Evaluation of the Evolution of the PCAOB Inspection Reports

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Abstract
Since the execution of Sarbanes-Oxley Act and the creation of the Public Company Accounting Oversight Board (PCAOB) in 2002, there have been many attempts in securing financial reporting of issuing registered firms and the audit quality of public accounting firms. One such attempt is the introduction of the inspection program by the PCAOB. In this inspection program, assessments of the design and operating effectiveness of a firm’s quality control policies and their performance in selected audit engagements are written in inspection reports available to the public. This study focuses on reviewing the development of these inspection reports since its initial implementation of inspections in 2003 and aims to provide detailed information about the inspection process and reports, in general, the content of these inspection reports, and its progress from 2003 until the most recent available reports today for better enlightenment for those who share an interest in auditing and the rest who may benefit from it.

1. Introduction

1.1 Background
Public accounting firms must comply with certain rules and regulations for auditing financial reports. According to the Auditing Standard (A.S. 1 1001), the objective of the ordinary audit of financial statements by the independent auditor is “the expression of an opinion on the fairness, with which they present, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.” Hence, the job of an auditor is to look into financial statements of companies to see if they comply with set regulatory standards. For any business investor to better assess risk and make better decisions with investing in a company, an auditor’s assessment of the company is significant.

1.2 Significance of the Study
All public accounting firms within the United States must register under the Public Company Accounting Oversight Board (PCAOB). By doing so, the Board is able to provide inspection reports among these registered firms. This is important to assess the degree to which each registered firm and its associates comply with regulations in connection with the performance of audits, the issuance of audit reports, and other related matters regarding public companies.

1.3 Objectives
This study seeks to inform about the PCAOB inspection reports, in general, and how they have evolved. The specific objectives of the study are:
1. To evaluate the development of inspection reports from the practice’s initial implementation to how it is currently being conducted based on factors that influence changes; and,
2. To present and discuss the varying issues public firms have been subjected to why inspection reports have since then mattered.

1.4 Scope and Limitations
This study evaluates the progress of the inspection reports conducted from public accounting firms under the PCAOB. Registered public accounting firms that have been inspected by the Board from June 2004 until 2016 are considered for the study. The number of participating firms varies from year to year since the inception of the inspection report program, causing certain limitations in the information provided in this study. This study primarily consists of reports presented by the Board and secondary research conducted by other researchers and thus limited only to the scope of such reports and research.

For the purpose of conducting this research on the evolution of inspection reports, valuable information from various resources and related articles have been collected presenting relevance on the progress of the PCAOB inspection reports. Based on the actual findings from the reports and statements documented and reported by the PCAOB, the facts are presented and discussed for factors influencing the developments in the inspection process and reports.

2. Review of Related Literature

2.1 Sarbanes-Oxley Act of 2002
The Sarbanes-Oxley Act was enacted in July 2002 in response to corporate scandals during that period, which had a huge negative economic impact. It led major changes to the regulations of corporate governance and financial practice.

The act created the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of accurate, and independent, audit reports for companies the securities of which are sold to, and held by and for, public investors. The act also mandated all individuals providing audit reports to any issuer to be registered in the Board.

2.2 Securities and Exchange Commission
The mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

According to the SEC, all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so as long as they hold it. The SEC requires public companies to disclose meaningful and other information to the public.

When Congress created the PCAOB, it gave the SEC the authority to oversee the PCAOB’s operations, to appoint or remove members, to approve the PCAOB’s budget and rules, and to entertain appeals of PCAOB inspection reports and disciplinary actions.

2.3 The Public Company Accounting Board
Under the SEC, the PCAOB is a private-sector, nonprofit corporation that governs accounting firms that provide audit services to public companies.

The Board’s responsibilities include registering public accounting firms; establishing auditing, quality control, ethics, independence, and other standards related to public company audits; enforcing compliance with Sarbanes-Oxley; and, conducting inspections, investigations, and disciplinary proceedings of registered accounting firms. This study now focuses on the inspection reports required by the PCAOB.

3. Methodology

Under the mandated program, the PCAOB inspects an accounting firm either annually or triennially. If an accounting firm provides audit reports for more than 100 issues, the PCAOB will provide annual inspection. If an accounting firm provides for 100 or fewer issues, the Board does a triennial inspection, an inspection done once every three years.

The inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include evaluations of the design and operating effectiveness of a firm’s quality control policies and of the firm’s performance in selected audit engagements.

4. Results and Discussion

Based on the overall findings of the Board stated in the “Report Dr-08-2012 Inspections of Smaller CPA Firms That Audit 100 or Fewer Public Companies,” the percentage of audit deficiencies for inspected firms between 2007 to 2010 has a significant audit performance deficiency compared to about 65% of those inspected from 2004 to 2006. In 2010 alone, triennial firms found with deficiencies has about 51% which declined to 45% in 2011. This shows that audit deficiencies are decreasing, which suggests that inspections help improve audit quality.

5. Summary and Conclusion

There are various factors that affect the quality of inspections in inspection reports. These factors include whether the firms were considered to be annually or triennially inspected reporting the structure of an accounting firm being inspected, the size of the firm based on the number of locations and partners, and the number of auditors actually inspected in each report; the pervasiveness of audit deficiencies such as those that involve auditing of revenue recognition, fair value measurements, of accounting estimates, or all risk in fraudulent material misstatement; and, the common occurring deficiencies of quality control such as fraud detection, misstatements in financial statements and risk assessments. These factors are continually being monitored, improved and investigated by the PCAOB in its inspections. These are reasons to believe the quality of audit performed by accounting firms are gradually being corrected each period that passes. The timeline below shows a synopsis of events that have transpired throughout the years of implementing inspections.

6. References


