practices.”⁶⁴

D. Analysis and Implications

There are clear problems in the auditing industry, and certain government organizations, namely the PCAOB and the SEC, are taking steps to resolve these issues.⁶⁵ In today’s climate, change seems likely to occur, as these organizations are actively researching and enacting reform proposals.⁶⁶

The PCAOB’s Auditing Standard No. 7 seeks to address the same main problem that the Researchers’ academic study highlights: the inaccuracy of auditor reports.⁶⁷ Both the PCAOB report and the Researchers’ academic study suggest ways to improve auditor accuracy.⁶⁸ Auditing Standard No. 7 focuses on correcting audits by enlisting engagement quality reviewers to evaluate them.⁶⁹ Similarly, the Researchers’ academic study assigned an independent party to check random samples of the work the auditors completed, and used a number of other factors to further increase auditor oversight and incentives to report accurately.⁷⁰

While the Researchers’ academic study successfully improved regulatory compliance of audited plants, as well as auditor truthfulness and accuracy,⁷¹ it does not appear that Auditing Standard No. 7 has been particularly effective, likely because engagement

⁶⁴ *Id.* at ii.

⁶⁵ See, e.g., Whitehouse, *supra* note 1 (“Audit regulators will propose new rules in 2014 for how auditors should audit accounting estimates, including fair value measurements, and how firms should manage their own internal audit quality control.”); OBSERVATIONS, *supra* note 3; Auditing Standard No. 7, *supra* note 6.

⁶⁶ See Whitehouse, *supra* note 1 (“Audit regulators will propose new rules in 2014 for how auditors should audit accounting estimates . . .”).

⁶⁷ Compare Duflo et al., *supra* note 3 at 1501–02 (“Our experiment altered the market structure in several complementary ways to incentivize accurate reporting.”), with OBSERVATIONS, *supra* note 3, at 3 (“Inspections staff concluded that the audit deficiency occurred in areas that were or should have been reviewed in the engagement quality review process . . .”).

⁶⁸ OBSERVATIONS, *supra* note 3, at 7; Duflo et al., *supra* note 3 at 1501–02.

⁶⁹ Auditing Standard No. 7, *supra* note 6, §§ 1–2; see OBSERVATIONS, *supra* note 3, at 1.

⁷⁰ Duflo et al., *supra* note 3, at 1501–02.

⁷¹ *Id.*

quality reviews are not being “properly performed.”⁷² However, Auditing Standard No. 7’s implementation lacks several factors that are found in the Researchers’ academic study, including incentive pay, pay from a central pool, and completely random assignment of auditors.⁷³ Thus, the PCAOB may be able to increase the effectiveness of the standard, and thus improve audit accuracy, by incorporating some of the Researchers’ Treatment into future regulations.⁷⁴

Another possible solution to this problem would be to have the PCAOB Inspections staff increase direct training of firms who are incorrectly implementing Auditing Standard No. 7.⁷⁵ After inspections of “domestic audit firms that audit the financial statements of issuers,” the PCAOB staff already “discusses the findings with the firm to make sure that all of the facts are considered and to help the staff and firm understand the deficiency identified.”⁷⁶ Thus, more training may help increase the accuracy of auditor reports.⁷⁷

In addition to monitoring engagement quality review, the PCAOB is also developing an audit quality indicator project, and they plan to produce a Concept Release on the subject.⁷⁸ The PCAOB staff is actively uncovering indicators that may help improve audit quality, while also analyzing these indicators to

⁷² See OBSERVATIONS, *supra* note 3, at 6 (“[A] properly performed engagement quality review should increase the likelihood that a registered public accounting firm will catch any significant engagement deficiencies . . .”).

⁷³ Duflo et al., *supra* note 3, at 1501.

⁷⁴ See *id.* at 1501–02.

⁷⁵ See PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, RELEASE NO. 2013-001, REPORT ON 2007–2010 INSPECTIONS OF DOMESTIC FIRMS THAT AUDIT 100 OR FEWER PUBLIC COMPANIES at ii (Feb. 25, 2013), http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf (“The Board encourages firms to initiate a dialogue with the Board’s Inspections staff early on about how the firm intends to address quality control criticisms . . .”).

⁷⁶ See *id.* at i–ii.

⁷⁷ See *id.*

⁷⁸ Greg Jonas, Office of Research and Analysis Director, Update on Audit Quality Indicators, Speech at the AICPA National Conference on SEC and PCAOB Developments (Dec. 10, 2013), http://pcaobus.org/News/Speech/Pages/12102013_Jonas_AICPA.aspx.

improve their effectiveness.⁷⁹ Their Concept Release will likely be extremely useful to firms who aim to increase audit quality.⁸⁰ The PCAOB may add other standards to improve engagement quality review in an attempt to bolster the accuracy of the auditing system for public companies in the United States.⁸¹

E. Conclusion

The Researchers' academic study suggests that in some contexts, firms can improve the accuracy of auditor reports by assigning auditors randomly, checking auditor's results, paying auditors from a central pool while setting a flat rate fee beforehand, and correlating the amount of pay auditors receive with how accurately auditors performed.⁸² However, the applicability of the study's findings in other contexts is questionable, and thus it is unclear that implementing all of these approaches in financial report auditing would yield the same positive results.⁸³ The PCAOB's engagement quality report found in their 2012 inspections that, even with the presence of engagement quality reviewers in firms, a high number of audit and engagement quality review deficiencies remained.⁸⁴ The PCAOB's plan for a new rule in 2014 may improve the quality of audits,⁸⁵ however, the staff may want to incorporate new factors to improve the effectiveness of Auditing Standard No. 7.⁸⁶

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⁷⁹ *See id.*

⁸⁰ *See id.* (describing "root causes and [audit quality indicators] to be two sides of the same coin [since] in both cases we need to identify, measure and improve at the root cause level of audit quality").

⁸¹ *Cf.* Whitehouse, *supra* note 1 ("PCAOB spokesman Colleen Brennan said the board's agenda calls for adoption of a standard on related parties and a proposal on using the work of specialists and other auditors in the first quarter of 2014.").

⁸² Duflo et al., *supra* note 3, at 1501–02.

⁸³ *See* Duflo et al., *supra* note 3, at 1541; Dizikes, *supra* note 5.

⁸⁴ OBSERVATIONS, *supra* note 3, at 6.

⁸⁵ *See* Whitehouse, *supra* note 1.

⁸⁶ *Cf. id.* ("Audit regulators will propose new rules in 2014 for how auditors should audit accounting estimates, including fair value measurements, and how firms should manage their own internal audit quality control.").

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