AN ANALYSIS OF AUDIT DEFICIENCIES BASED ON PCAOB INSPECTION REPORTS ISSUED DURING 2005

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Abstract

Audit deficiencies have far-reaching implications on the users of financial reports, accounting firms and their clients, and the accounting profession. Section 104 of the Sarbanes-Oxley Act of 2002 (USHR 2002) requires the Public Company Accounting Oversight Board to conduct inspections of each registered public accounting firm. The inspection process "is the Board's core function. It is the fundamental tool Congress gave the Board to restore public confidence in audited financial reporting" (PCAOB 2005n, 1). This paper contributes to the literature and debate on the Sarbanes-Oxley Act and its Section 104 inspection process by providing a comprehensive analysis of the inspection reports issued during 2005.

Understanding common audit deficiencies may help accounting professionals when conducting future engagements. Educators need to understand the types of common audit deficiencies that occur in practice in order to better prepare accounting students for today's complex audit environment (Carmichael 2004). To that end, this analysis examines the accounting firms inspected during

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2004 and 2005 and evaluates their audit deficiencies. Specific examples of deficiencies are identified in small, regional, national, and Big-4 accounting firms. Some common errors in the issuer's application of generally accepted accounting principles (GAAP) and procedural deficiencies that violate generally accepted auditing standards (GAAS) are summarized and discussed. Some final conclusions are presented.

INTRODUCTION

In *United States v. Arthur Young & Company*, 465 U.S. 805 (1984), the U.S. Supreme Court described the independent public audit as a "'public watchdog' function" (818). Michael Sutton (2002), former Chief Accountant of the U.S. Securities and Exchange Commission (hereafter SEC) asserts that "without investor confidence, arguments about how financial reporting does or does not contribute to economic goals or market efficiency simply are moot−they are a waste of time. If investors do not have confidence or lose confidence in the integrity of the information they receive, then they will flee the markets, and we all will pay a devastating price. … I believe that the road to a more lasting resolution begins with full acknowledgement by the auditing profession of the reality that seems so clear today. Failures in our financial-reporting system are more than aberrations. They seriously undermine the confidence of investors and the public in the institutions that are supposed to protect them" (321).

The Sarbanes-Oxley Act of 2002 [USHR 2002 (hereafter Act)] was signed into law on July 30, 2002. Cunningham (2002) asserts that the Act "is an achievement, perhaps a political/legislative masterstoke … with the force of federal law" (47). According to Carcello (2005), the Act "and the creation of the PCAOB are regulatory changes not changes in legal liability. But given the magnitude and significance of these regulatory changes, it is reasonable to expect auditors to react to the changed institutional environment in a manner consistent with the renewed emphasis and focus on audit quality" (32-33).

In 1939, the American Institute of Certified Public Accountants (hereafter AICPA) established a standing committee to issue a series of audit bulletins, a step precipitated by the legendary McKesson & Robbins auditing debacle (Zeff 2003). From 1939 to 2002, the AICPA was the chief architect and promulgator of U.S. auditing standards. Section 101 of the Act changed this by establishing the Public Company Accounting Oversight Board (hereafter PCAOB or Board). The PCAOB was created to oversee audits of public companies and to ensure the Board's "… independence from the profession, a longstanding philosophical and practical conflict between the SEC and the AICPA. Whether they will work is uncertain. But this is a major step, perhaps the silver bullet of the Act" (Cunningham 2002, 20).

Prior to the Act, oversight of the auditing profession was accomplished via the AICPA's peer review program. Auditors with SEC clients were monitored through mandatory reviews every three years. Section 104 of the Act requires the PCAOB to conduct an annual inspection of each registered public accounting firm that regularly provides audit reports for more than 100 public issuers. Firms with 100 or fewer issuers are inspected once every three years. "These inspections take a significantly different approach from that of the peer reviews in the pre-Sarbanes-Oxley self regulatory system, which focused on compliance with applicable standards but did not address the overall audit environment" (PCAOB 2006d, 2). The Board uses a risk-assessment process to conduct its inspections. Allen, Hermanson, Kozloski, and Ramsay (2006) review the academic literature, using the Board's 2005 briefing paper on risk assessment as their organizing framework, and conclude that the PCAOB's risk-assessment process for conducting its inspections is consistent with the auditing literature.

Board inspections include, among other things, a review of selected audits. If the inspection team identifies deficiencies in an audit, it alerts the firm to the deficiencies during the inspection process. Any deficiencies that exceed a certain significance threshold are summarized in the public portion of the Board's inspection report. According to Mark Olson, Chairman of the PCAOB, "When inspectors find an audit that is not satisfactory, they discuss with the firm precisely what the deficiency is. Often this dialogue leads to immediate corrective action" (PCAOB 2006d, 2). Gunny and Zhang (2006) "provide evidence that one benefit of switching from peer reviews to independent inspections is that audit reports from the PCAOB are able to distinguish earnings quality, whereas the peer review report was not" (3).

In part, audit failures led to the formation of the PCAOB and its inspection mandate. "The PCAOB was created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports" (PCAOB 2006c, Preface). The inspection process "is the Board's core function. It is the fundamental tool Congress gave the Board to restore public confidence in audited financial reporting" (PCAOB 2005n, 1). According to Donald Nicolaisen, former Chief Accountant of the Securities and Exchange Commission, the "SEC is a strong advocate of the PCAOB inspection process, which compares what firms say to what they do" (Colsen 2004, 21).

Learning from our mistakes is essential, both individually, and collectively, as a profession. Hodowanitz and Solieri (2005) evaluated the first 24 inspection reports issued during 2005. This paper contributes to the literature and debate on the Act and its Section 104 inspection process by providing a comprehensive analysis of all of the inspection reports issued during 2005.

Understanding common audit deficiencies may help accounting professionals when conducting future engagements. Furthermore, educators need to understand the types of common audit deficiencies that occur in practice in order to better prepare accounting students for today's complex audit environment (Carmichael 2004). To that end, this analysis examines the accounting firms inspected during 2004 and 2005 and evaluates their audit deficiencies. Specific examples of deficiencies are identified in small, regional, national, and Big-4 accounting firms. Some common errors in the issuer's application of GAAP and procedural deficiencies that violate GAAS are summarized and discussed. Some final conclusions are presented.

INSPECTION REPORTS ISSUED BY PCAOB DURING 2005

At the beginning of 2005, there were approximately 893 registered public accounting firms located in the United States, many of which have multiple offices, and 530 non-U.S. firms in 76 countries (PCAOB 2004b). By the end of 2005, 1,591 firms were registered with the Board (PCAOB 2006c). Statistics relating to the number of issuers per registered accounting firm for the period 2003-2005 are presented in Table 1.

TABLE 1
Accounting Firms Registered with the PCAOB: 2003-2005
Number of Issuers Per Registered Firm

Issuer clients (as of December 31):	2003	2004	2005
101 or more	8	9	9
51 – 100	5	8	8
26 – 50	22	27	26
11 – 25	60	81	81
6 – 10	77	113	107
1 – 5	563	600	559
0	0	585	801
Total Number of Firms Registered	**735**	**1,423**	**1,591**

Source: PCAOB Annual Reports: 2003–2005 (PCAOB 2004b, 2005b, & 2006c)

During 2005, the PCAOB issued 173 reports to accounting firms for inspections conducted during 2004 and 2005.[1] Included in this analysis are two reports for inspections conducted during 2004, which were not issued until 2006 (PCAOB 2006a and 2006b).

The 175 reports represent: 146 small firms; 21 regional firms; four national firms – BDO Seidman LLP (hereafter BDO), Crowe, Chizek and Company LLC (hereafter Crowe), Grant Thornton LLP (hereafter GT), and McGladrey & Pullen LLP (hereafter McGladrey); and the Big-4 firms – Deloitte & Touche LLP (hereafter Deloitte), Ernst & Young LLP (hereafter E&Y), KPMG LLP (hereafter KPMG), and PricewaterhouseCoopers LLP (hereafter PwC).[2] These firms represent a myriad of organizational structures. While structural titles or terminologies differ from state-to-state, all of the 175 firms, with the exception of 12 sole proprietorships and 5 partnerships, are afforded some form of limited liability.

The inspection reports represent 542 audit engagements (scope of PCAOB inspections). According to the PCAOB (2004a), of those U.S. accounting firms that were registered with the Board, only eight U.S. firms had more than 100 public audit clients, which were subject to an annual inspection in 2004.

Small and Regional Accounting Firms

During 2005, the PCAOB issued reports on 146 small firms and 21 regional firms for inspections conducted during 2004 and 2005. For this analysis, small and regional accounting firms are categorized based on the number of self-reported public issuer clients per firm, with 1 to 10 clients per firm and 11 to 67 clients per firm, respectively. Firm size was operationalized this way because of the wide range of small and regional firms represented.

Table 2 summarizes the number of self-reported audit clients per firm and the scope of inspections related to small and regional firms. In addition, the number and percent of audit deficiencies reported by the Board is provided for the two categories.

TABLE 2
PCAOB 2005 Inspection Report Statistics
Audit Deficiencies: Small and Regional Accounting Firms

					Audit Deficiencies (f – i)			
(a) Number of firms inspected	**(b)** Number of self-reported audit clients per firm	**(c)** Total number of clients represented (a x b)	**(d)** PCAOB Scope	**(e)** % of Scope (d/c)	**(f)** Yes (N)	**(g)** Yes % (f/a)	**(h)** No (N)	**(i)** No % (h/a)
Panel A: Small accounting firms with 1-10 audit clients per firm represented								
62	1	62	62	100%	27	44%	35	56%
25	2	50	47	94	9	36	16	64
23	3	69	62	90	7	30	16	70
10	4	40	33	83	0	0	10	100
7	5	35	21	60	3	43	4	57
6	6	36	20	56	2	33	4	67
7	7	49	31	63	6	86	1	14
1	8	8	4	50	1	100	0	0
2	9	18	7	39	1	50	1	50
3	10	30	11	37	3	100	0	0
146		**397**	**298**	**75%**	**59**	**40%**	**87**	**60%**
Panel B: Regional accounting firms with 11-67 audit clients per firm represented								
2	11	22	8	36%	2	100%	0	0%
1	12	12	4	33	0	0	1	100
3	14	42	14	33	3	100	0	0
2	15	30	10	33	2	100	0	0
1	16	16	3	19	1	100	0	0
1	17	17	5	29	1	100	0	0
1	18	18	12	67	1	100	0	0
1	19	19	14	74	1	100	0	0
2	21	42	7	17	1	50	1	50
1	22	22	8	36	1	100	0	0
1	26	26	3	12	0	0	1	100
1	28	28	4	14	1	100	0	0
1	50	50	10	20	0	0	1	100
1	59	59	9	15	1	100	0	0
1	61	61	16	26	1	100	0	0
1	67	67	4	6	1	100	0	0
21		**531**	**131**	**25%**	**17**	**81%**	**4**	**19%**

The 146 small firms represent 397 public issuers. Fifty-nine firms (40 percent) were deemed to have one or more audit deficiency. Sixty-two of the small firms (42 percent) had only one public issuer per firm, so 100 percent of these audits were inspected. Twenty-seven of the 62 audits (44 percent) performed by these small firms included audit deficiencies. The 21 regional firms represent 531 public clients. Seventeen (81 percent) of these audits were deemed to have one or more audit deficiency. Some examples of deficiencies in audits conducted by small and regional firms are presented to illustrate the audit deficiencies identified by the Board.

Small Accounting Firms. One small firm failed to document its audit procedures with respect to cut-off testing for sales and purchases. In addition, it failed to perform and document procedures to determine if the issuer's classification of leases was appropriate and to determine the existence of accounts receivable (PCAOB 2005e).

Another firm failed to identify, or to address appropriately, a departure from GAAP concerning the disclosure of a related-party transaction (PCAOB 2005d). In addition, the Firm failed to assess whether information concerning subsequent events indicated any inconsistencies requiring modification of the audited financial statements or the audit report.

One small firm failed to document its understanding of controls or test data from a service organization used by the issuer in recording its self-insurance reserve (PCAOB 2005a). Another small firm failed to test internal controls when relying on system-generated reports (PCAOB 2005e).

Regional Accounting Firms. One regional firm failed to perform and document adequate procedures related to revenue and two of the issuer's investments (PCAOB 2005c). Another firm failed to perform and document adequate testing of inventory, revenue recognition, and the existence of accounts receivable. In addition, the Firm failed to perform procedures to extend testing performed at an interim period to year-end (PCAOB 2005f).

One inspection report related to a regional accounting firm, where the Firm reported having 61 public audit clients; albeit, the firm had only one partner and two professional staff (PCAOB 2005g). The scope of the inspection included the review of 16 of the Firm's audits. Deficiencies were identified in eight of the audits reviewed, including issues related to: acquisition of rental property, capitalized software costs for impairment, testing fair value of equity securities, testing liabilities for completeness and accuracy, testing revenue recognition, valuation of expense upon the termination of an agreement, collectibility of a note receivable, despite evidence of impairment, and failure by the Firm to evaluate the issuers' ability to continue as a going concern. Two issuers restated their financial statements to address their deficiencies.

One regional firm failed to perform sufficient audit procedures with respect to controls at a third-party service organization (PCAOB 2005o). Another firm failed to adequately test information technology (IT) controls (PCAOB 2005c).

National Accounting Firms

During 2005, inspection reports were issued for BDO and McGladrey. The reports for Crowe and GT were not issued until January 2006 (PCAOB 2006a and 2006b, respectively), but these inspection reports were included in this analysis. A total of 48 audits performed by national firms were inspected from May 2004 to March 2005. The number of public audits conducted by each national firm, where one or more audit deficiency was identified, is summarized in Table 3.

TABLE 3
PCAOB 2005 Inspection Statistics
Audit Deficiencies: National Accounting Firms

	Number of public audit engagements with one or more audit deficiency
BDO Seidman LLP	11
Crowe Chizek and Company LLP [(a)]	11
Grant Thornton LLP [(a)]	15
McGladrey & Pullen LLP	11
Total Number of Audit Engagements	**48**

(a) Inspection reports were not issued until January 2006 (PCAOB 2006a and 2006b).

Some examples of deficiencies in audits conducted by national firms are presented to illustrate the audit deficiencies identified by the Board.

BDO Seidman. From May 2004 to July 2004, the inspection team performed field work at BDO's National Offices and at six of its 31 practice offices (PCAOB 2005j). Eleven of its audits included one or more audit deficiency.

One deficiency identified was a departure from GAAP, where the issuer misclassified its revolving line of credit as a long-term liability, rather than as a current liability, as specified in Emerging Issues Task Force (EITF) Issue No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*. The issuer subsequently restated its prior year's balance sheet to classify the debt as a current liability. In another audit, the Firm failed to obtain evidence, relating to goodwill, to support its audit opinion. The issuer performed an analysis on impairment because it sold a large portion of its operations. The issuer concluded that a small portion (7 percent) of its goodwill was impaired. The Firm failed to test or challenge the assumptions relating to the impairment. In particular, the Firm failed to address why goodwill, which represented approximately one-third of the issuer's total assets, was not fully impaired in light of the its deteriorating financial performance.

In three engagements, deficiencies in the auditing of revenue recognition resulted in the Firm failing to obtain sufficient evidence to support its audit opinions. One issuer analyzed its slow-moving inventory, using a non-routine report generated from its inventory file, which formed the basis for its reserve for inventory obsolescence. BDO failed to perform tests of controls or substantive audit procedures to verify that the report was complete and accurate. In addition, the Firm failed to obtain sufficient evidence to corroborate the reasonableness of the issuer's inventory obsolescence, given that the gross amount of the issuer's inventory was 67 percent of its total assets.

Deficiencies in the testing of internal control resulted when BDO failed to obtain sufficient audit evidence to support its audit opinion (PCAOB 2005j). For example, the Firm failed to change its level of controls assurance from "Moderate" to "Basic" when it identified certain weaknesses in the issuer's IT general controls. As a result, the Firm performed insufficient audit work on accounts receivable and inventories.

Crowe, Chizek and Company. From November 2004 to December 2004, the inspection team performed field work at Crowe's National Office and at four of its 19 other locations (PCAOB 2006a). Eleven of its audits included one or more audit deficiency.

One deficiency identified in four audits of financial institutions was the Firm's failure to obtain audit evidence, regarding the allowance for loan losses, sufficient to support its audit opinions. On a first-year audit for Crowe, the Firm failed to appropriately plan materiality. Based on the materiality used, sample sizes for confirming receivables and testing inventory would have been three times larger than the sample sizes used for these tests. The Firm failed to test all the relevant assertions relating to cost of goods sold. Further, the Firm failed to document its evaluation of SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, for a curtailment loss relating to the issuer's health care plan.

In one engagement, the Firm failed to obtain evidence regarding the issuer's sales contracts and its revenue recognition. In another audit, the Firm failed to evaluate and test revised assumptions used for goodwill impairment, which resulted in violations associated with the issuer's debt covenants.

In one audit, Crowe's IT audit personnel participated in evaluating and testing general computer controls to assess control risk below the maximum level for auditing revenue. While the Firm's personnel documented an understanding of the design of controls and identified potential control issues, the Firm failed to perform numerous tests and observations in its internal control work program due to "time constraints" (PCAOB 2006a).

Grant Thornton. From May 2004 to March 2005, the inspection team performed field work at GT's National Office and at 12 of its 49 practice offices (PCAOB 2006b). Fifteen of its audits included one or more audit deficiency.

In one audit, the Firm failed, in several respects, to obtain sufficient evidence to support its opinion relating to: reported gains on sales of certain loans through securitization transactions; controls and substantive audit procedures relating to loan originations; and financial instruments and hedge activities.

In three banking engagements, the Firm failed to obtain sufficient evidence to support its audit opinions. The deficiencies related to the issuers' allowance for loan losses, customer deposits, and IT controls. In another audit, the Firm failed to identify certain departures from GAAP associated with related-party transactions.

In one audit, the Firm failed to evaluate whether the issuer's deferred tax assets were recoverable and whether the current classification for a portion of those assets was appropriate. In another engagement, the Firm failed to perform procedures to evaluate the issuer's inventory allowance for lower of cost or market adjustments and for slow moving and defective inventory

In one audit, GT failed to test controls relating to an issuer's customer deposits (PCAOB 2006b). In two other audits, the Firm's tests associated with operating effectiveness of IT controls did not provide assurance that the controls operated effectively throughout the audit period.

McGladrey & Pullen. From October 2004 to December 2004, the inspection team performed field work at McGladrey's National Office and at four of its 75 practice offices (2005m). Eleven audits performed by McGladrey included one or more audit deficiency.

One deficiency identified concerned income on the sale of operating property to a related party. Based on SFAS No. 66, *Accounting for Sales of Real Estate*, the gain should not have been recorded in income because the sale was a related-party transaction. The issuer restated its quarterly and annual financial statements to make changes relating to the GAAP departure.

In several audits, McGladrey used analytical procedures as the primary audit procedures for testing assertions related to payroll, sales and operating expenses, investment income, fixed assets, other assets, interest and fee income, and interest expense. These procedures did not meet the requirements for substantive analytical procedures because the Firm failed to establish, or failed to include evidence in the work papers that it had established, expectations or the amounts of the differences from any expectations that could be accepted without further investigation.

One issuer used a service organization to process its payroll (PCAOB 2005m). McGladrey failed to obtain the service auditor's report or to gain an understanding of the service organization's controls. The Firm assessed control risk at the maximum for payroll expense, but it failed to test the accuracy and completeness of the payroll reports from the service organization.

Big-4 Accounting Firms

Sixty-five audits performed by Big-4 firms were inspected from May 2004 to January 2005. The number of public audits conducted by each firm, where one or more audit deficiency was identified by the Board, is summarized in Table 4.

TABLE 4
PCAOB 2005 Inspection Statistics
Audit Deficiencies: Big-4 Accounting Firms

	Number of public audit engagements with one or more audit deficiency
Deloitte & Touche LLP	8
Ernst & Young LLP	8
KPMG LLP	19
PricewaterhouseCoopers LLP	30
Total Number of Audit Engagements	**65**

Some examples of deficiencies in audits conducted by Big-4 firms are presented to illustrate the audit deficiencies identified by the Board.

Deloitte & Touche. From May 2004 to November 2004, the inspection team performed field work at Deloitte's National Office and at 26 of its 64 practice offices (PCAOB 2005i). Eight engagements were identified as having one or more audit deficiency.

In one audit, the Firm failed to identify an error in the computation of an impairment charge related to the shutdown of a manufacturing facility. The issuer restated its financial statements to correct this error. In another audit, the Firm assessed an issuer's ability to continue as a going concern, in part, on the availability of the issuer's revolving credit facility. The Firm did not include a going-concern paragraph in its audit report. However, the issuer's access to the revolving credit was dependent on its compliance with all debt covenants. The Firm failed to adequately assess the likelihood that the issuer would be able to meet one of these covenants, the 12-month trailing revenue covenant. Moreover, the issuer failed to comply with the covenant. Furthermore, the Firm did not obtain a management representation covering projections and assumptions related to the covenant.

During the Board's limited 2003 inspections (see footnote 2), the inspection staff identified failures on the part of all Big-4 firms to identify or address GAAP exceptions relating to the provision of EITF 95-22. Balances under revolving lines of credit must be classified as current liabilities, if the loan agreements contain both a subjective acceleration clause and a requirement to maintain a lock-box arrangement for customer remittances, whereby remittances from the borrower's customers immediately reduce the outstanding obligation. During its 2004 review, the inspection team identified one of Deloitte's clients that accounted for a balance under a revolving line of credit as a long-term liability, despite the presence of conditions that made such accounting inappropriate under the EITF 95-22 criteria. The issuer restated its financial statements relating to this issue.

Deloitte relied on general computer controls, automated application controls, and security controls, without performing, or without documenting in its work papers the performance of, sufficient testing to support reliance on those controls (PCAOB 2005i). For example, the Firm's work papers indicated that it used reports generated by the payroll department to perform certain tests of controls, but the Firm did not document any test work over the completeness of those reports.

Ernst & Young. From July 2004 to December 2004, the inspection team performed field work at E&Y's National Office and at 16 of its 86 practice offices (PCAOB 2005k). Eight engagements were identified as having one or more audit deficiency.

In one audit, the Firm failed to identify a departure from GAAP, whereby the issuer accounted for a lease as an operating lease, despite the presence of conditions that made such accounting inappropriate under SFAS No. 13, *Accounting for Leases*. The issuer restated its 2003 balance sheet in its 2004 Form 10-K to make the changes relating to this matter. In another audit, E&Y failed to identify a departure from GAAP, whereby the issuer disclosed in the notes to its financial statement two reportable segments, despite the presence of information that indicated the issuer was organized in more than two reportable segments, as defined by SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. This improper aggregation of reporting segments resulted in the offsetting of operating profits at one segment with losses at another.

In one audit, E&Y was aware of indications of deficiencies in the effectiveness of the issuer's controls over the allowance for loan losses (PCAOB 2005k). While the Firm assessed control risk as "minimum," the Firm's knowledge of such indications rendered its assessment of the control risk inappropriate.

KPMG. From June 2004 to October 2004, the inspection team performed field work at KPMG's National Office and at 11 of its 90 practice offices (PCAOB 2005h). Nineteen engagements were identified as having one or more audit deficiency.

In one audit, a sale-leaseback transaction was accounted for using normal sale-leaseback criteria, despite the presence of conditions that made such accounting inappropriate under SFAS No. 98, *Accounting for Leases*. As a result, the assets and the debt attributable to the properties were not reflected in the issuer's balance sheet, as they should have been, and the issuer recorded a deferred gain that it should not have recorded. The contractual terms of the transactions had the effect of precluding normal sale-leaseback accounting. In addition, the contractual terms of the transaction – guarantees, letters of credit, and indemnification arrangements – were not disclosed in the footnotes to the issuer's financial statements. The issuer restated its financial statements to correct this transaction. Further, the Firm failed to include copies or abstracts of the relevant contracts in the audit work papers.

In two other audits, deficiencies were identified concerning SFAS No. 95, *Statement of Cash Flows*. Approximately one-third of the cash and cash-equivalents reported by one issuer, and approximately 43 percent of the cash and cash-equivalents reported by another issuer, were invested in securities that were not appropriate for classification as cash or cash-equivalents. In each case, the Firm should have identified and addressed the incorrect accounting. The issuers reclassified their financial statements, prospectively, to correct this reporting issue.

In one audit, KPMG relied on the effectiveness of issuer controls for the revenue cycle, but the Firm's only testing of those controls was with respect to the period after the year under audit (PCAOB 2005h). In another engagement, the issuer used a service organization for payroll services. KPMG placed reliance on the controls at the service organization with respect to vacation expense and accrual testing. The Firm did not obtain an understanding of the controls at the service organization through its own assessment, nor had it obtained an auditor's report on the service organization prepared in accordance with AU 324, *Service Organizations*; hence, the Firm should not have relied on the controls at the service organization.

PricewaterhouseCoopers. From May 2004 to January 2005, the inspection team performed field work at PwC's National Office and at 25 of its approximately 65 practice offices (PCAOB 2005l). Thirty engagements were identified as having one or more audit deficiency.

In four audits, the Firm tested a sample of subsequent cash receipts that purportedly were received in payment of the accounts receivable. In each case, the sample size was inadequate for the testing required because the Firm used the wrong method of sampling. In another audit, the Firm did not test a material difference between a supporting schedule used in the alternative procedures and the general ledger.

In two audits, the Firm used analytical procedures as alternative procedures, but it did not perform certain required steps, such as developing expectations and defining a significant difference. In another audit, the Firm was aware that an issuer had not recorded a deferred tax liability for a portion of its accumulated foreign currency translation adjustment associated with the unremitted earnings from non-U.S. subsidiaries. These earnings were included in other comprehensive income. SFAS No. 109, *Accounting for Income Taxes*, requires that a deferred tax liability be recorded in this situation. The Firm failed to address the incorrect accounting. After the field work, and at the same time that the issuer restated its financial statements to address other issues, the issuer restated its financial statements for this issue.

In another audit, the Firm failed to test the derivatives in the issuer's trading portfolio. The planning documentation indicated that the Firm would test these items, but it failed to do so. In another audit, the Firm used a computer-assisted auditing procedure to identify potentially fraudulent journal entries. While certain entries were identified, the Firm failed to examine them to determine whether any of them were fraudulent.

In one audit, the Firm's sample size for testing the additions to an asset account was insufficient because it did not meet the requirements for calculating sample size. Further, when auditing the completeness, existence and valuation assertions for deferred revenue, the sample of items tested by the Firm was inadequate because the Firm used the wrong method of sampling.

In another engagement, the Firm failed to adequately evaluate the appropriateness of the issuer's accrued liability for medical costs. The issuer was created over a decade ago as the result of a spin-off. Under the terms of the agreement, the former owner of the issuer agreed to continue paying medical costs for certain employees, and these costs were subject to reimbursement by the issuer. In accepting the issuer's accrued liability for reimbursable medical costs at the end of 2003, the Firm relied on a letter from the issuer's legal counsel that had not been updated since July 2000.

In 13 instances involving the audits of ten issuers, PwC failed to test or failed to perform sufficient tests of controls that the Firm relied on in designing and performing its substantive procedures (PCAOB 2005l). For example, the Firm relied on IT application controls that had not been tested for several years and tested controls using samples that were smaller than necessary to support reliance on the types of controls tested.

COMMON AUDIT DEFICIENCIES

Based on the 175 inspection reports issued, a number of common audit deficiencies emerge. These deficiencies include failures to identify or appropriately address errors in the issuer's application of GAAP, some of which appear likely to be material to the issuer's financial statements. Some of the common GAAP departures and procedural deficiencies that violate GAAS are summarized in Panels A and B, respectively, of Table 5.

No one type of GAAP-related deficiency is shared by all categories of firms. However, errors affecting all accounting elements are common across the different categories of firms. GAAP deficiencies common to most firms include: (1) inventory and/or cost of sales transactions; (2) transactions related to the purchase and/or impairment of goodwill; and (3) revenue recognition and/or accounts receivable.

Four common GAAS-related deficiencies across the firms are of particular importance. They include: (1) the assessment of clients' internal control; (2) work paper discrepancies and/or the quality of audit evidence; (3) the inappropriate use of analytical procedures, and (4) inadequate sample sizes and/or sampling errors.

TABLE 5
PCAOB 2005 Inspection Report Statistics
Common GAAP and GAAS Audit Deficiencies: All Firms[a]

Legend for Abbreviations: BDO = BDO Seidman LLP; CCC = Crowe Chizek and Company LLP; D&T = Deloitte & Touche LLP; E&Y = Ernst & Young LLP; GT = Grant Thornton LLP; KPMG = KPMG LLP; M&P = McGladrey & Pullen LLP; and PwC = PricewaterhouseCoopers LLP.

	Small	Regional	National				Big-4			
Panel A: GAAP Deficiencies	N = 146	N = 21	BDO	CCC[b]	GT[b]	M&P	D&T	E&Y	KPMG	PwC
Accounting for inventory and/or cost of sales	✓	✓	✓	✓	✓	✓		✓	✓	✓
Bankruptcy and restructuring/reorganization							✓	✓		
Business combinations/mergers	✓	✓					✓			
Reportable segments	✓					✓	✓	✓	✓	✓
Cash/cash-equivalents and marketable securities						✓			✓	✓
Client disclosures to financial statements	✓	✓		✓			✓	✓	✓	
Debt covenant violations	✓			✓		✓	✓			
Derivatives and hedging transactions					✓				✓	✓
Foreign currency related transactions	✓				✓					✓
Goodwill purchase and impairment	✓	✓	✓	✓	✓		✓	✓	✓	
Lease and sale/leaseback transactions	✓						✓	✓	✓	
Related-party transactions	✓	✓			✓	✓			✓	✓
Revenue recognition and accounts receivable	✓	✓	✓	✓	✓	✓		✓	✓	✓
Panel B: GAAS Deficiencies										
Assessment of issuer's internal control	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Assessment of fraud-related issues									✓	✓
Assessment of going concern issues	✓	✓	✓			✓	✓			
Assessment and planning of materiality	✓			✓					✓	
Assessment of service provider's controls	✓	✓				✓			✓	✓
Inadequate sample size and sampling errors				✓	✓	✓	✓		✓	✓
Incorrect use of analytical procedures	✓	✓		✓	✓	✓		✓		✓
Reliance of another auditor	✓	✓				✓				✓
Review of contingent liabilities/subsequent events	✓	✓		✓					✓	
Review of interim financial statements	✓					✓			✓	
Work paper discrepancies/quality of evidence	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Year-end audit procedures		✓							✓	✓

[a] Source: PCAOB Inspection Reports 104-2005-001 – 104-2005-173 and [b] 104-2006-001 & 104-2006-002.

Internal control discrepancies are of particular concern, given management's assessment of internal controls for financial reporting and the firm's attestation of management's assessment as required by Section 404(b) of the Act and the Board's Auditing Standard (AS) No. 2 *An Audit of Internal Control Over Financial*

Reporting Performed in Conjunction With an Audit of Financial Statements.[3] Audit deficiencies relating to internal control discrepancies were common across all firm categories.

The quality and completeness of audit work papers are critical to the entire audit process. Work papers document that the audit has been properly planned and supervised and that the audit evidence supports the assertions tested and is sufficient for the type of audit report issued (Messier, Glover and Prawitt 2006). Audit deficiencies relating to work papers and/or the quality of audit evidence were common across all firm categories.

Analytical procedures are used for three purposes: (1) *preliminary procedures* are used to understand the business and to plan audit procedures; (2) *substantive procedures* are used to obtain audit evidence; and (3) *final procedures* are used as an overall review of the financial information in the final review stage of the audit. AU 329, *Analytical Procedures*, requires the use of analytical procedures during the preliminary and final stages of the audit. Audit deficiencies relating to the inappropriate use of analytical procedures were identified in a number of audits conducted by most accounting firms.

While a complete discussion about sampling methods and techniques is beyond the scope of this analysis, sampling procedures are an important part of the audit. The fact that an audit involves sampling is expressed to users of the financial statements in the scope paragraph of the auditor's report (Messier, Glover, and Prawitt 2008). Audit deficiencies relating to inadequate sample sizes and sampling errors were common discrepancies identified in a number of audits conducted by most accounting firms.

CONCLUSIONS

According to the General Accounting Office (USGAO 2003), Big-4 firms audited "over 78 percent of all U.S. public companies" (1-2) in 2002. In contrast, "mid-sized and small accounting firms conducted 30 percent of total public company audits in 2004–up from 22 percent in 2002. However, the overall market for audit services remains highly concentrated, with companies audited by large firms representing 98 percent of total U.S. publicly traded company sales (revenues)" (USGAO 2006, 8).

Following the mergers of the 1980s and 1990s and the dissolution of Arthur Andersen in 2002, market share among firms became more concentrated in the Big-4 firms. Given the post-Sarbanes environment, Big-4 firms are seeking to reduce some of their business risk via client selection and retention. "Big 4 firms have become more aggressive in shedding relatively small, marginal SEC audit clients. … The majority of these registrants have been absorbed by non-Big 4 audit firms, with local and regional audit firms gaining the most audit clients" (Rama & Read 2006, 108). Smaller firms face a number of significant challenges and barriers including staff resources, industry-specific and technical expertise, geographic limitations, and national and international reputation. Such challenges may become even more pronounced as smaller firms conduct more risky audits.

The ultimate objective of financial reporting is to provide transparent financial statements and disclosures that meet the informational needs of investors and other users of financial statements. Audit deficiencies identified in the inspection process may affect the number of restatements of public financial reports. In fact, the PCAOB expected an increase in issuer restatements as a result of its 2004 inspections (Farrell and Shadab 2005). Susan Schmidt Bies, a member of the Board of Governors for the U.S. Federal Reserve, posits that the Board's "inspection process … may be a factor in the increased number of restatements" (4).

Using data from Glass Lewis & Co., LLC, Turner and Weirich (2006)[4] evaluated restatements filed with the SEC in 2005 and determined that "1,195 U.S. public companies filed financial restatements to correct errors, as defined under generally accepted accounting principles (GAAP), which increased 95% from year-earlier results. … These restatements aren't just about revising subjective judgments or complying with esoteric, complex accounting pronouncements. In hundreds of instances, they stem from basic misapplications of simple rules or critical breakdowns in corporate controls and competencies" (14).

Turner and Weirich (2006) found that smaller firms restated six times more often than other firms. More than half of all restatements filed in 2005 were by companies that disclosed at least one material weakness in its internal controls. Grant Thornton and BDO (12 percent and 8.4 percent, respectively) had the two highest restatement rates, as measured by the number of restatements divided by the number of public companies audited. Among Big-4 firms, KPMG had the highest restatement rate (7.1 percent), while Deloitte had the lowest rate (5.6 percent). "PricewaterhouseCoopers and Deloitte had the largest volume of restatements in both 2005 and 2004. Both had 200 or more restatements last year. While Deloitte had the lowest restatement rate among the Big Four, its volume of restatements increased by 130% in 2005, the largest increase of the Big Four" (22). Former Chief Accountant of the SEC, Donald Nicolaisen, argues that "the number of restatements in financial statements filed with the SEC is unacceptably high, as is the number of material weaknesses companies have reported in this first year of 404" (Pickard 2006, 36).

Despite its accomplishments, the PCAOB has some thorny issues and controversies, yet to solve. One major hurdle that the Board must clear is the upcoming implementation of Section 404 of the Act for non-accelerated filers (see footnote 3). Undoubtedly, this will increase the Board's overall work, at least in the short term. A second major concern that the Board must solve is the significant time lapse between its inspection and the date the inspection report is issued. For example, field work was conducted at E&Y from July to December 2004, yet the report for its 2004 annual inspection was not issued until November 2005 (PCAOB 2005k). The reports for the 2004 annual inspections of Crowe and GT were not issued until January 2006 (PCAOB 2006a and 2006b). Lynn Turner (2006), former Chief Accountant of the SEC has called for more timely transparency on the part of the Board, arguing that inspection reports issued on Big-4 accounting firms almost a year after the inspections occurred is not good enough.

Another thorny issue that the Board must resolve is a lawsuit filed on February 7, 2006 against the PCAOB and its current Board members. Filed in the U.S. District Court for the District of Columbia, the suit claims that the Sarbanes-Oxley Act of 2002 is unconstitutional because it establishes a nonpublic regulator over auditors of public companies. The civil action was brought by the Free Enterprise Fund, a lobbying group, and Beckstead and Watts LLP (see PCAOB 2005g), an accounting firm located in Las Vegas, Nevada. According to the PCAOB, it "intends to defend this action vigorously" (PCAOB 2006c).

Hodowanitz and Solieri (2005) argue that one serious "… 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" (52). Nevertheless, the Act prohibits the PCAOB from disclosing criticisms of a firm's quality controls, unless it fails to correct deficiencies within 12 months, so the Board is left to contend with this legal controversy.

While no one group of accounting firms received a clean bill-of-health, vis-à-vis, as demonstrated in this study, it is important to remember that no audit deficiencies were identified in 91 of the 167 small and regional firms inspected during 2004 and 2005. Furthermore, while deficiencies are cited for national and Big-4 firms, audits which were reviewed where no deficiencies were identified or where the deficiencies did not reach or exceed the Board's significance threshold are not cited in the inspection report; therefore, any summary judgment about the quality of public audits is difficult to make because of the nature of the inspection reporting process. In fact, the PCAOB cautions against drawing conclusions about the comparative merits of any one firm or group of firms based on the number of reported deficiencies in any given year. It states (PCAOB 2005m, Preface):

> The total number of audits reviewed is a small portion of the total audits performed by these firms,

> and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in that year. Such weaknesses may emerge in varying degrees at different firms in different years.

Another reason why a summary judgment may be problematic is that some information about a given inspection is redacted due to confidentiality requirements under Section 104 of the Act; hence, it is essential to consider these facts when evaluating the results.

Learning from our mistakes is essential, both individually, and collectively, as a profession. This paper has provided a comprehensive analysis about public audits and the Board's inspection process. Specifically, information about the accounting firms that were inspected during 2004 and 2005 was provided, and examples were presented to illustrate the types of audit deficiencies that were identified by the Board's inspection staff.

The independent audit is the cornerstone of social responsibility and public confidence for the U.S. capital market. Ironically, it was audit failures that, in part, led to the formation of the PCAOB and its inspection mandate. In summary, the PCAOB, through its inspection process, has unearthed a number of significant audit deficiencies, which suggests that accounting firms need to do a better job on their audit engagements before public confidence can be fully restored to the accounting profession and the independent auditors of publicly-traded companies.

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FOOTNOTES

[1] Inspection Report Nos. 104-2005-001 – 104-2005-173.

[2] On August 26, 2004, the Board issued its first four reports, based on its limited inspections in 2003 of the Big-4 firms (PCAOB 2004c–2004f). Sixteen audits were originally reviewed for each firm, which were subsequently extended to include 20 D&T audits, 26 E&Y audits, 22 KPMG audits, and 21 PwC audits. At least 20 companies restated their 2003 balance sheets to correct improper debt classifications.

[3] AS No. 2 was issued on March 9, 2004 and approved by the SEC on June 17, 2004. It was effective for fiscal years ending on or after November 15, 2004, but implementation of Section 404 for non-accelerated filers ($75 million or less in market capitalization) was extended to December 31, 2007. In addition, a non-accelerated filer is not required to file the auditor's attestation report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 31, 2008 (USSEC 2006)

[4] A total of 1,796 types of errors were classified into 12 categories. From highest to lowest number of restatements, they include: expense, misclassification, equity, revenue recognition, tax accounting, other comprehensive income, acquisitions and investments, capital assets, inventory, liabilities and contingencies, reserves and allowances, and other errors not covered. Historically, restatements associated with revenue recognition have been high, and although "… revenue-recognition errors remained a leading cause of restatements, other categories grew at much faster rates in 2005; nine of the 12 error categories jumped 65% or more from their 2004 levels" (Turner and Weirich 2006, 18).