



Research Report

For better or worse: A study of auditors' practices under Auditing Standard No. 7

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ABSTRACT

The PCAOB's Auditing Standard No. 7 (AS No. 7) revised guidance for Engagement Quality Reviews (EQRs). To better understand the impact of resulting changes in practice, if any, that have occurred in the nature, extent, and timing of the EQR process, and the impact of such changes on audit quality, we surveyed practicing audit partners familiar with EQRs. Results indicate that AS No. 7 changed the nature of EQRs by impacting the role and approach of the EQ Reviewer. It impacted the extent of procedures performed by the EQ Reviewer and altered communications between the EQ Reviewer and most engagement team members, but it had little impact on the timing of EQRs. Collectively, results suggest AS No. 7 changed EQRs, but such changes may not have improved audit quality. These findings provide insight to the continuing conclusion of the PCAOB that many EQ Reviewers do not fulfill their role of monitoring audit quality, and are also suggestive of opportunities to improve the EQR process.

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1 Introduction

In the conduct of an audit, an engagement quality review (EQR) conducted by a qualified partner who is considered independent of the audit engagement (engagement quality reviewer – EQ Reviewer) is an important monitoring process intended to enhance audit quality and reduce the likelihood that the auditor will fail to identify a material misstatement in the financial statements. The Public Company Accounting Oversight Board (PCAOB), the regulator of auditors of publicly-traded companies, has referred to EQRs as “a pillar of audit quality” (PCAOB, 2009, 4). We provide an analysis of the impact of a recently-enacted standard aimed at improving the EQR process.

In 2009, the PCAOB issued Auditing Standard No. 7, *Engagement Quality Review for an Audit* (AS No. 7 – required for audits beginning on or after December 15, 2009). Prior guidance for EQRs was contained within quality control

guidance issued by the American Institute of Certified Public Accountants' (AICPA) SEC Practice Section (SECPS), and within an Exposure Draft of the AICPA's Auditing Standards Board that was passed along to the PCAOB when it became the standard-setter for audits of publicly-traded companies (AICPA, 2002).

Prior to the implementation of AS No. 7, findings from inspections conducted by the PCAOB of registered auditors raised concerns about the execution of EQRs (then called second or concurring partner reviews). As noted by one member of the PCAOB, “poorly performed second partner reviews are among the more frequently observed concerns cited in the Board's inspection reports” (Harris, 2009). Issues such as failure of the EQ Reviewer to use due professional care, demonstrate professional skepticism, or to seek evidence supporting or refuting assertions made by management are those that most frequently resulted in PCAOB disciplinary actions and Securities and Exchange Commission (SEC) enforcement actions (Messier, Kozloski, & Kochetova-Kozloski, 2010).

In response, AS No. 7 imposed changes to the nature, extent, and timing of EQRs. As evidenced in the 68 comment

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letters submitted to the PCAOB, practitioners, academics, regulators, and public policy groups anticipated significant changes to EQRs as a result of the implementation of AS No. 7. Many proffered opinions similar to that of the accounting firm, KPMG, that the proposed standard would result in a “fundamental change in nature and scope of an engagement quality review” (KPMG LLP, 2008, 2).

In terms of changes to the nature of the EQR, while prior guidance (for a summary see Epps & Messier, 2007, 170) required that the EQR be qualified in terms of competence and experience, AS No. 7: (1) adds explicit requirements about maintaining objectivity from the engagement team (§6), (2) requires that the EQ Reviewer must not have been affiliated with the engagement in the two-year period preceding his or her assignment as EQ Reviewer, and (3) limits the term of the assignment to five years (§7, 8). Important in terms of the relationship between the lead engagement partner and the EQ Reviewer, while prior guidance required that the EQ Reviewer confirm with the engagement partner that there were no significant unresolved matters prior to issuance of the audit opinion, AS No. 7 requires that the EQ Reviewer satisfy him or herself with respect to the engagement team’s appropriate response to (and documentation of) significant risks (§11a). Further, AS No. 7 requires that the EQ Reviewer approve issuance of the audit opinion.

In terms of extent of the EQR, AS No. 7 is much more explicit concerning the engagement documentation that must be reviewed and evaluated (§10), and in how the EQR process should be documented (§11). Further, prior guidance focused on communications between the EQ Reviewer and the engagement partner. AS No. 7 potentially broadened communications by suggesting that, in the execution of their responsibilities, EQ Reviewers may hold discussions with both the engagement partner and other members of the engagement team (§9).

Finally, in terms of timing of the EQR, while prior guidance was explicit in terms of an EQ Reviewer’s involvement in planning, and many auditing firms’ policies required timely “sign-off” by the EQ Reviewer (Epps & Messier, 2007), AS No. 7 is less explicit, requiring that the EQ Reviewer evaluate significant judgments that relate to planning (§10a), but not specifying when, in terms of the engagement phase, that evaluation should occur.

While logic may dictate that regulatory changes aimed at enhancing audit quality should have positive effects, theory and the results of prior research do not consistently provide convincing evidence in this matter. From a theoretical standpoint, as summarized by Pentland (1993, 619), “for any given rule, one must and can decide when and how to apply it,” which, in turn, gives rise to the need for more rules. Ergo, sociological (Giddens, 1984) and philosophical (Wittgenstein, 1958) reasoning leave open the possibility that attempts to influence auditors’ behaviors through the mere imposition of rules will fail. Malsch and Gendron (2013, 870) describe the response behavior of accountants as “a series of more or less connected experiments in trying to extend their professional jurisdiction through institutional innovation, while seeking to consolidate the traditional foundations of their jurisdictional legitimacy through institutional reproduction.” In other words, while auditors may make adjustments to technically comply with

new regulations, their actions may not have any real substance.

This possibility is enforced by the results of studies investigating the impact of other recently enacted regulations on audit quality. For example, mandatory engagement partner rotation may negatively impact audit quality as a result of structural changes increasing the likelihood of partner relocation and travel (Daugherty, Dickins, Hatfield, & Higgs, 2012). The performance of non-audit services by auditors, *per se*, has no effect on audit quality (Lim, Ding, & Charoenwong, 2013). On the other hand, the PCAOB’s independent inspections of auditors appear to have enhanced audit quality (Carcello, Hollingsworth, & Mastrolia, 2011); as did the increased independence of audit committees (Hoitash & Hoitash, 2009).

Interestingly, recently-summarized results of PCAOB inspections indicate, “...audit deficiencies and the related deficiencies in engagement quality reviews continued to be high” (PCAOB, 2013, 6). Noted criticisms include failure of the EQ Reviewer to identify all significant engagement risks, including those associated with multi-location scopes and use of audit firm affiliates, and failure to verify that all procedures necessary to address audit risk were conducted by the engagement team. The PCAOB (2013) suggests that the root cause of these deficiencies may be attributed to: (1) insufficiency of documentation prepared by the audit engagement team of its procedures and conclusions, (2) inadequacy of time devoted by the EQ Reviewer, (3) improper timing of the EQR, and/or (3) unqualified EQ Reviewers.

In the face of this conflicting evidence, we investigate how changes in the nature, extent, and timing of EQRs required by AS No. 7 are perceived to have impacted audit quality. Although there have been a number of studies that investigate different aspects of the EQR process prior to the issuance of AS No. 7 (Schneider & Messier, 2007, provide a helpful summary), we are unaware of any published studies that specifically address changes in the EQR process since the implementation of AS No. 7, or AS No. 7’s potential impact on audit quality.¹

To answer this question and to provide additional insight about EQRs and alternative potential root causes to the PCAOB’s observed deficiencies, we surveyed audit partners experienced with EQRs about changes in the EQR process resulting from the implementation of AS No. 7.² Results suggest that AS No. 7 changed the role and approach of the EQ Reviewer. Prior to AS No. 7 the role of the EQ Reviewer was more likely to be described by auditors serving as both engagement partners and EQ Reviewers as that of a “team member” than as an “inspector”; and the approach of the EQ Reviewer was more likely to be categorized by these same partners as “consulting” than as “second-guessing.” Although these changes likely signal an

¹ We are, however, aware of an experiment-based study in process that aims at evaluating the *objectivity* of EQRs (Mueller et al., 2014). This study was funded by a grant from the Center for Audit Quality.

² We use this methodology due to the likelihood of confounding events (e.g., macroeconomic events, implementation of other standards) when attempting to evaluate changes in auditing quality comparing pre- and post-AS No. 7 periods.

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