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Pcaob Inspection Reports: Quality Control and Firms' Characteristics

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Abstract

This study compared the weaknesses identified in the audit engagement performance and quality control (that have been made public by the PCAOB after a lack of progress report within 12 months by the firms) sections of the PCAOB's published reports. It also, examined the relationship between firms' characteristics (i.e. size of workforce, number of clients, number of audit offices, and number of audit engagement deficiencies) and PCAOB's report, to achieve these, 108 PCAOB Inspection reports for inspected firms were analyzed. The reports were grouped into two panels (i.e. clean reports-panel A and unresolved reports-panel B); 52 and 56 firms' reports respectively were analyzed for each group. The OLS regression results indicate that clean reports are positively and significantly associated with the size of work force, while, it is negatively associated with the number of clients, number of audit offices and number of audit engagement deficiencies. Unresolved reports increase as number of audit offices, and number of audit engagements increase, but it decreases as size of workforce and audit clients increase. We conclude that the number of audit clients is a key quality control determinant as well as the size of work force. We therefore recommend that the PCAOB should encourage firms to increase workforce because, the result of this study has shown that, the number of employees and partners impact greatly on the quality of report by audit firms.

Keywords: PCAOB inspection; quality control deficiencies; audit quality; PCAOB report

1. Introduction

When several accounting scandals broke out in late 1990s and early 2000, the Congress was forced to take action. Some of the largest scandals involving Enron and WorldCom resulted in very large corporate bankruptcies.

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Due to its role as the auditor of these companies, Arthur Andersen was at the center of several of these scandals and the firm collapsed when criminal charges were brought against this Big 5 firm. The Congress passed the Sarbanes-Oxley Act (SOX) of 2002. Section 101 of SOX established the Public Company Accounting Oversight Board (PCAOB) to oversee the public accounting profession. Section 104 of SOX assigned PCAOB the responsibility to inspect registered public accounting firms and to issue a report on its findings.

Since the early 2000, the PCAOB has been overseeing the reports of registered audit firms and has been publishing the reports of these firms. Some researchers have actually compared the reports of the PCAOB to other peer review reports on same audit firms (Anantharamann, 2012; Lennox and Pittman, 2010). Others have examined the audit quality in line with the type of reports issued to firms (Gunny and Zhang, 2009). In some other studies, the researchers tried to examine whether the effect of peer review reports on firms over time improves (Colbert and O' Keefe, 1995) while, Payne (2003) looked at the effect of frequency of inspection on audit quality.

In all of these studies outlined so far, none looked into the relationship between the reports and the firms' characteristics. Therefore, this paper makes the following incremental contributions to the literature. It extends prior research in the area of PCAOB inspection reports in three ways. Firstly, while several studies have examined the PCAOB inspection reports (part I) and/or AICPA peer review reports, this study examines the weaknesses identified in the PCAOB part I & II reports. Secondly, the PCAOB reports are compared both to (i) all peer review firms and (ii) to peer review firms that received modified or adverse opinions using descriptive analysis while this study used the regression analysis on PCAOB's reports only. Thirdly, it uses an OLS regression to examine the relationship between PCAOB reports and firms' characteristics.

This paper is organized as follows; section two describes the PCAOB review process. Section three outlines prior research in this area. Section four describes the methodology and data sources. Section five provides a brief overall discussion of the results and a summary.

2. Pcaob Review Process

The PCAOB has adopted the supervisory model and uses a risk-based audit approach to seek out areas where audit problems are most likely to occur. The PCOAB inspection report contains four parts. Part I of the report is captioned "Inspection Procedures and Certain Observations." Part I gives some information about the registered firm that is being inspected – the name, number of audit offices, number of partners (sole proprietor, shareholder), number of professional staff, number of issuer clients, dates of inspection, etc. Part I also describes the type of inspection (audit engagement review and/or Quality Control System review), number of issuers (names not identified) examined, and significant deficiencies discovered during the audit engagement review. All of the above information is made public by PCAOB by posting it on the Board's website. However, results of the Quality Control System review are not disclosed to the public initially.

Part II and part III are the non-public portions of the inspection report. Part II of the PCAOB Inspection report is titled "Issues Related to Quality Controls (QC)" and it contains non-public information and is omitted initially from public portion of the report. The inspected firm is given a year to remediate the quality control deficiencies identified by the inspection team. If these quality control criticisms are addressed to the satisfaction of the PCAOB, the criticisms are not made public. If the inspected firm fails to address these deficiencies within 12 months, the PCAOB issues an amended inspection report and publicly discloses these quality control deficiencies. According to PCAOB, QC engagement performance standard refers to:

The quality control policies and procedures applicable to a firm's accounting and auditing practice should encompass the following elements:

a. Independence, Integrity and Objectivity
b. Personnel Management
c. Acceptance and Continuance of Clients and Engagements
d. Engagement Performance
e. Monitoring. (PCAOB, 2014, Part II)

In reports issued to "Firms" the description of some deficiencies included the following illustrative language:

- ✓ ''The inspection team considered certain of the deficiencies that it observed to be audit failures''.
- ✓ "Certain of the identified deficiencies were of such significance that it appeared that the Firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting ("ICFR")."
- ✓ "[D]epartures from GAAP that it [the Firm] should have identified and addressed before issuing its audit report"
- ✓ "[D]eficiencies…relate[d] to auditing aspects of the issuers' financial statements that the issuers either restated or announced an intention to restate after the primary inspection procedures"
- ✓ "[O]ne of the identified deficiencies…was of such significance that it appeared that the Firm had not obtained sufficient appropriate audit evidence to fulfill the objectives of its role in the audit".
- ✓ "[F]ailures by the Firm to identify, or to address appropriately, financial statement misstatements"
- ✓ "[F]ailures to comply with disclosure requirements"
- ✓ "[F]ailures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures"
- ✓ "The Firm, however, failed to perform procedures, beyond inquiry of management, to assess the appropriateness of the change in the weighting between these [fair value] models."
- ✓ "Further, the Firm failed to obtain corroboration of management's explanations of significant unexpected differences between expected and actual revenues."
- ✓ "The Firm failed to sufficiently test the ALL [Allowance for Loan Losses], as its testing of this [new unallocated reserve] component was limited to obtaining a general understanding of how management developed the unallocated reserve, without testing any of the specific assumptions used in determining the recorded amount."
- ✓ "The Firm concurred with the issuer's conclusion that no allowance was required for certain loans classified as troubled debt restructurings based on the issuer's assumption that it was probable that the issuer would receive all payments in accordance with the restructured terms of the loans. The Firm, however, failed to test this assumption beyond inquiry of management."
- ✓ In testing the valuation of goodwill, "the Firm failed to evaluate, beyond inquiry of management, the reasonableness of the issuer's revenue and earnings projections."

- ✓ In testing the valuation of goodwill, "the Firm failed to sufficiently test important controls related to the development of certain key assumptions used in the issuer's impairment analysis, as it limited its procedures to observing evidence of management's review and evaluating whether the reviewers had the appropriate expertise."
- ✓ "The Firm failed to perform procedures, beyond reading a management-prepared memo and inquiring of management, to test the residual value of returned leased equipment."
- ✓ "For certain impaired loans that the Firm selected for testing, the Firm failed to test the specific reserves, beyond inquiring of management."
- ✓ "The Firm failed to adequately test a significant adjustment to the issuer's inventory and cost of sales in that it tested only certain elements of the adjustment and limited its procedures on those elements to inquiry."
- ✓ "Further, the Firm relied on management's uncorroborated representations to determine whether the issuer was in compliance with certain debt covenants."
- ✓ "[T]he Firm failed to perform sufficient procedures to test the valuation of contract revenue and costs, as it failed to perform procedures beyond inquiry to evaluate the changes in certain contract reserves etc." [PCAOB'S website; Davis, E.K. and L. Joe Moravy, (2013)].

3. Related Studies

Engagement (audit) performance deficiencies are key defects in the audit process. These are deficiencies that indicate that the engagement personnel have not complied with applicable auditing standards or regulatory requirements or firm's own standards of quality. Croteau (2011) argued that both the PCAOB and the audit firms have to concentrate on identifying the root causes of audit performance deficiencies. According to Croteau (2011), the PCAOB has started training its inspectors on the process of root cause analysis and the PCAOB's inspection processes have been revamped to include lessons learned from root cause analyses. He also called on the audit firms to include root cause analysis into firms' own internal quality control systems and address root causes of deficiencies.

Most researches in this area had compared the reports of the PCAOB to other peer review results. None had analyzed the PCAOB's report to its merits only. However, most of these studies have testified to the superiority of work performed by the PCAOB as against other peer reviewers; showing the worth of the PCAOB in enhancing audit quality. Therefore, in reviewing these studies we can also gain an insight into the reviewing process of the PCAOB.

Anantharaman (2012) examined a sample of 407 firms that received both a peer review opinion and a PCAOB inspection report and found that peer reviewers with similar industry experience as the peer reviewed firm tended to agree more with the PCAOB inspectors. Interestingly, the reports of peer reviewers in the same geographic area as the peer reviewed firm tended to be more unfavourable than the PCAOB inspectors. She also found that peer reviewers with industry expertise or from the same geographic area as the reviewed firms were able to provide opinions that are informative about future audit failures. Lennox and Pittman (2010) examined 1,982 peer review reports and 545 PCAOB inspection reports to understand audit quality signals. Their findings suggested that the audit clients of PCAOB inspected firms do not find the inspection reports to be useful as a signal for audit quality. They recommended that the PCAOB inspectors include an evaluative summary and a quality rating of the firm they inspected. Gunny and Zhang (2009) examined a sample of 295 PCAOB inspection reports. They used four proxy measures for audit quality: 'abnormal current accruals, propensity to restate earnings, propensity to just meet an analyst forecast, and propensity to issue a going concern.' They found that lower audit quality is positively associated with firms which received a seriously deficient inspection report from the PCAOB.

Colbert and O'Keefe (1995) showed that firms that regularly and continuously participated in peer reviews audit quality got better over time. The fact that even after the PCAOB inspection became mandatory for firms that have issuer audit clients, these firms subjected themselves to peer reviews as well indicated that there are benefits associated with peer reviews. It is certainly possible that both peer reviews and PCAOB inspections have their strengths and weaknesses (Anatharaman, 2012).

Payne (2003) looked at the effect of frequency of inspections on audit quality. Payne used a simulation with college students as participants. Some participants in Payne's experiment played the role of auditors and others portrayed clients. Payne analyzed the behaviour of the participants and noted that the clients were willing to pay higher audit fees if the auditor was peer reviewed annually rather than triennially. Further, Payne observed that clients were willing to pay higher fees if the auditors who were reviewed triennially had their review more recently than others who had their review not as recently (but still within the three year period).

However, the "clients" had access to the full inspection reports (peer reviews) that were performed on the prospective auditor. The peer review reports, apparently, were emphasized as being an important quality factor in auditor selection and auditor fees.

Offermanns and Peek (2011) examined market reactions to 224 first-round and 134 second-round PCAOB inspection reports issued between January 2005 and March 2010 and conclude that these reports were useful indicator of audit quality. They showed that shareholders care about the signals about audit quality contained in the inspection reports by documenting significant stock price reactions to these deficiency reports. They demonstrated that the magnitude of these stock price reactions is about 29 percent of market response to earnings announcements. Their findings strongly apply to small audit firms that audit less than 100 issuers. Landis, Jerris, and Brasswell (2011) examined 770 PCAOB inspection reports issued between 2005 and 2008. They argued that small audit firms have more opportunities to improve audit quality and suggested that the PCAOB inspection reports can be used to motivate triennial firms to remediate the defects. They also reported that the number of part I deficiencies identified decreased with time. This declining trend is consistent with either improved audit quality over time or a change in PCAOB inspection philosophy. Hermanson and Houston (2007) and Hermanson, Houston, and Rich, (2008) concluded that firms that received QC criticisms are smaller, have fewer audit resources and are understaffed.

4. Methodology and Data Description

We adopted the historical research design. This is because the data used for the study are ex-post in nature. The PCAOB makes available its inspection reports on its website as soon as it is ready to post it. As of February, 2014, the PCAOB had posted inspection reports for 2,073 firms. Of these 2,073 firms inspected by the PCAOB, 107 firms' quality control reports (part II) criticisms were made public. Out of these 107 firms, fifty six firms were randomly selected to represent unresolved reports and fifty two clean firms were also randomly selected from 1,966 firms' reports. Therefore, a combined number of 108 firms inspected by the PCAOB inspection team constituted our sample. The data used for the study were secondary. The hypotheses are tested using T-statistics, Correlation analysis and OLS. The data used for this study were extracted from PCAOB's website.

The proposed models for this study are:

$$NOAED = \lambda_0 + NOAF\lambda_1 + NPARTNER\lambda_2 + NPROSTAFF\lambda_3 + NAC\lambda_4 + \lambda_K \quad \text{.....EQ (i)}$$

$$NOAQD = \beta_0 + NOAF\beta_1 + NPARTNER\beta_2 + PROSTAFF\beta_3 + NAC\beta_4 + NOAED\beta_5 + \beta_K \text{.....EQ(ii)}$$

The null hypotheses would be: H_0: $\lambda\beta_k = 0$, where k = 1…4 & 5.

Table I: Variable Measurements and Coding

	MEASUREMENTS	CODE
DEPENDENT VARIABLES	Number of Engagement performance Defici	NOAED
	Number of Audit Quality Deficiencies	NOAQD
INDEPENDENT VARIABLES	NUMBER OF Audit Offices	NOAF
	Firm Status	FTYPE
	Number of Partners, Proprietors and Shareh	NPARTNER
	Number of Professional Staff including othe	NPROSTAFF
	Number of audit clients	NAC

5. Data Analysis and Results Discussions

The firms examined were classified as shown in table II below.

Table II: Classification of Firms Examined

	Number	**Percent of Reports**
Total Sample Size	**108**	**100**
Total Firms With Clean Audit Reports on Issuers	**52**	**48**
Total Firms With unresolved Audit Reports on Iss	**56**	**52**

Source: Extracted from pcaob's website (2014)

From table II, 108 firms were sampled comprising of 52 clean firms representing 48% while 56 firms with unresolved reports were used representing 52% of the total firms sampled. The characteristics of these firms were analyzed to determine the factors that can explain the nature of the reports that are issued. The result of the descriptive statistics is shown below.

Table III: Mean and Standard Deviation Report

VARIABLES	PANEL A (Clean Report Firms)		PANEL B (Unresolved Report Firms)	
	Mean	Standard Dev.	Mean	Standard Dev.
NOAF	3	8	4	11
FTYPE	2	1	2	1
NPARTNER	10	14	6	8
NPROSTAFF	65	138	36	90
NAC	11	11	14	21
YR=Report Year	9	2	8	2
NOAED	1	2	3	2
NOAQD	0	0	2	2

Source: E-views descriptive statistic report (2014)

From the above table III, the result shows that firms in Panel A have average number of 3 offices with 10 partners and 65 professional staff resulting to a total workforce of 75. The average number of clientele is 11 while Panel B shows an average number of offices of 4 with 6 partners and 36 professional staff leading a total workforce of 42 and an average of 14 clients. The result has shown that firms in panel B i.e. unresolved quality control deficiencies are spread over the countries where they operate with larger number of offices than those with clean report. By implication, it can be said that unresolved quality control firms are more business-like than clean reports firms. Panel B firms also displayed an average number of partners and professionals of 6 and 36 respectively, with a large clientele of 14 on the average while on the other hand Panel A firms have average number of partners and professionals of 10 and 65 respectively, with clientele of 11 on the average. By implication, Panel A firms have more workers with lesser work load. By extension, this explains why they conduct a better audit engagement with better quality control; the manpower is there to meet with the challenging nature of the job. Based on the descriptive statistics, the features of the firms descriptively explain critical issues of the firms. To ascertain the extent of impact the variables have on the type of report a firm gets, we conducted correlation analysis on the variables to test whether there is perfect association between the variables. This is because, a perfect association means multicolinearity and this can affect the result of the regression.

Table IV: The Correlation Result between Clean Report (QCN), Unresolved Quality Control Reports (QCD) and the Firms Characteristics

Dependent variable / Independent variables	QCN %	QCD %
NOAF	-0.04	0.02
FTYPE	-0.25	0.08
NPARTNER	0.32	-0.003
NPROSTAFF	0.24	-0.003
NAC	0.03	-0.01
NOAED	-0.61	0.03
NOAQD	-0.67	100

Source: Eviews Correlation Result (2014)

The correlation result from table IV above, has shown that clean report have positive or direct association with the number of partners (NPARTNERS), number of employees (NPROSTAFF), and number of clients (NAC) (r= 0.32, 0.24, and 0.03) respectively. But, clean report have indirect association with the number of audit offices (NOAF), firm status (FTYPE), number of audit engagement deficiencies (NOAED) and number of audit quality control deficiencies (NOAQD) (r = -0.04, -0.25,-0.61 and -0.67) respectively. This implies that the more clean reports are acquired by the firms the more their partners, professionals and clientele they have while, the less clean report are gotten, the more the number of audit offices, firm status, the number of audit engagement deficiencies and quality control deficiencies.

For unresolved quality control report firms (i.e. Panel B), the more the number of quality control deficiencies, the more the number of offices (NOAF), the higher the firm status (FTYPE) and the more the number of audit engagement deficiencies (NOAED) (r = 0.02, 0.08 and 0.03) respectively. But, Quality control report firms have indirect association with the number of partners (NPARTNERS), number of professionals (NPROSTAFF), number of clients (NAC) (r = -0.003, -0.003, and -0.01) respectively. This result shows that, the more the firms have quality control problems the lesser the number of partners, professionals and even clients. By implication, this shows that, clients consider the performances of firms in making choice of audit firms, since the result shows that the higher the default, the lesser the clientele. On these notes, we ran a regression analysis to test for the explanatory power of the independent variables on the dependent variable.

Table V: Regression Result Showing the Explanatory Power of the Independent Variables

Dependent Variable: QCN (NOAQD)				
Method: Least Squares				
Sample(adjusted): 108				
Included observations: 108 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	**0.1419** (1.8160)	**0.2973** (0.6964)	**0.4772** (2.6079)	**0.6343** (0.0120)
NOAF	**-0.0068** (0.0206)	**0.0054** (0.0231)	**-1.2544** (0.8912)	**0.2126** (0.3772)
FTYPE	**-0.1475** (0.0768)	**0.0492** (0.2761)	**-2.9979** (0.2782)	**0.0034*** (0.7821)
NPARTNER	**0.0094** (-0.0026)	**0.0039** (0.0828)	**2.4005** (-0.0319)	**0.0182**** (0.9747)
NPROSTAFF	**0.0003** (-0.0027)	**0.0004** (0.0071)	**0.8228** (-0.3757)	**0.4126** (0.7088)
NAC	**-0.0054** (-0.013)	**0.0026** (0.0132)	**-2.0624** (-0.9890)	**0.0418**** (0.3275)
NOAED	**NA** (0.2825)	**NA** (0.1054)	**NA** (2.6808)	**NA** (0.0100*)
R-squared (R-squared)	**0.3107** (0.1695)	**F-statistic** (F-statistic)		**6.4374** (1.6664)
Adjusted R-squared (Adjusted R-squared)	**0.2624** (0.0678)			
Durbin-Watson stat (Durbin-Watson stat)	**0.6761** 2.08	**Prob(F-statistic)** Prob(F-statistic)		**0.0000002*** (0.14934)

Note: Clean Report in Bold (Panel A) and Unresolved Reports in Brackets(Panel B)

The result of panel A shows that the independent variable can explain between 31 to 26 percent ***[R^2 (Adjusted R^2) = 0.31 (0.2624)]*** while panel B shows that the independent variable can explain between 7 to 16 percent ***[R^2 (Adjusted R^2) = 0.1695 (0.0678)]***.

The result has shown that there are about 69 to 74 percent extraneous factors which explain clean report firms and about 83 to 93 percent extraneous factors explain unresolved reports. The **R^2** value of **0.2624** indicates that about **26%** of audit firm's characteristics explain **clean report** while, **R^2** value of **0.0678** indicates that about **7%** of audit firm's characteristics explain unresolved reports. It simply shows that, about **74%** systematic variation exist in **clean report** and about **93%** systematic variation exist in unresolved reports that are left unaccountable for by the model. The implication of this report is that, unresolved report has more extraneous variables that can explain it than clean report.

In support of the above, the F-statistic measures the overall significance of the model, that is, whether **R^2** (R^2) = **0.2624** (0.068) is different from zero. The **R^2** (R^2) values of **0.2624** (0.068) are different from zero and the **clean report** is statistically significant at 1% while, unresolved report is not statistically significant at 1% or 5% levels of significance. The coefficients for clean reports show statistical significance for all variables except for NOAF and NPROSTAFF. The Durbin-Watson statistic employed as a model to test for auto- correlation and partial auto-correlation; although, its result is not relevant here because the study was a cross-section analysis.

The sign of the estimated coefficient for the Firm status (FTYPE), Number of Partners (NPARTNERS), number of clients (NAC) and Number of Audit Engagement Deficiencies (NOAED) are consistent with expectations. The t-statistics of the slope coefficient of above variables are **-2.998, 2.401, -2.062** and 2.681 are observed to be significant at **1%, 5%, 5%** and 1% levels of significance for **clean report** and unresolved report respectively. In particular, an increase in NPARTNERS and Number of Professional Staff (NPROSTAFF) improve the audit firms' clean report by 0.9% and 0.03%. It could be observed from the findings of this study that there exist positive relationships between **NPARTNERS, NPROSTAFF** and clean report while NOAF, FTYPE, NOAED and unresolved reports are positively related also during the periods under review. However, **Number of Audit Office (NOAF), Firm TYPE (FTYPE) and Number of Audit Clients (NAC)** are indirectly related with clean report while, NPARTNER, NPROSTAFF and NAC have negative relationship with unresolved reports during the periods under review.

6. Conclusion

In this study, we examined the relationship between firm characteristics and the two types of audit reports by PCAOB. These reports in this study are classified as clean report and unresolved report. The clean report firms are those firms which do not have quality control deficiencies and / or those whose quality control deficiencies were rectified within the provided one year. Unresolved report firms are firms with unresolved quality control deficiencies i.e. those firms which have not cleared their quality control deficiencies after the stipulated period and whose reports are shown as unresolved.

From the analysis and findings, we conclude that clean report firms continue to remain clean as their work force increases while the more the number of audit offices and number of audit clients increase the lesser the clean report. This result is consistent with anecdotal expectations which expect audit quality to increase with quality of workforce and reduce with expansion which do not consider staff/clients ratio as well as staff/audit office ratio.

On the other hand, it was observed that the increase in the number of audit offices and increase in the number of audit engagement deficiencies increase the rate of unresolved reports while, the increase in the number of workforce and audit clientele reduces the number of unresolved report firms.

Conclusively, number of clientele is an active ingredient for quality of firms report. That is, firms with clean report should watch out to know the number of clients that keep their work load at the level that will not jeopardize their quality. Firms with unresolved report suffer from less patronage and when patronage increases then the tendency is that its report will move to clean. We also, conclude that the size of workforce as represented by number of partners and professional staff is very key to quality of reports. This is because, as these duo increase, the more the quality of firm report increases on both report types. We therefore recommend that the PCAOB should encourage firms to increase workforce because, the result of this study has shown that, the number of professionals and partners impacts greatly on the quality of report by audit firms.

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