PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

# SPOTLIGHT

## Staff Update on 2023 Inspection Activities

August 2024

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# OVERVIEW

One of the many ways the PCAOB fulfills its investor-protection mission is through its inspection program. PCAOB inspections seek to assess an audit firm's compliance with applicable laws, rules and standards, as mandated by the Sarbanes-Oxley Act.

In 2023, the PCAOB advanced this mission by inspecting 227 PCAOB-registered public accounting firms ("audit firms" or "firms"), reviewing portions of 793 issuer audits, and 103 audits of brokers and dealers ("broker-dealers") registered with the U.S. Securities and Exchange Commission (SEC).

This Spotlight presents the Division of Registration and Inspections' ("staff" or "we") results and activities from these inspections as of its publication date, including broker-dealer inspections (where comparable and indicated).

## Trends

A notable inspection trend in recent years is an increase in deficiencies among audit firms. In 2023, these negative trends continued in the aggregate. However, we have begun to see the aggregate deficiency rate at the Big Four[1] firms level off, as well as improvements in the deficiency rates at several of the other annually inspected firms. Additionally, as discussed below, a closer look at the results reveals that outliers are strongly influencing the aggregate deficiency rates.

While there is no single reason for the aggregate increase in deficiencies, it's clear the COVID pandemic influenced audit quality. Broadly speaking, audit firms with strong quality control (QC) systems and centralized structures and processes in place before the start of the pandemic seem to have had a better chance of weathering the crisis and more quickly righting their ships.

The "leveling off" of deficiencies at the largest firms four years since the start of the COVID pandemic indicates audit firms across the board have the ability to curtail their rising deficiency rates and continue on a path toward improvement.

Audit firms continue to tell us remote work and the lack of in-person training for new hires – and especially hires new to the profession – during the start of pandemic in 2020 negatively affected their audit quality and resulted in a surge of inspection deficiencies in 2021 and 2022. To be clear, the onus for proper training, supervision, and review lies with senior staff and audit firm leadership, not those new to the profession. It is important that work not only be assigned to appropriate personnel with relevant experience but also that those reviewing the work are qualified to do so, that they have adequate time, and that they exercise due professional care and professional skepticism when doing so.

Some firms have suggested other factors contributing to the trend may include:

- Challenges with firm technology;
- Overreliance on prior year results;
- Ineffective timing and project management; and
- Insufficient testing of significant transactions.

Firms have been addressing the deterioration in inspection results in various ways. Some firms have implemented policies to require staff to work on-site together for a portion

[1] The Big Four accounting firms are commonly known to be Deloitte & Touche LLP ("Deloitte"), Ernst & Young LLP ("EY"), KPMG LLP ("KPMG"), and PricewaterhouseCoopers LLP ("PwC").

of their work week. Other firms are increasing the training of less experienced staff, reducing the number of engagements (some of which may be higher risk), strengthening national office resources related to audit quality and implementing programs or policies to increase supervision and review. Many of these actions were implemented in 2023, but more needs to be done. Firms are encouraged to consider common deficiencies and general topics, good practices, and reminders, many of which can be found in our Spotlights that highlight important considerations and examples for auditors (see "How We're Helping" and Section V below).

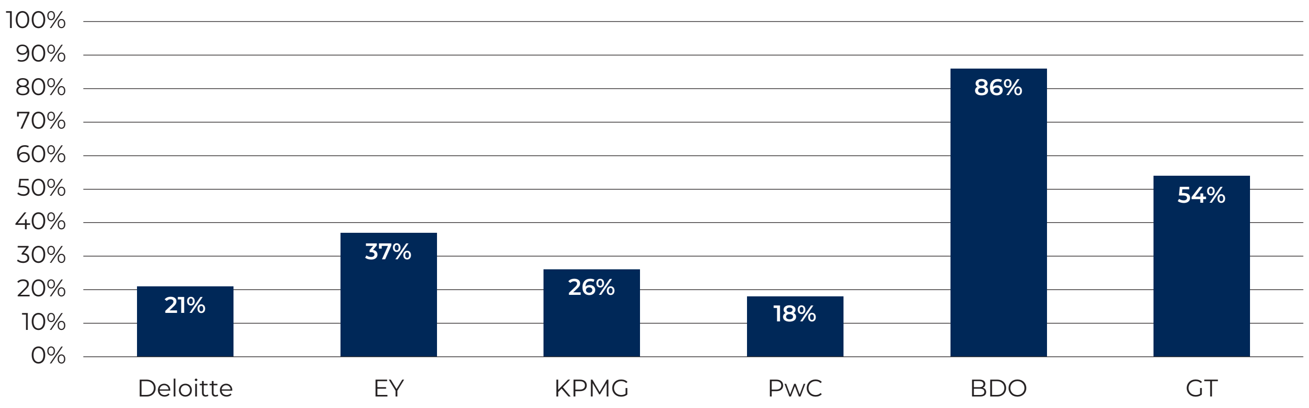
## Key Findings

In our 2023 issuer audit inspections, aggregate deficiency rates have continued to increase across all inspection programs, and 46% of the engagements reviewed in 2023 had at least one Part I.A deficiency, excluding broker-dealer audit inspections.[2] However, a closer look at what is driving that rate reveals the following:

**Signs of "Leveling Off" at the Largest Firms** – When we look at the U.S. Big Four firms (this excludes their non-U.S. affiliates), which as of December 31, 2023 collectively audit approximately 80% of the market capitalization, aggregate Part I.A deficiencies held steady at 26% in 2023 after previously jumping from 12% in 2020 to 16% in 2021 and 26% in 2022. Similarly, the percentage of audits reviewed with multiple Part I.A deficiencies was nearly stagnant, at 21% in 2022 and 20% in 2023, after previously jumping from 9% in 2020 to 13% in 2021 to 21% in 2022. Aggregate Part II criticisms at the U.S. Big Four firms also fell for the first time in three years.

**Outliers Heavily Influence Averages** – A closer look at the six[3] U.S. Global Network Firms (GNF), where the aggregate Part I.A deficiency rate is 34%, reveals that outliers are substantially affecting the aggregate deficiency rate. For example, Figure 1a reveals two firms are strongly contributing to the increase in deficiencies.

### Figure 1a – 2023 Inspection Part I.A Deficiency Rates

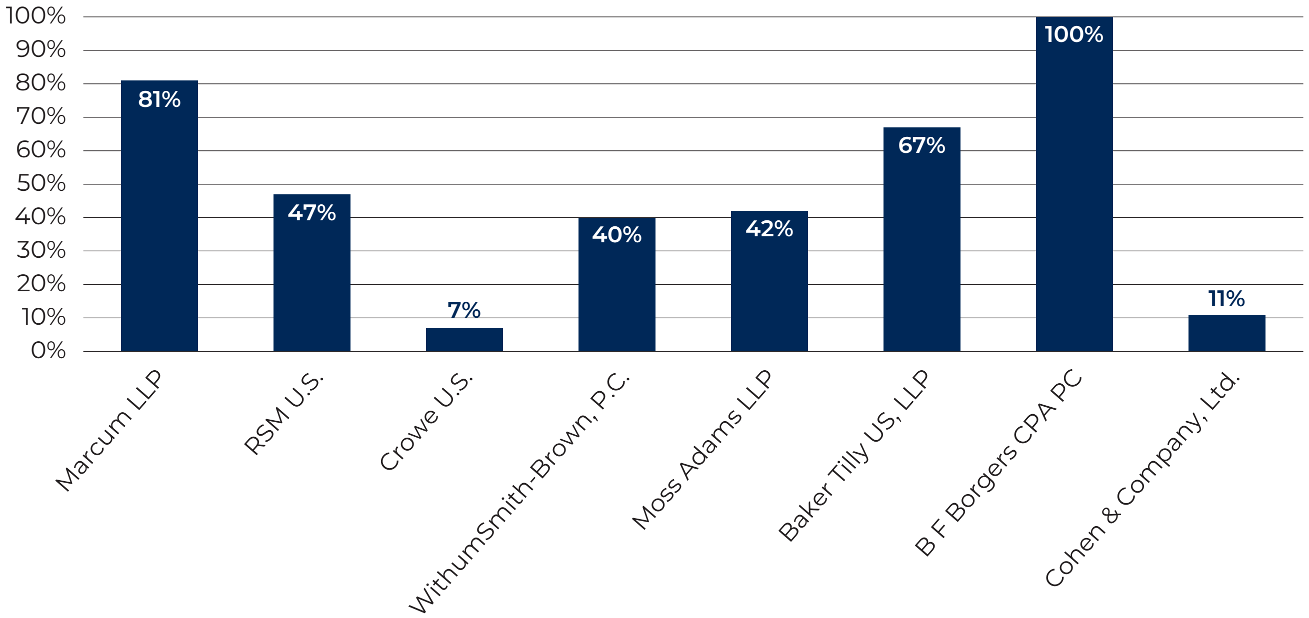



[2] The 46% represents engagements that have or are expected to have one or more comment forms that will be included in Part I.A of the inspection report.

[3] The Big Four, BDO USA, P.C. ("BDO"), and Grant Thornton LLP ("GT").

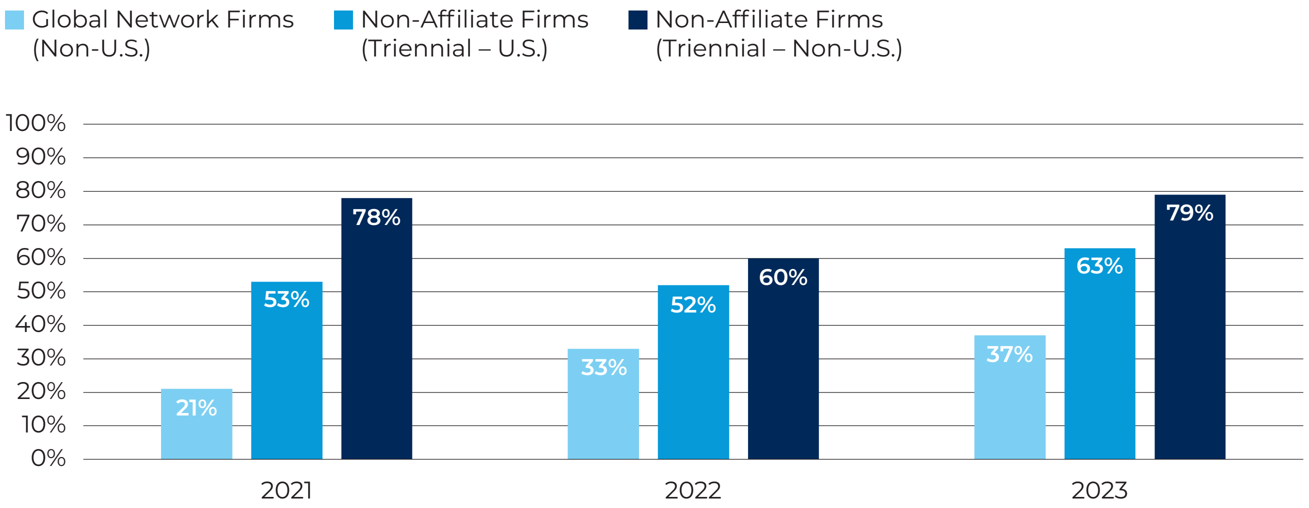
Similarly, we see outliers driving up the deficiency rate among U.S. Non-Affiliate Firms (NAF) inspected annually, where the aggregate Part I.A. deficiency rate was 51% in 2023. However, this aggregate rate does not necessarily reflect audit quality at individual firms, some of which have deficiency rates in 2023 near 10%, while others are as high as 80%-100% as shown in Figure 1b.

### Figure 1b – 2023 Inspection Part I.A Deficiency Rates




**Audit Quality at Triennially Inspected Firms Is Not Improving Quickly Enough** – Over half of the NAF triennially inspected firms in 2023 that were previously inspected had no notable changes to Part I.A deficiency rates when compared to the firm's prior inspection. We also observed an increase in the expected Part I.A deficiency rate at 26 of the 82 NAF triennial firms that were previously inspected. We observed decreases in the expected Part I.A deficiency rates for five of the 82 NAF triennially inspected firms in 2023 that were previously inspected. While there are various distinct possible reasons for the Part I.A findings, including mergers between firms, increases in the number of issuer audits conducted by the firms, and an inspection focus on regional banks, the increase in Part I.A deficiencies requires immediate attention by the applicable firm.

## Figure 1c – Triennial Firms – Part I.A Deficiency Rates




**First-Time Firm Inspections Typically Have Higher Deficiency Rates** – An increase in the percentage of firms inspected for the first-time is one factor driving the overall increase in the percentage of engagements expected to be in Part I.A. In 2023 and 2022, we inspected 28 and 19 firms, respectively, that we had previously never inspected. Our experience is that first-time inspections historically have a higher percentage of Part I.A findings. For example, approximately 96% and 76% of engagements reviewed at NAF triennial firms inspected for the first time in 2023 and 2022, respectively, resulted in a Part I.A finding.

**Different Engagement Selection Criteria Produce Similar Results** – The percentage of randomly selected engagements expected to be in Part I.A is 39% in 2023, an increase from 26% in 2022 and 19% in 2021. The high and increasing rate of Part I.A findings, even among randomly selected engagements, demonstrates that the risk-based selection of engagements for review is not the sole factor driving these rates. We highlight this metric because most of our selections are risk-based and are not a representative sample of a firm's audit engagements.

**Signs of Potential Improvements in Quality Control Findings** – At least with regard to some of the Big Four firms, the Part I.A audit deficiencies for 2023 appear to represent more isolated incidents than in the past, where we often saw the same or related types of deficiencies on multiple audits. The more isolated nature of the incidents in 2023 means the deficiencies are less likely to indicate QC system concerns. The staff is hopeful that this decrease in the concentration of deficiencies, together with an overall decline in the combined number of QC system criticisms among the Big Four firms, signals improvement in those firms' QC systems, which in turn could lead to declines in their audit deficiencies going forward. These results are promising. However, it will be up to the firms to ensure any improvements in QC systems, in turn, drive higher-quality audit engagements and fewer Part I.A findings.

More broadly, further strengthening of firms' QC systems – and a new quality control regulatory standard,[4] if approved by the SEC – may help to reverse the trend toward increasing rates of audit deficiencies.

[4] Please see PCAOB Release No. 2024-005.

**Market Volatility and Iterative Risk Assessment** – Macroeconomic events can affect the nature of deficiencies we identify, particularly related to auditing estimates. For example, inflation and interest rates considered during the audit firm's risk assessment process can change over the course of the audit. These changes may merit further consideration as part of the audit firm's iterative risk assessment and adjustments to the audit response. Risk assessment is an iterative process that begins during planning and continues until the audit report is issued. When we see vulnerabilities in certain markets, we pivot our inspection plan to include more audits potentially affected by the market change. Typically, we identify more deficiencies in audits of industries that have been affected by market changes because firms do not always adjust their risk assessments and audit responses accordingly. For example, in 2023, we pivoted to focus on banking audits, given the banking crisis, and as seen in Figure 12, we saw an increase in deficiencies related to the allowance for credit losses, deposit liabilities, and investment securities. We also highlight important considerations and examples for audit firms to consider as they plan audits, such as the Spotlight published in May 2024, "Auditing Considerations Related to Commercial Real Estate."

**Recurring and Pervasive Deficiencies Continue** – Many of the financial statement audit observations discussed in this Spotlight relate to areas in which we see recurring deficiencies, in the aggregate. These include insufficient testing of estimates and/or data and reports used to support audit conclusions. Many other observations relate to auditors' testing of controls that include a review element, specifically auditors' insufficient testing of whether such controls operated at a level of precision sufficient to prevent or detect material misstatements, a continuing challenge for many firms. In April 2024 we published a Spotlight, "Inspection Observations Related to Auditor Use of Data and Reports," and we believe many firms could benefit from applying the good practices we discussed. We strongly encourage audit firms to focus on assessing the underlying root causes of a deficiency so that the deficiency can be effectively addressed and ultimately eliminated. In April 2024 we also published a Spotlight, "Root Cause Analysis – An Effective Practice To Drive Audit Quality."

**Noncompliance With Other Rules and Standards Increased** – Beyond what is discussed above, we remain concerned about compliance with all PCAOB standards and rules that are included in Part I.B and Part I.C of our inspection reports, discussed further below in this Spotlight. Fraud, audit transparency (audit committee communications and Form AP), and independence are important aspects of our standards and rules to help and protect investors.

**Overall, Firms Need To Do Better** – We continue to be concerned about audit quality as reflected in the overall deficiency rates. We have provided – in this Spotlight and in other publications – resources and examples for firms to consider, especially smaller firms, to reverse this trend. Continued declines in audit quality shake public confidence in the capital markets and call into question the protection that investors deserve.

## How We're Helping

Inspections are the primary way that the staff drives improvements in audit quality, but they are not the only way. We are working to reverse the decline in audit quality by:

- Launching an initiative to understand what role firm culture plays in the performance of quality audits;
- Increasing transparency in reporting on our inspection results and publishing inspection reports timelier;

- Regularly engaging with firms and participating in broker-dealer and small business forums;
- Encouraging feedback, especially from small firms, to give us their unique perspectives regarding a proposed or amended standard or rule;
- Encouraging open and frequent, two-way communication between the audit firms and the PCAOB during the remediation process;
- Engaging directly and regularly with U.S. audit committees, which is a priority because we share the goal of driving audit quality by exercising appropriate oversight of external auditors; and
- Writing and publishing Spotlights like this one that offer actionable recommendations and reminders for auditors that draw directly from our inspection teams. As discussed in Section V below and in other Spotlights, we also observed practices that we believe may be effective in enhancing a firm's QC 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 and to help ensure compliance with PCAOB standards.

## Questions for Audit Committees To Consider

These suggested questions may be of interest to audit committee members to consider in discussions with their independent auditors.

- What are the pros and cons of audit tenure?
- How does the firm ensure non-U.S. affiliate personnel, staff from other areas of the firm, and/or other auditors used on the engagement maintain their independence?
- How does the firm ensure affiliates outside the U.S. follow PCAOB standards and rules, when required, on referred work related to the group audit?
- What were the results of your most recent remediation efforts with the PCAOB?
- Does the firm have any new initiatives related to improving audit quality?

Please also read our December 2023 Spotlight, "**Staff Priorities for 2024 Inspections and Interactions With Audit Committees**."

# Terms Used in This Spotlight

## PCAOB Inspection Report Terms

- **Part I.A** of our PCAOB inspection reports discusses deficiencies, if any, that were of such significance that we believe the firm, at the time it issued its audit report(s), had not obtained sufficient appropriate audit evidence to support its opinion(s) on the public company's financial statements and/or internal control over financial reporting (ICFR).
- **Part I.B** discusses certain deficiencies, if any, that relate to instances of non-compliance with PCAOB standards or rules other than those where the firm had not obtained sufficient appropriate audit evidence to support its opinion(s). This section does not discuss instances of potential non-compliance with SEC rules or instances of non-compliance with PCAOB rules related to maintaining independence.
- **Part I.C** discusses instances of potential non-compliance with SEC rules or instances of non-compliance with PCAOB rules, if any, related to maintaining independence.

## Other Terms

- **Audit Firm Categories** are defined in Section I below along with a description of how we select firms for inspection.
- **Brokers and Dealers** means a broker (as defined in Section 3(a)(4) of the Exchange Act) and a dealer (as defined in Section 3(a)(5) of the Exchange Act) that are registered with the SEC as both a broker and a dealer and to entities that are registered as only one or the other.
- **Comment Form** is a written communication with the audit firm when, after discussion with the audit firm, the inspection team still believes that a potential deficiency exists with the audit work. Comment forms are evaluated for inclusion in the firm's inspection report.
- **Engagement** refers to the firm's audit being reviewed.
- **Focus Area** refers to the audit area(s) and/or procedure(s) of an engagement selected for review over which our inspection team will review the audit work papers and interview engagement personnel.
- **Issuer** means an issuer (as defined in Section 3 of the Exchange Act), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn. Please see Rule 1001, ***Definitions of Terms Employed in Rules***. In this Spotlight, the term "public company" is used to refer to an issuer.
- **Workpapers** are the firm's documentation, typically in electronic form, documenting their audit procedures and conclusions for a particular engagement.

# I. 2023 INSPECTIONS APPROACH

The PCAOB continued a rigorous program of inspections in 2023, primarily related to audits of public companies completed in 2023 for financial statements with a fiscal 2022 year end. Our procedures anticipated financial reporting and audit risks driven by economic conditions, particularly those related to complex accounting or judgment required from the auditor and included an element of selection unpredictability.

Each year, the PCAOB develops an inspection plan informed, among other things, by our inspection experience, current events that have an impact on audits, and areas of concern.

## Inspection Program Enhancements We Implemented

The Board's strategic plan includes a goal to enhance its inspections. During 2023:

1. We expanded the number of audits we reviewed for certain annual firms by approximately 6%.
2. We responded to events in the banking sector by selecting 10 additional banks deemed to have higher risk and reviewed the interim review procedures performed by the applicable firm in support of the public company's Form 10-Q filing. We will be publishing a Spotlight specific to bank audits this year that will discuss our findings and good practices in more detail.
3. We began a set of general inspection procedures to facilitate the consistent performance and documentation of review procedures related to various topics for most of the public company and broker-dealer audits we review.

These enhancements to our approach allowed us to (1) address the audit risks emanating from the uncertainties and volatility in the economic and geopolitical environment, (2) further assess the effects of the continued remote/hybrid work environment on compliance with our auditing standards, and (3) maintain a level of unpredictability.

## How We Selected Firms for Inspection

A firm may audit public companies and may also audit broker-dealers. There are also firms that only audit broker-dealers. Generally, audit firms that audit issuers are selected for an inspection based on the number of issuer audit reports they release each year. Audit firms are either inspected annually or at least on a triennial basis according to the number of issuer audit reports they issue each year. Audit firms are categorized as either GNF or NAF.

Firms that audit broker-dealers are selected for inspection based on potential risks associated with the protection of customer funds and securities, among other things, and, as such, the number and mix of broker-dealer audit firms has varied over time. Firms that audit both issuers and broker-dealers may be selected for inspection under either or both programs.

We currently categorize audit firms in our inspection programs as follows:

- **U.S. GNF** – These firms are headquartered in the U.S. and are members of global networks through which they affiliate with firms in other countries for various business and client service purposes. Registered public accounting firms provide information about those affiliations in their annual reports on PCAOB Form 2. These U.S. firms all issue more than 100 issuer audit reports each year and are therefore inspected annually.
- **Non-U.S. GNF** – These firms are headquartered outside of the U.S. and are

members of global networks. Currently, all of these firms are inspected on a triennial basis because they issue 100 or fewer issuer audit reports per year.

- **NAF Annual** – These firms are non-affiliated firms that are not part of a network but are inspected annually because they issue more than 100 issuer audit reports per year. Currently, all NAF Annual firms are headquartered in the U.S.
- **U.S. NAF Triennial** – These firms are non-affiliated firms that are not part of a network, are headquartered in the U.S., and are inspected on a triennial basis because they issue 100 or fewer issuer audit reports per year.
- **Non-U.S. NAF** – These firms are non-affiliated firms that are not part of a network, are headquartered outside of the U.S., and are inspected on a triennial basis because they issue 100 or fewer issuer audit reports per year.
- **Broker-Dealer Firms** – These firms, which can also be part of an issuer inspection program as described above, perform audits of broker-dealers and are included in this Spotlight where inspection results are comparable.

## How We Selected Engagements for Inspection

During 2023, our inspection procedures (as more fully discussed in our Spotlight publication, "Staff Priorities for 2023 Inspections") considered overall business risks present for audits of public companies with a fiscal 2022 year end. A few of these business risks included:

- Volatility in financial and commodity markets due to factors such as inflation, interest rates, and currency fluctuations.
- Disruptions in supply chains.
- The trend of deal cancellations and redemptions related to special purpose acquisition companies (SPACs).
- Mergers and acquisitions (M&A) activities, including de-SPAC transactions.
- The ongoing impact of the remote/hybrid work environment.

Various strategies were used to select individual audit engagements of public companies and broker-dealers for review. Some were selected based on risk and some were selected based on other strategies, including random selection, that enhance unpredictability. Our approach emphasized engagements of:

- Public companies in industries and sectors potentially impacted by uncertainties and volatility in the economic and geopolitical environment.
- Fortune 100 companies.
- Public companies with sizable or volatile market capitalization.
- Public companies or broker-dealers with material or significant digital asset activities.
- Public companies engaging in M&A activities, including de-SPAC transactions.
- Broker-dealers that file compliance reports (many of whom typically hold customer funds and maintain control over the custody of customer securities).

## PCAOB Inspection Procedures

For a full description of what the PCAOB inspects and how those inspections are conducted, please visit our website for information on **PCAOB Issuer Inspection Procedures** and **Broker-Dealer Inspections**.

## Target Team Focus in 2023

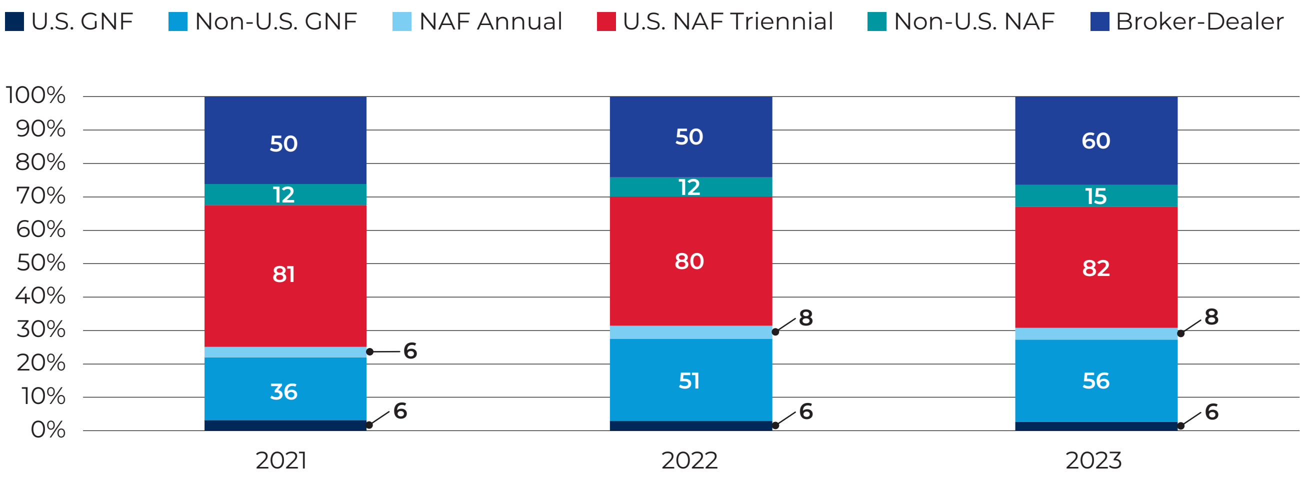
In 2023, the PCAOB's target team, a group of inspectors who focus on emerging audit risks and issues, reviewed procedures on selected audits of identified public companies with material crypto assets, multi-location audits, interim reviews in support of Form 10-Q filings of 10 banks, and public companies that had a significant unusual transaction or event. Observations of those inspections will be published in a future Spotlight.

In December 2023 we published our Spotlight, "**Observations From the Target Team's 2022 Inspections**." This Spotlight highlights the target team's 2022 inspections.

# Inspection Profile Information

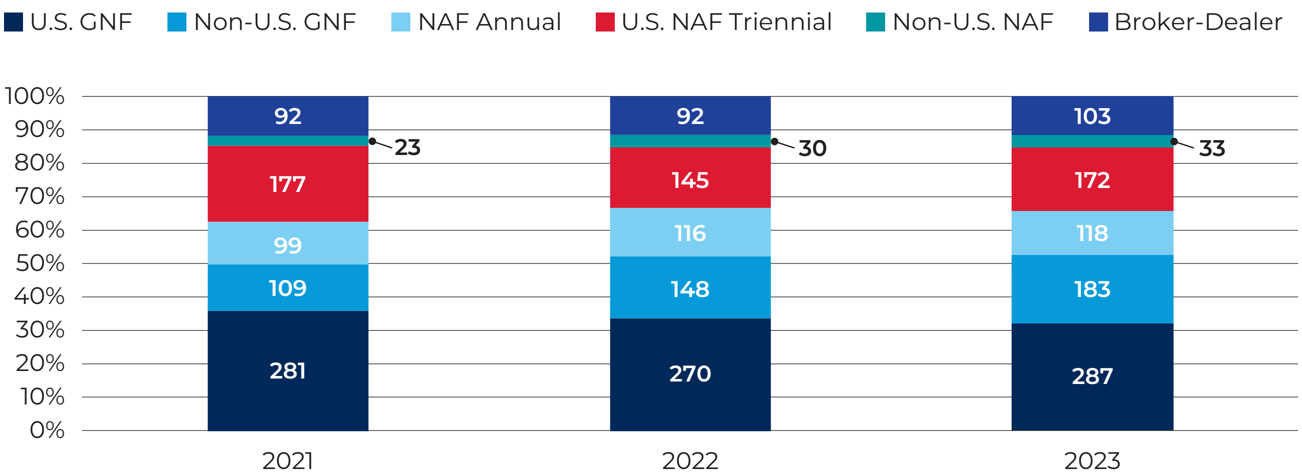
Figures 2 and 3 present profile information related to our inspection programs by audit firm category over the most recent three-year period to inform the reader of our inspection activities. In Figure 2, the number of NAF Annual firms inspected can change year-to-year based on the number of issuer audit reports released by the firms. The figures show how our work was distributed across types of firms, engagements, and industries. Figure 4 does not include audits of broker-dealers inspected as part of the broker-dealer inspection program. Figures 5 and 6 present information about the engagements we selected.

### Figure 2 – Number of Firms Inspected in Our Programs by Audit Firm Category, 2021 to 2023




Some of the firms inspected by the broker-dealer program are also included in the counts for U.S. firms shown in Figure 2 if they performed both broker-dealer audits and issuer audits.

**Figure 3 – Engagements Reviewed in Our Programs by Audit Firm Category, 2021 to 2023**

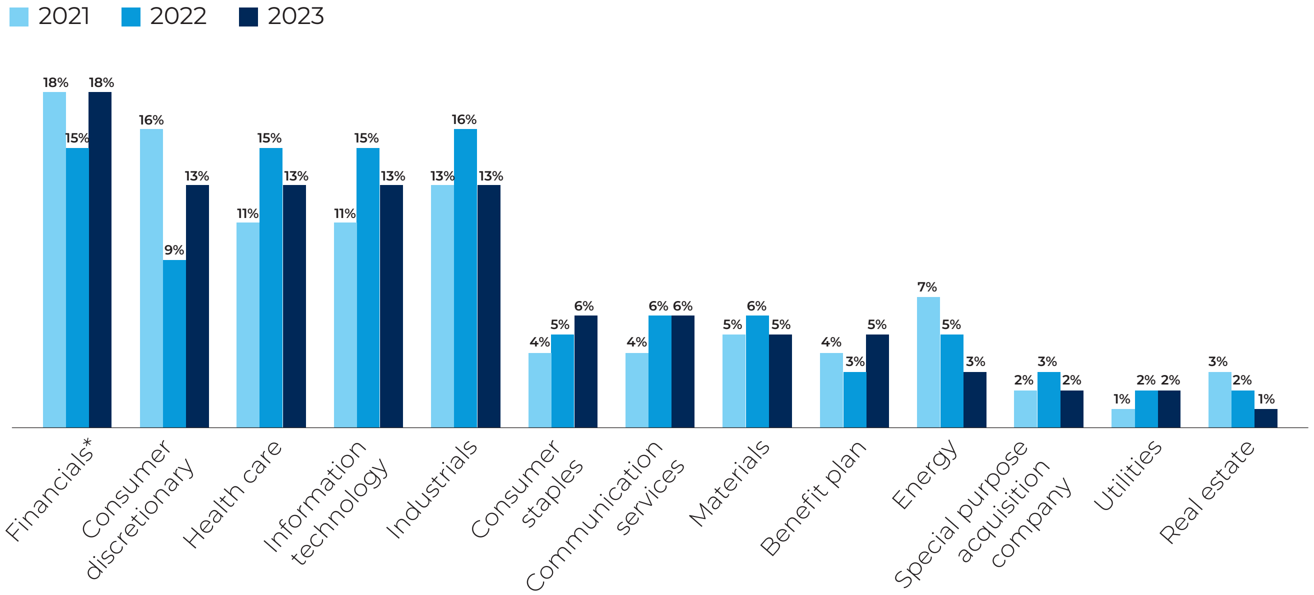



## International Financial Reporting Standards

Most inspections are performed on audits of public companies that follow U.S. Generally Accepted Accounting Principles (U.S. GAAP), but there are many non-U.S. inspections, where the public company is domiciled outside the U.S and follows International Financial Reporting Standards (IFRS). We assign staff to these inspections that have additional IFRS training, and many of the assigned staff have certifications in IFRS. For inspection cycles 2023, 2022, and 2021, excluding broker-dealers, 14%, 12%, and 9%, respectively, of inspections were performed on audits where the basis of accounting was IFRS.

In Figure 4, we followed the Global Industry Classification Standards (GICS), as reported by S&P Global Ratings, to categorize our inspection reporting by industry. All years have been conformed to GICS.

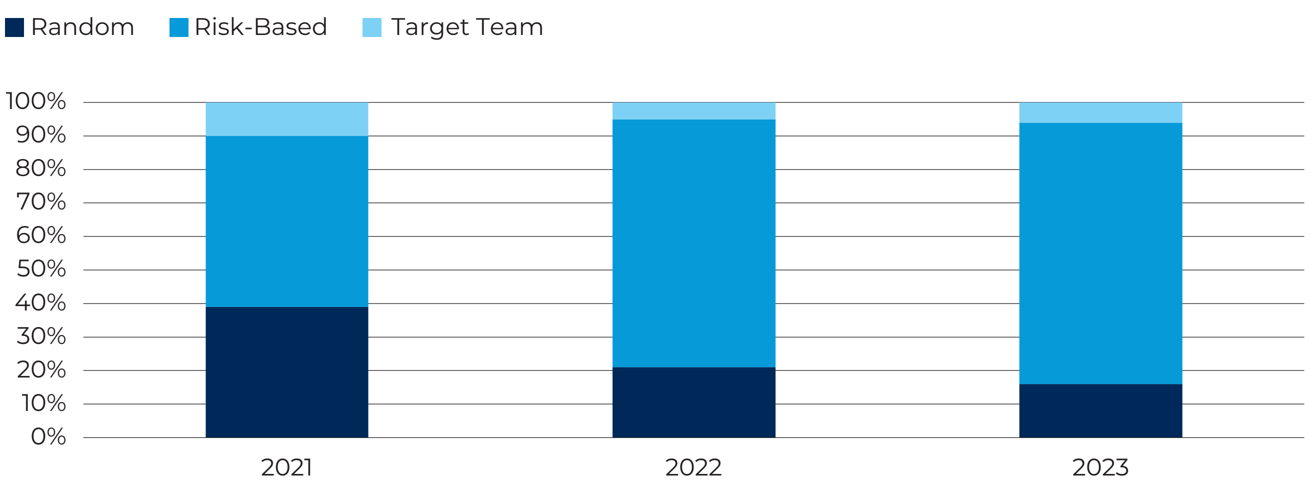
## Figure 4 – Audit Engagements Inspected by Industry Sector




* The Financials GICS sector includes industry classifications for companies engaged in Banking, Financial Services, Consumer Finance, Capital Markets and Insurance activities. It also includes Financial Exchanges & Data and Mortgage Real Estate Investment Trusts. Within this GICS category, we consider public companies that account for loan losses and take deposits from customers to be a bank for purposes of our inspection reporting. Certain public companies also account for loan losses because they finance purchases, however, we do not count these as banks.

Annually inspected firms have a larger pool of engagements subject to our inspection, and we use a risk-based and random-based selection process to select which engagements we will review. We tailor the selection of engagements for review based on the size, nature, structure, and complexity of the audit, and we consider several factors when evaluating all the engagements we may select for review. Those factors can include economic trends, industry, market capitalization, and prior inspection history.

## Figure 5 – Selection Method for Audit Engagements (Annual Firms Only)



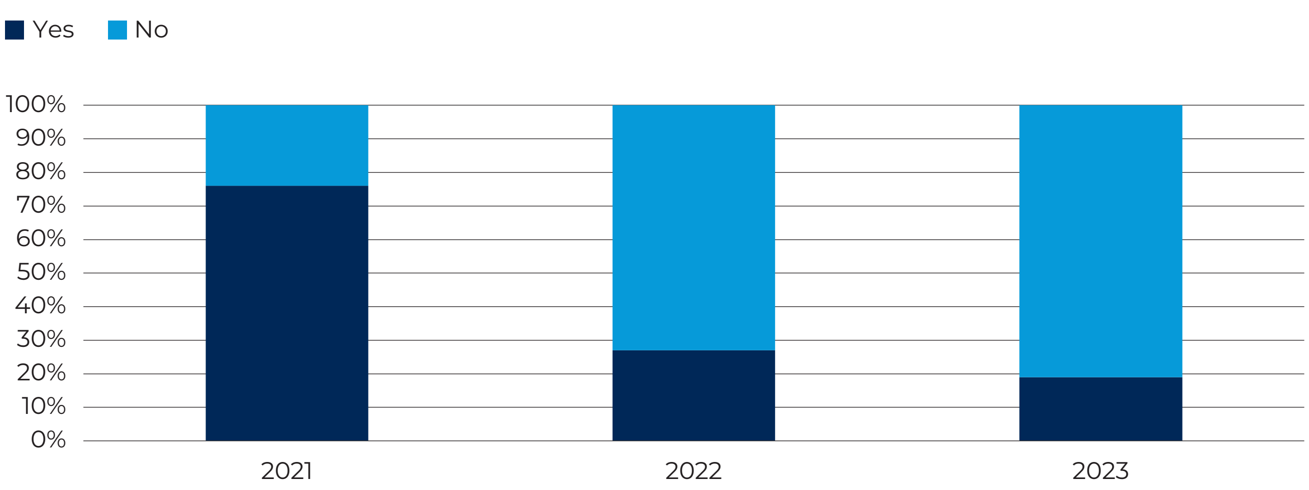
## Randomly Selected Engagements

In 2023, 60% of the randomly selected public company audit engagements resulted in at least one deficiency, and we expect approximately 39% of those randomly selected engagements will be included in Part I.A. In comparison, 62% of our risk-based selections resulted in at least one deficiency, and we expect approximately 47% of those risk-based selections will be included in Part I.A.

A PCAOB inspection is not designed to review all aspects of a firm's quality control system, to review all of the firm's audits, or to identify every potential deficiency in the reviewed audits. We generally focus our attention on audit areas we believe to be of greater complexity, areas of greater significance or with a heightened risk of material misstatement to the issuer's financial statements, and areas of recurring deficiencies. Audit work related to specific financial statement accounts is an important aspect of our review. The top 10 financial statement accounts included in our inspections are (1) revenue and related accounts, (2) accounts affected by business combinations, (3) inventory, (4) cash and cash equivalents, (5) investment securities, (6) long-lived assets, (7) goodwill and intangible assets, (8) accruals and other liabilities, (9) equity and equity-related transactions, and (10) debt.

We can also select non-traditional focus areas. A non-traditional focus area generally varies by audit firm, has not been frequently reviewed in the past, is an area of the audit where a firm has not had a recent quality control criticism, and/or is subject to a risk of material misstatement. We vary our selection of non-traditional focus areas on a number of engagements each year to observe how areas of an audit that may be less complex, and more routine, are performed. During 2023, 2022, and 2021, 19%, 15%, and 9%, respectively, of our non-traditional focus areas inspected on public company audits resulted in a deficiency. These deficiencies are all expected to be included in Part I.A of the applicable inspection report.

### Figure 6 – Engagement Selections With Non-Traditional Focus Areas (Annual Firms Only)



For the engagements we reviewed in 2023, 2022, and 2021, the mix between integrated audits that require an ICFR report and non-integrated audits which do not require an ICFR report was 59% and 41%, 55% and 45%, and 53% and 47%, respectively. Audits of public companies subject to ICFR audit procedures are primarily in the U.S. and non-U.S. GNF inspection programs.

Only accelerated filers that are not emerging growth companies and large accelerated filers (as defined by the SEC) must provide an auditor's report on ICFR. Most integrated audits are covered by the GNF program. Currently, there are no broker-dealers that are themselves issuers, although some broker-dealers are subsidiaries of issuers. Nevertheless, certain internal controls at broker-dealers may be subject to auditor testing and our inspection when the auditors include these controls in planning the nature, timing, and extent of substantive testing and internal control over compliance.

In 2023, we reviewed a variety of focus areas not directly related to financial statement accounts or disclosures. The top 10 were (1) compliance with the auditor's reporting model, (2) evaluation of software audit tools used on the audit, (3) Form AP compliance, (4) fraud considerations considered by the auditor and related audit response, (5) how the engagement team evaluated overall audit findings, (6) communications with the audit committee, (7) how a cybersecurity event impacted the auditor's risk assessment and related audit response, (8) independence, (9) use of other auditors, and (10) related party transactions.

## Key Inspection Considerations

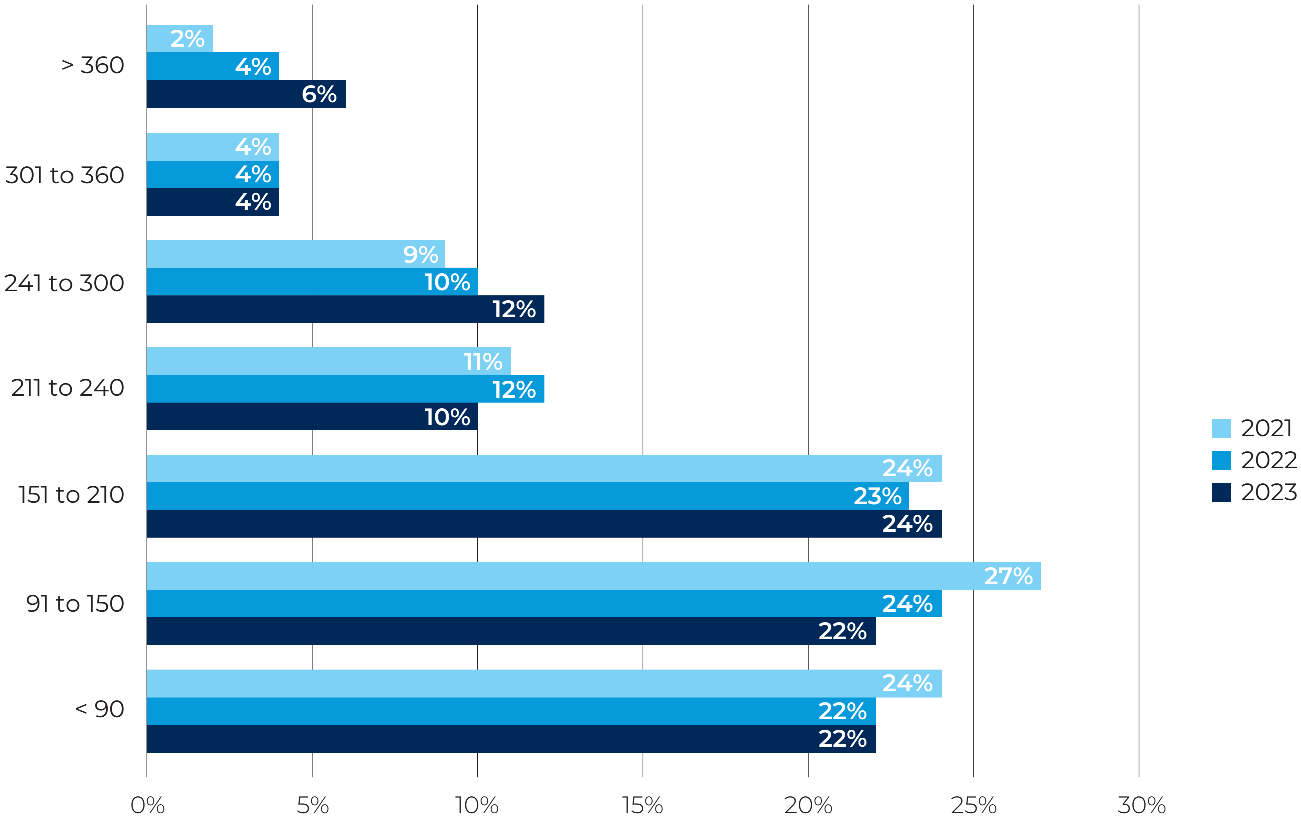
The 2023 inspection plan mainly covered the review of 2022 fiscal year-end audits with audit reports signed in early 2023 and considered the business risks important for auditors to consider when planning and performing audit procedures. As discussed more fully in our Spotlight, "Staff Priorities for 2023 Inspections," these planned inspection focuses included:

1. Risk of fraud
2. Auditing and accounting risks
3. Risk assessment and internal controls
4. Financial services specific considerations
5. Broker-dealer specific considerations
6. Digital assets
7. M&A, including de-SPAC transactions
8. Use of the work of other auditors
9. Quality control
10. Critical audit matters
11. Cybersecurity
12. Use of data and technology

The staff selects the audits and the audit areas, including non-financial areas such as independence, that it will review. The inspected firm has no opportunity to limit or influence our selections. We generally select the audits most recently completed by the firm but may also select audits completed in prior years if, for example, there are no recently completed audits or to be unpredictable.

Figure 7 illustrates the time between the date of the auditor's report and our first day of fieldwork, for engagements selected for review:

**Figure 7 – Inspections Relative to Audit Report Date (Days Between Report Date and Fieldwork)**




A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (documentation completion date). Not all firms use the full 45-day period and therefore, in those cases, our inspections can start as soon as the firm informs us the final set of audit documentation has been assembled for retention. Most inspections are performed within seven months of the report release date. Inspections performed after 301 days are mostly related to non-U.S. firms with only one public company audit or our decision to select a prior period audit to be unpredictable.

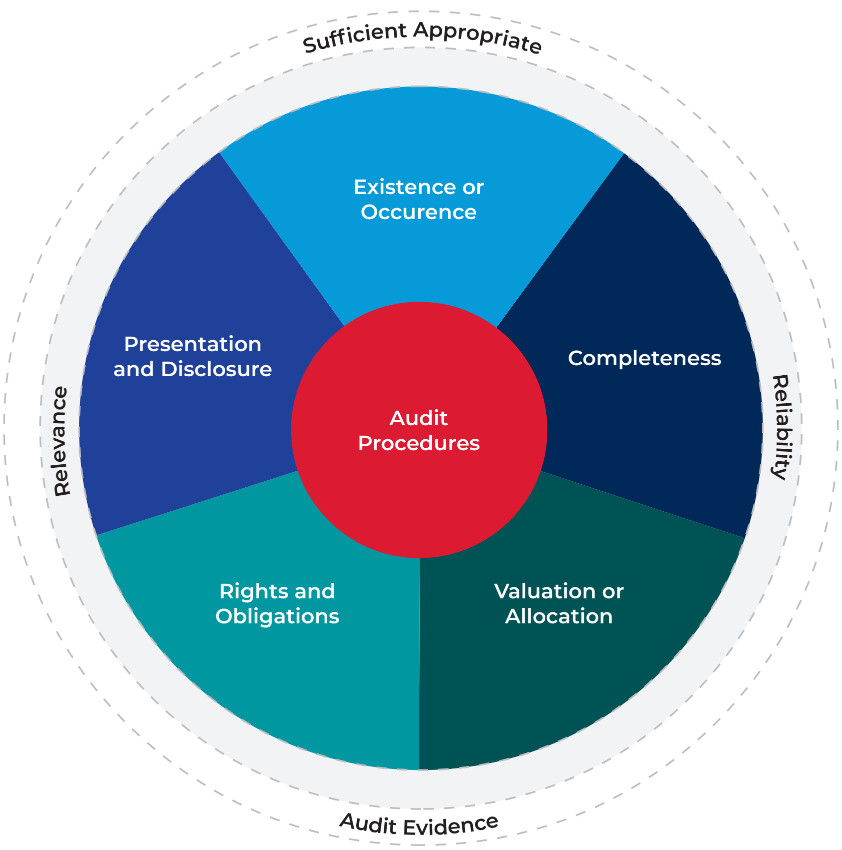
# II. COMMON DEFICIENCIES FOUND BY 2023 INSPECTIONS

Our observations, presented as examples, on audit deficiencies in this section can include terms unfamiliar to individuals not in the audit profession. We are committed to providing material to educate our stakeholders on our regulatory activities and believe the following may be helpful to better understand our inspection observations.

In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, and presentation and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- *Existence or occurrence* – Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.
- *Completeness* – All transactions and accounts that should be presented in the financial statements are included.
- *Valuation or allocation* – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.
- *Rights and obligations* – The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.
- *Presentation and disclosure* – The components of the financial statements are properly classified, described, and disclosed.

**Figure 8 – Financial Statement Assertions and Procedures for Obtaining Audit Evidence**



## Deficiency Examples in Auditing ICFR

An integrated audit of financial statements and ICFR reporting benefits investors because the auditor's reports address both the audited financial statements and the effectiveness of the controls the public company uses to produce its financial statements. Appropriate application of the top-down, risk-based approach pursuant to PCAOB standards can result in an effective ICFR audit without redundancy. The following are aspects of an ICFR audit along with related deficiency observations from our staff.

### Risk Assessment and the Audit of Internal Control

Data gathering procedures in this area can benefit both the financial statement audit and the ICFR audit. While obtaining an understanding of the information system, the auditor can also perform procedures to understand the flow of transactions for relevant assertions. Similarly, while obtaining an understanding of the public company's risk assessment process and control activities, the audit firm can also identify the controls that management has implemented to address potential misstatements. The following table illustrates how certain of the procedures required by Auditing Standard (AS) 2110, *Identifying and Assessing Risks of Material Misstatement*, can be coordinated with the procedures applied to meet certain of the AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, objectives and is included as a reminder.

| Audit Planning and Risk Assessment | Auditing ICFR |
|---|---|
| Obtain an understanding of the information system, including the related business processes, relevant to financial reporting. | Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded. |
| Identify and assess the risks of material misstatement at the assertion level and identify significant accounts and disclosures and their relevant assertions. | Verify that the auditor has identified the points within the public company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material. |
| Obtain an understanding of the public company's risk assessment process and control activities. Consider controls that address fraud risks and other significant risks. | Identify the controls that management has implemented to address the potential misstatements.<br><br>Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the public company's assets that could result in a material misstatement of the financial statements. |

The following are examples of deficiencies staff observed related to risk assessment and the audit of internal control:

- The engagement team did not appropriately assess the risks of material misstatement related to the valuation of the allowance for expected credit losses.
- The engagement team did not appropriately assess the risk of material misstatement related to the valuation of investment securities and to the amortization of premiums and discounts related to investment securities and, as such, did not identify the risk of material misstatement and performed no control testing over this aspect.
- The engagement team did not reevaluate and revise its initial risk assessment after it obtained audit evidence during the course of the audit that contradicted the audit evidence on which it originally based its risk assessment.

## Selecting Controls To Test

In selecting controls over significant accounts and disclosures, an important consideration is determining that the auditor has selected controls that, individually or in combination, sufficiently address the identified risks of material misstatement, including risks for the relevant assertions and the components of the account or disclosure with differing risks. For example, the following is a partial list of components for which we have observed, over time, that auditors failed to identify and sufficiently test controls that addressed the risks of material misstatement:

- Revenue: Significant business units or significant revenue categories, significant contract provisions affecting revenue recognition, and significant inputs to percentage-of-completion calculations.
- Inventory: Pricing of significant inventory components and determination of reserves for excess and obsolete inventory.
- Fair value of financial instruments: Inputs used to value hard-to-value financial instruments and determinations of the classification of securities within the fair value hierarchy.

Internal control is not limited to frequent processes and normal recurring transactions. It also applies to infrequent processes, such as an analysis of whether long-term assets are impaired, and to nonrecurring transactions outside the normal course of business, such as a material business combination.

The following are examples of deficiencies staff observed related to selecting controls to test:

- Particularly for smaller reporting entities, the engagement team did not identify and test controls that addressed the risk that the same individual could prepare and post journal entries in the general ledger system without approval.
- The engagement team did not identify and test controls over the accuracy and completeness of a calculation file that was used in the performance of a key control.

## Testing Design Effectiveness

The auditor should test the design effectiveness of controls that are selected for testing by determining whether the public company’s controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the public company’s control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. The procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

The following is an example of a deficiency staff observed related to testing design effectiveness:

- The engagement team did not sufficiently test the design effectiveness of a control because it did not evaluate the effect of incomplete information available to the control owner and, as such, the ability of the control, as designed, to effectively prevent or detect a material misstatement.

## Testing Management Review Controls

Verifying that a review was signed off provides little or no evidence by itself about the control's effectiveness. Considerations include evaluating the precision of management review controls, testing design effectiveness, and testing operating effectiveness.

The following are examples of deficiencies staff observed relating to testing management review controls:

- The engagement team did not evaluate the specific review procedures that the control owner performed to assess the reasonableness of assumptions used in the valuation of securities. Controls with a review element, as shown in Figure 10, is the most common deficiency we see over the testing of ICFR and is common for all financial statement areas.
- The engagement team did not test the aspects of the control that addressed whether the method used by the public company to develop the estimates subject to management review were in conformity with the applicable financial reporting framework.

## Management Review Controls

Auditors often select and test management review controls in audits of internal control. Such management reviews might be performed to monitor the results of operations, such as (1) monthly comparisons of actual results to forecasted revenues or budgeted expenses; (2) comparisons of other metrics, such as gross profit margins and expenses as a percentage of sales; and (3) quarterly balance sheet reviews. These reviews typically involve comparing recorded financial statement amounts to expected amounts and investigating significant differences from expectations.

- The engagement team did not evaluate the specific review procedures the control owner performed to evaluate the reasonableness of the projected amounts for revenue growth and costs that the public company used in its impairment analysis.

## Considering Information Technology (IT)

Information technology can significantly affect a public company's overall internal control environment. For example, risks of material misstatement may result from IT processes or systems; controls may depend on the effectiveness of IT controls because they use system-generated data or reports; and IT controls may be related to automation.

The following is an example of a deficiency staff observed related to IT considerations, including system-generated data and reports:

- The engagement team did not identify and test controls over the accuracy and completeness of the reports used in the operation of a control as they relied on information that originated from the system.

## Rolling-forward Controls Tested at an Interim Date

When controls are tested at an interim date, the PCAOB standards require the auditor to determine what additional evidence concerning the operation of the controls for the remaining period is necessary. The evidence needed from the roll-forward procedures depends on several factors, including the specific risks associated with the control being tested.

The following is an example of a deficiency staff observed related to rolling-forward controls tested at an interim date:

- The engagement team tested operating effectiveness as of an interim date and did not perform any procedures, including inquiries, during the period from the interim testing until year-end.

## Using the Work of Others

The following is an example of a deficiency staff observed related to using the work of others:

- The engagement team did not evaluate whether it had a reasonable basis for using the work of internal audit as audit evidence of the operating effectiveness of selected controls given the increased risk associated with the controls.

## Using the Work of Other Auditors

The following is an example of a deficiency staff observed related to using the work of other auditors:

- Auditors of large multinational public companies frequently use the work of other auditors. In this example, the component engagement team did not fulfill the objectives of its role in an audit in which it was not the principal auditor because it did not identify and test appropriate controls related to assertions specifically identified by the principal auditor as important in the instructions to the component firm.

  This is a reminder that communication with the other auditor is important and reviewing certain audit documentation of the other auditor should be considered.

## Evaluating Identified Control Deficiencies

Evaluating whether a control deficiency, or a combination of control deficiencies, results in a material weakness requires professional skepticism and a careful analysis of all the evidence obtained. A mechanical or cursory evaluation of deficiencies might reach premature conclusions without appropriately considering critical information.

### Certain Definitions

A **deficiency** in ICFR exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

A **significant deficiency** is a deficiency, or a combination of deficiencies, in ICFR that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the public company's financial reporting.

A **material weakness** is a deficiency, or a combination of deficiencies, in ICFR, such that there is a reasonable possibility that a material misstatement of the public company's annual or interim financial statements will not be prevented or detected on a timely basis.

The following are examples of deficiencies staff observed related to evaluating identified control deficiencies:

- The engagement team did not sufficiently evaluate whether the deficiencies identified in controls represented a material weakness because it did not identify that the compensating controls did not address all the risks the primary control was designed to detect related to inaccurate and unauthorized sales orders and prices.
- The engagement team did not sufficiently evaluate the severity of the identified deficiencies to determine whether these deficiencies, individually or in combination with other deficiencies, constituted a material weakness.
- The engagement team did not communicate to the public company's management in writing, all deficiencies in ICFR identified during the audit prior to the issuance of the audit report.

## Deficiency Examples in Auditing Financial Statement Areas

Figure 12 illustrates common financial statement deficiency areas we have communicated by comment form by financial statement area. The top five categories, in terms of financial statement area, remain relatively consistent year-to-year, and significant estimates, evidence, and/or data and reports used to support audit conclusions are often a component.

In addition to the top five categories, because we are aware there is a specific interest, we have also summarized our observations over digital asset transactions, allowance for credit losses, and cybersecurity.

### Top Five Financial Statement Area Deficiency Categories and Accounting Estimates

- Revenue and related accounts
- Inventory
- Accounts impacted by business combinations
- Investment securities
- Long-lived assets, goodwill, and intangible assets

Failures to properly test accounting estimates, including fair value measurements, result in deficiencies in many financial statement accounts.

Accounting estimates are found throughout the financial statements. By their nature, accounting estimates, including fair value measurements, generally involve subjective assumptions and measurement uncertainty, making them susceptible to management bias. Some estimates involve complex processes and methods. As a result, financial statement accounts with accounting estimates are often some of the areas of greatest risk in an audit, requiring additional audit attention and appropriate application of professional skepticism. The challenges of auditing estimates may be compounded by cognitive bias, which could lead auditors to anchor on management's estimates and inappropriately weight confirmatory over contradictory evidence.

We observed deficiencies across a broad range of financial statement accounts and transactions related to accounting estimates. Our most common observations related to significant assumptions are (1) revenue recognition, such as standalone selling price, (2) accounts impacted by business combinations, including fair value and contingencies, and (3) forecasted information used to evaluate potential impairments or calculated fair value.

## Revenue and Related Accounts

Revenue is a frequently selected focus area in our inspections given, among other things, (1) complexities often associated with revenue recognition accounting policies and practices and (2) complexities associated with the auditing of such policies and practices. The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Perform sufficient procedures to test disaggregated revenue presentation and disclosure.
- Perform appropriate or sufficient procedures to evaluate data used in a software-assisted correlation analysis (an analysis that shows the level of correlation between specified factors, such as certain costs and revenue recognition). In some instances, the engagement team even identified data in their analysis that did not relate to revenue but did not evaluate the implication of that finding to their testing, resulting in the engagement team not performing sufficient procedures to address the occurrence, allocation, and completeness of revenue.
- Perform sufficient procedures related to valuation and allocation of bundled sales transactions to test that those sales transactions were recorded at relative standalone selling prices.
- For accounts receivable, perform confirmation testing for existence or occurrence and document how they overcame the presumption to perform confirmation procedures.
- Perform any procedures on significant assumptions in a percentage of completion basis of revenue recognition.
- Test whether the public company's arrangements to provide multiple services as one distinct performance obligation recognized over time had been satisfied before revenue was recognized.
- Test the accuracy of historical data used in testing procedures related to current year transactions.
- Identify or overcome the presumption of fraud risk involving improper revenue recognition.
- Select a sample that could be expected to be representative of the product revenue population.

## Inventory

Inventory can often present a significant risk of material misstatement due to the complexities of determining the cost of inventory and measuring inventory on-hand at a point in time. The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Perform any procedures to test the accuracy and completeness of the period-end inventory listing reports, and the completeness of the physical inventory adjustments used in the testing of the existence of inventory.
- Perform appropriate procedures to test inventory movement between the interim date and period-end date when the physical

inventory observation is not as of the period-end date.

- Perform price testing of old inventory, including a comparison to price in the prior audit, or otherwise evaluate management's assessment and accounting for old inventory.

- Obtain sufficient appropriate audit evidence that the public company's cycle count procedures over inventory were sufficiently reliable to produce results substantially the same as those that would have been obtained by a count of all items at a point in time.

- Perform any testing of the valuation of inventory (whether inventory was recorded at the lower of cost or net realizable value).

- Perform sufficient substantive procedures to test the completeness, existence, and valuation of inventory held at the public company's subsidiary because the firm limited its procedures to reviewing the public company's inventory reconciliation.

## Accounts Impacted by Business Combinations

Business combinations, by their nature, impact many accounts and include a broad spectrum of accounting estimates, including fair value, and many of our observations are included above under Deficiency Examples in Auditing ICFR, particularly management review controls. The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Perform sufficient substantive procedures to test valuation and allocation of purchase accounting, including forecast information used in valuations.

- Perform sufficient substantive procedures to test other significant aspects of the acquisition agreement such as contingent consideration.

## Investment Securities

Investment securities usually represent the second largest asset class for banks. Key risks presented by investments include interest rate risk, market risk, liquidity risk, and credit risk. The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Perform sufficient substantive procedures to test the fair value hierarchy presentation and disclosures in the notes to the financial statements.

- Obtain an appropriate sample for testing the investments that could be expected to be representative of the population.

- Perform any substantive procedures to test assumptions used in the valuation of investments.

## Long-lived Assets, Goodwill, and Intangible Assets

The valuation of long-lived assets requires considerable judgment and professional skepticism, and an appropriate assessment of the risks of material misstatement at the financial statement level and the assertion level. The process to assess if an impairment exists is often complex and includes both qualitative and quantitative factors. A company's specialist is often used to model a forecast of revenue, operations, or cash flows used to test for impairment and/or determine fair value. The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Perform sufficient procedures with respect to using the work of a company's specialist as audit evidence, specifically, testing the accuracy and completeness of information prepared by the public company and used by the company's specialist in developing the estimates; evaluating the reasonableness of significant assumptions; and performing procedures to evaluate whether the methods used by the issuer's specialist were appropriate.

- Sufficiently evaluate the valuation of the assets and whether there were indicators of potential impairment.
- Obtain a sufficient understanding of the processes used to develop the accounting estimates for the impairment to appropriately test valuation.
- Evaluate the reasonableness of a forecast period in the cash flow projections used to test present value.
- Identify and evaluate the significance to the financial statements of the public company's omission of certain required disclosures related to goodwill to appropriately test presentation and disclosure.
- Perform any procedures to evaluate the reasonableness of the significant assumptions underlying an estimate, beyond reading the public company's memorandums.

## Digital Asset Transactions

We continued to focus on identifying public companies that have material digital asset holdings and/or have significant activity related to digital assets. We reviewed cryptocurrency (e.g., a type of digital asset) transactions on several audits that met these criteria and had findings on over 80% of the related audits we reviewed. The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Perform sufficient substantive procedures to test the occurrence of digital asset revenue transactions.
- Perform any procedures to test rights and obligations and to establish that the public company owned the digital wallets that received the digital asset payments.
- Perform any audit procedures to establish that the issuer had control over the digital assets to support its ownership rights to the digital assets.

## Allowance for Credit Losses

The allowance for credit losses (ACL) represents one of the most significant accounts for financial institutions and involves significant management judgment incorporated into models that can be very complex. The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Sufficiently test the reasonableness of commercial loan risk ratings. Specifically, the engagement team did not select an appropriate sample that could be expected to be representative of the total loan population because the engagement team did not appropriately consider the characteristics of the population.
- Evaluate whether the public company's valuation methodologies used in their purchase price allocation were in conformity with the requirements of the applicable financial reporting framework.
- Sufficiently test the completeness and accuracy of reports that support significant assumptions and are used in the engagement team's testing of the ACL valuation.
- Perform any procedures to identify assumptions used to develop the unallocated reserve and evaluate the reasonableness of those assumptions as part of their valuation testing.
- Perform sufficient substantive procedures to test the reasonableness of loan grades, a significant input to valuation testing.

## Cybersecurity

The risk of cybersecurity attacks to public companies and broker-dealers is always present and increases for those public companies and broker-dealers who have not understood their vulnerabilities and are unprepared to identify and react to cyber incidents when they do occur. The following is an example of a deficiency staff observed:

- The engagement team did not sufficiently identify, assess, and respond to the risks of material misstatement. Specifically, despite obtaining evidence at the time of the audit that a cyber-incident occurred, which contradicted the results of certain inquiries, the engagement team did not revise its risk assessment. As a result, the firm did not modify its planned audit procedures or perform additional procedures in response to the revised risk assessment.

Starting in 2024, as discussed in our Spotlight, "Staff Priorities for 2024 Inspections and Interactions With Audit Committees," we will also review the audit firm's audit response (1) to material cybersecurity incidents, as well as (2) to the incident disclosures made in compliance with SEC rules, requiring, among other things, public companies to disclose material cybersecurity incidents they experience.

# Deficiency Examples Related to Other PCAOB Standards or Rules

The Rules of the Board also include a variety of topics that can be subject to our inspection activities. We report other instances of non-compliance with PCAOB standards or rules in Part I.B of our inspection reports. These deficiencies relate to instances other than those where the firm had not obtained sufficient appropriate audit evidence to support its opinion(s). Our most common Part I.B deficiencies relate to fraud, critical audit matters, auditor tenure, and audit committee communications. A high-level overview of Form AP findings, which have improved, is also included.

## Fraud

The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud. An understanding of the public company, its relationships and transactions with related parties, its environment, and its flow of transactions, including how transactions are initiated, authorized, processed, and recorded, better informs the auditor to identify fraud risks and to develop an appropriate audit response.

Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (1) recording inappropriate or unauthorized journal entries throughout the year or at period end or (2) making adjustments to amounts reported in the financial statements that are not reflected in individual journal entries, such as through consolidating adjustments, report combinations, and reclassifications. Accordingly, the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the financial statements' preparation, such as top-side entries. To do this effectively, the auditor should understand the public company's financial statement close process, including the recurring and automated journal entries.

Auditors with strong data and analytical skills, which may be accompanied by technology-driven tools appropriate for the public company's environment, are important to effectively perform fraud procedures – which should never be taken as routine requirements that need to be checked complete on a list.

The following are examples of deficiencies staff observed. In these examples, the engagement team did not:

- Conduct a discussion among the key engagement team members about the potential for material misstatement due to fraud.
- Sufficiently test the completeness of the population that was used to make selections for journal entry testing.
- Perform required inquiries with the audit committee, management, and others within the public company about fraud risks.
- Support its rationale used for identification and selection of journal entries for testing.
- Support its rationale for limiting its testing to only certain journal entries that met its identified fraud criteria.
- Include in its journal entry testing entries that met their fraud risk criteria.
- Examine the underlying support for certain of the journal entries identified based on the risk criteria.
- Perform any procedures to identify and select journal entries and other adjustments for testing.

## Critical Audit Matters (CAMs)

An auditor's communication of CAMs in the auditor's report is intended to inform investors and other financial statement users about any matters arising from the audit of the financial statements that were communicated or required to be communicated to the audit committee and that relate to accounts or disclosures that are material to the financial statements and involve especially challenging, subjective, or complex auditor judgment, and the auditor's response to those matters.

The deficiencies found by 2023 inspections are consistent with prior years' inspection results and primarily relate to instances in which audit procedures to determine whether or not matters were CAMs did not include every matter that was communicated, or required to be communicated, to the issuer's audit committee and that related to accounts or disclosures that were material to the financial statements. These instances of noncompliance do not necessarily mean that other CAMs should have been communicated in the auditor's report. We also observed instances where the firm did not accurately describe how the CAM was addressed in its audit, because the CAM description in the auditor's report included procedures that were not performed to address the CAM or were not performed as described. In limited instances within the NAF program, staff performing triennial firm inspections found instances where some auditors performed no procedures regarding CAMs.

## Auditor Tenure

We continued to identify deficiencies in auditor reporting of the year the firm began serving consecutively as the public company's auditor.

## Audit Committee Communications

Both the auditor and the audit committee benefit from a meaningful exchange of information throughout the audit to assist in understanding matters relevant to the audit. However, we continued to identify deficiencies in the required auditor's communication with the audit committee.

Deficiencies broadly ranged across all types of firms and the following are examples of deficiencies staff observed. In these examples, the auditor did not communicate to the public company's audit committee:

- An understanding of the terms of the audit engagement in an engagement letter and determine that the audit committee had acknowledged and agreed to the terms of the engagement.

- The significant risks that were identified during its risk assessment procedures.
- Critical accounting estimates and related significant assumptions with a high degree of subjectivity.
- The names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit.
- The management representation letter and/or a complete list of uncorrected misstatements identified during the audit.

In December 2023, we published "Staff Priorities for 2024 Inspections and Interactions With Audit Committees," which includes an effective practice for audit committee communications. Firms are encouraged to read this effective practice because approximately 30% of the deficiencies related to audit committee communications may have been prevented had an appropriate approach to communicating the names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the audit firm, that perform audit procedures in the current period audit, been properly implemented.

Templates for audit committee communications can be very useful, but care needs to be taken that these templates are correct. Our staff observed one firm's template had an option for the engagement team to incorrectly communicate that none of the proposed adjustments could potentially cause future-period financial statements to be materially misstated. We also observed other audit committee communications that included "template text" related to integrated audits in the communication, when an integrated audit had not been performed.

## Form AP

Form AP was adopted to provide investors and other financial statement users with information about engagement partners and accounting firms that participate in audits of public companies. The information is filed on Form AP, *Auditor Reporting of Certain Audit Participants* (in accordance with Rule 3211) and is available in a searchable database on the PCAOB website.

Investors and others can find out who is leading and participating in the audits of public companies through AuditorSearch, a public database based on Form AP filings. In addition, our Staff Guidance, Form AP, Auditor Reporting of Certain Audit Participants, and Related Voluntary Audit Report Disclosure Under AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, was updated in November 2023.

Form AP took effect during 2017. For many firms, 2023 was the sixth year of execution, and we believe firms should be familiar and experienced with the process. In 2023, less than 10% of engagements reviewed had a Form AP deficiency and the following summarizes our observations regarding those deficiencies:

- Thirty-nine percent of the Form AP deficiencies involved inaccurate information. This included, but was not limited to, instances where the public company's name, the public company's CIK number, and information about other firms, including their name and level of participation were not accurately reported.
- Twenty-five percent of the Form AP deficiencies involved instances where the forms were filed late. The form is due by the 35th day after the date the audit report is first included in a document filed with the SEC. If such document is a registration statement, the form is filed by the 10th day.

- Thirty-six percent of the Form AP deficiencies involved omitted information, including other firms that participated in the audit.

# III. OBSERVATIONS RELATED TO QUALITY CONTROL SYSTEMS

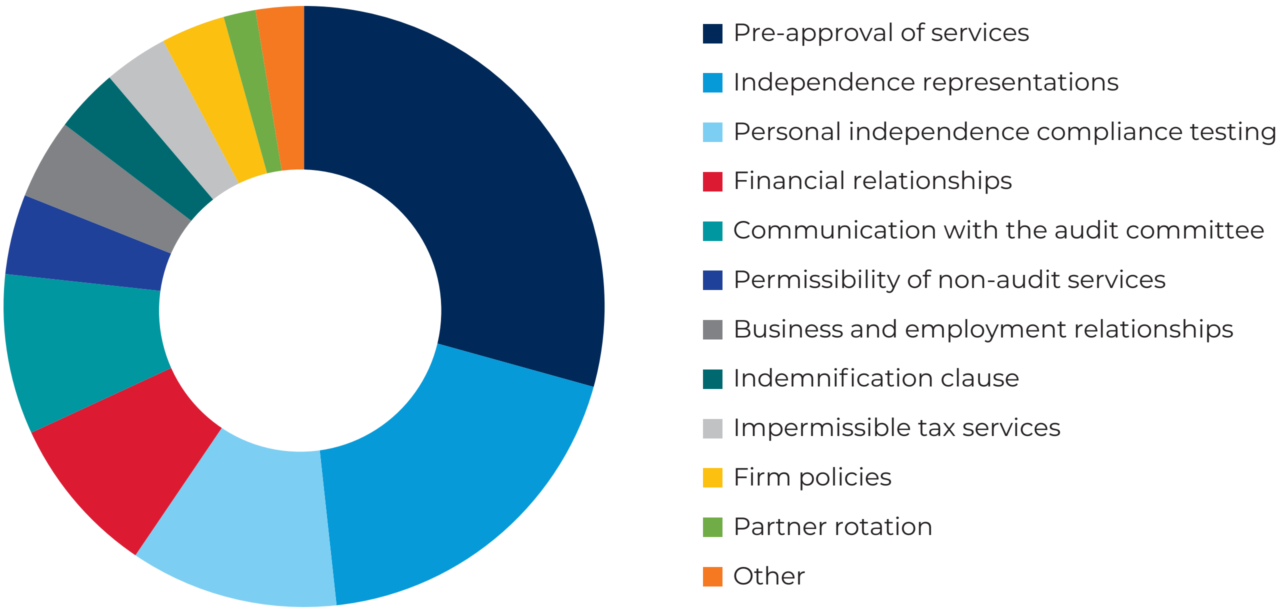
PCAOB inspection teams conduct quality control reviews to assess a firm's QC system. This assessment includes evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control. Our reviews have evolved over the years and are scaled to each firm based on the size, nature, structure, and complexity of the firm.

## Independence

Independence is a critical element to be addressed by an audit firm's QC system and remains an area for improvement. Instances of potential noncompliance with SEC rules or instances of noncompliance with PCAOB rules, regardless of the means of identification of the deficiency (by the PCAOB or reported to us by the firm) during 2023 increased significantly. Compliance by all personnel and partners with a firm's process to preserve independence, in fact and in appearance, with the public companies and broker-dealers they audit is fundamental to a strong culture of integrity and audit quality. Figure 9 summarizes all independence comment forms for the period 2021 through 2023.

We continued to identify potential violations of the SEC's independence requirements, including financial relationship requirements. These potential violations, mainly with triennially inspected audit firms (which includes non-U.S. GNF), include financial relationships, employment relationships, business relationships, non-audit services, contingent fees, and audit committee administration of the engagement. Some of the annually inspected firms continue to report a high rate of noncompliance by audit firm personnel reporting their financial relationships in accordance with firm policies that could be more restrictive than the SEC or PCAOB independence requirements, in the applicable audit firm's monitoring system. We also observed deficiencies related to PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*.

### Figure 9 – Independence-Related Comment Forms, 2021 to 2023



A public company or broker-dealer should be particularly concerned with potential noncompliance with SEC and PCAOB independence rules because if the auditor's independence is impaired then the public company or broker-dealer has not satisfied the requirement to file financial statements audited by an independent registered public accounting firm. We expect to publish a Spotlight later in 2024 discussing this topic further.

## Engagement Quality Review

We continued to identify deficiencies in the engagement quality review (EQR) in many of our inspections. The deficiencies are not limited to a single type or size of firm, nor are they limited to a specific type of engagement. The deficiencies observed by the PCAOB range from the firm not obtaining the required EQR for the audit, which we see once or twice a year at smaller firms, to the firm failing to perform an EQR with due professional care, which is a more common observation.

The following are examples of deficiencies staff observed:

- The firm did not have a competent engagement quality reviewer perform the EQR.
- The firm did not obtain concurring approval from the engagement quality reviewer prior to issuance of the audit report(s).
- The engagement team's documentation did not contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand all of the procedures performed by the engagement quality reviewer because the inspection team could not identify documents reviewed by the engagement quality reviewer that evidenced the engagement quality reviewer evaluated whether the engagement team responded appropriately to the significant risks, and supported the conclusions reached by the engagement team with respect to the matters reviewed.
- The EQR did not identify deficiencies in audit responses to areas of significant risks, including fraud risks, that were subsequently identified by PCAOB staff.

### Engagement Quality Reviews

In October 2023 we published a Spotlight, "**Inspection Observations Related to Engagement Quality Reviews**," that highlights staff observations from our inspections between 2020 and 2022.

## Monitoring

Firms, based primarily on size and structure, utilize a variety of methods to ensure that the quality control policies and procedures established by the firm are suitably designed and are being effectively applied. Monitoring involves ongoing consideration and evaluation. Many firms' documented systems of quality control indicate aspects of the monitoring are performed through internal inspection programs, typically after release of their audit report (a post-issuance review program).

The following are examples of deficiencies staff observed:

- The firm's internal inspection program (performed after report issuance) did not identify the deficiencies identified by the PCAOB inspection team in the engagements despite having reviewed the same area. The fact that these deficiencies were not identified raises questions about the effectiveness of the firm's system of quality control for monitoring compliance with the firm's policies, procedures, and applicable professional and regulatory standards.

- The firm's pre-issuance review (a review performed in accordance with a firm's monitoring program prior to report issuance) did not identify and result in the engagement team addressing, before the firm issued its report(s), the deficiencies identified by the PCAOB inspection team, despite the pre-issuance review team having reviewed the same area.
- The firm's policies and procedures for monitoring its accounting and auditing practice required the performance of periodic internal inspection procedures; however, the firm did not perform internal inspection procedures during the year.
- The firm's policies and procedures for monitoring its broker-dealer practice required, in some instances, post-issuance review on an annual basis by a group in the firm or in other instances a peer review every third year by an independent third-party firm, but the firm did not perform these monitoring, or alternative procedures.

## Remediation

During 2023, the Board made remediation determinations related to 92 firm inspection reports. On average, these firms provided two to three draft responses during the remediation period with respect to which we provided feedback to the respective firms. The Board reached a satisfactory determination for each of the quality control criticisms included in the firms' inspection reports for approximately 60% of the 2023 remediation determinations ("fully satisfactory determination").

For the remaining approximately 40% of the 2023 remediation determinations, the Board determined that each firm did not satisfactorily remediate one or more of the quality control criticisms included in the firm's inspection report ("unsatisfactory determination"). The areas of quality control with an unsatisfactory determination by the Board most frequently related to testing controls, EQR, policies for personal independence compliance testing, and testing revenue.

# IV. TRENDS IN AREAS WITH RECURRING DEFICIENCIES, 2021 TO 2023 INSPECTIONS

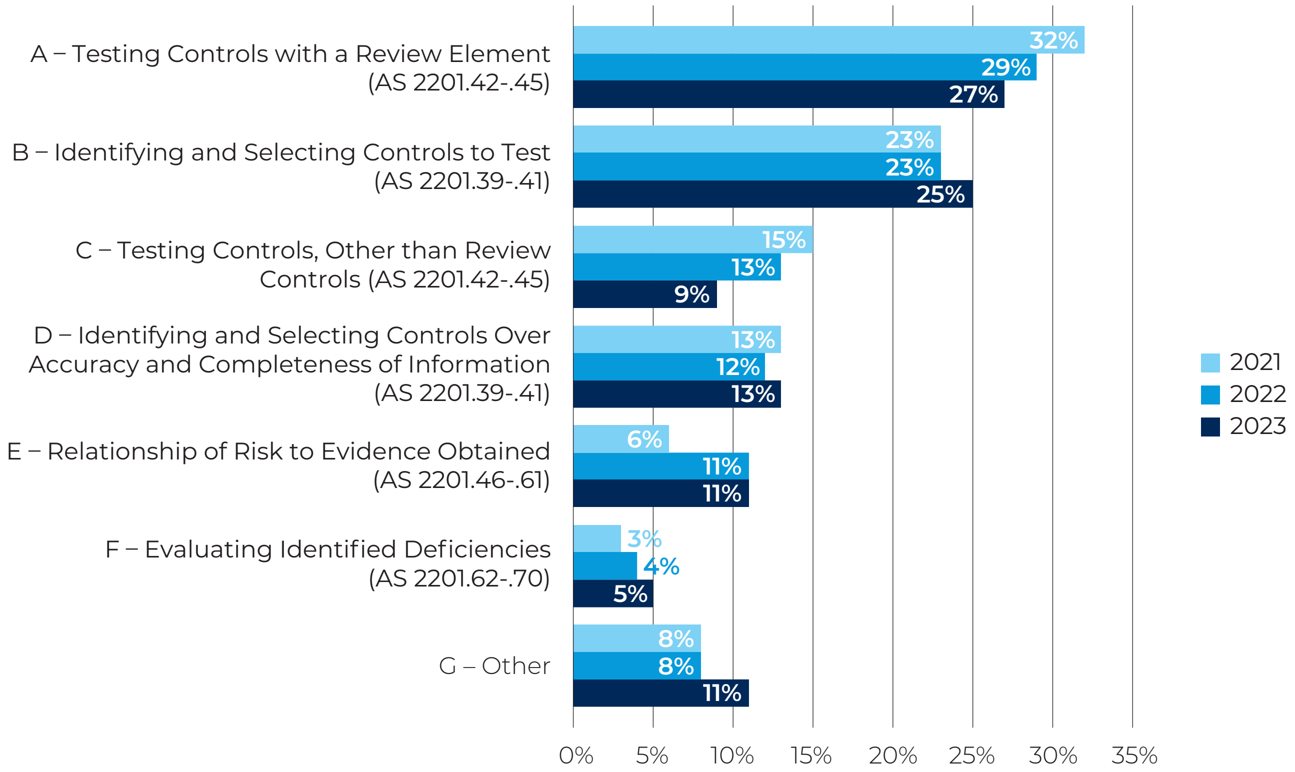
Firms that have repeated or persistent criticisms should thoughtfully consider "why" and make meaningful changes where appropriate. The inspection staff believes that a firm's analysis of the root cause(s), although not required, may be helpful in determining appropriate actions to remedy repeated or persistent criticisms from our inspections. The nature and extent of the root cause process will likely differ significantly with a firm's size and structural complexity.

## 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 noncompliance with AS 2201.

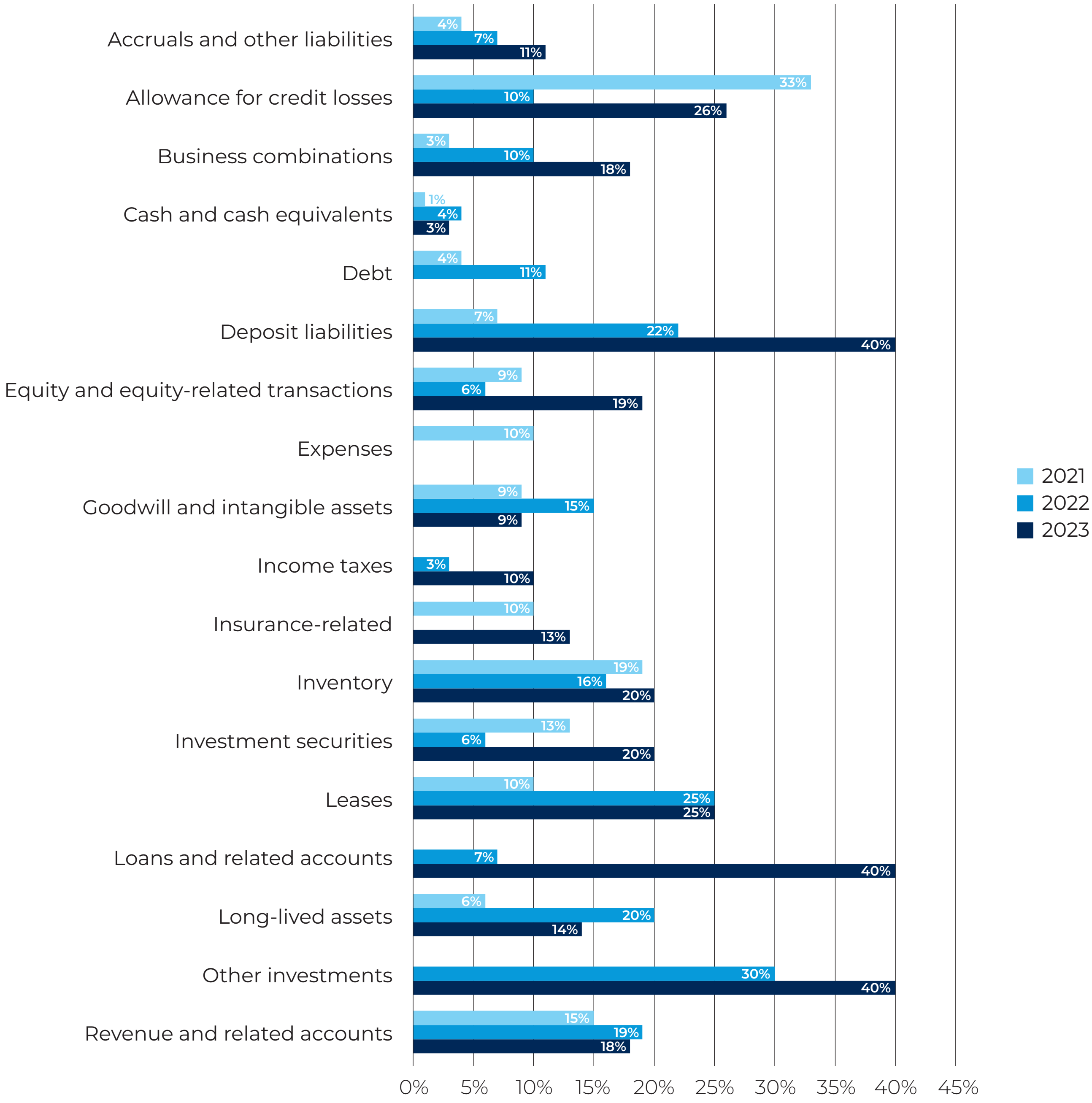
The three-year data highlights the nature of ICFR auditing deficiencies and deficiencies in auditing ICFR by area that have generated the most comment forms since 2021. The data related to the nature of ICFR can total more than 100% because the comment forms can contain multiple deficiencies.

## Figure 10 – Nature of ICFR Auditing Deficiencies




In previous Spotlights, we have reported deficiencies in auditing ICFR by area using the total deficiencies as the denominator and showing the percentage for each audit area relative to total deficiencies. Based on feedback, we now present the deficiencies by audit area using the number of times the audit area was selected for review in our inspections as the total and showing the number that resulted in a comment form deficiency as a percentage. See Figure 11.

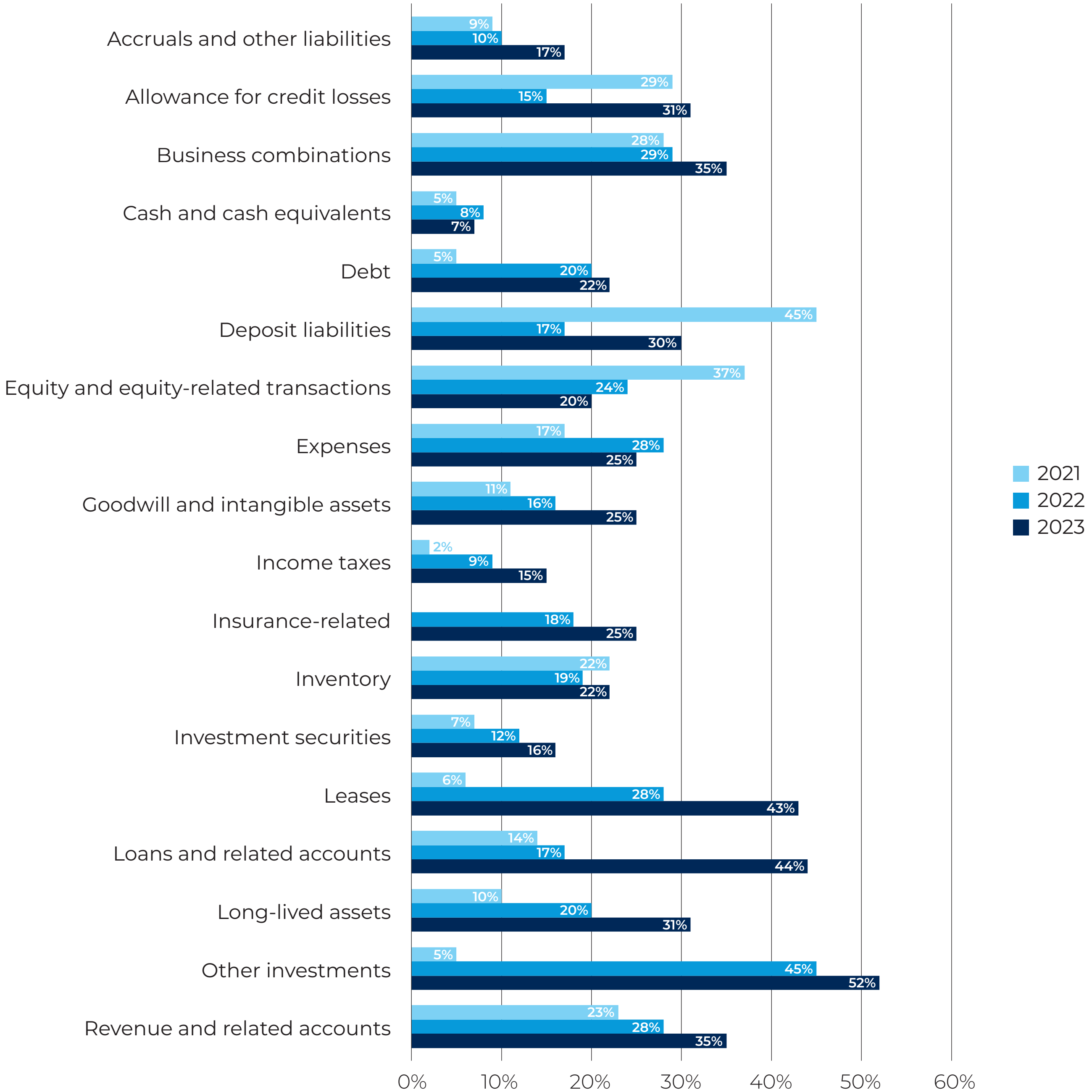
**Figure 11 – Deficiencies in Auditing ICFR by Financial Statement Area (as a Percentage of the Number of Reviews)**




## Trends in Deficiencies in Financial Statement Audit Areas

Consistent with Figure 11, we have changed the presentation of deficiencies by financial statement audit areas, excluding those that relate to ICFR. Figure 12 lists the financial statement areas across both the issuer and broker-dealer inspections that generated the most comment forms, excluding those that related to ICFR. We have listed the percentage of our reviews of each area that resulted in a comment form deficiency.

## Figure 12 – Common Financial Statement Deficiency Areas, Excluding ICFR (as a Percentage of the Number of Reviews)



# V. GOOD PRACTICES AND IMPORTANT REMINDERS

Our inspectors, through the course of their reviews, see good practices at certain firms, implemented in ways appropriate for the firm's size and unique structure. We have been sharing these observations throughout the year in our publications. These good practices and important reminders are not prescriptive and need to be considered in the context of the facts and circumstances specific to a firm's practice.

## Good Practice – Long-lived Assets

Evaluating triggering events for impairment can be a challenge for auditors because management of the public company understands their business and the events that can negatively impact their business, and more specifically their assets (or asset groups), most thoroughly. The public company's management initially evaluates triggering events and the impact, for example, the loss of a significant customer might have on certain manufacturing assets if production volumes decrease, how the loss of a patent might impact competition and recoverability of related assets, or how political instability in a region might impact their supply chain and recoverability of related assets.

As a reminder, as part of the auditor's understanding of the public company, the auditor should understand measures that the public company uses to monitor its operations that highlight unexpected results or trends that prompt management to investigate their cause and take corrective action, including correction of misstatements. In the case of an integrated audit, the auditor verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion. In obtaining an understanding of the public company, the auditor should evaluate whether significant changes in the public company from prior periods, including changes in its ICFR, affect the risks of material misstatement.

In this example, the auditor should obtain sufficient appropriate evidence that the public company has identified all long-lived assets for which an impairment test is required, and we have observed several effective approaches for doing this. Generally, all approaches begin by evaluating whether the public company has identified all assets subject to impairment testing by comparing the assets or asset groups in the analysis to a consolidated balance sheet to demonstrate completeness of the population. Our inspection procedures in this area have informed our understanding that this analysis becomes the basis, and ensures completeness, of periodic discussions during the year regarding the public company's monitoring over such assets and asset groups.

## Important Reminder – Consideration of Fraud

Consideration of fraud in a financial statement audit requires an audit response that is tailored to the public company. We are providing some important reminders, in areas where we have the most observations.

**AS 2110: Identifying and Assessing Risks of Material Misstatement**

- Understand management's process for identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks").
- In applying analytical procedures as risk assessment procedures, the auditor should include the objective of identifying unusual or unexpected relationships involving revenue, including material misstatement due to fraud.
- Have a fraud brainstorming meeting with all key engagement team members. As a good practice, solicit ideas from engagement team members that performed detail tests in the prior year.
- Tailor required inquiries related to specific fraud risks at the public company.
- The potential for management override of controls is always a fraud risk and needs an appropriate audit response.
- The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.
- Don't forget that a fraud risk is a significant risk that requires the auditor to perform substantive procedures, including test of details that are responsive to the assessed risks.

**AS 2401: Consideration of Fraud in a Financial Statement Audit**

- Test the completeness of the journal entry population that is used to make selections for journal entry testing.
- Support and evidence your rationale for determining the nature, timing, and extent of the testing of journal entries and other adjustments.
- Support and evidence how management override of controls at components out-of-scope for the group audit are addressed.
- Examine the underlying support for journal entries selected for testing.

## Good Practice – Revenue

For many public companies, revenue is one of the largest accounts in the financial statements and is an important driver of a public company's operating results. In audits performed under PCAOB standards, revenue typically is a significant account, often involving significant risks that warrant special audit considerations. PCAOB standards require auditors to presume that improper revenue recognition is a fraud risk.

To audit revenue effectively, auditors should understand, among other things, the company's key products and services, and business processes that affect revenue. PCAOB standards require as part of identifying significant accounts and disclosures and their relevant assertions, the auditor to determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. As different types of revenue may have different likely sources of potential misstatement, disaggregating the product and service revenue into similar revenue recognition streams – e.g., point in time, over time, single element, multiple elements, variable pricing – and then further disaggregating the revenue based on system of record, accounting location controlling the transaction, and, if significant to the process, the control owner, may assist with the auditor's identification and assessment of risks and the development of an appropriate audit response.

This effective practice example is intended to highlight selected considerations for addressing certain auditor responsibilities under PCAOB standards when auditing revenue. Please see Staff Audit Practice Alert No. 12, **Matters Related to Auditing Revenue in an Audit of Financial Statements**.

PCAOB standards require the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. In designing the audit procedures to be performed, the auditor is required to:

(1) Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

(2) Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement; and

(3) In an integrated audit, design the testing of controls over revenue to accomplish the objectives of both audits simultaneously: (a) to obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements; and (b) to obtain sufficient evidence to support the auditor's opinion on ICFR as of year end.

As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain to test revenue also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate audit evidence to respond to the assessed risk of material misstatement.

When using information produced by the company to select samples for testing, the auditor should test the completeness of or test controls over the completeness of such information. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and
- Evaluate whether the information is sufficiently precise and detailed for the purpose of the audit.

Also consider, for example, the public company may receive and use information from a third party, perhaps a shipping company, in its process to recognize revenue when delivered. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence. Appropriateness is the measure of the quality of audit evidence (i.e., its relevance and reliability). To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based. The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained.

Auditor considerations:

- Do the professionals assigned have the relevant industry and technical expertise?
- Have appropriate engagement team members, including partners, managers, and information technology professionals, been involved in planning meetings, identifying and assessing risks, understanding and testing internal controls, and designing and performing substantive testing? Tailor procedures to design and implement audit responses that address the risks of material misstatement that are identified and assessed in accordance with AS 2110, *Identifying and Assessing the Risks of Material Misstatement*.
- Does the audit documentation prepared demonstrate (1) a thorough understanding of the public company's contracts with its customers and (2) the engagement team's evaluation of whether the issuer's accounting for such contracts is in conformity with the applicable financial reporting framework?
- Has the engagement team identified and tested controls that are important to the auditor's conclusion about whether the public company's controls sufficiently address the assessed risk of material misstatement for each relevant assertion?
- Did the engagement team consider performing procedures throughout the year to update its understanding of the public company's contracts with its customers, including its understanding of significant contracts entered into during the year?

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