

## A New Sheriff In Town

Research by SMU Assistant Professor Tracey Zhang is revealing the progress of a new breed of audit regulators.

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AsianScientist (Jul. 9, 2015) - By David Turner - Like clean air and drinking water, we take reliable financial information for granted until we taste the unpleasant consequences of a polluted source. Rarely does the limelight fall on those who make our complacency possible—the humble auditor.

Auditors check company financials for ‘pollutants’ such as fictitious sales and hidden liabilities so they can tell investors whether the financial statements are true and fair. This indirectly makes investing in a company an act of trust in the auditor, but what happens when auditors do not live up to this faith?

Witnessing trust drain from the accounting profession during the Enron accounting scandal showed the perils of failing to watch the watchmen, says Assistant Professor of Accounting (Education) Tracey Zhang from the Singapore Management University (SMU) School of Accountancy.

“The Enron scandal shocked me as an accounting student,” recalls Professor Zhang, who was studying for her PhD degree at the University of California-Berkeley when news broke that audit firm Arthur Anderson was implicated in US energy company Enron’s massive accounting fraud.

“My lectures were held in an auditorium named after Arthur Anderson. I had never imagined that this global giant could collapse overnight but that was exactly what happened.”

## **Accounting reform after the Enron scandal**

Professor Zhang watched with fascination as the US authorities scrambled to restore trust through a slew of accounting reforms, including the establishment of the Public Company Accounting Oversight Board (PCAOB), to set watch over the auditors. Legislators armed the PCAOB with unprecedented inspection powers to scrutinise the audit profession's work, which until then had remained unregulated despite its importance and a spotted record.

Professor Zhang observed that this record showed a repeating pattern, going back to the 1970s, when waves of scandals were followed by moves to improve standards.

“But these efforts rested on market incentives and presumed that accounting firms competed on audit quality,” she explains. “The failures suggested otherwise and so the government had to act.”

Like the PCAOB, a new breed of audit regulators sprang up around the world. However, just like the market, they faced the challenge of tackling the abstract notion of audit quality. Regardless of the hours spent scouring through a company's financials and questioning management, an audit's only tangible outcome is a single piece of paper. Although auditors must comply with rigorous standards, the actual process is complex and involves a significant degree of professional judgment. How then do we tell whether auditor watchdogs are barking at the wind or sniffing out real problems that could lead to audit failure?

Professor Zhang's research tackles precisely this problem by examining the financial statements of companies whose auditors had undergone PCAOB inspections. She studied two groups—large audit firms that the PCAOB inspects annually due to their significant coverage of the capital market, and smaller firms that the PCAOC inspects every three years.

Among small audit firms, those with poor PCAOB records were more likely to have clients with faulty audited financial statements. Their financial statements had significantly higher abnormal current accruals and needed to restate their financials more often—issues which a good audit should prevent.

At the same time, results for the large audit firms were inconclusive for a variety of reasons says Professor Zhang.

“While we found that the ‘Big Four’ do have higher quality, none of them earned a clean PCAOB report, because their importance to the market means the PCAOB has to be tough on them. And with so many clients, you would expect that some audits might have deviated from the standards.”

## **Assessing the impact of audit regulation**

Even if an audit regulator were to strike its target, whether its assessment reverberates through the market and promotes audit quality is another question. Directors and investors tend to be more interested in auditors' final endorsements rather than the audit process. At the other end of the spectrum, there is also the possibility that audit firms might downplay the PCAOB's findings.

Encouragingly, a second study by Professor Zhang and her colleagues found that clients were much more likely to dismiss auditors with deficient PCAOB reports and appoint auditors with clean PCAOB records.

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“This suggested that companies wanted to employ higher quality auditors to show investors that the company was well-audited,” says Professor Zhang.

This was especially so when the audit client had good reasons to work harder to retain investor trust. The most significant factor in whether a company cast off their deficient auditor was found to be the presence of an independent and expert audit committee, suggesting that expertise is critical to interpreting the PCAOB’s signals and taking appropriate action.

## **Challenges to understanding the audit market**

Gaining an understanding of the market for audit services is particularly challenging, says Professor Zhang, as there are only four large audit firms and a few medium-sized firms around, with the remainder being very small firms. “The challenge is to obtain clear evidence to point the way forward,” she says.

With audit regulators being the new kids on the block in financial regulation, Professor Zhang says she feels optimistic about the progress and contributions of her research.

“Our research has captured evidence that audit regulation works and that it sends a powerful signal.”

Her motivation to continue researching into audit regulation also stems from its importance to a large swathe of society.

“As academics, we sometimes delve deeply into a narrow issue, but audit regulation affects every industry. Financial statements determine what society sees as worth investing in, so when they are wrong everybody suffers.”

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