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PCAOB Quality Control Inspections: Unresolved Issues of Registered Firms

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PCAOB Quality Control Inspections: Unresolved Issues of Registered Firms

Abstract

The Public Company Accounting Oversight Board (PCAOB) has oversight responsibilities that include inspection of not only the audit of financial statements, but also of internal controls and quality controls. The topic of this paper, however, relates only to the inspection of quality controls of registered firms.

This paper presents the results of an exploratory survey of quality control issues that registered firms were unable to resolve within the 12 months from the date of the inspection report. If remediation is not successful within the 12-month period, the issues not resolved by the firm are revealed to the public. The original report is not posted until the communications between the firm and the PCAOB related to issues are concluded. The inspection is then posted as an expanded inspection report, dated as of the original inspection report date.

All the firms with expanded inspection reports, which included 107 inspections as of December 18, 2011 were included in the survey. The issues that were most common that were not resolved included issues related to *audit performance.* The seven most common issues were: 1. Technical competency, due care, and professional skepticism (firms with issue, 59, 55.1%); 2. Auditor Communications (firms with issue, 45, 42.1%); 3. Concurring Partner Review (firms with issue, 43, 40.2%); 4. Appropriate Procedures (firms with issue, 21, 19.6%); 5. Fraud Procedures (firms with issue, 16, 14.9%); 6. Engagement Completion Document (firms with issue,12, 11.2%); and 7. Testing Appropriate to the Audit (firms with issue, 12, 11.2%)

The limitations of disclosure, including the agreement to maintain confidentiality of certain issues by the firms, precludes providing conclusions about the status of quality control in registered public accounting firms. The question that cannot be answered is: "Has the PCAOB's strategy for the inspection of quality controls and the nonpublic disclosure of extent of issues identified resulted in significant improvement in quality controls in registered firms?"

There is need for empirical, objective research to determine the effectiveness of the PCAOB's strategy in enhancing audit quality. Within a year (of March 2012), the PCAOB will have completed a decade of oversight. To date, there has been no publicly revealed evidence of achievements.

PCAOB Quality Control Inspections: Unresolved Issues of Registered Firms

The oversight responsibilities of the Public Company Accounting Oversight Board (PCAOB) include inspection not only of the audit of financial statements but also of internal controls and of quality controls. The topic discussed in this paper relates only to the inspection of quality controls of registered firms.

The extent of public disclosure of findings differs for the three components: financial statements, internal controls, and quality controls. While deficiencies in the performance of the financial audit that reach a level of significance are revealed in the public report, the weaknesses/deficiencies of internal controls and quality controls are not disclosed in the initial inspection report issued. If there are quality control issues the initial report has no public disclosure until after the 12-month period allowed to resolve the problems identified during the inspection. The PCAOB identifies the problems observed as *criticisms* in the listing as an expanded report. However, since the discussions between Firms and the PCAOB that seemingly, at times, require considerable time, *issues* appears to be a more appropriate term for the problems perceived related to quality control. Therefore, the term, *issues,* is usually used in this paper.)

If the firm fails to make progress in resolving the issues identified in an inspection, the report is issued (with the original date) and includes the quality control issues that had not been resolved satisfactorily. There is provision, though, for the firm to request that certain matters identified in the quality control inspection be considered confidential in the extended disclosure that results.

Quality controls are critical for the assurance of effective auditing. Since the inspection report provides no information, not even that the inspection concluded that there were issues, there is little knowledge about the effectiveness of quality controls in registered firms. However, the disclosures of unresolved quality control issues are one source for gaining some insight about problems that undermine effective quality controls, and possibly the quality of audits performed.

The purpose of this survey of disclosed unresolved quality control issues is to provide some clues re quality controls that may be helpful in identifying the topics that prospective public accountants should be taught in colleges and universities, alert public accounting firms of quality controls of the value of enhanced monitoring related to the topics,, and aid public accounting firms in the design of their continuing education for professional staff related to audits.

The topics included in the remainder of this paper include: 1. The PCAOB Strategy for Inspections of Quality Control; 2. Methodology for the Survey; 3. Firms with Expanded Inspection Reports; 4. Nature and Extent of Quality Control Issues Related to Audit Performance; 5. Independent and Monitoring Issues 6. The Question that Cannot be Answered; 7. Questions Remain Re Quality Control; and 8. Summary and Final Comment.

1. The PCAOB Strategy for Inspections of Quality Control

It is not surprising that there appear to be minimum references available related to outcomes of quality control in registered firms' inspections performed by the PCAOB. The PCAOB does disclose what is regularly inspected related to quality control, but the results of the review are not identified.

Attention to Quality Controls for Public Accounting Firms

This discussion provides, initially, a brief comment from an early article dealing with introduction of guidance for quality controls in the 1970s. Then, there are comments from a limited number of references that relate to quality controls as investigated for peer reviews and inspections. Searches at ABI-Inform, SSRN, and Google resulted in few sources related directly to quality control provided by AICPA and by the PCAOB.

It is worth noting that the public accounting profession did not undertake an explicit program for establishing quality control guidance until the early 1970s. Bremser wrote an article of the initiation of peer review by the AICPA. He noted:

> The accounting profession now has a well-conceived external quality control review program. . . . The proposal was a product of an open forum development process. Meetings . . . . were held throughout the country to expose the committee's ideas . . .The program is being administered by the AICPA via a quality control review committee. (Bremser)

The lack of disclosure of the PCAOB was highlighted in an article by Hodowanitz and Solieri. They noted in their 2005 article, *Guarding the Guardians*:

> "A significant shortcoming of the PCAOB's inspections is that important information isn't made public. That leaves investors and public companies wondering what's buried in the confidential portion of the report." (Hodowanitz)

The disclosures from peer reviews provided information for a study by Casterella, Jensen, and Knechel. These authors stated in their 2006 study, *Is Self-Regulated Peer*

Review Effective at Signaling Audit Quality? These researchers examined the effectiveness of the AICPA's voluntary peer review regime for accounting firms performing audits. Their conclusions include the following comments:

> We found that there does appear to be a link between the number of weaknesses identified in the peer report and firm-quality attributes. .. . . We found that firms having weaknesses related to personnel-management and engagement-performance are more likely to experience an audit failure in terms of having a malpractice claim filed against them. We also found that audit firms having more weaknesses in general identified in their peer-review reports are more likely to experience audit failure. (Casterella, et. al.)

A study by Lennox and Pittman entitled *Auditing the Auditors: Evidence on the Recent Reforms to the External Monitoring of Audit Firms (2008) noted in the abstract:*

> First, we find that audit clients do not perceive that the PCAOB's inspection reports are valuable for signaling audit quality. Collectively, our evidence implies that less is known about audit quality under the new regulatory regime. (Lennox and Pittman)

Further comment in their conclusions included:

> . . . . empirical evidence on whether the PCAOB is effectively discharging its regulatory responsibilities remains elusive. . . . . our results lend preliminary empirical support to extending the disclosures in PCAOB reports to include an evaluative summary of the audit firm, quality control weaknesses, and the inspectors' sample sizes. To the extent that clients would find such disclosures to be informative, the audit firms would have stronger incentives to supply higher quality audits in order to increase their market shares. (Lennox and Pittman)

The Lack of Transparency in Disclosure in PCAOB Public Inspections Reports

The nature of an inspection engagement performed by inspectors at the PCAOB does not provide for a study such as the one noted above by Casterella, *et. al*. As established by the PCAOB, the inspection was perceived as most valuable if a supervisory approach was used. This supervisory approach resulted in inspectors determining which audits would be inspected, what aspects of the audit would be assessed, and the sample size. There is not sufficient information in the public inspection report to know if the topics of concern identified are used for all audits in a given year or the basis for selecting the size of the sample and whether the sample was randomly selected.

Unfortunately, the lack of sufficient information has not deterred a study of audit quality through the use of PCAOB inspection reports. For example, one abstract for a research study concluded: "We find evidence that PCAOB reports are able to discriminate audit quality. . . ." Such a statement is not warranted if based on what is

reported in inspections reports posted at the PCAOB website. The inspection report provides explicit disclaimers in each publicly posted inspection report that state the limitations of interpretation of what is disclosed.

Since a random sample is not involved in the selection of audits, this disclosed disclaimer which appears in inspections of all registered firms that audit more than 100 audits each year states in just one disclaimer comment:

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect o 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.

(Refer to any inspection report at www.pcaob.org)

The strategy for an inspection engagement which was established initially, and continues to be used, is identified as the *supervisory approach.* The first Chairman of the PCAOB supported this approach by stating that the outcome would be the enhancement of audit quality among the registered firms.

In the testimony of the Chairman of the PCAOB before the Committee on Financial Services in September 2006 was this statement: "When firms approach inspections with a cooperative attitude, the PCAOB has been able to achieve significant real-time improvements, often even before an inspection is concluded." (Olson)

There was no reference in the testimony to empirical studies that supported such *improvements.* Audit quality has not been discussed in any publication from the PCAOB that has been publicly available.

The continued reference to an inspection as a *rigorous engagement* by the Center for Audit Quality, for example, may be effective to preclude an objective review of what is not seemingly assessed in inspections.

Quality Control Guidance in Use by the PCAOB

The PCAOB has the authority to establish the guidance for quality controls. However, at the initial meeting in April 2003, the Board chose to use initially the guidance provided by the AICPA for quality controls. It was determined that the Statements on Quality Control Standards as of April 16 2003, would be accepted as interim standards.

To date, (March 2012) those standards continue to be in effect. Since 2003, the AICPA has revised Quality Control guidance twice, in 2009 and again as of January 2012. Fortunately, critical basic concepts for effective quality control persist in the revised editions of the original guidance. To date there are no proposals for change of the interim standards in use by the PCAOB.

Quality Controls Factors as Identified in Inspection Reports

There have been changes in the information provided related to quality control. In initial years, an inspection reports provided a listing of the key factors that were reviewed by inspectors. A common statement prior to 2009 is the following:

> The review [of quality control] addresses practices, policies and procedures concerning audit performance and the following five areas: 1) management structure and practices; 2) practices for partners; 3) policies and procedures for considering and addressing the risks involved in acceptance and retaining clients, including the Firm's risk-rating system: 4) processes related to the Firm's use of audit work related to foreign affiliates and; 5) processes for monitoring audit performance. . . . . (note the statement generally is in Part 1 of the report.)

The most recent inspection reports of the four largest public accounting firms provide a listing of topics included in the review of quality controls, but also add an appendix where each of the topics is discussed. There has been added the topic: Review of Response to Weaknesses in Quality Control. This topic may not, however, apply to the firm that is the subject of the report. This expanded discussion provides no disclosure related to the conclusions of a firm's quality controls.

Initial Quality Controls Review of Four Largest U. S. Firms

During the first year of functioning, the PCAOB decided that there would initially be limited inspections of the four largest firms in the United States. Those inspections reviewed both the financial statements and quality control, but not internal controls. The inspection reports for each of the four firms were issued on August 26, 2004. Included was a listing of the 7 functional areas related to quality controls that were reviewed. There was a limited disclosure re quality controls in those four reports. The statement was that issues had been identified that will "warrant more probing scrutiny in a full inspection. There was also in every one of these publicly posted inspection reports that the cooperation and response of the firms was favorable and some changes related to quality controls had been implemented. All four firms met the remediation required to resolve issues identified in these limited, initial inspections.

The four inspection reports identified the topics considered in the review of quality controls: 1 Audit performance; 2. Internal inspection; 3. Evaluation and compensation of partners; 4. Independence; 5. Establishment and communication of policies, procedures, and methodologies; 6. Acceptance and continuance of client; and

7. Supervision of foreign affiliates. The findings from the inspection of quality control were submitted to the firms.

On March 21, 2006, the PCAOB published a summary report of the implementation of the process for addressing quality control issues within 12 months of the date of the report. The PCAOB had earlier concluded that all four firms had made sufficient progress in resolving quality control issues. Therefore, there was no disclosure related to unresolved criticisms. The summary report noted the validation of the remediation process in these words:

> The Board's initial experience with the 12-month remediation process generally validates the premise of the approach set out by Congress, in Section 104(g)(2) of the Act. That legislative approach rested on the hypothesis that firms could be genuinely motivated by the prospect of keeping the Board' quality control criticisms confidential. The Board's initial experience with the larger firms supports that hypothesis. Moreover, the firms were responsive to the Board's supervisory model, taking the initiative to engage constructively with the staff in an ongoing dialogue toward a result satisfactory to the Board, rather than emphasizing points of disagreement and taking an adversarial approach. (PCAOB Release No. 104-2006-078 March 21, 2006)

The seven topics that guided the limited inspection of the largest four firms' quality control review concluded with a number of steps that needed attention by one to all firms. Number of steps ranged from two to seven for the seven topics. There was no disclosure how many of the four firms needed remediation of each step specified.

A second report by the PCAOB, *Report on the PCAOB's 2004, 2005, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms,* issued on December 5, 2008. There was a section that discussed briefly quality control issues identified.

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2. Methodology for the Survey

The methodology for this survey of issues was a content analysis of the nature and extent of occurrence of the identified issues listed in the expanded reports under Part II.

Because of the limited disclosure of quality control issues, there is no basis for determining how effective quality controls are in registered public accounting firms. There are, for example, no disclosures of the number of registered firms that receive criticisms related to quality controls who are successful in resolving the criticisms cited.

The PCAOB expanded inspection reports reflect the inability of the registered firms to resolve issues within the 12 months after the date of the initial inspection report that

included undisclosed issues that needed remediation. The issues unresolved by the deadline are revealed in the expanded reports.
While conclusions must be tentative, at best, they can initiate innovative thinking about what may be valuable strategies to reduce the presence of such issues to some extent.

Source of Information

The expanded inspection reports posted at the PCAOB website were the source used for this survey. The master list of all inspection reports includes those that have been expanded because of the additional disclosure, which is noted in the listing as, Q*C criticisms now public*. The inspection report has the date of the initial report, with no information of the date of posting the expanded report. Also, at the website there is a separate listing of all inspection reports that have been expanded.

All the inspection reports with expanded disclosures were included in this survey of unresolved issues. (list of firms used as of December 18) The total population of inspection reports with expanded disclosures was 107. (As of March 4, 2012 the total number of expanded reports had increased by 4, to a total of 111.)

There is no available figure of the number of inspections completed and reported through December 31, 2011. Therefore, the proportion of expanded reports to all reports posted cannot be determined. The most recent figure related to total number of inspections performed was a comment in the letter of the Acting Chairman in the *PCAOB Annual Report of 2010* (which discussed status as of December 31, 2009.) Goelzer, the acting head stated "that as of December 31, 2009 had conducted more than 1,300 inspections and issued more than 1,000 reports since regular inspection reports began in 2004. (PCAOB 2009 Annual Report) The time between completion of an inspection and its posting at the PCAOB website appears to vary considerably. There are undoubtedly a number of reasons for the variability.

Limitations of the Methodology

Two factors related to inspections in general immediately reveal serious limitations that cannot be overlooked. They preclude conclusions or generalizations. Those two factors are: 1) There is not a random sampling of issuer audits for an inspection. Thus, the findings of deficiencies cannot be generalized. Yet, the deficiencies identified are often used for consideration of quality control problems; and 2) There is the possibility that all issues are not provided in the final report that is posted at the PCAOB website, since firms with unresolved criticisms are able to gain confidentiality for some topics that would otherwise be disclosed.

Among the other limitations that limit significantly any conclusions are the following:

1. The absence of number of firms that receive quality control issues but remediation is satisfactorily provided before the end of the 12-month deadline.

2. The nature and scope of issues identified in the reports of those who are successful in remediation.

3. The nature, scope, and extent of dialogue between the firm with quality control. issues and the PCAOB. To what extent is an issue judged to be unwarranted after discussion and the registered firm "wins"?

4. The length of time required for those who do not meet the 12-month deadline to resolve criticisms. (Should not the date of posting of the expanded report be provided?)

5. Any empirical research undertaken by the PCAOB related to quality controls has not been shared with the public. To what extent are audit failures are disclosed in firms with quality control weaknesses that persist? To what extent are there quality audits, yet quality controls have weaknesses? How many registered firms have had NO quality control issues for any inspection?

6. Since some topics may remain confidential, this survey does not include all issues identified. There is no note about an indication of omission. There is, however, a hint of omission in some of the 107 expanded reports. For example, under Audit Procedures, there was an item identified as (a) and there is a space before the next entry which is identified as (d). Were two items declared confidential after a request from the Firm? Or, there may be a series of * * * * . . what does that mean? Omission? Could some hint be disclosed, such as the number of items requested for confidentiality and judged worthy of nondisclosure by the PCAOB?

The confidentiality of information related to quality control which is available to the firm limits determination of conclusions related to unresolved issues.

The Information Recorded from Expanded Inspection Reports

Each of the 107 reports was read and the following information recorded:

Name of firm
Date of original inspection report
The number of clients (The PCAOB accepts the figure provided by the Firm. In a limited number of instances the Firm noted *None* as the

number. In such instances, the inspectors reviewed an earlier year audit.)

All items listed as issues/criticisms (ranged from a single issue to multiple Issues.)

Data Analysis

The central task was the categorizing of the unresolved issues identified by the inspectors that were disclosed by the PCAOB. Inspection reports are prepared by many inspectors. There was a considerable degree of similarly among the 107 reports. However, there were instances, for example, when a topic was listed with other topics in a general way in some reports and as a separate topic in other reports. The decision was to classify as the inspectors did rather than imposing a variation in classification with so little knowledge of the reason for the presentation as provided in the publicly issued report.

3. Firms with Expanded Inspections Reports

The 107 firms whose quality control issues were added to their original inspection reports ranged from firms that identified no issuer clients during the year of the inspection to one firm with more than 100 issuer clients.

The number of expanded reports varied over the years to date. Reports with expanded information related to quality control issues were listed through December 2010 for years 2005, 2006, 2007, 2008, 2009, and 2010. The range of listings was from 8 in 2010 to 31 in 2006. Table 1 presents the information related to issuer clients and number of reports per year to date.

TABLE 1

Number of Expanded Reports Each Year Classified by Number of Issuers Audited

	Range of Number of Issuers Audited						
Year	Zero to 5	6-10	11-25	26-50	51-100	More than 100	Total
2005	12	3	3	1	0	0	19
2006	23	5	3	0	0	0	31
2007	3	1	4	4	0	0	12
2008	9	2	6	3	0	1	21
2009	8	1	5	2	0	0	16
2010	3	2	0	2	1	0	8
Totals	58	14	21	12	1	1	107
Percentages	54.2%	13.1%	19.6%	11.2%	.9%	.9%	99.9%

The majority (54.2 percent) of expanded reports were for firms that identified no more than 5 issuer clients. Only two expanded reports were for firms with more than 50 issuer clients. As noted in limitations, without information about the total numbers of firms that receive quality control issues that require remediation, there is little comment that can be made about the information provided in Table 1. The figure for 2010 may be low because of pending reviews of inspections with quality control criticisms continue. (In one PCAOB report, there was reported a two-year period for posting expanded reports, which would mean 2010 to 2012 for reports issued in 2010) (Recall, that an expanded report posted in late 2011 was for an audit performed on the 2007 audits of a registered firm that has an initial date of October 2008.)

4. Nature and Extent of Quality Control Issues Related to Audit Performance

The disclosures at times indicate one of the general headings: 1. Audit Performance; 2. Independence, and 3), Monitoring and Audit Identification of Weaknesses. The major issues are related to the first topic, audit performance. The individual topics identified in expanded reports that reflect issues of audit performance are listed in Table. 2. The topics are listed in order of frequency in the total group of 107 expanded reports.

Table 2
Quality Control Issues Related to Audit Performance and
Number of Firms with Each Unresolved Issue

Audit Performance Issues Unresolved	Number of firms with issue	%age of total (107)
Technical competency, due care, and professional skepticism	59	55.1
Auditor Communications	45	42.1
Concurring Partner Review	43	40.2
Appropriate Procedures	21	19.6
Fraud Procedures.	16	14.9.
Engagement Completion Document	12	11.2
Testing Appropriate to the Audit	12	11.2
Audit Documentation	8	7.5
Partner Workload	8	7.5
Financial Statement Disclosures	4	*
Audit Policies, Procedures, Methodologies, including Training	3	*
Personnel Management	2	*
Competency of Engagement Team.	1	*
Foreign Affiliates	1	*
Income Taxes.	1	*
Management Estimates	1	*
Reliance on reports, databases of issuer	1	*
Review of Interim Information.	1	*

** number below 4 percent*

Most Common Criticisms Related to Audit Performance

The range of criticisms related to the seven most common audit performance quality control issues listed in Table 2 was from 55.1 percent to 11.2 percent. These seven most common audit procedures issuers are briefly discussed:

1. Technical competence, due care, and professional skepticism (55.1%)

The most frequent comment about this issue in the expanded reports was merely a single sentence:

The firm's system of quality control appears not to do enough to ensure technical competence, and the exercise of due care or professional skepticism.

There were a few instances with a longer comment, but the comment related to the same concepts. The extent of failures related to these three critical fundamental concepts impact an audit and could result in less than quality audits.

2. Auditor Communications (42.1%)

In most instances, the issues related to auditor communications were failures to provide sufficient information to the audit committee (or the group that performed tasks typical of those of an audit committee). In some instances, the statement referred to specific deficiencies that had been identified during the inspection of financial statement audits. An illustration of a comment is:

> The Firm's system of quality control appears not to provide sufficient assurance that all required auditor communication between the Firm and the audit committee occur and are appropriately documented, including the independence confirmations required by independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees.* [Issuers A, B, C, and D] (PCAOB Inspection of Reuben E. Price & Co. April 27, 2009)

3. Concurring Partner Review (40.2%)

There was a range of issues related to the concurring partner review. The range was from the omission of such reviews to using auditors who were not affiliated with the issuer who failed to find deficiencies in their reviews. A common comment was:

> Serious questions exist about the effectiveness of the Firn's existing arrangement for concurring partner reviews... .Such reviews should involve the performance of appropriate procedures using due care and professional skepticism, with the Firm appropriately addressing the reviewer's findings and documenting the process. The information reported by the inspection team suggest that there is no evidence that the concurring partner review procedure used by the Firm resulted in the identification of any of the deficiencies noted by the inspection team. This may result from a lack of competency, due care or professional skepticism on the part of the concurring partner; deficiencies in the scope of he concurring partner's procedures; and/or the Firm's failure to properly address the concurring partner's findings.... (PCAOB Inspection of Randolph Scott & Company, Certified Public Accountants, Inc. February 11, 2005)

Concurring partner reviews in some instances noted that the Firm used the services "of an accountant not affiliated with the Firm to perform such reviews." The inspection report revealed in all such instances noted that ". . . there is no evidence that the concurring partner review procedure . . . resulting in the identification of any of the deficiencies noted by the inspection team." The failures for such outsiders were essentially the same as those of in firm partners who performed concurring reviews.

4. Appropriate Procedures (19.6%)

In many instances the comments related to *appropriate procedures* refer to specific

deficiencies noted during the inspection of the financial statement audits. Two illustrations reflect the general scope of comments made:

The Firm's system of quality control appears not to provide reasonable assurance that the Firm will conduct all testing appropriate to a particular audit. The information reported by the inspection team suggests an apparent pattern of failures to perform the appropriate procedures related to the testing of equity transactions [issuers A and E]. (PCAOB Inspection Of Perrella & Associates, P. A. April 6, 2006)

The firm's system of quality control appears not to provide sufficient assurance that the Firm will conduct all testing appropriate to a particular audit. The information reported by the inspection team suggest an apparent pattern of failures to perform the appropriate procedures related to testing the completeness and accuracy of shareholder\balances and testing the extinguishment of liability balances. [Issuers A and B] (PCAOB Inspection of Kempisty & Company, Certified Public Accountants November 21, 2008.)

As noted, in Table 1, there was only one firm that audited more than 100 issuers yearly that failed to respond within the 12 months of the date of related inspection report. The discussion of deficiencies was somewhat different for this one expanded report. A statement, that is judged to parallel those found in other expanded reports related to appropriate audit procedures, is provided in the report. It stated, in part:

The inspection results provide cause for concern that the Firm's system of quality control may not do enough to assure that accounting and auditing issues are evaluated with the objectivity that is contemplated in the auditing standards. In too many instances, the inspection team's support for significant areas of the audit consisted of management's views on the results of inquiries of management, (footnote *34 listed the issuers noted at end of this excerpt)* The Firm's apparent failure to appropriately challenge management's representations occurred in numerous areas, including when the Firm evaluated management's estimates, considered the valuation of investment securities, performed alternative procedures in connection with confirmations s, and tested income tax accounts and disclosures. . . . [Issuers noted were A, D, E F, G, H, I J, K, L, M, N, O, P, Q, V, Y and Z] (PCAOB Inspection of Deloitte & Touche LLP, May 19, 2008) *(Expanded report was reported disclosed in a press release from the PCAOB on October 17, 2011. Such a disclosure was the first one that resulted in a press release from the PCAOB.)*

The range of inappropriate audit procedures is wide. What is presented in the three excerpts from expanded reports merely provide illustrations of the nature of quality control issues.

5. Fraud Procedures (14.9%)

There are references related to attention to fraud in several different comments in expanded reports. The most common comment identifies the specific professional guidance that is not seemingly influencing the auditors. The following is illustrative of the comments (there are differences in references to specific deficiencies specified) disclosed:

> The Firm's system of quality control appears not to provide sufficient assurance that the Firm will perform all required procedures in accordance with the provisions of AU 316, *Consideration of Fraud in a Financial Statement Audit.* Specifically, the Firm did not perform audit procedures to test journal entries and other adjustments for evidence of possible material misstatements due to fraud. [Issuers A, B, C, and D] (PCAOB Inspection of Paritz & Company, P. A. July 30, 2009)

It would be interesting to know the extent to which the failure to follow professional guidance was an issue for firms that were able to meet remediation requirements within the 12-month deadline period.

6. Engagement Completion Document (11.2%)

A PCAOB audit standard specifies the requirement for the preparation of an *engagement completion document.* In the references to this issue, there is explicit reference to relevant guidance. The typical issue is described in this manner:

> The Firm's system of quality control appears not to provide sufficient assurance that the Firm will prepare an engagement completion document in accordance with PCAOB Auditing Standard No. 3, *Audit Documentation,* which is necessary to demonstrate that the work performed by engagement personnel addresses the significant findings and issues of the engagement. [Issuer A] (PCAOB Inspection of Dave Banerjee CPA, an Accountancy Corporation, June 29, 2009)

7. Testing Appropriate to the Audit (11.2%)

This issue relates to a range of failure to conduct testing appropriate to a particular audit. What is quoted here is a combination of the issues, rather than a specific report excerpt, in several different expanded reports. A common statement initially contains this comment:

> The Firm's system of quality control appears not to provide sufficient assurance that the Firm will conduct all testing appropriate to a particular audit.
>
> Appropriate testing not implemented applied to the following topics: 1. accounts receivable confirmations; 2. Business combinations; 3. evaluation of opening balances; 4. extinguishment of liabilities; 5.goodwill impairment; 6.income taxes; 7. preferred stock; 8. related parties; 9. revenue recognition; 10.sale of subsidiary; 11. statement of cash flow; 12. Stock issued for services and other expenses; 13. use of specialists; 14. valuation of inventory.

In general, the issues reveal the failure to follow clearly specified professional guidance for auditing such areas as those listed above. Also, there was failure to adhere to the appropriate generally accepted accounting principle (s) relevant for proper presentation.

The Next Four Issues Related to Audit Performance in Table 2

The four topics following the top seven are briefly discussed. These four issues are: audit documentation, partner workload, financial statement disclosures, and audit policies, procedures, methodologies, including training. A brief discussion of the remaining seven items ends this segment. .

Audit Documentation (7.5%)

Insufficiency of audit documentation is a common deficiency of many firms. The topic of audit documentation is also identified as a quality control issue. An illustration of the type of comment made follows:

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will adequately document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions to enable an experienced auditor, having no previous connection with the engagement to determine the date the audit work was completed and reviewed.. .Also, on both engagements reviewed, certain audit program steps were referenced to other work papers; however, in certain instances, there were no work papers at the referenced locations. This information provides cause for concern regarding the Firm's quality control policies and procedures related to the Firm's documentation of audit work. [Issuers A and B] (PCAOB Inspection of Larry O'Donnell, CPA.P. C. July 30, 2009).

Partner Workload (7.5%)

The review of workload of partners provides an explanation, in many instances, for the failure of sufficient and effective oversight in the leadership of providing quality audits. An illustrative comment is the following:

The Firm's system of quality control may not provide sufficient assurance that the audit partner's workload requirements realistically allow for sufficient time to supervise staff and review work papers with due care. The Firm's only audit engagement partner is responsible for servicing all of the Firm's issuer audit clients.(18 as identified by issuer) In addition, the Firm acquired over 70 percent of its issuer audit clients from March 2005 to November 2006 and approximately half the Firm's issuer audit clients report their financial results on a calendar year=end basis. (PCAOB Inspection of Lawrence Schartman & Company, September 24, 2007)

Financial Statement Disclosures (3.7%)

A comment that reflects the nature of the issue related to financial statement disclosures is the following:

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will identify any missing or incomplete financial statement disclosures [issuers A and B] (PCAOB Inspection of Bassie & Co. May 21,

2008)

Audit Policies, Procedures and Methodologies, Including Training (2.8%)

A typical comment related to this topic is the following:

> The Firm's system of quality control appears not to provide sufficient assurance that the staff and partners of the Firm possess the necessary competencies and proficiency to perform audits of issuers. Specifically, the Firm does not have a system in place to ensure that individuals assigned to issuer clients have the technical training and proficiency required in the circumstances and that they participate in continuing professional education and other development activities related to generally accepted accounting principles in the United States, PCAOB auditing standards, and SEC reporting requirements, rules and regulations. (PCAOB Inspection of Petrie Raymond, Chartered Accountants - L.L.P, (CA) December 21,2009)

Remaining Topics Identified for Audit Performance

The seven items that conclude the listing in Table 2 are: Personnel Management; Competency of Engagement Team; Foreign Affiliates; Income Taxes; Management Estimates; Reliance on Reports, Databases of Issuers; Review of Interim Information. Some of these topics were identified in a discussion of *Testing Appropriate to the Audit.* There is inevitable overlapping of the topics. These final seven items are issues that clearly reflect failure to adhere to auditing guidance, general accounting principles guidance, and quality control guidance.

5. Independence and Monitoring Issues

The two other segments of quality control analyses are independence and monitoring. There were 29 firms (27.1%) that were reported to have independence issues and 22 firms (20.6%) that had monitoring and audit identification of weaknesses. Examples of typical comments related to each are presented.

Independence Procedures (27.1%)

There were two issues related to independence that were disclosed in a limited number of expanded inspection reports. Two illustrations are:

> The Firm’s independence procedures appear not to meet the requirements of PCAOB Rule 3400T(b) in that the Firm does not have procedures to verify the completeness and accuracy of independence representations made by the Firm's partners and managers. (PCAOB Inspection of Rehmann Accounting L.L.C., November 6, 2007)

> The Firm's system of quality control appears not to provide reasonable assurance that the Firm will comply with independence requirements. As described in Part IIC below, the inspection team reported

> information indicating that the firm may not have been independent of certain of its issuer clients within the meaning of the Commission's independence requirements. (PCAOB Inspection of S. W. Hatfield, CPA, September 28,2005)

The requirement identified in the first excerpt above, PCAOB Rule 3400T (b), requires registered firms to comply with the quality control standards described in section 1000 of the AICPA SEC Practice Section Reference Manual, which in turn requires that a firm have policies and procedures in place to comply with Appendix L. section 1000.46 of that manual The reference, Part II C in the second excerpt above was not disclosed. Apparently, the PCAOB accepted the wish of the Firm to keep that information confidential.

Monitoring and Addressing Identified Weaknesses (20.6%)

Two illustrations of this third segment of a review of quality control, monitoring and addressing identified weaknesses are:

> The Firm's system of quality control appears to lack a monitoring element sufficient to provide the Firm with reasonable assurance that the Firm's policies and procedures for engagement are suitably designed and effectively applied. The Firm's monitoring appears to have been deficient with respect to at least three types of previously identified weaknesses. In connection with a 2007 inspection of the Firm, the inspection team brought to the Firm's attention that the Firm's procedures appeared not to provide sufficient assurance that the Firm would (1) perform appropriate procedures with respect to the valuation of stock issued for services; (2) perform appropriate procedures with respect to accounting for convertible debt with warrants; and (3) make the required auditor communications to the audit committee, or equivalent. ... [Issuers A, B, C. D. and E] (PCAOB Inspection of Baum & Company, P. A. , July 2, 2010)

> The Firm's system of quality control appears to lack a monitoring element sufficient to provide the firm with reasonable assurance that the Firm's policies and procedures for engagement performance are suitably designed and effectively applied In a report dated February 2, 2008, which related to an inspection of the Firm conducted in late 2004, the Board noted that the firm's procedures appeared not to provide sufficient assurance that all required auditor communications to the audit committee occur and are appropriately documented. An appropriate approach to monitoring would have resulted in the Firm avoiding this deficiency in audits performed after it was brought to the Firm's attention, yet the same deficiency, with respect to the same issuer client, was noted in this inspection. This indicates that the Firm had not responded meaningfully to this deficiency identified in its previous PCAOB inspection. (PCAOB Inspection of Jerome Rosenberg, C.P.A., P.C. September 30, 2008)

6. The Question that Cannot be Answered

The limitations of disclosure, including the agreement to maintain confidentiality of certain issues by the Firms, preclude providing conclusions about the status of quality control among registered public accounting firms.

The question that cannot be answered is: "Has the PCAOB's strategy for the inspection of quality controls and the nonpublic disclosure of extent of issues identified resulted in significant improvement in quality controls in registered firms?"

In 2003, the initial year of functioning, as noted in an earlier segment of this paper, the PCAOB performed limited inspections of the four largest firms. Those limited inspection reports were posted at the PCAOB website, following the rule that quality control issues could be limited, although there was a brief comment about issues related to some of the functional areas reviewed. However, as noted earlier, there was a report issued in 2006 that discussed criticisms (issues) noted.

All four firms met the requirement that of satisfactory remediation of all issues within the twelve months of the date of the initial inspection report. Therefore, no expanded inspection reports were reported. The report of 2006 merely identified nature of issue, not the number of instance noted in the four firms. The 2008 report combined the four firms with the other firms that audited more than 100 issuers. Again, the report identified nature of issues, but provided no figures of the extent of occurrence. (Excerpts from the 2006 and the 2008 reports are provided in Appendix A)

7. Questions Remain re Quality Control

This exploratory survey of quality control issues that were not resolved by registered firms was for the purpose of determining the nature of issues that continued to be unresolved. However, a byproduct of this exploratory survey is the number of questions that arose that may justify further consideration. Questions were prompted by a realization of how little there is to conclude about quality control issues. For example, the listing of Audit Performance items in Table 2 was not totaled. Since confidentiality was allowed for information that could be disclosed, there are undoubtedly additional firms who have incurred issues that were not revealed in expanded reports. Firms sought and gained approval for nondisclosure of certain issues. Therefore, a total of audit performance issues would be incomplete. Among the questions that have arisen, these are the ones that seem most in need of answers:

1. Is there value in reconsidering the legislative approach set forth by Congress in Section 104(g) (2) which was noted in in the PCAOB Release related to observations of initial quality control among the four largest U. S. firms?

   In that release is this statement:

   The Board's initial experience with the 12-month remediation process generally validates the premise of the approach set out by Congress in Section 104 9g) (2) of the Act. That legislative approach rested on the hypothesis that firms could be genuinely motivated by the prospect of

keeping the Board's quality control criticisms confidential. The Board's initial experience with the larger firms supports that hypothesis. Moreover, the firms were responsive to the Board's supervisory model, taking the initiative to engage constructively with the staff in a ongong dialogue toward a result satisfactory to the Board, rather than emphasizing points of disagreement and taking an adversarial approach. *(Noted in PCAOB Release No. 104-2006-078, March 21, 2006, Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 months After an Inspection Report.)*

2. What is the justification for the support for the above identified hypothesis?

To read the 2011 inspection reports of the four largest firms is to realize that the number of deficiencies is somewhat surprising. After eight inspections, including the limited inspections reported in 2004, there continue to be from 13 to 28 issuers with audit deficiencies identified in these four reports. These 2011 inspection reports as well as the disclosure that one of the big 4 firms required more than three years before an expanded inspection report was posted raise a question: Nonetheless is quality control in these large firms reasonably effective? However, this limited observation is not sufficient to provide any generalizations about quality control quality overall among any group of registered firms. Is it reasonable to believe that quality audits are possible even though quality controls are ineffective?

3. Is there value in providing to the public a summary report that does not need to disclose names of registered firms involved?

The following information deserves consideration for disclosure: 1. Total number of reports concluded each year; 2. Total number of firms inspected during each year that included quality control issues; 3. Total number of firms with quality control issues that successfully implemented appropriate and successful remediation; 4. Total number of firms with quality control issues that had not met the 12-month period allowed for remediation.

4. Should there be brief publications from the PCAOB related to quality control issues that seem persistent?

5. Have there been compensating strategies that are seemingly as successful in resulting in quality audits as are the quality control specifications?

6. Is there need to reconsider the categories for assessing quality control factors during an inspection?

7. Should the guidance for quality control be developed for specific ranges of

firm sizes?

8. Is the supervisory approach to an audit sufficient to assure audit quality?

   Is such an audit appealing, as noted in the limited inspections performed for the four largest firms, because there is no basis for making judgments about the overall quality of audit performance? How valuable is quality control that is to some extent influenced by deficiencies, when those deficiencies are based on an audit selection process that provides no basis for generalizations.

8. Summary and Final Comment

The purpose of this exploratory survey of quality control issues was to gain an overview of the nature and extent of issues identified in all the firms that failed to implement remediation requirements within 12 months of the date of the inspection report. Although there are limitations, knowing the nature and scope of issues that are unresolved within the remediation period may provide useful information in determining course content in colleges and universities, in professional courses by specialized organization, and in preparing in firm training programs.

The PCAOB provides a complete record of all inspections, including the initial limited inspections of the 4 largest U. S. firms. This listing identifies the firms inspection reports that are expanded to include quality control issues not resolved. Also, the PCAOB provides a separate listing of the firms with quality control issues revealed. Neither listing - the complete listing of all inspections nor the listing of inspections with quality control issues - provides any indication when the remediation after the 12 months was actually completed.

Key Findings

As indicated in the question related to lack of information related to quality control details in the preceding segment, there is no basis for providing conclusions. Among the findings are the following:

1. The total number of inspections with unresolved quality control issues was 107 from 2005 through 2010 (as noted as of January 1, 2012). The number per year ranged from eight for 2010 to 31 for 2006. (It is likely that there will be additional numbers for 2010 inspections.)

2. The largest group of firms with quality control issues, 58 of the 107 firms identified 0 to 5 issuer audit clients. (Inspectors inspected an earlier year audit in cases where the number was zero during the year of the inspection.)

3. A large number of quality control issues are identified through a review of audit deficiencies noted during an inspection. In some instances there are references to the Issuer audit involved.

4. Audit performance issues are the most common issues. The issue related to technical competence, due care, and professional skepticism was the most frequently identified issue. Because of its pervasive influence, this issue identifies a critical influence in reducing the effectiveness of an audit engagement.

5. The second and third issues by frequency are: Auditor Communications and Concurring Partner Review. These two have special pervasive impact on audit quality, as does the most common issue identified in Item 4. Appropriate communication with the audit committee, or a group that assumes the responsibility of an audit committee, is a valuable activity in enhancing audit quality.

   Concurring Partner Review provides assurance that a quality audit was indeed performed. Yet, both of these issues were identified in more than 40 inspection reports.

6. There are issues related to both Independence (27.1 % of the firms in the population) and Monitoring and Audit Identification of Weaknesses (20.1%).

7. The implications of the nature and extent of quality control issues should be assessed by those who select courses and materials for the education of auditors and accountants in our academic institutions as well as for continuing professional education provided in firms and by others.

Final Comment

The PCAOB is to be commended for their website that does provide information that made this survey possible. The tasks for which the PCAOB has responsibility are comprehensive and demand wise assessment of alternative strategies.

The Board was established following in the enactment of the Sarbanes-Oxley Act of 2002. The first decade of PCAOB's functioning years will end in April 2013. There continues to be a question overall: Are the contemporary oversight strategies of the PCAOB providing optimum assurance of quality audits? Isn't an objective, wise empirical study justified of the assumptions that have guided this new organization's strategies since it began functioning in early 2003?

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APPENDIX A

Excerpt from *Observations of the Initial Implementation of the Process for Addressing Quality Control Criticisms Within 12 Months After an Inspection Report,* PCAOB Release No. 104-2006-078, March 21, 2006, page 6.

Steps that emerged from the Rule 4009 process to address criticisms (issues) in this area (*Audit Performance)* included the following:

- 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.
- Establishing an internal network to coordinate second tax partner reviews of income tax provision work papers on selected audits.
- Adding internal guidance indicating that when reviewing contracts in the course of an audit, contracts exhibiting characteristics that may be associated with greater risks of material misstatement should be read by more experienced audit personnel, and adding guidance related to documenting consideration of whether significant contracts exhibit those characteristics.
- 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.
- communicating strong, firm-wide messages from firm leadership concerning the importance of adequate audit documentation and its contribution to improved audit quality, and reinforcing the message by factoring significant documentation deficiencies into the partner evaluation and compensation process.
- adding various topics to in-house audit partner and manager training curricula. (Ibid)

The report noted that the steps recommended above reflect significant need for change In meeting the expectations specified in quality control guidance. The Board reported that all four firms made a timely submission, pursuant to PCAOB Rule 4009 and the

undertaken important steps that, if conscientiously implemented, will have beneficial effects on audit quality. (Ibid.)

A report of the 8 U. S. accounting firms that are inspected annually was issued in December 2008. This report dealt with inspections of 2004, 2005, 2006, and 2007. The final segment discussed quality control factors, including some similar to comments made in the March 21, 2006 report. The December 5, 2008 report included 8 firms, while the 2006 related to the four largest U. S. firms only. While there is no disclosure of criticisms of the initial four in contrast with the other four firms added for the 2008 review, the criticisms and issues of the second report may be reflecting persistence of earlier criticisms and issues. There is not sufficient disclosure to learn what had happened to those criticisms of just four firms two years earlier.

This report, much like the earlier one, provided some general comments. One paragraph from the 2008 report, *Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms*, is:

> The Board made favorable determinations on the domestic annually inspected firms' remediation of quality control criticisms contained in the reports on the 2004 and 2005 inspections of the firms.[41/] Many (although by no means all) of the firms' remedial actions with respect to those first two years of inspections, fell within five broad categories of changes. Across the various categories of deficiencies described in this report (as well as with respect to other deficiencies not specifically described in this report), the firms made changes in or additions to (a) policies and procedures, (b) programs and checklists, (c) tools and templates, and (d) audit-related training. In addition, in numerous instances the firms issued releases or other firm-wide communications that emphasized the importance of adhering to or using the revised procedures or tools or emphasized the importance of the areas highlighted in the Board's inspection reports.