# Audit and legal implications of PCAOB's inspections among BRIC



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## Abstract

**Purpose** – This paper aims to analyze Public Companies Accounting Oversight Board (PCAOB) inspection reports on audit reports of those inspected accounting firms in Brazil, Russia, India and China (BRIC). In meeting the requirements of the Sarbanes-Oxley Act, the PCAOB conducts inspections on audit reports of firms listed on the New York Stock Exchange.

**Design/methodology/approach** – The reports include those submitted by both the US audit parent firms and their secondary firms located outside the USA. In each PCAOB report, it unravels the nature of audit deficiencies. The focus is on Big Four because they play a dominant role in the marketplace and issuers' market capitalization. All the seven-year deficiencies are documented since publications of the reports from 2004 to 2012.

**Findings** – Of the 37 reports, 19 (51 per cent) were issued relating to audits conducted by the Big Four. Out of these 19 reports, 10 (53 per cent) contain inspection criticism. These include audit quality and common recurring audit deficiencies.

**Research limitations/implications** – This paper is based solely on those inspection reports published by the PCAOB.

**Practical implications** – The findings have significant implications to audit firms and the audit profession on improving audit quality, firms' internal control and reports.

**Originality/value** – No known prior research paper is available on the ramifications of the PCAOB's inspection reports relating to BRIC.

**Keywords** Regulation, Audit quality, Inspection reports, PCAOB inspections

**Paper type** Research paper

## Introduction

Are the Big Four firms in Brazil, Russia, India and China (BRIC) ready for Public Companies Accounting Oversight Board (PCAOB) audits? Can stockholders rely on audit quality and audit work of the foreign partner firms? This paper analyzes the PCAOB's inspection reports since its inception in 2004 till end of 2012. The seven-year trend helps identify key audit deficiencies of local representatives of the Big Four.

The inspection process represents a fundamental change in regulating the public accounting firms from a self-regulated regime by the American Institute of Certified Public Accountants (AICPA) to a statutory regulation. Incorporation of the PCAOB is to improve firms' audit quality (PCAOB, 2009) and to project quality and confidence, as

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well as firms' accountability and trust to the stakeholders, in particular the stockholders. All the US parent auditing firms remain responsible for audits conducted by their foreign secondary auditors. This means that secondary auditors are required to comply with the requirements as stipulated by the PCAOB. Given the scenario, literature (Church and Shefchik, 2012 and Daugherty *et al.*, 2011, and Robertson and Houston, 2010) remains focused on findings of inspections among the US firms. A typical inspection report by the PCAOB reveals the types of audit deficiencies, accounting restatements, extent of departures from generally accepted accounting principles (GAAP), inadequacy in documenting and insufficiencies in testing. Church and Shefchick (2012) focus on the reports for 2004-2009 on those large US accounting firms because of the issuers' market capitalization, while Daugherty *et al.* (2011) examine the implications of post-inspection outcomes of the reports (2004-2008) including auditors' resignations, clients' dismissals and auditors' cessation of the PCAOB registration. They find that deficiency reports are associated with triennially inspected auditors, that is, auditors who audit less than 100 issuers in a particular year, voluntarily resigned from their publicly traded clients and ceased to register with the PCAOB. This suggests that triennially inspected auditors with deficiency reports may be more likely to assess the post-inspection cost of regulatory compliance as greater than the rewards associated with auditing public companies. In summary, prior findings tend to focus on US data, while this paper fills the void of focusing on reports issued pertaining to the Big Four in BRIC. We ignored China in our analysis because of the PCAOB's inaccessibility to China due to foreign jurisdictions. Apart from China, countries that deny accessibility to audit files include Finland, France, Germany, Greece, Ireland, The Netherlands, Norway, Portugal, Sweden, Switzerland and the UK (PCAOB, 2010).

By examining the results of all the 37 inspection reports in detail, we can pinpoint the common and recurring audit deficiencies, while providing a general understanding of the overall inspection reports and allow firms and regulators to be aware of similar erroneous and failing audit quality. We focus on the inspection reports of those Big Four because Church and Shefchik (2012) report no significant differences regarding the audit quality between the Big Four and second-tier firms (BDO Seidman, Crowe Horwath, Grant Thornton and McGladrey & Pullen). Of these 37 reports, 19 (51 per cent) were issues relating to audits conducted by the Big Four. Out of these 19 reports, 10 (53 per cent) contain inspection criticism. Our findings are of interest to academics, practicing accountants, regulators and users of the inspection reports.

The remainder of the paper is organized as follows. First, we briefly summarize the PCAOB inspection process, including how the regulatory system came into place and the perceived benefits and drawbacks of the current system. Next, we describe how we code the findings of the inspection reports and then present our results. Last, we offer concluding remarks.

## The Public Companies Accounting Oversight Board inspection process

Prior to 2004, the AICPA conducted a mandatory peer review on selected firms on a three-year cycle. Although Woodlock and Claypool (2001) and Hilary and Lennox (2005) report that the AICPA's peer-review processes have benefited the firms, both Fogarty (1996) and DeFond (2010) report that the process was ineffective because the peer reviewers were not independent and the system was generally non-punitive. Despite criticism, the AICPA continues its peer-review program to monitor the members' audit quality. With the demise of Enron and its auditors Andersen, the US Securities and Exchange Commission (SEC) announced plans to overhaul the regulation of public accounting firms, and the US Congress passed the Sarbanes-Oxley Act (SOX) of 2002, which established the PCAOB and mandated that PCAOB to inspect accounting firms' audit papers and to assess their audit quality. The process intends to put a stronger grip on the audit processes, and reviews the internal controls of accounting firms and quality of their audits. In 2003, the PCAOB conducted scaled-down inspections of the Big Four accounting firms, meaning all audit reports by the Big Four are subject to inspections by the PCAOB because each firm has conducted more than 100 audits on the SEC firms in a particular year. From 2004 onward, the PCAOB conducted full-fledged annual inspections on all registered accounting firms with over 100 issuers and triennial inspections on small firms, that is, firms with 100 or fewer issuers in a particular calendar year. The PCAOB targets riskiest engagements, more specifically evaluates an accounting firm's quality control and reviews high-risk areas of high-risk audits. Upon completion of an annual inspection, the PCAOB issues a report to the accounting firm. Without identifying the issuers, the PCAOB publishes on its web link (www.pcaob.org) the date of the report, major deficiencies, and the firms' responses and date of responses.

Creation of the PCAOB's investigation processes address key ineffectiveness of the AICPA's reviewing processes. First, the PCAOB's inspection staff is independent. This means, inspectors are prohibited from being active auditing practitioners. Second, the PCAOB has investigative and disciplinary authorities over registered accounting firms that fail to comply with SOX; the rules of the PCAOB and the SEC; and other rules, laws and professional standards (PCAOB, 2003). For unintentional violations including any negligent acts, the PCAOB is authorized to levy fines of up to $100,000 per person and up to $2,000,000 per firm. For intentional violations, the amounts increase to $750,000 and $15,000,000, respectively. The PCAOB also has the authority to prohibit or to suspend an accounting firm from conducting audits of public companies by means of suspension or revocation of accounting firms' registrations. The change from being a self-regulated industry to a statutorily regulated one is a tradeoff of independence (Stigler, 1971; Peltzman, 1976; Ogus, 1995; DeFond, 2010), and the PCAOB staff members' technical knowledge can become outdated all too quickly, especially when compared to the AICPA's peer reviewers (Glover *et al.*, 2009; Hodowanitz and Solieri, 2005; Kinney, 2005). Despite this, we believe that the inspection processes will enhance auditors' performance and audit quality among audit firms. Being independent, the PCAOB has more authority than the AICPA for the oversight organization is authorized to impose penalties on failing auditors and to prohibit a firm from conducting an audit for a listed firm (DeFond, 2010). Failing to comply will bring shameful effects on the firm in terms of its reputations and images. The implication could spill over to the profession as a whole and may have huge implications on the confidence and accountability of the stakeholders (Cheng *et al.*, 2010).

On the other hand, inspectors may be under pressure to be critical of the others' audit work (Farrell and Shadab, 2005). The critics' pressure and unwarranted exposures may discourage some firms, in particular medium-sized firms, from accepting audit and assurance services for listed firms (Read *et al.*, 2004). We believe the inspection process promotes learning and mentorships among peers. Mutual supports and continuing dialogs help improve quality and performance. In the course of auditing a peer's audit files, inspectors discuss issues with the accounting firms' representatives and provide formal feedbacks on audit deficiencies and firms' quality controls (PCAOB, 2009). These detailed examinations of the inspection reports help reveal audit deficiencies that may undermine the audit quality and areas that firms and the audit profession could learn and progress in the techniques and approaches.

## Research method

We systematically examine all the inspection reports of the Big Four in Brazil, India and Russia for the period from 2004 to 2012. The reports are available from the PCAOB's website (http://pcaob.org/Inspections/Public_Reports/index.aspx), allowing us to analyze the audit deficiencies. The web does not contain any Chinese reports because the local authority does not allow the PCAOB to gain access and to inspect the audit files. In this respect, instead of BRIC, we confine our findings to Brazil, Russia and India. We adopt the PCAOB's definition of audit deficiencies which states that audit deficiencies are "those with lack of sufficient and competent evidential matter to support the audit opinion on the issuer's financial statements" (PCAOB, 2008).

### *Nature of deficiencies*

For the nature of deficiencies, we focus on identifying common auditing issues similar to those identified by the PCAOB (2008, 2010). Key deficiencies from the finding include the fact that the audit firms failed to follow-up on post-balance reviews and disclosures and the lack of sufficient and reliable audit evidence to support audit opinions. An interesting case pertaining to PricewaterhouseCoopers (PwC) in India reveals that the chairman of the issuer has misled the board of directors in the disclosure of and reporting of financial information including "inflated cash and bank balances, non-existent accrued interest, an understated liability, an overstated debtors' position and overstated revenues covering certain reporting periods". The firm subsequently informed the issuer that the firm's audit reports and opinions in relation to the financial statements for certain periods should no longer be relied upon. The Board has taken those developments into account in connection with its ongoing regulatory oversight activities regarding the firm, including in connection with the Board's assessment of the firm's quality control system. Although these reports reveal weaknesses in both the audit procedures, the PCAOB failed to identify the extent of the weakness and impact of the weakness in the firm's control systems.

### *Firms' responses to the Public Companies Accounting Oversight Board 's findings*

For each inspection report, we examine the firm's response regarding any disagreements to the PCAOB's findings included in the draft report. We find that all audit firms have responded to the PCAOB by acknowledging the PCAOB's findings. This differs from Church and Shefchik's (2012) finding that they encountered three other types of reports. This means that, apart from the audit firm acknowledging the PCAOB's findings but not mentioning any disagreement with the findings, they find some firms acknowledge differences in professional judgment between the firm and the PCAOB's inspectors, without explicitly disagreeing with the findings. Another approach is that the firm may disagree with some of the PCAOB's findings, but not provide a specific defense, and the last format was that the firm may disagree with some of the PCAOB's findings and offer specific arguments to defend their position.

**Results and conclusions**

Although the finding reveals a small number of deficiencies, this is an interesting insight into how audit firms operating in Brazil, Russia and India cope with the cross-border demand of the PCAOB. This study provides insight into the PCAOB's inspection results of large, annually inspected accounting firms (Table I). These inspection reports identify audit deficiencies that have implications for the audit quality. By examining the inspection reports in detail, we can assess the nature of audit deficiencies in Brazil, Russia and India from 2004 to 2012. Of the 37 reports, 19 (51 per cent) were issued relating to audits conducted by the Big Four. Of these 19 reports, 10 (53 per cent) contain inspection criticism. These criticisms are mainly on audit firms' failure to collect sufficient and reliable audit evidence and failure to review and disclose post-balance sheet events.

Our findings should be interpreted in light of various limitations. First, our samples are based on the BRIC. Without the Chinese data because of the Chinese SEC and jurisdictions that do not allow the PCAOB from investigating its audit files of the local practices, we focus on our findings from Brazil, Russia and India. Also, we focus on the audit findings of the Big Four that is Deloitte Touche, Ernst & Young, KPMG and PwC. The lack of details in the PCAOB inspection reports prevent us from conducting much-needed details on how and why these deficiencies have taken place. The standardized one-page response from accounting firms is vague and unhelpful, and it does not provide much details on the action plans of the firms in terms of improving their audit quality in future. Also, there is no mention on the firms' penalties imposed by the PCAOB, the parent auditors and the local regulators. All these seem to reflect upon the PCAOB's wasted efforts on having to conduct these inspection reports, while there is no immediate or firmed actions on those default foreign audit firms.

Notwithstanding these limitations, our analysis provides useful insights into the inspection results for all the accounting firms and the audit profession. Further research is needed to follow up the PCAOB inspections and whether the inspection process has enhanced the audit quality and, more importantly, the impact of these criticisms including stock prices of the issuers, impact and reputation of the firms on their recruitment strategies for interns and placements and implications on the firms' market niche and audit fees. The aim is to isolate the effect of inspection outcomes on suitable proxies for audit quality (Bedard *et al.*, 2010). Also, this will help extend the research direction on implications of a particular International Accounting Standards on the sector (for example, Chong *et al.* (2012) reveal a deficiency on compliance by banks in the USA). A longitudinal review on the progress could help reveal the extent of success and impact of the inspection reports to the audit profession and regulators. Also, focus group discussions and semi-interviews with representatives of the PCAOB could be useful to understand how the inspectors have conducted the audits and key challenges of how the audits were being conducted, in particular in the foreign soils that uphold their own rules and jurisdictions. The PCAOB need to be transparent on how the sample firms were selected, in particular the extent of materiality and risk (Chong, 1992). In all aspects, the audit firms should conduct the audits based on highest level of integrity and honesty, without compromising their reputations and images. While some researchers have begun to address this issue (Gunny and Zhang, 2009; Carcello *et al.*, 2010), the empirical challenges remain daunting. The PCAOB needs to exercise its stipulated power and authorities to enforce full compliance by local auditors. Pressuring the

**Table I.**
An analysis of the inspectors' reports (2004-2012)

| Countries | Brazil | Russia | India | Total |
|---|---|---|---|---|
| Total number of reports | 10 | 10 | 17 | 37 |
| Total reports on the Big Four audits | 6 | 6 | 7 | 19 |
| The Big Four audits with criticism | 4 | 1 | 5 | 10 |
| Number of deficiencies noted on the Big Four audits | 4 | 1 | 5 | 10 |
| Key deficiencies: post-balance sheet review and disclosures | 4 | 1 | 5 | 10 |
| Key deficiencies: lack of sufficient audit evidence | 4 | 1 | 5 | 10 |

| Firm | PCAOB criticism | Audit engagement | Key deficiencies |
|---|---|---|---|
| *Brazil* | | | |
| Deloitte Touche Tohmatsu Auditores Independentes | No | | |
| Deloitte Touche Tohmatsu Auditores Independentes | Yes | 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. In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure<br>PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence. The Board inspection process did not include review of any additional audit work related to the restatement | Post-balance sheet review and disclosures<br>Lack of sufficient audit evidence |

(*continued*)

Table I.

| Firm | PCAOB criticism | Audit engagement | Key deficiencies |
| --- | --- | --- | --- |
| Ernst & Young Auditores Independentes S/S | Yes | 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. In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure<br>PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB in sections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence | Post balance sheet review and disclosures<br>Lack of sufficient audit evidence |
| Ernst & Young Terco Auditores Independentes S.S. | No | | |
| KPMG Auditores Independentes | Yes | 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. In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence | Post-balance sheet reviews and reporting<br>Poor documentation and obtaining of audit evidence |

(*continued*)

Table I.

| Firm | PCAOB criticism | Audit engagement | Key deficiencies |
|---|---|---|---|
| Price waterhouse Coopers Auditores Independentes | Yes | 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. In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure<br>PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence | Post-balance sheet review and disclosures<br>Lack of sufficient audit evidence |
| *Russia* | | | |
| Ernst & Young LLC | No | | |
| KPMG Limited | No | | |
| Limited Liability Company Ernst and Young | Yes | 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. In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9; Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence | Post-balance sheet review and disclosures<br>Lack of sufficient audit evidence |
| ZAO Deloitte Touche | No | | |
| ZAO Deloitte Touche | No | | |
| ZAO Price waterhouse Cooper | No | | |

(*continued*)

Table I.

| Firm | PCAOB criticism | Audit engagement | Key deficiencies |
|---|---|---|---|
| *India* | | | |
| Deloitte Haskins & Sells | Yes | In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or eached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9 and Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence. The deficiencies identified included a deficiency of such significance that it appeared to the inspection team that, in one of the audits in which the Firm played a role but was not the principal auditor, the Firm had not obtained sufficient competent evidential matter to fulfill the objectives of its role in the audit. That deficiency was – the failure to perform sufficient audit procedures to test general computer controls | Post balance sheet review and disclosures<br>Lack of sufficient audit evidence |
| Deloitte Haskins & Sells | Yes | 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. In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9; Appendix A to AS No.3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence. Those deficiencies were: the failure to project misstatement results of a sample, related to the Firm's testing of revenue, to the items from which the sample was selected;<br>the failure to perform sufficient procedures related to the existence of accounts receivable; and | Post balance sheet review and disclosures<br>Lack of sufficient audit evidence |

(*continued*)

Table I.

| Firm | PCAOB criticism | Audit engagement | Key deficiencies |
|---|---|---|---|
| Ernst & Young | Yes | In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9 and Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence. The deficiencies identified included deficiencies of such significance that it appeared to the inspection team that, in two of the audits performed by the Firm, the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. Those deficiencies were:<br>the failure to perform sufficient audit procedures related to revenue, including the inadequate performance of substantive analytical procedures; and<br>the failure to perform sufficient audit procedures with respect to the existence of accounts receivable. The deficiencies identified also included deficiencies of such significance that it appeared to the inspection team that, in the audit in which the Firm played a role but was not the principal auditor, the Firm had not obtained sufficient competent evidential matter to fulfill the objectives of its role in the audit. Those deficiencies were:<br>the failure to perform sufficient audit procedures with respect to income tax contingencies; and<br>the failure to perform sufficient audit procedures with respect to cash and cash equivalents | Post balance sheet review and disclosures<br>Lack of sufficient audit evidence |
| Ernst & Young | No | | |
| KPMG (2008 Inspection) | No | | |
| KPMG (2010 Inspection) | Yes | In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, Audit Documentation ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9 and Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence. The deficiencies identified included deficiencies of such significance that it appeared to the inspection team that, in one of the audits performed by the Firm, the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements or ICFR. Those deficiencies were:<br>the failure to perform sufficient audit procedures to test the existence of the issuer's investment securities; and<br>the failure to perform sufficient audit procedures to test the issuer's information technology ("IT") change management controls and processes. The deficiencies identified also included deficiencies of such significance that it appeared to the inspection team that, in the engagement in which the Firm played a role but was not the principal auditor, the Firm had not obtained sufficient competent evidential matter to fulfill the objectives of its role in the audit. Those deficiencies were:<br>the failure to perform sufficient audit procedures to test legal liability accruals and related disclosures relating to litigation, claims and assessments; and<br>the failure to perform sufficient audit procedures to test the existence of cash and investment securities | Post balance sheet review and disclosures<br>Lack of sufficient audit evidence |

(*continued*)

| Firm | PCAOB criticism | Audit engagement | Key deficiencies |
|---|---|---|---|
| Price Waterhouse (Bangalore) | Yes | Following the performance of the inspection procedures, a significant issue came to light that had not been identified in the inspection review. Specifically, the issuer disclosed that its then Chairman had informed the board of directors of misstatements in the audited financial statements involving, among other things, inflated cash and bank balances, non-existent accrued interest, an understated liability, an overstated debtors' position and overstated revenues covering certain reporting periods. The Firm, subsequently, informed the issuer that the Firm's audit reports and opinions in relation to the financial statements for certain periods should no longer be relied upon. The Board has taken those developments into account in connection with its ongoing regulatory oversight activities regarding the Firm, including in connection with the Board's assessment of the Firm's quality control system | Post-balance sheet review and disclosures for the chairman has misled the board |

Table I.

international governments and authorities for allowing the inspection process is a way forward and educating the local regulators could be another way forward (Chong and Vinten, 1998). This line of research is needed to shed light on the efficacy of the PCAOB inspection process and extent of compliance with the International Auditing Standards.

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