



Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg

Research Report

A note on the effect of PCAOB inspections on the audit quality of triennial CPA firms



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ARTICLE INFO

Article history:
Available online 26 September 2014

Keywords:
PCAOB inspections
Audit quality
Triennial firms
Audit fees

ABSTRACT

This note reports the results of a study conducted regarding PCAOB inspections of triennial CPA firms. The purpose was to see if there was any evidence that inspections contributed to improved audit quality. It was found that small firms did not correct staffing deficiencies, which were related to previous audit deficiencies determined by the PCAOB. However, deficient firms did increase their audit fees significantly more following their first inspections than non-deficient firms. This result is consistent with applying greater audit effort after the inspection.

Interestingly, this response does not persist through second inspections.

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Introduction

Early studies examining the results of Public Company Accounting Oversight Board (PCAOB) inspections of small public accounting firms indicated that a major characteristic of firms that received an audit deficiency judgment was that they were over-extended.¹ By and large, these small firms had too many issuer clients – too much work – for the size of their staffs. After studying inspection results through July 2006, Hermanson, Houston, and Rice (2007) concluded that firms that had performed audits where the PCAOB had identified deficiencies in their engagements tended to be smaller, had more issuer clients, and were growing more rapidly than non-deficient firms.

If it is true that the size of the staff, the number of issuer clients, and the likelihood of being found deficient are related, then it seems reasonable to suppose that corrective action to reduce the number of issuer clients, or increase the number of staff, or both, would help improve the quality of these firms' audits by relieving a constraint on the number of audit hours available for issuer client engagements. Such action would be consistent with the notion that the inspection was instrumental in helping to improve the audit quality of triennial firms. Of course, relative staff imbalances could also be improved through redirecting effort from non-issuer clients to issuer clients, or by increasing the total hours worked on issuer engagements as well. This redirected effort would likely be reflected in increased fees for issuer clients; it would also be consistent with an improvement in audit quality following the inspection.

To determine whether PCAOB inspections helped to improve audit quality of small accounting firms, the inspection reports for 947 triennial firm-years between January 2004 and June 2012 were examined. The study first investigated whether the structural problems identified by Hermanson et al. (2007) continued to be an issue after 2006. The study then examined whether deficient firms improved their staffing relative to the number of issuer clients after their inspections, and finally examined audit fee

Note: The authors express their appreciation for the assistance of Dr. Gregory Jonas, Associate Professor, Case Western Reserve University, and assistant editor of *Research in Accounting Regulation*, for his assistance.

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¹ For convenience, firms that received an audit engagement deficiency judgment from the PCAOB during an inspection will be referred to as “deficient” firms, and those for whom the PCAOB did not identify any audit engagement deficiency as “non-deficient” firms. This use of the term should not be interpreted to mean the firm is deficient (or not) in any other sense.

<http://dx.doi.org/10.1016/j.racreg.2014.09.004>

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changes for both deficient and non-deficient firms after their first two inspections.

The results indicated that firms cited for having an audit engagement deficiency during their first PCAOB inspection had significantly fewer total staff relative to issuer clients than non-deficient firms. Moreover, deficient firms did not improve their relative staffing issues following the inspection. What they did appear to do was to redirect effort. It was found that deficient firms increased audit fees following their first inspection visits significantly more than non-deficient firms. Interestingly, the same increase was not found in audit fees for deficient firms following the second inspection visit. It can be concluded that these results are consistent with PCAOB inspections helping to improve the audit quality of small accounting firms, but that the greatest marginal improvement in audit quality occurred during the initial inspection, as the audit review paradigm was changing. By the time of the second inspection, many – perhaps most – firms had already changed their processes to the point that any additional changes resulting from subsequent inspections were not substantial enough to be observed in empirical tests of audit fees.

The rest of this note is organized as follows: firstly, a discussion of the rationale for the study; secondly, more information on the empirical tests and their results, and finally a conclusion discussing how these results can be of use to regulators or practitioners.

Rationale for the study

One of the principal objectives of the Sarbanes–Oxley Act of 2002 was to improve audit quality. Indeed, when the law established the PCAOB, it charged the new agency with the task of improving the quality of audits. Since its inspection process is arguably the Board's primary means of achieving that objective, it is important to evaluate whether PCAOB inspections are, in fact, helping to improve audit quality. This is especially true for small firms. Previous research into audit quality has shown, across various measures of audit quality, that small firms are associated with lower quality audits compared to large firms (see, for example, DeAngelo, 1981; Francis, 2004; Francis & Krishnan, 1999; Jackson & Liu, 2010; Palmrose, 1988; Simunic, 1980). Recently, Gunny and Zhang (2013) examined PCAOB inspection reports and found that for smaller firms, PCAOB inspections were effective in identifying lower-quality audits.² Of course, identifying audit engagement deficiencies and providing feedback during and after the inspection would be likely to help promote audit quality improvements, as the PCAOB suggests (PCAOB, 2012). Intuitively, this claim is appealing. But is there any empirical evidence that the audit quality of small firms actually improves after the inspection?

Audit quality is a difficult concept to measure. In this study, two measures were used, both related to audit effort.

² It is interesting to note that Gunny and Zhang (2013) do not find the same effectiveness for annually inspected firms. For that group, their results were conflicting and they conclude that the PCAOB inspections did not distinguish audit quality during their test period.

Hermanson et al.'s (2007) paper indicates that deficient firms were over-extended, so measures of relative staffing per issuer client were evaluated to see whether firms brought their staffing more in line with the needs of their issuer client base after an inspection. The logic here is that if the firm did not have adequate staffing to provide the audit effort required to perform a quality audit for its issuer client base, then increasing the available audit effort is a necessary, but not a sufficient, condition to improve audit quality. Thus, improved staffing metrics following an inspection would be consistent with a tangible effort to improve audit quality.

The second measure of audit quality used is audit fees. Previous research supports the use of audit fees as a proxy for audit quality. O'Keefe, Simunic, and Stein (1994) initially developed a theoretical model linking audit quality (the level of assurance) with audit effort (the levels of labor hours). Knechel, Rouse, and Schelleman's (2009) audit production model assumes that the more extensive the evidence-gathering activities are, the higher the audit quality will be, suggesting that as audit effort increases, the quality of the audit increases as well. Effort and quality have also been linked empirically. Bedard and Johnstone (2004) show that auditors plan more hours for clients with higher perceived risk of earnings management. Similarly, Lee and Son (2009) find that auditors who lengthened their audit work permitted less earnings management, and Caramanis and Lennox (2008) report a negative association between audit effort and abnormal accruals. Prior research also links audit fees and audit effort. Whisenant, Sankaragurusuvamy, and Raghunandan (2003), Blankley, Hurtt, and MacGregor (2012), Lobo and Zhao (2013), and Asthana and Boone (2012) all indicate that below-normal audit fees may be associated with shorter, lower quality audits. Thus, if deficient firms increase fees to a greater extent than non-deficient firms following an inspection, then that would be evidence suggesting the firm is increasing audit effort, and would be consistent with an attempt to increase audit quality.

The study

The study had three empirical tests. First, the audit firm staffing characteristics were evaluated to determine whether staffing was, in fact, associated with audit engagement deficiencies over the test period (2004–2012). Second, it was determined whether the deficient firms increased their relative staffing in an attempt to alleviate the constraints that existed. Finally, it was determined whether deficient firms increased audit fees following inspections more than non-deficient firms. A discussion on the sources of the study's data can be found below.

Data sources

The data includes information gathered from 1399 first and second PCAOB inspection reports on inspections conducted between January 2004 and June 2012 for triennial CPA firms. All inspection reports are publicly available from the PCAOB website. Inspection reports for firms that do not appear in *Audit Analytics* and those pertaining to third inspection visits were excluded. The resulting data set included 947 inspection reports of domestic small firms, of which 578

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