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PCAOB Inspections:
Perceptions of Triennial Firms with No-Deficiency Inspections

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PCAOB Inspections:
Perceptions of Triennial Firms with No-Deficiency Inspections

ABSTRACT

The drive to enhance audit quality after the cascade of audit failures in the final decades of the last century and first two years of the new century resulted in a new structure for the oversight of public accounting firms. The Public Company Accounting Oversight Board (PCAOB) was established with the passage of the Sarbanes-Oxley Act of 2002. This Board was given the authority to inspect all public accounting firms who provide audits to publicly-owned companies reporting to the Securities and Exchange Commission. Such public accounting firms were required to register with the PCAOB. Accounting firms who audit more than 100 clients per year are required to undergo a yearly inspection; firms who audit 100 or fewer clients undergo inspections at least once every three years and are referred to as *triennial firms.*

No firms that are inspected yearly have to date received a deficiency free inspection report. However, some of the triennial firms have had deficiency free reports. It is this sub population of registered companies -- the triennial firms -- that is the topic of this paper. Furthermore, the interest here is limited to inspection of the auditing process of the firm; there is no attention to quality control, which constitutes a separate assessment and conclusion.

A simple, relatively brief survey inquiry questionnaire was designed to obtain the opinions of a key person in the sample of firms chosen at random. Questions asked for reasons for their deficiency-free inspections, opinions related to the value of inspections, the role of the PCAOB, and their interest in increasing the number of SEC reporting clients they serve. The questionnaire was accompanied by a covering letter.

Executives of 41 (35.6 percent) of the 115 to whom requests were mailed responded. Among the findings were: A. Factors perceived critical for achieving no-deficiency audits accepted by the respondents were: 1. Systematic, timely and thorough review process; 2. Level of knowledge/skill of the total audit team and; 3. audit partner's skill in team leadership. B. A majority of respondents concurred the reasons for deficiencies were 1. inadequate review process, 2. weaknesses in knowledge of relevant GAAP and 3. audit partner leadership skills inadequate. Other conclusions are included in the report.

PCAOB Inspections:
Perceptions of Triennial Firms with No-Deficiency Inspections

The drive to enhance audit quality after the cascade of audit failures in the final decades of the last century and first two years of the new century resulted in a new structure for the oversight of public accounting firms. Among the changes were: accounting firms. providing audits to clients reporting to the Securities and Exchange Commission (SEC), (1) were required to register with the Public Company Accounting Oversight Board (PCAOB) and (2) had to undergo inspections of their auditing function and their quality control programs. These requirements are stated in the Sarbanes-Oxley Act of 2002 which established the PCAOB. That Act stated the general nature of the Board's responsibilities for inspections of registered public accounting firms:

> The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons. . . 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, Section 104)

The Act also set the frequency of inspections stating that

> (A) annually with respect to each registered public accounting firm that regularly provides audit reports for more than 100 issuers, and (B) not less frequently than once every 3 years with respect to each registered public accounting firm that regularly provides audit reports for 100 or fewer issuers. (Sarbanes-Oxley, Ibid.)

Inspection reports relate to both auditing and quality control programs. Deficiencies found related to auditing are identified in the publicly-disclosed inspection reports posted at the PCAOB website. If no deficiencies are discovered in the inspection of audits performed, the report includes this information.

Weaknesses in quality control are not noted initially in the publicly-disclosed inspection reports. However, if there are no problems related to quality controls the publicly-disclosed report will include a note about this matter.

Most inspected registered firms have received inspection reports with deficiencies noted. (Deficiencies are referred to as Issuer A, issuer, B, etc; names of audit clients are not identified in the publicly disclosed reports at the PCAOB Website.) None of the ten firms that audit over 100 clients has received to date (as of late March 2008) a no-deficiency report. However, there are some firms among those that audit 100 or fewer companies reporting to the SEC that have had deficiency-free reports.

Olson, the Chairman of the PCAOB in testimony before the Committee on Small Business of the House of Representatives noted the importance of small registered firms by stating:

> . . . of the 1,000 plus domestic audit firms that are registered with the PCAOB, the overwhelming number are small firms. . . . While our experience in inspecting these firms [the triennial firms] varies, we are reassured to discover that many very small firms provide high quality audits for their clients, many of whom are small businesses. (Olson,, 2007)

It is this sub population of registered companies -- the triennial firms -- that have deficiency-free reports that is the topic of this paper. Furthermore, the interest here is limited to inspection of the auditing process of the firm; there is no attention to quality control, which constitutes a separate assessment and conclusion. It is true that there is in reality an overlap between the two components of inspections. Indeed, many quality control problems identified have been related to the auditing process and audit conclusions of the firms. The overlap and interrelations are worthy of study but are beyond the scope of this exploratory survey investigation.

A simple, relatively brief survey inquiry questionnaire was designed to obtain the opinions of a key person in the sample of firms chosen at random. Questions range from perceptions of the reasons for their deficiency-free inspections, opinions related to the value of inspections, the PCAOB to their interest in increasing the number of SEC reporting clients they serve. The questionnaire was accompanied by a covering letter.

In the remaining parts of this paper, the following topics are discussed: 1. The Inspection Process; 2. Extent of Inspections Completed; 3. Criticism of the Inspection Process; 4. Methodology and Limitations of the Survey; 5. Responses from Triennial Firms; 6. Review of Literature; and 7. Summary and Reflections on Responses.

1. The Inspection Process

From the initial functioning of the PCAOB, the Board determined that a supervisory approach would be the strategy for determining compliance with rules and audit guidance. Inspections began in 2003 with limited inspections of the largest 4 U. S. public accounting firms. Then in 2004 inspections began for registered accounting firms of all sizes. At the conclusion of each inspection, a report is prepared that is submitted to the SEC and to the inspected accounting firm. Additionally, there is a publicly disclosed inspection report that is posted at the PCAOB Website.

The Nature of an Inspection

The inspection process has been designed to encourage public accounting firms to maintain a high quality auditing process through an inspection of both auditing policies and practices and quality control programs. The goal is to enhance the quality of audits through identifying and addressing weaknesses and deficiencies related to how the firm under inspection conducts audits.

The overriding question for the inspectors is: Has this firm adhered to the rules and practices of auditing in the performance of audits of publicly-owned companies?

Failures that are identified as *deficiencies* are described by the PCAOB as "only those deficiencies that, in the inspection team's judgment, resulted in the firm failing to obtain sufficient competent evidence to support its opinion on the financial statements." (PCAOB, Report on the PCAOB's 2004. . . .)

There is no established strategy that is used for all inspections. The inspectors for a particular inspection determine which audits are selected, and what aspects of those selected will be reviewed. Through the review of such aspects, the inspectors "may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately whether the financial statements are fairly present the financial position, results of operations, or cash flows of the issuer in conformity with GAAP." (Each inspection report includes this statement or a similar one.)

Inspectors review audit documentation for those audits selected and also interact with staff in discussions about what is being inspected. Changes in what is to be done, in some instance, are made as the inspection proceeds.

Each inspection report states:

> It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report. (See an Inspection Report at the PCAOB Website for this paragraph or a similar one.)

Limitations in Conclusions Drawn from an Inspection Report

Conclusions from an inspection report are limited. There is no basis for a judgment about audit quality in the particular registered firm under inspection. Furthermore, there is no basis for determining of audit quality of all the inspected firms or a subgroup of inspected firms. The unique, or custom, design of each inspection precludes any overall generalizations about audit quality. Each inspection report states that there is no basis for supporting any negative inference in this standard paragraph that is found in each inspection report:

> 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. (See an inspection report for this statement)

Each inspection report informs the reader that "any references . . . to violations or potential violations of laws, rules, or professional standards should be understood in the supervisory context in which this report was prepared."

Therefore, the question can be raised: "Why be concerned about triennial firms that have no-deficiency inspection reports if there is no basis for judging the firm?" "Is it not appropriate to conclude simply that those who have no deficiencies have "done something right," if only partially?

Also, since the Board has chosen a supervisory approach, there is a possibility that receiving a report that indicates that the firm's inspection revealed no deficiencies is an incentive to maintain high standards for audit engagements. If deficiencies are disclosed, will such information motivate firms to reduce the incidence of deficiencies in the future?

At this point, the preceding paragraph is merely identifying potential hypotheses for future investigation. This exploratory survey of firms with deficiency-free inspection reports provides merely some opinions and reflections on the experience of heads of triennial firms about the topics included in the survey.

Information Provided about the Firm and the Process

Information in the publicly-disclosed inspection reports is not identical from one inspection report to another. In general, the reader does find some information about the firm and some about the process.

Information about Each Firm

Inspection reports identify the number and location of offices, the nature of ownership structure, number of partners, number of professional staff and number of issuer audit clients. However, the latter number – number of issuer audit clients -- is noted to be the number provided by the registered firm under inspection. The inspectors do nothing to verify the figure provided.

Some information is not provided including who is responsible for the management and oversight of the auditing function and the quality control function. If there has been a merger or split in the firm, there is no reference to such change. There is no identification of the persons with whom the inspectors interacted. However, the respondent was asked to identify his/her position. There is no information about how any challenges to deficiencies are reviewed and what resolution, if any, is reached.

Information about the Process

Information is provided about the period during which the inspection took place; however, it is not sufficiently detailed so the reader does not learn the number of inspectors involved or how many hours were spent in field work. Additionally, there is a general reference to the offices of the registered firm that were included in the inspection.

In most reports, there is reference to the number of audits involved in the inspection, but there is no explanation why, for example, 2 audits of the 5 were inspected in one instance while in another instance all of the 4 audits of SEC reporting clients were inspected.

For firms with deficiencies, there is provided a general discussion of the deficiencies found. An example of the explanation for a firm where the audits of all 3 issuers were included in the inspection report that included deficiencies is the following:

> The scope of the inspection procedures performed included reviews of aspects of the performance of all three of the Firm's audits of the financial statements of issuers. Those aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.
>
> The inspection team identified matters that it considered to be audit deficiencies. The deficiencies identified in two of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements. Those deficiencies included the failure to perform and document adequate procedures related to the existence of plan investment in two of the audits reviewed. (See Inspection of Dannible & McKee LLP, May 11, 2006 at PCAOB Website)

As noted earlier, if there are no deficiencies related to auditing, the inspection report will include a paragraph that so states. The statement below is from the second inspection of the same Firm (where there were no deficiencies) noted in the preceding excerpt from the Firm's first inspection report. While the firm continued to report that it had 3 issuers, in the second inspection, only one issuer's audit was inspected. The statement quoted about no deficiencies is typical of the statement found in most such inspection reports:

> The inspection procedures included a review of aspects of the Firm's auditing of financial statements of one issuer. The scope of this review was determined according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the scope. This review did not identify any audit performance issues that, in the inspection team's view, resulted in the Firm failing to obtain sufficient competent evidential matter to support this opinion on the issuer's financial statements. (See Inspection of Dannible & McKee, LLP, October 23, 2008 at PCAOB Website)

2. The Extent of Inspections Completed

The PCAOB issued a report on the PCAOB's 2004, 2005, and 2006 inspections of domestic triennially inspected reports. The Report included some details about the extent of inspections through 2006 of accounting firms that audit no more than 100 issuers each

year. These firms are referred to as "the triennial firms" since they are subject to inspections at least once in every three calendar years. The report stated that

> 91 inspections were performed during the 2004 inspection cycle, 257 inspections during its 2005 inspection cycle, and 149 inspections in 2006 cycle, for a total of . 497 inspections. (However, as of October 2007, there were 439 reports issued; 58 were yet to be issued.). Of the 439 reports on the first inspections of U. S. triennial firms issued to date (through 2006), 124 (approximately 28 percent) did not identify any audit performance deficiencies. . . . (PCAOB, Report on the PCAOB's)

A footnote in the above noted PCAOB Report indicated the extent of domestic registered firms were inspected: Approximately 4 percent had from 51 through 100 issuers; six percent had from 26 through 50 issuers; twenty-seven percent had from 6 through 25 issuers and 62 percent had five or few issuer audit clients. (Ibid.)

The last available Annual Report of PCAOB is for 2007 (as of April 10, 2009). This Report noted that for the year 2007, PCAOB inspectors reviewed 461 audit engagements performed by the 10 firms that had audited more than 100 issuers in 2007 and 574 audits performed by the 226 other firms inspected. (Inspection reports of the 10 firms reveal no information about the number of audits inspected in each audit.) However, the figures provided in the 2007 Annual Report provide a basis for calculating averages: For those auditing more than 100 clients, the average is 46 audits per firm; for the triennial firms, the average was 2.5.

The average for triennial firms is reasonable given that in the first three years' inspections, 62 percent of the inspections were of firms with five or fewer issuers. Actually, there were a few inspection reports that noted "none" for number of issuers that were explained as firms that had ceased to be a client's auditor so a prior audit of the client was reviewed to determine effectiveness of the firm's auditing policies and procedures.

Role of the PCAOB's Office and Research and Analysis

As noted in the Annual Report for 2007, the Office of Research and Analysis (ORA) assists "in selecting audit engagements and identifying the risk areas within each engagement that might be reviewed." Additionally, the ORA provides research notes and training on complex accounting issues and trends in the market. For the year 2007, training was related to "fair value accounting, accounting treatment of subprime mortgage securities and resulting audit issues."

The Inspection Staff

Experienced auditors are hired to serve as inspectors. In 2007, the inspection team leaders responsible for large firm inspections had had 23 years of relevant experience.

The average for inspection team members averaged 15 years of relevant experience. These inspectors are located in the several branch offices of the PCAOB.

Budget Allocated for Inspections

It is not surprising that an oversight agency allocates considerable resources to inspections. The actual expenditures for inspections in 2007 were $54.944 M (43.74 percent of total budget); in 2008 budgeted expenditures were $64,573 M (44.65 percent of total budget) and for 2009 the budgeted expenditures are 68,753 M (43.62 percent of total budget) The extent of increase between actual expenditures for 2007 and budgeted expenditures for 2009 is essentially the same. (Increase in total budget is 25.4 percent, while the increase in expenditures for inspections is 25.13 percent) (PCAOB Budgets for 2007 and 2009)

Where Inspections are Performed

Initially all inspections were on site. However, more recently some inspections are performed in PCAOB offices throughout the United States. In 2007 the PCAOB performed 44 percent of its inspections of the 179 U. S. firms from PCAOB offices, which are located in Atlanta, Chicago, Dallas, Denver, New York, San Francisco, Los Angeles and Washington, DC.

The Annual Report for 2007 noted that "while not appropriate in every case, where they make sense, these PCAOB office-based inspections save time and money for both the PCAOB and the firm. (See comment on office inspections on page 19, *Related to Statement 3)*

3. Criticism of the PCAOB Inspection Process

Although inspections have been underway since 2003 (with the initial inspections of the big four firms only limited in scope), there has not been disclosed any serious assessment of the effectiveness of the process. An interesting paper suggesting needed changes is one by Glover, Prawitt and Taylor. The abstract includes the following:

> Although we acknowledge the benefits brought about by SOX, some of the problems that we outline are attributable to PCAOB choices that are not vetted publicly. In our view the Board's ability to achieve its mission is severely limited by its early choices, together with its incentives, organizational composition and structure. We believe fundamental changes are needed in the areas of inspections and standard setting. (Glover, et.al.*)*

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*)

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 . . .*)

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*)

A Google search (early January 2009) revealed no empirically driven assessment of the effectiveness of the inspection process. There is support for the efforts of the PCAOB. There is generally a realization that oversight is required. The support for what is expected, for example, is highlighted in an award winning paper by Wegman, who noted:

> While parties coming before the PCAOB can assert their legal rights in the enforcement process, they should be mindful that the Board's "supervisory approach" affords them an opportunity to work constructively with the Board. The Board much prefers to preserve public accounting firms rather than to see them fail. In almost all cases a firm will be better off taking advantage of the Board's supervisory approach rather than by aggressively contesting the Board's determinations. After all, both the Board and the profession share the common goal of providing the best possible financial information to decision makers. By working constructively with the PCAOB, public accounting firms can best serve their clients and themselves and attain the high standards to which their profession aspires. (Wegman)

Wegman's expectations are appealing. Now, such expectations need to be transformed into hypotheses and empirically investigated.

4. Methodology and Limitations of the Survey

Triennial firms that received no-deficiency inspection reports were identified by reading the inspection reports posted at the PCAOB Website, under the heading "Inspections" as of early November.. There were three groups identified: 1. Firms that had had one inspection only and it was reported that there were no deficiencies. 2. Firms that had had two inspections and both were reported to have no deficiencies, and 3. Firms that had had two inspections, with the first one containing deficiencies and the second was deficiency free. (There were no firms listed at the time of the sample selected that had a no-deficiency first inspection and had deficiencies in its second inspection.)

Sample Selection

From the list of such firms (listing revealed 251 firms with one or two inspections without deficiencies as of November 18, 2008), a random sample of 115 firms was selected with no attention to whether they had had one or two deficiency free inspections. At the time of questionnaire analysis, though, the original sample selected was classified into the three groups: One no-deficiency inspection: 54 firms; two no deficiency inspections: 24; and two inspections, with deficiencies in the first one; no deficiencies in the second: 37 firms. A tally of responses by these three categories did not show significant variations, so there were no separate analyses of the three subgroups.

The selection was from triennial firms only inasmuch as none of the 10 firms that audit more than 100 issuers annually has to date received a no-deficiency inspection report. These 10 firms are inspected yearly. The success of some of the firms who audited no more than 100 issuers yearly justified the focus on this group.

Letter and Survey Questionnaire

The website for each of the firms in the sample was accessed to determine who was the head of the firm. In some instances, the information provided was insufficient, so calls

were made to obtain the name of the managing partner or head of the firm. In only two instances were letters directed to Managing Partner, with no name.

The covering letter requested a response to a survey questionnaire of 14 questions as well as the title of the person (s) who responded to the survey. Copies of these two documents are in Appendix A. The respondents were asked to return the questionnaires by December 22, 2008. An envelope was enclosed for the response. There was no identification of responses, so responses were anonymous. A few identified the name of the person who completed the questionnaire, even though the question asked merely for the title of the person. There was no second mailing.

Limitations of Survey Questionnaire

Seeking opinions from busy practitioners through a written survey questionnaire is not the optimum strategy for gaining insight into the thoughts of practitioners. While some questions allowed for additional comments and a number of respondents did take time to write additional notes, there continue to be more interesting questions that arise from such additional notes than are answered..

At best, our exploratory survey provides some clues to current thinking and at the same time raises some interesting questions for further exploration.

5. Responses of Triennial Firms

The responses were summarized with no statistical testing to determine significance since this was an exploratory study to gain some general insight about a group of registered firms that had had at least one no-deficiency inspection report. After requesting information about the date of registration with the PCAOB, the inspections they had undergone, how many audits they provided for issuers and for other entities respondents were asked about the value of the PCAOB inspection process, the PCAOB overall, their plans for expanding their services to issuers, and expectations for new employees. The title of the person (s) responding to the questionnaire was to be identified.

At the time of the sample, there were no triennial firms that had been the subject of more than two inspections. No firm was identified that had a no-deficiency inspection initially and then a deficiency inspection as the second inspection. (It will be interesting to see what happens with the 3rd inspection.)

Basic Information about Respondents

While there were 41 responses (35.6 percent), in some instances not every question was answered. There was no second request sent to the total group. The responses by the three categories were as follows:

	Frequency	*%*
On inspection only and no deficiencies	15	36.6
Two inspections, both with no deficiencies	12	29.3

Two inspections, first with deficiencies, second with no deficiencies	14	34.1
total	41	100.0

The original percentages of the three groups included in the sample are somewhat different from the percentages of the responses. (No statistical test was used to determine if differences are significant since this is an exploratory survey investigation.)
The two sets of percentages are:

	Percentage	
Inspections	In sample	In responses
One inspection only, with no deficiencies	46.9	36.6
Two inspections, both with no deficiencies	20.9	29.3
Two inspections, first with deficiencies, second with no deficiencies	32.2	34.1
	100.0	100.0
Total numbers*	115	41
	100%	35.6%

**(as noted earlier, in the sample of firms asked to participate, there were 54 one-inspection only firms; 24 two inspection firms; 37 two inspection firms with first one with deficiencies.)*

Date of registration

The respondents indicated when they became registered firms. Table 1 reports their responses. Most of the firms registered during the first or second year of functioning of the PCAOB.

Table 1
PCAOB Registration Dates of Respondents
N = 41

Year of Registration	*Number of Respondents*
2003 (first year of the PCAOB)	22
2004	14
2005	3
2006	0
2007	1
No response	1
Total	41

Number of Audits: For Issuers and Others

Respondents were to write in the number of SEC reporting companies (issuers) for which they had performed financial audits during their most recent fiscal year.
Thirty five of the respondents answered this question. Results are presented in Table 2.
The categories are identified as they are in PCAOB reporting.

Table 2
Number of Audits of Issuers and Other Entities
N = 35

Audits of Issuers		Audits of other entities
Five or fewer	21	15
6 – 25	11	12
26-50	1	3
51-100	2	0
Over 100*	0	5
Total	35	35

*Not applicable to this group of triennial firms since the group is identified as providing audits for no more than 100 issuers.

Factors Responsible for No-Deficiencies Inspections

Respondents who had had one or two no-deficiencies inspections were given three factors to judge as "critical, not critical or not sure" in achieving no-deficiencies inspections. There was an additional item, "Other: Please describe". In Table 3 the responses of the two groups – those who had received a no-deficiencies inspection report for one or two inspection engagements – who represented 27 of the 41 respondents.

Table 3
Respondents' Opinion of Critical Factors
in Achieving No-Deficiency Inspection Reports
N = 27

Critical Factors	Critical	Not critical	Not sure
Audit partner's skill in team leadership	17	7	3
Level of knowledge/skill of the total audit team	23	0	4
Systematic, timely, and thorough review process	26	1	0

A few comments were added to the open-end 4th item:

a. we limit SEC work only to industries in which we have a high level of expertise.
b. we are careful to limit how many issuers we accept.
c. we have been careful about audit documentation.

Reasons for Deficiencies and Changes Introduced

There were 14 respondents who had had two inspection reports with deficiencies noted in their first inspection reports. These respondents were asked: ***4a:*** Which of the following

were the reason (s) for a deficiency (or deficiencies) during the first inspection of our audits? (Check reasons) In Table 4, are the number of responses to each of the factors.

Table 4
Reasons Identified for Deficiencies by Respondents
N = 14

Audit partner leadership skills inadequate	9
Weakness in knowledge of relevant GAAP	10
Inadequate review process	13

Additionally, respondents made the following comments as reasons for deficiencies in their first inspection reports:

a. Documentation needed to be enhanced; procedures had been performed in earlier audits, but had not been completely documented.
b. PCAOB reviewers were very rigid in their review. They didn't understand the audit issue and refused to listen to the facts we presented.
c. There was a difference of opinion between the PCAOB inspectors and us that was not resolved appropriately, we believe.
d. PCAOB was unwilling to accept auditor judgment in addressing audit issues that arose.
e. In our opinion, the deficiencies cited by the inspection team were, in fact, not audit deficiencies, but rather differences in opinion of audit workpaper presentation, and their personal opinions about how a particular audit step should be completed and evidenced in the audit workpapers.
f. Partner in charge had an overload; concurring review was not properly completed

Summary. As noted, the majority of the 14 respondents checked all three of the factors as important. The additional comments reveal perceived inadequacies in the relationship between the firm and inspectors, except for the final one (f) which acknowledges an overburdened partner.

These 14 respondents were asked the following question: ***4b.*** What changes did you introduce after receiving the first inspection report? (Check the most important changes.) The final item was: "Other changes we introduced included": (Please discuss briefly) Table 5 indicates the responses to the first four changes:

Table 5
Changes Made in Audit Performance
N = 14

Changes Introduced	Number of Respondents
We enhanced attention to the audit partner's role in encouraging careful adherence to auditing standards	6
More orientation provided to all audit teams re their clients.	10
Monitored the review process more closely with quick feedback when problems were identified	12
No specific changes were made	2

Additional comments included:

a. Most important change: we developed an audit completion checklist to ascertain strict compliance with AS #3. instituted a substantial monitoring process to assure compliance.
b. Added more reliance on PPC standard forms for documentation.
c. Because the PCAOB has significant power, we had no alternative other than to make changes to how we audited certain areas based on the opinions of those inspectors.

Summary. Good faith implementation of changes is reflected in both the responses to the structured part of the question and the additional comments, except for c which reflects willingness to assume that the firm "had no basis for challenging the judgment of the inspection team."

Value of PCAOB Inspection Process

Respondents were asked to indicate "agree, disagree, or no opinion" about statements related to value of the PCAOB inspection process. There was space, also, to add comments. Table 6 presents respondents' opinions. Note the extent of agreement with items 1, 4, and 5. Some additional comments, you will note, relate to these topics. Note the extent if disagreement to Item 6. Also, again, note the comments related to Item 6, which, in the end, support the need for inspections.

Table 6
Respondents' Judgments of Value of PCAPB Inspection Process
N = 41

Statements	*Number of respondents*		
	Agree	*Disagree*	*No opinion*
1. We found the inspectors knowledgeable, competent, and fair in their inspection (s).	29	9	3
2. We think the inspection process needs to be redesigned for both efficiency and effectiveness	14	16	11

3. We find the process no more effective than that of the earlier peer review under the Public Oversight Board. .	10	25	6
4. We would prefer an inspection every five years rather than every three years.	28	8	5
5. We think the inspection process should require a sufficient sample of our audits to provide an overall measure of our audit quality.	31	5	5
6. Inspections aren't necessary; our commitment to meeting auditing guidance is sufficient	13	24	4

Additional comments related to specific statements included:

Related to Statement 1:

The success of the process lies with the inspection team and their willingness to talk about documentation options and reporting issues without becoming "police."

We found inspectors to be generally knowledgeable and competent, but found the inspections, themselves, to be fairer during their second inspection of our firm, almost as if they "lightened up" slightly from the first inspection.

The team was there to report on problems but avoided constructive recommendations for best practices.

An outside agency should periodically review the staff of the PCAOB for competency.

Related to Statement 4:

Some firms should not be inspected every 3 years, if SEC practice is small.

Related to Statement 6:

In general, I believe the inspection process is a good thing because it keeps our firm members on their toes, and we welcome an inspector's fair analysis.

Regulatory oversight makes process more serious to many in the firm. (the respondent, though encircled "no opinion" for the item.)

Regulatory inspections help put all firms on a level playing field. Easier to enforce the standards internally.

I believe the oversight is important to the profession. Like it or not, as a profession our audit process was faulty previously.

Very important process, albeit painful.

Summary: Both the responses to the structured part of the question and the additional comments reflect varying points of view. There is considerable agreement about the overall effectiveness of the inspection process and the superiority of the inspection process when compared with the earlier Public Oversight Board peer review strategy. However, the opinions related to whether there should be a redesign of the inspection process or not resulted in a narrow difference between the number who disagree and the number who agree. A majority agree that there should be a sufficient sample to provide a measure of overall audit quality. A majority in the end did not agree that "inspections were unnecessary." To what extent is the reality reflected in the final comment added: "Very important process, albeit painful." Is there a strategy that could be less painful? Why should there be anxiety about the process? Would a more clearly specified process with full disclosure of basis for conclusions in an inspection report reduce the "pain?"

Assessment of the PCAOB Overall

Respondents were asked to indicate "agree, disagree, or no opinion" to four statements about the PCAOB. There was an additional item for the respondent to comment on the items. Responses are presented in Table 7. There are more agreeing with Statements 1, 3, and 4 than disagreeing. However, Statement 2 was one with which more respondents disagree than agree.

The responses are somewhat puzzling. While a majority agreed that the inspection process "meets the compliance requirement," the respondents in Statement 4 agreed, again a majority, but to a smaller extent, that an inspection should be a compliance audit.

It may not be surprising that the respondents are not agreeing that the PCAOB be the audit standard setting since most of the respondents have far more clients who are not SEC reporting companies and, thus, are required to adhere to two different sets of audit guidance. The added comments have clues for further consideration and study.

Table 7
Assessment of Selected Factors Related to the PCAOB
N = 41

		Number of Respondents		
	Statements	*Agree*	*Disagree*	*No Opinion*
1.	The PCAOB is an effective oversight board.	24	12	5
2.	The PCAOB was wise to become the audit standard setter for those who audit publicly-owned companies and leave auditing guidance for nonpublic companies to the Auditing Standards Board.	11	26	4
3.	The inspection process we believe meets the Sarbanes-Oxley Act of 2002 requirement that an inspection is to determine degree of compliance with relevant rules. .	32	6	3
4.	An inspection should be a compliance audit and conclude with a judgment about firm audit quality overall	21	16	4

Additional comments included the following:

Related to Statement 1:

PCAOB inspections should be stricter.
There should be better linkage between the planning and field work of the inspectors.

Related to Statement 3:

I think the office based reviews do not allow the PCAOB to assess the expertise and work ethic of the firm. It is nice to say the workpapers have to stand on their own, but the individuals conducting the work do matter.

General comment related to both the process and the PCAOB:

Overall our inspection was positive. I think we got lucky with our review team, and it was done on site. However, the letter that is issued if you fail, which basically states that you did not gather sufficient evidence to issue an opinion, is offensive. The PCAOB is too strict in what they expect. I feel as if perfection is the only acceptable level of work. In summary:

1. Agree PCAOB is necessary and better than the earlier peer review process.
2. Think it is a waste of money to inspect small firms with small clients.
3. Think PCAOB needs to change their evaluation procedures and pass/fail system

Summary. There are contradictions in responses to the structured part of the question inasmuch as the majority indicate that the PCAOB is effective, yet a majority believe that the PCAOB should not have become the audit standard setter. A majority believed that the inspection meets the expectations of the Sarbanes-Oxley Act's requirements, yet a majority at the same time indicate that the inspection should be a compliance audit. The additional comments provide clues of possible areas for improvement.

Plans for Providing More Audits of Issuers

There is discussion from time to time about the extent to which smaller registered firms are capable of handling more audits for issuers (companies that report to the SEC) The respondents of this survey when asked: Are you interested in providing auditing services to more SEC clients (issuers) The responses were:

Yes	30
No	8
No response	3

Those 30 who responded "yes" were asked to write in how many additional issuers could you serve now? The responses were:

Extent of adding additional clients	*Number of respondents*
Five or fewer new clients	19
Six to 25 clients	6
Twenty six to 50 clients	2
Fifty one to 100 clients	1
No response	2
Total	30

It is interesting to note that the majority would consider adding no more than five additional clients. A second question asked: "Are you considering expanding capacity to handle additional clients (issuers)? Only 14 of the 30 answered "yes" to this question. The others indicated "no" or did not respond.

Reasons for "not interested in serving more SEC clients (issuers)" were requested in an open-ended question. Among the responses from the 8 who stated "No." were:

a. We are currently staffed to handle our three issuers now. Only will take on another issuer as a replacement, if needed, for a current issuer
b. We want to maintain high quality by just keeping our current SEC clients. If we take on more jobs, they must be "clean." Most potential clients are not "clean."
c. Staffing is a problem. . .
d. Our firm is small; we want to keep it small
e. Our risk tolerance level doesn't allow for additional audits of issuers
f. Although our firm welcomes a fair inspection of our audit process, I don't trust individual inspectors to be fair for all inspections. Negative comments in the report, whether true or not, can have a significant negative effect on our small firm's practice. Although we had a comment-free report this past inspection, the comments included in the report from our first inspection actually prevented us from obtaining a new "non-SEC client. In that particular case, we were proposing to perform consulting services, not even relate d to a certified audit. As such, I believe larger firms can weather negative comments in their reports much easier than smaller firms..
g. Our firm s not large enough to have partner rotation; therefore, we must have no more than 5 SEC clients.

Summary. The comments reflect a range of attitudes, from awareness that the firm wishes to maintain high quality to reluctance to take on risk or meet requirements if client list is larger, to awareness of the problems of obtaining quality staff, to uncertainty about the repercussions of negative comments in inspections.

Basis for Accepting Issuers

Respondents were asked: As you consider audit engagements for SEC clients (issuers), do you have some limit on size of client you accept as measured by revenues?

Twelve of the 41 respondents checked "yes" and indicated a range of revenue cut off points:

Revenue Cut-off	*Number of respondents*
$20 M	2
50 M	3
100 M	4
500 M	2
2B	1
Total	12

As noted only three registered small firms indicated a cut-off of $500 Million or more.

Respondents were asked to indicate factors used as a basis for accepting a new SEC client (issuer).. There was a range of comments about the factor (s) identified in this open-end question:

Factors Identified	No. of Respondents
Audit risk of potential client	6
Accounting complexity	4
Determine factors in case by case	4
Nature of company; our expertise	4
Only accept 11-K audits of pension plans	4
Professional judgment	3
No answer	4

Summary. The limitation of a questionnaire is highlighted when responses from open-end questions are reviewed. In no instance were there explanations of brief comments. It would be informative to know, for example, what was the nature of accounting complexity that resulted in declining to accept an audit engagement for an issuer. What were the factors, as another example, that were components of the *professional judgment* made in assessing a potential client?

Industries Considered in Accepting Audits for Issuers

There were 27 (65.9 percent) respondents who answered "yes" when asked if there were major industries for which they are willing to consider audit engagement. Therefore, 14 respondents (34.1 percent) did not identify specific industries as a basis for considering an audit engagement. The industries identified were:

Industries	*Number of Respondents*
Financial Institutions/banking	5
Manufacturing and Service	5
Pension/retirement plans	4
High tech	3
Mutual Funds	3
Energy, manufacturing, construction	2
Oil and Gas	2
Any industries but not insurance, not banks	3
Total	27

Other Audit Services Provided

Except for one response, all others who answered the question: What audit services, beyond financial audits, do you provide that are under PCAOB oversight? wrote "none" The one exceptional was: "none other than two SOX 404 audits."

Expectations for New Employees

The respondents were given an open-end question: "As you consider your needs in the years ahead, what do you list as the ***most critical competencies*** you seek in new recruits?

The responses were as follows:

Critical Competencies	Number of Respondents
1. Interest in continuing to learn "ability to learn and comprehend quickly" "willingness to learn and ask questions? "ability to ask questions about what they told" "desire for life long learning"	21
2. Written and oral communication skills "ability to talk with client in appropriate manner" "excellent communication skills (written and oral) "excellent reading and comprehension skills"	19
3. Good work ethic "willingness to work overtime" "less focus on personal, feel good attitude" "less selfish" "common sense; business sense" "willingness to work hard"	15

"desire for profession, not job"

4. Technical knowledge 15
   "industry knowledge"
   "strong GAAP knowledge"
   "both SEC accounting and IFRs"
   "technical and computer proficiency"
5. Analytical skills and critical thinking 9
6. Integrity, character, ethical 9

Summary: This question was answered with phrases as are quoted above. Limited answers reflect that the question was open end and asked for ***critical competencies.*** If competencies had been listed, there is high probability that the listing would be somewhat different from the one presented here.

Titles of Respondents

The final question was also an open-end question that asked: " What is the title of the person (s) who responded to this survey?" In all instances, there was a single title noted.

The responses were as follows:

Titles	Number of respondents
Partner, Senior partner, Managing partner	23
Shareholder/stockholder	7
Director of Accounting and Auditing	4
Head of Department	3
Manager	2
No response	2
Total	41

6. Review of Literature

There has been limited attention to empirical studies of triennial firms of the PCAOB. In fact, the inspection process has not been broadly studied. However, to illustrate the range of attention to the topic of triennial firms, two sources were accessed: These were Google (*Triennial firms in the PCAOB)* and ABI-Inform. (*Small public accounting firms in the U. S.*) A limited number of references are here discussed:

Inspections Do Not Measure Audit Quality

A few studies that have been reported make assumptions about what inspection reports actually present. In a study by Daugherty, et al, for example, a reference to several other studies, begins with the comment: *Consistent with the view that PCAOB inspection reports are a powerful signal of audit quality. . . . .*and the sentence continues to identify two studies that built study designs on that assumption. Yet, in every inspection report

there is a disclaimer that an inspection report is not a basis for determining audit quality of the firm inspected. (as discussed earlier; see pages 4 and 5)

Daugherty and his research colleagues, though, undertook a study questioning whether negative outcomes of the PCAOB's inspection program were associated with triennially inspected auditing firms no longer being registered with the PCAOB or losing their publicly-traded clients, either voluntarily or involuntarily. These authors concluded:

> :These results suggest that negative inspection outcomes may lead to the smallest of the triennially inspected firms being *involuntarily* pushed out of public company auditing arena. This finding could be viewed as a favorable consequence of the new audit quality oversight mechanism implemented by the PCAOB inspection process if the smallest of triennially inspected firms indeed have the poorest audit quality relative to their larger competitors inspected triennially. (Daugherty, 11)

There may be justification of equating audit quality with deficiencies or lack of deficiencies, but there should be some discussion of how the perception was assured in the presence of the disclaimer about audit quality. Are those making judgments rejecting the disclaimer stated in inspection reports or do such individuals know the disclaimer but believe that what is presented as deficiencies provides evidence related to audit quality in the firm? Further study of how readers of inspection reports interpret of what is provided in an inspection report would be of value.

First and Second Inspections of Triennial Firms

Hermanson, et.al examined 316 PCAOB inspection reports issued to smaller (triennial) firms through July 2006. They found that 60 percent had audit deficiencies. They found that firms who had deficiencies were smaller, had a larger number of clients and were growing more rapidly than those firms that received no-deficiency inspection reports. There was no reference to the fact that such inspections do not follow a standardized strategy, so the evaluation of inspections among those inspected has serious limitations. (Hermanson, et. al. *PCAOB Inspections of Smaller CPA Firms. . . .)*

A followup study of 116 second inspection reports of small firms (as of October 23, 2008) was conducted by Hermanson and Houston to determine whether smaller audit firms have "made improvements in their processes as a result of the PCAOB inspection process."

There results showed that the results "were much more favorable" the second time a small firm was inspected. This result "appears to be attributable to smaller audit firms learning from their first inspections and improving their audit procedures, rather than a softening of the PCAOB posture." (Hermanson, *Evidence from the PCAOB. . .*) This statement is supported by the results of our exploratory survey. (see page 16)

Improved Grade for Timeliness

A study of the time lapse between an inspection and the date an inspection report is issued was completed by Roybark. . Articles in the business press had noted the lack of timeliness in reporting in a number of instances. In the report of the study, Roybark presented a table showing the mean number of days from last date in field to report date. She presented disaggregated data for: 1. all triennial firm; 2. those with audit deficiencies; and 3. those with no audit deficiencies. In all instances the time lapse has decreased markedly. (for all firms, from 398 days in 2004 to 156 in 2007; for those with deficiencies, from 416 to 221; for those without deficiencies, 272 to 150. There was improvement for all sizes of inspected firms between the beginning and ending dates, though there were some increases in years between 2004 and 2007. (Roybark, 66)

The PCAOB and the Smaller Firms

In the PCAOB's Strategic Plan for 2008 – 2013, there is a discussion of challenges including one refers to smaller firms:

> Firms of different sizes present different challenges to the PCAOB ad risks to the investing public. While difficult to generalize, smaller firms do not have sufficient resources to invest in the technical skills and quality controls necessary to be able to audit large or multi-national clients. In addition, resource constrains, as well as lack of opportunity and experience, have prevented smaller firms from diversifying their practices the way larger firms have been able to do. At the same time, a smaller firm may be able to devote relatively more senior-;level attention to a client than a large firm. Moreover, a smaller firm, which focuses on one industry and has developed an expertise in audits of that industry, may, in fact, provide higher quality audits in that particular area than a larger firm with no particular expertise in that area. The PCAOB's strength in addressing the
>
> challenges associated with both these small firms as well as larger firms is its ability to tailor its programs to address differences in the size and nature of firms.
>
> (PCAOB, *Strategic Plan. .)*

The foregoing appears to be a collection of opinions – potential hypotheses. There are no references to systematic investigation of how behavior of auditors in smaller firms differ from those in mid-size and large firms. The PCAOB has valuable data for empirical studies of triennial firms.

An initiative provided by the PCAOB, The Forum on Auditing in the Small Business Environment, is for registered smaller accounting and public companies. The Forum, for example, has planned six one day meetings in 2009 in six locations across the United States. Agenda items deal with current issues and trends that impact audits to the inspection process and new auditing standards.

The General Accountability Office Study of Public Accounting Firms

A comprehensive report related to concentration in audits of public companies revealed some shifts in changes in which public accounting firms are participating in auditing publicly-owned companies.

From January 2003 to June 2007, the largest firms had a net loss of 1,149 clients; while midsize firms had a net increase of 282 clients, and smaller firms had a net increase of 867, Noted in the report was the following:

> . . . despite the largest firms experiencing a net loss of over one thousand clients, most of these were smaller companies with lower revenues and audit fees. . Companies that changed from one of the largest firms to another had average revenues of over $1 billion, while companies that changed from one of the largest firms to a smaller firm had average revenues of just over $60 million. (GAO, 83)

In a discussion of disincentives and challenges to entering the large public company audit market, the response of 75 percent of smaller firms surveyed said they were not interested in serving as auditor for additional large public companies.

In the survey reported in this paper, a comparable question was not asked. However, thirty of the 41 who participated in the survey indicated an interest in serving more issuers. A specific question about the audit of large public companies was not asked, although a question about revenue cut off was asked; only 12 responded, with 7 indicating revenue cutoffs of $100M or $500 M or $2 B. (See page 22)

The Report revealed that the largest accounting firms audit 98 percent of the more than 1,500 largest public companies; these have annual revenues of more than $1B. At the same time, smaller firms audit 69 percent of the more than 3,600 smallest companies; these have revenues of less than $100M. *(Note: Triennial firms are those who audit 100 or fewer SEC clients; revenues is not basis for cutoff)*

While 82 percent of the Fortune 1000 companies saw their choice of auditor as limited to three or fewer firms and about 60 percent viewed competition in their audit market as insufficient, most small public companies reported being satisfied with the auditor choices available to them. (GAO, 2) The shift between 2002 and 2006 for auditing public companies with revenues of $100M - %500M indicates the following:

Segment of Accounting Firms	2002	2006
Largest firms	90%	71%
Midsize firms	6%	16%
Smaller firms	5%	13%

However, for publicly-owned companies with revenues greater than $1B, the largest firms continued to be the auditors (98 percent in both 2002 and 2006) and for larger public companies with revenues greater than $500M (95% revenues in 2002 and 92% in 2006) .

The GAO team responsible for the investigation considered proposals by academics and business groups to reduce risks of current and further audit market concentration. In the end, they concluded that the evidence was limited "that the currently concentrated market has created significant adverse impact" and thus, they concluded "we found no compelling need to take action." The GAO does not reveal the basis of their judgment. Possibly, the shift in who is providing audits for the smaller publicly-owned companies, as noted in the figures above, was one factor in concluding that no action needed to be recommended at this point.

The role of the midsize and smaller firms in the future will be worthy of study in innovative, objective ways. There are undoubtedly opportunities for expansion.

Summary: Possibly, the most critical factors about the inspection process (described as the core oversight responsibility of the PCAOB) have yet to be empirically studied. The limited references identified in the search for related literature did not reveal concern with basic issues. For example, a supervisory approach to oversight with a standard strategy for determining compliance needs to be rigorously studied. Inasmuch, as noted in inspection reports, inspectors make judgments about what areas of audits will be reviewed in an inspection engagement, there is no disclosure that a random sample is taken, there is no assurance of consistency among inspections for a single year or year after year. It must be underscored that the inspection reports clearly indicate the limitations in interpreting what is presented.

The Sarbanes-Oxley Act of 2002 states that the inspection is for the purpose of determining *compliance.* Standard, consistent, assessment measures are typically present in determining *compliance.* The process for PCAOB inspections, as described in the first annual report issued by the PCAOB, noted that a supervisory approach was the strategy for an inspection. Such a strategy appears more relevant for a consulting engagement than a compliance engagement.

Ultimately, an oversight process for audits should result in a determination of audit quality. To date there is no basis for making any judgment about "progress" in enhancing audit quality in the performance of audits of publicly-owned companies. To continue to rely, for example, on the number of deficiencies reported from an engagement as a measure of effectiveness about a firm's performance of audits does not seem warranted..

To date, there has been no disclosure of the PCAOB's concern about the adequacy of its strategy for inspection engagements. Possibly, the Research and Analysis Office is undertaking such an investigation.

7. Summary and Reflections on Responses

As noted initially this was an exploratory survey to gain an initial view of audit performance of a sample from the group of registered firms who had received one or two inspection reports that had no deficiencies. They are a minority of the total population of

registered firms who have been inspected since full inspections began in 2004. At the time the sample was drawn there were no triennial firms that had had more than two inspections.

The largest four firms had limited inspections in 2003 and inspections yearly since that year. The next 6 largest firms have had annual inspections since 2004. To date none of these annually inspected firms has received a no-deficiency inspection report.

Summary

Executives of 41 (35.6 percent) triennial firms of the 115 to whom requests were mailed responded to the questionnaire. Respondents from each of the three subgroups were: 15 with one inspection, which revealed no deficiencies; 12 with two inspections with no deficiencies; and 14 with two inspections, with the first disclosing deficiencies and the second without deficiencies.

1. Factors perceived critical for achieving no-deficiency audits accepted by the respondents were: 1. Systematic, timely and thorough review process; 2. Level of knowledge/skill of the total audit team and; 3. audit partner's skill in team leadership.

2. A majority of respondents concurred the reasons for deficiencies were 1. inadequate review process, 2. weaknesses in knowledge of relevant GAAP and 3. audit partner leadership skills inadequate.

3. Those with deficiencies in their first inspections implemented changes which resulted in no-deficiency second inspections.

4. While there was agreement among the respondents that an inspection process is necessary and most agreed that the PCAOB was effective, there was disagreement, to some extent, about the need for an inspection of triennial firms every three years and about the PCAOB choosing to be audit standard setter for registered firms auditing SEC clients (issuers).

5. Far more of the respondents are interested in serving more issuers than they are currently serving a limited additional number of SEC clients , there were eight who said that they are not interested in expanding their services to issuers.

6. Critical competencies highlight the importance of meeting changing demands with the most commonly identified critical competency (21 respondents of 41) noted that new recruits must be interested in continuing to learn.

Reflections on Opinions Expressed by Triennial Firms' Respondents

There is an acceptance of the need for an oversight function for public accountants who audit SEC clients. However, among the responses and additional comments are clues that indicate that the inspection process is not as effective as it should be.

Questions yet to be answered:

1. Is the supervisory approach sufficient to enhance audit quality?

2. How much disclosure should there be when there are differences between the firm under inspection and the PCAOB inspection team?

3. While a majority noted that the PCAOB is an effective oversight board, a majority at the same time did not believe that the PCAOB should have become the audit standard setter. Why did they not think the PCAOB should be the audit standard setter? Did they believe here was a conflict of interest? Did they question the independence of the standard setting responsibility in the presence of making judgments about the implementation of auditing standards by the registered firms? There has been heightened attention to the importance of good internal controls, yet a newly established oversight board assumed standard setting responsibilities (these were not mandated by the Sarbanes-Oxley Act of 2002, but could be assumed by the PCAOB). There has been no discussion of this clearly questionable overlap of responsibilities if assurance of good faith review of auditing standards was to be achieved.

4. Is there a need for a compliance style audit that concludes with an assessment of a firm's performance of audits? Possibly, the most puzzling opinions were related to the responses to two statements in Question 7 that the inspection process meets the expectations of the Sarbanes-Oxley Act of 2002 requirement, a majority also agreed that the inspection should be a compliance audit.

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As noted in the summary of the preceding section of this paper, much more detailed study is needed to resolve the contradictory opinions and to determine the effective of the current inspection process. The PCAOB's inspection process needs an objective, comprehensive assessment.

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4/19/09

Appendix A

(Copy of the letter sent to the 115 firms)

Name
Address

Your opinion about the PCAOB inspection process and related topics are of interest to us. Your firm is unique: it is among the minority of registered firms that have achieved deficiency-free inspection reports. We believe your experience in achieving quality audits would be of value to many interested in enhancing audit quality in our society. .

We have selected a random sample of 115 firms from the listings of inspection reports posted at the PCAOB website. (as of early November). These selected firms have had at least one deficiency-free audit; some selected have had two deficiency-free audits; some had an initial audit with deficiencies but a second one without deficiencies.

The enclosed survey is to be answered anonymously. There is to be no identification of your firm. In addition to questions about the inspection process, there are questions related to some of the PCAOB responsibilities. Any additional comments about other aspects of the PCAOB's responsibilities are welcome.

If possible, we hope you will participate in this survey investigation and forward your responses in the enclosed envelope by December 22.. If you have any questions, send an email or call one of us.

We thank you for considering our request. We applaud your fine performance as auditors and we extend our best wishes to you and your firm for continuing success in this challenging economic environment.

Sincerely

Enclosures: Survey form; return self-addressed envelope

(*Copy of the survey questionnaire that was sent to 115 firms)*

Your Opinion: PCAOB Inspection Process and Related Matters

As noted in the covering letter, your firm has received one or two deficiency-free inspection reports. Your responses are valuable in our gaining insight as efforts to enhance audit quality are underway. Please know that your responses are totally anonymous; candid responses are deeply appreciated.

1. In what **year** did you become a registered firm with the PCAOB?_____.
2. Your firm has been inspected (please check)
   2.1 _____once only; with no deficiencies
   2.2 _____twice, both with no deficiencies
   2.3 _____ twice, first with deficiencies; second, without deficiencies

If you checked 2.1 or 2.2, please respond to Question 3; if you checked 2.3, please respond to Question 4.

3. ***(for No- deficiencies firms)***What factors ***directly*** related to the audit performance do you believe were critical in assuring no deficiencies identified by inspectors. Indicate whether or not critical for each factor:.

	(encircle one opinion)		
3.1 audit partner's skill in team leadership	Critical	Not critical	Not sure
3.2 level of knowledge/skill of the total audit team	Critical	Not critical	Not sure
3.3 systematic, timely, and thorough review process	Critical	Not critical	Not sure
3.4 Other (please identify factors that are also critical)			

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4. ***(for firms with deficiencies during first PCAOB inspection)***

4a: Which of the following were the reason (s) for a deficiency (or deficiencies) during the first inspection of our audits? (Check reasons)

_____ audit partner leadership skills inadequate
_____ weakness in knowledge of relevant GAAP
_____ inadequate review process
_____Other: please describe: _____:
_____

4b. What changes did you introduce after receiving the first inspection report? (Check the most important changes.

_____ We enhanced attention to the audit partner's role in encouraging careful adherence to auditing standards
_____ More orientation provided to all audit teams re their clients
_____ Monitored the review process more closely with quick feedback

when problems were identified
_____ No specific changes were made
_____ Other changes we introduced included: (Please discuss briefly)
_____
_____
_____

5. How many financial audits did your firm perform during your most recent fiscal Year? Indicate number for SEC reporting companies (Issuers)_____
Indicate number for privately held companies_____

Value of PCAOB Inspection Process

6. Indicate whether you agree, disagree, or have no opinion with each of the following statements:

(Encircle response)

6.1 We found the inspectors knowledgeable, competent, and fair in their inspection (s). . . . . agree disagree no opinion
6.2 We think the inspection process needs to be redesigned for both efficiency and effectiveness . . . . . agree disagree no opinion
6.3 We find the process no more effective than that of the earlier peer review under the Public Oversight Board. . agree disagree no opinion
6.4 We would prefer an inspection every five years rather than every three years. . . . . agree disagree no opinion
6.5 We think the inspection process should require a sufficient sample of our audits to provide an overall measure of our audit quality. . . . . agree disagree no opinion
6.6 Inspections aren't necessary; our commitment to meeting auditing guidance is sufficient . . . . . agree disagree no opinion
6.7 (Other) Please discuss briefly any other comments about the inspection process:_____
_____
_____

Note: Further comment re any of the above you encircled "disagree" is welcome. (attach a sheet to this form)

The PCAOB OVERALL

7.. Indicate whether you agree, disagree, or have no opinion with each of the following statements:

(Encircle response)

7.1 The PCAOB is an effective oversight board. . . . . agree disagree no opinion
7.2 The PCAOB was wise to become the audit standard setter for those who audit publicly-owned companies and leave auditing guidance for nonpublic companies to the Auditing Standards Board. . . . . agree disagree no opinion

7.3 The inspection process we believe meets the Sarbanes-Oxley Act of 2002 requirement that an inspection is to determine *degree of compliance with relevant rules.* . . . . . agree disagree no opinion

7.4 An inspection should be a compliance audit and conclude with a judgment about firm audit quality overall . . . . . agree disagree no opinion

7.5 (Other) Please discuss briefly comments related to any aspect of the PCAOB_____
_____
_____
_____

Note: further comment re any of the above you encircled "disagree" is welcome. (attach a sheet to this form)

Your Plans for Providing More Audits of Issuers

8. Are you interested in provided auditing services to more SEC client (issuers)?
_____Yes _____No

9. a. If you checked "Yes" how many additional issuers could you serve now?
_____

b. Are you considering expanding capacity to handle additional issuers?
_____

10. If you checked "No" in response to 8, why are you not interested in serving more SEC clients (issuers)? _____
_____
_____

11. As you consider audit engagements for SEC clients (issuers), do you have some limit on size of client you accept as measured by revenues?
_____Yes, we have a cut off at $_____
_____No, we use (indicate factor) _____as a basis for determining acceptance of an issuer.

12. As you consider audit engagements for issuers, do you choose firms from certain industries?
_____Yes, primarily from (identify major industries for which you are willing to consider engagements)_____
_____

_____No, we do not consider the industry in making our decision about acceptance of an issuer who seeks an auditor.

13. What audit services, beyond financial audits, do you provide that are under PCAOB oversight?_____
_____

Expectations for New Employees

14. As you consider your needs in the years ahead, what do you list as the ***most critical competencies*** you seek in new recruits?_____
_____
_____

What is the title of the person (s) who responded to this survey?
_____

As noted earlier, additional comments are welcome; attach pages for such comments. We thank you for your response.

Return by December 22 in enclosed envelope to: