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**PCAOB Inspection Process:  
An Objective, Comprehensive Assessment is Justified**

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# PCAOB Inspection Process: An Objective, Comprehensive Assessment is Justified

## Abstract

The Public Company Accounting Oversight Board (PCAOB) is charged with performing inspections of registered accounting firms. (Sarbanes-Oxley Act of 2002, Section 104) Basically, inspections are to “*assess the degree of compliance. . . with the Act, the rules of the Board, the rules of the Commission, or professional standards.*”

The inspection process has many aspects. Matters that have been discussed include timeliness of reports, extent of public disclosure of findings, qualifications of inspections, and the nature of the inspection process. Only the last identified matter, the nature of the inspection process, is the subject of this paper.

After a review of the administrative structure for inspections, of the nature of the current inspection process, a tentative list of postulates is provided following by questions about the current process and a concluding summary.

The review provides the following brief summary:

- 1, The current inspection strategy does not appear to reflect *an assessment of the degree of compliance*. The process, as reflected in inspection reports, is that of a consulting engagement that has its purpose to aid the entity reviewed in understanding where deficiencies are serious. The Board’s declaration that an inspection follows a “supervisory approach” seems related to consulting not compliance.
2. After more than five years of implementing the inspection process, the PCAOB has not established a clear, consistent model for inspections. Therefore, no generalizations about audit performance can be provided.
3. An objective, comprehensive assessment of the process in relation to what was needed at the time of the passage of the Sarbanes-Oxley Act of 2002 appears justified. That assessment must go beyond the inspection process itself, however. What is presented here is exploratory.

## **PCAOB Inspection Process: An Objective, Comprehensive Assessment is Justified**

The Public Company Accounting Oversight Board (PCAOB) is charged with a continuing program of inspection of registered firms. (Sarbanes-Oxley Act of 2002, Section 104) Basically, inspections are “*to assess the degree of compliance. . . with this Act, the rules of the Board, the rules of the Commission, or professional standards.*” Accounting firms undergo inspections yearly if they provide audit reports “for more than 100 issuers and at least triennially if such firms that provide audit reports for fewer issuers.”

There are many aspects of the inspection task assigned to the PCAOB which have been subject to discussion and review. Matters that have been discussed include timeliness of reports, extent of public disclosure of findings, qualifications of inspectors, and the nature of the inspection process. It is the last topic only that is the subject of this paper.

The following topics are discussed: 1. PCAOB’s administrative structure for inspections; 2. Initial limited Inspections 3. The nature and limitations of full scale Inspections; 4. Perceptions of inspection process in the business press; 5. Postulates needed for framework of an inspection that determines compliance; 6.. Questions about the current inspection process; and 7. Summary..

### **1. The PCAOB Administrative Structure for Inspections**

The PCAOB division responsible for administrating the inspection process is *Registration and Inspections*. It is headed by a director who is supported by three deputy directors. The Division’s expenditures for 2007 totaled \$65.7 Million (50.3 percent of total expenditures) compared to \$63.0 Million in 2006 (49.7 percent of total expenditures)

As reported in the PCAOB 2007 Annual Report, there were 236 registered companies inspected. Of these there were 10, including one Canadian firm, that audited 100 or more publicly-owned companies. Of the 226 firms, 179 were U. S. firms, the other 47 were non U. S. firms located in 16 countries. The PCAOB conducted 44 percent of the inspections from one of their offices, which are in Atlanta, Chicago, Dallas, Denver, New York, Orange County, San Francisco, and Washington, D. C.

The PCAOB annual reports note that Board’s inspection teams are experienced accountants. Leaders of teams in 2007, for example, had an average of 23 years of relevant experience and all other members of teams had an average of 15 years of relevant experience.

## 2. Initial Limited Inspections

Initially, the PCAOB did not begin full scale inspections. The Board during its initial year of functioning (2003) determined that limited inspection of the four largest U. S. firms would be undertaken. The Board's opinion was that such inspections were feasible and would serve the public interest and provide "an important foundation for full-scale inspections." (PCAOB, August 26, 2004, Release No. 104-2994-001) The full-scale inspection process began in 2004.

### Attention to the Act's Specifications

The limited inspections included the three components that were identified in the Act for full-scale inspections:

- 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 as are necessary or appropriate in light of the purpose of the inspection and the responsibility of the Board.

### The Process

In each of the four limited inspections 16 audits were selected for review. As would be the case for all inspections, the PCAOB inspection staff selected the audits to be reviewed and in no instance was the firm allowed "to limit or to influence the selection process." Additionally, the staff selected "certain subject matters for review, such as revenues, reserves or estimated liabilities, related party transactions, supervision of work performed by foreign affiliates, the assessment of risk by the audit team and journal entries and adjustments."

The limited inspections were completed for three of the four largest U. S. firms in the period from June 2003 to January 2004. (The period was indicated as noted here.) All four reports were issued on August 26, 2004. There was no disclosure of how many inspectors were assigned to each or how many hours were spent during the periods indicated.

## Reports Provided

Reports of all four firms indicated deficiencies in audit performance. All, for example, had failed to properly apply EITF 95-22. In all firms there were issuers who had to restate their financial statements. (There were 3 such restatements for the clients of two firms; 6 for clients of one firm and 8 for clients of one firm). The following statement (or one expressing the same thought) was included in each of the four reports: "In addition, some of the audit engagements reviewed were found to involve some degree of departure from PCAOB standards or the firm's own quality control policies or both." Such departures were not disclosed in the public reports of these limited inspections.

## Follow Up from Limited Inspections

A press release from Nicolaisen, the Chief Accountant at the SEC, on the date of issuance of the report of the four registered audit firms included the following:

The goal of these reviews is to improve audit quality and thereby enhance financial reporting and the integrity of our markets. Although the Commission was not involved in the preparation of the reports, based on my initial reading, the PCAOB's process appears to be thorough and the reports are candid and transparent. While I am disappointed with the findings of the reports, it is important to keep in mind that this is the first inspection which covers a period during which the firms were undergoing significant change following the July 2002 enactment of the Sarbanes-Oxley Act. The reports indicate that each of the four firms reviewed need to improve the quality of their audits. (Nicolaisen, SEC Press Statement, August 26, 2004)

On the date the four reports were issued, the PCAOB noted the nature of the inspection report process and the public availability of information in the reports. This report notes, though:

The public portions of the inspection reports issued today include two general categories of information. First, the reports include detailed descriptions of the types of matters on which the Board focused its inspection procedures, and the procedures the Board staff carried out to examine those matters. Because these are the Board's first reports, the Board is providing somewhat more detail about procedures than future reports will typically include. (PCAOB, Press Release 104-2004-001)

The report reflects the Board's understanding of what is required to establish legally a violation of professional standards and notes:

. . . the Board is sensitive to the fact that a firm's cooperation in constructively addressing an issue in a supervisory regulatory context is not the same thing as the firm admitting, for any legal purpose, a fact or a violation. For these reasons, the Board emphasizes that an inspection report's descriptions of departures from professional standards are not the result of an adversarial adjudicative process and do not constitute conclusion finding of fact or of violations for purposes of imposing legal liability. (PCAOB, Press Release 104-2004-001)

Pursuant to Section 104 (g) (2) of Sarbanes-Oxley Act of 2002, no portion of the limited reports dealing with criticisms of a firm's quality control systems was made public. (However, there had been a brief comment about this matter in the reports from the limited inspections, as noted earlier in this paper.) Each firm knew that the Board would publicly disclose such criticisms if the firm failed to address them to the Board's satisfaction within twelve months of the issuance of the report. All four firms submitted reports concerning their efforts to deal with criticisms identified. The Board issued a Release about the initial implementation of the process for addressing quality control. The Board's conclusion was: "[the firms] have crafted and undertaken important steps that, if consciously implemented, will have beneficial effects on audit quality." (PCAOB Release 104-2006-78) That statement doesn't quite declare that the problems were resolved. This ambiguous statement is disappointing inasmuch as it provides no clue to how easy or difficult it is to resolve quality control problems.

Then, the Report continues with listings of "steps that emerged from the review process in which each of the four firms engaged as they responded to criticisms of their quality control systems. There were seven categories identified. To illustrate the nature of steps, two items from the first two categories were:

Audit performance:

- changing the organizational structure so that responsibility for ethics, independence, client acceptance, and audit quality monitoring is separated from responsibility for audit operations and business development with a separate and direct reporting line to the firm Chairman,
- adding a new requirement to include, in the audit documentation, evidence of engagement partner and manager involvement in, and review of, certain detailed work papers; (PCOB, Release 104-2006-78)

Internal inspections:

- increasing the number of engagements subject to internal inspection;
- making changes to affect the internal perception of participation as a reviewer in the firm's internal program by, for example, making clear that participation in the program is an indication that an individual is

viewed as a top performer and that it is an important developmental step in the career path of any senior manager who aspires to partnership, rather than being treated as a distraction from other responsibilities viewed as more important to advancement in the firm. (PCAOB, Release 104-2006-78)

### 3. The Nature and Limitations of Full Scale Inspections

The PCAOB transformed the requirement of the Act to “*determine compliance with relevant rules and regulations*” into a supervisory style of inspection with focus on self improvement. Noted in the Board’s 2007 Annual Report is the following::

From the viewpoint of public investors, the most important features of the supervisory model are the effects the PCAOB’s program have on strengthening quality control and risk-management practices of registered firms and, in a broader sense, achieving more consistent compliance with applicable professional standards. (PCAOB 2007 Annual Report)

In earlier annual reports, the PCAOB, had underscored that the supervisory approach encourages firms to improve their practices and procedures.

#### The Strategy for an Inspection

Inspections are not identical from one firm to another. There is no basis, therefore, for determining the quality of audits performed by a single firm or all firms inspected in a year, therefore. (Given the status of measurement of audit quality there is support for not providing a *measure* of quality at the firm level; however, it is not clear that a macro level assessment (of all firms for a year) could not be tentatively determined, at least for the Board’s consideration, if not sufficiently valid for public disclosure.

As noted in the Board’s annual reports, inspections include only portions of selected audit engagements performed in the prior year by each registered firm undergoing an inspection. Engagements, as well as portions of engagements, are selected for inspection primarily based on an assessment of the risk of material misstatement or significant audit deficiencies as well as other firm-specific risks. (PCAOB, 2007 Annual Report)

The focus is on aspects of the selected audits that are most likely to present “challenging issues.” This risk-based approach is the result of cooperative efforts between the Division of Registration and Inspection and the Office of Research and Analysis. (2007 PCAOB Annual Report)

During the process, while maintaining “a constructive, arms-length dialogue with the registered firm, identified deficiencies are discussed with the Firm’s staff

members related to the auditing process and/or to the particular audits under review.

Each inspection has two components: inspection of selected audit engagements and assessment of quality control factors that are considered critical in the consistent quality performance of audits. Disclosure requirements for the two component differ, however.

### Disclosure in Inspection Reports

A written report of the findings of an inspection is required. However, as noted by one Board member, Niemeier: “The reports are not designed or intended to rate firms according to a scorecard. . . .” He later commented: “The primary purpose of PCAOB reports is to further the dialogue between the Board and the firm about areas where the firm can improve its auditing.” (Niemeier)

Complete disclosure of findings is not provided to the public. In an effort to protect what is perceived to be confidential and proprietary information, the Board may further limit disclosures, beyond those related to quality control systems.

Deficiencies in Audits. The findings related to deficiencies noted in the review of selected audits of financial statements and of internal control over financial reporting are included in the public portion of the inspection report. The inspection team alerts the firm to the deficiencies during the inspection process and in those instances where the team’s judgment is that “those deficiencies that exceed a certain significance threshold are summarized without disclosure of the client.” Such deficiencies are identified in the publicly issued report as related to Issuer A, Issuer B, etc.

Each full-scale inspection report includes a statement about the meaning of deficiencies identified. That statement generally includes:

First, inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm’s attention. Under PCAOB standards, a firm must take appropriate action to assess the importance of the deficiency to the firm’s present ability to support its previously expressed audit opinions. . . . A Board inspection does not typically include review of a firm’s actions to address deficiencies identified, but the Board expects the firms are attempting to take appropriate action. (see initial pages of an inspection report or PCAOB Release No. 104-2007-001)

Generalizations not Warranted. The limitations for generalizing from reading a firm’s annual inspection report are noted in each report:

- . . . the Board cautions against drawing conclusion 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 audit performed. . . and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm’s practice. . . . if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits . . . .(See any inspection report posted at the PCAOB website)

Quality Control Findings. There is explicit specification that

“ . . . no portions of the inspection report that deal with criticisms or potential defects in the quality control systems of the firm under inspection shall be public if such criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than twelve months after the date of the inspection report. (Sarbanes-Oxley Act of 2002, Section 104, (g) (2)) weakness and this may increase the number of deficiencies reported for that firm in that year. (See any initial pages of an inspection report)

Supervisory Context is Highlighted. An inspection team is not performing a legally-driven engagement with a specified measurement of compliance. References to violations or potential violations of laws, rules, professional standards are to be understood in the supervisory context in which a report is prepared. As noted in each inspection report:

. . . any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm’s cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation. (See initial pages of an inspection report.)

#### 4. Perceptions of the Inspection Process

There is limited discussion of the effectiveness of the inspection process available at the PCAOB website or in professional accounting literature. Among the references found through a Google search using the phrase *PCAOB inspection process* revealed a few relevant references. A search of ABI-Inform, using the same phrase, resulted in 15 items, most were merely discussing the process; few provided any critical assessments.

## The Overall Inspection Process

In an article discussing William McDonough's leadership style after he had left the PCOAB and had joined Merrill Lynch as vice chairman, there was reference to his experience in serving as the first chairman of PCAOB. This comment was made:

McDonough pushed forward, molding the PCAB to act more as an inspector than as an enforcer. From his term at the Fed, which has certain regulatory responsibilities over banks, McDonough knew that it was important to get input from the auditors, learn their problems, win their trust. His instincts told him that was the surest route to real reform. Play bad cop and you'll only drive them away. . .

. . . McDonough hired 160 new PCAOB inspectors but only 20 enforcement officers. . . McDonough's approach worked. The PCAOB was able to sit down with auditors and hammer out a set of workable standards that have since helped overhaul professional practice. (Martin)

Concern about the sufficiency of the process was discussed by an experienced auditor, McDonnell, who noted:

The PCAOB made it clear the profession must regain the public's confidence or face severe censure. But the board's decision to use an inspection process to perform its oversight creates a high-risk environment for the profession. In a February 2004 speech at the Economic Club of Chicago, McDonough said the PCAOB inspection process would consist of reviews of audit engagements to ensure compliance with securities laws, the rules of the SEC and the PCAOB and the highest professional standards.

Unfortunately, experience shows this approach provided little assurance of mitigating the risk of audit failure. Even though such reviews were an integral part of the internal quality control programs of audit firms for years, they weren't very effective in preventing audit failures. Why would the PCAOB's experience be any different? When I visited the PCAOB several months ago and posed that question to George H. Diacont, the PCAOB's director of registration and inspections, he answered, "We'll do it better." (McDonnell)

A similar concern about the adequacy of the overall process was noted by Alles et. al. who noted:

Given its ambitious agenda to extend inspections beyond the Big 4, the PCAOB should reflect on its experiences during both the 2004 and 2005 inspection programs and evaluate its procedures. For example, are the inspections structured so they will help restore the credibility of the audit

function? More importantly, will the PCAOB's inspection process uncover the underlying auditing and reporting problems that led to the creation of the Sarbanes-Oxley Act? Probably not. (Alles, et al.)

Ciesielski noted the extent of inspections implied in SEC Chairman Cox's testimony in mid September (2006) by quoting Cox commenting about the SEC's concern about audits being done without wasted time and effort:

We anticipate that the SEC staff's next inspection of the PCAOB will focus on the PCAOB's own inspection program for registered audit firms. In particular, the staff will likely focus on the PCAOB's inspection of audits under PCAOB Auditing Standard No. 2. . . .we hope to achieve greater compliance with the Commission's and the PCAOB's own guidance that these be risk-based and cost-effective. (Cox's words as quoted in Ciesielski, The AAO Weblog)

Ciesielski then noted:

In short, carrying out the task of auditing public companies in accordance with the standards set by the PCAOB won't be good enough – they have to be efficiently done as well. Considering that the vast initial job of documenting control systems and getting them in order is now out of the way – at least, for firms above the \$75 million market cap threshold – it's reasonable to expect that auditors re moving along the learning curve. We'll see when the PCAOB completes its inspections. (Ciesielski)

## Results of Inspection

Gullapalli, in a *Wall Street Journal* article reported, after talking with companies who had the results of their limited inspections, that:

In general, the companies [interviewed for the article] dub the change superficial and say it didn't have anything to do with their fundamentals. . . . Still however small the dollars in these particular instances may be, some accounting specialists see the accounting board's close look at this relatively obscure rule [reference to requirement in Emerging Issues Task Force Issue No. 95-22: "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Arrangements."] as a possible preview of more stringent rule enforcement in general. (Gullapalli)

Johnson noted that the "second round of official inspection reports related to the Big Four audit firms" led to a "handful of negative headlines" which may reflect the inadequacy of the shared information as well as the fact that the reports are for past periods and do not truly reflect how the audit firms are currently performing. As Johnson stated:

Using the terms "failed" and "failure" numerous times, the PCAOB cited the firms for basic accounting issues, some of which relate to lease and

tax accounting, revenue recognition, and goodwill-impairment testing. All four of the reports, and the PCAOB's previous evaluations of the Big Four's work, noted that in some instances the firms did not "identify or appropriately address errors in the issuer's application of GAAP." (Johnson, *Why the Big Four are Still a Mystery*)

Leone noted that the 2005 inspections of two of the big four that were issued in early January 2007. She commented:

. . . one report identifies 10 companies for which audits were deficient, and says that in 'some cases' the errors appeared 'likely to be material to the issuer's financial statements.' The other report identifies 11 deficient audits, and says that in 'one case' the result is likely to be material. (Leone)

Leone noted that neither auditor changed any of its audit opinions as a result of the PCAOB report or the completion of further procedures.

In responses to questions posed in an E-mail to Charles Niemeier, a PCAOB Board member, a "behind-the-scenes" look was provided. In response, for example, to the question: What do the 2005 inspections reports on the Big Four tell us about the audit firms?, Niemeier stated:

. . . they are intended to focus firms on the areas where they can improve. . . . I feel comfortable saying the firms have come a long way in identifying and addressing risks to their audit quality, as a part of our inspections as well as on their own. (Johnson, *O&A: The PCAOB's Charles Niemeier*)

#### Disclosure Provided in Reports

The position of the Board for maintaining confidential sections of the inspection report was stated clearly in the 2005 annual report noting the statutory limitation of disclosures related to a firm's quality control system. That requirement "reflects a legislative policy choice encouraging self-correction." Further comment included:

The inspection report [the confidential portion, that is] encourages the firm to initiate a dialogue with the Board's inspection staff about how the firm intends to address the criticism. The Board provides the opportunity for dialogue so that a firm acting in good faith can receive timely feedback from the staff and enhance its efforts accordingly before the 12-month deadline. (2005 *PCAOB Annual Report*)

David Costello, CEO of the National Association of State Boards of Accountancy, in an exclusive interview with *The Practical Accountant*, explained changes due to Sarbanes-Oxley. He noted:

The principal mission of boards of accountancy is to protect the public through licensing qualified individuals and firms in the practice of accountancy, and providing quality assurance to the public through programs of continuing education, firm reviews, and when appropriate, enforcement of its rules and regulations. While the role of boards hasn't changed (i.e., its statutory mandate). SOX has indeed influenced the methodologies of boards.

Most obvious is the public dissemination of the PCAOB's inspection reports. Boards are now made aware of deficiencies in audit performance earlier than under the previous firm-on-firm peer review process of the profession. Some boards are seeking more information about deficiencies in these inspection reports directly from their licensees. (Anonymous)

In an news article related to the issuance of the four limited audits issued on August 26, 2004, Weil noted:

KPMG's decision to voluntarily disclose the finding of potentially significant conflicts [the inspection had found that the accounting firm had accepted fees from independent-audit clients based on how much money it helped them save in taxes] highlights how shrouded in secrecy the new agency's process will be. The other three firms . . . declined to specify what concerns, if any, the board raised about them in the confidential sections of their reports.

Weil continued his discussion, noting:

When Congress created the Board, it acceded to pressure by the Big Four firms to include a provision in the law under which the Board only would disclose the existence of deficiencies in a firm's quality controls if the firm hadn't fixed them within a year.

Weil quoted Turner, the SEC's chief accountant from 1998 to 2001 who stated: 'Congress needs to quickly bring that out into the sunshine.' Weil also noted that the other three big firms declined to discuss the confidential sections of their reports. One of the three assured Weil that they did not intend to depart from Congress's process. (Weil)

##### 5. Postulates Needed to Guide Behavior of Inspectors

While there is an explicit, straight-forward statement about the purpose of a continuing program of inspections, the implementation in the policies and practices of the PCAOB is not as clear. Section 104 of the Act states, as noted earlier, that an inspection is *to assess the degree of compliance* . . .

The implication from such a statement of purpose is that there are objective criteria for establishing compliance and that a process can be established that will provide assurance that a firm is performing audits in conformity with such

criteria. Assumptions, that are accepted as postulates are needed to establish the framework to guide the behavior of inspectors. A parallel to the postulates of auditing promulgated by Mautz and Sharaf (see their *The Philosophy of Auditing*, American Accounting Association, 1961) is needed.

The following is a suggested tentative set of postulates for consideration:

1. An inspector undertaking an inspection of an audit firm is acting only as an inspector, who is a qualified, independent individual, whose integrity assures acceptance of responsibility to determine the extent to which the audit firm is adhering to the rules and standards specified.
2. An inspection is an objective engagement for which relevant evidence is obtainable.
3. Evidence ranges from documentation maintained by the audit firm to evidence that confirms what is provided in the documentation, including, but not limited to observations, inquiries, and analyses of work completed.
4. The audit firm has an obligation to be cooperative, honest, and accepts the value of such an investigation.
5. The inspection team is able to determine the materiality of deficiencies disclosed during the inspection process and conclude its report with an objective judgment relative to materiality as the report is prepared.
6. The audit firm's response to the draft of the report is to be carefully reviewed and judgments challenged are to be subjected to further review by another designated review group.
7. There shall be provided sufficient information about the inspection process and the findings that an interested reader has a clear understanding of both the process and the findings, taking into account information that is perceived to be best maintained confidentially.
8. The inspection process should be subjected to regular assessment for the purpose of determining changes needed to assure higher reliability for findings and improved methods that assure more timely reporting.
9. The information gathered from inspections related to quality control systems should be analytically studied for discovery of behavioral and administrative strategies that appear to result in high quality audits.
10. A persistent goal for inspections is to be the enhancement of audit quality to the extent that there is perceived to be credibility in the audit reports provided to audit clients.

None of these refers to the scope, nature, or extent of public disclosure. Until a number of years of inspection results are subjected to empirical statistical analysis for validity and reliability there is no basis for disclosure of findings for individual registered public accounting firms. Public disclosure of a compliance score, for example, is not likely to be justified without such objective study. An overall compliance report for a year's audits could be disclosed publicly after the establishment of valid measurement strategies.

## 6. Questions for an Assessment of the Inspection Process

The foregoing tentative postulates are inspired by what are perceived to be potential flaws in the current inspection process. The following are merely questions raised as a result of problems identified or implied in comments that have appeared in inspection reports, conferences, newspapers, and in conversations.

### Is the role of an inspector confused?

The Board takes "a supervisory approach to oversight and seeks through constructive dialogue to encourage firms to improve their practices and procedures." Is the inspector to be a counselor, a consultant? Is there no awareness, as McDonnell noted (discussed earlier in this paper) that audit firms have had quality control systems for decades. Yet, those systems were noted to be lacking in what many would call basic components of such systems such as appropriate segregation of duties of those responsible for monitoring ethics, independence, client acceptance, and audit quality from those responsible for audit operations. Should an inspector assume that an audit firm has an understanding of quality control? Is it possible to be *both* an inspector and a consultant?

Compliance implies the need for objective and clear criteria. Traditionally, auditors are only auditors when they provide audits; they cannot at the same time be a consultant.

### How objective is the current inspection process?

How independent is an inspector if there is a continuing dialogue with members of the audit firm? The inspector must gain information from staff and must clarify the meaning of information provided. Inspection team members and audit firm staff meeting on a continuing basis about deficiencies identified may undermine the objectivity of decision making on the part of the inspection team.

How is objectivity safeguarded and assured in a supervisory environment?

### How persuasive is the evidence obtained?

There are often references to the documentation read during an inspection.

However, there is no information provided of *additional* evidence obtained to provide corroboration of the documentation. Is it sufficient, for example, to read memoranda (or emails) that state clearly that there are to be no sign offs on procedures that have not been completed as a basis for concluding that such a practice is not tolerated in this firm?

Inspection reports fail to reflect sensitivity, for example, to the hierarchy of employees in public accounting firms as well as other likely attitudes that could influence the nature of response of individuals. For example, reports identify focus groups that include more than one level of employees. Seeking evidence of how the tone at the top is perceived by staff members at the staff auditor level when those staff auditors are included in the same group with seniors may fail to get candid opinions.

Do inspectors get training in the art of asking questions, in observing, in assessing behavioral factors that are basic skills developed among sociologists and educators who undertaken field research studies and/or work with individuals and groups to gain understanding of what is actually happening.

#### How does the inspector inform the audit client of its role?

There are often references to the “watchdog” role of the inspectors. Public accounting firms have a long tradition of self-regulation. They had had more than two decades of a peer review process under the auspices of the Public Oversight Board that was gentle and essentially worthless. The imposition of a government-driven oversight process breaks with tradition. The proper nature of oversight is, possibly, not yet devised.

The failure of oversight was revealed in the extensive weaknesses in quality control noted by the PCAOB. Yet, possibly, the positive conclusion of the first report related to quality control weaknesses was justified during this initial period. If such gentleness continues, the possibility of enhancing audit quality is likely not realized. The statement in the PCAOB report doesn’t communicate clearly a level of satisfaction but merely states: “the Board determined that the firm addressed the quality control criticisms to the Board’s satisfaction for purposes of Section 104 (g) (2) of the Act.” (PCAOB, *Observations on the Initial Implementation.*)

The reality of the need for more systematic, objective oversight must be communicated to audit firms. Reasonable accountants who understand their public interest responsibilities will understand the need for credibility of audit reports.

Another aspect of this question relates to the extent of public accounting responsibility. In February 2008, the PCAOB proposed a new standard related to public accounting firms conducting internal evaluations. In a brief article, Johnson noted: that Scates of the PCAOB stated that: The engagement quality

reviewers [of a registered firm] have a real potential to reduce after-the-fact audit failures.” (Johnson, *Auditor, Audit Thyself*)

### What is the threshold for materiality?

While a series of deficiencies in application of GAAP has value what does the series reflect when the audit as a whole is considered? Somehow that question should lead to a general statement about materiality for an inspection report that can be communicated in the public portion of the report. It is not sufficient for the Board to indicate that it is not a “score card.” However, we live in a society where the sense of the whole is of great significance. Just as the auditor must reflect an opinion about the financial statements taken as a whole, should not the inspector be able to reflect a judgment about the adequacy of the application of GAAP for the sample of audits inspected?

### At what point should an audit firm receive a draft of a report?

From information disclosed, there have been problems with the timely completion of an inspection report because of matters that were subject to challenge by the audit firm. It is not clear who participates in resolving the challenges. There is noted that it is the audit firm’s responsibility to determine whether or not a proposed change in the treatment of a transaction, for example, will be accepted.

Is the process related to review of drafts optimum? Should inspectors, if among themselves have varying opinions about the treatment of a transaction have access to some review group – possibly, inspectors not participating in the particular audit – to serve as a consultant? The matter presented to such a group – or an outside group – can be presented in a manner that there is absolutely no disclosure of the audit firm or the audit firm’s client that is the subject of the unresolved matter.

### Why is the written report provided to the public vague?

The initial limited audits resulted in reports that provided somewhat more information than was provided in the full-scale audits. While the detailed strategy may indeed need to be maintained confidential, there should be sufficient disclosure that a reader has a macro sense of what is done during an inspection. The reports of the full-scale inspection omit all information related to quality control, because it is the judgment of the Board that confidentiality encourages self-correction. This latter assumption may need to be explored empirically by noting the extent to which there is indeed self correction observed in subsequent inspections.

### How does the Board review the inspection process?

There are delays in reporting, for example, that may be providing clues to problems with the current structure. For example, the continuing interaction with the client may prolong the process. Would it be more efficient to deal with

conflicts between the perceptions of the inspection team and the client through using a review group – from the inspection staff or an outside, competent group of people – to come to a judgment about which explanation – the team’s or the client’s -- is better?

#### Is information being analyzed?

The inspections provide a range of information heretofore not available for empirical study of what actually is the behavior – and outcome – of audit engagements. Now, there is being gathered information that will contribute to understanding, for example firm characteristics, policies, and practices that enhance quality performance – and undermine such performance. One of the valuable outcomes of the inspection process is the accumulation of information that may be of great value in learning what differentiates an office where effective audits are standard outcomes and where there are significant number of audits that are not effective. For too long there has been the “black box” of uncertainty about external auditor behavior.

#### Can the value of quality audits be internalized?

External auditors, audit clients, and regulatory agencies must have a sustaining belief that a reasonable goal is that audits be consistently effective and do provide the reasonable assurance claimed in auditor reports.

How genuine is the interest in maintaining high quality in the performance of audits? A common statement in the letters from firms attached to the inspection reports is “Quality is our top priority and we are committed to continuously improving our audit quality.” Is this statement made without impact on the reality of how audits are indeed performed? As noted earlier, there is no general conclusion about the degree of effectiveness of the audits performed by the firm because of the nature of the process as explained by reports provided by the PCAOB, As an illustration of the difficulty of interpreting statements that hint at quality, consider the language used in discussing the extent to which the firms responded to weaknesses in quality control:

. . . the Board believes that those firms have crafted and undertaken important steps that, if conscientiously implemented, will have beneficial effects on audit quality.(PCAOAB Release 104-2006-078)

Such a statement does not provide the reader with *exactly* what was the outcome of the quality control issues raised and for which the firms had to submit reports (Under Rule 4900 process) in response to the issue. The wording of the PCAOB’s comment would lead a reader to believe that the firms are being required to undertake practices that are brand new. Yet, quality control systems are not new; as noted earlier, professional guidance about quality control has been provided for decades. Has the Board identified why prior guidance was seemingly ignored to a significant extent by public accounting firms?

## 7. Summary

The discontent with the inspection process persists. Much of the discontent has been deemed to be self-serving on the part of firms and issuers and seems not to be influencing behavior of the PCAOB.

Such criticism deserves attention. Furthermore, a comprehensive, objective review of the inspection process is justified. The Act of 2002 targeted a woefully ineffective aspect of the self-regulatory strategies of the public accounting industry. However, oversight that fails to meet its goal is not worthy of continuing support.

The summary of this exploratory review is:

1. The Board continues to use the strategy established with the initial Board's deliberations. Does the Board plan to continue the current strategy which has now been used for more than five years? Does the current strategy reflect the need to begin with something less than a compliance engagement because of the unanticipated problems encountered in attempting to assess *compliance*?

Possibly, the need for reform is an evolutionary process and a long learning period is needed, notwithstanding that, in the case of public accounting, there has been long-term regulation and oversight .

To date, it is not clear that the strategy is better than that provided by the Public Oversight Board, which persisted for more than two decades without achieving anticipated oversight success. There was no objective review of POB, for example, after the first year or even the first five years.

2. The vague discussion of the actual inspection process established for a particular engagement does not provide sufficient information to judge the nature of the process.

3. The process has the tone of a consulting group that is attempting to be helpful to individuals who do not seem to know accounting principles or are uncertain about what is required for an audit engagement. The tone is not clearly one that is objective and could lead to a reasonable conclusion that has meaning to all interested in audit quality for the population of audit firms registered.

4. The Sarbanes-Oxley Act of 2002 reflected the need for a more reliable oversight process than one then in use. The PCAOB is a new oversight Board. Getting underway is not a simple task; it requires time. However, inasmuch as oversight was not a new concept and there had been professional guidance for auditors to follow, it is not quite clear how much introductory time is needed to achieve an optimum and sufficiently rigorous oversight strategy to assure confidence in the opinions expressed by external auditors.

5. The current inspections do not provide sufficient information about an assessment of auditor performance for the population of registered companies as a whole. There has not been sufficient study of audit quality to give an inspected firm a rating.

6. Oversight credibility of the PCAOB is still an uncertainty. Recent disclosures of inadequate internal controls, including risk management, have been noted in some major financial services organizations. Yet, such firms received unqualified opinions about their internal controls. Were the weaknesses at a level below significance?

7. Is there not a need for an established framework for an inspection that determines *compliance* and includes postulates?

8. An objective, comprehensive assessment appears justified. For example, the opinion of Neimeier that “. . . I think both our inspections and firms’ own initiatives are driving improvements” may indeed be the reality. Is it reality or merely a wish? At this point, such an opinion needs to be transformed into an hypothesis for empirical investigation.

What is provided here is exploratory. Nonetheless, tentatively there is support for an objective assessment. That assessment must be comprehensive and go beyond the one topic included here, the inspection process. The process, itself, was selected for discussion, since it appeared to be the core driver of what the Act of 2002 sought to achieve.

9. Beyond the inspection process, for example, there needs to be an answer to the question: Is the current structure for oversight optimum? Why isn’t oversight a direct, rather than a vague indirect, responsibility of the Securities and Exchange Commission or of a newly constituted substitute for the Securities and Exchange Commission?

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