"**An Analysis of Alleged Auditor Deficiencies in SEC Fraud Investigations: 1998–2010**"  
Mark S. Beasley North Carolina State University   
Joseph V. Carcello University of Tennessee Dana R. Hermanson Kennesaw State University   
Terry L. Neal University of Tennessee  
Center for Audit Quality, May 2013  
<http://www.thecaq.org/resources/pdfs/CAQ_deficienciesMay2013.pdf>

EXECUTIVE SUMMARY   
This study examines U.S. Securities and Exchange Commission (SEC) sanctions against auditors over the period 1998–2010 that are related to instances of alleged fraudulent financial reporting by U.S. publicly traded companies. During that time period, there were 87 separate instances where the SEC imposed such sanctions, and this report summarizes our analysis of alleged auditor deficiencies noted by the SEC in these 87 cases.

In considering the results contained in this report, it is important to appreciate that SEC allegations of fraudulent financial reporting are rare, with 347 cases examined by the SEC from 1998–2007 out of thousands of U.S. public companies. 1 Despite the small number of fraud-related SEC enforcement actions, we believe that analysis of these 87 cases involving auditor sanctions by the SEC provides important insights for auditors and others concerned with improving audit quality, especially in the context of detecting material financial statement misstatements due to fraud. Thus, we highlight key findings related to the audits underlying these 87 cases.

The primary results of our analysis are as follows:

• From 1998–2010, we identified 87 instances of SEC investigations of fraudulent financial reporting leading to sanctions against auditors. Based on companies with available information for these 87 SEC investigations, the associated registrant companies were primarily small (median revenues and assets under $40 million) and concentrated in four key industries (over 40 percent of the sample is in financial services / insurance, general manufacturing, telecommunications, or consumer goods manufacturing).

• Based on available information for these 87 SEC investigations involving auditors, 58 percent of the audit reports issued for the last fraudulently reported financial statements included an unqualified opinion with no additional report modifications.  The other 42 percent of the companies received unqualified audit opinions on the last fraudulently reported financial statements, but those reports included explanatory paragraphs that addressed other issues noted by the auditor, such as highlighting changes in accounting principle or going concern issues.

 • For purposes of our study, we categorized the Big Six/Big Four international firms and the next tier of global network or national firms as “national firms.” 2 Here is a summary of the 87 instances we examined:

-Total instances of SEC investigations examined in this study 87

-SEC sanctions involving audits performed by non-national firms 46

-SEC sanctions involving audits performed by national firms 35

-Bogus audits 3 where auditor did not perform procedures 6

Of the 35 national firm cases, nine involved audits performed by Arthur Andersen. There were six instances where the auditor prepared the financial statements or did not perform any meaningful level of audit procedures. We refer to these six instances as “bogus audits

An Analysis of Alleged Auditor Deficiencies in SEC Fraud Investigations: 1998–2010

• In Accounting and Auditing Enforcement Releases (AAERs) involving sanctions against auditors, the SEC typically alleges that the auditor either (a) violated the anti-fraud statutes (e.g., by participating in the fraud) or (b) performed a negligent audit that allowed the fraud to occur (without the auditor actively participating in the fraud). Among the 81 cases examined (excluding the six bogus audits noted above), the SEC charged the auditor for violating the anti-fraud statutes in 24 cases. The remaining 57 cases were limited to allegations of deficient audits unrelated to anti-fraud statutes. • Among these 81 cases, the SEC issued sanctions against individual auditors in 80 cases and sanctions against the audit firm in 27 instances (26 cases involved sanctions against both individual auditors and the audit firm, with the SEC sanctioning only the audit firm in one case).

• The top five areas cited by the SEC in these 81 cases involved the following:

1. Failure to gather sufficient competent audit evidence (73 percent of the cases)   
2. Failure to exercise due professional care (67 percent)   
3. Insufficient level of professional skepticism (60 percent)   
4. Failure to obtain adequate evidence related to management representations (54 percent)   
5. Failure to express an appropriate audit opinion (47 percent)

• Most of the 81 cases involved multiple alleged deficiencies. 4 For example, 58 of the cases cited more than one of the top three deficiencies, and 42 cases cited the top three deficiencies.

• The most common deficiencies were quite similar for national firms and non-national firms. The top four issues are consistent across these two groups (with a slightly different ranking), and 11 of the top 14 deficiencies appear in both the national firm and non-national firm lists. Based on findings contained in this report, we explore implications for the audit process centered around four key themes. To that end, we explore challenges associated with each of the four themes found in the analysis:

1. Failure to Exercise Due Professional Care: Some of the deficiencies cited suggest a failure on the part of the auditor to discharge responsibilities with competence and diligence to the best of the auditor’s ability, including the performance of procedures generally expected to be performed in an audit. This suggests that there may be opportunities for additional training and education on the fundamentals of the audit process. Also, there may be opportunities for additional analysis to better understand root causes that led to failures in the execution of those fundamentals in a particular audit engagement, so as to strengthen the competence and diligence of the performance of the audit.

2. Insufficient Levels of Professional Skepticism: Similarly, some of the cases examined highlight challenges in maintaining appropriate levels of professional skepticism that affect the auditor’s mindset. Interestingly, the concept of professional skepticism has been embedded in auditing standards for decades; however, in some cases auditors may have struggled in maintaining an appropriate mindset throughout the various stages of the audit process. This challenge has implications for training and helps to motivate analyses such as the present study to understand root causes of failures in applying professional skepticism consistently. Additional research is needed to determine if these challenges may be exacerbated by differences in cultural norms that will be increasingly realized as the audit process continues to be affected by globalization or as new generations of audit professionals emerge who may apply professional skepticism differently than today’s audit professionals.

3. Inadequate Identification and Assessment of Risks: The findings noted in this report also have implications regarding the risk assessment process, given that all cases examined in the study involved undetected instances of fraudulent financial reporting. While auditing standards have been risk-based for a number of years, more recent developments in the risk management arena, 5 including the emerging discipline of enterprise risk management, Beasley, Carcello , Hermanson, and Neal. 2013. are revealing a number of complexities associated with any risk identification and risk assessment task. Any improvement in risk assessment skills that can be identified will help enhance audit quality and improve the recognition of fraud risk. The audit profession, including undergraduate and graduate accounting programs, may want to leverage insights that are emerging in other risk management disciplines to better train and educate audit professionals in risk identification and risk assessment tasks.

4. Failure to Respond to Identified Risks with Appropriate Audit Responses to Gather Sufficient Competent Audit Evidence: In some cases, the auditor failed to adjust audit procedures to gather sufficient competent evidence in light of risks identified and documented by the audit team. While this type of deficiency may be the result of the first three concerns noted above, it may also be triggered by failure to adequately link audit procedures to underlying risks. Because prior research has shown that this type of linkage can be a difficult task, perhaps greater emphasis on quality control review of these linkages may be beneficial, or new tools and techniques may be needed to facilitate this difficult linkage task. Training and education on the use of those tools may be warranted as well. The next section discusses the research approach, and Section 3 presents the results of our analysis. Section 4 develops the implications of the analysis, and Section 5 profiles the research team. The Appendix presents the detailed findings underlying the tables presented in the monograph.