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Report of the President

By Kathryn Kadous



Hello everyone! I hope that summer is treating you well and that you are getting caught up on work and maybe even enjoying a day off here and there. I would like to thank you again for giving me the honor of serving as your president. This is my last presidential letter. As of August, I'll leave the section in Scott Vandervelde's capable hands. Scott has a lot of energy and enthusiasm for the office, and I'm sure he has great things planned for next year.

It's been summer for a while already in Atlanta, so I am really looking forward to attending the Annual Meeting in temperate San Francisco, CA in August. The theme for our meeting is "Bold Transformations toward a Prosperous Society." The Annual Meeting Planning Committee, consisting of Scott Bronson, Tamara Lambert, Joe Schroeder, and Karen Ton (Directors) and Stephen Perreault, Miguel Minutti-Meza, Sarah Stein, and Jonathan Shipman (Vice Directors), have been working for months to put together an outstanding program for the Auditing Section. Please thank them if you see them at the meeting! Our Auditing Section luncheon will be held on Monday, August 12th. John King, Assurance Vice-Chair for EY, will be our speaker. I look forward to seeing you there.

Here are a few updates of activities that our friends and colleagues have been working on.

Center for Audit Quality (CAQ).

The CAQ's [Access to Audit Personnel \(AAP\) Request for Proposals](#) for data collection in Summer 2020 is now available on the CAQ's website. Proposals are due by February 6, 2020. This program is designed to assist scholars in obtaining access to auditor participants for their experimental/behavioral research. Please see the RFP for specifics on submission requirements and evaluation criteria.

The [2019 AAP grant recipients](#) were announced in April. Additionally, in May, the CAQ's Research Advisory Board awarded [five grants to fund independent academic research](#) on projects of interest to the auditing profession. The list of grantees can be found on the CAQ website. The RFP for the 2020 grant year has not yet been released.

CAQ Research Feedback Session

The Center for Audit Quality is once again holding a Research Feedback Session for auditing researchers. You can receive feedback from senior audit practitioners and gain new perspectives that may help in refining and further developing your research question. A similar session held at the 2019 AAA Auditing Section MYM was well received by those who were able to take advantage of it. The next session will be held virtually (using Zoom Video Conferencing) in late October.

The CAQ will be accepting applications via email between **Monday, July 1 – Friday, September 13th at 8:00 pm EDT.**

- Submit a request expressing interest to research@thecaq.org.
- Include a draft of your Kinney Three Paragraphs (up to two pages). *Requests that do not include a Kinney Three Paragraphs write up will not be considered.*
 - You may also include up to three questions you would like the practitioners to be prepared to answer.
- Space is limited, so researchers will be chosen via a lottery
- Participants will receive a confirmation email by **Wednesday, September 18, 2019.**

For additional information please contact Lauren Tuite (ltuite@thecaq.org) or visit <https://www.thecaq.org/virtual-research-feedback-session/>

2020 Auditing Section Midyear Meeting

Even though it is only June, planning for the 2020 Midyear Meeting has already begun. Pennie Bagley, Allen Blay, and Marlene Willekens, Program Co-Chairs, are excited about the meeting venue in Houston, TX, and they're working hard to make the meeting a great experience for all of us. Look for the upcoming calls for submissions and for volunteers. Please volunteer as a reviewer and take the time to provide thoughtful and valuable feedback to your colleagues on their research.

Auditing Section Presidential Transition

The Annual Meeting is the time when the Section officers and other committee positions transition. Scott Vandervelde, Vice-President, Academic and incoming President, has completed the staffing of the Section committees, and the committee chairs are busy planning their activities for the new academic year. The Executive Committee would like to thank all of the volunteers who served on committees this past year, as well as those who have volunteered for the coming year. The audit section could not do all that it does without your generous and enthusiastic support. Thanks for all of your valuable time and hard work!

I would like to personally thank Rick Hatfield for serving as VP-Academic, President, and Past-President over the past three years. Rick has worked tirelessly and effectively on behalf of the Section and has graciously answered all of my frantic questions during this time. In addition, I would like to thank Chad Stefaniak for serving as Treasurer for the past two years. As many of you know, the AAA and the section have experienced some financial turmoil recently, and Chad's proactive and diligent leadership on financial issues was instrumental to putting us on a path towards solvency again. I cannot say enough

about the dedication of these individuals and how much they do on behalf of the Section and our profession. I am honored to have served on the Executive Committee with them and am better off for their friendship. I hope you take the time to thank these individuals for their service. The Section will be in good hands this coming year as Scott Vandervelde transitions into the role of President. Becky Sproul (KPMG) continues as Vice President-Practice; Marsha Keune continues as Secretary, Randy Elder continues as Council Representative; and Mark Taylor continues as Historian. New members of the Executive Committee include Keith Jones as Vice President-Academic and Tina Carpenter as Treasurer.

Thanks again to the many individuals who contribute to the mission of our Section. Enjoy the rest of your summer and I look forward to seeing you in San Francisco.

PCAOB Update

Megan Zietsman – PCAOB Acting Chief Auditor, Jennifer Rand – PCAOB Deputy Chief Auditor and Elena Bozhkova – PCAOB Assistant Chief Auditor

Introduction

This Update addresses select PCAOB developments since the Spring 2019 Update that are likely to be of interest to accounting and auditing researchers, educators, and students. The developments include:

- PCAOB Staff Guidance on Critical Audit Matters (CAMs),
- PCAOB/AAA Annual Meeting,
- Webinars on CAMS,
- PCAOB Conference on Auditing and Capital Markets,
- Staff Preview of 2018 Inspection Observations,
- New Liaison for Investors, Audit Committees, and Preparers,
- Staff Guidance on PCAOB Rule 3536,
- PCAOB Staff Changes,
- Updates to the Data and Technology Project Page,
- New PCAOB Chief Economist, Director of Economic and Risk Analysis,
- Settled Disciplinary Order.

PCAOB Staff Guidance on Critical Audit Matters (CAMs)

On March 18, 2019, the PCAOB released three staff guidance documents developed to support implementation of the new CAM requirements; on May 22, 2019, a fourth guidance document was released. The four documents provide proactive, timely, and useful information on CAMs to auditors and other interested parties and include:

- The Basics – a high-level overview of CAM requirement,
- Staff Observations from the Review of Audit Methodologies – thematic observations that arose from the Office of the Chief Auditor’s review of audit firms’ CAM methodologies,
- A Deeper Dive on the Determinants of CAMs, and
- A Deeper Dive on the Communication of CAMs.

These documents were informed by discussions with auditors regarding their experiences conducting dry runs of CAMs with their audit clients, the staff’s review of methodologies submitted by 10 U.S. audit firms that collectively audit approximately 85% of large accelerated filers, and other outreach efforts.

The Board and staff will continue to monitor CAM implementation and determine if further guidance is needed.

The staff guidance documents are available on the new auditor's report implementation page at:

<https://pcaobus.org/Standards/Implementation-PCAOB-Standards-rules/Pages/new-auditors-report.aspx>.

PCAOB/AAA Annual Meeting

On April 4-5, 2019, the PCAOB held its fifteenth annual meeting with the Auditing Section of the American Accounting Association. The meeting was attended by approximately 120 academics.

The meeting started with an interactive session with the PCAOB Board members. The Office of the Chief Auditor (OCA), the Division of Registration and Inspections (DRI), and the Division of Enforcement and Investigations (DEI) each had a session to discuss the activities of the division, as well as address takeaways for the classroom and specific areas where academic research would be useful.

The agenda also included panels on Research Implications for the Quality Control (QC) Standards and Implementation of Critical Audit Matters. The QC panel included three academics who discussed specific implications for the PCAOB's QC research project from academic research. The CAMs panel discussed the new CAM requirements and implementation activities of OCA, DRI, and the Office of Economic and Risk Analysis regarding CAMs.

Webinars on CAMS

In April and May 2019, the PCAOB held three webinars on the implementation of the new CAM requirements. The webinars covered CAM determination, communication, and documentation requirements, as well as other considerations relevant to CAM requirements. Each webinar lasted approximately 75 minutes and covered the same material.

A recording of the webinar and the related slides are available on the new auditor's report implementation page at:

<https://pcaobus.org/Standards/Implementation-PCAOB-Standards-rules/Pages/new-auditors-report.aspx>.

PCAOB Conference on Auditing and Capital Markets

The PCAOB, in conjunction with *The Accounting Review*, announced plans for its sixth annual 2019 Conference on Auditing and Capital Markets. The conference will be held in Washington DC on October 17-18, 2019. Conference organizers are W. Robert Knechel, University of Florida, and the PCAOB Office of Economic and Risk Analysis.

The conference organizers encourage submissions that can inform the Board's efforts to promote continuous improvement in the quality of audit services. The paper submission deadline is July 31, 2019.

More information about the topics, paper submission details, and program committee members is available at:

<https://pcaobus.org/EconomicAndRiskAnalysis/Conference/Pages/2019-Conference-on-Auditing-and-Capital-Markets-and-Call-for-Papers.aspx>.

Attendance is free and by invitation only. Academics interested in receiving an invitation should contact the conference organizers at ERA@pcaobus.org.

Staff Preview of 2018 Inspection Observations

On May 6, 2019, the PCAOB posted to its website the Staff Preview of 2018 Inspections Observations. This staff preview includes, for the first time, good practices regarding efforts to improve audit quality. It also addresses areas of common deficiencies, observations on technology, and implementation of new accounting and auditing standards and rules. The preview includes observations of U.S. and non-U.S. audit firms, inspected both annually and triennially.

Highlights of good practices observed include:

- Expanding accounting and revising training programs,
- Establishing a network of specialized professionals to address emerging risks.

Areas of deficiencies observed in 2018 include:

- Internal Controls over Financial Reporting and Revenue Risk Assessment,
- Accounting for Estimates, such as Allowance for Loan and Lease Losses.

The staff preview is available on the PCAOB's web page at:

<https://pcaobus.org/Inspections/Documents/Staff-Preview-2018-Inspection-Observations.pdf>

New Liaison for Investors, Audit Committees, and Preparers

On May 29, 2019, the PCAOB announced that Erin Dwyer had been named deputy director of the Office of External Affairs to serve as the direct point of contact for and liaison to investors, audit committees, and preparers.

As outlined in its 2018-2022 Strategic Plan, the PCAOB is committed to advancing its engagement with investors, audit committees, and preparers. This newly-created role will be dedicated to expanding outreach to and events for these key stakeholders.

More information about Ms. Dwyer's background can be found at:

<https://pcaobus.org/News/Releases/Pages/new-liaison-investors-audit-committees-preparers-Erin-Dwyer.aspx>.

Staff Guidance on PCAOB Rule 3526

On May 31, 2019, the PCAOB posted to its website staff guidance on PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. The guidance provides background on Rule 3526 and technical guidance for auditors on the independence-related communications required by the rule. Additionally, the PCAOB posted an overview document that summarizes the staff guidance for audit committees, investors, and other interested parties.

The guidance and the overview documents are available at:

<https://pcaobus.org/Standards/Documents/Staff-Guidance-Rule-3526%28b%29-Communications-Audit-Committee-Concerning-Independence.pdf>

<https://pcaobus.org/Standards/Documents/Overview-Staff-Guidance-Audit-Committee-Communications-Related-Independence.pdf>.

PCAOB Staff Changes

In June 2019, the PCAOB announced that the following staff members are leaving the PCAOB:

- Patricia Ledesma, Acting Director and Chief Economist, Research and Economic Tools, in the Office of Economic and Risk Analysis,
- Andres G. Vinelli, Chief Economist, Standards and Risk Assessment, in the Office of Economic and Risk Analysis.

More information about their accomplishments and backgrounds can be found at:

<https://pcaobus.org/News/Releases/Pages/acting-director-office-economic-risk-analysis-patricia-ledesma-leave-PCAOB.aspx>

<https://pcaobus.org/News/Releases/Pages/Andres-Vinelli-leave-PCAOB.aspx>.

Updates to the Data and Technology Project Page

On June 5, 2019, the PCAOB updated the Data and Technology web page with information on the project's objective, background, and status. The update includes details about staff activities and the Board's Data and Technology Task Force.

The updated Data and Technology web page is available at:

<https://pcaobus.org/Standards/research-standard-setting-projects/Pages/data-technology.aspx>.

If interested, you can sign up to receive email updates on PCAOB research, standard-setting, and implementation projects at:

<https://pcaobus.us10.list-manage.com/subscribe?u=124c85b50a8374f0468d767b1&id=6529ce9373>

New PCAOB Chief Economist, Director of Economic and Risk Analysis

On June 17, 2019, the PCAOB announced that Dr. Nayantara Hensel has been named the PCAOB's Chief Economist and the Director of the Office of Economic and Risk Analysis. In this role, Dr. Hensel will advance the organization's economic analysis, research programs, and risk and other policy analysis. This research and analysis will inform PCAOB activities, including standard-setting, inspection, and enforcement, to achieve the most effective outcomes to further investor protection and enhance audit quality.

More information about Dr. Hensel's background can be found at:

<https://pcaobus.org/News/Releases/Pages/Nayantara-Hensel-named-PCAOB-Chief-Economist-Director-Economic-and-Risk-Analysis.aspx>.

Settled Disciplinary Orders

In the period from March through June 2019, the PCAOB posted several settled disciplinary orders.

The orders are available on the PCAOB's web page at:

<https://pcaobus.org/Enforcement/Decisions/Pages/default.aspx>.

Auditing Standards Board Update

Audrey Gramling

Oklahoma State University

The ASB has been quite busy since the last two meetings I discussed (October 2018 and January 2019) in *The Auditor's Report*.

The ASB met in Nashville, TN from May 20-23. Topics discussed included:

- Materiality Definition,
- Audit Evidence,
- Other Information,
- Estimates,
- Attestation Standards,
- Employee Benefit Plan Auditor Reporting,
- Auditor Reporting (800 Series),
- Risk Assessment.

You will find a high-level 3-page summary of the discussion related to these topics at:

<https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/asb/documents/mtg/1905/2019-05-asb-mtg-high-level-summary.pdf>

Two notable highlights of the meeting, for which I provide classroom applications, include the ASB voting to ballot for exposure a proposed SAS *Audit Evidence*, which would supersede AU-C section 500, *Audit Evidence*, and the ASB voting to issue a proposed SAS and a proposed SSAE, both titled *Amendments to the Description of the Concept of Materiality*, for exposure.

The exposure draft on audit evidence sets out characteristics of information to be used as audit evidence including its source, relevance, reliability, and whether the information corroborates or contradicts the assertions in the financial statements. The attributes and factors used to evaluate whether information to be used as audit evidence are presented in a diagram in the proposed SAS. In a graduate classroom setting, I have had class discussions centered on this diagram – whether the diagram is complete, helpful to the auditor, presented in an appropriate manner, and more (including whether the diagram is the right shape!). I invite you to do the same, as I anticipate that you and your students will find the discussions to be involved, insightful, and maybe even entertaining. I have even had a couple students propose alternative diagrams to what is included in the proposed SAS. You can find the diagram in paragraph 5 of the proposed standard, which is available at:

<https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/asb/documents/mtg/1905/2019-05-asb-item2b.pdf>

The exposure draft on materiality proposes to eliminate inconsistencies between the description of materiality in AICPA Professional Standards and the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators. I have developed a graduate classroom application related to this exposure draft, which requires students to read the Background section of the exposure draft (pages 6 to 12 of the exposure draft that can be found at:

<https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/asb/documents/mtg/1905/2019-05-asb-item1a.pdf>).

The Background section provides a thorough discussion of the history of the term “materiality.” In teams, students then prepare a brief video in which they provide guidance to the ASB on the issues raised in the exposure draft and other issues, including whether the materiality definition should be changed, whether audit practice will change if the definition changes, and how the change aligns with the ASB’s strategic initiative to converge with international standards. (The ASB’s 2012 Strategic Plan is available at:

<https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/asb/downloadabledocuments/asb-strategic-plan-june-2014.pdf>.)

The summer meeting of the ASB is July 22-25, 2019, in Dallas, Texas. You can find agenda items for that meeting at:

<https://www.aicpa.org/research/standards/auditattest/asb/201907-asb-meeting-agenda-materials.html>.

Have you Seen...?

Lindsay M. Andiola, Virginia Commonwealth University

Candice Hux, Northern Illinois University

James D. Whitworth, University of South Florida

“How do Audit Offices Respond to Audit Fee Pressure? Evidence of Increased Focus on Nonaudit Services and their Impact on Audit Quality.” By Eric Beardsley, Dennis Lassila and Thomas Omer. *Contemporary Accounting Research* 36 (2): 999-1027.

Taking a different perspective on consulting (non-audit) revenues, this study considers whether unexpected changes in audit fees at the office level are associated with a spike in non-audit services provided to attest clients. Establishing fee-type substitution, the authors next test whether audit quality declines in the presence of both fee pressure and an increase in consulting services, finding evidence that supports this conjecture. A series of nuanced and interesting sensitivity tests follow, delving into whether both sets of main findings are driven by larger local offices (relative to smaller local offices) and Big 4/non-Big 4 differences, then trying to disentangle office size from firm size (i.e., most Big 4 offices are larger than the overall sample median). The study acknowledges the significant limitation that consulting (non-audit) fees to non-attest clients are not publicly available.

“An Investigation of Auditors’ Judgments when Companies Release Earnings before Audit Completion.” By Lori S. Bhaskar, Patrick E. Hopkins and Joseph H. Schroeder. *Journal of Accounting Research* 57 (2): 355-390.

This study investigates whether auditors’ judgments are affected by the differential timing of firms’ annual earnings releases and firms’ financial statement audit completion. The authors draw on motivated reasoning theory to predict that client pressure from earnings released *prior* to audit completion will lead auditors to adopt directional goals consistent with the clients’ aggressive accounting treatment, leading to lower-quality judgments. They also posit that this effect could be mitigated by the extent of the audit committee’s involvement. They conduct an experiment with 114 highly experienced auditors where they manipulate the timing of the annual earnings release relative to the completion of the audit and the audit committee effectiveness. They find that releasing earnings before audit completion pressures auditors to adopt the goals of management, thereby reducing the likelihood of postannouncement audit-adjustment recommendations. Yet, this negative effect on auditors’ judgments is mitigated when the audit committee is actively involved in resolving accounting issues. These findings suggest potential unintended consequences of early earnings releases and the role high-quality audit committees can play in mitigating adverse effects of client pressure on auditor judgments.

“Auditor Sensitivity to Real Earnings Management: The Importance of Ambiguity and Earnings Context.” By Benjamin P. Commerford, Dana R. Hermanson, Richard W. Houston and Michael F. Peters. *Contemporary Accounting Research* 36 (2): 1055-1076.

This study examines how auditors respond to real earnings management (REM), which is an ambiguous strategy management can employ to meet or beat earnings expectations. The authors administer a 3x2 between-subjects experiment with 113 highly experienced auditors, where they vary the ambiguity associated with REM at three levels (explicit REM, potential REM, and no REM) and whether the client’s

earnings beat or missed the analysts' forecast. Using correspondent inference theory, they predict that REM causes auditors to make inferences about management tone based on management's behavior, and perceptions of weaker management tone will affect auditors' actions and judgments. Additionally, the earnings context will be used as a signal of management's intent to commit REM, and this will vary under the different REM settings. They find that in the explicit REM setting, auditors focus on management's perceived intent, not whether REM helps management beat the forecast target. Auditors' responses to potential REM depend upon the earnings context, responding to potential REM only when the client beats the forecast target. Mediation analysis shows that REM affects auditors' discussion with the audit committee and client continuance decisions indirectly through management's tone. Overall, the results suggest that auditors view REM as a signal about management's operating style and integrity.

“Evidence of Industry Scale Effects on Audit Hours, Billing Rates, and Pricing.” By Simon A. Dekeyster, Ann Gaeremynck, and Marleen Willekens. *Contemporary Accounting Research* 36 (2): 666-693.

The authors utilize a proprietary data set of private company audits from one Big 4 firm in Belgium to examine efficiency gains realized with industry expertise and how those gains are distributed (between client and auditor). The authors find an efficiency increase with greater industry expertise in the local auditor office in the form of reduced audit hours in the aggregate, as well as at the partner and staff level, and that the reduced hours do not impair audit quality. This reduction in hours is entirely passed on to the client in the form of reduced fees, as auditor industry experience does not significantly impact audit fees. However, this fee reduction (passing of efficiency gains to the client) lessens as the auditor's market power in the industry increases.

“Do Accounting Firm Consulting Revenues Affect Audit Quality? Evidence from the pre- and post-SOX Eras.” By Ling Lisic, Linda Myers, Robert J. Pawlewicz, and Timothy A. Seidel. *Contemporary Accounting Research* 36 (2): 1028-1054.

The authors examine the impact of auditor's consulting fees on audit quality. Critically, the authors utilize consulting fee data at the audit *firm* level, where publicly-traded clients are not required to disclose consulting fees paid to CPA firms that are not also performing their audit. The authors find a negative significant association between audit quality and consulting fees pre-SOX, but that association becomes insignificant post-SOX despite the well documented increase in consulting fees overall. Interestingly, investor perceptions appear to mirror this finding, as the earnings response coefficient decreased with consulting revenues pre-SOX, but post-SOX no significant association was found between firm level consulting fees and the earnings response coefficient.

“PCAOB Inspections: Public Accounting Firms on “Trial”.” By Kimberly D. Westermann, Jeffrey Cohen, and Greg Trompeter. *Contemporary Accounting Review* 36 (2): 694-73.

This study explores the effectiveness and impact of the PCAOB's inspection process from the auditors' perspective. The authors surveyed 55 auditors (staff through partner) and interviewed 20 experienced auditors (i.e., partners and senior managers) from the Global 6 firms with varying degrees of inspection experience. They find that auditors perceive the inspection process as a “trial”, where the inspectors (e.g., sometimes referred to as the judge or jury) have significant power over the auditors. These “trials” produce stress and fear among auditors, and they are motivated to pass the inspection. In response to and to mitigate future negative inspection outcomes, firms strategize which engagements or audit areas will be the focus of inspectors. Auditors have also modified their approach to auditing, where auditors are perceived to adopt defensive documentation approaches to mitigate inspection comments rather than performing thoughtful auditing. While PCAOB inspections are perceived to have improved audit quality, some respondents suggest that PCAOB inspectors put undue emphasis on low risk areas. This

encourages auditors to shift more focus to regulatory or inspection risk versus client risk. Lastly, the heavy scrutiny of the inspection process (i.e., sometimes the risks are greater than the rewards) and perceived loss of personal autonomy about the audit process also affects who stays in the profession.