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# Deficiencies Noted in PCAOB Inspections: Implications for Auditing Instruction

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***Deficiencies Noted in PCAOB Inspections:  
Implications for Auditing Instruction***

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## Deficiencies Noted in PCAOB Inspections: Implications for Auditing Instruction

### Abstract

The Public Company Accounting Oversight Board (PCAOB) has responsibility for monitoring public accounting firms that provide audits for publicly owned companies. Among the duties assigned to the PCAOB was “conducting inspections of registered public accounting firms.” A strategy for such inspections was developed that includes reporting deficiencies judged to be significant for supporting conclusions made.

This paper presents a content analysis of deficiencies disclosed in the nine inspections (during three years) of three accounting firms, along with the largest four firms, that are inspected each year. Also discussed are the general implications for auditing teaching in colleges/universities and in continuing education programs in public accounting firms. There is no attempt in this paper to evaluate the PCAOB inspection process in relation to the responsibility as stated in the Sarbanes-Oxley Act of 2002, except for some comment in the concluding segment. Furthermore, there is no discussion of quality control deficiencies, since those are not revealed in inspection reports that are provided on PCAOB’s Website.

Among the conclusions of the analysis of the nine inspections are the following:

Auditing is a generic process and auditors must understand that process through initial instruction that is engaging, relevant and meaningful. The auditor needs to internalize the basic simple concept that “an audit is more than the sum of its parts,” and the process is applicable across many types of entities.

Professional guidance is not properly understood or if understood, not implemented in practice. Deficiencies provide evidence of failure to do what is *expected*.

A concept-driven education/training strategy is needed. The reality of actually participating in the performance of an audit demands that learning be both conceptual and practical. Critical operational concepts must be reflected in instruction. These are: a. need for comprehensive understanding of the entity and its environment; b. understanding that an audit is more than the sum of its parts. Its parts, therefore, cannot be evaluated in isolation of other parts; c. value of corroborating evidence d. evidence requires assessment and evaluation; and e. criteria (GAAP, etc.) must be carefully reviewed (in basic source documents) to be assured of proper interpretation in financial reporting

**(Note:** An earlier draft of this paper was presented at the American Accounting Association, Mid-Atlantic Region Meeting April 24-26, 2008, Hyatt Regency, Penn’s Landing, Philadelphia, PA)

## **Deficiencies Noted in PCAOB Inspections: Implications for Auditing Instruction**

The Public Company Accounting Oversight Board (PCAOB) has responsibility for monitoring public accounting firms that provide audits for publicly owned companies. Among the duties assigned to the PCAOB was “conducting inspections of registered public accounting firms.” A strategy for such inspections was developed that includes reporting deficiencies judged to be significant for supporting conclusions made.

The purpose of this paper was to do a content analysis of deficiencies disclosed in a selected group of inspections over a three-year period and to present some general implications for auditing teaching in colleges/universities and in continuing education programs in public accounting firms. There is no attempt to evaluate the PCAOB inspection process in relation to the responsibility as stated in the Sarbanes-Oxley Act of 2002, except for some comment in the concluding segment. Furthermore, there is no discussion of quality control deficiencies, since those are not revealed in inspection reports that are provided on PCAOB’s Website.

The following topics are discussed: 1. Inspection Process and Report of Results; 2. Rationale and Method of Review of Inspections; 3. Deficiencies Noted; 4. Implications for Auditing Instruction; and 5. Some Comments

### 1. Inspection Process and Report of Results

The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB or “the Board”) to provide protection of interests of investors and assure that public accounting firms who provide reports are honoring their public interest responsibilities. The Act directs the PCAOB to undertake a program of inspections to determine if the registered firms that conduct audits of public companies who report to the SEC are performing audits in compliance with the Act of 2002, with rulings of the SEC, and with professional standards.

The Board began functioning in 2003; with a full-scale inspection program beginning in 2004. However, in 2003, the Board did complete limited inspections of the four largest U. S. public accounting firms (Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP). Reports were issued for the four limited inspections.

The Act provides that an inspection is to include at least these three components:

- a. an inspection and review of selected audit and review engagements of the firm, performed at various offices and by various associated persons of the firm.

- b. an evaluation of the sufficiency of the quality control system of the firm, and the manner of the documentation and communication of that system by the firm, and
- c. performance of such other testing of the audit, supervisory, and quality control procedures of the firm that are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the Board. (See Sarbanes-Oxley Act of 2002, Section 104[a].)

### 1.1 The Nature of the Inspection Process

As implemented by the current Board, the approach to responding to the requirement for inspections is reflected in what the Chairman noted in the Annual Report for 2005:

The inspection team takes a supervisory approach to oversight and seeks through constructive dialogue to encourage firms to improve their practices and procedures. Every Board inspection that includes a quality control criticism alerts the firm to the opportunity to prevent criticism from becoming public. (PCAOB, Annual Report 2005, 9)

During an inspection engagement there are discussions about problems identified. Such discussions are held with members of the audit team, the firm's staff member responsible for the inspection, national office experts and managing partner or chief executive of the firm. (for more discussion re inspection reports see PCAOB, *Statement Concerning*. . . )

Generalizations not warranted. There is no basis for making a judgment about the overall audit quality of the firm inspected based on the public report provided for each inspection. . There is silence in each report about the basis of selection of audits to be inspected in a given firm; however, the selection is not random. There is no information that assures the reviewer that the approach was consistent among all firms of like size inspected in the same year or that the inspections from year to year follow the same procedures. Further comments that reflect the nature of an inspection are presented in a preface to reports:

. . . the board cautions against drawing conclusions about the comparative merits of the annually inspected firms based on the number of reported deficiencies in any given year. The total number of audits reviewed is a small portion of the total audits performed by these firms, and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in that year.

Notwithstanding the limitations of an inspection, the deficiencies noted do reflect failure to meet professional guidance in the particular audit inspected. Left unanswered is the

extent to which a deficiency is pervasive throughout the population of a firm's yearly audits. There is no basis for conclusions about quality of performance of a Firm.

Deficiency operationally defined. The inspection team considers a deficiency to be noted for a particular issuer (only identified by A, B, C, etc ) as one:

. . . of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. . . . that conclusion followed from the omission, or insufficient performance, of a single procedure, while other audits included more than one such failure. (See introductory page of an Inspection Report of a firm that is inspected yearly at PCAOB website [www.pcaob.org](http://www.pcaob.org).)

## 1.2 Inspection Reports

As noted in the Act, the PCAOB is required to prepare a report concerning each inspection that is to be transmitted in appropriate detail to the Securities and Exchange Commission and to each appropriate state regulatory authority. Additionally, the PCAOB is to "make available" in appropriate detail to the public a report, with limitations imposed by law which restrict the disclosure of information. . The Act provides (Section 104(g) (2) which states the following:

. . . no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.

No identification of specific issuer While the inspectors may publicly describe apparent failures or deficiencies in a firm's actual performance of audits, there is no identification of the issuer or of information that would reveal who the issuer is.

From time to time the PCAOB has issued reports that provide summaries of findings from inspections, including those related to quality control. (See, for example, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms* PCAOB Release No. 2007-010, October 22, 2007 or *Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 months after an Inspection Report* PCAOB Release No. 104-2006-078, March 21, 2006.) Such publicly issued documents do not reveal identity of firms or issuers.

Disclaimers noted in each inspection. An introductory page for each inspection states clearly the scope and limitation of what an inspection report provides. Among the statements are these comments:

The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of

the firm's systems policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.

Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report is prepared.

The Board. . . has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP or Commission disclosure requirements, rests with the Commission [Securities and Exchange Commission]. (See any Inspection Report posted at the PCAOB website)

Information provided about the firm inspected. There is provided information about where the national offices are as well as the number of U. S. practice offices. There is also noted the number of offices where field work was performed. The period of the inspection is also reported.

The scope is described in general terms initially:

. . . includes reviews of aspects of selected audits of financial statements and of internal control over financial reporting performed by the Firm. Those audits and aspects were selected according to the Board's criteria and the Firm was not allowed an opportunity to limit or influence the selection process.

Additional details are provided. There is noted that the inspection team reviews the issuer's financial statements and certain SEC filings. The team selects certain higher-risk areas for review and, at the practices offices, inspects the engagement team's work papers and interviews engagement personnel regarding those areas. The items listed relate to each firm inspection. In one inspection for 2006, for example, the areas identified the following areas: revenues, reserves or estimated liabilities, derivatives, valuation of intangible assets, business acquisitions, income taxes, consideration of fraud, related party transactions, supervision of work performed by foreign affiliates, and assessment of risk by the audit team. (Illustrative of statement see: Inspection of Grant Thornton LLP, 2006 Report issued on June 28, 2007 at PCAOB website, p. B-1)

Deficiencies that "reached the specified degree of significance" as defined operationally (see definition on page 5) are provided audit by audit included in the inspections. The number of deficiencies varied among the issuers' deficiencies noted.

Response of firm to Inspection Report. Firms may respond to an inspection report draft, but are not required to do so. In the instance of a response, it is appended to the publicly issued inspection report. The response, though, that is published is "minus any portion granted confidential treatment."

Firm letters range from general comment of acceptance and of commitment to “continuously improving audit and quality control processes” to challenges to the deficiencies noted. There is no disclosure of a response from the PCAOB, if any, to these firm letters.

## 2. Rationale and Method of Review of Inspections

The inspection reports provide useful information of failures of auditors to adhere to professional standards and related guidance. Although, as noted, earlier there is currently no basis for making a judgment about the quality of audit performance based on an inspection of a single firm or a summary of a year’s inspections. Nonetheless, there are worthwhile clues of areas where attention is warranted as auditing instruction is designed both in our colleges and universities and in public accounting firms for continuing education of auditing staff.

### 2.1 Selection of Inspections for Review

A review of the total listing of inspections as of the middle of October 2007 revealed that only 7 firms had had full inspections for the first three years (2004, 2005, 2006) during which inspections were performed. These were the four largest firms plus BDO Seidman LLP, Crowe Chizek and Company LLC and Grant Thornton LLP. Inasmuch as the four largest firms had undergone limited reviews in 2003, the decision was made to review the deficiencies noted in the nine inspections of the three other firms only. (All these nine inspection reports revealed that each included deficiencies, as is true of the inspections of the largest four audit firms.)

The scope of inspections of entities that were required to have an inspection every three years was assumed to be different when compared with entities inspected yearly. The publication of the PCAOB related to the triennially inspected firms which was published in 2007 supported the decision to focus on the three firms above noted. (See PCAOB, *Report on the PCAOB’s 2004, 2005, and 2006 Inspections. . . .*) (*This 2007 report has implications for education/training, but these have not been reviewed in this paper.*)

Each inspection report disclosed the period during which the inspection was performed. General terms are used in identifying the period of the audit, so there is not sufficient information to determine time spent for each inspection. In each instance, the time period is noted as “from (month only year) to (month only year) such as “from May 2005 to January 2006,” which was the longest interval noted. In one instance, among the nine there was an additional notation that “one engagement review was completed in March 2005, yet the field work for that audit otherwise was from May 2004 to October 2004.

## 2.2 Nature of Review

Deficiencies are described by the team responsible for reporting. Such deficiencies, therefore, are not described in the same manner from inspection to inspection. Thus, they are not in the form for a straight-forward analysis.

An overall review of the inspection reports revealed the following numbers of issuers for each of the years where one or more significant deficiencies were disclosed:

Number of Issuers with Deficiencies for Inspections				
	2004	2005	2006	Total
BDO	10	7	11	28
Crowe Chizek	11	8	3	22
Grant Thornton	<u>15</u>	<u>12</u>	<u>8</u>	<u>35</u>
	36	27	22	85

As noted earlier, there is no basis for commenting about any of these figures. The inspection did not remain constant as far as strategy was concerned for the three years reported. There is no basis, for example, for attempting to “interpret” the decline in number of deficiencies each year. The figures are presented merely to indicate the scope of evidence that forms the basis of discussion.

A first-approximation content analysis was undertaken. This analysis consisted of the following:

1. Careful reading of each issuer’s deficiencies
2. Identifying the specific focus of each deficiency using specified categories that reflected the manner in which deficiencies were noted. Therefore, there is overlapping. For example, if the deficiency was described as a failure in substantive testing, it was categorized as a “substantive testing deficiency.” However, if it was initially noted as an analytical procedure deficiency but then was described as inappropriately used as a substantive test, it was listed as “analytical process.” This first approximation content analysis effort underscored the highly interrelated nature of audit strategy!
3. Identifying illustrative descriptions of each.
4. Developing straight-forward, overall implications for instruction

### 3. Deficiencies Noted

The deficiencies are identified in categories developed after reading the 85 reports of issuer’s deficiencies. Illustrative descriptions are provided of deficiency only with minimum notation of what should have been done. Comments related to what should have been done varied considerably among the deficiencies disclosed. Some of the

following topics are relate to GAAP requirements; however, the persistence of failures justified identification beyond “failure to adhere to GAAP guidance.”

### 3.1 Analytical Procedures

Deficiencies ranged from inappropriate use of analytical procedures for substantive testing when internal controls were not supportive of use of analytics to failure to establish expectations. Illustrative deficiencies included:

Firm tested minimum rental income primarily through use of analytical procedures that did not meet substantive analytical procedure requirements. Firm did not set an expectation that was precise enough to provide the desired level of assurance that difference may be potential material misstatement, individually or when aggregated.

Firm used high-level analytics. . . but failed to establish expectations for analytics.

Issuer had significantly increased portfolio of mortgage loans it services. Firm performed analytical procedures, consisting principally of trend analyses and reviewed amortization expense general ledger account . . . However, analytics were deficient; Firm failed to establish the expectation and the amounts of the differences from the expectations that the Firm could accept without further investigation. . . Firm failed to evaluate significant variances that their analytics identified that indicated the issuer may not have properly accounted for the mortgage servicing rights and the amortization expense.

### 3.2 Confirmations

The guidance for confirmations was not implemented in a number of inspection reports. Illustrative deficiencies included:

Confirmations for notes receivable not controlled; Firm permitted issuer’s employees to select the notes to be confirmed with no supervision by the Firm. Undelivered confirmations not reviewed, yet confirmations related to a portfolio that the Firm had determined was a specific fraud.

Firm failed to request confirmation of key contract terms or the absence of side agreements, even though the “work papers implied that customers had been requested to confirm the terms.”

There was use of negative confirmations yet “controls over customer deposits had not been tested.” No response from positive confirmation did not result in evaluation of propriety or collectibility of an accounts receivable.

### 3.3 Fair Value

The determination of fair value failed to meet professional expectations in some instances. Illustrative deficiencies included:

The firm used another party to test the fair value of a sample of marketable available-for-sale securities (AFS). There was no evidence that the Firm had assessed the competency and objectivity of the other party.

Firm's issuer engaged an outside valuation specialist to appraise fair value of fixed and intangible assets acquired in a business combination; Firm, however, failed to obtain and test the completeness and accuracy of certain data issuer provided to the valuation specialist.

Auditor provided no evidence about the assumptions when valuing warrants granted to creditors in exchange for an extension of payments terms and other modifications to its debit.

### 3.4. Departures from GAAP

Failure to assure adherence to relevant guidance was noted in a number of instances. The following specific references were noted as ones where there were deficiencies in issuer's interpretation/application of guidance:

Among the failures in interpretation or implementation were those related to Financial Accounting Standards Board's statements and interpretations, Emerging Issues Task Force statements, Accounting Principles Board's opinions, PCAOB's Auditing Standards, SEC Accounting Bulletins, Codification of Commission Staff Accounting Bulletins, and SEC Regulation S-X. The specific references to such criteria are provided by each year reviewed in Appendix A of this paper.

The range of authoritative accounting guidance noted in deficiencies underscores the command of accounting principles that auditors must possess to perform quality audits.

### 3.5 Goodwill

Auditors failed to perform sufficient procedures to support a range of judgments related to goodwill. This, of course, is a specific departure from GAAP, but warranted specific identification. Illustrative failures include:

Issuer performed an interim goodwill-impairment analysis. Issuer sold large portion of its operation and concluded that only 7 percent of goodwill was impaired. Firm failed to address why goodwill, which represented approximately 1/3 of the issuer's total assets, was not fully impaired in light of issuer's deteriorating financial performance.

Approximately 60 percent of issuer's assets were classified as goodwill with most related to one unit of the reporting units. Impairment tested at end of third quarter and determined to be 35 percent of goodwill, which was recorded at the end of third quarter. Evaluation was done by third-party valuation specialist. Specialist based valuation on management's assumptions that sales would increase 12 percent in next year, even though sales had declined in preceding three years, which resulted in losses for the past three years. Though fourth quarter results and the first two quarters of next year were lower than expected. The Firm failed to evaluate adequately the appropriateness of the assumptions and failed to analyze significant relevant information.

### 3.6 Internal Control

The deficiencies reported in the inspections related to the auditor's responsibility for internal control in performing a financial audit. There have been no disclosures in inspection reports of deficiencies noted in internal control audits. (There were general comments about internal control audits in one report, PCAOB Release No. 2005-023 *Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, November 30, 2005.)

Illustrative deficiencies related to internal control as noted in inspections of financial audits include:

The issuer's internal audit department had tested relevant controls. The Firm, however, was unable to demonstrate to the inspection team that the controls tested by internal audit were the appropriate controls to justify Firm conclusions.

The Firm failed to change its level of controls assurance from "moderate" to "basic" when it identified certain weaknesses in the issuer's information technology general controls. As a result the Firm performed insufficient audit work on accounts receivable and inventories.

The Firm failed to adequately evaluate the service organization's report related to controls in effect in processing issuer's data over the lending and deposit areas. Firm failed to evaluate user control considerations, failed to perform procedures to test the six months not covered by the report and failed to evaluate control exceptions identified in the service auditor's report. Firm failed to consider the need to modify the nature, timing and extent of its audit procedures.

There was no evidence and no persuasive other evidence, that the Firm had performed adequate tests of controls related to the existence of loans receivable to support control risk assessment of low.

### 3.7 Inventory

Inventory deficiencies are illustrated in the following instances:

Issuer used perpetual inventory system for tracking finished goods, but not for tracking raw materials or work-in-process inventories. Physical inventory tested five or six months before year end were observed at some locations by Firm personnel. Physical inventories generally results in favorable adjustments to inventory which led to significant increases in income in the period recorded. The Firm failed to test inventory transactions between interim dates and end of year; also, Firm failed to test physical inventories for raw materials and work-in-process at year end. Firm failed to evaluate the potential implications of the interim inventory adjustments for possible adjustments to year-end inventory balances.

Issuer analyzed slow moving inventory using a non routine report generated from inventory file. . . issuer used this analysis as basis for determining inventory obsolescence. . . the Firm failed to perform tests of controls or substantive audit procedures to verify that the report was complete and accurate. There was no evidence that the Firm had corroborated the reasonableness of the resulting reserve for inventory obsolescence. The gross amount of inventory was 67 percent of total assets, and the reserve was 61 percent of the gross amount.

### 3.8 Loans/Allowances

The subject of loans was one noted as selected by inspectors for review. Illustrative of deficiencies noted include:

The Firm failed to evaluate, or failed to include evidence in the work papers that it had evaluated the loan loss factors the issuer used to determine the allowance. Also, failed to link the various allowance, charge-off and delinquency ratio analyses it had performed, or the results of them, to the loan loss factors the issuer used.

Firm determined issuer had assigned a risk classification that was too high by two grades to one of the credit relationships they analyzed. The Firm, however, failed to evaluate, or to include evidence in work papers that it had evaluated, the discrepancy in relation to the issuer's ability to grade loans properly and the potential implications on the allowance for the remainder of the loan portfolio.

Firm determined that issuer had weak loan review function and that the loan loss factors assigned by issuer to homogeneous loans did not correlate to the issuer's actual loss experience. Firm failed to quantify the effects of these deficiencies on the financial statements. Firm used "high-level trend analyses" to conclude that the two deficiencies offset each other.

### 3.9 Materiality

Seldom was there a specific item that highlighted materiality. However, throughout the deficiencies, there were references to the “materiality” of a particular account.

Illustrative deficiencies:

*(One of the infrequent instances where materiality was noted directly)* On a first-year audit for the Firm, the Firm failed . . . to obtain sufficient competent evidential matter to support the audit opinion: If the Firm had used an appropriate amount for planning materiality, the Firm’s sample sizes for confirming receivables and performing certain tests of inventory would have been approximately three times larger than the sample sizes that the Firm used for these tests.

Issuer’s available-for-sale securities represented 17 percent of the issuer’s assets. . . Firm’s audit procedures were limited to testing, at an interim date, the market value of the securities, representing less than 3 percent of the available-for-sale securities.

Issuer classified outstanding restricted share units as a liability rather than as a component of stockholders’ equity. Amount represented approximately 23 percent of the issuer’s total liabilities. Firm failed to identify and address error before issuing its audit report. (The issuer restated its financial statements related to this matter)

The Firm failed to perform sufficient audit procedures with respect to the issuer’s incentive compensation expense, which approximated 50 percent of the issuer’s expense.

### 3.10 Property

Deficiencies related to property are illustrated in the following instances:

Firm failed to obtain sufficient competent evidential matter to support its conclusion. Issuer had owned property for over a decade which contained potential environmental contingencies, which were disclosed in the financial statements as fairly stated at the lower of cost or fair value. The Firm relied on an appraisal letter which updated a prior appraisal report issued in 2001 that specifically excluded anyone other than the issuer from relying on it. The appraisal letter noted that a final appraisal report was in preparation. The Firm, however, failed either to obtain a final appraisal report in order to verify the consistency of the methodology used, the appropriateness of using the appraisal, and whether the issuer provided any data or assumptions to the appraiser that required testing, or to evaluate the effect of not obtaining an appraisal report on the scope of the audit.

Issuer had rental fleet of equipment deployed at customer locations, as well as rental equipment available for deployment. Issuer discussed risk factors in Annual Report on Form 10-K that noted its rental fleet is exposed to the risk of non-renewal, reduced customer acceptance, and obsolescence. The Firm, while completing procedures to test accuracy of the issuer's list of equipment in its possession available for deployment, did not undertake procedures to address the completeness of the entire population of equipment available for deployment since procedures did not address whether any customers were holding equipment that was actively deployed. No Firm procedures addressed the risk that there may have been unrecorded disposals of equipment that continued to be reflected as equipment actively deployed at customer locations..

### 3.11 Revenue Recognition

It appears that for all inspections, revenue recognition was selected for review. Illustrative of deficiencies included:

Approximately 67 percent of the issuer's fee revenues was derived from clients who were affiliated with the issuer. The Firm determined that this circumstance required additional audit procedures, yet the Firm tested the receipt of fee revenue from these affiliated clients without testing whether these revenues were recognized in accordance with terms of the underlying contracts and GAAP, which the Firm had planned to do to mitigate the fraud risk it had identified.

During the second quarter, one issuer recognized as other income the remaining portion of deferred revenue related to agreements made three years previously granting certain distribution rights and technology licenses. In previous years, revenue was recognized on a straight-line basis over the life of the agreements. Firm failed to evaluate, or failed to include in the work papers evidence that it had evaluated, the propriety of either the original method or revenue recognition or the recognition of all the remaining deferred revenue in its second quarter. The recognition of the remaining deferred revenue as other income reduced the issuer's net loss by approximately 18 percent.

Issuer generates revenue principally through two lines of business. The firm performed, as its primary substantive procedures, analytical review procedures using the aggregated amounts reported in the financial statements. The Firm established expectations for changes in revenue compared to prior periods and performed certain procedures to obtain corroboration of the amounts that differed from its expectations. There was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had designed and performed these analytical procedures at a sufficiently disaggregated level to identify potential material misstatements.

Issuer's revenue was mostly derived from sales of products and services in accordance with contracts that were tailored for each specific customer.

Accounting method applied varied in relation to relevant contract terms. The Firm selected contracts for testing and summarized the contract terms for each contract selected for audit procedures. There was, however, no evidence in audit documents, and no persuasive other evidence, that the Firm had performed procedures at the individual contract level to determine whether the issuer had used the correct method to account for each contract in light of contract's specific terms. In addition, in some of the contracts tested, the Firm identified the existence of multiple deliverables, but there was no evidence in the audit documentation and no persuasive other evidence, that the Firm had tested the fair values ascribed to the undelivered multiple elements.

### 3.12 Sampling

Insufficient sampling was noted in a number of instances where the inspectors stated that there was "insufficient competent evidential matter" to support conclusions. There were instances of explicit reference to sampling. Among illustrative comments were these:

The Firm's tests of these controls were very limited. (noted earlier in the presentation the inspectors noted: "The Firm was aware of significant weaknesses in the issuer's access controls over processes that originated approximately half of the issuer's loans. . .") The Firm should have increased the sample size as a result of the weaknesses in the access controls but the Firm failed to do so. Sample covered only the first six months of the year. Furthermore, the Firm did not test the completeness of the population from which the sample was selected and "could not explain to the inspection team how the sample was selected."

Failed to perform sufficient tests. . . . did not test the issuer's controls over this process [securitization transactions] and only substantively tested approximately three percent, three transactions, of the issuer's securitization.

. . . . there was no apparent rationale for the sample sizes or the items selected, and the issuer's "management picked the sample items for one test"

The Firm assessed the control risk and inherent risk relating to loan valuation as high and moderate, respectively. However, the Firm did not consider these levels of risk when determining the sample size for testing whether the loans were valued at the lower of cost or market, and consequently the Firm's sample size was insufficient.

### 3.13 Substantive Testing

As noted earlier, there is indeed overlapping among the topics selected for highlighting in this review of deficiencies. In many instances, "substantive testing" could have been classified by one of the other topics. Illustrative deficiencies that appeared to highlight *substantive testing* include:

Firm identified a fraud risk associated with issuer's rapid growth and identified a significant deficiency in internal control over journal entries. However, when testing journal entries, the Firm covered only the last month of the issuer's fiscal year and failed to examine supporting documentation or obtain other corroboration for the journal entries it examined in order to determine the appropriateness of the journal entries.

The issuer, during the year, adopted a new method of depreciation for all newly acquired fixed assets. The issuer, however, did not quantify the effect of the change and did not disclose the change. The Firm failed to evaluate whether the issuer's approach to the charge was in accordance with Accounting Principles Board Opinion No. 20, *Accounting Changes*.

The Firm did not verify that the incentive compensation was appropriately authorized. In addition, the Firm performed a reconciliation of the issuer's incentive compensation expense and related liability to payroll reports produced by an outside service organization. The Firm did not address significant unreconciled amounts.

The issuer classified its revolving line of credit, which included both a subjective acceleration clause and a provision for a lock-box arrangement as a long term liability rather than as a current liability. The issuer's classification was not in accordance with Emerging Issues Task Force No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*.

The Firm consideration of one issuer's ability to continue as a going concern failed to evaluate, or failed to include in the work papers, evidence that it had evaluated management's plans for dealing with the issuer's adverse liquidity position. The issuer had negative working capital, shareholders' deficit, recurring net losses, a significant portion of its debt maturing with the next 12 months and a cash deficit from operations that primarily was funded through advances from its majority shareholder and private placements of its common stock.

Firm provided no evidence in audit documentation that the Firm had performed substantive procedures related to loans and deposits to extend to year end the audit conclusions reached at an interim date, but rather, limited its procedures to high level analytical reviews.

The Firm failed to perform sufficient audit procedures with respect to the issuer's contract cost accounting. . . . The analytical procedures did not meet the requirements for substantive analytical procedures as the Firm did not obtain corroboration of management explanations for unexpected differences.

The issuer had concluded that it was not required to disclose certain related party transactions. The Firm agreed with the conclusion. The inspectors, observed that these transactions, including advances to key members of management, should have been disclosed based on qualitative considerations. The Firm, also, failed to audit the disclosure that certain other related party transactions were conducted at arm's length.

#### 4. Implications for Auditing Instruction

The preliminary content analysis of the inspection of 85 audits with deficiencies by three public accounting firms during three years of inspections provides a basis for a highly tentative discussion of what is now required in auditing instruction at the college/university level as well as in continuing education programs in public accounting firms and in publicly provided courses. There is one reservation that must be noted. As stated earlier, some letters from the Firms indicate challenges to the deficiencies about which there is no source of information from the PCAOB to learn whether such challenges are reviewed and the conclusions of such reviews supported the judgment of Firms..

The nature of the deficiencies provide clues for consideration as efforts to enhance auditing instruction are undertaken. Two reasonable hypotheses at this point are:

- a. Instruction is improvable; and more effective strategies are yet to be determined and investigated. The points discussed briefly here may be useful as more empirical research efforts at enhancing auditing instruction are undertaken.

##### 4.1 Auditing is a Generic Process

Auditing is a generic process. Auditors must understand that process. They must understand the application of the concepts that drive the process in concrete, vivid manner. The initial education in auditing and accounting, as well as continuing education, must be provided in an engaging, relevant, and meaningful style. With such an approach, the auditor is likely to develop a thorough, comprehensive understanding of the responsibility present in participating in an audit of financial statements that is to enhance the credibility of an entity's financial presentation. The auditor needs to internalize the basic simple concept that "an audit is more than the sum of its parts," and the process is applicable across many types of entities. Internalization should lead to higher level comprehension of content.

##### 4.2 The Relevance of Professional Guidance

Deficiencies provide some evidence of failure to do what is *expected* of auditors. Again and again, deficiencies relate to topics that are the subject of sufficient guidance. For example, there is professional guidance related to confirmations. Yet, deficiencies noted were basic aspects, carefully detailed in professional guidance and responsible auditing textbooks. Deficiencies included the use of negative confirmations in inappropriate situations, the failure to control the confirmation process, the failure to use alternative procedures when there was no response to a positive confirmation. Another example,

there is explicit professional guidance related to auditor responsibility for understanding internal control and for the task of assessing control risk. Yet, deficiencies noted, for example, that even though control risk was judged to be high, the auditor chose to use an analytical procedures approach to substantive testing. In other instances, control risk was assessed as low with no evidence of controls testing.

#### 4.3 The Potential Value of a Concept-Driven Education/Training Strategy

The reality of actually participating in the performance of an audit demands that learning be both conceptual and yet practical. Auditors must *understand* and also actually *practice* – implement understanding. Auditing is a process that provides a strategy for doing a wide range of financial audits – for small, simple enterprises, for vastly different types of businesses from airlines to zirconium manufacturing. . .

Basic foundational concepts. All behavior of the auditor is pervasively influenced by three critical concepts: a. due professional care; b. professional skepticism; and c. persistent, unrelenting independence in mental attitude that assures objectivity in all decisions.

While these foundational aspects are included in content of professional guidance, textbooks, in firm materials, there is still considerable mystery of what educational experiences will assure that there is a depth of understanding both the concepts and their meaning in relation to the reality of every phase of an audit. Mere ability to recognize what is required in a quiz, a final examination, the CPA examination, or in a discussion at an in firm training session is not sufficiently powerful. Such recognition or first level discussion does not assure the internalization that is deemed essential for seeing the significance of each of these concepts in the performance of an audit. In firm educational experiences are especially promising as the source of enhancing, reinforcing, and encouraging the unrelentingly, sustaining adherence to these basic foundational concepts.

Critical operational concepts. Five critical operational concepts are:

- a. need for comprehensive understanding of the entity and its environment
- b. an understanding that an audit is more than the sum of its parts. Its parts, therefore, cannot be evaluated, assessed in isolation of other parts.
- c. value of corroborating evidence
- d. evidence requires assessment and evaluation
- e. criteria (GAAP, etc.) must be carefully reviewed (in basic source documents) to be assured of proper interpretation in financial reporting

Again, because auditing is a process broadly applied, operational aspects must be driven by the foregoing concepts. Yet, instruction seems, too often, to be based on segments of *content* without the learner gaining a sense of the significance of what is to be done or

how it is to be done. Deficiencies, for example, reflect that while control risk was assessed as high, an analytical procedures approach to substantive testing was selected. Such a judgment may be reflecting the failure to connect an earlier step with one later.

Reflections from inspections. The reports of inspections may be reflecting the nature of education and understanding that experienced auditors, who serve as inspectors, possess. There is virtually complete silence of deficiencies in those sections of audit documentation that deal with understanding the firm and its industry (or industries) or of the nature of overall planning including the establishment of risk. Since such topics are part of audit documentation, should not deficiencies related to such matters be included? In reading the deficiencies for a particular issuer, this question arose often: “To what extent does this deficiency relate to a failure to establish a planning framework that was appropriate for this issuer?” The inspection reports, to some extent, reflect the silo style in which audits have been performed. Are inspections done in the same style?

#### 4.4 Drivers of the Teaching/Learning Task

What is stated here is, at best, a highly tentative hypothesis:

Education/training fails to effectively integrate concepts with practical applications that are focused on enhancing a deep understanding of the concepts.

Audits are performed by individuals, for the most part, who are CPAs. These auditors have studied auditing and accounting; they have passed the CPA examination; they have had continuing education for a considerable number of years. They have spent an impressive amount of time to be prepared for the task of auditing. Yet, there is a serious concern that the preparation and continuing training have not been as effective as would have been anticipated.

While there are fewer issuers with deficiencies in the third year when compared with the two preceding years, there is no basis for any conclusions about *improvement*. Inspection reports disclosed no information about the scope of inspections; even a general comment about extent of deficiencies is not justified. When the *nature* of deficiencies was reviewed by year, there was no significant difference in nature of such deficiencies during the three years. Deficiencies in the third year were as reflective of failure, for example, to adhere to professional guidance as disclosed in the first year of inspections.

#### 5. Some Comments

This exploratory study of deficiencies in inspection reports for the purpose of identifying tentative implications for teaching/training in auditing. While there are some clues that provide a basis for comment, the inspections are not appropriately designed to draw any quantifiable conclusions.

The PCAOB has taken a supervisory approach to performing inspections as noted earlier. The Board’s approach is expected “through constructive dialogue to improve their [the

Firms] practices and procedures.” To date, the PCAOB has not revealed the extent to which that improvement has taken place.

Furthermore, it remains uncertain if a supervisory approach is sufficient to meet the expectation for sufficient oversight which Sarbanes-Oxley Act of 2002 specified in Section 104. *Inspections of Registered Public Accounting Firms* as:

(a) In general: The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.  
(Sarbanes-Oxley Act of 2002, Section 104)

The parts of inspection reports that are made public give some clue about the nature of violations of professional guidance and regulatory requirements. Such public reports fail to provide sufficient information about the quality of audits, though, since audits are seemingly not selected at random for inspection. Therefore, it is not clear how the PCAOB concludes that a supervisory approach is sufficient to meet the requirements of the 2002 Act. Given the disclaimers provided in each inspection report, the basic inspection of an audit doesn't appear sufficient to “assess the degree of compliance. . . .”

The PCAOB through its inspection process has access to data that are valuable in the development of measures for determining audit quality. As the issuers' deficiencies were read, many questions arose, including:

To what extent were audits with deficiencies performed under the direction of the same partner? same manager?

.To what extent would a larger sample of audits reveal the same deficiencies?

To what extent were general aspects of the audit reviewed in comparison with detailed accounts, for example, to determine if the deficiency arose early in the overall planning, including assessment of vulnerability for material misstatements due to fraud?

To what extent was an audit opinion adequate notwithstanding a significant deficiency? (There are instances, though rare possibly, where internal control is weak; however, a detailed investigation reveals no evidence that such weak controls resulted in material misstatements. Haphazard samples, at times, on more extensive investigation turn out to be representative! ) What kind of further probing did any of the inspectors undertake to see the ultimate impact of a deficiency that was significant??

Where there observations that extended the insight of inspectors of the nature of quality performance? What observations re the culture of a firm were noted

and assessed?

To what extent has the supervisory approach been assessed as sufficient for meeting the requirement to determine “compliance?”

The public reports provide a window into audit deficiencies that is sufficient to realize that performance of audits can be improved. Furthermore, there are tentative hints at the nature of shifts that might prove worthwhile in auditing courses both in colleges and universities and in continuing education provided by public accounting firms and other educational groups.

## References

Sources of data related to deficiencies:

Annual Inspections:

2004 Inspection of BDO Seidman , LLP (Issued November 17, 2005)

2005 Inspection of BDO Seidman, LLP (Issued November 30, 2006)

2006 Inspection of BDO Seidman, LLP (Issued May 16, 2007)

2004 Inspection of Crow Chizek and Company (not identified as LLC)

(Issued January 19, 2006)

2005 Inspection of Crow Chizek and Company, LLC (Issued November 30, 2006)

2006 Inspection of Crow Chizek and Company, LLC (Issued September 24, 07)

2004 Inspection of Grant Thornton, LLP (Issued January 19, 2006)

2005 Inspection of Grant Thornton, LLP (Issued November 30, 2006)

2006 Inspection of Grant Thornton, LLP (Issued June 28, 2007)

Other references noted : (not including references to GAAP and Related criteria)

Public Company Accounting Oversight Board. 2005. *Annual Report for 2005*.

Public Company Accounting Oversight Board. 2006. *Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 months after an Inspection Report* PCAOB Release No. 104-2006-078, March 21.

Public Company Accounting Oversight Board. 2005. *Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Release No. 2005-023, PCAOB Release No. 2005-023, November 30.

Public Company Accounting Oversight Board. 2007. *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms* \_PCAOB Release No. 2007-010, October 22.

Public Company Accounting Oversight Board. 2004. *Statement Concerning the Issuance of Inspection Reports*. PCAOB Release No. 104-2004-001. August 26.

Sarbanes-Oxley Act of 2002. H. R. 3763, U. S. Congress, July 30, 2002.

## APPENDIX A

### GAAP Guidance for which Deficiencies were Identified

#### *From 2004 Inspections:*

Emerging Issues Task Force (EITF) issue No. 95-22 *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include both a Subjective Acceleration Clause and a Lock-Box Arrangement.*

Financial Accounting Standards Board Interpretation No. 46, *Consideration of Variable Interest Entities*

Statement of Financial Accounting Standard No. 86 *Accounting for the Costs of Computer Software to be Sold, Leased, or otherwise Marketed*

Statement of Financial Accounting Standard (SFAS) No. 106 *Employers' Accounting for Postretirement Benefits Other than Pensions*

Statement of Financial Accounting Standard No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

Statement of Financial Accounting Standards No. 142 *Goodwill and Other Intangible Assets*

#### *From 2005 Inspection Reports*

Accounting Principles Board Opinion, No. 20, *Accounting Changes*

Accounting Principles Board Opinion No. 30, *Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*

Emerging Issues Task Force No. 95-8 *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*

Emerging Issues Task Force No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credits that Include a Subjective Acceleration Clause and a Lock-Box Arrangement*

PCAOB Auditing Standard No. 3 *Audit Documentation*

SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*

Statement of Financial Accounting Standards No. 5 *Accounting for Contingencies*

Statement of Financial Accounting Standards No 94, *Consideration of All Majority-Owned Subsidiaries*

Statement of Financial Accounting Standards No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

***From 2006 Inspection Reports***

Codification of Commission Staff Accounting Bulletins, Topic 2.A.6, *Debt Issue Costs*.

Emerging Issues Task Force Issue 01-9, *Accounting for Consideration Given by a Vendor to a Customer (including a Reseller of the Vendor's Products)*

Financial Accounting Standards Board Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

Financial Accounting Standards Board Interpretation 46(R), *Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51*

SEC Regulation S-X, Rule 5-03

Statement of Financial Accounting Standards No. 13, *Accounting for Leases*

Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*

Statement of Financial Accounting Standards No. 133, *Accounting for Derivatives Instruments and Hedging Activities*

Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations*

Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*