financial reporting? As the dust of controversy begins to settle, some new research raises doubts.

Sep. 23, 2019

It has proved to be one of this century's most contentious issues in accounting regulation: Should the U.S. follow the example of various other nations in requiring companies to disclose not only the firms that perform their audits but the identity of the lead engagement partner overseeing the job?

First proposed by the Public Company Accounting Oversight Board (PCAOB) in 2009, the idea was strongly opposed by the accounting profession, and it was not until January 31, 2017, after several iterations and compromises, that a regulation went into effect. While it does not mandate identifying lead engagement partners in companies' annual reports, as originally proposed, it does require doing so

Association, finds the regulation's effect to be meager. In the words of the study, results "for eight of nine dimensions of audit quality are not statistically significant, suggesting that trends in quality surrounding January 31, 2017 are not convincingly attributable to the adoption of Rule 3211."

Collaborating on the research were Lauren M. Cunningham of the University of Tennessee, Chan Li of the University of Kansas, Sarah E. Stein of Virginia Tech, and Nicole S. Wright of James Madison University.

Paradoxically, despite lack of evidence that the much-contested regulatory initiative made a difference, audit quality showed improvement during the period surrounding its implementation. In the words of the study, "results indicate that several of the proxies of audit quality...increased in the first year of Rule 3211," which was a continuation of a similar improvement in the prior year. The finding of general improvement matches the conclusion of a paper in the current issue of *Auditing: A Journal of Practice and Theory*, also published by the American Accounting Association, which finds "in the first year of the disclosure requirement ...a significant increase in audit quality."

But, when the authors of the *Accounting Review* study investigate further, their findings suggest that whatever improvement may have been occurring had little, if anything, to do specifically with Rule 3211. They determine this by some ingenious analysis that involves making use of two control groups of publicly traded audit clients. One group (the "early discloser sample") consists of S&P-1500 companies that disclosed audit engagement partners at their annual meetings and on their Web sites in the year prior to Rule 3211. A second group (the "pseudo adopter sample") consists of all companies that issued their annual reports in the months prior to January 31, 2017 and therefore did not have to identify the lead engagement partners overseeing their audits.

The professors' reasoned thus: If the new rule spurred a boost in audit quality, that

attributable to Rule 3211."

The study employs three principal proxies of audit quality that are favored in the accounting literature – 1) amount of discretionary accruals, non-cash accounting items that are often subjective (such as predictions of future write-offs for bad debts or estimates of inventory valuations) and are considered particularly subject to manipulation; 2) F-scores, measures of companies' propensities to misstate earnings; and 3) mistaken assessments of firms' internal controls over financial reporting. To enhance the robustness of their findings, the professors add six further proxies, only one of which (a measure of timeliness in recognizing expenses and losses) appears to have been significantly improved by the new regulation. In sum, eight of nine measures do not show significant improvement.

Why such meager enhancement in audit quality attributable to Rule 3211, at least in the early stages of its implementation? The professors suggest two possibilities:

"First, accounting firms argued that partner accountability was already sufficiently high prior to mandatory disclosure, such that partner identification would not induce additional improvements to audit quality. Second, the final adoption of Rule 3211 required audit partner disclosure in Form AP, which…may not pervasively affect partners' sense of accountability as the PCAOB originally intended."

They add this caveat: "Since our research focuses on the initial adoption of mandatory audit partner identification in the U.S.…future research is necessary to investigate the long-term effects of this regulation…[As] each audit partner's entire public company portfolio will be accessible to all interested parties …important unanswered questions relate to whether this increased transparency informs decisions by investors and audit committees or influences audit partner behavior."

As for why audit quality should have increased during the period of Rule 3211's

organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Auditing: A Journal of Practice and Theory, Accounting Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Journal of Information Systems, Journal of Financial Reporting, The Journal of the American Taxation Association,* and *Journal of Forensic Accounting Research.*

Accounting • Auditing • PCAOB • Technology