2-2009

Evidence from the PCAOB's Second Inspections of Small Firms

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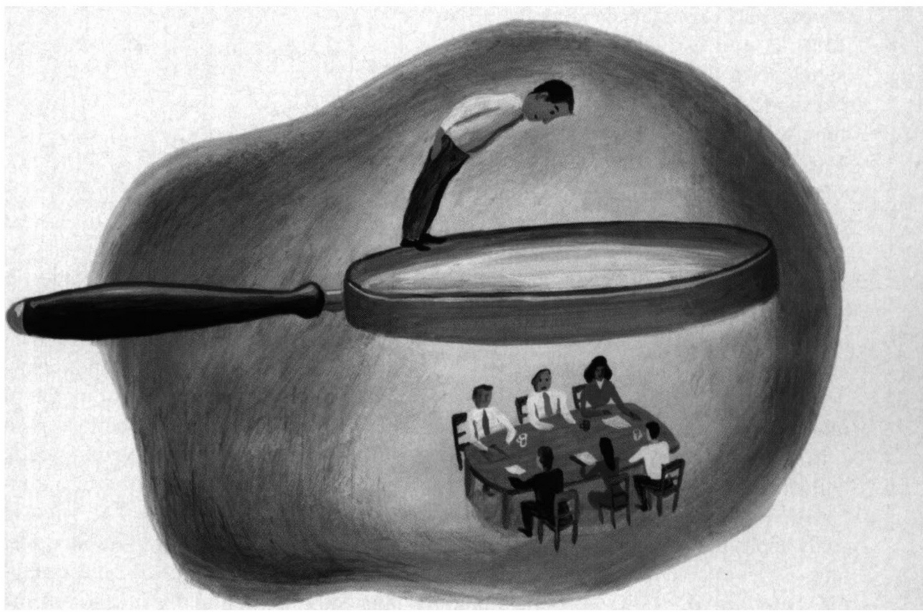
Driving Improvements in Auditing and Quality Control

By Dana R. Hermanson and Richard W. Houston

The Sarbanes-Oxley Act of 2002 (SOX) section 104, "Inspections of Registered Public Accounting Firms," and the PCAOB's "Rules of the Board" [section 4, Rule 4003(b)] require that smaller auditing firms (those that audit fewer than 100 issuers annually) under the PCAOB's oversight be inspected at least once every three years. The small firm inspections began in 2004, and the first round of inspections revealed a large number of audit deficiencies (problems with individual audits) and quality control defects (broader issues related to firms' quality control practices and procedures). For example, the authors' prior research ("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) found that, of the first 316 smaller audit firms inspected, 60% had audit deficiencies and 72% had quality control defects. The authors provide a detailed analysis of the types of audit deficiencies found by the PCAOB.

As of early November 2008 (which includes all inspection reports dated through October 23, 2008), the PCAOB had issued 116 inspection reports regarding smaller firms' second inspections. The authors examined these second inspections to determine whether smaller audit firms have made improvements in their processes as a result of the PCAOB inspection process. If so, then this would be consistent with the goal of the inspection process: driving improvements in audit processes and firms' quality control systems.

The results indicate that the inspection results are much more favorable the second time a smaller firm is inspected. This result appears to be attributable to smaller audit firms learning from their first inspections and improving their audit processes, rather than to any softening of the PCAOB's posture. In addition, the 116 firms were able to remediate the bulk of their previous audit deficiencies and quality control defects without altering the basic structure of the firm or its practice (size, staffing, number of issuer clients, and so on).



Firms Inspected Twice

Exhibit 1 presents a comparison of the results of the first and second inspections for the 116 smaller audit firms that have been inspected twice (through October 23, 2008). In their first inspections, 60% of these firms had audit deficiencies, while only four firms (3%) had any audit deficiencies in the second inspections. Consequently, the second inspections reveal virtually no audit deficiencies, suggesting a dramatic improvement in audit quality. The results for quality control defects are similarly striking—the percentage of firms with quality control defects dropped from 72% in the first inspections to 28% in the second inspections. Based on Exhibit 1, it appears that the 116 smaller firms inspected twice have made meaningful improvements in their audit and quality control processes.

Firms Not Yet Inspected Twice

The second inspection reports began to be issued by the PCAOB on September 24, 2007. While the authors assert above that the results in Exhibit 1 are consistent with significant improvements implemented by the firms inspected twice, a possible alternative explanation for the results is that the PCAOB inspectors simply became less rigorous in their inspections, such that all inspection results have recently improved. That is, one can see in Exhibit 1 that the second inspection reports issued from September 24, 2007, to October 23, 2008, are quite clean, but has the PCAOB issued more clean first reports in the past year than they had issued before September 24, 2007, simply because the PCAOB inspectors have "lightened up"?

To address this issue, *Exhibit 2* analyzes the inspection results for the 474 audit firms not yet inspected twice—split between first reports issued prior to September 24, 2007 (347 firms) and first reports issued on or after September 24, 2007 (127 firms). The results indicate no significant differences in the percentage of firms with audit deficiencies or quality control defects between the two periods. In both periods, approximately 50% of the firms had audit deficiencies, and over 70% had quality control defects. Based on the results presented in Exhibit 2, it does not appear that the PCAOB has lightened up or changed the rigor of its inspections of smaller firms. In fact, there is some evidence that the PCAOB has cited a slightly greater percentage of firms for quality control defects in the more recent time period. (As an aside, approximately 48% of the inspection reports issued on or after September 24, 2007, are for firms inspected twice, suggesting that the PCAOB has been splitting its inspection efforts, with respect to smaller firms, fairly evenly between first and second inspections.)

The authors also tested to see if the 116 firms inspected twice differ in any systematic way from the 347 firms not yet inspected twice in the same period (prior to September 24, 2007). There are no significant differences in the two groups in terms of audit deficiencies or quality control defects in the first inspection reports. In addition, there are no significant differences in firm size, staffing, number of issuer clients, or other measures. Thus, the 116 firms inspected twice are not unique in any fundamental way, other than having been inspected twice. Consequently, it does not appear that the PCAOB is selecting firms for second inspections based on any firm-specific factors (i.e., the selection of a firm for a second inspection does not appear to be risk-based).

Possible Structural Changes in Firms Inspected Twice

Based on the results in Exhibits 1 and 2, the authors conclude that the 116 firms inspected twice have made meaningful

EXHIBIT 1
Results of Inspections: Firms Inspected Twice

For the 116 firms inspected twice, does the incidence of audit deficiencies and quality control defects differ between first and second inspections?

Audit Deficiencies?	First Inspection Report	Second Inspection Report
Yes	70 (60%)	4 (3%)
No	46 (40%)	112 (97%)

The incidence of audit deficiencies is significantly lower for the second inspection reports (Chi-square statistic = 86.4, $p < 0.01$).

Quality Control Defects?	First Inspection Report	Second Inspection Report
Yes	84 (72%)	33 (28%)
No	32 (28%)	83 (72%)

The incidence of quality control defects is significantly lower for the second inspection reports (Chi-square statistic = 44.9, $p < 0.01$).

EXHIBIT 2
Results of Inspections: Firms Not Yet Inspected Twice

For the 474 firms not yet inspected twice, does the incidence of audit deficiencies and quality control defects differ based on whether the inspection report was released before or after 9/24/07 (the first date on which a second inspection report was released)?

Audit Deficiencies?	Report Date Pre-9/24/07	Report Date on or after 9/24/07
Yes	183 (53%)	63 (50%)
No	164 (47%)	64 (50%)

The incidence of audit deficiencies does not differ across report release dates (Chi-square statistic = 0.37, $p = 0.55$).

Quality Control Defects?	Report Date Pre-9/24/07	Report Date on or after 9/24/07
Yes	247 (71%)	100 (79%)
No	100 (29%)	27 (21%)

The incidence of quality control defects does not differ across report release dates (Chi-square statistic = 2.71, $p = 0.10$).

* This includes firms not yet inspected twice whose inspection reports were released prior to 9/24/07 (the first date on which a second inspection report was released). The authors used this date so that the time period corresponds with the timing of the original (first) reports for the 116 firms inspected twice.

Conclusion: Firms are significantly less likely to be cited for audit deficiencies and quality control defects in their second inspection report (Exhibit 1). At the same time, the incidence of audit deficiencies does not differ over time for firms not yet inspected for a second time (above), while the incidence of quality control defects for firms not yet inspected a second time may be slightly higher in the latter time period. In other words, firms inspected for a second time show significant improvement, while the results of first-time PCAOB inspections of smaller firms are generally stable across time (i.e., overall, the PCAOB inspectors are not easing up; if anything, they are getting slightly tougher with respect to quality control defects).

improvements in their auditing processes and quality control systems. In light of these improvements, the final question to be answered is: Has the basic profile of the firms inspected twice changed in any way (e.g., size, staffing, number of issuer clients) between the first and second inspections? The results in *Exhibit 3* indicate that the firm profiles are virtually identical at the time of the first and second inspections. Therefore, the authors conclude that the 116 firms were able to remediate the bulk of their audit deficiencies and quality control defects, without altering either the basic structure of the firms or the extent to which they provide audit services to issuer clients.

Informal Learning and PCAOB Guidance

The analysis above provides evidence of improvements in auditing and quality control processes during the second round of PCAOB small firm inspections. It is interesting to note that the apparent improvements were achieved before the PCAOB offered any formal guidance or observations from its first three years of small firm inspections. On October 22, 2007, the PCAOB released its "Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms" (www.pcaobus.org/inspections/other/2007/10-22_4010_report.pdf) to highlight "areas of the audit where PCAOB inspectors have observed significant or frequent deficiencies in the first PCAOB inspections of triennial firms. The descriptions … included in [the] report … alert triennial firms to areas where they could improve performance and … inform the public about certain inspection findings for triennial firms over the past three years." This report was released subsequent to the commencement of most, if not all, of the second inspections. Consequently, it appears that the improvements were accomplished without specific PCAOB guidance and are attributable to inspected firms informally learning from the results of their first inspections and implementing actions to improve audit quality.

In September 2008, the PCAOB released its 2007 Annual Report (www.pcaobus.org/About_the_PCAOB/Annual_Reports/2007.pdf), which also provides insights into the inspection process. Firms that are anticipating PCAOB inspections should examine all PCAOB guidance for such insights that can assist in conducting quality audits and designing effective quality control systems.

EXHIBIT 3
Attributes of Firms at the Time of the First and Second Inspections

Do the attributes of firms inspected twice differ between the times that the first and second inspections were conducted?

Median Firm Attributes	First Inspection	Second Inspection
Number of Offices	1.00	1.00
Number of Partners	5.00	6.00
Number of Staff	16.00	18.00
Total Professionals	20.50	24.00
Number of Issuer Clients	3.00	3.00
Partners/Total Professionals	0.25	0.23
Partners/Issuer Clients	2.00	1.85
Total Professionals/Issuer Clients	7.00	8.75

None of the firms' attributes differ based on the Mann-Whitney test. Medians (i.e., the middle value in the sample) are used rather than means (i.e., the average) because the presence of several extreme values makes the mean potentially misleading. Statistical results are virtually the same if the authors conduct appropriate tests to compare means across the first and second inspections.

Conclusion: The firms that were inspected twice did not change significantly between the first and second inspections on a number of characteristics, including size, composition of personnel, and number of issuer clients.

Continuous Improvement

In a 2005 speech before the Colorado Society of CPAs SEC Conference, PCAOB member Daniel L. Goelzer described the goal of the inspection process as follows:

> The engagement inspections are the key to the Board's impact on auditing. The knowledge that, in the case of any particular audit, PCAOB inspectors who are themselves experienced auditors but who are not "peers" may review the work-papers and form their own judgment on how well the audit was conducted has had a very significant effect on how auditors do their work. While there is a place for enforcement proceedings and a place for liability to private parties who are injured by bad auditing, in my view a well-thought-out inspection is more likely to improve the day-to-day quality of auditing than are those other, blunter tools.

The results of the analyses presented in this article are consistent with improvements in auditing and quality control among smaller audit firms that have been inspected twice. If these results continue in the future, then the PCAOB should be well on its way to achieving its goal of improving the quality of auditing. ❑

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