Audit Quality in the Post-SOX Audit Environment: What Your Auditing Students Must Know about the PCAOB Inspection Process

Richard R. Riley, Jr., J. Gregory Jenkins, Pamela Y. Roush, and Jay C. Thibodeau

SUMMARY: At the American Accounting Association’s (AAA) Auditing Section Midyear Meeting in January 2007, the Education Committee organized a panel to discuss the educational issues that have surfaced as a result of the PCAOB inspection process. The discussion focused on changes that have occurred in the audit environment, particularly concerning audit documentation and the audit process, as a result of the PCAOB auditing standards and feedback to the firms from the PCAOB inspection process. The goal was to provide a forum for panelists to interact with educators, to develop suggestions to help prepare students for their careers in the post-Sarbanes-Oxley auditing environment. In this paper, we first provide an overview of the PCAOB inspection process and then provide a report on the actual panel discussion, which included a spirited question-and-answer session with the audience. We also incorporate the results of follow-up interviews with the three panelists that occurred in April 2008. Finally, we provide case material and other resources to assist professors as they incorporate the panelists’ suggestions related to PCAOB inspection issues in the classroom.

Keywords: Public Company Accounting Oversight Board (PCAOB); inspections; audit documentation; audit education.

INTRODUCTION

The Public Company Accounting Oversight Board (PCAOB) was created by the Sarbanes-Oxley Act of 2002 (SOX) to regulate the public company auditing profession (U.S. House of Representatives 2002). Its regulatory responsibilities require that the PCAOB set audit standards for the audit of all publicly traded companies and conduct inspections of the auditing work completed by all registered accounting firms. As of the end of 2007, there were more than 1,800 audit firms registered with the PCAOB (Kranacher 2008).

Richard R. Riley, Jr. is an Associate Professor at West Virginia University, J. Gregory Jenkins is an Associate Professor at Virginia Polytechnic Institute & State University, Pamela Y. Roush is an Associate Professor at the University of Central Florida, and Jay C. Thibodeau is an Associate Professor at Bentley University.

The authors gratefully acknowledge the contributions of John Gribble of PricewaterhouseCoopers, Russ Wieman of Grant Thornton LLP, and Greg Scates of the PCAOB in completing this article. The completion of this article would not have been possible without the assistance and cooperation of these individuals.
The PCAOB standards and the inspection process have had a significant impact on the financial statement auditing process, especially concerning audit documentation. While SOX identifies certain aspects of the inspection process, such as how often firms are subject to inspections, it does not specifically address how those inspections are to be performed. As a result, the initial policies and procedures developed by the PCAOB for firm inspections continue to evolve as inspections are completed and reviewed. The Auditing Section Education Committee believes that understanding the impact of the PCAOB standards and the inspection process on the audit process and documentation will benefit auditing educators' efforts to prepare students for careers in the post-Sarbanes audit environment. To this end, the Auditing Section’s Education Committee hosted a panel discussion entitled “The PCAOB Inspection Process: What Your Auditing Students Should Know” during the Auditing Section 2007 Midyear Conference.

The goal of the panel discussion was to provide a forum that allowed panelists, including the PCAOB and practicing audit partners, to offer educators suggestions to help prepare students for their auditing careers. The remainder of this paper is organized as follows. Following an overview of the backgrounds of the distinguished panelists, we provide an overview of the PCAOB inspection process. We then provide a summary of the panel comments, highlight resources for educators and offer concluding remarks and observations for educators. Also incorporated throughout the paper are the results of interviews conducted in April 2008 with the panelists in order to ensure that the information presented remains timely.

Panelists

Greg Scates is currently the Deputy Chief Auditor for the PCAOB. Prior to joining the PCAOB in 2003, he worked in the Enforcement Division of the Securities and Exchange Commission (SEC), and before joining the SEC, Scates spent 17 years working with international accounting firms. Scates has an undergraduate degree from the University of Tennessee at Martin and a master’s degree from George Mason University.

John Gribble is currently the Assurance Quality Leader for PricewaterhouseCoopers, a position that he has had since 2000. Gribble was admitted to the partnership in 1991 and prior to admission spent time at the Financial Accounting Standards Board (FASB). Gribble earned his degree from the University of Wisconsin.

Russ Wieman is currently the National Managing Partner for Assurance and Advisory Services at Grant Thornton LLP. Wieman was admitted to the partnership in 1986, became a member of the Firm’s Executive Committee in 2000, and was elected Chairman in 2001. Wieman earned his degree from the University of Illinois.

THE PCAOB INSPECTION PROCESS

“The PCAOB’s mission, as derived from the Act, is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.”

1 As an example, see Able (2007).
2 For example, the AICPA Center for Audit Quality recently issued a report entitled “Analyses of Deficiencies Cited by PCAOB Inspection Reports.” The information contained in this type of report allows audit firms to observe audit issues and make adjustments in a proactive manner. We suggest that auditing and accounting professors can also incorporate this type of information into their classroom discussions.
3 The information, views, and other content captured in this paper are those of the panelists and session participants and do not necessarily reflect the official positions of any firm or the PCAOB.
4 Refer to the PCAOB website for additional relevant information: http://www.pcaobus.org/About_the_PCAOB/Strategic_Plan.pdf.
To help fulfill that mission, Section 104(a) of SOX directs the PCAOB to conduct a continuing program of inspections to assess firm compliance with the Act, PCAOB rules, and SEC and professional standards. Inspections occur annually for firms that regularly issue audit reports for more than 100 public companies (hereafter, large firms). Firms with 100 or fewer issuer clients (hereafter, small firms) are subject to inspection no less than once in a three-year period. Nationally, the PCAOB has approximately 230 staff members based in eight offices to perform inspections.

**Inspections**

The PCAOB large firm inspections encompass the national office procedures and practice office procedures, and rely on a top-down approach. This policy review is supplemented extensively with interviews of key national office personnel to determine operating philosophies related to compensation, quality control, independence, training, consultations, and other engagement support. While these are all integral aspects of the inspection process, the vast majority of PCAOB time is spent on examining audit documentation for completed engagements and interviewing engagement team members. For the top eight accounting firms, PCAOB inspection teams visit approximately 15–20 practice office locations per firm. The size of the inspection team varies depending on the size of the firm and the practice office location. Inspection teams usually spend approximately one week on site at a practice office location and then one week back at the PCAOB offices before moving on to the next practice office. This pattern continues until the PCAOB field work is complete. The following bulleted list summarizes the inspection process, based on information provided by the panelists:

- contact the firm to be inspected;
- determine the inspection commencement date;
- issue a formal document request to the firm;
- select audit engagements and offices for inspection;
- complete audit partner and manager interviews at both the national and local levels, including the quality control assessment and all engagement inspections;
- prepare the inspection comment forms (while on-site) and share with the audit team;
- prepare the draft report based on analysis and review of all comment forms;
- deliver the draft report to the firm;
- firm has 30 days to respond to the draft report;
- issue final report to the firm, the SEC, and certain state licensing boards; and
- firm has 12 months to cure any quality control criticisms or defects noted.

In the 2007 inspection cycle, the firms have credited the PCAOB with being more transparent. While the PCAOB does not negotiate with the audit firms when they identify potential concerns, in the most recent year, the PCAOB inspection staff has been more likely to discuss their concerns during the completion of the inspection work to ensure that they understand the issue from the firms’ perspective and resolve potential issues while on-site. The benefit to the firms is not only to

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5 Given the background of the panelists from Grant Thornton LLP and PricewaterhouseCoopers, the paper primarily addresses large firm inspections. Please refer to the PCAOB (2007a) report on small firm inspections for a detailed discussion of findings related to these inspections. Also, see Hermanson et al. (2007) for an analysis of small firm inspection reports.

6 From time to time, inspectors will also use findings from the inspection of audit documentation for completed engagements to help provide relevant information for the overall review of a firm’s national office procedures (e.g., quality control).

7 Importantly, the PCAOB is limited as to public disclosure of the portion of the inspection report related to criticisms or defects of the firm’s quality control found in the inspection process. However, under certain circumstances, public disclosure may be made if such items are not remediated within the required 12 months.
be able to give voice to the rationale behind their choices, but also to be aware of issues likely to be included in the comment forms and the PCAOB firm inspection report. Finally, for selected engagements, inspectors interview the auditee company’s audit committee chairperson.

The selection of practice office engagements as well as the specific accounts or audit areas to be inspected are risk-based, giving consideration to economic and industry factors. The PCAOB also uses firm history as a basis for determining future engagement selections and areas of inquiry at the national and practice-office levels. Fewer PCAOB inspectors are assigned to small firm inspections. Because of firm size, inspections may be completed in less than a week. They are sometimes conducted using telephone interviews combined with audit documentation review.8

**Inspection Reports**

Once the inspection field work is finished for an engagement, comment forms, if any, are completed by the inspection staff outlining facts, issues, areas of concern, and deficiencies noted on the inspected audit engagements. A draft report is then provided to the firm as required by SOX. After receiving a firm’s comments about the draft report, the inspection staff revises the draft, if appropriate, prior to preparing the “final” report for presentation to the PCAOB Board for approval. Upon approval by the Board, the public portion of the report is posted on the PCAOB website.9 The full report that discusses the details of identified deficiencies related to quality control and inspected audit engagements is provided to the firm, the SEC, and the appropriate state licensing authorities.

**Learning Take-Aways for the Classroom**

Panel members emphasized that students, especially those planning to take positions at firms that audit public companies, should have knowledge of SOX, the PCAOB and its inspection process, as well as the SEC’s regulatory role, including an understanding of the regulations affecting auditors of public companies.

Although there are significant confidentiality restrictions for the PCAOB inspection results, under PCAOB Rule 4010 “the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such published report identify the firm or firms to which any quality control criticisms in the report relate.” By reviewing reports issued under Rule 4010 (i.e., 4010 reports dated 11/30/2005, 1/22/2007, 4/18/2007, and 10/22/07), educators can provide students with important general findings made by the PCAOB inspectors. The PCAOB inspections website (http://www.pcaobus.org/Inspections/index.aspx) also provides meaningful resources for the classroom. At present, the inspections website contains hundreds of inspection reports issued for large and small firms alike, along with the following reports that may be useful for auditing educators:

- All comments to date on Guidance Regarding Implementation of PCAOB Rule 4012 (i.e., inspection of Foreign Registered Public Accounting Firms [3/27/2008]);
- Guidance Regarding Implementation of PCAOB Rule 4012 (12/5/2007);
- 4010 Report on the PCAOB’s 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms (10/22/2007);

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8 See the PCAOB (2007a) report for a discussion of findings related to small firm inspections.

9 Disclosure to the public of information obtained and Board deliberations made in relation to inspection, investigations and disciplinary proceedings are subject to section 105(b)(5)(A) of SOX and are to be confidential and privileged as an evidentiary matter. As previously noted, portions of inspection reports that deal with criticisms of or potential defects in the quality control systems of the firm will not be made public if the firm addresses the problems within a year of the report date. Accounting firms may also seek review of reports by the SEC if they disagree with the report findings.
• 4010 Report On The Second-Year Implementation of Auditing Standard No. 2 (4/18/2007);
• 4010 Report With Observations on Auditors’ Implementation of PCAOB Standards Relating to Auditors’ Responsibilities with Respect to Fraud (1/22/2007);
• Statement Regarding the PCAOB’s Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle (5/1/2006); and
• Process for Board Determinations Regarding Firms’ Efforts to Address Quality Control Criticisms in Inspection Reports (3/21/2006).

ADDITIONAL RESOURCES FOR EDUCATORS:
RESEARCH WORKING PAPERS

The following research related to the PCAOB inspection process is also currently available to educators from the SSRN (Social Science Research Network, www.ssrn.com):

• Carpenter, T., and J. Reimers, “Professional Skepticism: The Effects of Tone at the Top and Individual Skepticism on Fraud Risk Assessments and on Identified Audit Procedures” (SSRN Working Paper Series, December 2007)
• Daugherty, B., and W. Tervo, “PCAOB Inspections of Smaller CPA Firms: The Perspective of Inspected Firms” (Working paper, University of Wisconsin-Milwaukee, December 2007)
• Lennox, C., and J. Pittman, “Auditing the Auditors: Evidence on the PCAOB’s Inspections of Audit Firms” (SSRN Working Paper Series, September 2007)

THE PROFESSION’S RESPONSE

Impact of Inspections

Under the AICPA peer review system, each firm is examined once every three years. The firm panelists felt that the annual PCAOB process for large firms is far more rigorous and burdensome, but overall, they agreed that the inspection process has contributed significantly to improved audit quality. Firm representatives indicated that the firms are committed to an internal inspection process and are devoting significant firm resources to ensure compliance with professional standards prior to the arrival of PCAOB inspectors. One panelist noted that his firm recently enhanced its internal engagement inspections by requiring a 20 percent increase in its own inspection staff. These internal inspections are considered by the firms to be more comprehensive

10 The AICPA peer review process is still in effect for firms that are subject to inspection by the PCAOB. Firms that are subject to PCAOB inspection must be enrolled in the AICPA’s Center for Public Company Audit Firms Peer Review Program.
11 As an example, see Gunny and Zhang (2006).
than the PCAOB inspections because, while the PCAOB uses a risk-based, targeted approach to examine particular aspects of selected engagements, the firm’s internal inspectors examine entire engagements for the consistent application of auditing policies and procedures and to ensure that appropriate levels of documentary evidence have been examined.

In addition, in preparation for a PCAOB inspection, the large firms may devote as many as 400 hours preparing for and participating in the inspection of each audit engagement. For example, panelists noted instances where firm personnel have spent approximately 150 hours to prepare for the arrival of the PCAOB team, 150 hours during the engagement inspection process itself, and 100 hours during the response phase to address the draft report. With more experience, it is likely that the number of hours devoted to an inspection will decrease. However, the amount of time spent by firm personnel in the inspection process is substantial.

**Professional Skepticism**

The inspection process, much like the audit process itself, inherently requires professional skepticism by the inspector. It has been challenging for the audit firms to adjust to these increased levels of scrutiny. The overall focus of the inspection process can be summarized as follows: (1) did the firm complete an audit in accordance with professional and regulatory standards; and (2) was the work completed at the highest quality levels and was that quality reflected in the audit documentation? Firm panelists voiced two primary concerns regarding the impact of the inspections. First, they indicated that PCAOB inspections create significant anxiety for firm personnel. It is expected that audit firm personnel will become more accustomed to the PCAOB inspection process as more inspections are completed. Second, the inspection process relies heavily on the engagement team manager and partner which results in logistical challenges for the firms. Nonetheless, the firms recognize that the PCAOB is continuing to work to make inspections run more efficiently.

Overall, after the Enron, WorldCom, and other scandals, panelists noted that accounting firms have moved “back to the basics,” both in accounting and auditing. The PCAOB inspection process has highlighted the importance of high audit quality and changed the focus of firms to emphasize quality with an attitude of “let’s get the audit right.” Complete, accurate, and clear audit documentation is an absolute point of emphasis for all firms. Further, partner compensation has changed. Many accounting firms have now established compensation policies that penalize partners for failing to meet expected quality standards on their audits.

**Changes in Training**

The panelists noted that consistent audit quality requires a commitment to continuous auditor training. One panelist’s firm is focusing on the apprentice model where experienced personnel work with those at lower levels on the engagement team to ensure that everyone knows what they are doing, as well as ensure that work is being done properly at the highest quality levels. Going beyond the review process, the firms promote increased manager and partner involvement in field work. While the review process is an important aspect of a quality audit, a review does not always provide less experienced auditors with a deep understanding of the accounting and auditing issues. So, the increased field work involvement of partners and managers has worked out very well for the firms. Some points of emphasis for this type of hands-on learning approach include:

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12 The PCAOB’s Auditing Standard No. 3 (PCAOB 2004) outlines documentation requirement for audits of publicly traded companies.
making sure that audit staff members understand the audit objectives of applying each of the various procedures;
reviewing and discussing the various audit tools and techniques that are available for consideration with audit staff members;
demonstrating to audit staff members which audit tools work best in various situations; and

demonstrating to audit staff members what the results would look like if various types of audit procedures had been applied differently.

**Documentation**

Auditing Standard No. 3 (PCAOB 2004) places considerable emphasis on detailed audit evidence by increasing the requirements for documentation. The challenge facing the firms is that if it is not written down, it must be assumed that it did not happen unless the audit staff can point to evidence located in other places in the work papers. While documentation should satisfy basic auditing standards requirements, it should also capture the rationale and judgment underlying audit decisions. Adequately expressing the decision rationale requires a disciplined approach to the execution of work papers. Complete and thorough documentation is a focus of the inspection process, and when documentation is incomplete, PCAOB inspectors heighten their examination of the area in question.

**Learning Take-Aways for the Classroom**

Panelists emphasized the need for students to understand that quality audits are a function of consistent application of proper auditing tools and techniques. Audit firms have the necessary policies and procedures in place to complete high-quality audits. However, consistent execution and documentation of those policies and procedures is now the point of focus. The firms believe that defects in past audit performance have generally resulted from the improper execution of existing audit policies and procedures or failure to adequately document audit work rather than improper design of those audit policies and procedures.

As a result, professors need to emphasize substance over form in the classroom and encourage students to ask themselves, “What is the appropriate course of action given the facts and circumstances?” Quality does not mean using Generally Accepted Accounting Principles (GAAP) to justify management’s preferences for economic transactions; alternatively, it means using GAAP to determine the appropriate course of action that a company’s management should be taking given the relevant facts and circumstances. This understanding can then be used to audit management’s accounting treatment of the economic transaction.

Panelists also want graduating students to understand the importance of asking questions when they do not understand a transaction, event, procedure, or any other audit issue. They suggest using interactive in-class case exercises to help develop critical thinking and encourage students to learn how to properly ask questions. For example, although a tool primarily for intermediate accounting, the Business Activity Model (Catanach et al. 2000) requires students to formulate questions in order to elicit client information that is both complete and accurate.

Panelists also suggested that students could benefit by further coverage of best practices related to audit documentation preparation. Most auditing texts devote several pages to audit documentation; however, panelists suggest that students could benefit by becoming more familiar with quality working papers that document the procedures considered, the work performed, important considerations related to audit choices, and complete conclusions with supporting rationale.
Panelists also emphasized the importance of instructors utilizing classroom experiences where students are challenged to understand and apply accounting and auditing standards in open-ended situations. Their collective belief is that if students “use” the knowledge, they will be better able to apply such knowledge in a variety of situations. This type of approach is necessary in everyday practice given the principles-based nature of new accounting and auditing standards. For example, the PCAOB’s (2007b) new standard on auditing internal control over financial reporting (Auditing Standard No. 5) is a more principles-based standard, designed to allow auditors to focus on matters they deem most important. The PCAOB and the firms want to encourage audits that are more effective, efficient, and risk-based. To accomplish this in practice an auditor must have the skills to adjust audit procedures to fit each company based on size and complexity rather than simply applying a set of specific rules in a generic manner.

It is important that students realize the importance of completing audit documentation contemporaneously, as the procedures are performed and the conclusions are developed. In addition, professors should consider course content that increases student knowledge and skills related to good documentation and proper working paper tools and techniques. Few auditing texts address working paper preparation and proper documentation of work performed beyond cursory descriptions. Faculty should emphasize that proper documentation includes noting the audit issue, what audit work was done, the standard(s) used to develop the work plan, the conclusions derived, and the rationale behind those conclusions. This could be accomplished by using a short audit/accounting scenario for homework and/or class discussion that involves identifying the issue, researching applicable professional standards, forming a conclusion, and providing a rationale for the choice.

CONCLUSION

While the Sarbanes-Oxley Act of 2002 specifically charges the PCAOB to promote public trust in both the financial reporting process and the auditing profession, panelists from both audit firms and the PCAOB acknowledged the importance of maintaining public confidence in the audit report. All panelists shared a common goal: audit quality. Overall, the panelists agreed that the general and specific guidance provided by SOX, the PCAOB standards, and the PCAOB inspection process have improved the audit process. While the PCAOB inspection process is still evolving, the panelists supported the objective of the inspection process to provide assurance to the investing public by improving audit quality and reducing the risks of audit failures in the U.S. public securities market.

The purpose of the Auditing Section Education Committee summarizing the panelists’ remarks and insights was to highlight the educational challenges presented by the post-SOX audit environment where audits are more complex and the inspection process is more thorough. We feel that the PCAOB inspection process affords a valuable resource for developing curriculum content that will best prepare students as they enter the profession in the post-SOX audit era. Much of the panel discussion centered on completing auditing work that meets professional and regulatory standards as well as compliance with internal firm policies and procedures. However, panelists noted that the outcomes from the inspection process reiterate the importance of educators continuing to emphasize accounting and auditing fundamentals in the classroom. Students need analytical skills to help them understand and evaluate complex accounting and auditing situations and communicative skills to adequately document work performed, including rationale.

As an example, instructors might consider relevant case material developed by Thibodeau and Freier (2009) and/or Cohen et al. (2008) to meet this objective.
and conclusions. While the PCAOB inspection process continues to support the importance of critical thinking, sound decision-making, and professional skepticism, more than anything, the inspection process emphasizes the need for these attributes to be properly and completely reflected in the final audit documentation.

REFERENCES