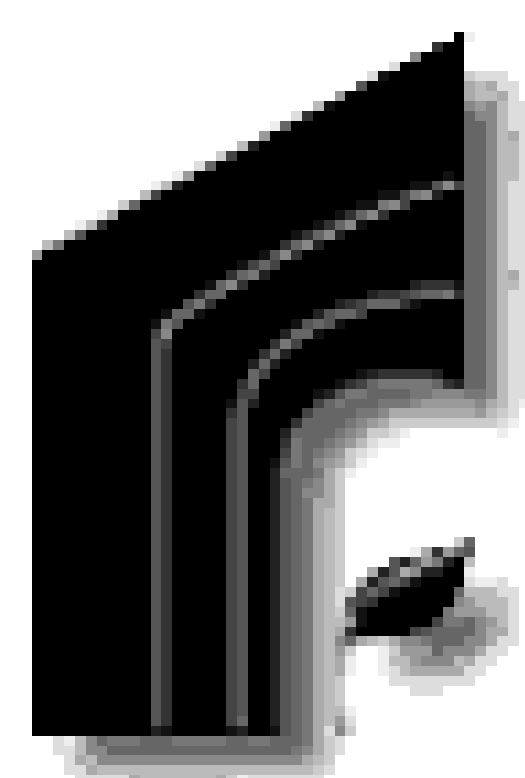
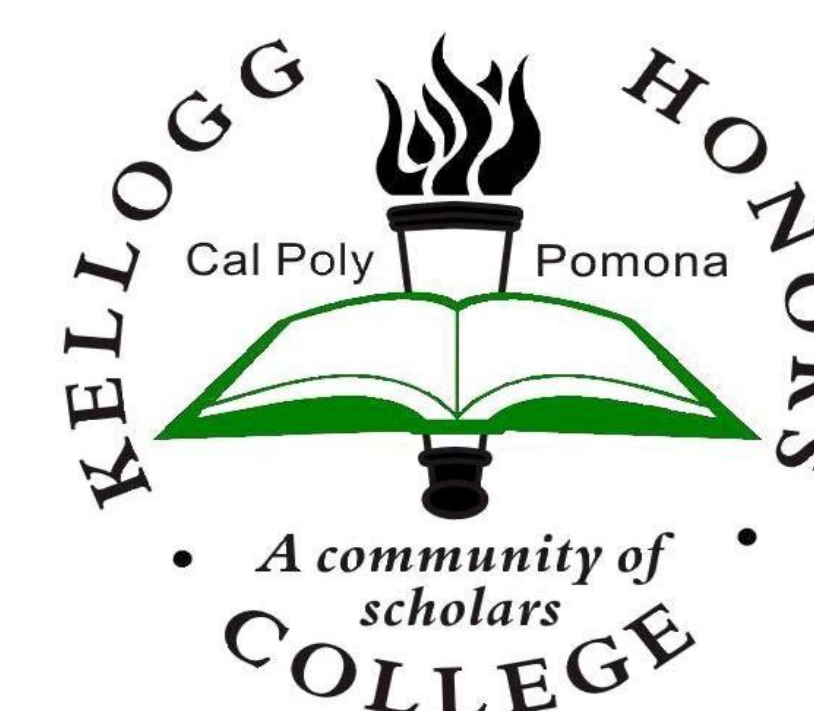


# Evaluation of the Evolution of the PCAOB Inspection Reports



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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 researching the development of these inspection reports since the 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.) 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 its 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 years 2004 until 2016 are considered for this study. The number of participating firms varied 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.

### 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 regulation 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 informative, 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 long as they hold it. The SEC requires public companies to disclose meaningful financial 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 Oversight 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 relating 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

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.

### 4. Results and Discussion

Figure 1: Firm Details from An Inspection of Aaron Stein, A Triennially Inspected Firm

PART I INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS	
Members of the Board's inspection staff ("the inspection team") conducted fieldwork for the inspection from January 18, 2005 to January 20, 2005. The fieldwork included procedures tailored to the nature of the Firm, certain aspects of which are summarized as follows:	
Number of offices	1 (Woodmere, New York)
Ownership structure	Sole practitioner
Number of partners	1
Number of professional staff <sup>1</sup>	None
Number of issuer audit clients <sup>2</sup>	3 <sup>3</sup>

Figure 2: Firm Details from An Inspection of Moss Adams, LLP

PART I INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS	
Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from October 21, 2013 to November 1, 2013. These procedures were tailored to the nature of the Firm, certain aspects of which the inspection team understood at the outset of the inspection to be as follows:	
Number of offices	24 <sup>1</sup>
Ownership structure	Limited liability partnership
Number of partners	262
Number of professional staff <sup>2</sup>	1,213
Number of issuer audit clients <sup>3</sup>	83

### Inspection Reports

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 issuers, the PCAOB will provide annual inspection. If an accounting firm provides for 100 or fewer issuers, 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**.

### Inspection Process

- Contact the firm to be inspected.
- Determine the inspection commencement date.
- Issue a formal document request to the firm.
- Select audit engagements and offices for inspection.
- Complete audit partner and manager interviews at both the national and local levels, including the quality control assessment and all engagement inspections.
- Prepare the inspection comment forms (while on-site) and share with the audit team.
- Prepare the draft report based on analysis and review of all comment forms.
- Deliver the draft report to the firm.
- A firm has 30 days to respond to the draft report.
- Issue final report to the firm, the SEC, and certain state licensing boards.
- A firm has 12 months to cure any quality control criticisms or defects noted.

Source: Riley Jr., Richard R., et al. "Audit Quality In The Post-SOX Audit Environment: What Your Auditing Students Must Know About The PCAOB Inspection Process." *Current Issues In Auditing* 2.2 (2008): A17-A25.

### 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 audit issuers actually inspected in each reports; the pervasiveness of audit deficiencies such as those that involve auditing of revenue recognition, of fair value measurements, of accounting estimates, or of 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.

Table 3: Timeline of Development of PCAOB Inspection Reports

Year	Events That Have Transpired For In Each Milestone
Past	Mandatory peer reviews every three years under the AICPA.
2003	Voluntary inspections of the Big 4 firms to support the PCAOB inspection program's implementation. Reports produced in 2004.
2004	The PCAOB released an initial statement concerning the issuance of inspection reports.
2006	The PCAOB released information about Rule 4009 Submissions that address quality control criticisms in the reports.
2007	The Board released observations that address the auditor's responsibility with respect to fraud in financial statement audits.
2008	The Board released a report describing registered audit firms' first year implementation of Auditing Standard No. 5.
2010	The Board reported on observations of inspections relating to audit risk areas affected by the economic crisis between 2007-2010 period.
2011	The PCAOB began conducting inspections of registered firms' audits of brokers and dealers.
2013	The Board released observations regarding compliance with Auditing Standard No. 7.
Current	The Board continues to provide inspections as a logical means for public accounting firms to provide dependable audit engagements.

Table 1. U.S. Firms Subject to Annual PCAOB Inspections by 2016

BDO USA, LLP	Ernst & Young LLP	MaloneBailey, LLP
Crowe Horwath LLP	Grant Thornton LLP	Marcum LLP
Deloitte & Touche LLP	KPMG LLP	RSM US LLP
	PricewaterhouseCoopers LLP	

Table 2. Countries with Firms That Are Inspected by The PCAOB

Argentina	Colombia	Ireland*	Nicaragua	Spain
Australia	Denmark	Israel	Norway	Sweden
Belize	Finland	Japan	Panama	Switzerland
Bermuda	France	Kazakhstan	Papua New Guinea	Chinese Taipei (Taiwan)
Bolivia	Germany	Republic of Korea	Peru	Thailand
Brazil	Greece	Malaysia	Philippines	Turkey
Canada	Hong Kong*	Mexico	Russian Federation	Ukraine
Cayman Islands	India	Netherlands	Singapore	United Arab Emirates
Chile	Indonesia	New Zealand	South Africa	United Kingdom

Based on the overall findings of the Board stated in the "Report On 2007-2010 Inspections of Domestic Firms That Audit 100 Or Fewer Public Companies," about **44%** audit firms inspected between 2007 to 2010 has a significant audit performance deficiency compared to about 61% of those inspected from 2004 to 2006. In 2010 alone, triennial firms found with deficiencies has about 51%, which declined to **45%** in 2011 (PCAOB 2013). These shows that audit deficiencies are decreasing, which suggests that inspections help improve audit quality.

Figure 3: Confidential Portion of the 2016 Inspection Report of Deloitte & Touche LLP

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