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A content analysis of CPA firms' correspondence following PCAOB inspections: 2004–2010

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ABSTRACT

The Public Company Accounting Oversight Board (PCAOB) has conducted well over 1000 inspections of public accounting firms since 2004, the year their inspections began. The PCAOB inspections are mandated by the *Sarbanes–Oxley Act of 2002*, and are designed to promote high professional audit standards and improve the audit quality of registered public accounting firms (U.S. House, 2002) Since then, a growing body of research has emerged focusing on the process, results, and decision implications of the inspections. Most of the research to date has focused on determining the impact of the inspection regimen from the perspective of regulators, clients, or markets, but there has been very little research focused on the effect of inspections on the accounting firms themselves.

We evaluate the letters provided by triennial audit firms (100 or fewer issuer clients) to the PCAOB in response to their inspections. The response letters provide insight into what the firms themselves think about the value of the inspection and the results of the inspections. Our study and its findings are particularly timely in light of the PCAOB Chairman James Doty's recent speech (Doty, 2011) in which he claimed that deficiencies were concrete instances of audit failure, and sharply criticized the responses of many audit firms who received inspection deficiency reports, most of whom maintain that their deficiency finding resulted from either differences in professional judgment or inadequate documentation, or both (but not audit deficiencies).

We find that a majority of firms writing response letters (1) state they support the PCAOB's objective of improving audit quality and (2) believe the inspection process will lead to higher audit quality. However, a substantial majority of firms that had an audit engagement deficiency disagreed with the PCAOB's evaluation, citing differences in professional judgment and/or documentation issues. Our findings do not support but run counter to the PCAOB Chairman's criticisms and insistence that inspection deficiencies are not attributable to professional judgment differences.

Introduction

The Public Company Accounting Oversight Board (PCAOB) has conducted well over 1000 inspections of public accounting firms since 2004, the year their inspections began. The purpose of PCAOB inspections was not only to fulfill the mandate required by Congress in section 104 of the *Sarbanes–Oxley Act of 2002* (SOX), but also to promote high professional standards and improve the audit quality of registered public accounting firms by assessing accounting firms' degree of compliance with the Act and professional standards (U.S. House, 2002). Since then, a growing body of research has emerged focusing on the process (Glover, Prawitt, & Taylor, 2009), results (Gunny & Zhang, 2009; Hermanson & Houston, 2008; Hermanson, Houston, & Rice, 2007; Hermanson, Houston, Rice, & Ye, 2010; Roybark, 2006, 2009), and decision

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implications (Abbott, Gunny, & Zhang, 2008; Gramling, Krishnan, & Zhang, 2011; Lennox & Pittman, 2010; Robertson & Houston, 2010) of the inspections. Most of the research to date has focused on determining the impact of the inspection process from the perspective of regulators, clients, or markets, but there has been little research focused on the accounting firms' responses to inspections, even though Robertson and Houston (2010) show that investors evaluate the credibility of inspected firms' responses.

Because part of the PCAOB's vision is to improve audit quality and reduce the risks of audit failure (PCAOB., 2008), it is vital that its inspection process effectively promotes those objectives. By considering firms' feedback, the PCAOB should be able to refine its inspection process, allocate capital and manpower more effectively, and better match its expertise to its process needs.[1] The PCAOB has been criticized for its standard-setting and inspection models (Glover et al., 2009), and any evidence regarding quality improvements among small audit firms – those widely regarded as providing lower quality audits – attributable to the inspection process could potentially be useful in strengthening its inspection model. In this respect, written firm responses provide insight into the PCAOB's process, methods, and conclusions that are simply not available anywhere else. An evaluation of response letters thus provides important information to regulators concerning the inspection process.

In addition, Wainberg, Kida, Piercey, and Smith (2011) demonstrate that the anecdotal data presented in PCAOB reports of small audit firms can lead to incorrect perceptions of small firms since users tend to focus on the anecdotal information even in the presence of informative quantitative or statistical data. If that is true, the firm's response letter is an important counterweight or complement to the anecdotal information contained in the report since it allows the firm to bring up private, disconfirming (or confirming) evidence, which could have the effect of reducing the information asymmetry among the firm, its client, and the regulator.

In this paper, we evaluate the letters provided by triennial firms to the PCAOB in response to their inspections.[2] In the aggregate, the response letters provide insight into what the firms themselves think about the value and results of the inspections; in particular cases, they illustrate both strengths and weaknesses of the inspections on the firms. Reviewing the firm responses to the inspections seems particularly timely since the Chairman of the PCAOB, James Doty, recently delivered a speech in which he pointedly criticized the response that many firms make to a deficiency finding: that is, that the deficiency finding reflects either differences in professional judgment or inadequate documentation, or both (Doty, 2011). Since the PCAOB directly disputes that claim, it is important to evaluate the response letters themselves to determine how often such claims are made and what facts or circumstances are detailed that may support them.

We first categorize the response letters into three categories representing their overall tone and content: Acknowledgments only, concurrences, and disagreements. This classification is based on our judgment of the principal points raised in the letter, and while many of the responses were easily classified, some required careful consideration and judgment to classify.[3] We then provide descriptive statistics of the responses across firm size, time, results of the inspection, and the particular inspection visit (i.e., whether it was the first, second, or third inspection of the firm). We also provide examples illustrating the themes that emerge from our analysis, as well as interesting or exceptional cases.

Our analysis is revealing. We find that 71% of firms responded to their first inspection, but the response rate falls with each subsequent inspection. This may reflect the improving inspection results in subsequent inspections, since we also find that firms with deficiencies respond much more frequently than firms without deficiencies, although we observe a monotonic decrease in the response rate as the severity of the deficiencies increases. We further find that a majority of firms writing response letters claim to support the PCAOB's objective of improving audit quality, but by a substantial margin, firms that were found to have had an audit engagement deficiency tend to disagree with the PCAOB's evaluation citing differences in professional judgment and/or documentation issues. A majority of those firms concede that there may have been some trivial deficiencies (usually related to documentation), but nothing that merits a finding that the firm failed to obtain sufficient evidence to support its audit opinion. This is a recurring theme throughout the responses, and suggests that one element of tension in the PCAOB's process is that it relies on (necessarily) *post hoc* judgments by its professionals to audit-related issues which may appear, after-the-fact, different than when the auditor faced them.

PCAOB inspection process for triennial firms

Under its mandate, the PCAOB inspects all auditing firms that audit at least one "issuer" client.[4] Firms auditing

[1] We believe firms' correspondence with the PCAOB can be a valuable source of feedback to the Board that has the potential to affect its decisions and policy. Rule 4007 notes that the Board can revise its report based on feedback from a firm's written response (PCAOB., 2011). In addition, the Board actively solicits feedback from audit firms in the small business community. On its website, the Board notes that it holds meetings throughout the country to which accounting firms in the small business community are invited to attend and give feedback directly to Board members. Since the Board seeks feedback from small firms, and response letters are a direct form of feedback, it is reasonable to suppose that letters potentially have some influence with respect to the Board's policy-making activities. See http://pcaobus.org/Information/Pages/PublicCompanies.aspx.

[2] Triennial firms are those firms having 100 or fewer issuer clients who are inspected on a three-year rotation. According to the PCAOB, smaller firms audit approximately 34% of issuers based in the United States (PCAOB., 2007).

[3] Some firms do not respond at all, and letters responding specifically to quality control deficiencies are not made public by the PCAOB unless such deficiencies have not been remediated within one year. Thus, we have five categories of responses in all – acknowledgment only, concurrence, disagreement, no response, and non-public response. Hermanson et al. (2007) employed a similar classification scheme, except that they further partitioned disagreements into those firms that defended their position and those that did not.

[4] The Sarbanes–Oxley Act defines "issuer" as follows: "The term 'issuer' means an issuer (as defined in section 3 of the Securities Exchange Act of 1934), the securities of which are registered under section 12 of that Act, or that is required to file reports under section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn."