Post-Implementation Review of AS 1220, Engagement Quality Review

Introduction

The PCAOB is committed to robust economic analysis, including post-implementation reviews of new or amended rules and standards. The objective of the PCAOB’s post-implementation review program is to evaluate the overall effect of a rule or standard after a reasonable period of time has passed since its effective date. This includes:

- Evaluating whether the rule or standard is accomplishing its intended purpose, as identified in the rulemaking release;
- Identifying, wherever possible, costs and benefits; and
- Identifying unintended consequences.

PCAOB staff have completed a post-implementation review of AS 1220, Engagement Quality Review. The review of AS 1220 is the PCAOB’s first post-implementation review. To perform the review the staff analyzed information collected through the PCAOB’s inspection and enforcement programs, third-party data and responses to a public request for comment.

The review allowed us to achieve certain objectives. In particular, the review provided new evidence related to the impact of AS 1220. The review also demonstrated, however, a need for us to enhance PCAOB procedures, data and techniques in advance of conducting future post-implementation reviews. These enhancements will include an earlier identification of data needs and a more proactive approach to external engagement.

Background on AS 1220

For audit engagements under PCAOB standards, AS 1220 requires an engagement quality review (“EQR”) and the engagement quality reviewer’s concurrence to the issuance of an audit report. In the EQR process, the reviewer should evaluate the significant judgments made by the audit engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report. The reviewer may provide concurring approval of issuance only if, after performing the review with due professional care, he or she is not aware of a significant engagement deficiency.

The PCAOB adopted the standard to increase the likelihood that auditors will identify significant engagement deficiencies before issuing their audit reports. To achieve this objective, the PCAOB made a number of changes to the predecessor standard, including changing the EQR process and the requirements for reviewer qualifications.
Results

The staff’s review of AS 1220 provides new insights into changes in EQR practices and audit quality over time, but does not provide causal evidence regarding the impact of the standard. For example, the evidence indicates that engagement quality reviewers have greater involvement earlier in the audit process, and that audit firms have reassessed their EQR assignment practices. The staff’s review also provides some evidence of improvements in audit quality after the effective date of AS 1220. Additionally, the evidence indicates that the standard did not give rise to significant unintended consequences. In terms of direct costs, although engagement quality reviewers, on average, spend more time performing their reviews in the post AS 1220 period, increases in reviewer hours are, overall, very small relative to average total audit hours.

Improvements in Audit Quality

Audit partner interviews and responses to a public request for comment indicate that audit quality improved after the effective date of AS 1220. Empirical results from examining longer-term trends in audit and financial reporting quality, such as financial statement restatements, also indicate some improvement post-AS 1220. These results, however, are likely driven by more general changes in the accounting and auditing environment rather than by AS 1220.

Insignificant Changes in Direct Costs

On average, engagement quality reviewers spend more time performing their reviews post-AS 1220 than before the effective date of the standard. For audits performed by large and small domestic audit firms, the data suggests an increase of up to 28 percent and 23 percent (16 hours and 4 hours per engagement), respectively. Relative to average total audit hours, the increases are small as reviewer hours comprise only 1 percent and 3 percent of total audit hours, respectively. Results of empirical analysis also indicate that AS 1220 is not associated with an increase in audit fees. This result is unsurprising given that engagement quality reviewer hours represent only a small portion of total audit hours. The result is also consistent with interviews of audit firm partners where only one of 74 partners interviewed recalled discussing fee increases specifically related to AS 1220.

Changes in Audit Firm and Engagement Quality Reviewer Behavior

Audit firms and engagement quality reviewers have made changes to their EQR practices. These changes may be driven not only by AS 1220 but also other factors, including the impact of the PCAOB inspection program. For example:

- Engagement quality reviewers have slightly increased their involvement earlier in the audit in the post-AS 1220 period. One of the key changes made in AS 1220 is the requirement that the reviewer evaluates the significant judgments made by the engagement team that relate to engagement planning. For the sample of PCAOB-inspected issuer audits of large domestic firms, the average proportion of reviewer hours
spent in the preliminary review and planning phases of the audit increased from approximately 11 percent before AS 1220 was effective to 13 percent after its effective date. In addition, results indicate a similar, although smaller, increase in the proportion of reviewer hours spent in the interim phase of the audit after the effective date of AS 1220. The available data does not allow a similar analysis for small domestic audit firms.

- The variation in engagement quality reviewer hours decreased in both large and small domestic audit firms in the post-AS 1220 period, perhaps suggesting a more consistent approach by reviewers to EQRs.

- Large domestic audit firms have changed their EQR assignment practices. In particular, some large domestic firms took steps to reassess the size of the partner pool performing EQRs or changed the number of EQR assignments given to each reviewer, or both. Large domestic firms have continued to make further changes to EQR assignment practices well into the post-AS 1220 period.

- In interviews, audit practice leaders of large domestic audit firms maintained that they hold reviewers more accountable for deficient EQRs post-AS 1220. Empirical analysis also finds that, on average, at large domestic firms there are some consequences for reviewers associated with AS 1220 inspection findings. Leaders of some small domestic firms indicated that AS 1220 has not led to significant changes in the way their partners are evaluated.

Use of Outside Reviewers

Among small domestic audit firms, in general, the use of engagement quality reviewers from outside the firm issuing the audit report is associated with fewer review hours than the use of reviewers from within the firm. In addition, when an audit team uses a reviewer from outside the firm, empirical findings indicate a higher likelihood of restatement and PCAOB inspection findings, as compared with the use of a reviewer from within the firm.

Impact of PCAOB Oversight

The PCAOB’s efforts to improve audit quality are multifaceted; standard-setting is only one part of the overall approach to improving audit quality. The evidence indicates that changes in EQR requirements, coupled with a focus on AS 1220 by PCAOB inspectors, may have impacted positively the incentives to audit firms and reviewers to comply with the standard as well as the incentives to engagement teams to perform high quality audits. For example, data collected through PCAOB oversight activities indicates that engagement quality reviewers increase their hours subsequent to PCAOB inspection findings. PCAOB and SEC enforcement actions involving violations of AS 1220 could also impact how audit firms approach EQRs, especially among smaller firms. From 2011 to 2016, 45 settled and litigated PCAOB and SEC enforcement actions involved violations of AS 1220 in approximately 200 issuer audits. None of these actions related to an EQR performed on an issuer audit client of a large domestic audit firm.
Messages for Auditors and Audit Committees

The PCAOB reiterates to auditors and audit committees the importance of having an EQR performed by a qualified reviewer who appropriately evaluates the significant judgments made by the engagement team, including the assessment of, and audit responses to, identified significant risks in an audit. Analysis of PCAOB inspection data suggests that, on average, the time spent by the engagement quality reviewer as well as the reviewer’s seniority and industry experience are all associated with improved audit quality.1

Enhancements to Achieve More Effective Reviews

In the future, the PCAOB intends to better leverage economic analysis in setting auditing and related rules and standards. Post-implementation reviews of new or amended rules and standards that better leverage data from our oversight activities and input from our stakeholders play an important role in ensuring that our standards framework remains effective. The staff’s review of AS 1220 resulted in the identification of several opportunities for enhancing future reviews. In particular:

- Analysis of the impact of AS 1220 was limited by data availability. For future reviews, the PCAOB will work with inspected firms and further engage our stakeholders (e.g., through surveys and other outreach) to gather data needed to evaluate the overall effect of a rule or standard.

- As in other studies of the impact of regulatory changes, the PCAOB encountered significant challenges in establishing causation and quantifying the incremental effects of AS 1220. Some of these challenges stem from how AS 1220 was implemented (effective at a single point in time for all registered firms rather than in phases). Where appropriate, the PCAOB will consider alternative implementation schemes for new or amended rules and standards, including phased implementation schedules, which can assist in measuring impact.

Further Information

Further details regarding the review of AS 1220, including technical details of the statistical analyses, are presented in a separate staff white paper. The white paper provides additional transparency into the staff’s approach to the review, properties of the data sets used, the methods applied, and results of the analyses.