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EXAMINATION OF THE DETERMINANTS OF WHETHER REGISTERED
AUDITING FIRMS CORRECT THEIR QUALITY CONTROL SYSTEM
DEFECTS IDENTIFIED IN PCAOB INSPECTION REPORTS

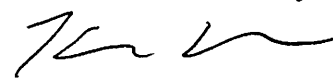
By Robin Jackson

A thesis submitted to the faculty of the University of Mississippi in the partial
fulfillment of the requirements of the Sally McDonnell Barksdale Honors College

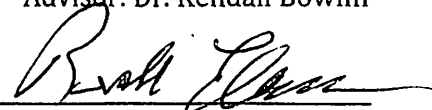
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ABSTRACT

The Public Company Accounting Oversight Board (PCAOB) is charged with inspecting both individual public company audits as well as audit firm quality control systems. PCAOB inspection reports include information on deficiencies in individual audits as well as quality control system defects. However, portions of the inspection reports describing any quality control system defects are not made public unless the firm does not correct those deficiencies within one year. I classify each firm as Type 1, Type 2 or Type 3. Type 1 firms are those whose quality control system defects were uncorrected and therefore disclosed after the allotted year. Type 2 firms are those that had control system defects and corrected those defects within the year. Type 3 firms never had quality control system defects. As the quality control system defects for Type 2 firms are not made public, subtle wording differences in Part B of PCAOB inspection reports allow a reader to distinguish between Type 2 and Type 3 firms as inspection reports for Type 3 firms explicitly state that the inspection team identified no quality control system defects. This study explores the characteristics of audit firms that have quality control system defects and the determinants of whether those firms resolve their quality control system defects within the allotted year. I examine these questions based on data hand-collected from publicly available PCAOB inspection reports. I find that variables indicative of firm size, particularly number of partners, may be positively

associated with the tendency to correct quality control system defects in a timely manner. Also, I find that firms with more issuer clients scaled by proxies for firm size are less likely to correct their quality control system defects. Similarly, I find that firms with only one partner may be less likely to correct their quality control system defects. Finally, my results show that firms who provide written responses to PCAOB inspection reports are more likely to fix their quality control system defects in the allotted year. These findings are important because there has been little research on the inspection reports of triennially-inspected firms (audit firms with 100 or fewer issuer clients), particularly on the quality control system defects. Because PCAOB inspection reports are more opaque than the Peer Review reports they replaced, it is important for users to be aware of potential relationships between firm characteristics and whether or not that firm corrects its quality control system defects. Further, it is important that the PCAOB understand when its inspections are likely to prompt improvements in quality.

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I. INTRODUCTION

The Public Company Accounting Oversight Board (PCAOB) is charged with inspecting both individual public company audits as well as audit firm quality controls systems. PCAOB inspection reports include information on deficiencies in individual audits as well as quality control system defects. However, portions of the inspection reports describing any quality control system defects are not made public unless the firm does not resolve those deficiencies within one year. This study explores the characteristics of audit firms that have quality control system defects and the determinants of whether those firms resolve their quality control system defects within the allotted year. I determine the existence of quality control system defects according to subtle wording differences in PCAOB inspection reports. Part B of the inspection reports for firms who never had quality control system defects explicitly states that the inspection team found no quality control system defects. Part B in the inspection reports for firms that had quality control system defects and corrected them within the year state that any quality control system defects will be disclosed a year from the inspection date if they remain uncorrected. The quality control system defects are disclosed in Part B of the inspection reports for firms who failed to correct their quality control system defects in the allotted year. I examine these questions based on data hand-collected from publicly available Public Company Accounting Oversight Board (PCAOB) inspection reports.

Prior research has explored various aspects of the PCAOB's inspection regime. Some recent studies examine the economic effects of PCAOB inspections. For example, Lennox and Pittman (2010) explore the usefulness of inspection reports to audit market participants as well as the impact of the PCAOB inspection reports on the usefulness of reports produced under the extant peer review system. Other studies consider the attitude of various constituencies of the inspection regime towards the quality of the inspection process. For example, Daugherty and Tervo (2010), survey the leadership of inspected firms regarding their perceptions of PCAOB inspection team performance and the inspection process.

Further research explores the actual contents of inspection reports. Hermanson et al. (2007) find that among triennially inspected firms¹, inspection reports are more likely to report auditing deficiencies for firms that are smaller and have larger numbers of issuer clients. I add to the literature on the contents of inspection reports of these triennially inspected firms by examining the relationship between firm demographics and the likelihood that they will resolve quality control system defects in a timely manner. Thus far, little research has focused on quality control system defects included in the inspection reports. This is likely true because the PCAOB was created in 2002 and firms with quality control system defects are given a year to resolve those deficiencies before information about them is disclosed publicly. Therefore, because many firms resolve their quality control system defects within the time allowed, there has until recently been little data available about

¹ Auditing firms with fewer than 100 issuer clients are inspected triennially, while firms with 100 or more issuer clients are inspected annually.

those deficiencies. However, over the last several years, the PCAOB has made public the quality control system defects section of a number of firms' inspections reports, making it possible to explore factors that affect the likelihood that a firm will remedy those deficiencies.

I examine PCAOB inspection reports for a sample of 188 firms, 94 of which corrected their quality control system defects and 94 that did not correct their deficiencies within the allotted year. I hand collect data from each inspection report including firm characteristics, audit deficiencies, and quality control system defects. I then analyze this data to determine whether any firm characteristics may be determinants of a firm's tendency to fix its quality control system defects.

My findings indicate that larger firms in terms of number of offices, number of partners, and number of professional staff may be more likely to correct quality control system defects. I also find that firms who have more issuer clients scaled by firm size, and therefore may face a higher resource strain, are less likely to correct their quality control system defects. Similarly, my findings show some evidence that firms with only one partner are also less likely to correct their quality control system defects. Finally, my results also indicate that firms who provide written responses to PCAOB inspection reports may be more likely to correct their quality control system defects within the allotted year.

In addition, I find that firms that fail to correct their quality control system defects in a timely manner have a greater total number of audit deficiencies than those firms that do correct their deficiencies. I also classify each of the disclosed

quality control system defects according to the taxonomy of the Generally Accepted Auditing Standards plus one additional category for system wide deficiencies.

II. CREATION OF THE PCAOB

Until the Sarbanes-Oxley Act was enacted, the accounting profession was self-regulated, relying primarily on private organizations including the Peer Review Program for supervision and guidance. While the Securities and Exchange Commission (SEC) had statutory authority to regulate financial reporting and financial statement auditing, both the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) played key roles in determining the authoritative criteria to be followed in the accounting profession. The FASB is a private-sector organization responsible for establishing standards of financial accounting that governs financial reporting for nongovernmental entities. These standards are recognized as authoritative by the SEC. The AICPA is a national professional organization that develops standards for services provided by CPAs. According to Kinney (2005), Congress and the SEC merely provided oversight for private regulation in the profession and applied the “fire alarm” approach regarding reporting regulation. According to the “fire alarm” approach, a regulator does not take action until constituents- in this case the users of financial statements-express complaints. The regulatory changes that occurred over the next twenty years were primarily “fire alarm” responses to changing economic and legal conditions, criticisms of the Peer Review Program, and several highly publicized audit failures. These responses emphasized increased self-regulation until the passage of the

Sarbanes-Oxley Act of 2002 and with it, the creation of the Public Company Accounting Oversight Board (PCAOB).

Three factors remained constant in the twenty-five years leading to the creation of the PCAOB and therefore re-regulation of the accounting profession. First, user perceptions of relevance, due professional care, and trustworthiness remained the core determinants of value of audited financial statements. Next, there was a consistent expectations gap with users of financial statements. It is often difficult for financial statement users to separate a business failure from an audit failure, particularly during an economic downturn. Finally, the organization of audit firms was constant. Virtually all large audit firms organized as limited liability partnerships, and as such, auditors assume greater personal responsibility although they are generally viewed as performing a “public service”. These factors combined with several events in the two decades preceding 2002 led Congress to re-regulate the accounting profession.

Throughout the 1980's, the accounting profession experienced an increase in competition as the ban on advertising, solicitation, and competitive bidding was lifted. An expansion of services into the consulting function also increased audit firm size. This increased firm size coupled with the increased price competition negatively affected audit quality. The 1990's brought about a combination of conditions that led to a substantial increase in stock based compensation. As such, the pressure for management to manipulate stock prices by pennies in order to meet performance goals increased. At the time, these differences were allowed

because they were deemed “immaterial” but they led to the adoption of SAS No. 89 and and SAB No. 99, which increased self-regulation by improving the effectiveness of audit committees. Despite these efforts, there was still a call for increased regulation in the profession that would eventually be answered by the creation of the PCAOB (Kinney 2005).

Another factor leading to the passage of the Sarbanes-Oxley Act was investor concern over large corporations (or clients) manipulating revenues and possible corresponding audit failures. The most highly publicized case of this is the Enron audit failure. In October of 2001, Enron announced that it suffered over a \$600 million third quarter net loss and was reducing shareholder equity by \$1.2 billion. The following day, the SEC opened an investigation and requested information from Enron’s management. Shortly after, the engagement team from Enron’s auditor, Arthur Andersen, began destroying Enron-related documents. Andersen, the lead partner from the audit team, as well as four former Enron executives faced criminal charges in what was the largest bankruptcy in Unites States history at the time. Following Enron, it became clear that the problem of earnings management was not isolated as investigations began into several other companies (Brickey 2003). The public audit failure of Enron and subsequent investigations were yet another reason for the call to increase regulation in the accounting profession.

Finally, there were also several criticisms of the Peer Review Program that contributed to the re-regulation of the accounting profession in 2002. The Peer Review Program, started by the AICPA in 1977, was a response to public audit

failures throughout the 1970's. Firms who audited SEC registrants were encouraged to join the SEC Practice Section, and as such were subject to triennial peer review. Peer reviews typically involved the reviewer(s) familiarizing themselves with the company's control environment and performing a walkthrough of procedures for a sample of engagements. The reviewer(s) then issued an overall opinion with supporting comments (Anatharaman 2012). Firms could be reviewed by a team appointed by the AICPA, a private CPA firm or an individual CPA firm (Hilary 2005).

Common criticisms of the Peer Review Program are that it lacked independence and credibility. The AICPA attempted to address the issue of independence by prohibiting reciprocal reviews. This theoretically prevented firms from entering into arrangements where clean opinions were issued in return for clean opinions. In a study by Hillary and Lennox (2005) examining the credibility of self-regulation, no cases of reciprocal review were found in the sample, which suggests that this rule was being enforced. While the remaining evidence in their study led them to conclude that peer reviews did provide credible information about audit quality, they also noted that modified or adverse opinions were rarely issued, which could be an indication that serious deficiencies were overlooked in some cases. Similarly, they found that reviewers were not as likely to disclose audit deficiencies for firms with which they did not compete (Hilary and Lennox 2005). The potential lack of credibility and independence was yet another reason for the need for further regulation in the profession.

In 2002, as a response to these growing complaints, Congress passed the Sarbanes-Oxley Act. The Sarbanes-Oxley Act was a drastic change in that it led away from the long accepted practice of self-regulation and established an outside regulatory authority for the accounting profession, the Public Company Accounting Oversight Board, or PCAOB.

Section 101 of the act established the PCAOB as a private, nonprofit organization to oversee the audits of public companies. Public accounting firms with SEC issuer clients are required to register with the PCAOB. The Sarbanes Oxley Act also tasks the PCAOB with establishing auditing, review, independence, ethics and quality controls standards for its registered firms. In addition, the PCAOB is required to inspect these firms to ensure that they are complying with the PCAOB's standards. The PCAOB inspects registered firms with more than 100 issuer clients on an annual basis and inspects firms with 100 or fewer issuer clients triennially. Those inspections include reviews of specific audit engagements as well as the firms' quality control systems.

When an inspection is completed, the PCAOB compiles a report on the results of the inspection. An example of one of these inspection reports can be found in the Appendix of this manuscript. Each report summarizes the PCAOB's inspection process and provides demographic data regarding the firm, including its location, number of offices, number of partners and professional staff, number of issuer clients and organizational structure. The reports also describe the inspection team's findings. Specifically, each report details any audit engagement deficiencies or

quality control system defects identified by the inspection team. The inspection reports are made available to the public and firms are given the opportunity to provide written responses to these inspection reports. However, information about any defects in the firms' quality control system and related discussion in firm responses are redacted from the public report unless the firm does not resolve those defects within one year of the report date.

III. PRIOR RESEARCH

A significant amount of research has examined various aspects of the PCAOB inspection reports and the findings documented within them, particularly related to those firms that are inspected on an annual basis. The current study focuses on the inspection reports of firms with 100 or fewer issuer clients and, in part, follows Hermanson Houston and Rice (2007).

Hermanson et al. (2007) examine the PCAOB inspection reports of 316 triennially-inspected CPA firms covering the period from the PCAOB's inception through June 2006. Their objective was to determine whether or not a relationship exists between firm characteristics and the existence of certain audit engagement deficiencies. The firm characteristics they examined are almost all found on the public portion of PCAOB inspection reports and include: the nature of written responses, presence of audit and quality control system defects, inspection date, number of issuer clients, duration of inspection, report lag, number of offices, number of partners, number of staff, and total professionals.

After documenting that 60 percent of the inspected firms have audit deficiencies, Hermanson, et al. (2007) explore several possible associations between certain firm characteristics and the likelihood of audit deficiencies. They classify

each audit deficiency in two ways as shown in Table 1. Their research indicates that firms with audit deficiencies tend to be smaller in that they have fewer staff, partners, and total professionals. Despite being smaller in size, firms with audit deficiencies have a larger number of issuer clients and are growing more rapidly than firms without deficiencies. They also find differences relating to the inspection year. Specifically, they show that firms inspected in 2004 were more likely to have audit deficiencies than those firms inspected in 2005.

There is also a growing amount of literature that explores whether PCAOB inspection reports reflect audit quality. For example, Lennox and Pittman (2010) reported findings that suggest that many audit clients do not view the PCAOB reporting model as being informative about audit quality. A more recent study by Gramling, Krishnan and Zhang (2011) adds to the literature on triennially inspected firms by investigating a different side of the PCAOB inspection reports. Their study explores whether or not a firm with identified audit deficiencies is likely to change its going-concern reporting behavior for its financially distressed clients. Based on an analysis of PCAOB inspection reports from 2004 to 2006, they find that firms with deficiencies were more likely to issue going-concern opinions after their PCAOB inspection than prior to their inspection.

After reading several reports on the PCAOB inspection process and examining the findings of many researchers on this topic, it was unclear what relationship, if any, the quality control system defects identified in the inspection reports had to identified audit deficiencies, firm characteristics, or perception of

Table 1: Audit deficiency classification used by Hermanson et al. (2007)

1. According to the general nature of the deficiency:	2. According to the specific nature of the deficiency:
Substantive Tests	Failure to Perform and Document Various Procedures or Analyses
Audit Report	Failure to Adequately/Properly Evaluate (related to various issues)
Tests of Controls	Failure to Test (related to various issues)
Planning	Failure to Identify, or Address Appropriately, GAAP Departures
General Documentation	Inappropriate Reliance on Others' Work (other external or internal auditors)
	Documentation Deficiencies
	Other

audit quality. My research follows a similar process and examines many of the same firm and inspection characteristics as Hermanson et al. (2007). However, rather than focusing on the relationship between these characteristics and the existence of audit deficiencies, my research focuses on exploring any relationships between these characteristics and whether or not a firm will correct its quality control system defects within the allotted year.

IV. THEORY/HYPOTHESIS DEVELOPMENT

Several prior studies suggest that larger audit firms produce higher audit quality (e.g., DeAngelo 1981; Dye 1993; Lennox 1999; Geiger and Rama 2006). There are a number of arguments that predict this relationship. First, DeAngelo (1981) argues that larger firms are more independent because no one client is essential to their business. Further, because they have many clients and partners, larger firms have more to lose and are therefore more concerned with maintaining their reputation than smaller firms. Similarly, Dye (1993) argues that larger auditors have deeper pockets. Therefore, larger firms have more wealth to protect and more incentive to maintain higher audit quality. In addition, studies have also shown that relative to other firms, the Big 4 carry a 20% higher audit fee. This higher fee could be due to either a greater number of hours worked or a higher billing rate, reflective of greater auditor expertise. Either case would imply higher audit quality (Francis 2004).

As prior studies show a relationship between larger firms and higher audit quality, it is reasonable to predict that larger firms will be more likely to correct any identified quality control system defects within the allotted year. Further, this potential relationship is intuitive in that larger firms are more likely than smaller firms to have the necessary resources to correct quality control system defects. That is, the ability to correct some of the quality control system defects described in

PCAOB inspection reports is directly related to firm size. For example, one common quality control system defect concerns the firm's engagement quality review process. Under PCAOB auditing standards, each engagement should be reviewed by a partner, who is otherwise independent of the engagement. Smaller firms with fewer partners would necessarily have fewer resources with which to remedy quality control system defects related to this process simply because they are less likely to have other partners available to perform this task. For these reasons, I make the following prediction:

HYPOTHESIS 1: Larger firms are more likely than smaller firms to correct quality control system defects identified in PCAOB inspection reports within the allotted year.

In general, the number of issuer clients may be a proxy for the size of an audit firm. However, if firm resources remain constant while the number of issuer clients increases, that increase in clients could result in strained resources that could impact audit quality as well as the firm's ability to maintain an adequate system of quality control. For example, Hermanson, Houston and Rice (2007) find that firms with audit engagement deficiencies tend to have more issuer clients. In addition to direct effects on engagement quality and the effectiveness of the firm's quality control system, resource strain is also likely to impact the firm's ability and the resources available to respond to quality control system defects identified by PCAOB inspectors. Therefore, I predict the following:

HYPOTHESIS 2: Firms with more issuer clients scaled by firm size are less likely to correct quality control system defects identified in PCOAB inspection reports within the allotted year.

I also specifically examine whether the number of partners in a firm effects whether or not the firm corrects its quality control system defects within a year. It is reasonable to believe that in firms with only one partner, there will be less accountability because the sole partner answers to no one else. Also, similar to above, firms with only one partner may not have the resources available to correct quality control system defects such as problems with concurring partner review. Therefore, I believe that firms with only one partner will be less likely to correct their deficiencies.

HYPOTHESIS 3: Firms with only one partner are less likely to correct their quality control defects within the allotted year than are firms with more than one partner.

Finally, the PCAOB allows inspected audit firms to submit a response letter for inclusion in the inspection report. Hermanson, Houston and Rice (2007) find that many firms submit such response letters and are more likely to do so when the PCAOB identifies audit engagement deficiencies. While those authors do not further explore the implications of those response letters, they do encourage future research on the matter. Therefore, I also explore the relationship between a firm's tendency to provide a written response for inclusion in the PCAOB's inspection report and the firm's tendency to correct its quality control system defects within the allotted year. Without taking into account the tone of the response, one could

logically expect that firms that provide written responses to PCAOB inspection reports are more responsive to these reports in general. Therefore, it would be reasonable to also predict that these firms will be more likely to specifically respond to and correct the identified quality control system defects than those firms that did not provide a written response. Therefore, I make the following prediction:

HYPOTHESIS 4: Among firms with identified quality control system defects, firms that provide a written response to PCAOB inspection reports are more likely to correct their quality control system defects within the allotted year.

V. METHODOLOGY

To begin my research process, I examined all of the PCAOB inspection reports made available on the Board's public website with inspection dates through March 2009. I classified each report as Type 1, Type 2, or Type 3 as shown in Table 2.

Table 2: Criteria for determining firm type

TYPE	CRITERIA
1	These inspection reports had quality control system defects that were not corrected within the allotted year and therefore were made public by the PCAOB.
2	These inspection reports had quality control system defects that were corrected within the allotted year and therefore were not made public by the PCAOB.
3	These inspection reports identified no quality control system defects and were not considered for the purpose of this thesis.

I classified each report according to the language in the report. Type 1 firms are easily identified because quality control system defects are made public in part B of the inspection report as shown in the sample report in the Appendix. However, distinguishing between Type 2 and Type 3 reports requires reading Part B of each report for subtle differences in the wording of the explanation of the PCAOB's inspection of each firm's quality control system. As illustrated in the excerpts below, the inspection reports are ambiguous about the potential presence of quality

control system defects when those deficiencies do in fact exist. However, when no such defects have been identified, the inspection report explicitly states that the inspection team did not identify any defects in the quality control system.

Type 2:

*“In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies and procedures related to audit quality. This review addressed practices, policies and procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures. **As described above, any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.**”*

Type 3:

*“In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies and procedures related to audit quality. This review addressed practices, policies and procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures. **The inspection team did not identify anything that it considered to be a quality control defect that warrants discussion in a Board inspection report.**”*

After classifying each inspection report as a Type 1, Type 2, or Type 3 report, I hand-collected certain data from all of the Type 1 and Type 2 inspection reports. Initially, I recorded the report date and inspection date, noting the month and year that the inspection began as some inspections lasted several weeks. Excluding annually inspected firms, my sample included 94 Type 1 reports with quality control system defects. Next, I chose a matched sample of 94 Type 2 reports based

on the year of inspection. After excluding any annually inspected firms, I sorted the Type 2 reports by the year of the inspection date and assigned a random number to each report within each year. Next, I sorted the reports within each year based on the random number and, starting from the beginning of the list, selected a number of Type 2 reports such that the number of Type 2 reports equaled the number of Type 1 reports in that year.

For each Type 1 report and for each Type 2 report included in the matched sample, I hand-collected additional data from the inspection reports including firm location, number of offices, ownership structure, number of partners, number of professional staff, number of issuer audit clients, and whether or not the firm provided a written response to the inspection report. For the purposes of my research, I considered number of offices, number of partners, and number of total professional staff as a proxy for firm size. This is intuitive, as larger firms would most likely have more offices, partners, and total staff. In addition to the above characteristics, ownership structure and number of issuer audit clients may also be suggestive of firm size. For example, it makes sense that sole proprietorships would likely be smaller in size, and a large number of issuer audit clients would probably indicate a larger firm. The last demographic characteristic I collected, whether or not a firm provides a written response, may be an indication of overall firm responsiveness. A firm that provides a written response may be more likely to respond and fix quality control system defects in a timely manner.

In addition to the above characteristics, I examined the occurrence of audit deficiencies to determine whether these deficiencies had any impact on whether a firm corrected its quality control system defects. To do so, I classified the audit deficiencies in each report according to the specific nature of the deficiency, based on Hermanson, Houston, and Rice (2007) in column two of Table 1. Those classifications include (1) Failure to Perform and Document Various Procedures or Analyses, (2) Failure to Adequately/Properly Evaluate (related to various issues), (3) Failure to Test (related to various issues), (4) Failure to Identify or Address Appropriately GAAP Departures, (5) Inappropriate Reliance on Others' Work (other external or internal auditors), (6) Documentation Deficiencies, and (7) Other. Examples of each type of deficiency can be found in Table 3.

Next, I classified the quality control system defects for those firms that did not correct their deficiencies within the allotted year. These quality control system defects can be found in the firms' PCAOB inspection reports. I classified each quality control system defect according to the taxonomy of Generally Accepted Auditing Standards (GAAS) plus one additional category for system wide deficiencies as follows: (1) General, (2) Field Work, (3) Reporting, and (4) System Wide. Examples of each type of quality control deficiency can be found in Table 4.

Table 3: Examples of audit deficiency classifications

Audit Deficiency	Examples
<p>Failure to Perform and Document Various Procedures or Analyses</p>	<p>The failure to perform sufficient audit procedures to determine whether consulting service costs were recognized in the proper period.</p> <p>The failure to perform and document audit procedures related to an inventory valuation adjustment.</p>
<p>Failure to Adequately/Properly Evaluate (related to various issues)</p>	<p>The failure to evaluate appropriately the accounting for an acquisition.</p>
<p>Failure to Test (related to various issues)</p>	<p>The failure to perform adequate audit procedures to test the existence and valuation of investments and goodwill.</p> <p>The failure to perform and document sufficient tests of equity transactions in two of the audits reviewed.</p>
<p>Failure to Identify, or Address Appropriately, GAAP Departures</p>	<p>The Firm's failure to identify, or to address appropriately, a departure from GAAP that related to potentially material misstatements in the audited financial statements concerning the accounting for a business combination.</p>
<p>Inappropriate Reliance on Others' Work (other external or internal auditors)</p>	<p>The unwarranted reliance on revenue data provided by a third-party service organization.</p> <p>Inappropriately taking responsibility for the work of another auditor when the other auditor performed substantially all of the audit procedures that served as the basis for the Firm's opinion.</p>
<p>Documentation Deficiencies</p>	<p>The failure to perform and document an evaluation of whether substantial doubt exists about an issuer's ability to continue as a going concern.</p>
<p>Other</p>	<p>The failure to identify all material subsequent events and to evaluate the issuer's disclosure of these events.</p>

Table 4: Examples of quality control system defect classifications

Quality Control Deficiency	Examples
General	Technical Competence, Due Care, and Professional Skepticism: The Firm's system of quality control appears not to do enough to ensure technical competence and the exercise of due care or professional skepticism.
Field Work	Testing Appropriate to the Audit: The Firm's system of quality control appears not to provide sufficient assurance that the Firm will conduct all testing appropriate to a particular audit.
Reporting	Auditor Communications: The Firm's system of quality control appears not to provide sufficient assurance that the required auditor communications to the audit committee, or equivalent, occur and are properly documented, including the independence confirmations required by Independence Standards Board Standard No. 1, <i>Independence Discussions with Audit Committees</i> .
System Wide	Concurring Partner Review: Questions exist about the effectiveness of the Firm's existing arrangement for concurring partner reviews.

VI. FINDINGS

Hypothesis 1:

Hypothesis 1 predicts that larger firms will be more likely to correct their quality control system defects within the allotted year. I use the firm characteristics number of offices, number of partners, and number of professional staff as a proxy for size. My preliminary findings are shown in Table 5.

My findings in Table 5, Panel A indicate that there may be a relationship between a firm's number of offices and whether or not they correct their quality control system defects in a timely manner. While the minimum number of offices of 1 is the same for both types of firms in my sample, the average number of offices and maximum number of offices are slightly higher for those Type 2 firms that fixed their quality control system defects. The average number of offices for Type 1 and Type 2 firms is 1.50 and 2.25, respectively, and the maximum number of offices is 15 and 18 respectively. This slight increase could indicate that firms with more offices, viewed as larger firms in this study, may be more likely to correct their quality control system defects within the allotted year.

Table 5, Panel B also presents my findings regarding the relationship between number of partners and whether a firm corrects its quality control system

Table 5: Firm characteristics representing size

PANEL A: Number of Offices		
Firm Type:	1 (Did not correct quality control system defects)	2 (Corrected quality control system defects)
Minimum # of Offices	1	1
Average # of Offices	1.50	2.25
Maximum # of Offices	15	18
Standard Deviation	1.72	2.51
PANEL B: Number of Partners		
Firm Type:	1 (Did not correct quality control system defects)	2 (Corrected quality control system defects)
Minimum # of Partners	1	1
Average # of Partners	3.60	12.82
Maximum # of Partners	39	201
Standard Deviation	5.79	25.30
PANEL C: Number of Professional Staff		
Firm Type:	1 (Did not correct quality control system defects)	2 (Corrected quality control system defects)
Minimum # of Professional Staff	0	0
Average # of Professional Staff	19.04	92.65
Maximum # of Professional Staff	701	1346
Standard Deviation	81.35	236.23

defects. Based on my sample, the minimum number of partners for both firm types is 1, but the average and maximum number of partners in Type 2 firms is significantly higher. The average number of partners for Type 1 firms that did not correct their quality control system defects in a timely manner is 3.60, while the average number of partners for Type 2 firms is 12.82. Similarly, the maximum number of partners for Type 1 firms is 39 whereas the maximum number of partners for Type 2 firms that corrected their deficiencies is 201. With the number of partners as a proxy for firm size, this could indicate that firms with more partners, or larger firms, are more likely to correct their quality control system defects in a timely manner.

Finally, Table 5, Panel C presents my findings regarding the correlation between the number of professional staff and whether or not they correct their quality control system defects in the allotted year. Based on my sample, both firm types have a minimum number of professional staff of 0 and, again, Type 2 firms that corrected their quality control system defects have a higher average and maximum number of professional staff. Type 1 firms have an average and maximum number of professional staff of 19.04 and 701, respectively, while Type 2 firms show an average of 92.65 and a maximum of 1346 professional staff. These findings could indicate that firms with a higher number of professional staff are more likely to correct their quality control system defects.

Table 6 presents a logistic regression predicting the likelihood that a firm will be a Type 2, or will fix its quality control system defects. These results indicate

Table 6: Logistic regression

Parameter	DF	Estimate	Standard Error	Wald Chi-Square	Pr > ChiSq
Intercept	1	-0.6320	0.3801	2.7642	0.0964
Number of Offices	1	-0.3684	0.1776	4.3017	0.0381
Number of Partners	1	0.1966	0.0720	7.4503	0.0063
Number of Professional Staff	1	-0.00479	0.00356	1.8133	0.1781
Clients per Office	1	-0.0120	0.0291	0.1686	0.6813
Clients per Partner	1	0.0612	0.0780	0.6161	0.4325
Clients per Total Staff	1	-0.2048	0.1150	3.1684	0.0751
Response	1	0.7198	0.3620	3.9531	0.0468

that number of partners is positively associated with the tendency of a firm to fix its quality control system defects within the allotted year, but that both number of offices and number of professional staff are negatively associated with the tendency to correct quality control system defects. Therefore, the logistic regression results in Table 6 are inconclusive and neither support nor disprove the prediction that larger firms are more likely to correct their quality control system defects.

Because the number of offices, number of partners, and number of professional staff are highly correlated, as shown in Table 7, the results obtained in a logistic regression model that includes all of those variables may not be reliable. In order to eliminate this multicollinearity and to clarify my results, I use factor analysis (see Table 8) to reduce these variables to the underlying construct that they collectively represent. This analysis identifies three significant factors, including one that is primarily a linear combination of my proxies for firm size (see Factor 2 in Table 8). Therefore, I interpret that factor as representing the underlying construct of firm size.

Table 9 presents a more parsimonious logistic regression that only includes the factors identified in Table 8. Factor 2 (firm size) has a strong positive association with a firm's tendency to correct its quality control system defects within the allotted year ($p = 0.0084$). These findings support Hypothesis 1, the prediction that larger firms will be more likely to correct their quality control system defects in a timely manner.

Table 7: Pearson Correlation Coefficients, N=188 Prob > |r| under H0: Rho=0

	# Offices	# Partners	# Prof. Staff	# Clients	Clients per Partner	Clients per Office	Clients per Total Staff
# Offices	1.00000	0.82859 <.0001	0.66780 <.0001	0.28826 <.0001	-0.15048 0.0393	-0.13057 0.0741	-0.15522 0.0334
# Partners	0.82859 <.0001	1.00000	0.74485 <.0001	0.28617 <.0001	-0.17502 0.0163	-0.07411 0.3122	-0.15279 0.0363
# Prof. Staff	0.66780 <.0001	0.74485 <.0001	1.00000	0.18122 0.0128	-0.14712 0.0439	-0.08670 0.2368	-0.13067 0.0739
# Clients	0.28826 <.0001	0.28617 <.0001	0.18122 0.0128	1.00000	0.55405 <.0001	0.77597 <.0001	0.27522 0.0001
Clients per Partner	-0.15048 0.0393	-0.17502 0.0163	-0.14712 0.0439	0.55405 <.0001	1.00000	0.76108 <.0001	0.82393 <.0001
Clients per Office	-0.13057 0.0741	-0.07411 0.3122	-0.08670 0.2368	0.77597 <.0001	0.76108 <.0001	1.00000	0.50471 <.0001
Clients per Total Staff	-0.15522 0.0334	-0.15279 0.0363	-0.13067 0.0739	0.27522 0.0001	0.82393 <.0001	0.50471 <.0001	1.00000

Table 8: Rotated factor pattern

Firm Characteristics	Factor 1	Factor 2	Factor 3
Number of Offices	-4	92	-1
Number of Partners	-2	94	8
Number of Professional Staff	-5	86	2
Number of Clients	78	34	26
Clients per Partner	93	-15	-14
Clients per Office	91	-7	18
Clients per Total Staff	76	-16	-39
Response	1	2	93

Table 9: Logistic regression with factor analysis

Parameter	DF	Estimate	Standard Error	Wald Chi-Square	Pr>ChiSq
Intercept	1	-0.7067	0.2893	5.9673	0.0146
Factor 1	1	-0.3363	0.1696	3.9324	0.0474
Factor 2	1	0.8690	0.3297	6.9452	0.0084
Response	1	1.1335	0.3475	10.6394	0.0011

Hypothesis 2:

Hypothesis 2 predicts that firms with more issuer clients scaled by firm size are less likely to correct quality control system defects identified in PCOAB inspection reports within the allotted year. To test this prediction, I first construct three proxies for resource strain by dividing the number of clients by the number of partners, the number of offices, and the total number of partners and professional staff, to compute clients per partner, clients per office, and clients per total staff. These variables may be viewed as an indication of a firm's resource strain.

The logistic regression in Table 6 includes all three of these proxies for resource strain. However, none of these are significant at traditional levels. Therefore, the results presented in Table 6 do not support Hypothesis 2. However, the factor analysis in Table 8 identifies another factor, Factor 1. This factor is primarily a combination of the three proxies of resource strain plus the raw number of issuer clients. Therefore, Factor 1 may be viewed as representing the underlying construct of resource strain. I also include this factor in the more parsimonious logistic regression model in Table 9. In this model, Factor 1 is negatively associated with a firm's tendency to correct its quality control system defects within the allotted year ($p = 0.0474$). These results support the prediction that firms with more issuer clients scaled by firm size, or more resource strain, are less likely to correct quality control system defects within the allotted year.

Hypothesis 3:

Hypothesis 3 predicts that firms with only one partner are less likely to correct their quality control system defects within the allotted year. Due to a potential lack of accountability and shortage of resources, it is probable that firms with one partner will not correct their quality control system defects as often as firms with a greater number of partners.

My findings in Table 10 show that there is a higher percentage of Type 1 firms with only one partner, with nearly twice as many one partner Type 1 firms than Type 2 firms. In my sample, 33 Type 1 firms had only one partner as compared to only 16 Type 2 firms that did not correct their quality control system defects. Similarly, the analysis in Table 6 indicated a positive association between number of partners and the tendency to correct quality control system defects in a timely manner. These findings suggest that it is less likely that firms with one partner will correct their quality control system defects.

Table 10: Firms with one partner versus firms with multiple partners

Firm Type:	1 (Did not fix quality control system defects)	2 (Fixed quality control system defects)
Number of firms with one partner:	33	16
Number of firms with more than one partner:	61	78
Percentage with only one partner	35.11%	17.02%

Hypothesis 4

Hypothesis 4 predicts that firms who provide a written response to PCAOB inspection reports are more likely to correct their quality control system defects within the allotted year. Inspected firms are given the option to provide a written response to PCAOB inspection reports to be published along with the inspection report. I use the existence of a written response, regardless of the nature of the response, to gauge a firm's overall responsiveness. My preliminary findings are shown in Table 11.

Table 11: Firms' written responses to PCAOB inspection reports

Firm Type:	1 (Did not fix quality control system defects)	2 (Fixed quality control system defects)
Number that provided a written response:	54	75
Number that did not provide a written response:	40	19
Percentage that provided a written response:	57.45%	79.57%

Based on my sample, the results in Table 11 show that a significantly higher number of Type 2 firms provided written responses. Nearly eighty percent of the Type 2 firms that corrected their quality control system defects in a timely manner also provided a written response. When compared to only 57.45% of Type 1 firms that provided a written response, this may indicate an association between a firm's

level of responsiveness and whether or not they fix their quality control system defects.

The results of the initial logistic regression in Table 6 show similar findings: that there is a strong positive association between a firm providing a written response and the tendency to correct quality control system defects. This variable is also positive and significant in the more parsimonious logistic regression model in Table 9 ($p = 0.0011$). These findings support the prediction that firms who provide a written response to PCAOB inspection reports are more likely to correct their quality control system defects within the allotted year.

Other Findings:

In addition to the tests relating to my four hypotheses, there are also several interesting findings pertaining to firms who do not correct their quality control system defects. Because information regarding audit engagement deficiencies are made public in all inspection reports, I am able to explore differences in those deficiencies between Type 1 and Type 2 firms. Table 12 shows the number of each type of audit deficiency disclosed in the inspection reports of both Type 1 and Type 2 firms. Recall that the quality control system defects are not initially made available and are only eventually made public for those firms that do not correct those defects. Therefore, it is difficult to identify any relationships between specific audit deficiencies and either the existence of quality control system defects or whether or not the firm corrects these deficiencies. However, my findings show that there are more total audit

Table 12: Classification of identified audit deficiencies

Audit Deficiency	Did not fix quality control system defects	Fixed quality control system defects
Failure to Perform and Document Various Procedures or Analyses	49	50
Failure to Adequately/Properly Evaluate (related to various issues)	37	21
Failure to Test (related to various issues)	39	24
Failure to Identify, or Address Appropriately, GAAP Departures	19	12
Inappropriate Reliance on Others' Work (other external or internal auditors)	9	11
Documentation Deficiencies	6	3
Other	2	0
TOTAL:	161	121

deficiencies identified in Type 1 firms that do not fix their quality control system defects. While Type 2 firms only have 121 total identified audit deficiencies, Type 1 firms have 161 identified audit deficiencies.

As well as recording the audit deficiencies for both Type 1 and 2 firms, I also classify the quality control system defects according to the Generally Accepted Auditing Standards plus one additional category as shown in Table 13. As the quality control system defects for Type 2 firms are not disclosed, it is difficult to draw any conclusions about the relationship between the type of deficiency and whether or not a firm corrects these deficiencies.

Table 13: Classification of disclosed quality control system defects

Quality Control System Defect	Number found in Type 1 (Did not fix quality control system defects)
General	58
Field Work	45
Reporting	36
System Wide	59
TOTAL:	198

I also examine the differences in ownership structures between Type 1 and Type 2 firms. As ownership structure is not necessarily indicative of size, I chose not to test this variable as a proxy for firm size. My findings with regard to ownership structure are summarized in Table 14. My findings show no significant differences in ownership structure between the two firm types.

Table 14: Ownership structures among Type 1 and Type 2 firms

Ownership Structure	Did not fix quality control system defects	%	Fixed quality control system defects	%
Corporation	45	48.39%	39	41.94%
Partnership	6	6.45%	6	6.45%
LLP or LLC	29	31.18%	40	43.01%
Sole Proprietorship	12	12.90%	8	8.60%
Other	1	1.08%	0	0.00%

VII. CONCLUSION

The PCAOB conducts inspections of audit firms with 100 or fewer issuer audit clients every three years, and firms are given one year to correct any quality control system defects identified in the inspection before they are made public. I examined 188 PCAOB inspection reports of triennially inspected audit firms, half of which corrected their quality control system defects within the allotted year, and half that did not. I hand collected data from publicly available PCAOB inspection reports in order to determine whether any firm characteristics were associated with the firm's tendency to fix their quality control system defects in a timely manner. I predict that:

1. Larger firms are more likely to correct their quality control system defects within the allotted year.
2. Firms with more issuer clients scaled by firm size are less likely to correct their quality control system defects within the allotted year.
3. Firms with only one partner are less likely to correct their quality control defects within the allotted year than are firms with more than one partner.
4. Firms who provide written responses to PCAOB inspection reports are more likely to correct their quality control system defects.

The results of this thesis support these predictions. Specifically, my findings indicate that firm size is positively associated with a firm's tendency to correct its quality control system defects. On the other hand, my results suggest that resource strain limits the likelihood that firms will correct their quality control system defects. I further find evidence that firms who provide a written response to PCAOB inspection reports are more likely to correct their quality control system defects.

These findings are important because there is less prior research on the inspection reports of triennially inspected firms with 100 or less issuer audit clients, specifically on the quality control system defects in those reports. In the Peer Review Program, quality control system defects were disclosed immediately and served as an indication of audit quality. This study is also important because under the PCAOB, quality control system defects are not immediately disclosed, and prior research has shown associations between certain firm characteristics and audit quality.

Opportunities for future research include examining the relationships between identified audit deficiencies and disclosed quality control system defects in the PCAOB inspection reports of those firms that do not correct their quality control system defects within the allotted year. As there were only 94 firms whose quality control system defects had been made public at the time of my research, it would have been difficult to look into relationships between specific audit deficiencies and quality control system defects. As the amount of inspection reports with disclosed quality control system defects grows, it will be more feasible to research these

relationships. Similar to the findings of the current study, this future research could help users of inspection reports make assumptions about audit quality in those reports that do not disclose a firm's quality control system defects.

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APPENDIX



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Inspection of Perrella & Associates, P.A.

Issued by the

Public Company Accounting Oversight Board

April 6, 2006

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

**PORTIONS OF THE COMPLETE REPORT ARE OMITTED
FROM THIS DOCUMENT IN ORDER TO COMPLY WITH
SECTIONS 104(g)(2) AND 105(b)(5)(A)
OF THE SARBANES-OXLEY ACT OF 2002**

PCAOB RELEASE NO. 104-2006-096A
(Includes portions of Parts II and IV of the full report that
were not included in PCAOB Release No. 104-2006-096)

Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. Board inspections encompass, among other things, whether the firm has failed to identify departures from Generally Accepted Accounting Principles ("GAAP") in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("SEC" or "Commission"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.



INSPECTION OF PERRELLA & ASSOCIATES, P.A.

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Perrella & Associates, P.A. ("the Firm"). The Board is issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report and portions of Part IV of the report. Part IV of the report consists of the Firm's comments, if any, on a draft of the report.^{1/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{2/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

^{1/} The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

^{2/} See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted fieldwork for the inspection from June 7, 2004 to June 10, 2004. The fieldwork included procedures tailored to the nature of the Firm, certain aspects of which the inspection team understood at the outset of the inspection to be as follows:

Number of offices	1 (Pompano Beach, Florida)
Ownership structure	Corporation
Number of partners	1
Number of professional staff ^{3/}	3
Number of issuer audit clients ^{4/}	8

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present

^{3/} "Professional staff" includes all personnel of the Firm, except partners or shareholders and administrative support personnel. The number of partners and professional staff is provided here as an indication of the size of the Firm, and does not necessarily represent the number of the Firm's professionals who participate in audits of issuers or are "associated persons" (as defined in the Act) of the Firm.

^{4/} The number of issuer audit clients shown here is based on the Firm's self-reporting and the inspection team's review of certain information for inspection planning purposes. It does not reflect any Board determination concerning which, or how many, of the Firm's audit clients are "issuers" as defined in the Act.

fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.⁵⁷ It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of the performance of five of the Firm's audits of the financial statements of issuers. Those audits and aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

The inspection team identified matters that it considered to be audit deficiencies.⁵⁸ The deficiencies identified in all five of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements. Those deficiencies included –

- (1) the Firm's failure to identify, or to address appropriately, a departure from GAAP that related to potentially material misstatements in the audited financial statements concerning the loss per share;

⁵⁷ When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations or cash flows of the issuer in conformity with GAAP, the Board reports that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

⁵⁸ PCAOB standards require a firm to take appropriate actions to assess the importance of audit deficiencies identified after the date of the audit report to the firm's present ability to support its previously expressed opinions. See AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T). Failure to comply with these PCAOB standards could be a basis for Board disciplinary sanctions.

- (2) the failure to perform appropriate audit procedures related to a business combination;
- (3) on two audits, inappropriately taking responsibility for the work of another auditor when the other auditor performed substantially all of the audit procedures that served as the basis for the Firm's opinion;
- (4) on two audits, the failure to audit appropriately nonmonetary transactions involving issuances of stock;
- (5) the failure to perform and document appropriate tests of inventory;
- (6) the failure to perform and document appropriate audit tests regarding the extinguishment of debt;
- (7) the failure to perform and document a consideration of the implications of the payment of issuer costs by related entities; and
- (8) on one audit, the failure to perform and document any procedures (a) to test three significant balance sheet accounts; (b) related to a write-off of a related party receivable balance, the issuance of shares of common stock in exchange for services, and the computation of weighted average shares outstanding used in computing loss per share; and (c) to search for unrecorded liabilities or to obtain an understanding of the issuer's business, accounting processes, and related internal controls.

Following the inspection fieldwork and the inspection team's discussion with the Firm of the matters identified above, the Firm performed additional audit procedures and identified misstatements in two issuers' financial statements. The issuers subsequently restated their financial statements.^{2/}

B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies and procedures related to audit quality. This review encompassed practices, policies and

^{2/} The Board inspection process did not include any review of the additional audit work or the restated financial statements.

procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures. As described above, any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I



PCAOB Release No. 104-2006-096A
Inspection of Perrella & Associates, P.A.
April 6, 2006
Page 6

PORTIONS OF THE REST OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED
FROM THIS PUBLIC DOCUMENT

PART II

• • • •

B. Issues Related to Quality Controls

The inspection of the Firm included consideration of aspects of the Firm's system of quality control. Assessment of a firm's quality control system rests both on review of a firm's stated quality control policies and procedures and on inferences that can be drawn from respects in which a firm's system has failed to assure quality in the actual performance of engagements.^{8/} On the basis of the information reported by the inspection team, the Board has the following concerns about aspects of the Firm's system of quality control.

Audit Performance

A firm's system of quality control should provide reasonable assurance that the work performed on an audit engagement will meet applicable professional standards and regulatory requirements. On the basis of the information reported by the inspection team, including the audit performance deficiencies described in Part II.A and any other deficiencies identified below, the Board has concerns that the Firm's system of quality control fails to provide such reasonable assurance in at least the following respects -

a. Technical Competence, Due Care, and Professional Skepticism

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

b. Appropriate Procedures

The Firm's system of quality control appears not to provide reasonable assurance that the Firm will conduct all testing appropriate to a particular audit. The information reported by the inspection team suggests an apparent pattern of failures to

^{8/} A firm's failure to comply with the requirements of PCAOB standards when performing an audit may be an indication of a potentially significant defect in a firm's quality control system even if that failure did not result in an insufficiently supported audit opinion.

perform the appropriate procedures related to the testing of equity transactions [Issuers B and C] , as well as an apparent pattern of inappropriate reliance on the work of other auditors to perform substantially all of the audit procedures that serve as the basis for the Firm's opinion. [Issuers A and E]

c. Concurring Partner Review

Questions exist about the effectiveness of the Firm's existing arrangement for concurring partner reviews. Having procedures for concurring partner review by a competent reviewer is an important element of quality control. Such reviews should involve the performance of appropriate procedures using due care and professional skepticism, with the Firm appropriately addressing the reviewer's findings and documenting the process. The Firm used the services of an accountant not affiliated with the Firm to perform the concurring partner review of the five issuer audits included in the inspection. The information reported by the inspection team suggests that there is no evidence that the concurring partner review procedure used by the Firm resulted in the identification of any of the deficiencies noted by the inspection team. On one engagement, the concurring review did not take place until after the financial statements had been filed with the SEC. [Issuer D] With respect to the other four engagements, the failure may result from a lack of competency, due care or professional skepticism on the part of the concurring partner; deficiencies in the scope of the concurring partner's procedures; and/or the Firm's failure to properly address the concurring partner findings. Apparent deficiencies in documentation of the scope and results of the concurring partner's reviews preclude the Board from determining the relative contribution of each of these potential causes to the failure of the concurring partner process to prevent the deficiencies reported by the inspection team.

* * * *

PART IV

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report. In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted.

PERRELLA & ASSOCIATES, P.A.
CERTIFIED PUBLIC ACCOUNTANTS

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September 27, 2006

Mr. George H. Diacont,
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Re: Response to Public Company Accounting Oversight Board Report of
2004 Inspection of Perrella & Associates, P.A.

Dear Mr. Diacont:

We appreciate the opportunity to review and comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") draft Report on 2004 Inspection of Perrella & Associates, P.A. ("Report").

Perrella & Associates, P.A. ("Firm") is committed to improvement in its audit quality and the PCAOB's inspection comments and report contribute directly to that process. The PCAOB has proven its commitment to help restore investor confidence in the capital markets and in the public accounting profession to improve audit quality by having a highly dedicated professional staff. Our Inspections' staff provided constructive dialog and performed an in depth review of issuer's files resulting in quality and detailed comments. We take seriously the findings identified by the Board during the 2004 inspection of our 2003 audit engagements, and we will incorporate these findings into our ongoing audit quality efforts.

We have taken, and are continuing to take, substantive steps to address the Board's findings and concerns that we believe are necessary to improve our audit quality and that are responsive to those findings and concerns. Significant steps taken include more skeptical client acceptance, more extensive audit documentation to support auditor's representations, enhanced concurring reviewer procedures, staff education and better adherence to standards when audit procedures are performed by other auditors. These steps also include changes made to our audit procedures in response to PCAOB Auditing Standard No. 3 related to audit documentation, which became effective in 2004.

The comments that follow respond to Part I - *Inspection Procedures and Certain Observations* of the Firms 2004 Inspection Report. The inspection of each of the engagements selected was performed thoroughly. Professional judgment is involved in both performance of an audit and the subsequent inspection process, and we view the

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Board's comments as positive and helpful. We accept the PCAOB's findings in the Report. With respect to the findings identified by the Board in the Report, we considered whether it was necessary to perform additional procedures in accordance with AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. For a number of findings, additional procedures were necessary, were performed and or enhanced documentation was obtained or prepared. We and two clients agreed that their financial statements needed to be restated based on findings. As a result of these actions, we have concluded that no new facts came to our attention that caused us to believe that our previously issued reports should be withdrawn. Part II discusses findings and specific procedures.

We take seriously the Board's findings, and recognize the need to have in place the ability to execute and document audit procedures in accordance with PCAOB standards. Appropriate testing was done in some findings, but the work papers did not partially or at all capture the testing or rational underlining all conclusions. Under new audit documentation standards, the outcome is not the judge of audit documentation.

We have taken substantive steps, as mentioned above, to enhance our audit procedures in order to begin to meet the standards of the Board. Additionally, we have significantly reduced our public company client base. At the time of our inspection, we had eight micro-cap issuers. Following our inspection, we decided to reduce the number of issuers. Today we have two. The purpose is to better serve those clients and more importantly, to ensure that quality controls and abilities are in place for our size and resources.

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We have a better understanding of the importance and need to strengthen our Firm as we work with the PCAOB in order to improve audit quality. We would be pleased to discuss our response or answer any questions the Staff or Board may have regarding this response.

Sincerely,

Berella & Associates, P.A.

Redacted
Comments on Non-public Aspects of Report

A. Issues related to Quality Controls

Perrella and Associates, P.A. acknowledges the professional performance of the PCAOB and its staff and what has been accomplished in a short time. We desire to continue our public company audit practice and recognize that we must enhance our professional standards, which consist of auditing, attestation, quality control, ethics, and independence standards and related rules of audit reports for Issuers, as defined by the Sarbanes-Oxley Act.

Significant steps taken to meet those standards include more skeptical client acceptance, more extensive audit documentation to support our auditor's representations, enhanced concurring reviewer procedures, staff education and better adherence to standards when audit procedures are performed by other auditors.

Regarding client acceptance, we had listed eight audit clients during the time of our review. As of today, only one of them is retained. Of the seven, one was not an issuer, one is non-reporting and five were declined. The five declined Issuers were acquired and there were no retaining benefits by the acquirer at acquisition or soon thereafter. Our skepticism of client acceptance will include an issuer's ability to recognize their responsibilities and our ability to meet PCAOB professional standards in regard to the issuer.

Audit documentation will be in compliance with PCAOB Auditing Standard No. 3, Release No. 2004-006, which became effective in 2004. A complete understanding of the nature, purpose and recording of share transactions will be emphasized. Our concurring reviewer has agreed to and will have more involvement in the audit process.

We take this review and report seriously and have responded to all deficiencies in the engagements as best as we could. We have take steps to implement the enhancements of the Firm's quality controls.