

SESSION 1: AUDIT
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Peaob Inspections: A Comparison of Large and Small Audit Firms

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ABSTRACT: The inspection of audits and quality controls of large and small CPA firms who audit public clients was mandated by the Sarbanes-Oxley Act of 2002 (the Act) which also established the Public Company Accounting Oversight Board (PCAOB). The PCAOB began operations in 2003, and CPA firms were required by the Act to register after October 22, 2003. As of October 3, 2006 332 firms have been inspected.

The American Institute of Certified Public Accountants (AICPA) –Center for Public Company Audit Firms released two reports in May 2006. One report, *Small Firm PCAOB Inspection Deficiency Analysis* (Small Firm Report), gives the results for small firm inspections from January 21, 2005 through March 9, 2006 with a small firm being defined as firms with no more than 100 SEC issuer audit clients. The other report, *Large Firm PCAOB Inspection Deficiency Analysis* (Large Firm Report), is for large firms with more than 100 SEC issuer audit clients. The large firm report is based on inspection reports issued from September 29, 2005 through January 2006 on 2004 audits performed in 2004. The inspection reports break down the deficiencies into four categories: Balance Sheet line items, Income Statement line items, Audit performance and GAAP departures.

Eight firms make up the large firm group: the Big 4 (Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP) plus BDO Seidman LLP, Crowe Chizek and Company LLP, Grant Thornton LLP, and McGladrey & Pullen LLP. The inspection process identified 248 deficiencies for the large firm group.

Of the approximately 950 small U. S. firms registered with the PCAOB at the time the Small Firm Report was issued, 242 were inspected. The number of issuer audits performed by these small firms can be as high as 100, but there are examples of firms having only one issuer. The average number of public audit clients (issuers) for the 242 firms was just less than six (1355/242), and 47% (639) of them were inspected. The Small Firm Report identifies 210 different deficiencies in the four categories described above.

The types of Balance Sheet deficiencies differ considerably between the Large and Small firms, though the percentage of total deficiencies was approximately the same with 48% for the large and 49% for the small firms. Most of the large firms' deficiencies are related to the asset side of the balance sheet (83%), while only 44% of small firms' deficiencies are asset related.

Income Statement deficiencies accounted for ten percent of large firm deficiencies and nineteen percent of small firm deficiencies. The distribution of deficiencies within the income statement accounts was fairly similar, except that some small firms appear to have difficulty with EPS calculations.

Audit Performance deficiencies differed between the small and large firms. As a percentage of total deficiencies, the large firms (32%) exceeded the small firms (22%). Four auditing areas accounted for almost 84% of the large firms' deficiencies in this category: internal control (33%), audit risk and materiality (21.5%), analytical procedures (16.5%), and relying upon service organizations (12.7%). Small firms also had internal control (13%) and service organizations (13%) in their top four along with related party (15%) and reliance on other independent auditors (11%). These top four accounted for only 52% of the small firms' deficiencies in this category, plus they had deficiencies in nine standards where the large firms had none.