Should auditors be reviewed by peers or should the state do it?

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Financial reporting and auditing are vital elements for global capital markets. The confidence in the financial market's efficiency is bolstered by the trust placed in auditing being able to operate as an external controlling function, something that has led to the audit profession being perceived as the "guardians of truth in markets". However, concerns over the guardians' trustworthiness are raised on a regular basis every time it emerges, in the face of serious accounting scandals, that the audit profession has remarkably failed to meet society's expectation.

On this view, the so-called peer reviews (firm-on-firm reviews) and government inspections are seen as pivotal instruments for restoring the necessary trust in auditing. In short, peer reviews and government inspections are modes of external quality control that aim at assessing whether audit firms have developed appropriate quality control policies and procedures, and whether these are implemented in compliance with professional accounting and auditing standards.

Over the last decade, the audit profession has been directly responsible for safeguarding audit quality through firm-on-firm peer reviews. Yet, the pendulum has swung away from self-regulation towards state actors playing a more active role, a trend that was initiated at the beginning of this century, when the detection of massive accounting frauds, that were not revealed by the firms' audit firms, severely put the public's belief in professional self-regulation to the test. As a direct consequence, the European Union, starting from 2006, has passed various regulatory reforms, requiring European Member States to introduce "independent audit oversight systems", including inspections for audit firms with public interest clients.

It is often argued that the change from self-regulation to government inspections represents a trade-off of expertise for independence because government inspectors are perceived as being more independent but lacking sufficient accounting skills. In my paper, I investigate whether the shift from self-regulation to government regulation can be supported through research findings. In other words, I have taken the freedom to find fault with the guardians' guardians by acting as their guardian myself.

The analysis compares the research findings on the former U.S. self-regulatory peer-review system and the literature on the current government inspections under the Public Company Accounting Oversight Board (PCAOB), the latter being the independent regulator in the U.S. (i.e. the U.S. equivalent to the Financial Reporting Council in the U.K.).

The analysis shows that critics of the professional self-regulatory peer review system are not entirely unfounded as multiple studies revealed that peer review results were significantly affected by the characteristics of the reviewing firm. The findings demonstrate that reviewing firms were more likely to issue unfavourable review opinions if they were a direct competitor of the reviewed audit firm, and that audit firms strategically changed their reviewer after unfavourable review outcomes. Yet, synthesising the research on the regulatory regimes suggests that both peer reviews and government inspections improved overall audit quality. However, the analysis indicates that external users, such as financial investors or audit committees, do not seem to recognise peer review and PCAOB reports as helpful tool in financial decision-making, which is in line with an identified rather skeptical perception of the audit profession itself on reviews and inspections.

From my analysis, it emerges that increased regulation (both through peer reviews and inspections) particularly impacts the segment of small auditors. As a direct consequence of the PCAOB inspections, almost half of the small audit firms left the audit market in the U.S. Similar effects can be observed in various European countries, thereby contradicting one of the main objectives of the European regulatory reforms, which was to break up the dominance of large audit firms over the accounting industry.

Overall, my paper reveals that whether government regulation has decreased the risk of major accounting scandals is still to be shown. The impact of government inspection on large audit firms, commonly referred to as the "Big 4", is not straightforward. This is because of two main reasons.

First, the debates on audit regulation tend to focus on the question of *who* is controlling the quality, rather than *how* it is controlled. As government inspections are not much different than the review procedures, the risk of "creative-compliance" exists, a term that refers to the practice of complying with rules by box ticking, rather than taking substantive organisational steps. I therefore argue that both policy makers and researchers have to move beyond the classical dichotomy of self-regulatory reviews versus government inspections, and to concentrate more on the potentials of *process modifications* of external quality controls.

Second, regulatory failure needs to be separated from the organisational failures of regulated parties. In other words, a late train does not necessarily indicate poor railway regulation. In the end, it is the individual audit firm that determines audit quality. It is important to assess the intra-organisational learning processes subsequent to an audit inspection.

In my paper, I identify a gradual improvement in review and inspection results over time. But can we really link these results to an *actual* improvement of audit quality? An alternative explanation might be that the inspection philosophy shifted over time or that audit firms have become better prepared for the inspections by providing more attention to issues that are common targets for inspection or by "stylising" working papers to appease inspectors. Thus, although literature suggests that the results for an audit firm improve with the number of reviews and inspections, the organisational learning process is unknown, and *whether* and *how* internal audit procedures are adjusted within audit firms is still unclear. Thus, we still need to investigate whether and how government inspections processes change, shape, and eventually improve the audit practices of audit firms, as this still remains unfathomable.

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Notes:

- *This post is based on the author' paper From peer review to PCAOB inspections: Regulating for audit quality in the U.S., Journal of Accounting Literature, June 2016.*

- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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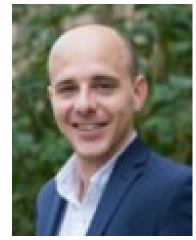

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