

Or Closer Inspection

BY / JUSTIN WALKER

STUDY TAKES A HARD LOOK AT THE EFFICACY OF MEASURES MEANT TO ENSURE PUBLIC COMPANY AUDIT QUALITY.

You might remember a social media trend from a few years ago where parents filmed their child's response to temptation. The parent instructed the child not to eat the food placed in front of them, while the child was left to decide to listen or not with the parent waiting in anticipation in the next room.

The cute and often funny videos highlighted examples of a regulatory relationship. Although no serious consequences came from disobeying, that is not the case in real-world settings, especially in public company auditing.

Michael Mowchan, an assistant professor of Accounting and Business Law at the Hankamer School of Business, investigated the regulatory relationships between the Public Company Accounting Oversight Board (PCAOB) and public company auditing in the paper, "Does PCAOB Regulatory Enforcement Deter Low-Quality Audits?" published in *The Accounting Review*.

MICHAEL MOWCHAN

“Are firms responding to sanctions within their own firm or are they responding to competitors within their local market?”

“The PCAOB has argued that they deter low-quality audits among non-sanctioned groups,” Mowchan said. “But in 2019, a Project on Government Oversight report said the PCAOB was a ‘toothless body of law.’”

This sparked Mowchan, along with Phillip T. Lamoreaux of Arizona State University and Wei Zhang of the University of Massachusetts Amherst, to study whether PCAOB governance prevented low-quality audits—misstatements identified through subsequent financial statement restatements.

“We looked at enforcement broadly,” Mowchan said. “Are firms responding to sanctions within their own firm or are they responding to competitors within their local market?”

Mowchan and the research team hand-collected all PCAOB enforcement actions from the organization's website from 2005 through 2015, identifying the involved audit firm, the penalties imposed and the geographic location of each audit office. They examined whether audit quality improved among non-sanctioned auditors following the public revelation of these actions.

The team's findings fell somewhere in the middle of the conversation, Mowchan said. They did not observe a general deterrence across the board following all enforcement actions, but the size

and location of the firm did make an impact. The team split non-sanctioned audit firms into groups based on whether they were the same size as the sanctioned firm and whether they were in the same Metropolitan Statistical Area (MSA)—a large city and its suburbs.

Mowchan and the team found that small firms are less likely to produce low-quality audits following repercussions to a similarly sized firm within their MSA. Large firms, however, do not respond based on geography, but due to sanctions of another office within their own firm.

“These findings, to some extent, silence some of the critics of the PCAOB,” Mowchan said. “It is constrained to a geographic region, and occasionally within a firm, but at least they are doing something to deter low-quality audits on a broader perspective.”

Mowchan also noted the interesting result that press coverage impacted a non-sanctioned firm's response.

“We found when those PCAOB enforcements received more coverage in the media, there was a stronger reaction from those non-sanctioned auditors as well,” he said.

Since the study entered the review process, Mowchan has seen a lot of changes from the PCAOB. Fines have increased in recent years, and he suspects it is the board's way of addressing the previous criticism.

“What we are seeing now is the PCAOB realizing they may not have the clout they were claiming to have, but now they are going to enforce even more,” he said. “They will create more enforcement actions than before, and that will lead to larger magnitude penalties.”

Building from this research, Mowchan is interested in examining the individual partner's response to sanctions, investigating the social networks that exist from office to office and firm to firm.

“We are potentially going to look at how the social networks for those individuals that are sanctioned can impact perceptions of another partner's audit quality,” he said.

There are significant implications for the general public from low-quality audits, Mowchan said. It is essential for accountants to exercise great care in their work, he said, because when they don't and a big scandal occurs, the financial markets can be significantly impacted.

“From a societal standpoint, auditors are doing work to help the financial markets run smoothly,” he said. “Hopefully, that work prevents any large financial scandals in the future.”

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