
PERFORMANCE REVIEW

THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S **LARGE FIRM INSPECTIONS** **(IOPA-2007-001)**

INTERNAL OVERSIGHT AND PERFORMANCE ASSURANCE **July 12, 2007**

Objective

In accordance with its 2006 review plan, Internal Oversight and Performance Assurance ("IOPA") conducted a quality assurance review of selected aspects of the Public Company Accounting Oversight Board's ("PCAOB") 2006 large-firm inspections.^{1/} The specific objective was to determine whether inspections of the largest eight U.S. accounting firms were supported by documentation as outlined in the Division of Registration and Inspections' ("Division") Large Firm Inspection Manual.

Background

In December 2005, IOPA issued a report^{2/} that included observations on the Division's progress in establishing effective and appropriate internal controls over operations. At that time, the Division was in the midst of its second cycle of full-scope inspections.

In our 2005 report, we noted that the Division had developed a procedures manual for its small-firm inspections, but had no such manual applicable to its

^{1/} This is a public summary of the report. The full report, prepared in accordance with Government Auditing Standards, has been issued to the Board. The full report includes a detailed discussion of the review objective, scope, and methodology.

^{2/} *Internal Control Review of the Public Company Accounting Oversight Board's Inspections Activities* (IOPA-2005-003), December 14, 2005.

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inspections of the largest firms.^{3/} Although other large-firm inspection guidance was available, inspectors expressed a desire for more information about how large firm inspections were to be conducted. Another issue was that the system then in use for organizing large-firm inspection guidance and documentation was confusing. In response to these findings, the Division developed and put into place a Large Firm inspection manual. The manual provides guidance through virtually every step of the inspection process, from planning to comment form development and report-writing. Regarding the organization of guidance and documentation, the Division adopted a document management system (“DMS”)^{4/} that was used for aspects of large-firm inspections prior to 2005, and fully deployed it for all eight large-firm inspections in 2006.

Framework for Large-Firm Inspections

The statutory basis for PCAOB inspections is Section 104(a) of the Sarbanes-Oxley Act of 2002, which provides that:

The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the [Securities and Exchange] Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.^{5/}

The Act further specifies that inspections should be conducted annually for firms that regularly provide audit reports for more than 100 issuers (the large-firm inspections

^{3/} Together, the largest eight U.S. accounting firms audit approximately 15,000 issuers that account for over 99 percent of the total market capitalization of U.S. exchanges.

^{4/} IOPA issued a report on its *Review of the Public Company Accounting Oversight Board's Document Management*, (IOPA-2006-005), in December 2006.

^{5/} Under Sarbanes-Oxley, issuers are those “...(as defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 781), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.”

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referred to in this report), and not less frequently than every 3 years for firms that provide audit reports for at least one, but no more than 100 issuers. Section 4 of the Rules of the Board establishes the basic framework for the PCAOB's inspection process, including reporting the results of inspections, notifying the Securities and Exchange Commission regarding possible violations of the Act or other requirements, and communicating with the registered firms regarding the results of inspections.

Board Rule 4000 assigns responsibility for inspections "steps and procedures" to the Division of Registration and Inspections. The Division is led by a Director and includes a Washington, DC office and regional offices in Atlanta, Chicago, Dallas, Denver, New York, and Orange County and San Mateo, California. As of March 2007, the Division included 231 regular employees, of whom 153 were considered involved, to at least some degree, with large-firm inspections.

Large Firm Manual

In 2006, the Division finalized its Large Firm Manual and made it effective for the 2006 large-firm inspections. The manual's stated purposes are to (1) document the process and related policies for carrying out inspections of large firms; and (2) provide guidance to inspectors who are conducting inspections of large firms. Introductory language makes clear that the manual is not intended to be a set of prescriptive documents dictating the specific actions of the inspection teams. Rather, it "...provides overall guidance on the conduct of inspections while providing flexibility to inspections leadership and inspection teams to adapt to the facts and circumstances of any given large firm inspection." The manual further specifies that inspection documentation is intended to provide evidence to support conclusions that can withstand challenge in legal proceedings.

In addition to providing the Division's basic policy framework and governing approach to large-firm inspections, the manual also includes chapters specific to:

- Initial coordination with firms,
- National office procedures,
- Practice office preparation procedures,
- Performing the inspection,
- Post-inspection procedures,

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- Comment form process,
- Report writing,
- PCAOB-based inspections,
- The remediation process,
- International inspection considerations, and
- Large issuer considerations.

Review Approach

In support of our review objective, IOPA selected aspects of each of the 2006 inspections of U.S. large firms^{6/} and evaluated related documentation. We developed a detailed review methodology, discussed in the full report, for considering whether Division staff followed the guidance in the newly-developed Large Firm manual. In all, we examined documentation associated with 37 issuer inspections, as well as selected information associated with PCAOB's inspections of the large firms' national offices, practice offices, and internal control over financial reporting procedures.

Results of Review

Inspection teams documented the results of the 2006 large firm inspections in a manner generally consistent with guidance established in the Large Firm Manual. Supporting evidence from firm work papers was maintained and cross-referenced to assertions made in PCAOB comment forms. In addition, inspection procedures associated with the large firms' national and practice offices were generally documented in accordance with criteria established in the Large Firm Manual. Similarly, inspection procedures related to large firms' audits of internal controls over financial reporting were

^{6/} A ninth firm also meets the Sarbanes-Oxley requirement for annual inspection. This firm is based in Canada, however, and is therefore subject to different inspections procedures. This firm was not included in IOPA's scope of review.

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consistently documented using a three-tiered assessment process of firm efficiency that the Division developed during 2006.

We also found, however, that the Division's use of its primary tool for documenting large-firm inspections, DMS, was not always consistent with Large Firm Manual criteria. Due to concerns over timeliness and a perception that DMS was cumbersome and slow, inspection teams used work-arounds to document the status of work-flows on a real-time basis, did not consistently "promote" documents to ensure their timely archival, and did not always complete properties fields designed to allow later analysis and data-mining. As a result, Inspections DMS is unlikely to fully achieve the objectives set out for it, and the PCAOB may not realize all the potential benefits of its \$1.3 million^{7/} investment in this automated system.

Division personnel told us that DMS was not always used as intended because of delays or inconvenience associated with getting and maintaining consistent network connections; working with network response times considered slow; and duplicative or burdensome processes for performing certain DMS tasks. DMS was considered a hindrance to timely completion of inspections work rather than a tool that facilitated Division objectives.

The full report included a recommendation for the Division Director to work with the Board and the Office of Information Technology to facilitate a cost-benefit analysis of DMS and potential alternatives. The Director, Registration and Inspections, concurred with this recommendation.

^{7/} At IOPA's request, the PCAOB's finance office provided cost data on DMS. IOPA did not audit these figures.