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## The Methodology Behind POGO's Investigation of the PCAOB

Here's an explanation of how the Project On Government Oversight gathered and analyzed the data for its September 2019 report, [“How An Agency You've Never Heard of Is Leaving the Economy At Risk.”](#)

### PCAOB Inspection Findings

POGO reviewed Public Company Accounting Oversight Board (PCAOB) annual inspection reports on the U.S. Big Four audit firms: Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. These firms also have foreign affiliates; POGO focused on the U.S. firms.

The inspection reports can be located using PCAOB's [search function](#).

POGO found that, since the PCAOB's inception, its inspection reports have noted 808 instances in which audits performed by the U.S. Big Four were so deficient that the audit firm should not have certified a company's financial statements and/or “internal control over financial reporting” (ICFR).

That count of 808 failed audits was based on issuer audits listed in Part I.A. of the inspection reports, the “Review of Audit Engagements.”

For example, in the PCAOB's [Report on 2017 Inspection of KPMG LLP](#), issued on January 24, 2019, Parts I.A.1. through I.A.26. described 26 audits that fit that description. The audits involved companies identified as “Issuer A” through “Issuer Z.” (They are called “issuers” because they issue securities, such as shares of stock.) Those findings accounted for 26 of the 808.

By way of illustration, the report on KPMG generalizes about the 26 audits as follows:

Certain of the deficiencies identified in the inspection were of such significance that the inspection team determined that the Firm issued an opinion without obtaining sufficient appropriate audit evidence that the financial statements were free of material misstatements and/or the issuer maintained effective ICFR. These deficiencies are described in Part I. A. (p. 6)

“The audit deficiencies that were so significant that it appeared that the audit opinion was unsupported are described in Parts I.A.1 through I.A.26, below.” (p. 7)

Also by way of illustration, for Issuer A, the report says, “the Firm failed in the following respects to obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements and on the effectiveness of ICFR.” (p. 7)

The report uses identical or similar wording to describe the other 25 audits. For six of them, it says the audit firm failed to obtain sufficient audit evidence to support its audit opinion on the internal controls. For two of them, it says the audit firm failed to obtain sufficient audit evidence to support its audit opinion on the financial statements. For one audit, it says the firm was engaged by another audit firm to play a supporting role: auditing the financial statements of a particular subsidiary and performing “certain procedures” on the subsidiary’s internal controls. For that audit, the report says the audit firm “failed to obtain sufficient appropriate audit evidence to fulfill the objectives of its role in the audit.”

Elsewhere, the PCAOB has [explained the significance](#) of issuing an audit opinion without obtaining sufficient appropriate audit evidence to support the opinion:

In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement and/or the issuer maintained effective ICFR. ... Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.

POGO's count of apparent violations identified in inspection reports is in key ways conservative. First, botching both the audit of the financial statements and the audit of ICFR of the same company would apparently constitute separate violations, but POGO counted such cases as one alleged violation. Second, the PCAOB frequently describes with bullet points multiple ways the audit firm botched a particular audit, even citing the auditing standards that were apparently violated in each of those bulleted lapses. For some lapses, the inspection reports cite multiple auditing standards. POGO did not count each of the specified failures as a separate violation—partly because the exact number reflected in the description of a particular annual audit is not always clear.

The PCAOB issued its first round of annual inspection reports on the U.S. Big Four in 2004. Those initial reports did not use the format the PCAOB later adopted and did not clearly indicate which of the audits, if any, were found to be fatally flawed. Therefore, POGO's data on inspection findings does not include any from the initial round of inspections.

PCAOB inspection reports generally describe audits in which the inspected audit firm served as principal auditor. They have included a small number of audits in which the inspected firm played a supporting role—for example, auditing the U.S. subsidiary of a company based overseas on behalf of the firm that issued the audit report on the parent company. POGO's tally of allegedly botched audits includes instances in which an audit firm was found to have botched its work in a supporting role.

POGO computed failure rates by dividing the number of audits identified as deficient by the number of audits inspected, including audits in which a firm played a supporting role. A PCAOB board member used the same methodology to compute what she described as “deficiency rates” in a November 30, 2018, [speech](#), board spokesperson Torrie Matous explained by email.

To illustrate penalties the PCAOB had the potential to impose based on inspection findings, POGO multiplied the number of defective audits identified in inspection reports on the U.S. Big Four—808—by \$2 million, which yields just over \$1.6 billion. Under the Sarbanes-Oxley Act, which created the PCAOB, the PCAOB was empowered to fine audit firms up to \$2 million per violation for ordinary violations.

That illustrative math is in two ways conservative.

First, the law empowered the PCAOB to impose bigger fines on audit firms for more serious violations—up to \$15 million per violation where the offense involves

intentional or knowing conduct, including recklessness, or repeated instances of negligence. The inspection reports do not clearly or objectively indicate whether particular audit failures meet that test.

Second, the maximum fines have been ratcheted up over time through inflation adjustments. Cumulatively, the maximums have been increased by 39.5 percent. However, in light of the complexities involved in correlating inflation adjustments with individual alleged violations, POGO's illustrative math does not include inflation adjustments.

To impose actual penalties, the PCAOB would have to prove its findings in the equivalent of a trial or persuade auditors to enter a disciplinary settlement.

## **PCAOB Enforcement Cases**

POGO searched PCAOB enforcement actions for cases against the U.S. Big Four and individuals associated with those firms.

PCAOB enforcement actions are archived on [PCAOB's website](#).

As of August 21, 2019, POGO found 18 cases against the U.S. Big Four and/or individual auditors sanctioned for their work at those firms.

Some of those cases cited multiple audits. For example, a May 23, 2018, action against Deloitte & Touche LLP faulted Deloitte [for three annual audits](#) of a banking software company called Jack Henry & Associates. Some audits served as a basis for more than one enforcement action. In some of the 18 cases, auditors were cited for fabricating, backdating, or otherwise doctoring audit records in connection with PCAOB inspections.

The 18 cases involved a total of 21 audits.

POGO tallied the civil money penalties—also known as fines—reflected in the enforcement actions.

(Excluded from this analysis is a case in which the SEC in May 2019 overturned a PCAOB disciplinary order. Records of that case can be found [on the SEC website](#) but not on the PCAOB site.)

## Securities and Exchange Commission Enforcement Actions

The SEC and the PCAOB have overlapping powers. Like the PCAOB, the SEC has the power to bring enforcement actions against audit firms and individual auditors.

To determine whether the SEC has been picking up the enforcement slack for the PCAOB, POGO reviewed every “Accounting and Auditing Enforcement Release,” or AAER, over a period of about 14 years archived [on the SEC website](#).

AAERs are disclosures about SEC enforcement cases involving accounting and auditing issues. The AAER archive includes enforcement orders and SEC releases summarizing enforcement actions.

POGO searched these records for the period beginning May 24, 2005, the date the PCAOB made its first announcement about a completed enforcement action, through August 25, 2019.

POGO reviewed the individual AAERs—about 2,500 of them—because a tool on the SEC website that ostensibly would allow users to search them by key words such as audit firm name was not working consistently.

POGO found SEC enforcement actions against U.S. Big Four firms and their personnel involving 35 allegedly failed audits—far too few to close the gap between PCAOB inspection findings and PCAOB enforcement actions.

That count includes AAER number 3834, in which KPMG agreed to pay \$230,000 to settle an allegation that it violated an auditing rule by failing to retain audit records. In the course of an investigation, the SEC had subpoenaed records of a particular KPMG audit and KPMG said some of those records could not be found, according to the AAER.

The count excludes SEC enforcement actions charging auditors with two types of violations: insider trading charges and so-called independence violations. (Though audit firms are selected and paid by the companies they audit and are therefore inherently conflicted, so-called auditor independence requirements prohibit auditors from engaging in various activities with companies they audit.) In the 808 instances described above in which PCAOB inspection reports essentially described audits as fatally flawed, POGO found no reference to insider trading or independence violations.

The SEC enforcement actions POGO found involving the U.S. Big Four may not be a complete list for at least two reasons.

First, some AAERs about enforcement actions against individual auditors did not identify the audit firms where those individuals were employed.

Second, the list of AAERs on the SEC website is not necessarily a complete inventory of SEC enforcement actions involving accounting and auditing, the SEC says.

The list “provides links to financial reporting related enforcement actions concerning civil lawsuits brought by the Commission in federal court and notices and orders concerning the institution and/or settlement of administrative proceedings,” the SEC website says. “This list only highlights certain actions and is not meant to be a complete and exhaustive compilation of all of the actions that fall into this category.”

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