12-2008

Quality Control Defects Revealed in Smaller Firms' PCAOB Inspection Reports

Dana R. Hermanson
Kennesaw State University, dhermans@kennesaw.edu

Richard W. Houston
University of Alabama - Tuscaloosa

Recommended Citation
Hermanson, Dana R., and Richard W. Houston. "Quality Control Defects Revealed in Smaller Firms' PCAOB Inspection Reports." CPA Journal 78.12 (2008): 36-39.

Quality Control Defects Revealed in Smaller Firms' PCAOB Inspection Reports

By Dana R. Hermanson and Richard W. Houston

The Sarbanes-Oxley Act of 2002 (SOX) created the Public Company Accounting Oversight Board (PCAOB) and granted it the authority to inspect registered audit firms. When conducting an inspection, PCAOB inspectors may identify two types of problems: audit deficiencies or quality control (QC) defects. Audit deficiencies (problems with the audits of individual companies) identified by the inspectors are disclosed in the inspection report, without revealing any client-specific information. Audit deficiencies disclosed in small firms' inspection reports have been analyzed by academic researchers ("PCAOB Inspections of Smaller CPA Firms: Initial Evidence from Inspection Reports," by Dana R. Hermanson, Richard W. Houston, and John C. Rice, *Accounting Horizons*, June 2007), and the AICPA has published various summaries of large and small firms' audit deficiencies (thecaq.aicpa.org/Resources/Inspections/).

QC defects relate to broader issues with the audit firm's overall processes for promoting audit quality. In the interim QC standards developed by the AICPA, quality control is described as: "a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality" (section 20.03). According to SOX section 104 (g)(2), QC defects cannot be publicly disclosed except under certain conditions:

> [N]o portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.

Until recently, no QC defects had been publicly disclosed by the PCAOB; however, enough time now has passed that some audit firms have not adequately addressed QC defects initially identified by the PCAOB inspectors in 2004 or 2005. Accordingly, some QC defects now are being disclosed on the PCAOB website (see www.pcaobus.org/Inspections/Public_Reports/index.aspx and PCAOB Release No. 104-2006-077 for details on the process of evaluating firms' responses to identified QC defects). These disclosures provide the first glimpse of the QC issues that have drawn the attention of PCAOB inspectors.

QC Defects Revealed to Date

As of June 2008, QC defects for 20 smaller registered audit firms had been disclosed on the PCAOB's website. The original release dates of the inspection reports for these 20 firms range from February 11, 2005, to May 11, 2006. It is worth noting that these QC disclosures were first made in April 2008, almost two years after the most recent report date for the firms whose defects were disclosed. This suggests that the PCAOB may be allowing firms more than 12 months to address QC defects.

Exhibit 1 presents a summary of the 56 QC defects found in these 20 firms (a mean of 2.8 defects per firm, and a median of 3), along with selected examples of each type of defect. The vast majority of the QC defects (46) relate to audit performance issues, followed by independence (6), monitoring and addressing identified weaknesses (2), partner workload (1), and review of interim financial statements (1). The descriptions of these QC defects in the inspection reports tend to be rather consistent across firms, with the exception of language related to specific audit areas (e.g., revenue, equity transactions) affected by the QC defects.

Within the audit performance category, 15 of the QC defects relate to technical competence, due care, or professional skepticism. Based on the examples presented, many of these defects relate to fundamental issues in ensuring basic audit quality. For example, the PCAOB cites problems related to assessment of fraud risks, audit report preparation, audit planning, analytical procedures, and review of journal entries.

Concurring partner review is also noted in 15 cases. The primary issues relate to nonexistent or nonsubstantive concurring partner reviews. The PCAOB is currently addressing concurring partner review and has proposed a new auditing standard to drive improvements in this area (see PCAOB Release No. 2008-002: "Proposed Auditing Standard—Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards"). Five of the 20 firms were single-partner firms with no staff at the time of the inspection. All five of these firms were cited for defects related to concurring partner review. Consequently, it appears that the PCAOB raised issues concerning concurring partner review for these firms that had to essentially "outsource" concurring partner review.

In nine cases, the PCAOB cited issues with auditor communications. There was very little variation in the language used by the PCAOB to describe this issue. The focus of this defect was that the firm's QC system might not ensure appropriate communications with the audit committee. Finally, the remaining audit performance issues relate to performing appropriate procedures (i.e., procedures related to revenue, equity, intangible assets, and other areas), ensuring that adequate documentation is prepared, and having adequate communications with the predecessor auditor.

Independence issues are noted in six of the cases. In all six cases, it appears that the audit firm may not have been independent of its client. In two cases, the audit firm was not responsive in addressing issues raised in previous peer review reports. Thus, the PCAOB tracks not only issues raised in its own inspections, but also issues raised when public company audits were inspected as part of the peer review process. In one case, the PCAOB questioned whether a partner's workload was too high to allow for quality oversight, and in another case, the firm had a QC defect related to review of interim financial information.

Overall, the most common QC defects disclosed relate to audit performance—technical competence, due care, and professional skepticism; concurring partner review; and auditor communications—and auditor independence. Additional PCAOB efforts to address these issues should be expected, perhaps through additional guidance provided to smaller audit firms.

As an aside, five of the 20 audit firms address the QC defects in their written responses to the PCAOB. One of the responding firms described how it had tried to rectify one of the QC issues raised by the PCAOB (i.e., concurring partner review), and another firm listed nine measures that, as a result of the PCAOB's findings, it had either implemented or planned to implement to address the PCAOB's concerns. The other three firms seemed to disagree with the PCAOB with respect to the QC defects.

Comparison with Other Audit Firms

Another question to consider is: Do the 20 audit firms with disclosed QC defects differ from the larger group of small audit firms with QC defects that have not been disclosed? In other words, what are the attributes of firms most likely to inadequately address a QC defect, at least based on data available to date?

To answer this question, the 20 firms with disclosed QC defects were compared to the 179 inspected small audit firms that had QC defects not disclosed by the PCAOB. The 20 will increase and the 179 will decrease as the PCAOB discloses QC defects for more audit firms after June 23, 2008, the date the data was collected. This study analyzes the first wave of disclosed QC defects (20 firms); as of early November 2008, there were 33 disclosed QC defect firms. (This analysis uses data from Hermanson et al. 2007, who analyzed PCAOB inspection reports issued to small audit firms and found that the smallest firms were more likely to have audit deficiencies.) For consistency between the two groups, the nondisclosed QC defect group was restricted to firms with inspection reports issued by May 11, 2006.

Exhibit 2 presents the comparison and reveals several significant differences. The data suggests that the two groups have very different staffing profiles. The 20 firms with disclosed QC defects are significantly smaller, a median of two partners and two staff members (six firms had no audit staff other than partners; five of these firms had one partner, and the other firm had two partners). This is in contrast to a median of four partners and 11 staff members in the 179 non-disclosed QC defect firms. This initial analysis indicates that firms that have inadequately addressed their QC defects tend to be among the smallest audit firms of those inspected.

The two groups also differ in terms of two key ratios, partners to public clients and total professionals to public clients, which provide insights into the firms' apparent ability to properly staff audits. The 20 disclosed QC defect firms have both fewer partners and fewer total professionals per public client. It is possible that this reflects an understaffing situation, in which the 20 firms are "too lean" to effectively support the number of public clients served. In particular, it is questionable whether a one-person audit firm is well positioned to audit public clients, and some might argue that there should be a minimum firm size to audit public companies.

The authors recognize that the size of the audit firm is not perfectly correlated with the staffing of any individual audit engagement. The size of a firm does, however, serve as an indication of the maximum staffing of an engagement. For example, a firm with one partner and one staff member has a maximum engagement-staffing model of one partner and one staff member. A larger firm might staff the same engagement with two partners and three staff members. In addition, given public companies' tight reporting deadlines, it is not possible to have a small engagement team spread their audit out over many months to arrive at the same overall effort level that a larger audit team can provide.

The medians for the two groups of audit firms were identical for the number of offices (1.00) and number of public clients (3.00), and did not differ significantly on the number of audit deficiencies (2.00 for disclosed QC defect firms and 1.00 for nondisclosed firms).

Remediating QC Defects

Richard Coppage and Patricia Selvy offer several tips to smaller CPA firms struggling to comply with QC standards ("Quality Control for the Small Firm," *National Public Accountant*, October 1990). Their advice is relevant to the present findings:

- *"Don't accept a job you aren't qualified to perform or which is more than you can handle efficiently and effectively."* The authors suggest alliances with other firms and accounting faculty as ways to bolster staffing, and they suggest that firms need to specialize and turn down work outside their key areas.

EXHIBIT 1
Summary and Selected Examples of QC Defects

No. of Firms	Category	Selected Examples
15	Audit Performance: Technical Competence, Due Care, and Professional Skepticism	■ Failed to obtain sufficiently detailed management representation letters that relate to all periods covered by the auditor's report. ■ Form and content of audit reports failed to correctly identify the basis of accounting, make appropriate reference to predecessor auditors, or correctly report on development-stage enterprises. In another case, the auditor's report did not include the opinion paragraph. ■ Did not employ sufficient procedures to review the audited financial statements and footnotes for errors and omissions prior to their issuance. ■ Failed to ensure that adequate audit planning was performed and documented, to ensure that adequate disclosures were made in the notes to the financial statements, and to conduct proper audit sampling. ■ Failed to perform the appropriate procedures related to the agreement of the financial statements to audited amounts. Failed to perform and document audit procedures required by AU Section 316, *Consideration of Fraud in a Financial Statement Audit*. ■ Did not perform analytical procedures in planning the audit and in the overall review of the audited financial statements. ■ Failures to test journal entries for evidence of possible material misstatement due to fraud, as required by AU 316, *Consideration of Fraud in a Financial Statement Audit*, and to perform all required quarterly review procedures in accordance with AU 722, *Interim Financial Information*. ■ Appropriate procedures related to the identification of fraud risks were not performed and documented in the work papers, and the Firm failed to determine whether the issuer's disclosures were adequate.
15	Audit Performance: Concurring Partner Review	■ There is no evidence that the concurring partner review procedure resulted in the identification of any of the deficiencies noted by the inspection team. ■ The firm used the services of an accountant not affiliated with the firm to perform the concurring partner review of the four issuer audits included in the inspection. ■ Did not obtain concurring partner reviews in the engagements reviewed by the inspection team. ■ A meaningful concurring partner review procedure would likely have identified the deficiencies described in this report before the firm issued the reports.
9	Audit Performance: Auditor Communications	■ The firm's system of quality control does not provide sufficient assurance that the firm would make or document all required auditor communications with audit committees, including making required independence confirmations and formally documenting communications with audit committees.
4	Audit Performance: Appropriate Procedures	■ An apparent pattern of failures to perform the appropriate procedures related to: ■ Testing of revenue and equity transactions. ■ Testing of classification of debt, revenue recognition, the recognition of beneficial conversion features, and the valuation of intangible assets from related parties. ■ The areas of property, plant, and equipment; intangible assets; accounts payable; notes payable; and accrued expenses. ■ Testing of stock-based transactions.
2	Audit Performance: Documentation	■ The frequency and nature of documentation deficiencies reported by the inspection team suggest that the firm did not obtain sufficient competent evidential matter to support its opinion on the financial statements.
1	Audit Performance: Communications with Predecessor and Client Acceptance	■ The predecessor auditor was not responsive to the firm's inquiries and communications. The firm noted several items during its first-year audit that required adjustment, but it was unclear as to whether the amounts related to the current year or to prior years. The firm did not communicate with the predecessor auditor with respect to potential restatements of prior period amounts and simply recorded the adjustments.
6	Independence	■ The firm may not have been independent of a public client within the SEC's independence requirements.
2	Monitoring and Addressing Identified Weaknesses	■ The firm has not responded meaningfully to related weaknesses that were identified in previous peer review reports.
1	Partner Workload	■ An audit partner has a significant number of public clients. The inspector has concerns that the significant number of clients assigned to this audit partner may affect the partner's ability to adequately supervise and review audit engagements.
1	Review of Interim Financial Statements	■ The firm's policies and procedures do not ensure that all required audit procedures with respect to reviews of quarterly financial information will be performed.
56	Total Number of QC Defects	

Note: The wording above is adapted from PCAOB inspection reports.

Stretching too far to serve public clients can lead to trouble, and the present analysis is consistent with this view.

- *"Stay up-to-date."* The authors suggest engaging in CPE beyond the regulatory minimum levels. Technical proficiency is at the heart of audit quality.
- *"Don't undercharge for services."* The authors assert that low fees can lead to cutting corners. Auditors must think about audit quality first and foremost.
- *"Use checklists."* This can help ensure that no obvious steps have been missed.
- *"Assure adequate review of your work."* The authors suggest that small audit firms work together to review each other's work. Considering the results above with respect to concurring partner review, it appears that many firms could benefit from establishing formal mechanisms to review each other's work, including at the partner level. Firms should explore any liability issues created by such arrangements.

A response letter from one of the firms cited for failing to adequately address QC defects to the PCAOB outlined nine steps that the firm planned to use in its effort to address its QC defects. The elements include top firm management commitment to QC, in-house inspection of audit engagements, employee training in QC, new employee orientation in QC, supplemental outside testing of QC, enhanced reporting to clients' audit committees, a strong focus on technical competence in the hiring process, and a focus on employee communication skills. The authors believe that each of these elements can be quite valuable in supporting effective QC.

While 20 firms have been cited for failing to rectify QC defects, 179 firms with QC defects inspected during this same period have successfully remediated their problems. This suggests that many firms have found ways to address the QC defects cited by the PCAOB. It appears that the PCAOB inspection process can assist firms in improving QC by providing comparative guidance. For example, did firms that rectified QC defects in the area of audit performance implement specific training or QC procedures that other firms would find useful? Are there examples of firms with effective concurring partner review practices, especially for the smallest firms? It may be possible for smaller firms that audit public clients to create a network to assist them in conducting effective training to overcome audit performance issues and perhaps help to identify individuals who could serve as effective concurring review partners (see Coppage and Selvy 1990). Overall, the authors urge the PCAOB to play an active role in identifying what it sees as "best practices" in the area of QC issues. Such disclosures would help firms avoid and rectify QC defects that ultimately could affect audit quality.

Inspections Can Lead to Improvement

The PCAOB's recent disclosure of 56 QC defects in 20 smaller audit firms provides the first insights into QC issues of concern to the PCAOB inspectors. The first lesson from this disclosure is that audit performance issues (in particular technical competence, due care, and professional skepticism; concurring partner review; and auditor communications) and independence issues are the PCAOB's leading QC concerns. The authors expect additional PCAOB efforts in these areas, perhaps additional guidance provided to assist smaller audit firms in complying with auditing standards. The authors encourage smaller audit firm personnel to carefully consider the issues highlighted in the disclosed QC defects. These reports are publicly available on the PCAOB's website, and interested readers can easily identify and find the inspection reports with the disclosed QC defects.

The second message is that the smallest, apparently understaffed, audit firms appear more likely to struggle to adequately address QC defects. This finding is consistent with earlier research on audit deficiencies. The authors' previous research has indicated that, within the small-firm segment of the audit market, the smallest, leanest firms are particularly susceptible to having audit deficiencies as well as difficulty responding to QC defects. To ensure quality audits of public companies, such firms need to carefully focus on bolstering their QC systems to promote audit quality, and they may need to add staff to help to handle the workload. ❑

Dana R. Hermanson, PhD, *is the Dinos Eminent Scholar Chair of Private Enterprise Professor in the school of accountancy at Kennesaw State University, Kennesaw, Ga.* ***Richard W. Houston, PhD,*** *is a professor of accounting at the Culverhouse School of Accountancy, University of Alabama, Tuscaloosa, Ala.*

EXHIBIT 2
Differences Between Disclosed QC Defect Firms and Non-Disclosed Firms

	Disclosed QC Defect Firms (20) Median	Non-Disclosed QC Defect Firms (179)* Median
Partners	2.00	4.00
Staff	2.00	11.00
Total professionals	5.00	15.00
Partners/Public Clients	0.45	1.50
Total Professionals/Public Clients	0.96	5.00

Note: All differences are statistically significant using the Mann-Whitney test.

* Firms with QC defects that were not disclosed as of June 23, 2008. Only non-disclosed QC defect firms that had their inspection reports issued by May 11, 2006, are included, as this time period corresponds with the timing of the original reports for the 20 firms with disclosed QC defects.

The medians were reported rather than the means because the presence of several extreme values causes the mean to be misleading. Statistical results are virtually the same if appropriate tests are conducted to compare means across disclosed QC defect and nondisclosed QC defect firms.