

SPOTLIGHT

Staff Update and Preview of 2021 Inspection Observations

December 2022

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I. OVERVIEW

This Spotlight provides a snapshot of our inspection results across the audit firms that were inspected in 2021. Inspections serve a critical role in helping the PCAOB fulfill its core mission to protect investors by assessing and reporting on whether auditors comply with the PCAOB's standards and rules, as well as other regulatory and professional requirements. The purpose of this Spotlight is to help support investors' and other stakeholders' understanding of the PCAOB's inspection findings during the 2021 cycle. It also provides basic information about the work of the auditors that the PCAOB inspected and describes common themes.

In 2021, the PCAOB advanced its investor-protection mission by inspecting 141 audit firms, reviewing portions of 690 audits. This Spotlight presents our aggregate observations from these inspections for investors and other stakeholders. We share the observations in this publication as a preview of the 2021 inspection reports that we will publish for individual audit firms.

As discussed in section II of this Spotlight, the PCAOB set two primary objectives for its 2021 inspections with a focus on investor protection: (1) continuing a rigorous program of inspections, including responding to the financial reporting and audit risks posed by the COVID-19 pandemic that began in March 2020, and (2) aiming to increase the overall unpredictability of our inspections.

In executing our 2021 objectives, we observed the following:

- For the audit firms that we inspect annually, we identified a collective increase in the

number of audits with deficiencies in 2021 compared to our 2020 inspections. In our inspections of audit firms inspected triennially, we also noted an increase in deficiencies, driven by an increase in deficiencies related to the auditor's assessment and reporting of critical audit matters (CAMs).¹

- In 2021, we continued to identify areas with auditing deficiencies that have recurred for many years. We expect audit firm leadership to address these deficiencies, which are discussed in sections III and IV of this Spotlight, as a top priority, including determining the underlying root causes of the deficiencies and reassessing the effectiveness of their past actions.
- As discussed in section VI, we also observed good practices that we believe may be effective in enhancing a firm's quality control system — and audit quality generally. We encourage auditors to consider how these practices may apply to their audit engagements and to implement changes to engagement procedures proactively to enhance audit quality in the public interest and to help ensure compliance with PCAOB standards and rules.

Auditors may find this publication useful as they continue to plan and perform their audits, and audit committees may also benefit from the use of this publication as a reference point when speaking with and evaluating their auditors. This information will help more fully inform investors and other interested parties about the inspection process and the matters we identify in our inspections.

¹ The requirements related to critical audit matters were effective for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after Dec. 15, 2020, for all other companies to which the requirements apply, as described in the standard.

Inspections: Key to the PCAOB's Mission to Protect Investors

The PCAOB oversees the audits of public companies and brokers and dealers registered with the Securities and Exchange Commission (SEC) to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.²

The Sarbanes-Oxley Act of 2002, which created the PCAOB, authorized the PCAOB to inspect audit firms for the purpose of assessing compliance with certain rules and professional standards in connection with a firm's audit work for public company and broker-dealer clients. Firms that audit these entities are required to register with us, as explained in more detail on our website.

Our inspections review portions of the audits selected for review and evaluate elements of an audit firm's quality control (QC) system. Each PCAOB inspection results in a report, specific to the portions of each audit firm inspected, which summarizes any identified deficiencies. These reports can aid investors in making informed decisions.

If a firm provides audit opinions for more than 100 public companies, the PCAOB inspects that firm annually. If a firm provides audit opinions for 100 or fewer public companies, the PCAOB, in general, inspects that firm at least triennially (i.e., once every three years).

The number of audit firms that the PCAOB regularly inspects fluctuates as there are changes in the number of registered audit firms who perform engagements and issue audit opinions under PCAOB standards.

² Information for auditors of broker-dealers, including annual reports on the interim inspection program, covering these audits is available on our website.

Figure 1 – PCAOB Inspections in 2021: U.S. vs. Non-U.S.



Note: The number of PCAOB Inspections for 2020 previously reported in “Spotlight - Staff Update and Preview of 2020 Inspection Observations” did not include the audits reviewed by the target team, which adds an additional 14 audits reviewed for U.S. annually inspected audit firms in 2020.

Figure 2 – PCAOB Inspections in 2021: Annual vs. Triennial Inspections



Note: The number of PCAOB Inspections for 2020 previously reported in “Spotlight - Staff Update and Preview of 2020 Inspection Observations” did not include the audits reviewed by the target team, which adds an additional 14 audits reviewed for U.S. annually inspected audit firms in 2020.

II. 2021 INSPECTIONS: OBJECTIVES AND APPROACH

The PCAOB had two main objectives in its approach to inspections in 2021.

First, we aimed to continue a rigorous program of inspections, including responding to the financial reporting and audit risks arising from the effects of the COVID-19 pandemic. Most of the audits that we inspected in 2021 involved the 2020 financial information of public companies with fiscal years ending in December 2020. Thus, our inspectors had an opportunity to assess the impact of the COVID-19 pandemic — which was declared a pandemic by the World Health Organization in March 2020 — on auditing practices.

Second, we aimed to increase the overall unpredictability of our inspections by including a higher percentage of random selections and non-traditional focus areas (considering the widespread impact the COVID-19 pandemic had on the planning and performance of audits). We also continued our emphasis on inspecting the audits of larger public companies, including the Fortune 100, given their complexity and inherently greater impact of those public companies and their audits on investors.

In 2021, we conducted all inspections remotely but did not scale back their scope and rigor. We observed an increase in the percentage of engagements reviewed with at least one “comment form” (the initial communication to audit firms of observed deficiencies from

our inspections, which generally result in Part I.A³ or Part I.B⁴ inspection observations). We expect approximately 33% of the audits we reviewed will have one or more deficiencies that will be discussed in Part I.A of the individual audit firm’s inspection reports, up from 29% in

Target Team Focus in 2021

The PCAOB’s target team consists of inspectors who focus on emerging audit risks and topics that could have implications for audits performed by audit firms we inspect.

In 2021, the target team focused on certain audit firms’ procedures concerning fraud, going concern, cash and cash equivalents, special purpose acquisition companies (SPACs), and de-SPAC transactions. (SPACs are publicly listed shell companies created to merge with private operating companies. SPACs typically issue both common shares and warrants to their investors. A de-SPAC transaction refers to the merger of a public SPAC with a non-public operating company.)

See our August 2022 Spotlight — **“Observations from the Target Team’s 2021 Inspections”** — for a summary of the target team’s work in 2021, including perspectives on the auditor’s responsibilities, observations, and good practices.

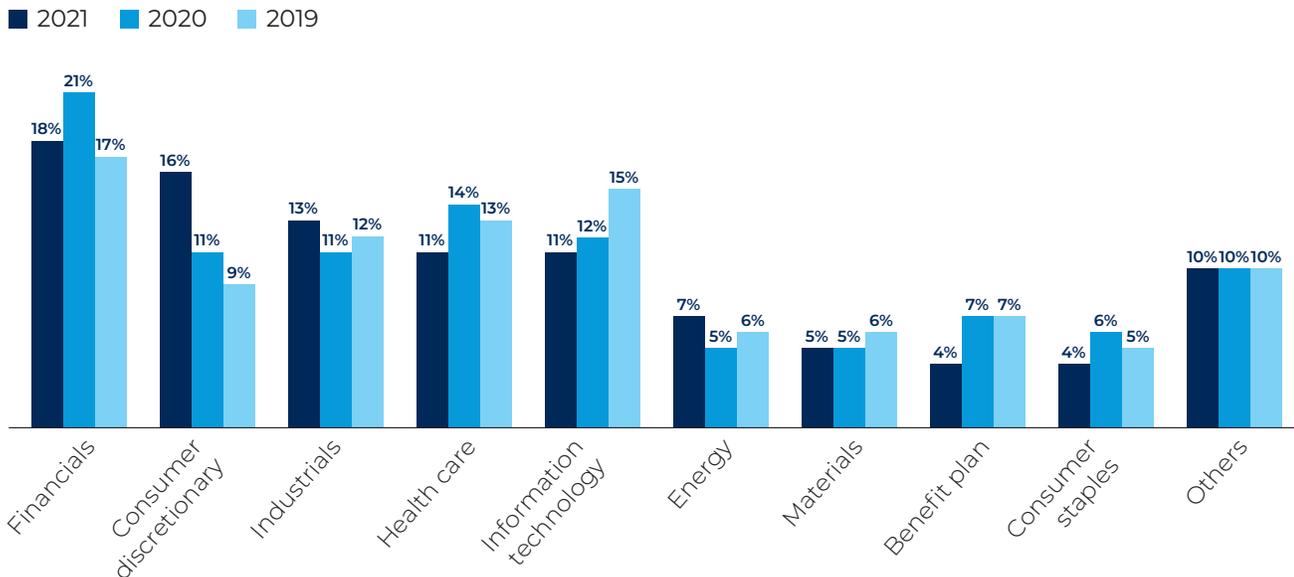
³ Part I.A of the individual audit firm’s inspection report discusses deficiencies, if any, that were of such significance that we believe the audit firm, at the time it issued its audit report(s), had not obtained sufficient appropriate audit evidence to support its opinion on the public company’s financial statements and/or internal control over financial reporting.

⁴ In Part I.B of our inspection reports, we provide observations regarding instances of noncompliance with PCAOB standards or rules that do not relate directly to the sufficiency or appropriateness of evidence the audit firm obtained to support its opinion(s), such as critical audit matters, Form AP, and certain independence related deficiencies.

2020. In addition, we expect that approximately 40% of the audits we reviewed will have one or more deficiencies discussed in Part I.B of the individual firm’s inspection reports, up from 26% in 2020. Some audits have both Part I.A and Part I.B deficiencies, such that we expect that approximately 55% of the engagements we reviewed will have one or more Part I.A and/or Part I.B deficiencies, compared to 44% in 2020. We discuss reasons for the increases throughout this Spotlight.

We selected audits for review in sectors and specific industries experiencing particularly significant disruptions or financial reporting risks during the COVID-19 pandemic. When selecting individual areas of audits to review, we also focused on certain financial statement estimates and other reporting matters that have been particularly affected by the pandemic, such as impairment, going concern assessment, expected credit losses (“CECL”), and the increased risk of fraud.

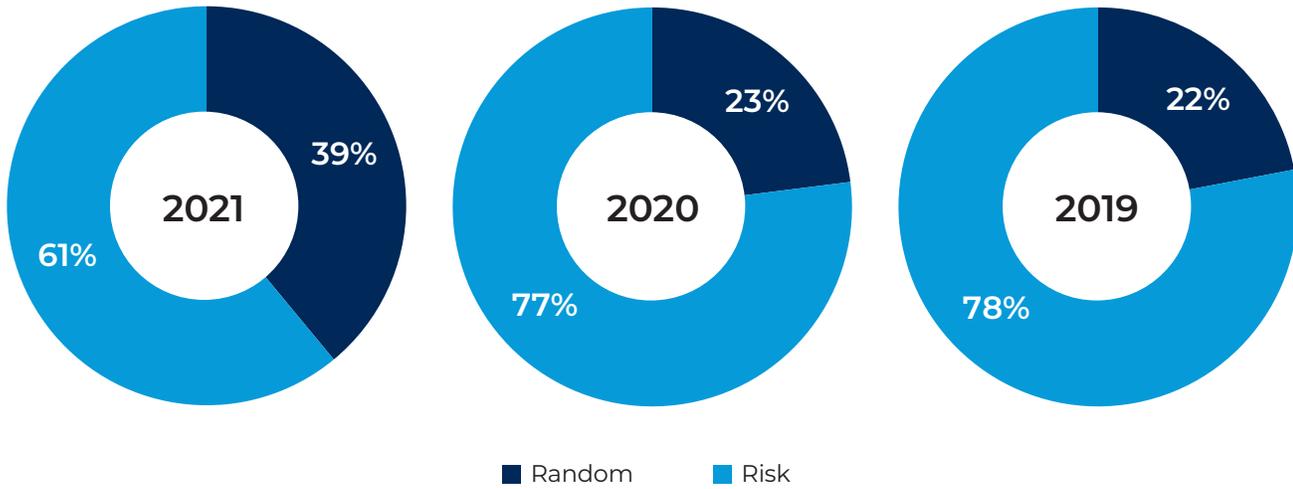
Figure 3 – 2021 Audit Engagements Inspected by Industry Sector



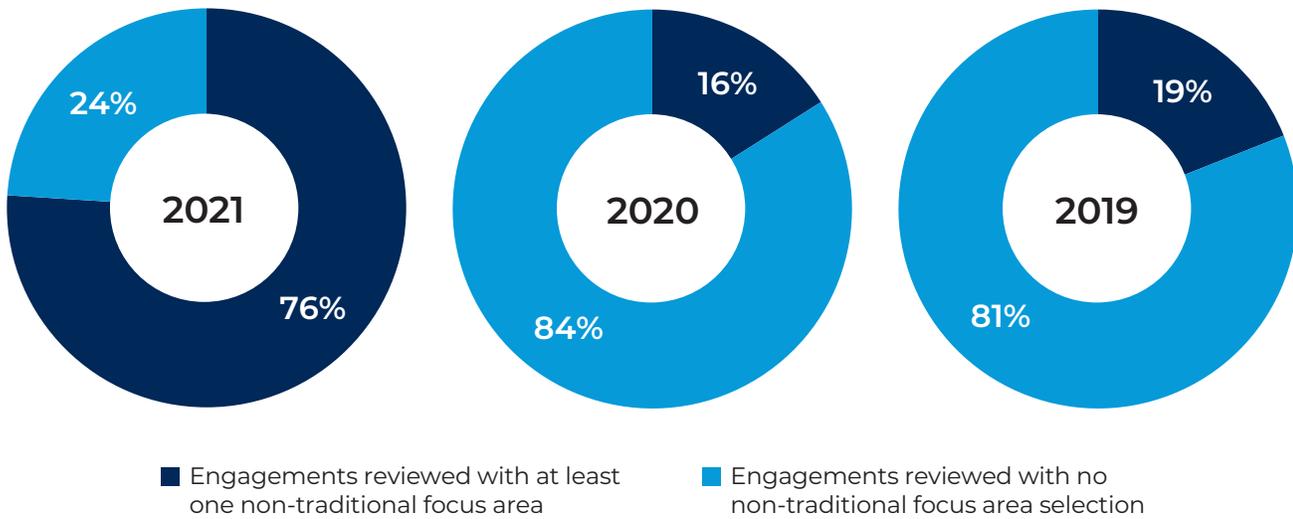
We also significantly increased the percentage of audits we selected randomly, especially for the largest audit firms, as the effects of COVID-19 were unpredictable. We also selected more non-traditional focus areas for inspection, again in part to measure the effects of COVID-19 on auditing. Non-traditional focus areas are financial statement areas that are typically less complex and more routine in nature. Examples of non-traditional focus areas selected for review in 2021 included cash and cash equivalents, deposit liabilities, debts, accruals, and foreign currency translations.

Figure 4 – Selection Method for Audit Engagements (Annual Firms Only)

Risk-Based vs. Random Engagement Selections



Engagement Selections with Non-Traditional Focus Areas



III. TRENDS IN AREAS WITH RECURRING DEFICIENCIES, 2019 TO 2021 INSPECTIONS

In our continuing efforts to monitor areas with recurring deficiencies, we analyzed the comment forms from the last three inspection cycles, beginning in 2019.

This analysis identified trends in deficiencies related to auditing internal control over financial reporting (ICFR) and to auditing financial statements.

We expect audit firm leadership to address the recurring nature of these deficiencies and monitor the effects of actions taken. An audit firm's inadequate response to address recurring deficiencies may warrant additional

action, such as the Division of Registration and Inspections referring firms to the Division of Enforcement and Investigations for potential investigation or disciplinary action for failing to comply with PCAOB standards.

Trends in Deficiencies in Auditing ICFR

Deficiencies in auditing ICFR were related to the sufficiency and appropriateness of audit evidence supporting an audit firm's ICFR opinion. These deficiencies represent instances of non-compliance with AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

The three-year data highlights certain areas in ICFR audits that have generated the most comment forms since 2019. Figure 5 illustrates those areas.

Figure 5 – Percentage of Total ICFR Auditing Deficiencies by Nature, Based on the Number of Comment Forms, 2019 to 2021

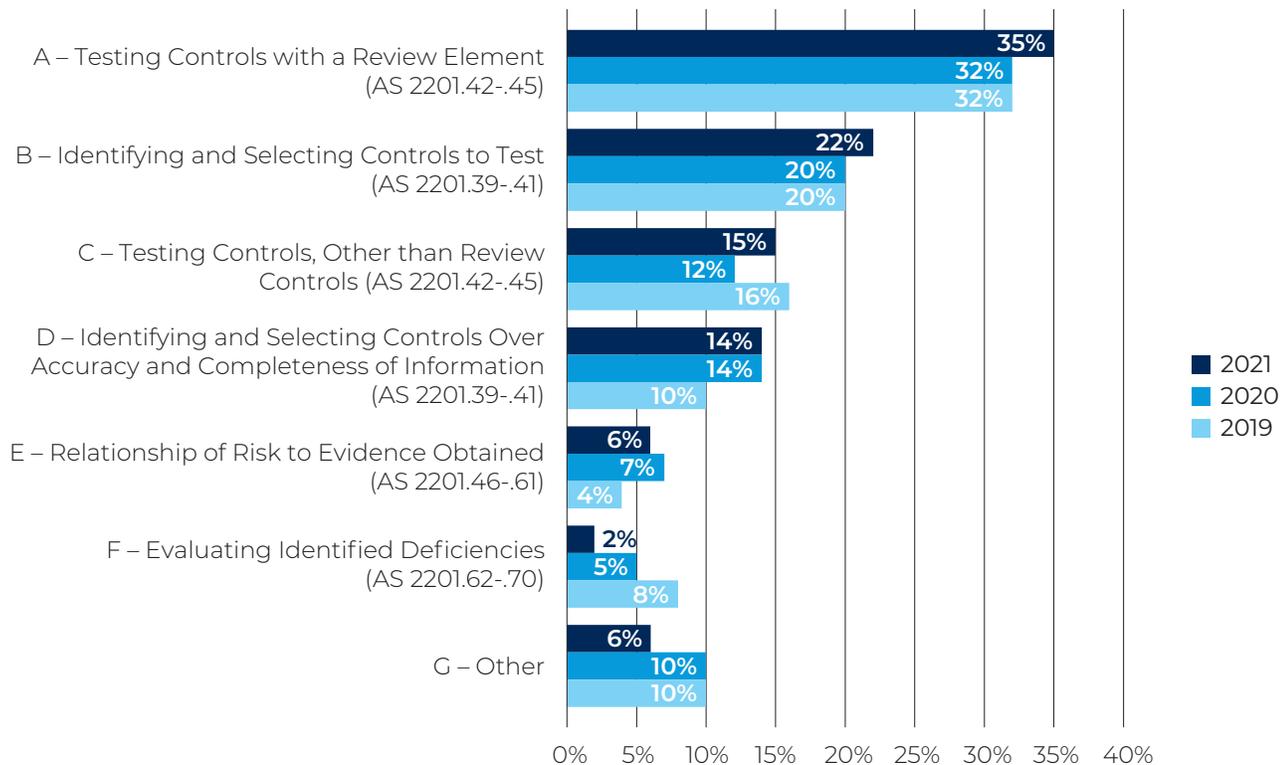
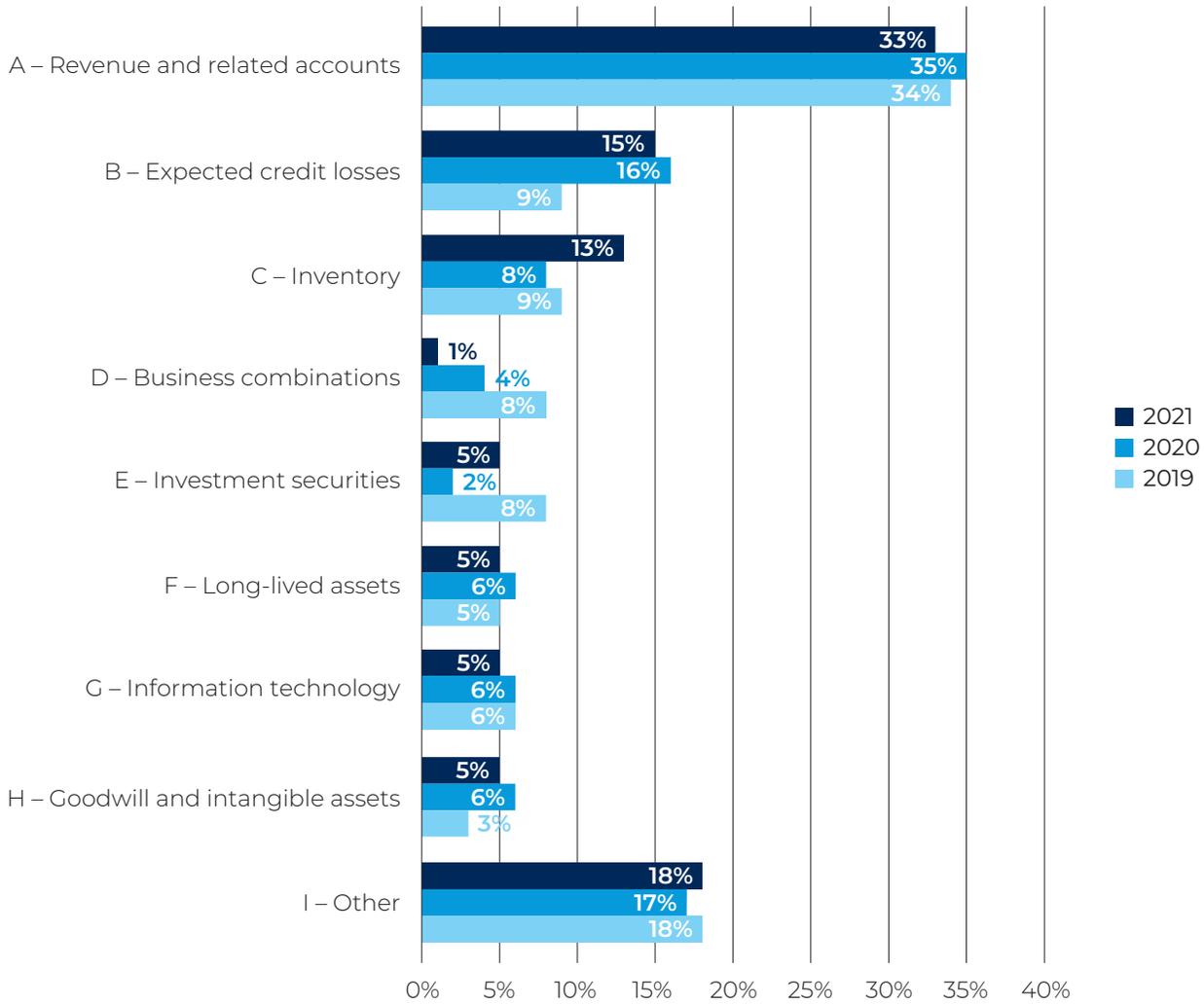


Figure 6 illustrates the financial statement audit areas to which our ICFR comments relate.

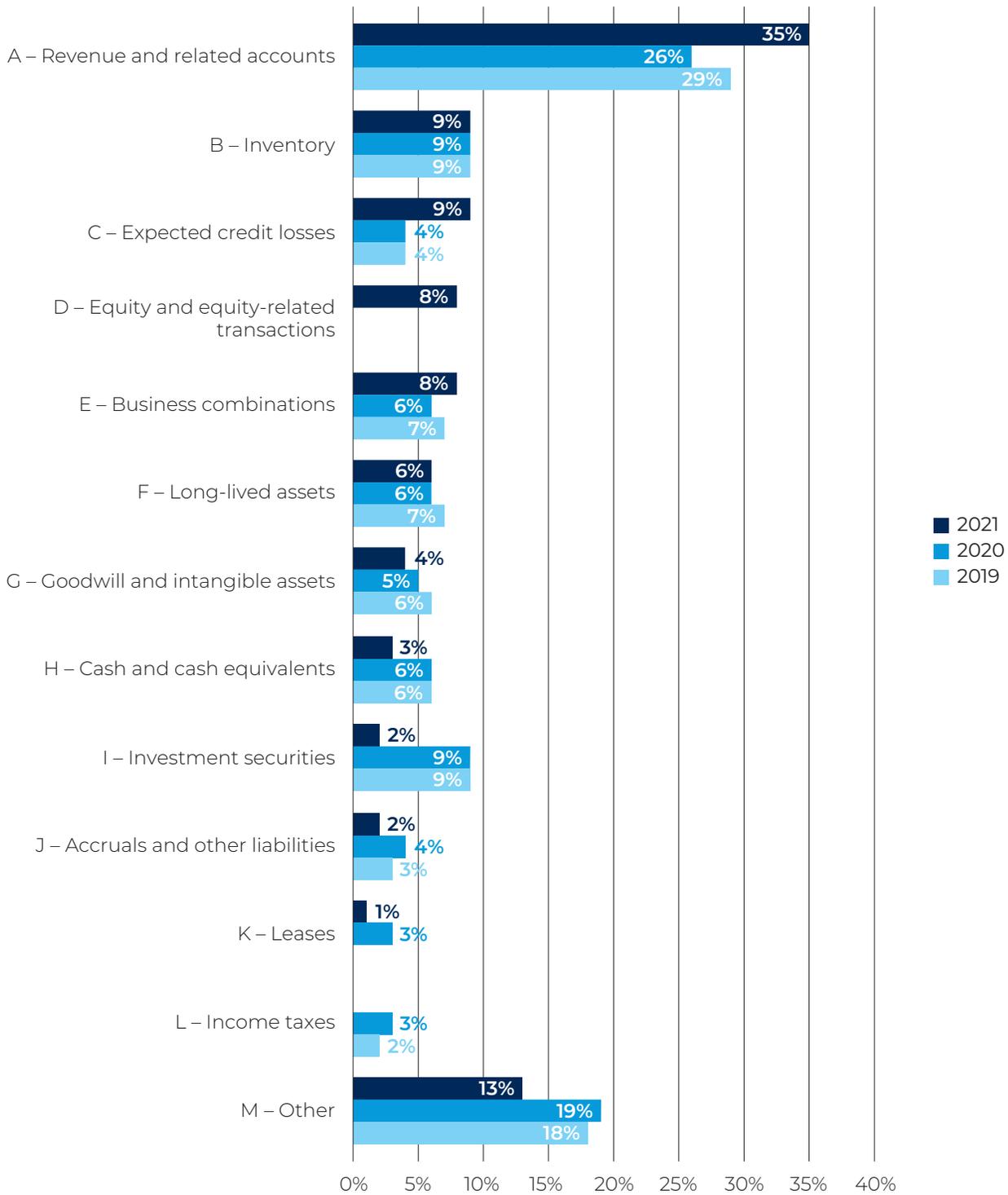
Figure 6 – Percentage of Total ICFR Auditing Deficiencies by Audit Area, Based on the Number of Comment Forms, 2019 to 2021



Trends in Deficiencies in Financial Statement Audit Areas

Figure 7 shows financial statement audit areas that generated the most comment forms on a recurring basis during this period, excluding those that relate to testing ICFR.

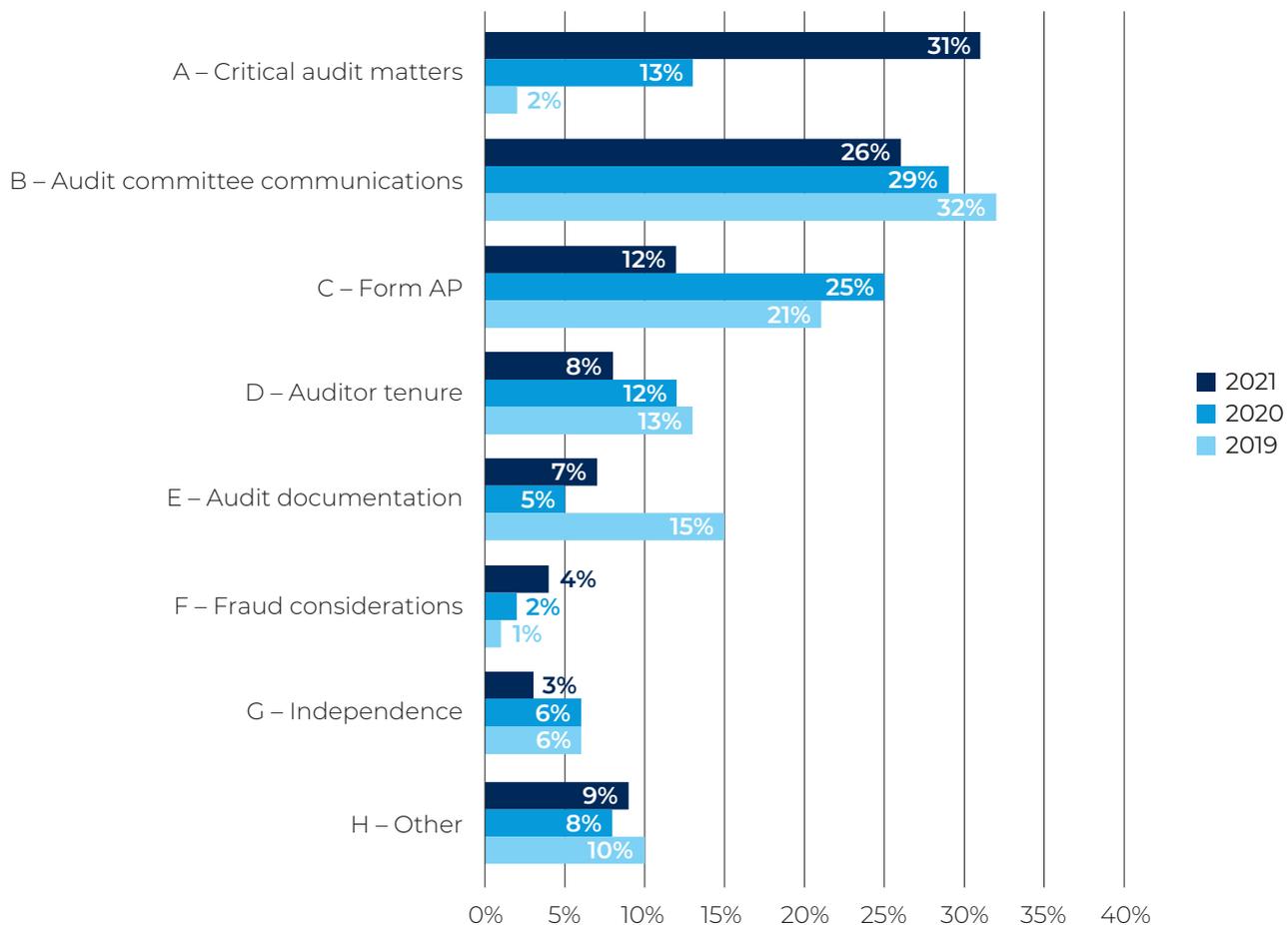
Figure 7 – Percentage of Total Financial Statement Deficiencies by Audit Area, Excluding ICFR, Based on the Number of Comment Forms, 2019 to 2021



Trends in Deficiencies Related to Other PCAOB Standards or Rules

In addition to issues related to the audit of the financial statements and ICFR, our inspectors also review audits for their compliance with other PCAOB standards and rules. As discussed in greater detail in section IV, the three-year trends in this area reveal a significant increase in the number of deficiencies related to the auditor's assessment and reporting of CAMs.⁵

Figure 8 – Percentage of Total Deficiencies Related to Other PCAOB Standards and Rules, Based on the Number of Comment Forms, 2019 to 2021

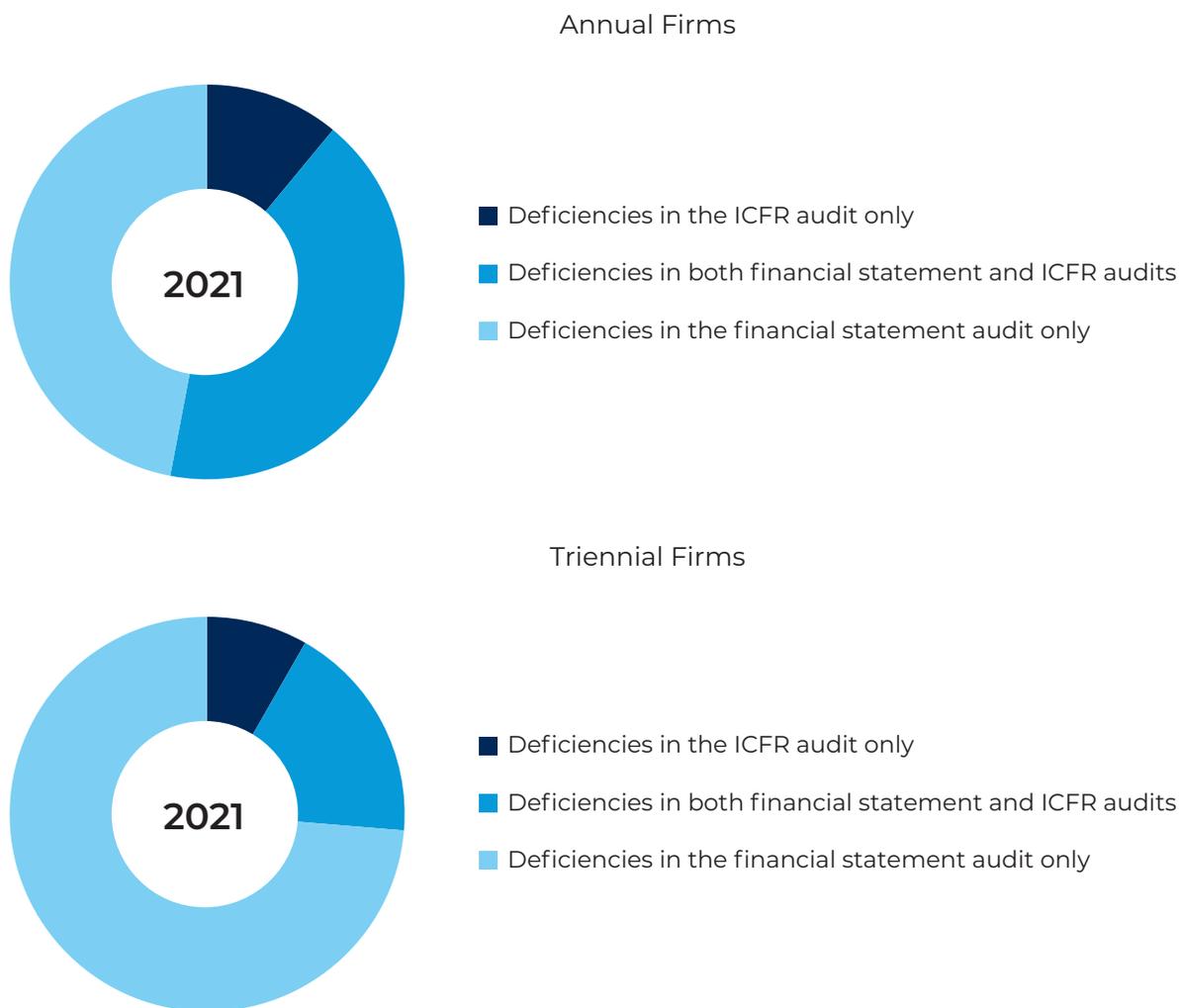


⁵ The requirements related to critical audit matters were effective for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after Dec. 15, 2020, for all other companies to which the requirements apply, as described in the standard.

IV. COMMON DEFICIENCIES IN 2021 INSPECTIONS

In 2021, we continued to observe deficiencies similar to those identified in prior years. Many of these deficiencies are in areas that are inherently complex and in turn generally include greater risks of material misstatement. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion. As the assessed risk of material misstatement increases, the amount of evidence that the auditor should obtain also increases.

Figure 9 – 2021 Audit Deficiencies Based on Type of Audit Opinion



For annually inspected firms, integrated audits with ICFR opinions make up 63% of the audits reviewed by our inspectors; for triennial audit firms, it was 39% of the audits reviewed.

Deficiencies in Auditing ICFR

As noted above, deficiencies in controls testing remain a common occurrence in both integrated audits and testing of controls in a financial statement audit. Despite improvements observed at certain firms, we continue to observe deficiencies related to testing ICFR across firms. Common audit deficiencies in this area include:

- Auditors did not sufficiently evaluate whether controls with a review element selected for testing operated at a level of precision sufficient to prevent or detect material misstatements. In these instances, the auditors did not evaluate the review procedures the control owners performed, including the procedures to identify items for follow-up, and the procedures to determine whether those items were appropriately addressed.
- Auditors did not identify and test controls relevant to the assessed risk of material misstatement. In many cases, the auditors did not identify and test controls over the accuracy and completeness of information used in the operation of a control. These can be critical errors, because the auditor's testing of controls is often used as the basis for reducing the nature, timing, and extent of substantive testing, also known as a control reliance approach. Therefore, any deficiencies in the testing of controls may affect the auditor's ability to use this approach.

Deficiencies in auditing ICFR remained high, and it is important that auditors continue to focus on auditor performance in these areas.

Deficiencies in Auditing Financial Statement Areas

Revenue and Related Accounts

Revenue continues to be a frequently selected focus area in our inspections given complexities often associated with revenue recognition accounting policies and practices and the auditing of such policies and practices.

Despite the focus of audit firms on the Financial Accounting Standards Board's standard on revenue recognition, as well as the training and/or tools audit firms have provided to their auditors, we observed frequent deficiencies related to the design and performance of audit procedures to identify and address assessed risks of material misstatement related to revenue. For example, we identified the following audit deficiencies:

- Auditors did not evaluate whether the performance obligations were satisfied, as required to recognize revenue.
- Auditors did not sufficiently evaluate whether the allocation of the transaction price to each performance obligation in a contract to transfer multiple distinct goods or services was based on the relative standalone selling prices of the distinct good or service underlying each performance obligation in the contract. Specifically, the auditors' substantive tests of details did not (1) identify performance obligations, (2) determine the total transaction price, and (3) evaluate whether allocation of the transaction price was required.
- Auditors did not perform any procedures to test or, in the alternative, identify and test any controls over, the public company-produced information that the auditor used in its substantive testing of revenue.

- Auditors did not evaluate the public company's revenue recognition disclosures, including evaluating the disclosure of the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period.

As a reminder, when using information produced by a public company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to (1) test the accuracy and completeness of the information or test the controls over the accuracy and completeness of that information and (2) evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

Technology-Based Tools

In addition, we observed that some annually inspected audit firms are using technology-based data analysis tools when auditing revenue. These tools enable auditors (1) to perform correlation analysis among revenue, accounts receivable, and cash receipts and (2) to identify items for investigation.

Audit deficiencies related to the auditor's use of such technology-based tools in an audit include the following:

- Auditors did not evaluate if the population of cash journal entries used to match trade accounts receivable to cash receipts included additional non-trade accounts receivable or cash receipts that should be treated as a separate population to be tested.
- Auditors did not sufficiently evaluate the implications of the exceptions identified when testing revenue transactions.

Accounting Estimates

Many financial statement accounts contain accounting estimates — which could in

Technology-Based Tools

We have observed technology-based tools used most frequently by auditors in the testing of revenue and related receivable accounts, inventory, journal entries, CECL, and investments.

turn involve subjective assumptions and measurement uncertainty — and may present heightened risks of material misstatement.

While we have observed improvements in auditing accounting estimates, deficiencies continue to occur, particularly in auditing CECL, as well as estimates related to accounting for business combinations, goodwill and intangible asset valuations, and long-lived asset impairments. Common deficiencies in auditing estimates included instances where:

- Auditors reviewed management's memorandum describing assumptions used in determining CECL but did not evaluate the qualitative factors or evidence supporting certain assumption changes from the prior year, or lack of changes, when evaluating the reasonableness of such assumptions.
- Auditors did not evaluate the reasonableness of significant assumptions used in a financial statement forecast to determine the fair value of certain acquired assets, because the auditors did not evaluate (1) whether there was a reasonable basis for those assumptions and whether the assumptions were consistent with relevant industry and other external factors; (2) the public company's objectives, strategies, and related business risks; and (3) existing market information.

- Auditors did not evaluate the reasonableness of the revenue growth projections used by the public company in determining the fair value of goodwill and intangible assets because the auditor did not take into account management's intent and ability to carry out these projections in light of recent declining revenue trends recognized by the public company.
- Auditors did not evaluate the reasonableness of significant assumptions used when evaluating the recoverability of certain long-lived assets because the auditors did not evaluate whether the assumptions were consistent with (1) industry, regulatory, and other external factors; (2) the public company's objectives, strategies, and related business risks; and (3) existing market information.

Inventory

Inventory can also present a heightened risk of material misstatement, due to the complexities of determining the cost of inventory. Common deficiencies identified in auditing inventory included instances where:

- Auditors did not test, or did not identify and test any controls over, the accuracy and completeness of data or reports produced by the public company and used in the auditors' substantive procedures to test the cost of inventory or in their evaluation of the reasonableness of inventory reserves recorded at year-end.
- Auditors did not perform any procedures to test the cost of certain material inventory balances recorded at year-end.

Equity and Equity-Related Transactions

In recent years, we have observed an increase in the number of audits related to SPACs.

In 2021, we reviewed over 40 audits of companies that were either considered SPACs or reported a de-SPAC transaction. Many of these companies classified warrants as equity, and subsequently the public company restated its financial statements to classify these warrants as a liability. Auditors inappropriately concurred with the public company's initial conclusion and did not identify, or appropriately address, this departure from Generally Accepted Accounting Principles.

Digital Assets

As more public companies venture into the realm of digital assets, including cryptocurrency and other crypto assets, we have selected certain audits for review where transactions in these assets were material to the financial statements. We identified deficiencies where the auditor did not perform procedures to evaluate the sufficiency and appropriateness of audit evidence obtained over the existence and valuation of crypto assets recorded at year end.

Deficiencies Related to Other PCAOB Standards or Rules

Critical Audit Matters

An auditor's communication of CAMs in the auditor's report is intended to inform investors and other financial statement users about matters that required especially challenging, subjective, or complex auditor judgment, and the auditor's response to those matters.

In 2021, we reviewed approximately 400 audits in which auditors were required to determine whether there were CAMs, and, if so, to communicate them in the auditor's report. We identified deficiencies in approximately one-third of these reviews. Deficiencies in this area are consistent with the deficiencies we identified in the prior year (during which we reviewed approximately 200 audits requiring consideration of CAMs).

Most deficiencies are instances in which auditor procedures to determine CAMs did not include every matter that should have been analyzed as a potential CAM. These instances of non-compliance do not necessarily mean that other CAMs should have been communicated in the auditor's report.

For a number of audits reviewed, we also identified instances in which auditors, when communicating a CAM in their reports, did not accurately describe (1) how the CAM was addressed in the audit or (2) the principal considerations that led the auditor to determine that the matter was a CAM.

Auditor Tenure

We also identified deficiencies in auditor reporting of the year the auditor began serving consecutively as the public company's auditor. In certain instances, the auditor did not report the year the auditor signed an engagement letter or began performing procedures, but rather the year the auditor signed its first auditor's report. In other instances, the auditor did not appropriately reflect the entire relationship between the public company and the auditor, which includes relationships involving predecessor firms and predecessors of the public company under audit.

Audit Committee Communications

Audit committees play a vital role in promoting high-quality auditing through their oversight of the audit process and the auditor. To enable audit committee members to perform this role effectively, auditors should communicate to the public company's audit committee certain matters related to the conduct of an audit. However, we continue to identify recurring deficiencies in the auditor's communication with the audit committee. Common deficiencies include instances where:

- Auditors did not communicate the names, locations, and planned responsibilities

of other accounting firms or other engagement team members, including the use of shared service organizations.

- Auditors did not communicate critical accounting policies and practices used by the public company, including the reasons certain policies and practices are considered critical.
- Auditors did not provide a copy of the management representation letters, a material written communication between management and the auditors, to the public company's audit committee.

Form AP

Registered audit firms are required to submit Form AP, *Auditor Reporting of Certain Audit Participants*, to disclose the names of engagement partners and other accounting firms that participated in their audits of public companies. For many audit firms inspected in 2021, this was the second year in which the audit firm was subject to inspection by the PCAOB since this rule became effective. Common recurring deficiencies include instances where:

- Auditors did not file, or timely file, their reports on Form AP. For certain audit firms inspected, the auditor did not timely file a new Form AP when it revised its audit opinion as a result of the public company restating its financial statements. For other audit firms, the auditor filed its Form AP only after the PCAOB notified them of non-compliance.
- An auditor's Form AP either contained inaccurate information or omitted information related to the participation in the audit by certain other accounting firms. In many of these instances, this deficiency occurred because the auditor did not include hours incurred by all engagement team members when calculating the percentage of participation.

Audit Documentation

Auditors are required to retain a complete and final set of audit documentation that includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. In certain instances, auditors provided persuasive other evidence that was not included in its final set of audit documentation to support the procedures performed and conclusions reached at the time of the audit. In other instances, auditors may not have assembled a complete and final set of audit documentation within 45 days after the audit report release date.

Fraud Considerations

As part of the auditor's responses to address the risk of management override of controls, auditors should examine journal entries and other adjustments to the financial statements for evidence of possible misstatement due to fraud. Common recurring deficiencies include instances where:

- Auditors did not perform sufficient procedures to test the completeness of the population used to select journal entries for testing.
- Auditors limited their procedures for the journal entries selected to inquiries of management and reviewing the journal entry descriptions, without examining the underlying support for such journal entries.
- Auditors did not consider the characteristics of potential fraudulent entries or other adjustments in identifying and selecting specific journal entries and other adjustments for testing.

V. OBSERVATIONS RELATED TO QUALITY CONTROL SYSTEMS

In 2021, we continued to enhance our approach to inspecting firms' QC systems. Our QC procedures are scalable and involve evaluating the audit firm's QC system based on the size, nature, structure, and complexity of the audit firm. We perform our QC procedures to gain or update our understanding of the design and operating effectiveness of an audit firm's QC system. We also gather information on changes audit firms are making to their QC systems, which may be in response to new or changing regulatory, economic environment, or audit firm-specific factors. Collectively, our QC procedures inform our understanding of how each audit firm we inspect designs and operates its QC system to obtain reasonable assurance that audit firm personnel comply with the PCAOB standards and rules and the audit firm's quality control policies.

Our assessment of an audit firm's QC system is derived from the results of our QC procedures as well as from analysis of the deficiencies identified in individual audits. We also consider other available information – for example, results of an audit firm's internal inspections, securities regulator investigations, other non-U.S. audit regulator inspections and enforcement actions – that may provide evidence as to the effectiveness of an audit firm's QC system.

In the last two years, we refined our inspection procedures for annually inspected audit firms and continued to increase our focus on the QC areas most likely to be affected by the COVID-19 pandemic and related economic uncertainty.

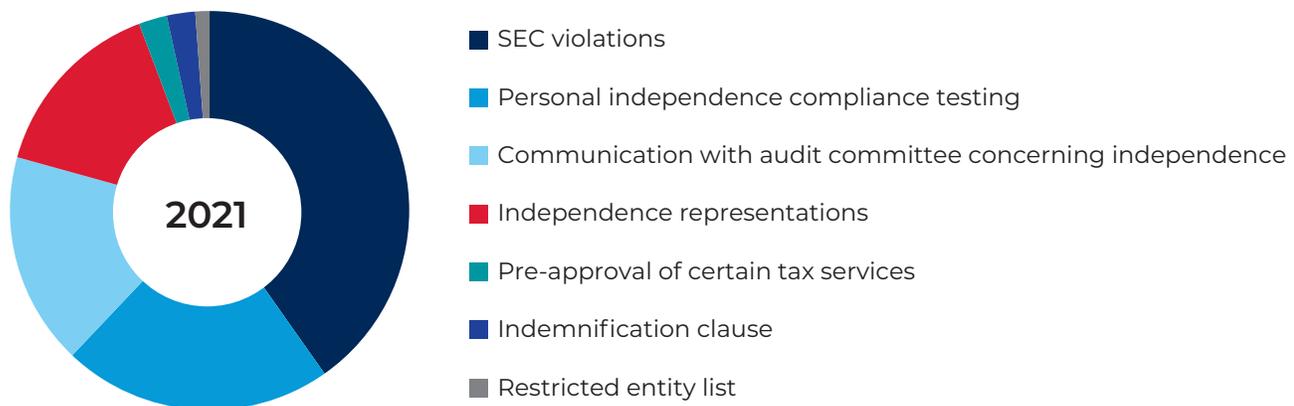
These areas included, for example, leadership communications, consultation requirements, client acceptance and continuance procedures, real-time monitoring, and pre-issuance reviews. In 2021, we continued to evaluate how audit firms' recent modifications to their QC systems have affected audit quality. This section discusses our QC findings in key areas.

Independence

Independence is a critical element to be addressed by an audit firm's QC system and remains an area for improvement.

In 2021, we continued to identify violations of the financial relationship requirements of Rule 2-01 of SEC Regulation S-X. For a number of triennially inspected audit firms, including many non-U.S. audit firms, we identified instances where audit committee approval was not obtained for certain audit-related services, non-audit services, or tax services prior to the auditor being engaged to perform such services. Additionally, we have observed that certain annually inspected audit firms and non-U.S. audit firms have instituted financial relationship reporting requirements, and some of these firms continue to report a high rate of non-compliance by audit firm personnel reporting their financial relationships into the audit firm's monitoring systems. We also observed deficiencies related to PCAOB Rule 3524, *Audit Committee Preapproval of Certain Tax Services*, and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*.

Figure 10 – 2021 Independence Comment Forms



Supervision of Audits and Engagement Quality Review

Supervision of audits, including engagement partners' reviews of audit work and the engagement quality reviewers' ("EQR reviewers") evaluations remain an area of concern.

In 2021, we continued to identify deficiencies in areas that the engagement partner should have identified and appropriately addressed. For example, we found instances where engagement partners did not address significant risks identified by the engagement team, including in some cases, fraud risks.

We also continued to identify deficiencies in areas that require the EQR reviewer's evaluation. Examples include the following:

- The audit firm's work papers did not contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand all the procedures performed by the engagement quality reviewer, including evidence that the engagement quality reviewer evaluated the engagement team's responses to the significant risks identified.
- In certain triennially inspected audit firms, the engagement team did not obtain the engagement quality reviewer's concurring approval prior to the issuance of the audit report.

Internal Monitoring

In 2021, we continued to identify deficiencies through our inspection procedures that were not identified through an audit firm's internal inspection procedures directed to the same audit area on a particular engagement.

In other instances, we observed that audit firms had established policies and procedures for monitoring the performance of annual internal inspections, but the audit firms had not performed an internal inspection during the most recent years. Such results may indicate that an audit firm's QC system related to monitoring did not provide reasonable assurance that the audit firm's internal inspection program was suitably designed and/or effectively applied.

State Practice Qualification Requirements

In our inspections of smaller audit firms in 2021, we observed a number of instances where the audit firm had performed audits of financial statements of public companies in jurisdictions where the audit firm was not registered or licensed to practice. States generally require either registration or licensure with the state as a prerequisite to performing audits in the state or audits of entities with home offices located in the state. The inspection results indicate that the firm's QC system does not provide reasonable assurance that the firm will comply with applicable regulatory requirements, including requirements to practice in a jurisdiction.

VI. GOOD PRACTICES

Based on our observations from our 2021 inspections, we highlight good practices related to ICFR, accounting estimates related to business combinations, critical audit matters, auditor independence, supervision of audits and engagement quality review. We encourage auditors to consider how these good practices may apply to their audit engagements and to implement changes to engagement procedures proactively where necessary to help ensure compliance with PCAOB standards and rules.

ICFR

Using audit firm developed templates.

One audit firm has implemented a template designed to help facilitate engagement team's testing of design and operating effectiveness of controls with a review element. The template links the identified risk with the related control activities within the control owner's review and captures the key considerations for evaluating and documenting the level of precision at which the control activities operate. The audit firm also provided guidance on how to complete the template including examples to further demonstrate the extent of testing procedures required.

Enhancing the risk assessment. One audit firm has implemented a template designed to help facilitate engagement team's risk assessment. The audit firm's risk assessment templates helped engagement teams capture the linkage between risks of material misstatements and the controls identified for testing that address the assessed risk of material misstatement.

Accounting Estimates Related to Business Combinations

For one audit firm, we noted improvement in audits of business combinations, which may have been attributable to implementation of a new subject matter expert program for business combinations. This program requires the assignment of a subject matter expert to all audits that had a material business combination during the audit period.

Critical Audit Matters

For many audits, this was the first year that CAM requirements were applicable. For others, this was the second year of implementation. For

audits in their second year of implementation, we identified fewer deficiencies, which may be attributable to good practices like the following:

- Some auditors developed tools to track every matter communicated or required to be communicated to the audit committee, which helped ensure that all potential CAMs were considered in the determination process.
- When communicating a CAM in their audit report, some auditors involved others outside the engagement team, such as specialists with subject matter expertise in the area of the CAM, who performed an independent review. For example, if the CAM was in the area of business combinations (where the engagement team used the work of a valuation specialist), the engagement team would have that specialist review the CAM language to ensure that what is being communicated in the audit report accurately reflects the audit work performed.

Independence

Good practices related to independence included the following:

- **Increasing the use of technology-based tools.** Some audit firms increasingly required engagement teams use technology-based tools to promote early detection of potential personal independence violations. For instance, audit firms have implemented tools to frequently compare time charged by its personnel to financial holdings reported by the personnel for early identification of potential violations. Audit firms have also automated the process to compare financial holdings reported by personnel to the restricted entity listings to identify potential violations prior to audit engagement assignment.

- **Expanding the monitoring and facilitation of financial holdings.** Certain audit firms have recently expanded the monitoring and facilitation of the reporting of financial holdings for all personnel by enabling the ability to import the information from certain broker-dealers directly into internal tracking mechanisms. Certain audit firms have only required this for managers and partners. To expand the use, audit firms have regularly added new broker-dealers into the program. One audit firm also requires personnel to roll over defined contribution employee benefit plans from previous employers and close family members (e.g., spouse and dependents) to a current employer with a participating broker-dealer to facilitate reporting.
- **Enhancing the frequency of personnel independence representation.** Certain audit firms have increased the frequency for personnel to provide independence compliance representations to a quarterly or semi-annual basis. To enhance the process, certain audit firms have tailored the representations based on personnel's financial interests and/or services provided.
- **Improving processes.** An audit firm also employed an improved process that guides professionals through their financial holdings including their close family members to ensure all factors are evaluated.
- **Establishing disciplinary actions.** Audit firms have put in place policies and procedures providing sanctions for personal independence violations. The process includes audit firms assessing the severity, frequency, and nature of personal independence violations and determining disciplinary actions commensurate with the violations and can include monetary sanctions.

Supervision of Audits and Engagement Quality Review

Good practices related to supervision of audits and engagement quality review include the following:

- **Tracking the progress of supervision and review procedures through milestone and other programs.** Certain audit firms have established milestone programs that capture relevant steps of the audit (e.g., planning review, interim procedures review, engagement quality review) that are monitored for compliance. Non-compliance with a milestone deadline without an approved extension is flagged for the performance management process and considered as a negative metric in quality. An audit firm also used its in-flight monitoring program to track whether partners and engagement quality reviewers were focusing on key working papers or audit procedures that addressed significant risks including fraud risk.
- **Establishing a baseline participation for partners and managers.** Certain audit firms have established guideline percentages for the combined hours of partners, directors, and managers in relation to the total audit hours. If the percentage is less than the guidelines, the audit firm's quality group will meet with the partner to determine if it is reasonable to fall below the guidelines.
- **Enhancing practice aids, tools, and templates to facilitate review and documentation.** Certain audit firms have provided well-designed templates and tools for partners and EQR reviewers to facilitate the performance of review and documentation (e.g., EQR forms that map to audit requirements). Audit firms have also enhanced their practice aids and guidance that incorporate supervision

and review considerations for virtual or hybrid work environment (e.g., frequency of touchpoints).

- **Trainings focused on improvement opportunities for EQR reviewers.** Certain audit firms' annual EQR trainings are focused on the most important findings from recent internal and external inspections that could be improved through additional attention from EQR reviewers. The trainings emphasize the need for the EQR to focus on the procedures that address identified significant risks, including fraud risk, potential barriers faced by EQR reviewers, and leading practices in performing EQRs, as well as available firm tools (such as guidance and practice aids) for EQR reviewers.

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