Using PCAOB Settled Disciplinary Orders to Improve Audit Quality Education

By Richard Coppage and Trimbak Shastri

One important use of the audit deficiencies identified by the PCAOB's settled disciplinary orders (SDO) is improving education related to audit quality. The audit deficiencies identified in SDOs and other PCAOB releases can be used by CPA firms, continuing education providers, and college audit professors in order to improve training and educational programs, with the goal of avoiding similar violations in the future. This, in turn, can help enhance audit quality.

PCAOB inspections of smaller public accounting firms have been explored in earlier research (e.g., Dana R. Hermanson and Richard W. Houston, "Quality Control Defects Revealed in Smaller Firms' PCAOB Inspection Reports," *The CPA Journal*, December 2008, pp. 36–38; Dana R. Hermanson and Richard W. Houston, "Evidence from the PCAOB Second Inspections of Small Firms," *The CPA Journal*, February 2009, pp. 58–60; James F. Boyle, Douglas M. Boyle, Dana R. Hermanson, and Richard W. Houston, "Quality Control Defects in Smaller Firms' PCAOB Inspection Reports: An Updated Analysis," *The CPA Journal*, June 2013, pp. 34–39). Although the inspection reports may describe apparent noncompliance with auditing and ethical standards, they might not include all of the PCAOB's criticisms regarding audit quality; for example, the PCAOB's criticisms of potential defects in the quality control system of a firm under inspection are not made public if the firm addresses those criticisms or defects to the satisfaction of the PCAOB within 12 months of the inspection report's date (PCAOB Release 104-200-077, "The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspections," Mar. 21, 2006).

In addition, inspection reports do not constitute conclusive findings of facts or violations; however, SDOs that detail violations of regulations established through the PCAOB's disciplinary process—providing an opportunity for the firm to defend itself—are conclusive (PCAOB Release 104-2004-001, "Statement Concerning the Issuance of Inspection Reports," Aug. 26, 2004). Thus, this discussion focuses on violations addressed in SDOs, which represent settled disciplinary actions against registered firms or associated persons for their noncompliance with the PCAOB's professional standards and rules. The findings of the PCAOB inspectors reported in these SDOs offer valuable information that, if utilized appropriately, can significantly improve the quality of future audits and related accounting information.

The PCAOB's Oversight Role

The Sarbanes-Oxley Act of 2002 (SOX) established the PCAOB to oversee the audits of public companies in order to protect the interests of investors and further the public interest through the preparation of informative, accurate, and independent audit reports. To accomplish this, the PCAOB registers public accountants and authorizes them to audit public companies and issue audit reports; promulgates auditing standards; inspects registered public accountants to ensure their compliance with SOX; disciplines registered public accountants for noncompliance; and, where appropriate, imposes sanctions on registered public accountants.

The PCAOB annually inspects firms that issue more than 100 audit reports; in 2012, the board inspected nine such large public accounting firms, according to its website. The PCAOB triennially inspects all other smaller firms, per PCAOB Rule 4000–4012 and Rule 4020(T). But the PCAOB does not inspect audit documentation of accounting firms located in some foreign countries, due to the laws of those countries (http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx).

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The results of the periodic inspections are summarized and posted on the PCAOB's website (http://pcaobus.org/Inspections/Pages/PublicReports.aspx). As previously mentioned, criticisms relating to quality control matters remain nonpublic if the firm addresses them to the board's satisfaction within 12 months of the report date; if the firm fails, these criticisms are made public.

In connection with the SDOs, the PCAOB can sanction a firm by suspending individual registered members from auditing public companies, revoking a firm's registration, or imposing monetary penalties. Furthermore, the board may also direct a registered public accounting firm to make improvements in its quality control system or training of staff, among other matters, in order to enhance the registered firm's compliance with PCAOB regulations.

Overview of SDOs

As indicated above, SDOs represent the settlements the PCAOB has reached with registered firms or their associated persons, arising out of disciplinary proceedings for violations of PCAOB standards and rules. These proceedings are kept confidential until a final decision about imposing sanctions is made; if sanctions are imposed, the PCAOB issues an SDO. From the issuance of the first SDO in 2005 to February 2012, the PCAOB issued approximately 40 SDOs, a relatively small proportion compared with the number of audits it inspected.

The PCAOB annually inspects eight large registered accounting firms: BDO, Crowe Chizek and Company, Deloitte & Touche, Ernst & Young, Grant Thornton, KPMG, McGladrey, and PricewaterhouseCoopers. The remaining registered public accounting firms, which audit fewer than 100 public companies annually, are inspected triennially. The board has inspected 1,662 audits (from 2004 to 2007) conducted by annually inspected firms and 497 audits (from 2004 to 2006) conducted by triennial firms. The PCAOB's inspections of these 2,159 audits revealed some audits free of any audit deficiencies, leaving the remaining audits with varying degrees of concerns about potential quality control issues and audit performance–related matters; however, the PCAOB has cautioned against using its inspection releases to draw broad conclusions about the quality of audits performed by any of these firms. The PCAOB also observed that the number of audits inspected constitutes a relatively small proportion of the total audits performed by CPAs and that the inspected firms are not representative of the total audits that the CPA firms performed. The PCAOB's cautionary advice likewise applies to the relatively small number of SDOs (less than 2% of inspections, constituting approximately 40 SDOs out of 2,159 total inspections).

Categories of Significant Violations

Violations by registered public accounting firms can be grouped into three broad categories: general standards, fieldwork standards, and reporting standards (AU section 150, "Generally Accepted Auditing Standards"). Key elements of general standards include exhibiting technical proficiency in audits, maintaining an attitude of independence (in fact and in appearance), and exercising due professional care. Implicit in exercising due professional care is maintaining an attitude of professional skepticism and exercising professional judgment when complying with the other standards relating to fieldwork and audit reporting. In other words, as shown in *Exhibit 1*, the general standards impact the other standards; therefore, adherence to the general standards should effectively contribute toward compliance with the others.

The three fieldwork standards are directed toward obtaining and evaluating sufficient and appropriate audit evidence; this, in turn, will help ensure a high (reasonable) degree of assurance that reported account balances (based upon an entity's transactions for the period) and disclosures in the entity's financial statements are presented in accordance

EXHIBIT 1
Categories of Significant Violations

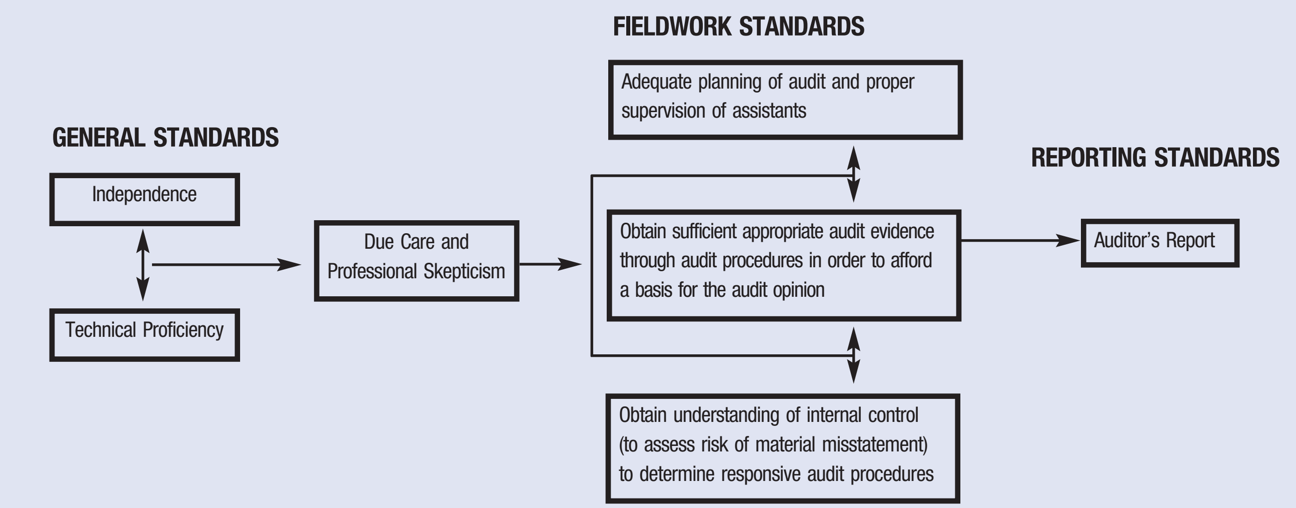

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EXHIBIT 2
Examples of Violations Identified in PCAOB Settled Disciplinary Orders

PCAOB Standard *	Example
AU section 150, "Generally Accepted Auditing Standards"	These pervasively affect all phases of an audit; for example, if an auditor does not exercise due professional care, it might result in a lack of appropriate audit evidence supporting an unqualified audit opinion.
AU section 220, "Independence"	Auditor owning shares of an audit client's stock.
AU section 230, "Due Professional Care in the Performance of Work"	Not maintaining an attitude of professional skepticism; for example, not developing and applying responsive audit procedures to address assessed risk level. Failure to take necessary steps to minimize the effect of incompetent professionals assigned to an audit.
AU section 310, "Appointment of the Independent Auditor"	Failure to establish and document an understanding with a client regarding the services to be performed for each engagement.
AU section 311, "Planning and Supervision"	Failure to plan the audit or prepare audit programs; review and supervise the work of audit assistants.
AU section 312, "Audit Risk and Materiality in Conducting an Audit"	Increasing the planned materiality level to make overstated earnings/assets immaterial. Failure to evaluate financial statements sufficiently to determine whether they are fairly stated.
AU section 315, "Communications between Predecessor and Successor Auditors"	Failure to make inquiries for determining whether to accept an audit by the successor.
AU section 316, "Consideration of Fraud in a Financial Statement Audit"	Failure to consider risk of material misstatement that could arise due to fraud, or not appropriately designing audit procedures when situations appear unusual. Preparing audit work papers to justify a misstatement as immaterial when it is not.
AU section 317, "Illegal Acts by Clients"	Failure to take necessary steps after becoming aware that a client has committed an illegal act.
AU section 326, "Audit Evidence"	Failure to obtain sufficient appropriate audit evidence in support of audit opinion.
AU section 328, "Auditing Fair Value Measurements and Disclosures"	Failure to audit or test impairment in value of intangibles (despite deteriorating business conditions).
AU section 329, "Analytical Procedures"	Failure to develop expectations in connection with performing analytical review.
AU section 330, "The Confirmation Process"	Failure to confirm accounts receivable (approximately 10% of assets) or other accounts receivable–related procedures were performed. No determination of a sufficient basis to conclude that the confirmation provided meaningful and competent evidence.
AU section 332, "Auditing Derivatives, Hedging Activities, and Investments in Securities"	Failure to evaluate valuation of investment in marketable securities.
AU section 333, "Management Representations"	Accepted management representation (as sufficient appropriate evidence) without meeting audit procedure requirements. Did not obtain management representation.
AU section 334, "Related Parties"	Accepting management representation without performing audit of a significant related party transaction. Failure to obtain sufficient appropriate evidential matter concerning property acquisitions from a controlling shareholder.
AU section 336, "Using the Work of a Specialist"	Failure to perform procedures to ascertain the qualifications of the specialists, their relationships to the client, or the methods or assumptions used by the specialists.
AU section 339, "Audit Documentation"	Failure to prepare documentation. Stating in the working papers, without performing, any of the following: "Reviewed all working papers," "reviewed completed audit programs," "reviewed the financial statements and [was] satisfied that they had been prepared in conformity with [GAAP]," "reviewed the auditor's report and [was] satisfied it properly expressed audit opinion in accordance with auditing standards."
AU section 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"	Wording (language) included in the explanatory paragraph was not according to the prescribed format.

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with GAAP and are free of material (qualitative and quantitative) misstatements due to error, fraud, or illegal acts.

The authors grouped the specific SDO violations examined into three categories: violations of general standards, violations of fieldwork standards, and violations of reporting standards (AU section 150, "Generally Accepted Auditing Standards"). The sections below review the types of violations that appeared in each category. *Exhibit 2* lists the PCAOB standards with which registered public accounting firms failed to comply and provides examples of the violations.

Violations of general standards. The PCAOB has reported several situations involving auditor violations of general standards. For example, one situation involved a registered public accounting firm with only one engagement partner responsible for 300 engagements over a three-year period. In addition, these audit engagements were staffed by individuals who had little or no accounting or auditing experience (PCAOB Release 105-2009-006, "Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions," Aug. 27, 2009). This situation—involving a large number of clients, a lack of proficient staff, and only one engagement partner—clearly violates the concepts of independence (in fact and in appearance) and due professional care in planning and executing audit engagements. In another situation, a public accounting firm partner assigned to an engagement was found to be incompetent.

Other situations involving an independence violation include providing prohibited services (e.g., bookkeeping), acquiring a financial interest (e.g., purchase of common stock), and having a close relative with a financial interest in an audit client. In other cases, auditors did not have adequate knowledge of PCAOB standards and rules, which include quality control and ethics standards.

Although auditors have an obligation to maintain an attitude of professional skepticism, the PCAOB has reported many situations where auditors did not maintain this attitude. For example, a firm did not take adequate steps to compensate for the effects of nonperformance of sufficient appropriate audit procedures managed by an incompetent engagement partner (http://pcaobus.org/Enforcement/Decisions/Documents/12-10_Deloitte.pdf). Other examples include a partner failing to exercise due care while reviewing the work of an engagement partner, and auditors failing to perform responsive audit procedures to gather sufficient appropriate audit evidence based on the assessed risk level.

General standards have a pervasive effect on fieldwork and reporting standards. As described previously, auditors' technical proficiency and independence could influence the effectiveness with which they exercise due professional care and maintain professional skepticism, which is implicit in exercising due care. Improper professional care, outright disregard, or gross auditor negligence could result in an auditor not developing and applying responsive audit procedures to obtain compelling evidence in support of an audit opinion.

Violations of fieldwork standards. The violations of fieldwork standards reported by the PCAOB included improper documentation of audit work and not performing necessary audit procedures, such as frequent violation of Auditing Standard (AS) 3, *Audit Documentation*, where auditors have added (or changed the date on) working papers after the completion of an audit, or where working papers were not reviewed but dated as though they had been reviewed. Moreover, auditors did not perform necessary audit procedures, including the following violations:

- Ineffectively auditing reported revenue from products for which a right of return existed (e.g., allowing client to adjust sales returns at replacement cost instead of gross sales price, thereby misstating sales revenue, and failing to properly audit return estimates)
- Failure to determine the reasonableness of a new estimating technique used, which resulted in a substantial (from 47% to 32%) reduction of the allowance for doubtful accounts, thereby increasing assets and revenue
- Failure to detect an overstatement of cash by $1 billion and accepting confirmation requests sent to (and received from) banks by management
- Failure to verify valuations (e.g., two assets which collectively accounted for 90% of total assets; research and development costs, existence and valuation of marketable securities, goodwill and intangibles accounting 97% of total assets; right to $500 million bonds and related interests; and approximately $300 million in notes)
- Failure to perform sufficient procedures to verify related party transactions (e.g., regarding disclosure, not obtaining evidence for the valuation of properties acquired in a related party transaction)
- Allowing an entity not to consolidate an affiliate in which it owned a 90% interest
- Failure to follow up when information about a client's illegal activity surfaced.

Many situations involved auditors not performing adequate procedures to determine the fairness of revenue related items and valuation of assets. Such lax audit procedures can encourage management to manage earnings.

Violations with respect to audit reports. As part of completing an audit, auditors should determine that the financial statements are free of material misstatement and are presented in accordance with GAAP. In its inspections, the PCAOB identified violations that included the following:

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■ Allowing material misstatement in the financial statements—for example, accepting a 50% increase of the materiality threshold, knowing that it would result in material ($19.7 million) misstatement of overstated assets, revenues, and earnings
■ Not reporting correction of a prior period error, and misclassification of certain other items
■ Failure to subject audit documentation to an independent review by a quality control section or department within the firm, or by a professional other than the engagement partner
■ Several situations involving noncompliance with quality control standards, which should include procedures relating to 1) acceptance of new clients or continuance of existing clients in repeat audits, 2) review of audit workpapers to determine that audits are planned and performed in compliance with standards/regulations, 3) management of personnel, and 4) procedures to monitor that the firm's quality control procedures have been effectively followed; despite the quality control standards, the PCAOB identified situations where firms had either no quality control system or an inadequate system
■ Situations where auditors issued unqualified audit reports without performing an audit or only a limited audit without obtaining sufficient supporting evidence.

Internal control deficiencies. In a recent PCAOB inspection report relating to 2010 inspections on audits of internal control over financial reporting (PCAOB Release 2012-006, "Observations from Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control over Financial Reporting," Dec. 10, 2012), the PCAOB staff found that in approximately 15% of audits of internal control, the auditors did not obtain sufficient appropriate audit evidence to support the audit opinion on the effectiveness of internal control over financial reporting. The PCAOB indicated that firms should be proactive in considering how to prevent similar deficiencies, through strong firm quality control systems, robust training and guidance, and strategies to better anticipate and address risks that might arise in specific audits.

Actions to Address PCAOB Criticism

To ensure that audit deficiencies identified by a PCAOB inspection remain nonpublic, a registered accounting firm must address the deficiencies within 12 months. If the firm fails to address the deficiencies, then the PCAOB may conduct a disciplinary proceeding to establish whether the deficiencies constitute violations of any laws, rules, or professional standards for which sanctions should be imposed. In contrast, if a firm addresses the deficiencies, and the PCAOB's determination regarding the actions taken by the firm is favorable, then the criticisms are not made public; however, the PCAOB observed that favorable determination should not be construed to mean that the firm has completely and permanently cured the audit quality control–related deficiency, but instead that the firm has demonstrated substantial progress to address the audit quality issue.

EXHIBIT 2 (CONTINUED)
Examples of Violations Identified in PCAOB Settled Disciplinary Orders

AU section 342, "Auditing Accounting Estimates"	Failure to obtain an understanding as to how the client developed its estimate concerning the fair value of goodwill, either by reviewing and testing the process used by management to develop the estimate or by developing an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
AU section 431, "Adequacy of Disclosure of Financial Statements"	Failure to adequately disclose related party transaction. Failure to adequately disclose accounting policy (e.g., relating to sales returns), which should include appropriateness of those principles when situations appear unusual.
AU section 508, "Reports on Audited Financial Statements"	Failure to obtain sufficient appropriate evidence in support of audit report.
AU section 543, "Part of Audit Performed by Other Independent Auditors"	Principal auditor's failure to properly coordinate audit with other audit firm, and failure to follow up on indications that another audit firm's work used by the firm may not have been performed in accordance with PCAOB standards and may not have provided sufficient competent evidential matter that the financial statements were in accordance with GAAP. Failure to obtain and review 1) a list of significant fraud risk factors and how other auditors addressed those risks, 2) information relating to significant findings or issues inconsistent with the auditor's final conclusions, 3) a schedule of audit adjustments, 4) all significant deficiencies and material weaknesses in internal control over financial reporting, 5) letters of representation from management, and 6) all matters to be communicated to the audit committee.
AU section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"	Failure to use the information (about significant amount of sales returns subsequent to year end) and effects on the financial statements as of year-end.

* The PCAOB issued Auditing Standard (AS) 8 through 15 in 2010, relating to the auditor's assessment of and response to risk of material misstatement in an audit. These eight standards replaced interim standards AU sections 311, 312, 313, 319, 326, and 431. AS 3 replaced interim standard AU 339.

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Most registered public accounting firms inspected by the PCAOB have taken steps to address the deficiencies identified and described in their inspection reports within

> Supervisors should document that due care has been exercised.

the 12-month remediation time frame. Matters relating to quality control, which have a pervasive impact on audit quality, were most frequently cited among the remedial actions taken by firms.

Actions taken by annually inspected firms include the following:

- Separated audit quality function and audit business operations to ensure that audit quality is not compromised
- Strengthened internal inspection programs (e.g., adding additional full-time personnel)
- Implemented specific continuing education for non-U.S. professionals who work on the audits of U.S. issuers' foreign locations
- Conducted independence reviews of foreign affiliates by a group dedicated to that purpose in order to ensure that prohibited services are not provided by foreign affiliates.

Actions taken by triennially inspected firms included the following:

- Implemented annual technical training for audit personnel to enable them maintain a high level of technical competence (e.g., achieve familiarity with SEC rules and regulations, PCAOB auditing standards, accounting standards, independence requirements, and specialized industry guidance)
- Improved audit methodologies, including audit programs and practice aids
- Strengthened the firm's own internal monitoring of audit performance.

Enhancing Audit Quality through Training and Education

In order to make audits more effective, CPA continuing education providers and audit educators should not just develop training and educational materials; they should also consider the concerns expressed in PCAOB inspection reports and in SDOs, which include significant violations of auditing standards that the CPA firms failed to address. Audit training and educational materials should highlight these violations and provide approaches to prevent such violations. For example, educators and continuing education providers should encourage supervision of audit assistants to ensure that they have exercised due care and maintained professional skepticism. Supervisors should document that due care has been exercised, particularly when risk of material misstatement is assessed at a relatively higher level.

In addition, educators and continuing education providers should stress the importance of a quality control review of each audit engagement and of monitoring the firm's quality control system. The quality control system should ensure that—

- quality control staff have the needed skills and authority to discharge their responsibilities effectively;
- staff assigned to audits are trained and possess adequate proficiency in audits, maintain professional skepticism, and effectively exercise due care and professional judgment;
- there is effective review and supervision of audit at various levels (e.g., supervisor, manager, partner);
- there are periodic workshops to develop skills of professionals at various levels (e.g., staff, supervisor, manager, partner); and
- there is periodic evaluation (monitoring) of quality control systems.

A Dynamic Process

Although PCAOB inspection reports, unlike SDOs, may not reveal disciplinary proceedings if there are any pending, the fact that PCAOB makes its inspection reports and SDOs available to the public increases the effectiveness of the process. Auditors are now aware that their work will be periodically inspected, with audit deficiencies identified and reported. Noncompliance with PCAOB regulations might result in sanctions against audit firms (or individuals), might expose audit firms (and auditors) to litigation, and might result in adverse publicity. Furthermore, the public now knows that it can report abuses to the PCAOB (via the PCAOB's "tip and referral" center, http://pcaobus.org/Enforcement/Tips/Pages/default.aspx). All of the above are likely to strengthen audit quality.

The issues brought out in the SDOs can be a rich resource for CPA firms, professional education providers, and academics, perhaps providing the bases for case studies focused on areas of concern in actual incidents. Enhancing audit quality is a continuous and dynamic improvement process, and SDOs and inspection reports can be used to further accomplish that goal. ❑

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