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Accounting Restatements Arising from PCAOB Inspections of Small Audit Firms

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

Richard W. Houston
University of Alabama - Tuscaloosa

Zhongxia Shelly Ye
Kennesaw State University, zye@kennesaw.edu

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By Dana R. Hermanson, Richard W. Houston, and Zhongxia (Shelly) Ye

Inspections by the Public Company Accounting Oversight Board (PCAOB) of small audit firms (i.e., those with 100 or fewer issuer clients) often reveal audit deficiencies or quality control defects, both of which have been studied previously (see Dana R. Hermanson, Richard W. Houston, and John C. Rice, "PCAOB Inspections of Smaller CPA Firms," *Accounting Horizons*, June 2007; Dana R. Hermanson and Richard W. Houston, "Quality Control Defects Revealed in Smaller Firms' PCAOB Inspection Reports," *The CPA Journal*, December 2008; and Dana R. Hermanson and Richard W. Houston, "Evidence from the PCAOB's Second Inspections of Small Firms," *The CPA Journal*, February 2009; PCAOB Release 2007-010, October 2007). In addition to identifying audit deficiencies or quality control defects related to the inspected audit firm, PCAOB inspections also may identify material misstatements in the financial statements. If so, a client of an inspected firm may end up restating its financial statements as a result of issues uncovered in the PCAOB inspection.

An examination of the types of accounting restatements triggered by PCAOB small firm inspections can highlight important issues for small audit firms and their issuer clients to consider. The results should reveal areas for improvement for issuers and their audit firms.

The PCAOB Inspection Process and Client Misstatements

According to PCAOB Release 104-2004-001 (pcaobus.org/Inspections/Documents/Statement_Concerning_Inspection_Reports.pdf), the process for handling misstatements discovered in the course of a PCAOB inspection is as follows (pp. 7–8):

> When, in the course of reviewing a firm's performance on selected audits, the Board [PCAOB] identifies possible departures from GAAP in an issuer's financial statements, the Board will encourage the firm to consider the issue and to review it with the audit client. If it appears to the Board that the departure is material to the issuer's financial statements, the Board generally will not identify the issuer in an inspection report but will report the information to the Commission [SEC]. The Commission has authority to prescribe the form and content of an issuer's financial statements, has direct authority with respect to issuers, and has long-established processes for addressing issuers' accounting practices.
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> Nevertheless, through discussions with a firm or through reporting to the Commission, the Board's inspection work may sometimes start a process that results in an issuer restating its financial statements. Indeed, the Board is aware that some issuers have publicly described recent restatements as related to issues raised by the Board while reviewing the issuers' audits as part of the 2003 inspection process. Additional restatements may emerge in the same way from the Board's work. It is plainly in the public interest that errors caught by Board inspections be corrected, where appropriate, through restatements, and the Board will take all appropriate steps to bring those errors to the attention of persons responsible for seeing that they are addressed. While Board inspection reports may indicate that issues raised by the Board led one or more issuers to restate, the inspection reports will not identify the issuers or describe the restatements in detail.

Sample Companies and Data Collection

The authors analyzed all of the PCAOB small firm inspection reports issued from the inception of the inspection process in 2004 through September 2009 in order to identify cases in which the inspection report made reference to a restatement or adjustments to recorded amounts or disclosures. Such references are typically made immediately after the discussion of audit deficiencies. For example, the inspection report may state: "One of the deficiencies described above related to auditing an aspect of an issuer's financial statements that the issuer revised in a restatement subsequent to the primary inspection procedures."

The authors identified 51 small firm inspection reports (out of the close to 1,000 small firm inspections and thousands of issuer client audits) that made reference to client restatements or adjustments to recorded amounts or disclosures. The vast majority were restatements, rather than adjustments to recorded amounts or disclosures, so for the sake of simplicity, the term "restatement" will be used to refer to restatements or other corrections of previously recorded amounts or disclosures. For each of these 51 reports, the authors then 1) gathered all available information about the restatement from the inspection report and the auditor's response to the inspection report, and 2) searched the restatements dataset of Audit Analytics to attempt to gather additional information. While the inspection report does not name the restating clients, many small audit firms have so few issuer clients that it is possible to be confident that the correct restatement has been identified.

This search process involved professional judgment, and there are limitations of the data used (e.g., some very small clients may not be included). Ultimately, the authors' searches yielded additional information beyond the PCAOB inspection report in 30 cases (see *Exhibit 1*). In 10 other cases, the authors could not find any client restatements in the relevant period for that audit firm in Audit Analytics, and in nine other cases the authors could not determine which client restatement in the relevant period was the one triggered by the PCAOB inspection. Finally, in two cases, a client restatement was referenced in a PCAOB inspection report but there was evidence that the PCAOB inspection did not actually trigger the restatement.

Nature of PCAOB-Triggered Restatements

Based on combined information from PCAOB inspection reports, audit firm response letters, and available SEC filings found using Audit Analytics, the authors used their judgment to identify the accounting issues involved in as many of the restatements as possible. *Exhibit 2* presents the issues underlying the PCAOB-triggered restatements for 43 clients of 39 small audit firms where the authors were able to find reliable information. Some audit firms had more than one client restatement, and one client restated for multiple reasons identified by the PCAOB.

The most common issue related to mergers, acquisitions, consolidations, and the equity method of accounting

EXHIBIT 1
Analysis of 51 Small Firm Inspection Reports Citing Client Restatements

Result of Authors' Searches of Audit Analytics	Number
Apparent SEC filing describing the client's accounting restatement	30
No restatements involving the audit firm's clients during the period	10
Audit firm clients with restatements during the period, but unable to determine which one was triggered by PCAOB inspection	9
Client inspection occurred or was in process before PCAOB inspection began	2
Total	51

EXHIBIT 2
Accounting Issues Present in Accounting Restatements
Arising from PCAOB Inspections of 39 Small Audit Firms

Accounting Area or Issue	Number
Merger, acquisition, consolidation, equity method	10
Equity transactions: issuance of stock for services or to satisfy payables, stock repurchase/put rights, earnings per share (misstated due to reverse stock split), stock compensation, stock options	9
Convertible debt	7
Going concern	3
Classification on the statement of cash flows	3
Amortization of intangible assets	2
Classification of investment in marketable securities, fair value of investment in securities	2
Disclosures: software development costs, debt maturities	2
Pension liability, self-insurance reserve	2
Asset retirement obligations	1
Deferred tax asset	1
Derivatives	1
Classification on the income statement	1
Revenue	1
Total	45

Note: This information is based on PCAOB inspection reports and—where possible—issuers' SEC filings describing the relevant restatements or adjustments to recorded amounts or disclosures. The information reflects 43 issuers audited by 39 small audit firms. Some audit firms had more than one client restate, and one client restated for multiple reasons identified by the PCAOB.

(10 cases). It appeared that the client and auditor may have lacked the technical expertise to appropriately handle complex issues in these areas. The next two most common restatement areas also reflected highly technical accounting issues: equity transactions (nine cases) and convertible debt (seven cases). Within equity transactions, the restatements related to the issuance of stock for services or to satisfy payables, stock repurchase/put rights, earnings per share (misstated because of reverse stock split), stock compensation, and stock options. The prevalence of equity transactions is consistent with the complex stock-related compensation and other financial activities that took place during the sample period.

Going-concern disclosures and classification issues on the statement of cash flows accounted for three restatements each. Amortization of intangible assets, classification of investment in marketable securities and fair value of investment in securities, disclosures related to software development costs and debt maturities, and pension liability or self-insurance reserves each accounted for two restatements. Five other areas, including revenue, accounted for one restatement each.

Overall, the top three areas (mergers, equity transactions, and convertible debt) accounted for 26 of the 45 (58%) accounting areas in PCAOB-triggered restatements. It appears to the authors that a lack of technical expertise required to address complex accounting areas is the primary factor underlying PCAOB-triggered restatements. This clearly has implications for issuers and their auditors and highlights the need for technical accounting expertise on the part of issuer management and auditors.

It is interesting to note that the most common accounting issues in PCAOB-triggered restatements are largely different from those typically seen in audit deficiencies cited in PCAOB small firm inspection reports and in accounting fraud cases brought by the SEC. For example, *Exhibit 3* presents results from a previous study (Hermanson, Houston, and Rice 2007) that summarize the most common financial statement areas associated with audit deficiencies in small audit firms. Revenue and receivables top the list, with equity transactions third. Similarly, other research (Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson, "Fraudulent Financial Reporting: 1987–1997," COSO 1999; www.coso.org/publications/ffr_1987_1997.pdf) found that accounting fraud cases brought by the SEC were most commonly related to revenues, receivables, and inventory. Thus, audit deficiencies and accounting fraud cases tend to be dominated by revenue and accounts receivable issues, while PCAOB-triggered restatements tend to be related to more unique, complex accounting areas.

EXHIBIT 3
Specific Financial Statement Accounts Emphasized in Small Firm Audit Deficiency Descriptions

Accounting Issue Emphasized in PCAOB Comment	Number
Revenue	79
Accounts, loans, and notes receivable	66
Equity-related and issuer stock	46
Liabilities	45
Expenses	44
Investments and securities	31
Inventory	27
Business combinations, acquisitions, and goodwill	25
Property, plant, and equipment/asset	20
Intangible assets other than goodwill	17
Deferred income taxes/tax liability	13
Leases	6
Other	16
Total	435

Source: Dana R. Hermanson, Richard W. Houston, and John C. Rice, "PCAOB Inspections of Smaller CPA Firms: Initial Evidence from Inspection Reports," *Accounting Horizons*, June 2007 (Table 7, Panel B).

Focus on Complex Issues

The authors' analysis of PCAOB-triggered restatements by clients of small audit firms reveals that complex, technical accounting areas account for the majority of restatements. This is in contrast to both small firm audit deficiencies and accounting fraud cases, which tend to be dominated by revenue and receivable issues.

The authors encourage issuers and small audit firms to pay particular attention to unique, complex accounting issues. For small audit firms, such issues can present much more of a challenge than they might for large audit firms with national office experts available to offer guidance. It is important for small audit firms to build technical expertise through training, in-house research, and possibly participation in audit firm networks. For small issuers, it may be helpful to hire a CFO or controller who is particularly strong on technical accounting issues. ❑

Dana R. Hermanson, PhD, *is the Dinos Eminent Scholar Chair of Private Enterprise and professor in the school of accountancy at Kennesaw State University, Kennesaw, Ga.* ***Richard W. Houston, PhD,*** *is a professor in the Culverhouse School of Accountancy at the University of Alabama, Tuscaloosa, Ala.* ***Zhongxia (Shelly) Ye, PhD,*** *is an assistant professor, also at Kennesaw State University.*