

## Guarding The Guards: Rethinking The PCAOB Review Function

by Miklos Vasarhelyi, Michael Alles and Alexander Kogan

As the PCAOB sets its agenda for 2005, it is time to stop and consider the best use it can make of the power granted it to conduct reviews of the audit industry. The reviews are conducted by auditors drawn from the same firms as the ones they are examining, trained in the same traditional methodologies, and one has to fear that this will lead to a failure in imagination and innovation in how the PCAOB conceives of the role of the review process.

In August the PCAOB released the first set of annual reviews of audit firms as mandated by the Sarbanes-Oxley Act: an examination of 16 engagements from each of the Big 4 audit firms. While fault was found with each firm, the errors were relatively minor, either being immaterial departures from GAAP, or the failure to perform certain tests. That no previously determined audit opinion was affected by the review is not surprising given that samples were drawn from engagements the firms had already reviewed themselves.

The PCAOB has chosen to rely on sample engagement audits, which it hopes will pinpoint failures in the audit firm's procedures and policies. The engagement-focused approach can certainly lead to some useful information about how the audit firms are operating, but how much is learned clearly depends on how the sample is chosen. Engagements that are the subject of firm review are inherently problematic and high risk, but it is questionable that the majority of audit failures are with such engagements which are already subject to closer scrutiny. The best candidates for fraud are more likely in those quiet, routine accounts that are considered too dull for an auditor to worry too much about – consider that the misrepresentation of expenses as assets at WorldCom far exceeded the total liability at Enron with its sexy special-purpose entities, or SPEs.

By inspecting engagements the PCAOB will help firms do those engagements better, but the approach is not explicitly designed to improve the 95% of audits that will not be inspected, and provides no protection for the industry if one of those unexamined engagements ends in a spectacular failure.

By contrast, consider the basis of Section 404 of the Sarbanes/Oxley Act which requires managers to certify as to the effectiveness of the company's controls with the auditor and attest to the certification. A glaring absence from Sarbanes-Oxley is a 404-type requirement on audit firms' controls on their own audit engagements. The PCAOB could fill that gap by focusing its review on the audit firms' control system itself, rather than on completed engagements. The point is to help the firm improve how it does an audit in the first place rather than to catch one that's been badly done. There is no reason why the preventive rather than corrective approach – which underlies Total Quality Control in manufacturing – cannot be applied to auditing.

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Inspections can serve as a deterrent to badly conducted audits, an approach that may appeal to a public burned by the Arthur Andersen meltdown. But deterrence only works if it is credible, and one has to question whether there remain too few audit firms to allow any one of them to fail, thus constraining what the PCAOB can do as a result of its reviews. If the PCAOB cannot realistically de-register one of the Big 4, or even publicly reveal information that could lead to a crippling lawsuit, then the reviews are equivalent to an audit in which both the auditor and the manager know that at the end of the day a qualified opinion will not be issued.

Another credibility problem facing the PCAOB is how, given the staff and resources at its disposal, it can review some 650 engagements, as it proposes to do in 2005, as opposed to the 16 it did in 2004.

The new review process is also little different from the old and reviled peer review system that it replaced, despite the fact that the PCAOB has far more legal authority to demand access and cooperation from the firm than peer reviewers ever did. This indicates a fundamental problem with the PCAOB approach: it is simply trying to do the old peer reviews better, rather than starting from scratch and asking what the optimal method of assuring auditing is.

Such reengineering would begin with technology, which, if allied with the new requirements for comprehensive documentation by both firm and auditor could lead to the creation of a vast store of digitized audits. Sophisticated audit tools could then be applied against this data set to provide real time monitoring of audit procedures and to develop models of emerging audit failures. This approach would give the PCAOB a major new capability: benchmarking across audit firms, something it could use to find discrepancies and best practices. Ideally a credible review system would comprise close to real time monitoring incorporating business rules based on statistical analysis and profiles of audit failures which would issue alarms as audit failures occur.

Finally, recall that an auditor checks whether a firm has prepared income in accordance with GAAP, but the auditor is not responsible for developing GAAP itself. By contrast, the PCAOB both audits auditors and now also has the duty to develop audit standards. This suggests that reviews should provide a mechanism to understand and improve the way in which auditing takes place, something which cannot happen if the reviews use traditional methodologies and thus perpetuate the current

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