

PCAOB Inspections of Smaller CPA Firms: The Perspective of Inspected Firms

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Abstract

We solicit perceptions of the Public Company Accounting Oversight Board's (PCAOB) recently implemented inspection process from the leadership of smaller firms (100 or fewer publicly-traded audit clients) registered with the PCAOB. Participating firms evaluated the performance of their respective PCAOB inspection teams on 14 qualitative factors, including eight quality control (QC) components, provided their perceptions related to the PCAOB inspection process on an additional 15 qualitative factors, and expressed their views on the continuance of the current confidential treatment afforded inspectors' findings on firms' QC systems. Participants generally evaluated their inspection team's *performance* favorably, but were much more critical of the inspection *process* itself. In particular, firms viewed the inspection process as negatively impacting many aspects of their public company audit practices. We provide suggestions for improving the inspection process as Congress contemplates revisions to the Sarbanes-Oxley Act (SOX) and the PCAOB's oversight of independent public accounting firms.

INTRODUCTION

The Sarbanes-Oxley Act's (SOX) creation of the Public Company Accounting Oversight Board (PCAOB) fundamentally changed the oversight of firms auditing U.S. registrants.¹ Larger auditing firms (greater than 100 issuer audit clients – inspected annually by the PCAOB) have received the most publicity related to PCAOB inspections (Hermanson et al. 2007). However, a growing stream of research examines the influence of the PCAOB inspection process on smaller firms (100 or fewer issuers, inspected triennially), including Read et al. (2004), the AICPA (2006), Hermanson et al. (2007), Abbott et al. (2008), Daugherty et al. (2008) and Gramling et al. (2008).

Nusbaum (2007) questions whether the performance of audits in the post-SOX era “fail to attain the objective of enhancing investor confidence in our capital markets” (C4) and calls for research to assist the profession in reducing the risk of such failure. Hermanson et al. (2007) note that smaller registrants (typically audited by smaller firms) have garnered increased attention in recent years, due in large measure to their disproportionate concentration of financial statement fraud and the debate over the efficacy of SOX requirements for smaller registrants. The PCAOB itself recognizes smaller firms have “importance to the market and investors ... as they audit almost 80 percent of the more than 3,600 companies with revenue of less than \$100 million” (PCAOB 2008, 1).

Hermanson et al. (2007) report smaller firms with deficient PCAOB inspection reports are smaller (fewer professionals), have a larger number of public clients, and have experienced rapid growth - suggesting some firms may have overextended into the public company audit arena. Abbott et al. (2008) posit that PCAOB inspection reports are a

¹ Hermanson et al. (2007) provide an overview of audit firm oversight in the pre- and post-SOX eras.

powerful signal of audit quality for smaller firms and find public companies with high agency conflicts are prone to switch away from firms receiving deficient PCAOB inspection reports. Abbott et al. also report effective audit committees are particularly sensitive to deficient inspection reports. Daugherty et al. (2008) report the PCAOB inspection process may unduly impact the smallest of the smaller auditing firms. Gramling et al. (2008) find deficient PCAOB inspection reports for smaller firms signal undetected or underreported going concern problems and report a positive association between deficient reports and the likelihood of going concern opinions in the year following the PCAOB inspection.

We respond to Nusbaum's (2007) request and extend the smaller firm PCAOB literature by soliciting the perceptions of leadership at smaller firms receiving their initial PCAOB inspection. Participating firms evaluated the performance of their respective PCAOB inspection teams on 14 qualitative factors - including eight quality control (QC) components -, and provided their perceptions related to the PCAOB inspection process on an additional 15 qualitative factors. Our research also extends knowledge of the PCAOB's focus on QC since little is publicly known as any criticisms or defects related to QC systems receive confidential treatment in the PCAOB inspection reports.²

Nearly one-third of the smaller registered firms having their initial inspection report posted on the PCAOB's website completed our research instrument.³ Participants generally evaluated their inspection team's *performance* favorably, but were much more critical of the inspection *process* itself. In particular, many firms viewed the inspection

² Firms risk having quality control deficiencies publicly disclosed if they fail to adequately address them to the PCAOB's satisfaction within one year of the inspection report date.

³ At the date of mailing, none of the surveyed firms had more than one inspection report released.

process as negatively impacting certain aspects of their public company audit practices. Analyzing responses by firm size (comprised of smaller, medium, and larger firms) we find significantly increasing levels of satisfaction with nearly all aspects of the PCAOB inspection process as firm size increases.⁴

Prior research on smaller firms and the PCAOB inspection process has focused on the publicly available information in inspection reports. To our knowledge, our research is the first to directly solicit the perceptions of the smaller inspected firms themselves. Our findings are important to practitioners, regulators, legislators, academicians, and other market participants as many aspects of SOX and the PCAOB inspection process have come under criticism, the U.S. Congress appears receptive to legislative remedies, and the profession itself has called for further research to investigate the impact of SOX and the PCAOB on enhancing investor confidence.

PCAOB Inspection Team Performance

Participating firms evaluated the performance of their PCAOB inspection teams on matters related to technical knowledge, professional conduct, and the appropriateness of the inspectors' focus on audit documentation, substantive audit procedures, and audits of internal control. Respondents also provided their assessments related to the inspectors' focus on various components of firms' QC systems.

Respondents collectively agreed the inspectors possessed adequate technical knowledge and exercised appropriate professional conduct during the course of the inspections. Medium and larger firms tended to agree that the inspectors' focus on audit

⁴ We use number of professionals to delineate firm size - consistent with the methodology used by Hermanson et al. (2007). The PCAOB inspection reports provide the number of professional staff which includes all personnel except partners or shareholders and administrative support personnel.

documentation, substantive procedures, and internal control audits were appropriate while smaller firms exhibited lower levels of agreement. Firms provided generally favorable evaluations related to the PCAOB's focus on QC elements with the smaller firms again being somewhat less enthusiastic in their assessments than medium and larger firms.

Perceptions of the PCAOB Inspection Process

Participating firms provided their perceptions related to various aspects of the PCAOB inspection process including the receipt of constructive criticism, engagement selection, inspector effort, impact of the process on audit practices (overall audit quality, engagement hours, billings, client acceptance and retention, personnel recruitment and retention, and litigation risk), and their level of agreement with the inspectors' published findings. We also solicited assessments of the PCAOB inspection process relative to the prior peer-review inspection process.

The medium and larger responding firms agreed inspectors' constructive criticisms were appropriate while smaller firms did not. Firms of all sizes believed the specific audit engagements selected for inspection were appropriate. However, there was less agreement that the amount of inspection time was appropriate, with smaller firms viewing the inspection time as excessive. Some respondents observed that inspection time on selected audits approximated (and for one firm exceeded) the total engagement time incurred by the firm. The medium and smaller firms tended to view the PCAOB inspection process as negatively impacting their audit practices - with smaller firms appearing to shy away from public company audits.

Contrary to the stated intentions of SOX, smaller firms do not view the inspection process as contributing to public confidence in the auditing profession with medium firms being ambivalent in their public confidence assessment. Larger firms, however, view inspections as a somewhat positive contributor to public confidence. Responding firms agree that PCAOB inspections have increased both the hours incurred on audit engagements and the fees billed to clients, and also view the inspection process as hampering their ability to attract and retain audit qualified personnel.

Larger firms report general agreement with the findings in inspection reports, smaller firms disagree, and medium firms are near neutral in their level of agreement. Smaller firms disagree that PCAOB inspections are an improvement over the peer-review process while medium and larger firms are closer to neutral in their comparisons of the two processes. Larger firms do not view PCAOB inspections as increasing their exposure to risk of audit litigation, smaller firms perceive increased exposure, and medium firms are near neutral in their assessment of the influence that inspections have on litigation risk. Responding firms of all sizes receiving a deficient PCAOB inspection report were generally more critical of both the inspectors and the process than were firms receiving a 'clean' inspection report. Many firms provided comments suggesting the PCAOB inspectors were inappropriately substituting their own professional judgments for those of audit engagement personnel.

Collectively, we interpret our research findings as suggesting that the efficacy of PCAOB inspections may be enhanced by focusing more on *process* modifications than on the qualifications and actions of inspection personnel. Specific suggestions for improving the PCAOB inspection process are provided.

RESEARCH METHOD AND DEVELOPMENT OF INSTRUMENT

Selection of Firms

Through November 7, 2007, over 1,800 firms and affiliates were registered with and approved by the PCAOB to conduct audits of U.S. registrants (PCAOB 2007a). Of these, 467 smaller domestic firms (auditing 100 or fewer issuers annually) had their initial inspection report posted on the PCAOB's website.⁵ The research instrument was mailed to 461 of these smaller inspected firms (98.7 percent), and 146 completed instruments (31.7 percent) were returned.⁶ The response rates for smaller, medium, and larger firms were 27.5 percent, 34.3 percent, and 33.1 percent, respectively. The cover letter stressed anonymity and requested that the instrument be completed by the person in the firm most closely involved with the PCAOB inspection process.⁷

As Hermanson et al. (2007) report deficient firms tend to be smaller and Daugherty et al. (2008) find the smallest of the smaller firms may be unduly impacted by the PCAOB inspection process, firms are further subdivided into three sizes to facilitate a between-groups analysis of smaller (zero to ten professionals), medium (11 to 40 professionals), and larger (more than 40 professionals) firms. Table 1 provides details of the sample selection.

⁵ We focus on domestic firms as the research instrument, in part, solicits evaluations of the PCAOB inspection process of public company audits vis-à-vis the AICPA's prior peer review program for public audits. Further, the PCAOB has recently issued a proposed policy statement whereby, in certain circumstances, the PCAOB may move towards full reliance on a non-U.S. oversight entity in the context of inspections of foreign-based registered firms (PCAOB 2007c).

⁶ We were unable to locate mailing addresses for six inspected firms (1.3 percent). In an effort to obtain addresses we examined Form 1 applications filed with the PCAOB, performed internet searches, and reviewed response letters filed with the PCAOB, as applicable.

⁷ Mailings were addressed to each firm's "primary contact name" (if available) as indicated on the firm's Form 1 – Application for Registration – as filed with the PCAOB (PCAOB 2007b), or the signatory on a firm's response letter (if applicable) appended to the inspection report. Otherwise, the mailing was addressed to the firm's "Office Managing Partner".

[Insert Table 1 about here]

Development of Research Instrument

Part I of the research instrument consists of 14 statements asking participants to evaluate the performance of their PCAOB inspection team on a number of dimensions, as well as a 15th statement related to inspectors' findings related to firms' QC systems. The first two statements relate to the technical knowledge and professional conduct of the inspectors. Statements three through five are included to evaluate inspector performance on the timely topics of workpaper documentation, as mandated by Auditing Standard No. 3 (AS3) – *Audit Documentation* (PCAOB 2004b), substantive auditing procedures, the most pervasive area of audit deficiencies for smaller firms (Hermanson et al. 2007), and audits of internal control as mandated by AS2 – *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (PCAOB 2004a).⁸ Statements six through 13 relate to specific elements of a firm's QC system - derived from standard language in PCAOB inspection reports.⁹ Statement 14 evaluates the inspectors' overall focus on QC and the 15th statement solicits participants' views on the confidential treatment afforded QC findings.

Part II of the research instrument consists of an additional 15 statements and solicits perceptions on various aspects of the inspection process. These statements cover inspectors' criticisms and findings, engagement selection, time devoted to inspection, inspection influence on firms' hiring and retention capabilities, and a comparison with

⁸ AS2 has been superseded by AS5 – *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* for fiscal years ending on or after November 15, 2007. AS5 was not effective for any of the years covered by the inspection reports in our selection of firms.

⁹ These statements encompass: tone at the top, partner evaluation, independence compliance, client acceptance and retention, consultation practices, audit policies and procedures, auditor training, and audit supervision.

the prior peer-review process. The remaining statements seek perceptions related to the influence of PCAOB inspections on overall audit quality, the ability to obtain and retain public audit clients, personnel time incurred in anticipation of inspection, incremental fees billed to clients as a result of inspection, public confidence in the audit profession, and risk of audit litigation. Certain of these statements were drawn from the stated intentions of SOX related to the formation of the PCAOB, while other statements are based on our review of the extant literature and discussions with relevant parties.¹⁰

Participants were asked to respond to each statement using a five-point Likert scale labeled as:

1 = Strongly Agree, 2 = Agree, 3 = Neutral, 4 = Disagree, 5 = Strongly Disagree

Respondents were also afforded an opportunity to respond with “NA” if they did not have an adequate basis to evaluate a particular statement. Finally, participants were asked to provide additional comments if they desired, with 57 of the 146 responding firms (39 percent) including written comments with the completed instrument. The survey instrument, including the full text of each statement, is included as Appendix A.

RESULTS

Table 2 provides descriptive statistics, partitioned by firm size, for the firms that were mailed a copy of the research instrument.¹¹

[Insert Table 2 about here]

¹⁰ A number of colleagues from academia and practice reviewed the statements for clarity and completeness prior to our mailing of the final research instrument. Due to the limited number of firms having an inspection report posted on the PCAOB’s website, the instrument was not pre-tested on smaller registered firms in an effort to maximize the number of usable responses from the final version of the instrument.

¹¹ Anonymity of the response process precludes us from providing descriptive statistics of the responding firms. While instrument coding allowed us to identify the *type* of respondent (i.e., relative firm size, recipient of a clean or deficient PCAOB inspection report, etc.), we are unable to identify specific responses to a specific registered firm.

The target firms average just over two practice offices, with approximately ten partners and 40 professionals each. Smaller and medium firms each average about six issuer clients (publicly traded audit engagements) with larger firms averaging nearly 12 issuer clients. The PCAOB inspected approximately 44 percent, 42 percent, and 34 percent of the public company audits for smaller, medium, and larger firms, respectively.

We evaluate the reliability of our scales related to PCAOB inspection team performance (statements one through 14) and perceptions of the PCAOB inspection process (statements 16 through 30) by examining Cronbach's alpha coefficients. For the performance and process statements we obtain alpha coefficients of .957 and .786, respectively, suggesting both sub-scales have strong internal consistency.

Evaluation of PCAOB Inspection Team Performance

Table 3 summarizes the responses, partitioned by firm size, for statements one through 14 used to evaluate the performance of each responding firms' PCAOB inspection team.

[Insert Table 3 about here]

Broadly, the results suggest a monotonically decreasing level of satisfaction with PCAOB inspection team performance as firm size decreases. However, the overall and firm-size partitioned evaluations of inspection team performance are still quite favorable. Collectively, the mean level of agreement for each of the positively worded inspection team performance statements range from 1.86 to 2.41, (1 = strong agreement with the statement, 2 = agreement, and 3 = neutral).

Technical Knowledge and Professional Conduct

Technical Knowledge

Respondents felt the PCAOB inspectors possessed adequate technical knowledge (statement 1, overall mean of 2.03). Utilizing analysis of variance (ANOVA), we find a significant ($F = 4.57$, $p = .012$) difference between the three firm sizes with the larger firm perceptions notably favorable (1.70), and the medium (2.21) and smaller (2.27) firms also perceiving their inspectors to be technically competent. Post-hoc analyses (all non-tabulated) reveal significant differences between smaller and larger firms ($p = .046$) and medium and larger firms ($p = .015$).

Professional Conduct

Respondents felt the PCAOB inspectors exercised appropriate levels of professional conduct (statement 2, overall mean of 1.86). There is a significant ($F = 7.32$, $p = .001$) difference between the three firm sizes with larger firm perceptions again being notably favorable (1.52). The medium (1.83) and smaller (2.29) firms also afforded their inspection teams with favorable marks for professional conduct. Significant differences are between smaller and medium firms ($p = .046$) and smaller and larger firms ($p = .001$).

Audit Documentation, Substantive Audit Procedures, and Internal Control Audits

Focus on Firm's Audit Documentation

Respondents collectively believed the PCAOB inspectors demonstrated an appropriate focus on firms' audit documentation (statement 3, overall mean of 2.19). A significant ($F = 8.89$, $p < .001$) difference again exists between firm size with larger firms indicating a relatively higher level of agreement (1.84) than did medium (2.12) and

smaller firms (2.67). Significant differences are between smaller and medium firms ($p = .011$) and smaller and larger firms ($p < .001$).

Focus on Firm's Substantive Audit Procedures

Respondents collectively believed the PCAOB inspectors demonstrated an appropriate focus on firms' substantive audit procedures (statement 4, overall mean of 2.25). A significant ($F = 7.95$, $p = .001$) difference exists between firm size with larger firms again indicating a relatively higher degree of satisfaction related to substantive procedures (1.83) than did medium (2.24) and smaller (2.71) firms in their assessments. The significant difference is between smaller and larger firms ($p < .001$), with a moderate difference between smaller and medium firms ($p = .069$).

Focus on Firms' Internal Control Audits

In the aggregate, the responding firms viewed inspectors' focus on internal control audits (statement 5) as appropriate (2.41).¹² There is no significant difference between firm sizes with larger firms evaluating this statement with a mean of 2.25, similar to the medium (2.41) and smaller (2.60) firms' assessments.

Focus on Firms' Quality Control Components

Responding firms in each size grouping gave the inspectors generally favorable marks for the eight components of QC (statements six through 13).¹³ For smaller firms,

¹² We note that only 94 of the 146 responding firms (64.4 percent) indicated their level of agreement with statement five regarding inspectors' focus on the firm's audit of internal controls. We attribute this relatively low response rate to the fact that SOX provided smaller registrants, typically audited by smaller firms similar to our respondents – see Hermanson et al. (2007) – with a delayed effective date for the newly required audits of internal control over financial reporting imposed by SOX. The initial effective date was subsequently extended a number of times and it is likely that a portion of our responding firms had not conducted an internal control audit at the time of their initial PCAOB inspection.

¹³ Only 88 of the 146 responding firms (60.3 percent) responded to the statement on consultation practices (statement ten) suggesting that the SOX ban on providing most non-audit services to attest clients may have resulted in many firms not having an adequate basis to evaluate the consultation statement.

the inspectors' focus on firms' audit policies and procedures received the lowest QC component evaluation (2.71), while the focus on independence compliance (2.26), client acceptance and retention policies (2.27), 'tone at the top' (2.38), consultation practices (2.38), and auditor training (2.41) received more favorable evaluations. The medium-sized firms had a very narrow corridor of mean scores on the eight QC components, ranging from 1.96 (independence compliance) to 2.21 (evaluation of partners and consultation practices) as did the larger firms, ranging from 1.96 (supervision of audits) to 2.28 (evaluation of partners). The only significant QC differences, based on firm size, were for statements six – focus on tone at the top ($F = 3.68, p = .028$), 11 – focus on audit policies and procedures ($F = 7.56, p = .001$) and 13 – focus on audit supervision ($F = 5.89, p = .004$).

With respect to inspectors' *overall* focus on QC (aggregate mean of 2.27), we find a significant ($F = 8.31, p < .001$) difference between firm sizes with larger firm (1.91), medium firm (2.22), and smaller firm (2.73) mean assessments. The significant differences are between smaller and medium ($p = .025$) and smaller and larger ($p < .001$) firms.

Confidential Treatment of Inspector Findings Related to Quality Control

Respondents were asked to provide their level of agreement with the statement that inspectors' findings related to firms' QC systems should continue to be afforded confidential treatment (statement 15). The participating firms agree (no significant differences) that QC findings should remain confidential with mean evaluations by smaller firms (1.39) followed by medium (1.64) and larger (1.67) firms, resulting in a collective mean level of 1.58.

PERCEPTIONS OF THE PCAOB INSPECTION PROCESS

Responding firms were also asked to provide their level of agreement with 15 statements (16 through 30) related to the PCAOB inspection process. Table 4 summarizes the responses, partitioned by firm size, for the statements on various aspects of the inspection process.

[Insert Table 4 about here]

While respondents evaluated the *performance* of their PCAOB inspection teams in generally favorable terms, the firms were much less enthusiastic about the inspection *process* itself. Similar to the performance statements, respondents were again asked to indicate their degree of agreement with the inspection process statements using the same five-point Likert scale labeled as:

1 = Strongly Agree, 2 = Agree, 3 = Neutral, 4 = Disagree, 5 = Strongly Disagree

Inspectors' Constructive Criticism

Overall, respondents expressed mild agreement (overall mean 2.53) with respect to the appropriateness of the inspectors' constructive criticisms (statement 16). As firm size decreases, participants are less likely to view the criticisms as appropriate. Larger and medium firms agreed that the criticisms were appropriate with mean assessments of 2.12 and 2.38, respectively. However, the smaller firms tended to disagree (3.17) with the inspectors' criticisms. Using ANOVA, we find significant ($F = 10.45$, $p < .001$) differences between firm sizes in their assessments of the inspectors' constructive criticism. Post-hoc analyses (all non-tabulated) reveal significant differences between smaller and medium firms ($p = .002$) and smaller and larger firms ($p < .001$).

The level of agreement with the inspectors' constructive criticism appears to correlate negatively with the frequency of deficient inspection reports received. Table 2 shows the population of smaller, medium, and larger firms receive deficient inspection reports approximately 67 percent, 54 percent, and 39 percent of the time, respectively, consistent with Hermanson et al.'s (2007) observation that firms inspected triennially exhibit disproportionately higher inspection failure rates, and that the smallest of firms have the highest level of deficiencies. The deficiency rates (not tabulated) for our smaller, medium, and larger responding firms were 76 percent, 60 percent, and 26 percent, respectively, with an overall deficiency rate of 54 percent.¹⁴

Engagement Selection and Inspection Time

Engagement Selection

Larger, medium, and smaller firms viewed the audit engagements selected for inspection as appropriate (statement 17, overall mean 1.88) with mean levels of agreement of 1.64, 1.86, and 2.12, respectively. There is a significant ($F = 3.49$, $p = .033$) difference between firm sizes with the level of agreement significantly ($p = .025$) different between the smaller and larger firms.¹⁵

Inspection Time

While our respondents viewed engagement selection as appropriate, they believed the amount of inspection time spent on the engagements (statement 18, overall mean

¹⁴ Hermanson et al. (2007) analyzed the inspection reports of 316 smaller firms registered with the PCAOB and reported an overall inspection deficiency rate of 60 percent. Their research examined smaller firms (100 or fewer issuer audit clients) in the aggregate and did not further subdivide the firms into smaller, medium, and larger classifications.

¹⁵ As shown in Table 2, the average number of issuer clients per firm approximates 12, six, and six for larger, medium, and smaller firms, respectively, and the proportion of issuer clients inspected is inversely related to the size of the firm.

2.65) was somewhat less appropriate with larger, medium, and smaller firms reporting significantly ($F = 5.96$, $p = .003$) different levels of agreement with the statement with means of 2.28, 2.52, and 3.15, respectively. The level of agreement was significantly different between smaller and medium firms and between smaller and larger firms ($p = .030$ and $p = .003$, respectively).

Influence on Overall Audit Quality

In the aggregate, responding firms were near neutral (2.88) with respect to the influence that the inspection process has had on overall audit quality (statement 19). Smaller firms disagreed (3.41) that inspections improve overall audit quality while medium (2.74) and larger (2.58) firms expressed some level of agreement that quality is increased. The levels of agreement are significantly ($F = 5.72$, $p = .004$) different with smaller firms significantly different than medium firms ($p = .021$) and larger firms ($p = .005$).

One firm thought the inspection process may have helped to restore investor confidence but did not believe it has helped improve audit quality at all, noting “quite the opposite is occurring. We are moving more and more towards a ‘form over substance’ audit just to satisfy inspection requirements, and in the process we are losing sight of the real audit objective”.

Influence of Inspection Process on Audit Practices

The research instrument asked respondents to evaluate the influence that the PCAOB inspection process has had on their auditing practices, acceptance and retention of public audit clients, and whether they have considered ceasing public audits due to the inspection requirements. Participating firms generally view the inspection process as

having a negative influence on these metrics, with smaller firms again viewing the process as more detrimental relative to the medium and larger firms.

Influence on Audit Business

Smaller (3.83) and medium (3.21) firms did not believe the inspection process positively impacted their audit business (statement 20, overall mean 3.28) while larger firms (2.87) felt inspections had a somewhat positive influence on this measure. The level of agreement with this statement is significantly ($F = 8.71, p < .001$) different with smaller firms differing significantly from medium ($p = .015$) and larger firms ($p < .001$).

Influence on Acceptance, Retention and Continuation of Public Audit Clients

The results suggest that the PCAOB inspection process has led to a shift in the types of firms willing to provide audit services to publicly traded enterprises. None of the firm size groupings reported an inclination to accept new public company audits as a result of the inspection process, with smaller (3.88) and medium (3.62) firms disagreeing with the statement that the inspection process will increase acceptance of new public audit clients (statement 21, overall mean 3.51). Larger firms were near neutral (3.02) in their assessment. The level of agreement differs significantly by firm size ($F = 8.14, p < .001$) with significant differences between smaller and larger firms ($p < .001$) and between medium and larger firms ($p = .010$).

In addition to dampening firms' appetites for *new* public audits, the inspection process also appears to increase the likelihood that firms will choose to terminate *existing* audit relationships with smaller (3.83) and medium (3.47) firms disagreeing that inspections will increase their retention of publicly traded clients (statement 22, overall mean of 3.41). Larger firms were again near neutral (2.98) in their assessment of the

retention statement. The level of agreement differs significantly by firm size ($F = 7.16$, $p = .001$) with significant differences between smaller and larger firms ($p = .001$) and marginal differences between medium and larger firms ($p = .051$).

The results also suggest that very small firms (zero to ten professional staff) are considering ceasing public audits due to inspection requirements (statement 23), with this group agreeing (2.18) with the statement. The medium (3.18) and larger (4.09) firms, on the other hand, disagree that inspection requirements might lead them to exit the public audit arena, resulting in an overall mean of 3.18. Agreement differs significantly by firm size ($F = 23.93$, $p < .001$) with significant differences between all three firm sizes: small firms versus medium firms ($p = .001$), small firms versus larger firms ($p < .001$), and medium firms versus larger firms ($p = .001$).

Public Confidence in the Audit Profession

SOX established the PCAOB to “oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors” (U.S. House of Representatives 2002, 8). We asked participating firms if they believe the PCAOB inspection process has increased public confidence in the audit profession (statement 24, overall mean of 3.01). Contrary to the stated intentions of SOX, smaller firms (3.53) tended to disagree with the statement and the medium firms (2.98) did not perceive an increase in public confidence as a result of PCAOB inspections. Larger firms (2.59), on the other hand, suggest the inspection process has increased public confidence. The level of agreement differs significantly by

firm size ($F = 8.64$, $p < .001$) with significant differences between smaller and medium firms ($p = .034$) and between smaller and larger firms ($p < .001$)

Engagement Hours and Client Billings

The research instrument solicited information with respect to the extent the PCAOB inspection process has increased hours incurred on audit engagements (statement 25, overall mean of 2.12) and whether fees billed to clients have also increased (statement 26, overall mean of 2.39). The smaller group of responding firms exhibited a high level of agreement that both hours incurred (1.80) and billings (2.15) have increased due to anticipation of inspection. Similarly, medium and larger firms agree, albeit less strongly, that engagement hours (2.21 and 2.28, respectively) and client billings (2.52 and 2.44, respectively) increased as a result of inspections. The level of agreement for hours incurred differs significantly by firm size ($F = 3.24$, $p = .042$) with marginally significant differences between smaller and medium firms ($p = .092$) and between smaller and larger firms ($p = .052$). There were no significant differences between firm sizes for the billing statement. All three groups had higher levels of agreement with the hours incurred statement than their respective levels of agreement with the billings statement, suggesting that firms at each level have absorbed a portion of the incremental costs associated with PCAOB inspections.

Recruitment and Retention Efforts

The responding firms were clearly negative in their perceptions that the PCAOB inspection process has had on their ability to attract and retain audit personnel (statement 27), overall mean of 3.50, with the smaller firms again exhibiting the strongest level of disagreement (3.73) with the statement. Medium (3.57) and larger (3.22) firms expressed

diminishing levels of disagreement with the notion that the inspection process positively influences the ability to attract and retain qualified personnel. The level of agreement differs significantly by firm size ($F = 4.15$, $p = .018$) with a significant difference between smaller and larger firms ($p = .018$) and a marginal difference between medium and larger firms ($p = .093$). Future research might separately distinguish the influence that PCAOB inspections have had on firms' ability to *recruit* entry-level candidates versus their ability to *retain* existing audit professionals.

Level of Agreement with Inspectors' Findings

We asked firms to provide their level of agreement with the inspectors' findings as reported in the PCAOB inspection reports (statement 28, overall mean 2.85). Smaller firms (3.49) tended to disagree with the findings while the medium (2.82) and larger (2.27) firms reported increasing levels of agreement with the inspectors' findings. The level of agreement differs significantly by firm size ($F = 8.00$, $p = .001$) with a significant difference between smaller and larger firms ($p < .001$) and a marginal difference between smaller and medium firms ($p = .053$).

PCAOB Inspections and Peer-Reviews

A negative reaction to the PCAOB inspection process lies with smaller firms' comparison of the process to that of the former peer-review inspections of public company audits (statement 29, overall mean 3.27). When asked if they viewed the inspection process to be an improvement over peer-reviews, our smaller firm respondents disagreed (3.83). The medium firms were milder (3.19) in their level of disagreement while larger firms perceived PCAOB inspections to be a slight improvement (2.87) over the peer-review process. The level of agreement differs significantly by firm size ($F =$

7.38, $p = .001$) with a significant difference between smaller and medium firms ($p = .024$) and between smaller and larger firms ($p = .001$).

Audit Litigation Risk

Clearly the PCAOB inspection reports have increased the transparency of the auditor oversight process, relative to the former peer-review process, though it is too early to empirically document whether this has translated into increased risk of litigation. Given the increased transparency of audit quality (or lack thereof) via PCAOB inspection reports, we asked the responding firms if they perceived any change in litigation exposure as a result of the new inspection process.

Collectively, the responding firms were near neutral (2.98) as to whether the inspection process has increased their exposure to audit litigation risk (statement 30). Smaller firms thought the process increased litigation exposure (2.69) whereas the medium (2.90) and larger (3.22) firms did not perceive an increase in litigation risk. The level of agreement differs significantly by firm size ($F = 3.17$, $p = .045$) with a significant difference between smaller and larger firms ($p = .039$).

Supplemental Analysis - Non-Deficient Versus Deficient Inspection Reports

We compare all responses for all statements between firms receiving ‘clean’ inspection reports and those receiving deficient inspection reports, partitioned by firm size. The results are set forth in Table 5.

[Insert Table 5 about here]

PCAOB Inspection Team Performance

In the aggregate, we find significant differences, by firm size, between clean and deficient firms for statements 1 (technical knowledge), 2 (professional conduct), 3

(workpaper documentation), 4 (substantive audit procedures), 6 (tone at the top), 11 (policies and procedures), 13 (supervision) and 14 (overall QC). The insignificant differences all relate to sub-components of QC with the exception of statement 5 (audit of internal controls).

PCAOB Inspection Process

With respect to the PCAOB inspection process itself, we find significant differences, by firm size, for every statement (statements 16 – 30) with the exception of statement 26 (increased fees billed to clients). Similar to the earlier results, the larger firms (more than 40 professionals), both deficient and non-deficient, appear to be more supportive of the PCAOB inspection process relative to their counterparts. While the results in our research are based on the self-reported perceptions of the participating firms, our findings are consistent with those of both Hermanson et al. (2007) and Daugherty et al. (2008) who report, based on data from the PCAOB inspection reports, that the smallest firms comprising the firms inspected triennially may be unduly impacted by the new auditor oversight mechanism put in place by the SOX legislation. Further, firms of all sizes receiving a deficient inspection report from the PCAOB tend to be more critical of both the inspectors and the process than their counterparts receiving clean inspection reports.

CONCLUSION AND IMPLICATIONS

This study solicits the perceptions of smaller firms registered with the PCAOB (inspected triennially) on the performance of their initial PCAOB inspection teams as well as their views on the inspection process itself. Respondents generally evaluated inspectors' performance in favorable terms but were much more critical of the inspection

process itself. Results suggest very small public accounting firms (ten or fewer professionals) are choosing to cease the performance of audits of publicly traded enterprises as a result of PCAOB inspections. Smaller firms disagree that the PCAOB inspection process increases the overall quality of audits performed (contrary to the stated intentions of SOX) and both the smaller and medium firms (11 to 40 professionals) did not view PCAOB inspections as positively impacting their audit business.

An overriding concern of many inspected firms, based upon written comments appended to the research instrument, is the perception that inspectors are, in many cases, substituting their own judgment for the auditor's professional judgment in determining whether audit engagements comply with applicable professional standards. This possibility is particularly troubling given the auditors' direct interaction with client personnel and audit committee members in an *ex-ante* setting while PCAOB inspections are, by definition, conducted in an *ex-post* setting with minimal audit client contact.¹⁶

The PCAOB publicly acknowledges the importance of smaller registered firms and the public companies they audit (PCAOB 2008) and periodically hosts forums for directors and financial executives of small and mid-sized public companies to "help share important information with registered public accounting firms and public companies operating in the small business community" (see http://www.pcaobus.org/News_and_Events/News/2008/08-20.aspx for an example). Our findings are important to practitioners, regulators, legislators, academicians, and other market participants as many aspects of SOX and the PCAOB inspection process have come under criticism, the U.S. Congress appears receptive to legislative remedies, and

¹⁶ A review of PCAOB inspection reports suggests the only client contact by inspectors is with the chair of the registrant's audit committee.

the profession itself has called for further research to investigate the impact of SOX and the PCAOB on enhancing investor confidence. Consistent with Nusbaum's (2007) call for research to enhance investor confidence in the capital markets, we provide suggestions for improving the PCAOB inspection process.

Suggestions for Improving the PCAOB Inspection Process

We suggest that consideration be given to improving the PCAOB inspection process in a number of ways. First, we believe that inspection reports would be more meaningful (and transparent) if inspection teams would adopt a graduated grading scale (A, B, C, etc.) for the various aspects of the inspection process in lieu of the current dichotomous format (pass / fail) for the entire inspection. A number of responding firms criticized the all or nothing approach related to 'passing' an inspection with one firm observing "the PCAOB's report of only negative findings is as misleading as a traditional peer review report with only an unqualified opinion". Grades could be assigned to the areas of audit documentation, substantive audit procedures, internal control audits, QC elements, as well as an overall grade.¹⁷ Market participants could more readily compare firms of different sizes, relative to their peer group, and the firms themselves would benefit from the specificity of feedback to enable a sharpened focus on areas needing improvement. The provision of collective grades for all firms, on a recurring basis, should prove meaningful and allow for a longitudinal assessment of firm performance.

A second suggestion is to implement a system whereby inspected firms are afforded an opportunity to evaluate inspectors' performance on an anonymous basis,

¹⁷ The responding firms collectively desire to retain confidential treatment related to any criticisms or defects in a firm's QC system. We suggest a grade can be assigned to a QC system without revealing specific shortcomings.

similar to the instrument used in this research. Provisions would be necessary (i.e., third-party compilation of evaluations and delayed release of results) to ensure that the PCAOB and inspectors are not granted access to collective evaluations until inspection reports are finalized, similar to the safeguards employed in academia when instructors are evaluated by students. The confidential results of individual inspectors' evaluations could be used by the PCAOB to identifying areas needing improvement while the collective evaluations could be publicly used as an early indicator of components of the inspection process that may need to be refined.¹⁸

One responding firm indicated it benefited from an on-site inspection due to interaction with the inspectors while another firm felt the PCAOB's desk review (off-site inspection) worked well. We believe there are advantages and disadvantages to both and suggest PCAOB reports distinguish the type of inspection performed. This enhances the ability of the reader to understand the level of interaction between inspectors and firm personnel and could facilitate further research into the pros and cons of each style.

Finally, we suggest that the PCAOB consider compiling and publishing a list of 'best practices' noted during the inspection process, without identifying specific firms. This, coupled with the graduated grading suggestion above, would assist firms as they strive to make improvements to their own audit processes.

Limitations

Potential limitations associated with this study include the response rate and potential non-response bias. Our 32 percent response rate compares favorably with that

¹⁸ We view this suggestion as feasible for smaller firms given the large number of firms inspected triennially. Assuring anonymity of the feedback process would be more difficult for the 'Top 8' firms and their affiliates inspected annually.

of other survey-based auditing research such as Bamber and Iyer's (2007) 23 percent rate and DeZoort and Salterio's (2001) 20 percent rate. The smaller and medium responding firms receiving a deficient PCAOB inspection report (76 percent and 60 percent, respectively) differ somewhat from the overall population deficiency rates (67 percent, and 54 percent, respectively) as shown in Table 2. Conversely, the responding larger firms with a deficient inspection (26 percent) are less than the larger firm overall population deficiency rate of 39 percent. Care should be exercised in generalizing our research findings to the entire population of smaller domestic firms registered with the PCAOB.

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TABLE 1
Selection of Firms ^a

	Smaller firms	Medium firms	Larger firms	Total firms
Firms inspected by the PCAOB	156	171	140	467
Current address unavailable ^b	<3>	<2>	<1>	<6>
Instruments mailed	153	169	139	461
No response	<111>	<111>	<93>	<315>
Responses received	42	58	46	146
Response rate	27.5 %	34.3 %	33.1 %	31.7 %

^a The selection of firms excludes the Top 8 registered firms (inspected annually) and foreign firms. All measures were drawn from PCAOB inspection reports available through November 7, 2007, at www.pcaobus.org. The number of professional staff documented in the PCAOB inspection reports is used to delineate firm size, consistent with the measure used by Hermanson et al. (2007). Smaller firms have zero to ten professionals, medium firms have 11 to 40 professionals, and larger firms have more than 40 professionals. PCAOB inspection reports indicate that professional staff includes all personnel of the firm, except for partners or shareholders and administrative support personnel. Thus a sole proprietorship would have zero professional staff and one partner.

^b Thirty research instruments (6.4 percent) were initially returned by the post office as undeliverable. The six firms listed here (1.3 percent) represent firms for which the post office did not provide a forwarding address and we were unable to separately identify a valid address.

TABLE 2 ^a
Descriptive Statistics of Target Firms ^b

	Smaller firms N = 156	Medium firms N = 171	Larger firms N = 140	Total firms N = 467
Firm Characteristics	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)
Number of Offices	1.09 (.37)	1.53 (.92)	3.88 (4.62)	2.09 (2.85)
Number of Partners	1.87 (.92)	5.40 (2.44)	24.67 (32.13)	10.00 (20.12)
Number of Professionals	2.57 (2.39)	17.63 (7.05)	110.54 (149.34)	40.45 (93.92)
Total Personnel, Excluding Administrative Support	4.44 (2.90)	23.03 (8.39)	135.21 (178.15)	50.45 (112.42)
Number of Issuer Clients	5.52 (9.29)	5.85 (11.18)	11.54 (16.36)	7.44 (12.70)
Number of Issuer Clients Inspected	2.42 (2.18)	2.44 (1.63)	3.88 (2.74)	2.87 (2.29)
Ratios				
Partners / Professionals	.73	.31	.22	.25
Partners / Issuer Clients	.34	.92	2.14	1.34
Total Personnel / Issuer Clients	.80	3.94	11.72	6.78
Issuer Clients Inspected / Number of Issuer Clients	.44	.42	.34	.39
Firms receiving a deficient PCAOB inspection report	.67	.54	.39	.54

The selection of firms excludes the Top 8 registered firms (inspected annually) and foreign firms. Smaller firms have zero to ten professionals, medium firms have 11 to 40 professionals, and larger firms have more than 40 professionals.

^aThe format of this table was adapted from Table 4, Panel A, of Hermanson et al. (2007).

^bAll measures were drawn from available PCAOB inspection reports of firms inspected triennially, through November 7, 2007, at www.pcaobus.org.

TABLE 3
Evaluation of PCAOB Inspection Team Performance

Scale: 1 = Strongly Agree, 2 = Agree, 3 = Neutral, 4 = Disagree, 5 = Strongly Disagree

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146	Sig. Diff. ^b
Statement ^a	Mean (s.d.) n =	Mean (s.d.) n =	Mean (s.d.) n =	Mean (s.d.) n =	F (p-value)
1. Inspectors possessed adequate technical knowledge	2.17 (0.96) n = 42	2.21 (1.02) n = 58	1.70 (0.73) n = 46	2.03 (0.94) n = 146	** 4.57 (.012)
2. Inspectors exercised appropriate professional conduct	2.29 (1.29) n = 42	1.83 (0.82) n = 58	1.52 (0.66) n = 46	1.86 (0.98) n = 146	* 7.32 (.001)
3. Inspectors' focus on firm's audit workpaper documentation was appropriate	2.67 (1.22) n = 42	2.12 (0.84) n = 58	1.84 (0.67) n = 45	2.19 (0.97) n = 145	* 8.89 (.000)
4. Inspectors' focus on firm's substantive audit procedures was appropriate	2.71 (1.33) n = 42	2.24 (0.96) n = 58	1.83 (0.83) n = 46	2.25 (1.09) n = 146	* 7.95 (.001)
5. Inspectors' focus on firm's audit of internal controls was appropriate	2.60 (1.25) n = 30	2.41 (0.80) n = 32	2.25 (0.98) n = 32	2.41 (1.02) n = 94	.91 (.406)
6. Inspectors' focus on firm's 'tone at the top' was appropriate	2.38 (1.04) n = 37	1.98 (0.79) n = 54	1.89 (0.77) n = 46	2.06 (0.87) n = 137	*** 3.68 (.028)
7. Inspectors' focus on firm's evaluation of partners was appropriate	2.55 (1.16) n = 38	2.21 (0.87) n = 52	2.14 (0.82) n = 44	2.28 (0.96) n = 134	2.22 (.113)
8. Inspectors' focus on firm's independence compliance was appropriate	2.26 (1.06) n = 42	1.96 (0.69) n = 56	2.02 (0.95) n = 46	2.07 (0.90) n = 144	1.42 (.245)
9. Inspectors' focus on firm's client acceptance and retention policies was appropriate	2.27 (0.84) n = 41	2.13 (0.88) n = 55	2.00 (0.79) n = 46	2.13 (0.84) n = 142	1.11 (.334)
10. Inspectors' focus on firm's consultation practices was appropriate	2.38 (0.74) n = 21	2.21 (0.81) n = 34	2.03 (0.77) n = 33	2.18 (0.78) n = 88	1.32 (.270)
11. Inspectors' focus on firm's audit policies and procedures was appropriate	2.71 (1.17) n = 41	2.14 (0.88) n = 57	1.96 (0.76) n = 46	2.24 (0.98) n = 144	* 7.56 (.001)
12. Inspectors' focus on firm's auditor training was appropriate	2.41 (0.99) n = 37	2.19 (0.75) n = 54	2.13 (0.69) n = 45	2.23 (0.81) n = 136	1.29 (.280)

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146	Sig. Diff. ^b
Statement ^a	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)	F (p-value)
13. Inspectors' focus on firm's supervision of audits was appropriate	2.56 (1.18) n = 41	2.04 (0.78) n = 54	1.96 (0.67) n = 45	2.16 (0.92) n = 140	** 5.89 (.004)
14. Inspectors' overall focus on the firm's quality control system was appropriate	2.73 (1.12) n = 41	2.22 (0.90) n = 58	1.91 (0.81) n = 46	2.27 (0.99) n = 145	* 8.31 (.000)
15. Inspector's findings related to quality control systems should remain confidential	1.39 (0.59) n = 41	1.64 (0.79) n = 58	1.67 (0.85) n = 45	1.58 (0.76) n = 144	1.74 (.179)

^a The full text of each statement is available in Appendix A.

^b *, **, *** denote significance at the .00, .01, and .05 levels, respectively (two-tailed).

TABLE 4
Various Aspects of the PCAOB Inspection Process

Scale: 1 = Strongly Agree, 2 = Agree, 3 = Neutral, 4 = Disagree, 5 = Strongly Disagree

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146	Sig. diff. ^b
Statement ^a	Mean (s.d.) n =	Mean (s.d.) n =	Mean (s.d.) n =	Mean (s.d.) n =	F (p- value)
16. Inspectors' constructive criticism was appropriate	3.17 (1.40) n = 41	2.38 (1.03) n = 55	2.12 (0.85) n = 43	2.53 (1.18) n = 139	* 10.45 (.000)
17. Engagements selected by inspectors were appropriate	2.12 (1.10) n = 41	1.86 (0.77) n = 56	1.64 (0.61) n = 45	1.88 (0.86) n = 142	*** 3.49 (.033)
18. Amount of inspection time spent on the engagements was appropriate	3.15 (1.41) n = 41	2.52 (1.14) n = 58	2.28 (1.07) n = 46	2.65 (1.24) n = 145	** 5.96 (.003)
19. The inspection process has increased the overall quality of the audits we perform	3.41 (1.48) n = 41	2.74 (1.19) n = 58	2.58 (0.98) n = 46	2.88 (1.26) n = 145	** 5.72 (.004)
20. The inspection process has positively impacted our audit business	3.83 (1.20) n = 41	3.21 (1.10) n = 58	2.87 (0.93) n = 46	3.28 (1.14) n = 145	* 8.71 (.000)
21. The inspection process will increase our acceptance of new public audit clients	3.88 (1.23) n = 41	3.62 (0.97) n = 58	3.02 (0.87) n = 45	3.51 (1.07) n = 144	* 8.14 (.000)
22. The inspection process will increase our retention of existing public audit clients	3.83 (1.15) n = 40	3.47 (1.06) n = 58	2.98 (0.89) n = 45	3.41 (1.08) n = 143	** 7.16 (.001)
23. We have considered ceasing public audits due to inspection requirements	2.18 (1.36) n = 40	3.18 (1.42) n = 56	4.09 (0.97) n = 45	3.18 (1.47) n = 141	* 23.93 (.000)
24. The inspection process has increased public confidence in the audit profession	3.53 (1.34) n = 40	2.98 (0.98) n = 58	2.59 (0.81) n = 46	3.01 (1.10) n = 144	* 8.64 (.000)
25. Anticipation of inspection has increased hours incurred on engagements	1.80 (0.90) n = 41	2.21 (1.04) n = 56	2.28 (0.86) n = 46	2.12 (0.96) n = 143	*** 3.24 (.042)
26. The inspection process has increased the fees billed to our publicly-traded clients	2.15 (1.27) n = 39	2.52 (1.10) n = 56	2.44 (1.06) n = 45	2.39 (1.14) n = 140	1.253 (.289)
27. The inspection process has increased our ability to attract and retain audit personnel	3.73 (0.84) n = 37	3.57 (0.81) n = 56	3.22 (0.85) n = 45	3.50 (0.85) n = 138	*** 4.15 (.018)

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146	Sig. diff. ^b
Statement ^a	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)	F (p-value)
28. We agree with the inspectors' findings in our inspection report	3.49 (1.45) n = 41	2.82 (1.36) n = 55	2.27 (1.34) n = 41	2.85 (1.45) n = 137	** 8.00 (.001)
29. The PCAOB inspection process is an improvement over peer-review inspections	3.83 (1.30) n = 40	3.19 (1.16) n = 58	2.87 (1.04) n = 45	3.27 (1.22) n = 143	** 7.38 (.001)
30. The inspection process has increased our exposure to audit litigation risk.	2.69 (1.10) n = 39	2.90 (0.97) n = 58	3.22 (0.87) n = 46	2.98 (1.00) n = 143	*** 3.17 (.045)

^a The full text of each statement is available in Appendix A.

^b *, **, *** denote significance at the .00, .01, and .05 levels, respectively (two-tailed).

TABLE 5
Responses for Firms Receiving Non-Deficient / Deficient Inspection Reports

Scale: 1 = Strongly Agree, 2 = Agree, 3 = Neutral, 4 = Disagree, 5 = Strongly Disagree

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146
Agreement with statement ^a	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n
1. Technical knowledge				Sig. ^b ***
Non-deficient firms	1.80 (.63) n = 10	2.04 (.88) n = 23	1.62 (.55) n = 34	1.79 (.71) n = 67
Deficient firms	2.28 (1.02) n = 32	2.31 (1.11) n = 35	1.92 (1.08) n = 12	2.24 (1.07) n = 79
2. Professional conduct				Sig. ^b **
Non-deficient firms	1.60 (.70) n = 10	1.65 (.57) n = 23	1.53 (.66) n = 34	1.58 (.63) n = 67
Deficient firms	2.50 (1.37) n = 32	1.94 (.94) n = 35	1.50 (.67) n = 12	2.10 (1.15) n = 79
3. Workpaper documentation				Sig. ^b *
Non-deficient firms	2.20 (1.03) n = 10	1.91 (.73) n = 23	1.79 (.65) n = 33	1.89 (.75) n = 66
Deficient firms	2.81 (1.26) n = 32	2.26 (.89) n = 35	2.00 (.74) n = 12	2.44 (1.07) n = 79
4. Substantive audit procedures				Sig. ^b **
Non-deficient firms	2.20 (1.32) n = 10	2.04 (.77) n = 23	1.71 (.63) n = 34	1.90 (.82) n = 67
Deficient firms	2.88 (1.31) n = 32	2.37 (1.06) n = 35	2.17 (1.19) n = 12	2.54 (1.21) n = 79
5. Audit of internal controls				Sig. ^b NA
Non-deficient firms	2.00 (.82) n = 7	2.29 (.83) n = 14	2.20 (1.04) n = 25	2.20 (.93) n = 46
Deficient firms	2.78 (1.31) n = 23	2.50 (.79) n = 18	2.43 (.79) n = 7	2.63 (1.06) n = 48
6. Tone at the top				Sig. ^b ***
Non-deficient firms	1.89 (.33) n = 9	1.77 (.69) n = 22	1.79 (.64) n = 34	1.80 (.62) n = 65
Deficient firms	2.54 (1.14) n = 28	2.13 (.83) n = 32	2.17 (1.03) n = 12	2.29 (1.00) n = 72
7. Evaluation of partners				Sig. ^b NA
Non-deficient firms	1.78 (.67) n = 9	2.00 (.93) n = 22	2.00 (.75) n = 33	1.97 (.80) n = 64
Deficient firms	2.79 (1.18) n = 29	2.37 (.81) n = 30	2.55 (.93) n = 11	2.57 (1.00) n = 70

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146
Agreement with statement ^a	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n
8. Independence compliance				Sig. ^b NA
Non-deficient firms	1.90 (.88) n = 10	1.91 (.79) n = 23	1.82 (.83) n = 34	1.87 (.82) n = 67
Deficient firms	2.38 (1.10) n = 32	2.00 (.61) n = 33	2.58 (1.08) n = 12	2.25 (.93) n = 77
9. Client acceptance / retention				Sig. ^b NA
Non-deficient firms	1.80 (.63) n = 10	2.00 (.74) n = 23	1.94 (.78) n = 34	1.94 (.74) n = 67
Deficient firms	2.42 (.85) n = 31	2.22 (.98) n = 32	2.17 (.84) n = 12	2.29 (.90) n = 75
10. Consultation practices				Sig. ^b NA
Non-deficient firms	2.00 (1.10) n = 6	2.07 (.80) n = 15	1.88 (.73) n = 25	1.96 (.79) n = 46
Deficient firms	2.53 (.52) n = 15	2.32 (.82) n = 19	2.50 (.76) n = 8	2.43 (.70) n = 42
11. Policies and procedures				Sig. ^b **
Non-deficient firms	2.00 (.71) n = 9	1.83 (.58) n = 23	1.82 (.67) n = 34	1.85 (.64) n = 66
Deficient firms	2.91 (1.20) n = 32	2.35 (.98) n = 34	2.33 (.89) n = 12	2.58 (1.09) n = 78
12. Auditor training				Sig. ^b NA
Non-deficient firms	1.90 (.57) n = 10	2.00 (.74) n = 23	2.09 (.72) n = 33	2.03 (.70) n = 66
Deficient firms	2.59 (1.05) n = 27	2.32 (.75) n = 31	2.25 (.62) n = 12	2.41 (.86) n = 70
13. Supervision				Sig. ^b **
Non-deficient firms	1.90 (.57) n = 10	1.78 (.60) n = 23	1.85 (.51) n = 33	1.83 (.54) n = 66
Deficient firms	2.77 (1.26) n = 31	2.23 (.85) n = 31	2.25 (0.97) n = 12	2.46 (1.08) n = 74
14. Quality control				Sig. ^b *
Non-deficient firms	2.10 (.88) n = 10	1.74 (.54) n = 23	1.82 (.72) n = 34	1.84 (.69) n = 67
Deficient firms	2.94 (1.12) n = 31	2.54 (.95) n = 35	2.17 (1.03) n = 12	2.64 (1.06) n = 78
15. Quality control/confidential				Sig. ^b NA
Non-deficient firms	1.50 (.85) n = 10	1.48 (.67) n = 23	1.73 (.91) n = 33	1.61 (.82) n = 66
Deficient firms	1.35 (.49) n = 31	1.74 (.85) n = 35	1.50 (.67) n = 12	1.55 (.71) n = 78

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146
Agreement with statement ^a	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n
16. Constructive criticism				Sig. ^b *
Non-deficient firms	2.00 (1.41) n = 9	1.95 (.81) n = 21	1.90 (.70) n = 31	1.93 (.85) n = 61
Deficient firms	3.50 (1.22) n = 32	2.65 (1.07) n = 34	2.67 (.99) n = 12	3.00 (1.18) n = 78
17. Engagements selected				Sig. ^b ***
Non-deficient firms	1.78 (0.97) n = 9	1.86 (.71) n = 22	1.64 (.65) n = 33	1.73 (.72) n = 64
Deficient firms	2.22 (1.13) n = 32	1.85 (.82) n = 34	1.67 (.49) n = 12	1.97 (.94) n = 78
18. Inspection time appropriate				Sig. ^b **
Non-deficient firms	2.44 (1.33) n = 9	2.39 (1.03) n = 23	2.06 (.81) n = 34	2.23 (0.97) n = 66
Deficient firms	3.34 (1.38) n = 32	2.60 (1.22) n = 35	2.92 (1.44) n = 12	2.95 (1.35) n = 79
19. Increased overall quality				Sig. ^b **
Non-deficient firms	3.33 (1.66) n = 9	2.52 (1.16) n = 23	2.57 (1.02) n = 34	2.66 (1.18) n = 66
Deficient firms	3.44 (1.46) n = 32	2.89 (1.21) n = 35	2.58 (.90) n = 12	3.06 (1.30) n = 79
20. Positively impacted business				Sig. ^b *
Non-deficient firms	3.33 (1.32) n = 9	2.91 (1.00) n = 23	2.88 (.98) n = 34	2.95 (1.03) n = 66
Deficient firms	3.97 (1.15) n = 32	3.40 (1.14) n = 35	2.83 (.84) n = 12	3.54 (1.16) n = 79
21. Acceptance of new clients				Sig. ^b *
Non-deficient firms	3.56 (1.42) n = 9	3.39 (.99) n = 23	2.91 (.90) n = 34	3.17 (1.03) n = 66
Deficient firms	3.97 (1.18) n = 32	3.77 (.94) n = 35	3.36 (.67) n = 11	3.79 (1.02) n = 78
22. Retention of existing clients				Sig. ^b **
Non-deficient firms	3.56 (1.24) n = 9	3.22 (.95) n = 23	2.82 (.87) n = 34	3.06 (.98) n = 66
Deficient firms	3.90 (1.14) n = 31	3.63 (1.11) n = 35	3.45 (.82) n = 11	3.71 (1.09) n = 77
23. Ceasing public audits				Sig. ^b *
Non-deficient firms	2.89 (1.69) n = 9	3.39 (1.23) n = 23	4.12 (1.02) n = 33	3.69 (1.27) n = 65
Deficient firms	1.97 (1.20) n = 31	3.03 (1.53) n = 33	4.00 (.85) n = 12	2.75 (1.49) n = 76

	Smaller firms N = 42	Medium firms N = 58	Larger firms N = 46	Total firms N = 146
Agreement with statement ^a	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n	Mean (s.d.) n
24. Increased public confidence				Sig. ^b *
Non-deficient firms	2.78 (1.20) n = 9	2.83 (.89) n = 23	2.50 (.71) n = 34	2.65 (.85) n = 66
Deficient firms	3.74 (1.32) n = 31	3.09 (1.04) n = 35	2.82 (1.03) n = 12	3.31 (1.20) n = 78
25. Increased hours				Sig. ^b ***
Non-deficient firms	2.22 (.83) n = 9	2.39 (1.08) n = 23	2.18 (.83) n = 34	2.26 (.92) n = 66
Deficient firms	1.69 (.90) n = 32	2.09 (1.01) n = 33	2.58 (.90) n = 12	2.00 (.99) n = 77
26. Increased fees				Sig. ^b NA
Non-deficient firms	2.89 (1.17) n = 9	2.57 (1.04) n = 23	2.47 (1.13) n = 34	2.56 (1.10) n = 66
Deficient firms	1.93 (1.23) n = 30	2.48 (1.15) n = 33	2.36 (.81) n = 11	2.24 (1.16) n = 74
27. Attract and retain personnel				Sig. ^b ***
Non-deficient firms	3.44 (.73) n = 9	3.50 (.60) n = 22	3.15 (.86) n = 34	3.31 (.77) n = 65
Deficient firms	3.82 (.86) n = 28	3.62 (.92) n = 34	3.45 (.82) n = 11	3.67 (.88) n = 73
28. Agree with findings				Sig. ^b **
Non-deficient firms	2.00 (1.32) N = 9	1.80 (1.11) n = 20	1.72 (.89) n = 32	1.79 (1.02) n = 61
Deficient firms	3.91 (1.20) n = 32	3.40 (1.14) n = 35	4.22 (.67) n = 9	3.71 (1.15) n = 76
29. Peer-review improvement				Sig. ^b **
Non-deficient firms	3.00 (1.58) n = 9	3.13 (1.06) n = 23	2.76 (1.05) n = 34	2.92 (1.13) n = 66
Deficient firms	4.06 (1.12) n = 31	3.23 (1.24) n = 35	3.18 (.98) n = 11	3.56 (1.22) n = 77
30. Increased litigation risk.				Sig. ^b ***
Non-deficient firms	2.78 (1.09) n = 79	3.00 (.91) n = 23	3.21 (.81) n = 34	3.08 (.88) n = 66
Deficient firms	2.67 (1.12) n = 30	2.83 (1.01) n = 35	3.25 (1.06) n = 12	2.83 (1.07) n = 77

^a The full text of each statement is available in Appendix A.

^b *, **, *** denote significant differences between total non-deficient and deficient firms at the .00, .01, and .05 levels, respectively (two-tailed). NA = not significant.

Appendix A

Part I Evaluation of PCAOB Inspection Team Performance

Using the scale below, please evaluate the **performance of the PCAOB Inspection Team** that conducted your *most recent inspection* by circling one response for each statement. If you do not have an adequate basis to evaluate a statement, so indicate by circling NA (not enough information to evaluate).

	Strongly <u>Agree</u>	<u>Agree</u>	<u>Neutral</u>	<u>Disagree</u>	Strongly <u>Disagree</u>	<u>NA</u>
1. The inspectors possessed adequate technical knowledge.	1	2	3	4	5	NA
2. The inspectors exercised appropriate professional conduct.	1	2	3	4	5	NA
3. The inspectors' focus on the firm's audit workpaper documentation was appropriate.	1	2	3	4	5	NA
4. The inspectors' focus on the firm's substantive audit procedures was appropriate.	1	2	3	4	5	NA
5. The inspectors' focus on the firm's audit of internal controls was appropriate.	1	2	3	4	5	NA
6. The inspectors' focus on the firm's 'tone at the top' was appropriate.	1	2	3	4	5	NA
7. The inspectors' focus on the firm's evaluation of partners was appropriate.	1	2	3	4	5	NA
8. The inspectors' focus on the firm's independence compliance was appropriate.	1	2	3	4	5	NA
9. The inspectors' focus on the firm's client acceptance and retention policies was appropriate.	1	2	3	4	5	NA
10. The inspectors' focus on the firm's consultation practices was appropriate.	1	2	3	4	5	NA
11. The inspectors' focus on the firm's audit policies and procedures was appropriate.	1	2	3	4	5	NA
12. The inspectors' focus on the firm's auditor training was appropriate.	1	2	3	4	5	NA
13. The inspectors' focus on the firm's supervision of audits was appropriate.	1	2	3	4	5	NA
14. The inspectors' overall focus on the firm's quality control system was appropriate.	1	2	3	4	5	NA
15. Inspectors' findings related to quality control systems should continue to remain confidential.	1	2	3	4	5	NA

Part II PCAOB Inspection Process Perceptions

Using the scale below, indicate your level of agreement with the following statements related to **your perceptions of the PCAOB inspection process** by circling one response for each statement. If you do not have an adequate basis to evaluate a statement, so indicate by circling NA (not enough information to evaluate).

	Strongly <u>Agree</u>	<u>Agree</u>	<u>Neutral</u>	<u>Disagree</u>	Strongly <u>Disagree</u>	<u>NA</u>
16. The inspectors' constructive criticism(s) were appropriate.	1	2	3	4	5	NA
17. The engagement(s) selected by the PCAOB inspectors were appropriate.	1	2	3	4	5	NA
18. The amount of time the inspectors spent on the audit engagement(s) was appropriate.	1	2	3	4	5	NA
19. The PCAOB inspection process has increased the overall quality of the audits we perform.	1	2	3	4	5	NA
20. The PCAOB inspection process has positively impacted our audit business.	1	2	3	4	5	NA
21. The PCAOB inspection process will increase our acceptance of new public audit clients.	1	2	3	4	5	NA
22. The PCAOB inspection process will increase our retention of existing public audit clients.	1	2	3	4	5	NA
23. We have considered ceasing public company audits due to PCAOB inspection requirements.	1	2	3	4	5	NA
24. The PCAOB inspection process has increased public confidence in the audit profession.	1	2	3	4	5	NA
25. Anticipation of engagement inspection has increased hours incurred on engagements.	1	2	3	4	5	NA
26. The PCAOB inspection process has increased the fees billed to our publicly-traded client(s).	1	2	3	4	5	NA
27. The PCAOB inspection process has increased our ability to attract and retain audit personnel.	1	2	3	4	5	NA
28. We agree with the PCAOB inspectors' findings as reported in our most recent inspection report.	1	2	3	4	5	NA
29. The PCAOB inspection process is an improvement over the prior peer-review inspection process.	1	2	3	4	5	NA
30. The PCAOB inspection process has increased our exposure to audit litigation risk.	1	2	3	4	5	NA

Please write any additional comments you wish to provide on the next page.