

PCAOB Inspections: Auditor Violations and Client Characteristics

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ABSTRACT

The Sarbanes-Oxley Act (SOX) was passed in 2002 to apply new controls over financial reporting for publicly traded companies in the United States. SOX established the Public Company Accounting Oversight Board (PCAOB). One mandate of the PCAOB is to perform inspections of audit firms. By analyzing results of recent PCAOB inspections, this paper develops a categorization of the outcomes for the Review of the Audit Engagement (RAE). Further, the remarks on deficiencies are categorized into several areas. The study finds that companies whose auditor was cited for failure to identify GAAP issues, expenses and liabilities, or revenues and assets were larger clients with lower debt. Only when audit firms were cited for a lack of documentation of internal controls were the client companies smaller, and had often received an audit opinion with modified language. These findings raise the issue of whether increased documentation required by SOX is necessary given certain client characteristics.

Key Words: Auditing, Sarbanes-Oxley, PCAOB, inspection reports, client characteristics

INTRODUCTION

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (SOX) into law. The Sarbanes-Oxley Act went into effect to address widespread outrage and waning investor confidence resulting from a series of financial disasters, earnings restatements, and other corporate and accounting abuses (Hein et al. 2002). To restore trust of investors and the general public the Public Company Accounting Oversight Board (PCAOB) was established shortly thereafter in conjunction with SOX. The PCAOB was established to police the accounting profession's audit of public traded companies (Tackett et al. 2006). The PCAOB is required to carry out audit inspections periodically and report on those inspections with respect to the professional standards and policies of the PCAOB and the Securities Exchange Commission (SEC). In its inspections, the PCAOB must identify and document deficiencies in audit working papers. The PCAOB inspections are regarded as assessments of the accounting firm's audit quality and other related matters that are vital to the framework of the firm.¹

The PCAOB is funded through fees paid by public companies and accounting firms. Its specific responsibilities include: (1) managing the registration of public accounting firms, (2) inspections, (3) investigations and enforcement, and (4) setting of auditing, quality control, ethics and independence standards for auditors of public companies (Mandaleris 2005). Several papers have already tried to analyze the reasons for requiring SOX inspections instead of peer review (Hillary and Lennox 2006) and the efforts and results of reporting (McCuaig 2006; McCollum 2006), with both positive and negative results. Tackett et al. (2006) reported on the examination of internal control reporting required by SOX and recommended that formal internal control reporting be eliminated.

This paper further investigates the findings of Tackett et al. (2006) by analyzing results of recent PCAOB inspections. A categorization is developed which identifies the possible outcomes for the Review of the Audit Engagement (RAE): an unqualified inspection report; a qualified inspection report, where 1 deficiency is found in the audit engagement; or an adverse inspection report, where 2 or more deficiencies were found by the PCAOB. Further, the remarks on deficiencies are categorized into one of seven areas: 1- Evidence and audit procedures issues; 2 – GAAP issues; 3 – Failure to identify a going concern problem; 4 – Expense / liability issues; 5 – Revenue / assets issues; 6 – Equity issues; and 7 – Internal control issues. An examination is then made of the characteristics of client companies whose auditors received the various remarks as a result of their inspection. Also examined was whether the clients had received an unqualified opinion or an opinion with additional language. The findings of the study are that companies whose auditor was cited for failure to identify issues with GAAP, expenses and liabilities, or revenues and assets were larger clients with lower debt. Only when audit firms were cited for failing to properly identify a client's lack of documentation of internal controls were the companies smaller, and often had received an audit opinion with modified language. As a result, this paper raises the issue of whether client characteristics indicate that increased documentation required by SOX is necessary.

¹ "Audit quality" refers to the probability that the auditor will detect misstatements

RELEVANT LITERATURE

Overview of the Inspection Process

The PCAOB's inspections measure the degree of compliance of audit firm practices with audit standards. In order for the inspection process to function each public accounting firm must be registered with the PCAOB, which provides implementation guidance to its 1,675 registered firms.² Inspections are conducted annually for audit firms that issue audit reports for more than 100 companies. Audit firms with a clientele base less than 100 are inspected once in a 3-year span. These inspections deal with potential audit deficiencies in the audit firm's quality control systems and audit engagements.

The inspection team is advised to consult and inspect the firm's national and practice offices. The PCAOB reviews the following audit procedures (PCAOB 2005): (1) review of partner evaluation, compensation, promotion and assignment of responsibilities; (2) review of independence policies; (3) review of client acceptance and retention policies; (4) review of the internal inspection program; (5) review of practices for establishment and communication of audit policies, procedures and methodologies, including training; (6) review of policies related to foreign affiliates; and (7) review of "tone at the top".

The PCAOB inspection team focuses on reviews of selected audit engagements.³ The inspection team reviews the issuer's financial statements and certain SEC filings. Other areas subject to review include, but are not limited to, revenues, reserves or estimated liabilities, derivatives, income taxes, related party transactions, supervision of work performed by foreign affiliates, assessment of risk by the audit team, and testing and documentation of internal controls (PCAOB 2005).⁴ Misrepresentations that are not recorded in financial statements during external audits may also be subject to inspection.

For each engagement selected for review, inspection deficiency opinions (IDO) are categorized as one of three possible outcomes: (1) an unqualified inspection report, whereas no deficiencies are found in the audit engagement; (2) a qualified inspection report, where one deficiency is found; or (3) an adverse inspection report, where two or more deficiencies were found by the PCAOB.

Effects of Audit Review on the Quality of Audit Working Papers and Reviewer Judgments

Agoglia et al. (2006) investigated the effects of audit review format on the quality of working paper and reviewer judgments. Their study is influenced by Auditing Standard No. 3, which focuses on audit working papers and their influence on audit quality. AS No. 3 states that auditors who prepare working papers (hereafter preparers) should document sufficient information in their audit working papers to enable experienced auditors (hereafter reviewers) to understand the procedures performed, evidence obtained, and conclusions reached (Agoglia et al. 2006). Due to recent technological advancements, reviewers have become more reliant on electronic reviews to correspond with preparers as opposed to traditional methods of review in which the reviewer and preparer meet face-to-face to discuss reviewer concerns (Agoglia et al. 2006). The authors note that face-to-face preparers provide a higher grade and quality of audit working paper documentation than the e-review preparers.

² As of Tuesday, July 18, 2006, the PCAOB reported 1,675 registered firms.

³ The term "review of audit engagements" refers to inspection deficiency opinions.

⁴ In the event of financial statements not in accordance with GAAP, PCAOB is required to report the misrepresentations to the SEC.

The recently reported financial reporting frauds (Enron, WorldCom, Tyco, etc.) have shaken investor confidence in U.S. capital markets (Walker 2003). McDonough (2005) claims that PCAOB oversight has significantly affected the structure of auditing for public companies. He indicates that the PCAOB often selects additional audits during the course of the inspection, enabling inspectors to follow leads to the root causes of poor auditing. This approach gives auditors a good bit of anxiety and incentive to stay on their toes.

Studies that examine the process of inspection reporting

McCuaig (2006) discusses the failures in the governance of financial reporting that led to Sarbanes-Oxley and proposes that internal auditors have a unique perspective and ability to identify critical processes and develop meaningful performance measures. He identifies a framework for identifying reportable incidents or conditions and defining intended results. He stresses that these recommendations can represent a new role for internal auditors.

McCollum (2006) also stresses that ineffective and inefficient external audit work helped necessitate the Sarbanes-Oxley legislation. Another requirement of the law is that the PCAOB is authorized to establish auditing and other professional practice standards. In a discussion of the implementation of Auditing Standard No. 2, the author reports that the PCAOB's reasoning was that some audit firms did not integrate audits of internal control with audits of financial statements as they were supposed to do. The PCAOB found two areas for improvement: first, auditors did not evaluate compensating controls adequately; and second, some auditors did not sufficiently test controls over the preparation of financial statement disclosures.

Hillary and Lennox (2005) evaluate the credibility of self-regulation by testing whether the opinions issued by the peer reviewers provided credible information to clients about audit firm quality. The authors' findings indicate that audit firms gained clients after receiving clean opinions from their reviewers and lost clients after receiving modified or adverse opinions. This suggests peer review opinions provided credible information about quality differences between audit firms, suggesting that the inspections required by Sarbanes-Oxley are unnecessary in this respect. Rouse et al. (2005) provide an update on the Sarbanes-Oxley reporting and inspection requirements. The authors report preparers' and auditors' opinions of the trends in audit fees, independence, and choice of firms. Their paper also presents and reviews auditing standards 1, 2 and 3 along with describing some practice issues such as the certifications required by the CEO and CFO in a company's annual findings, partner rotation and pre-approval of audit services by company audit committees. These authors indicate that investor confidence in the capital markets appears to be improving, although they caution that the SEC and the PCAOB still face major tasks with the goal of investor protection.

Tackett et al. (2006) perform a critical examination of the costs and benefits associated with Section 404 of SOX. Qualitative analysis and deductive reasoning are used to evaluate the net benefits of Section 404 to the securities markets. These authors find that the new internal control reporting requirements have negative net benefits to the securities markets because of excessive cost and ambiguous interpretation. Elimination of formal internal control reporting is recommended.

Since inspection reports have now been issued, the intent in this paper is to further investigate the findings of Tackett et al. (2006) and Rouse et al. (2005) by analyzing results of recent PCAOB inspections. The paper is organized as follows. First, the methodology is presented, including a description of the data, the research question and variables used. Then the results and conclusions are presented, along with suggestions for future research.

METHODOLOGY

Description of the data

Data for the study was obtained from the PCAOB web site for February 2006. The data reports the results of inspection reports, known as Reviews of Audit Engagements (RAE). There can be three different outcomes from an RAE, which for this paper are interpreted and coded as follows: (1) represents an unqualified inspection report; (2) is a qualified report, which means that one deficiency was found in the audit engagement; (3) is an adverse report, which means that two or more deficiencies were found by the PCAOB.

The footnotes supplied by the PCAOB are also interpreted and grouped into remarks which indicate the reason for the RAE opinion. Seven types of remarks footnotes were developed. The category for Remark 1 refers to evidence and audit procedures issues. This means that the firm didn't obtain sufficient competent audit evidence, or failed to plan, perform or document substantive testing or other audit procedures. Remark 2 cites failures of GAAP. For instance, if there is a failure to document sufficient procedures related to financial statement disclosures, or if the firm fails to document procedures related to accounting changes or management's estimates, or if there are failures to test accounting for a business combination or other lapses in reporting on contracts, then the PCAOB will add this footnote. Remark 3 indicates a failure to identify a going concern problem. For purposes of this study, it was noted that there were similarities in remarks 4, 5, and 6 so they are grouped together to refer to failures to document expense and liability procedures, revenue and asset issues, and equity issues, respectively. Remark 7 is categorized as comments regarding internal control issues, which means that there was a failure to document procedures related to internal control and/or fraud.

Research question and variables

Many of the remarks indicate failure on the part of the audit firm to document or report certain situations. So the rationale was to examine the characteristics of firms that might exist and thus lead to failure to report the conditions. For example, did the failure stem from a lack of items to report, making documentation redundant, or was the audit firm deficient in its procedures? Therefore, the research question looked at the most severe opinion, which was identified by this study as an adverse opinion and coded as a 3, to examine what specific or common characteristics of client companies were evident when each of the remarks was received in the PCAOB report.

The following variables of the client companies were considered. First considered was the size of the client, represented by the log of total assets (LNTA), to see if an audit firm was more likely to receive a particular remark if they had a "larger" client, in terms of total assets. Second was whether the auditor is one of the top 7 (TOP7) audit firms, to see if there was a difference in an audit firm receiving a remark if they were one of the top 7 firms or not. The top 7 firms were defined as (in no particular order): Deloitte and Touche, Ernst and Young, Grant Thornton, KPMG, PWC, BDO Seidman, and McGladrey and Pullen. The third variable looked at which of two predominant types of audit opinions (OPIN) the client might have received – identified as a "1" for an unqualified opinion or a "4" for an audit opinion with additional language. The reasoning for this choice was that perhaps more reporting issues were present when the client had an audit report with additional language. The next variables considered were income before extraordinary items (IBEXT) and return on equity (ROE). These figures reflect

profitability of the client and might require the audit firm to consider and document earnings management or earnings manipulation issues. Finally, the ratio of long-term debt to equity (LTDEQ) was examined, based on the assumption that a client with greater debt would have a greater number of reporting issues.

In reviewing the data, all of the audit firms that were designated as “top 7” received what was referred to in the study as an R2 (GAAP issues) and R4 (Expense / liability issues) comment. Six of the “top 7” firms received what was labeled an R5 (Revenue / assets issues) comment, and five of the “top 7” firms received the R7 (Internal control issues) comment. Of the other remarks, those that were categorized as R1 (evidence and procedures issues) and R6 (equity issues) were received by only one of the “top 7” firms, and the category R3 (failure to identify going concern problem) was received by only two of the “top 7”. These results led to the decision regarding which remarks to include in an examination of the client companies whose audit firm received those remarks. In order to have a large enough sample to analyze, the decision was made to include only those remarks which were received by a majority of the “top 7” firms in this examination.

Model and Results

A logistic regression model was used for the analysis. The dependent variable is indicated as a “1” if the remark is received, “0” otherwise. There were three different analyses performed. The first analysis was for audit firms that had received a remark R2 and R4 (GAAP issues and Expense / liability issues, respectively). Since all “top 7” firms received both these remarks, the characteristics of client firms for these remarks could be examined together. The second analysis was for firms that received a remark R5 (Revenue / assets issues). The third analysis was for firms that received a remark R7 (Internal control issues). In addition, since the “top 7” were predominant in the sample, there were not a significant number of firms for comparison using the TOP7 variable in the case of remarks R2 and R4, since all “top 7” firms received that remark. Further, the model did not converge for R5, either, as six of the “top 7” firms received that remark. So the first two runs in the study do not use that variable. The format of the model for the first two runs is thus:

$$Y = \alpha + \beta_1 LNTA + \beta_2 OPIN + \beta_3 IBEXT + \beta_4 ROE + \beta_5 LTDEQ + \delta,$$

where LNTA = log of total assets; OPIN = the type of opinion, where “1” is an unqualified opinion of the client company, and “4” is an opinion with additional language; IBEXT = income before extraordinary items; ROE = return on equity; and LTDEQ = long-term debt to equity ratio.

Descriptive statistics for these variables, using R2 as the dependent variable, are shown in Table 1, Panel A. There were originally 8,228 client companies in the sample, but because of missing data to be selected or used in computing the variables, the final sample consists of 5,588 companies. Of these, 3,782 were clients whose auditor received Remark 2 or Remark 4 from the PCAOB on their inspection report. The results show that the clients whose firm received the remark had higher total assets. The mean of the audit opinion shows that more of the client companies whose firm received the remark had an unqualified opinion, as opposed to an opinion with additional language. Income before extraordinary items was also higher for these companies, but the return on equity was lower and there was more long-term debt.

Table 1, Panel A – Descriptive Statistics
Of Client Companies Whose Auditors Received Remark 2 and Remark 4

Variable	Mean		Std. Dev.	
	Remark	Non-remark	Remark	Non-remark
LNTA	4.852	1.594	1.456	2.288
AUD_OPIN	1.805	2.304	1.329	1.487
IBEXT	4.206	- 1.973	43.267	10.437
ROE	- 1.541	6.371	94.335	200.550
LTD_EQ	24.993	10.762	129.506	117.021

Where LNTA = log of total assets, AUD_OPIN = audit opinion, IBEXT = income before extraordinary items, ROE = return on equity, LTD_EQ = long-term debt to equity.

The results of the logistic regression model for characteristics of client companies whose audit firm received a Remark 2 or Remark 4 are shown in Table 2, Panel A. The significant variables in the analysis are LNTA and LTDEQ. The sign of LNTA indicates that clients were larger in size, while the negative coefficient of LTDEQ indicates that they had lower debt. The signs for LTDEQ and ROE are not in the expected direction, but the model does indicate companies whose financial results would warrant further investigation, as they have higher ROE and lower LTDEQ while having lower income and an unqualified opinion. The model classified 84% of the companies correctly.

Table 2, Panel A - Results of Logistic Regression for Companies whose audit firm Received a Remark 2 or Remark 4 on the PCAOB Inspection Report

Variable	Coefficient	T-Value
LNTA	1.0713	35.829 ***
OPIN	- 0.0372	- 0.404
IBEXT	- 0.0031	- 1.409
ROE	0.0001	0.219
LTD_EQ	- 0.0018	- 4.500 ***
Constant	- 2.9358	- 24.203 ***

- * Significant at 0.10 level, ** Significant at 0.05 level, ***Significant at 0.01 level (two-sided test)
- Nagelkerke R-square = 0.572
- Remark 2 is for GAAP issues. Remark 4 is for Expense / liability issues
- See table 1 for description of variables.

Descriptive statistics for client companies whose audit firm received a remark 5 are shown in Table 1, Panel B. In the sample there were 3,118 client companies whose audit firm received this remark, which is about not properly documenting revenue or assets issues. The

statistics again show that those client companies whose auditor received the remark on average had higher total assets, an unqualified opinion, higher income, lower return on earnings and higher debt.

Table 1, Panel B – Descriptive Statistics
Of Client Companies Whose Auditors Received Remark 5

Variable	Mean		Std. Dev.	
	Remark	Non-remark	Remark	Non-remark
LNTA	4.798	2.513	1.481	2.586
AUD_OPIN	1.767	2.221	1.309	1.474
IBEXT	3.232	0.852	43.545	23.574
ROE	- 2.602	5.591	93.823	178.475
LTD_EQ	24.025	15.640	127.990	122.602

Where LNTA = log of total assets, AUD_OPIN = audit opinion, IBEXT = income before extraordinary items, ROE = return on equity, LTD_EQ = long-term debt to equity.

The results of the logistic regression model for clients whose audit firm received a Remark 5 are shown in Table 2, Panel B. The statistics indicate that the significant variables are LNTA, OPIN, IBEXT, and LTDEQ. The signs of the variables indicate that these clients had higher total assets. In a contradiction from the descriptive statistics, they also had lower debt to equity ratio, had lower income, and were more likely to receive an audit opinion with additional language. This model correctly classified 73% of the client companies.

Table 2, Panel B - Results of Logistic Regression for Companies whose audit firm Received a Remark 5 on the PCAOB Inspection Report

Variable	Coefficient	T-Value
LNTA	0.6065	30.631 ***
OPIN	0.3320	4.736 ***
IBEXT	- 0.0064	- 5.333 ***
ROE	0.0001	0.064
LTD_EQ	- 0.0010	- 3.333 ***
Constant	- 2.3226	- 23.919 ***

- * Significant at 0.10 level, ** Significant at 0.05 level, ***Significant at 0.01 level (two-sided test)
- Nagelkerke R-square = 0.325
- Remark 5 is for Revenue / assets issues.
- See table 1 for description of variables.

Finally, descriptive statistics for clients whose audit firm received a Remark 7 are shown in Table 1, Panel C. There were 2,074 companies that received this remark in the sample. These statistics show that companies whose auditor received the remark had on average higher total assets, an unqualified opinion, higher income, higher return on equity and higher debt.

Table 1, Panel C – Descriptive Statistics
Of Client Companies Whose Auditors Received Remark 7

Variable	Mean		Std. Dev.	
	Remark	Non-remark	Remark	Non-remark
LNTA	4.732	3.228	1.485	2.560
AUD_OPIN	1.831	2.050	1.343	1.431
IBEXT	5.108	0.477	39.529	33.763
ROE	1.626	0.608	94.154	157.669
LTD_EQ	21.243	19.669	134.623	120.204

Where LNTA = log of total assets, AUD_OPIN = audit opinion, IBEXT = income before extraordinary items, ROE = return on equity, LTD_EQ = long-term debt to equity.

The results of the logistic regression model for these companies are shown in Table 2, Panel C. This model includes an additional variable, as follows:

$$Y = \alpha + \beta_1 LNTA + \beta_2 TOP7 + \beta_3 OPIN + \beta_4 IBEXT + \beta_5 ROE + \beta_6 LTDEQ + \delta,$$

where LNTA = log of total assets; TOP7 = audit firm, where “1” is one of the audit firms designated as “Top 7”, “0” otherwise; OPIN = the type of opinion, where “1” is an unqualified opinion of the client company, and “4” is an opinion with additional language; IBEXT = income before extraordinary items; ROE = return on equity; and LTD_EQ = long-term debt to equity ratio. The significant variables in this model are LNTA, TOP7, OPIN, and IBEXT. The signs of the variables indicate that these clients are smaller companies, that they are clients of a “Top 7” firm, that they had an unqualified opinion, and that they had positive income before extraordinary items. The model correctly classified 70% of these companies.

Table 2 - Panel C - Results of Logistic Regression for Companies whose audit firm Received a Remark 7 on the PCAOB Inspection Report

Variable	Coefficient	T-Value
LNTA	- 0.1574	- 6.321 ***
TOP7	11.0021	2.882 ***
OPIN	- 0.1371	- 1.816 **
IBEXT	0.0023	2.555 ***
ROE	0.0006	1.500
LTD_EQ	- 0.0003	- 1.000
Constant	- 9.9425	- 2.606 ***

□ * Significant at 0.10 level, ** Significant at 0.05 level, ***Significant at 0.01 level (two-sided test)

□ Nagelkerke R-square = 0.447

□ Remark 7 is for Internal Control issues.

□ See table 1 for description of variables.

DISCUSSION AND CONCLUSIONS

The intent in this paper was to investigate whether the additional documentation required by SOX is necessary, in order to support authors in favor (McCullum 2006) or against (Tacket et al. 2006) the requirements. Given the above results, conclusions are mixed. For the first regression model, which was for comments categorized as Remark 2 (GAAP issues) and Remark 4 (Expense / liability issues), the clients were larger companies with lower debt. Since these statistics indicate companies with fewer problems, it does not seem necessary to provide extensive documentation of their condition. The results of the second regression model, for comments categorized as Remark 5 (Revenue / assets issues), include the previous two variables as significant, with the same sign, in addition to a significant variable which represents companies with audit opinions that had additional language. The other significant variable for these clients indicated that they have lower income. This could be something that should be documented, especially if it is a declining trend. Finally, the significant characteristics of those companies whose audit firm received what was categorized as a Remark 7, were that they were smaller companies, with “Top 7” firms, an opinion that had additional language, with positive net income. Given that this remark addresses internal control issues, it is more likely that smaller companies with an audit opinion that has additional language should require more extensive documentation. And although the income is positive, in a fraud situation income could be manipulated to be positive, so internal controls should be documented to be sure that is not the case.

In conclusion, the results of this study indicate support for additional documentation required by SOX for the revenue and assets issues, along with internal control issues, but not as much support for documentation of the other issues addressed by the PCAOB inspection reports. The study examined client companies whose audit firms had received what was labeled an adverse opinion on their report, with the remarks given in categories of GAAP issues, expense / liability issues, revenue / asset issues, and internal control issues (Remarks 2, 4, 5, and 7). Audit firms who received other remarks (our classifications 1, 3, and 6), for evidence issues, going concern issues, and equity issues, respectively, were not examined because very few firms received what was labeled by this study as an adverse report for these conditions. Future research could continue to examine the results of the inspection reports in order to address whether audit reporting gets better over time in terms of: (1) fewer occurrences of fraudulent financial reporting; and (2) fewer occurrences of audit firms receiving adverse opinions for the above reasons on their PCAOB inspection report.

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