Do More Frequent PCAOB Inspections lead to Higher Audit Quality? Evidence from the Annual and Triennial PCAOB Inspection Reports.

By

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ABSTRACT

This study examines Public Company Accounting Oversight Board (PCAOB) inspection reports for audit firms that are inspected annually and compares them to PCAOB inspection reports for audit firms that are inspected triennially. The purpose of this study is to determine if the firms that are inspected more frequently have higher audit quality than do the firms that are inspected triennially. This study uses the number of serious deficiencies cited in the PCAOB inspection reports as a proxy for audit quality, with fewer or no serious deficiencies indicating higher audit quality. A sample is taken from triennial PCAOB inspection reports through June 10, 2010, while the entire population of annual PCAOB inspection reports is analyzed. The PCAOB issued its first inspection reports on August 26, 2004. The total population of inspection reports during this time period is 1,099 reports.

In addition to comparing audit deficiencies in firms inspected annually with deficiencies in firms that are inspected triennially, this study compares firms within categories. Frances (2004) states that the Big Four firms have higher audit quality than do smaller firms. Hermanson, et. al. (2007), found that the larger of the triennially inspected firms have fewer deficiencies when compared to smaller firms in the same category. This present study tests the belief that “bigger is better” by determining, within categories (i.e., annual, triennial), if size is significant with regard to audit quality.
INTRODUCTION

In the 1970s the accounting profession instituted a self-regulatory review system for the auditors of public companies (Gunny and Zhang, 2009). The American Institute of Certified Public Accountants (AICPA) required its members that issued audit reports for public companies to join the AICPA’s SEC Practice Section (SECPS) and undergo peer reviews every three years (Daugherty, et. al.).

The peer reviews were conducted by professionals who were themselves practicing auditors. The advantage of using other auditors to conduct the reviews is that the profession was using persons with current expertise in auditing to audit the auditors. The public perception, however, was one of a good old boy network where you scratch my back and I will scratch yours. The perception was such because the reviewers were not independent from the accounting profession. Another disadvantage was that the peer reviewers were often prohibited from reviewing actual audit work papers, which some believe severely limited the reviewers’ ability to thoroughly review and opine on the quality of audits being performed (Gunny and Zhang, 2009).

This system of self regulation in the accounting profession continued for several decades largely unchanged. There is some indication that by the 1990s, however, audit quality had declined (Frances, 2004). Then, in the year 2001, the Enron Corporation declared bankruptcy. One of the consequences of the Enron fraud, in addition to its devastating impact on the lives of many investors, employees, and retirees, was the indictment and resulting meltdown of the Arthur Andersen accounting firm. As a result of the Enron/Arthur Anderson scandal the US Congress addressed what it viewed as the shortcomings in the accounting profession. The law that was crafted to address Congress’ concerns is called the Sarbanes Oxley (SOX) act, which was signed into law on July 30, 2002 (Payne, 2003). Among the provisions of SOX is the creation of the Public Company Accounting Oversight Board (PCAOB). Henceforth, auditors that opine on the financial statements of public companies will be regulated by the newly-created Board. SOX requires auditors of public companies to register with the PCAOB. In turn, SOX requires the PCAOB to inspect such auditors, and if appropriate, discipline the auditors. The PCAOB, in effect, is tasked with auditing the auditors.
With regard to the PCAOB inspection process, the US Congress determined that there should be a difference in the frequency of the PCAOB’s inspections. Specifically, Congress through its enactment of SOX charged the PCAOB with inspecting large audit firms every year. The SOX act charged the PCAOB with inspecting small audit firms once every three years. SOX defined the two groups as follows. Large firms are those that regularly opine on the financial reports of more than 100 SEC issuers. Small firms are defined as those that opine on 100 or fewer issuers’ financial statements annually. For 2009, the most recent year for which data is available, the PCAOB reports that there were ten audit firms that met the large firm criterion (PCAOB.com). These ten large firms, therefore, must be inspected annually. The remaining firms, some 840, are inspected on a triennial basis.

This present study follows the work of Payne (2003) in which he looks at the effect of frequency of inspections on audit quality. Payne used a simulation with college students as participants. (He did not examine directly the AICPA’s peer review system or the PCAOB’s inspection process.) Some participants in Payne’s experiment played the role of auditors and others portrayed clients. Payne analyzed the behavior of the participants and noted the clients were willing to pay higher audit fees if the auditor was peer reviewed annually rather than triennially. Further, Payne observed that clients were willing to pay higher fees if the auditors who were reviewed triennially had their review more recently than others who had their review not as recently (but still within the three year period). However, the “clients” had access to the full inspection reports (peer reviews) that were performed on the prospective auditor. The peer review reports, apparently, were emphasized as being an important quality factor in auditor selection and auditor fees.

A limitation of the Payne study, in addition to it being a laboratory experiment that did not examine actual PCAOB inspection reports, is that the clients were given the full peer review reports. In reality, actual auditing clients have access to only portions of the PCAOB inspection reports. Thus, the information contained in the inspection reports that was provided to the participants in Payne’s experiment may have been more informative, and thus may have affected the participants’ judgment differently, than actual PCAOB inspection reports might affect the judgment of actual audit clients.
MOTIVATION

The motivation for this study is to continue the dialogue, begun by Payne in 2003, of the effect of frequency with regard to inspections of auditing firms on audit quality. This problem is important because there may be public policy implications if the body of research suggests that more frequent inspections lead to enhanced audit quality. Specifically, perhaps the guidelines in Sarbanes Oxley (SOX) for when an audit firm should be inspected will be modified. Now there are only 10 firms that are inspected annually by the PCAOB. The 10 firms opine on financial statements of more than 100 public companies and as such are subjected to the annual inspections. Perhaps the criterion for firms qualifying for annual inspections will be lowered so that more firms are inspected annually. A result of any such modification would mean that a larger number of public companies will be audited by firms that are inspected by the PCAOB every year, rather than by firms that are inspected once every three years.

Further, this study’s focus on PCAOB inspection reports, rather than using a laboratory experiment or conducting an examination of the self-regulated peer review system under the AICPA, may be significant because the PCAOB focuses on inspecting the auditors of public companies. Specifically, there may be a greater need for higher quality audits of public companies because there is usually a greater distance between the owners and the managers of the issuing companies (Francis 2004), when contrasted with non-public companies. Thus, this study’s examination of the frequency of PCAOB inspection reports with regard to its effect on audit quality is significant and will add unique information to the literature. Regulators, investors, the capital markets, board members, and the auditing profession will benefit from this research.

Further, this study goes beyond examining perceived audit quality and examines actual audit quality as determined by the deficiencies reported by the PCAOB. This present study builds on the work of Payne (2003) by examining the effect of frequency of inspections on audit quality. However, it contributes uniquely to the literature in that it examines actual PCAOB inspection reports to determine if the effect of the frequency of the inspections is statistically significant with regard to its ability to signify audit quality. This study examines a random sample of triennial PCAOB inspection reports issued from August 26, 2004 (the date the PCAOB issued its first reports).
through June 10, 2010. It examines the entire population of annual inspection reports. The total population of both report types is 1,099 inspection reports.

**HYPOTHESES DEVELOPMENT**

**Null Research Hypothesis:**

There is no difference in audit quality between the auditors that are inspected annually by the PCAOB when compared to the audit quality of auditors that are inspected triennially by the PCAOB.

Research suggests that the self-regulated peer review process as conducted under the auspices of the AICPA is effective at signaling audit quality (Casterella, et. al., 2009; Hilary and Lennox, 2005; Lennox and Pittman, 2008). Studies that examine the effectiveness of inspections conducted under the auspices of the PCAOB, however, indicate the results are mixed in regard to their ability to signal audit quality, with some studies confirming their ability to signal audit quality (Gunny and Zhang, 2009) and others unable to find evidence of their ability to signal audit quality (Lennox and Pittman, 2010). None of the studies, however, measure the effect of frequency of examinations under the AICPA’s peer review process or under the PCAOB’s inspection regime in either’s ability to indicate audit quality.

One study (Payne, 2003) broached the subject of frequency by using a laboratory environment to simulate the effect of the frequency of peer reviews on perceived audit quality. Payne concluded that more frequent peer reviews, and/or more recent peer reviews within a triennial period, do in fact signal higher audit quality. In his interesting experiment, Payne demonstrated that more frequent inspections, and more recent inspections administered under a triennial regimen, signal audit quality. However, Payne administered a laboratory experiment to university students. This study proposes to use actual PCAOB inspection reports to determine if more frequent inspections indicate higher audit quality.
Further, DeFond (2010) suggests that “…PCAOB Inspections potentially impact auditors’ incentives [toward providing high quality audits] p. 1). Thus, it stands to reason that more frequent inspections might provide more incentives for the auditors to provide higher quality audits. Thus, Research Question one:

**Research Question 1:**

Do annual PCAOB inspection reports indicate higher quality audits than do triennial PCAOB inspection reports?

**Research Questions 2 and 3:**

According to Frances (2004), the Big Four auditing firms provide higher quality audits than do the smaller firms. This study seeks to examine if there is a difference within the largest firms (i.e., within those firms inspected annually by the PCAOB) with regard to audit quality. Hermanson, et. al., (2007) initially found that among the triennially inspected firms, those that are smaller have more audit deficiencies. This study seeks to build upon Hermanson, et. al.’s 2007 work and determine, within the broad range of firms that are inspected triennially, if there is still a difference in audit quality based on firm size. That is, that within their respective categories (large or small), do the largest firms have the highest audit quality. Thus, Research Questions 2 and 3 are as follows:

**Research Question 2:**

Within those firms that are inspected annually, do the larger of the annually inspected firms have higher audit quality than do the smaller annually inspected firms?

**Research Question 3:**

Within those firms that are inspected triennially, do the larger of the triennially inspected firms have higher audit quality than do the smaller firms?
Research Questions 4, 5, and 6:

The assumption underlying this study is that the number of serious audit deficiencies found in PCAOB inspection reports is a proxy for audit quality. Thus, fewer serious audit deficiencies in the PCAOB inspection reports indicate higher audit quality. Gunny and Zhang (2009) found that lower audit quality is consistent with seriously deficient PCAOB opinions. Gunny and Zhang (2009) distinguish between serious and minor audit deficiencies in the PCAOB inspection reports because they indicate that the PCAOB may be under pressure to not issue clean inspection reports. Therefore, the PCAOB may be inclined to find the audit firm deficient on minor matters. Thus, Gunny and Zhang examine only serious deficiencies.

PCAOB inspection reports contain one of four possible outcomes: 1) no audit deficiencies, 2) minor audit deficiencies, 3) serious audit deficiencies, or 4) some combination of minor and serious audit deficiencies. An inspection report with no audit deficiencies is self explanatory. Minor audit deficiencies may include items such as “failed to perform sufficient substantive tests.” There is some speculation that PCAOB investigators are under pressure to discover and report even minor deficiencies. Thus minor deficiencies may not indicate poor audit quality. Serious audit deficiencies relate to the auditors “failure to identify a departure from GAAP” and/or that a particular deficiency resulted in a “restatement” of the financial statements, we classify these deficient opinions as seriously deficient opinions” Gunny and Zhang (2009) page 13.

This present study will distinguish between serious and minor deficiencies in its analysis. Thus, Research Question 4:

Research Question 4:

Is there a difference in audit quality when comparing annually inspected firms to triennially inspected firms when examining all audit deficiencies?

Research Question 5:

Is there a difference in audit quality when comparing annually inspected firms to triennially inspected firms when examining only minor audit deficiencies?
Research Question 6:

Is there a difference in audit quality when comparing annually inspected firms to triennially inspected firms when examining only serious audit deficiencies?

The Sarbanes Oxley Section 104 definition of firm size will be used to distinguish between large firms (annual) and small firms (triennial). Specifically, the large firms are those that “regularly provide audit reports for more than 100 issuers” (PCAOB web site). The small firms are those that have 100 or fewer issuing clients. For 2009, there were 10 firms that qualified as large and therefore undergo annual PCAOB inspections.

METHODOLOGY

Statistical hypothesis testing will be utilized to address the research questions. Samples of PCAOB inspection reports from firms that are required to undergo triennial inspections. The entire population will be analyzed for firms that are required to undergo triennial inspections. The analysis will utilize descriptive statistics and an inferential statistical comparison of the two groups. I will analyze a random sample of PCAOB inspection reports from August 26, 2004 through June 10, 2010. The population is 1,099 inspection reports.

Controls will need to be made for client size and client profitability. (Hermanson, et. al., 2007).

Controls for size of the auditor, Large v. Small; and, the number of clients and offices PCAOB inspects for a big firm v the number of clients they inspect for a small firm.

The specific data needed for this study are contained in the PCAOB Inspection Reports. The reports are publically available. Most data will be derived from the Reports’ Part I, INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS Item A. Review of Audit Engagements. The data are available on the PCAOB’s web site.
As of May 11, 2010 there were 2,457 public accounting firms registered with PCAOB (PCAOB web site). The PCAOB does not regularly inspect all 2,457 firms. Rather, of the total registered, some 850 firms issue audit reports opining on the financial statements of public clients. Of the 850 public accounting firms, 10 are inspected annually and some 840 are inspected triennially. The ten large firms are inspected annually because the PCAOB inspects annually any public accounting firm that regularly issues audit reports on more than 100 public companies (issuers). The remaining 840 public accounting firms are inspected triennially because PCAOB’s charge is to audit triennially any firm that audits 100 or fewer issuing clients. The 840 firms fall into this category.

Table 1.

<table>
<thead>
<tr>
<th>Public Accounting Firms Registered with PCAOB</th>
<th>Number</th>
<th>Percent of</th>
</tr>
</thead>
<tbody>
<tr>
<td>As of May 11, 2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Registered Public Accounting Firms</td>
<td>2,457</td>
<td>100.0%</td>
</tr>
<tr>
<td>Total Firms That Provide Audit Reports on Issuers</td>
<td>850</td>
<td>34.6% 100.0%</td>
</tr>
<tr>
<td>Inspected annually – Provide Audit Reports on more than 100 issuers</td>
<td>10</td>
<td>0.4% 1.2%</td>
</tr>
<tr>
<td>Inspected triennially – Provide Audit Reports on 100 or Fewer issuers</td>
<td>840</td>
<td>34.2% 98.8%</td>
</tr>
</tbody>
</table>

For 2009, there were 10 firms that qualified as large and therefore undergo annual PCAOB inspections. According to the PCAOB’s web site, the ten large firms for 2009 were: BDO Seidman, LLP; Crowe Horvath LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; Malone & Bailey, PC; McGladrey & Pullen, LLP; PricewaterhouseCoopers LLP; Tait, Weller & Baker, LLP.
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