

## **SARBANES-OXLEY ACT AND THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S FIRST ELEVEN YEARS**

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**ABSTRACT:** the sarbanes-oxley act (sox) of 2002 was, no doubt, the most significant accounting and auditing legislation enacted in recent history. One of the major components of this law was the creation of the public company accounting oversight board (pcaob). Although it has only been in existence since July 30, 2002, the body has been extremely active in registering and inspecting accounting firms that audit public corporations, establishing auditing, ethics, independence, and quality control standards, and protecting investors and the general public by promoting accurate and independent audit reports.

### **INTRODUCTION**

The Sarbanes-Oxley Act, also known as the Public Company Accounting Reform and Investor Protection Act (Senate title) and the Auditing Accountability and Responsibility Act (House version), was signed into law by President George W. Bush on July 30, 2002 (Pub.L. 107-204). One of the major provisions of this legislation was the creation of the Public Company Accounting Oversight Board. The PCAOB defines itself as a nonprofit corporation established by Congress to oversee the audits of public companies (PCAOB, 2013). The PCAOB's declared mission is to "oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." Its related vision statement emphasizes that the PCAOB seeks to be a model regulatory organization.

It is obvious from these mission and vision statements that the PCAOB has a significant, if not monumental, set of tasks to accomplish. The original duties of the PCAOB, established by SOX, were broadened in 2010 with the passage of the Investor Protection and Securities Reform Act of 2010 (Pub.L. 111-203). This more recent legislation expanded the PCAOB's oversight to include brokers and dealers of securities. Subtitle I of this law expands the PCAOB's oversight duties to include "brokers and dealers" as defined in section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)). As of July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (a common name for this legislation) expanded the PCAOB's oversight of the audits of brokers and dealers to include inspections, enforcement, and standard setting authority.

In addition to establishing the PCAOB, SOX enacted changes to auditor independence that included the banning of consulting services by the independent accounting firm. Congress felt that accounting firms who were doing a major amount of management consulting services in addition to auditing lost their independence. In effect, the auditors were auditing a significant amount of their own work (consulting) and were very likely to find no problems in the firm's operations. In addition, SOX also required audit partner rotation every five years and enhanced the powers of the audit committee. Following SOX, auditors reported and were overseen by the company's audit committee, not management. Also, the audit committee was responsible for approving all services provided by the independent accountant. Finally, the auditor is required to report new information to the audit committee. This includes critical accounting policies and practices used and accounting disagreements between the auditor and management.

In order to accomplish these many significant goals, a five member PCAOB board is appointed by the Securities and Exchange Commission (SEC). The members are appointed to staggered five year terms. Current members include James R. Doty (Chairman), Lewis H. Ferguson, Jeanette M. Franzel, Jay D. Hanson, and Steven B. Harris. The importance of the audit committee is evident in the comments by the chairman, James R. Doty, in the 2012 PCAOB's annual report. He states that "the role of the audit committee has been a point of focus within the PCAOB" (PCAOB Annual Report, 2012).

### **ADDITIONAL DUTIES OF THE PCAOB**

The PCAOB was created by Congress to accomplish a number of specific responsibilities. These include the registration of public accounting firms in order to be able to conduct audits of public corporations. In addition, the board is entrusted to create necessary standards in the areas of auditing, ethics, independence, and quality control. An additional duty of the PCAOB is the inspection of public accounting firms relative to their auditing practices. This includes enforcing compliance through a variety of fines and penalties.

SOX required the PCAOB to register all accounting firms that provide audit services to public companies. Rule 2100 requires that effective October 22, 2003, every public accounting firm that prepares and issues an audit report (or plays a substantial roll in this process) must be registered with the PCAOB (PCAOB Rules, 2013). As of April 1, 2013, a total of 2,374 public accounting firms (both U.S. and non-U.S.) were registered with the PCAOB (PCAOB, Inspections, 2013). SOX authorizes the PCAOB to inspect registered firms to assess compliance with laws, rules, and professional standards related to the

firm's audit work completed on "issuer" clients. These are public accounting firms that audit one or more public corporations.

There are a number of forms that all public accounting firms must prepare in order to register with the board (PCAOB, Forms, 2013). Form 1 is the application for registration. They must be submitted electronically and approved by the board. All public accounting firms desiring to register must pay the initial application fee. This fee is based on the number of issuer audit clients that the public accounting firm serves (PCAOB, Fees, 2013). In addition to the application fees, there are annual fees that must be paid by the registered firms. Firms with less than 200 issuer clients pay an annual fee of \$500. For larger firms with more than 200 issuer clients and more than 1,000 personnel, the annual cost increases to \$25,000. Finally, public accounting firms with more than 500 issuer clients and more than 10,000 personnel pay an annual renewal fee of a healthy \$100,000. These fees represent the bulk of the revenues generated for the operation of the PCAOB.

In general, the PCAOB inspects public accounting firms that audit more than 100 issuers, brokers, or dealers on an annual basis. Those firms that audit less than 100 per year are typically inspected triennially (every 3 years). Many of the 2,374 public accounting firms that are registered with the PCAOB currently do no auditing of issuer, broker or dealer clients. A relatively small number of firms are inspected by the PCAOB on an annual basis. In 2013, there were only nine public accounting firms receiving annual inspections. They included BDO USA, LLP, Crowe Horwath LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, MaloneBailey, LLP, McGladrey LLP, and PricewaterhouseCoopers LLP. SOX requires the PCAOB to prepare a summary report on each inspection that it completes. A portion of this report is publically available when issued. Other portions of the report, such as a "discussion of potential defects in the firm's system of quality control" are not made public when issued.

### **REPORTING REQUIREMENTS**

In addition to Form 1 that is used to apply for registration with the PCAOB, registered firms must complete Form 2 which is an annual reporting form. The first annual reports were due on June 30, 2010. These forms are required (by June 30<sup>th</sup>) from firms who were registered with the PCAOB by March 31 of that year. These annual reports require the public accounting firm to disclose information such as the number of audit reports issued and any disciplinary histories of newly hired personnel. Form 3 is a special reporting document. It must be filed with the PCAOB within 30 days of certain events including certain legal proceedings initiated against a firm or its personnel. Finally, Form 4 is a succession document. It is used when a public accounting firm is taking over the registration status of a predecessor firm.

As discussed above, public accounting firms that do not satisfactorily respond to the board's criticisms of audit practices within a 12 month period find that these comments become a matter of public record. The authors thought that a review of the published reports on accounting firm failures to address PCAOB criticisms would prove interesting. Indeed, that is the case. It is not only the smaller firms with less resources that find themselves on the public listing but also several of the largest public accounting firms. The following paragraphs contain a brief summary of three such cases involving Deloitte & Touche, Ernst & Young, and PricewaterhouseCoopers.

The firms failing to address quality control criticisms of the board satisfactorily are faced with this information becoming a matter of public record. These cases are documented on the PCAOB's website (PCAOB, Inspection Criticisms, 2013). The first such case that the authors would like to discuss involves Deloitte & Touche for an inspection report dated May 19, 2008 (PCAOB, Inspection Reports, 2013). This relates to the 2007 inspection of the firm by the PCAOB. The report states that there were several audit deficiencies in the audit work completed by Deloitte & Touche. These included failures of Deloitte & Touche to identify or properly address errors in the client's application of GAAP. Deloitte & Touche were also criticized for the failure to sufficiently perform certain audit procedures.

The second situation involves Ernst & Young (EY) for a PCAOB report dated July 2, 2010 associated with inspections made in 2009 (PCAOB, Inspection Reports, 2013). This report, similar to Deloitte & Touche above, stated that EY failed to identify errors in the issuer's application of GAAP. In addition, inspection team determined that the firm failed to perform certain necessary audit procedures. An interesting addition to this report was a response by Ernst & Young on the board's statement of failure to satisfactorily address criticisms of the inspection team. The one page letter from EY stated that they believe that they did take sufficient remedial action with respect to all of the areas of criticism. These actions included providing audit personnel with new audit tools, additional training, and expanded technical guidance.

The third large firm case selected by the authors involved PricewaterhouseCoopers (PWC) for a board report dated August 12, 2010 pertaining to 2009 inspections (PCAOB, Inspection Reports, 2013). This situation, similar to the others, involved audit deficiencies by PWC. The identified audit problems included the failure to identify errors in the issuer's application of GAAP and the failure to perform certain necessary audit procedures. In particular, the inspection team claimed that in four audits, the firm failed to test the fair value of investment securities and derivatives.

## **HISTORY OF PCAOB AUDITING STANDARDS ENACTED**

Standard setting is often considered the major duty or task of the PCAOB. Indeed, this is a monumental task when considering that the board is responsible for the creation of auditing, ethics, independence, and quality control standards. Due to paper length considerations, the authors decided to trace only the history of auditing standards. In its first 11 years, the PCAOB has adopted 16 auditing standards that have been approved by the Securities Exchange Commission. In addition, the board has adopted numerous ethics, independence, and attestation rules. These are beyond the scope of this paper but the authors would like to impress upon the reader that a huge amount of effort has been expended by the board to create this network of rules to improve the quality of auditing and protect the stockholders of public corporations.

The standard setting process of the PCAOB is fairly comprehensive. The board has sought to involve a wide variety of stakeholders in the standard setting process. These stakeholder groups include investors, auditors, regulators, financial statement preparers, and various other interested parties. To begin the standard setting process, the board uses a variety of public roundtables, focus groups, and task forces to discuss relevant topics. The PCAOB also uses observations made during inspections of public accounting firm audits. Depending on the nature of the project, the board may issue a concept release in an effort to collect public comments. Using the feedback gathered, the board proceeds in the development of a draft standard.

The proposed (draft) standard is issued public comments are collected. The PCAOB considers these comments and decides whether to adopt the proposed standard as final or reissue a revised proposal for additional public comment. Once the board has adopted the standard, it is then submitted for Securities Exchange Commission approval. The next step normally involves the SEC collecting additional public comments prior to its final approval. If the public comments are basically favorable, the standard is then approved by the SEC. An auditing standard is not effective until approved by the SEC.

Auditing Standard No. 1 concerned newly required references to the standards of the PCAOB (PCAOB Release No. 2003-025). This required public accounting firms to change the wording in their audit reports from “generally accepted auditing standards or U.S. generally accepted auditing standards” to a revised wording of “the standards of the Public Company Accounting Oversight Board (United States).” This revised terminology applied to auditors’ reports issued or reissued on or after May 24, 2004.

Auditing Standard No. 2 was superseded by Auditing Standard No. 5 and will be discussed later in this paper. Auditing Standard No. 3 was adopted by the PCAOB on June 9, 2004 (PCAOB Release No. 2004-006). This standard deals with audit documentation also referred to work papers or working papers. It establishes general requirements for documentation that the auditor should prepare and retain relative to engagements conducted pursuant to the standards of the PCAOB. The standard emphasizes that documentation should be prepared in sufficient detail to provide a clear understanding of the conclusions reached. This pronouncement also specified that audit documentation must accomplish the following. First, it must demonstrate that the engagement complied with the standards of the PCAOB. Next, it must support the auditor's conclusions about all relevant financial statement assertions. Finally, audit documentation must show that underlying accounting records agreed with the set of financial statements. This standard also emphasizes that audit documentation must be retained for a period of at least seven years.

The next standard, Auditing Standard No. 4 was adopted on July 26, 2005 and effective on February 6, 2006 (PCAOB Release No. 2005-015). This pronouncement concerns reporting on whether a previously reported material weakness continues to exist at a later date specified by management. This standard establishes requirements and provides direction on when this subsequent reporting is required. Section 6 of this standard states that to obtain reasonable assurance the auditor must obtain and evaluate evidence concerning the specific controls that were developed and implemented to eliminate the previously discovered material weakness. These controls must be found to be operating effectively in order to satisfy the company's stated control objective. The standard concludes with specific direction on adherence to the standards of the PCAOB. To adhere to the standard, the auditor must plan the engagement, obtain sufficient understanding of the internal control system, test to see if the material weakness continues to exist, and finally, form an opinion on whether the previously reported weakness continues to exist.

The title of Auditing Standard No. 5 is "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements" (PCAOB Release No. 2007-005A). This pronouncement supersedes Auditing Standard No. 2. This standard establishes the requirements and provides direction to an auditor when he or she is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements. Section 2 of the standard clearly indicates that if the auditors identify one or more material weaknesses in the company's internal control system, that system cannot be considered effective.

Auditing Standard No. 6 “Evaluating Consistency of Financial Statements” was adopted on January 29, 2008 (PCAOB Release No. 2008-001). This standard established requirements and provided directions to auditors in the process of evaluating if the clients current year financial statements are consistent with those of the previous year. In particular, the standard suggests two key areas that should be reviewed. First, did the firm make a change in accounting principle? The standard emphasizes that this means a revision from one GAAP method to another. If the firm changed from a non-generally accepted principle to an accepted one, the standard clearly states that this represents a correction of a misstatement (error). Finally, Standard No. 6 reaffirms that the correction of a material misstatement in previously issued financial statements must be recognized in the audited financial statements through the addition of an explanatory paragraph in the audit report.

The next auditing standard, Auditing Standard No. 7 “Engagement Quality Review,” was adopted by the PCAOB on July 28, 2009 (PCAOB Release 2009-004). This pronouncement requires that an engagement quality review and concurring approval of issuance must be completed for each audit engagement and each review of interim financial information in order to satisfy the standards of the PCAOB. Standard No. 7 describes the qualifications of an engagement quality reviewer including the qualities of competence, independence, integrity, and objectivity. Finally, retention rules on audit work papers (7 yrs.) also apply to the documentation of the engagement quality reviewer.

Auditing Standard No. 8 “Audit Risk” was adopted by the PCAOB on August 5, 2010 (PCAOB Release No. 2010-004). Since audit risk is so important in the auditing process, this standard discusses the importance of understanding audit risk in both an integrated audit (financial statements and internal controls) and an audit of only financial statements. In the auditor’s process of determining if the financial statements are free from material misstatements due to error or fraud, a major goal is the reduction of audit risk to an acceptable level. This risk is reduced by applying due professional care to all aspects of the audit and collecting sufficient appropriate audit evidence. Note that PCAOB Release No. 2010-004 included Auditing Standards 8 through 15. They are all effective for audits of fiscal years beginning on or after December 15, 2010.

The next standard, Auditing Standard No. 9 “Audit Planning” provides guidance to auditors concerning planning the audit (PCAOB Release No. 2010-004). Standard No. 9 provides guidance on the establishment of overall

audit strategy for the engagement. Audit planning is described as a continual process that begins shortly after the completion of the previous audit and continues until the completion of the current audit. This standard emphasizes that the nature and extent of audit planning depends on the complexity and size of the organization, the auditor's previous experiences with the firm, and changes in company circumstances occurring during the audit.

Auditing Standard No. 10 "Supervision of the Audit Engagement" established requirements for the engagement partner's supervision of engagement team members (PCAOB Release No. 2010-004). The engagement partner is responsible for proper supervision of engagement team members and the work of specialists or other auditors. This standard directs the engagement partner, when providing supervisory activities of team members, to take into account the nature and size of the company, the nature of work assigned to each engagement team member, the risks of material misstatement, and the knowledge and skill of each team member.

"Consideration of Materiality in Planning and Performing an Audit" is the title of Auditing Standard No. 11 (PCAOB Release No. 2010-004). Quoting from Supreme Court interpretations of the federal securities laws, a material item or fact is something that a "reasonable investor" would find significant to him or her. In other words, it is something that is important enough to affect decision making by the investor or stakeholder. The standard discusses the process of establishing a materiality level for the financial statements as a whole as well as materiality levels for particular accounts or disclosures.

Auditing Standard No. 12 "Identifying and Assessing Risks of Material Misstatement" provides guidance on the process of identifying and assessing risks of material misstatement of financial statements (PCAOB Release No. 2010-004). This is a lengthy standard that addresses the very important task of how to evaluate the risks of material misstatements in the financial statements. It contains two basic segments or parts. The first (Paragraphs 4-58) discuss the auditor's responsibilities for the performance of risk assessment procedures. This involves the engagement team obtaining an accurate and complete understanding of the company and its environment. In other words, the "corporate climate" has a significant influence on the risk of material misstatement. The second portion of this standard (Paragraphs 59-73) discusses the process of identifying and assessing the risks of material misstatement.



“The Auditor’s Responses to the Risks of Material Misstatement” is the title of Auditing Standard No. 13 (PCAOB Release No. 2010-004). The theme of this pronouncement is how to design and implement appropriate audit responses and procedures to the identified risks of material misstatement. This standard basically explains how the engagement team should proceed in the process of addressing the identified material misstatement risks (as directed in Standard 12). Standard 13 discusses two types of audit responses to identified material risks. First, those responses that have an overall effect on how the audit is conducted (Paragraphs 5-7). Second, responses involving the nature, timing, and extent of audit procedures are discussed in the last portion of this standard (Paragraph 8-46).

Auditing Standard No. 14 is titled “Evaluating Audit Results” (PCAOB Release No. 2010-004). This pronouncement continues the audit process as discussed in the earlier audit standards included in this release (No. 8-13). As one of the final auditing tasks prior to the issuance of an opinion, the objective of this standard concerns the evaluation of the results of the audit in order to determine if sufficient and appropriate evidence has been gathered to support the opinion expressed in the auditor’s report. The pronouncement requires the auditor must assess audit results through the evaluation of the analytical procedures performed (overall review), qualitative aspects of the firm’s accounting practices, conditions identified in the assessment of the risk of material misstatement due to fraud, the presentation and disclosures of the financial statements, and the sufficiency of audit evidence obtained.

Auditing Standard No. 15 “Audit Evidence” contains a large number of definitions of terms and basic concepts (PCAOB Release No. 2010-004). It discusses what constitutes audit evidence and the requirements for designing and performing audit procedures that obtain sufficient appropriate audit evidence. This standard discusses the relevance and reliability concepts as they apply to audit evidence. In addition, it discusses management’s financial statement assertions that include existence or occurrence, completeness, valuation or allocation, rights and obligations, and presentation and disclosure. The auditor must gather sufficient audit evidence that supports the financial statement assertions made by management. Finally, this standard concludes with a discussion of audit procedures that may be used to obtain audit evidence. These include risk assessment procedures (from Standard 12) and further audit procedures (from Standard 13). These procedures include tests of controls, and substantive procedures (which include tests of details and tests of accounts). Specific audit procedures including inspection, observation, inquiry, confirmation, recalculation, reperformance, and analytical procedures (study of relationships of financial and nonfinancial data).

The title of Auditing Standard No. 16 is “Communications with Audit Committees” (PCAOB Release No. 2012-004). This standard emphasizes the current importance of the audit committee. It requires the auditor to communicate with the company’s audit committee on a variety of topics. The audit committee must be consulted regarding a number of matters during the audit. In addition, the auditor must establish with the audit committee an understanding of the terms of the audit engagement. This information must be included in an engagement letter to assure there are no material differences in audit expectations between the audit committee and the public accounting firm. Both parties must agree on the objective of the audit, the responsibilities of the auditor, and management (firm) responsibilities. The standard also directs the auditor to communicate to the audit committee matters including significant accounting policies and practices, critical accounting policies and practices, and critical accounting estimates.

The authors, due to paper length considerations, traced the development of only the PCAOB’s auditing standards. In addition, there have been nine ethics and independence rules that have been adopted by the PCAOB and approved by the SEC. There were also several independence standards that were adopted as preexisting standards. Those are described in the AICPA’s Code of Professional Conduct Rule 101.

The PCAOB has also been active in two other areas. These include staff audit practice alerts and staff questions and answers. From 2006 through 2012, the board published ten staff alerts. Topics ranged from auditor considerations regarding significant unusual transactions to maintaining and applying professional skepticism in audits (PCAOB, 2013, Guidance). In addition, the board has published numerous staff questions and answers that relate to the implementation of the standards of the PCAOB. For example, one set of questions and answers pertained to ethics and independence rules, tax services, and contingent fees (PCAOB, 2013, Guidance-SQA).

## **2012 ANNUAL REPORT – “10 YEARS OF PROTECTING INVESTORS”**

The board’s registration process is discussed early in the annual report. As of December 31, 2012, the board had a total of 1,452 U.S. firms registered (Annual Report, p.4). Of this number, 999 issued no reports for public corporations, brokers, or dealers. In 2012, the board approved 110 registration applications of

which 41 were non-U.S. firms. During that period, the PCAOB granted 129 requests to withdraw from registration. In addition to the 1,452 U.S. firms registered, the board also has 911 non-U.S. registrants from 87 foreign jurisdictions. The foreign country with the largest number of registrants was China with 96 followed by India with 67, and the United Kingdom with 63 (Annual Report, p.6).

The inspection of public accounting firms is another huge duty of the PCAOB. In 2012, the board inspected nine firms (as mentioned earlier in this paper) that issue audit reports for more than 100 public companies. In addition, the PCAOB inspected 244 firms that are reviewed every three years (servicing less than 100 public corporations). These included 77 non-U.S. firms located in 25 foreign jurisdictions (Annual Report, p.7). The PCAOB also inspected 45 brokers and dealers (since the passage of the Dodd-Frank Act).

#### **PCAOB'S LONG RANGE STRATEGIC PLAN: 2012 – 2016**

The final portion of the paper involves a brief review of the PCAOB's long range strategic plan that is titled "Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors" (PCAOB, 2013, Strategic Plan 2012-2016). This title reflects the mission of the board which is to provide protection for all investors. The strategic plan also includes a discussion of the PCAOB's core values. The three identified core values includes public interest and stewardship; excellence, integrity and fairness; and teamwork and diversity. In summary, the board is committed to protecting investors and serving the public interest. It also remains committed to quality and continual learning that demands integrity and ethical behavior. Finally, the board remains committed to maintaining a collaborative work environment staffed by individuals with a diversity of experiences, skills, cultures, and backgrounds (PCAOB, Strategic Plan, p.8).

The authors' final comments on the strategic plan involve the three "overarching" goals established by the PCAOB (PCAOB, Strategic Plan, p.7). These include the following items:

Goal 1: Our Knowledge: Foster maximum, effective use of the unique insight afforded the PCAOB into audit issues that enable the PCAOB to further investor protection.

Goal 2: Our Relevance: Enhance the relevance, quality and transparency of the audit and strengthen skepticism, independence, and objectivity in audit firm culture for the benefit of the investing public.

Goal 3: Our People: Establish a workplace culture that promotes excellence, integrity, diversity, respect, fairness, accountability continuous learning and careful stewardship of resources.

These well stated goals describe the desired operations of the PCAOB. Protection for investors was, is, and will be of paramount importance. These goals also emphasize the importance of a strong, ethical corporate culture.

### CONCLUSION

This paper traced the accomplishments of the PCAOB from its inception only 11 years ago. The PCAOB's duties of registering public accounting firms, inspecting the work of the registered firms on either an annual or three year basis, enforcing registrants who violated board regulations, and creating auditing, ethics, independence, and quality control standards appear to be overwhelming. It is apparent that the PCAOB during this period has succeeded in completing these very difficult and comprehensive tasks. It should be comforting for investors worldwide to realize that the PCAOB strives to "protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports" (PCAOB, Mission).

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