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**INFORMATION FOR AUDIT COMMITTEES
ABOUT THE PCAOB INSPECTION PROCESS**

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Executive Summary

The Public Company Accounting Oversight Board ("PCAOB or the "Board") is issuing this document to assist audit committees in (1) understanding the PCAOB's inspections of their audit firms and (2) gathering useful information from their audit firms about those inspections. Some audit committees have told the Board that their audit firms provide helpful information to them about their inspection, but others have said that their auditors decline to discuss their PCAOB inspection results with them or downplay the results of any adverse findings that may be included in the report.

Information about the results of a PCAOB inspection of a company's audit, as well as more general inspection results, can help an audit committee in carrying out its oversight role. Inspection reports can help inform an audit committee about how its auditor performed on specific audits and in high-risk areas across audits.

This is a high-level summary of matters that are discussed in more detail in the release. Audit committee members are urged to read the entire release for more information on each summarized topic.

The Nature of a PCAOB Inspection of an Audit Firm

PCAOB inspections assess compliance with certain laws, rules, and professional standards in connection with firms' audits of issuers. A PCAOB inspection of an audit firm examines in depth (1) certain aspects of a limited number of audits performed by the audit firm and (2) certain elements of the firm's system of quality control over its audit processes. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. A PCAOB inspection report – regardless of whether it identifies a deficiency – does not mean that the firm's unreviewed audit work was, or was not, deficient. Thus, results reported in a PCAOB inspection report should not necessarily be understood to mean that the unreviewed audit work of the firm was deficient. PCAOB inspection findings are contained in two of the four parts of an inspection report:

1. Part I – describes audit deficiencies where inspection staff found that the auditor failed to gather sufficient audit evidence to support an audit opinion. This may relate to the opinion that the financial statements are fairly stated or the opinion that the company's internal control is effective. Part I findings are made public and are available on the PCAOB's web site.

2. Part II – typically describes deficiencies in the firm's overall system of quality control such that the Board has doubts that the system provides reasonable assurance that professional standards are met. The Board is prohibited by law from publicly releasing these Part II findings unless the firm fails to remediate these findings to the Board's satisfaction within twelve months of issuance of the inspection report. The audit firms themselves have copies of this part of the report and are not prohibited by law from releasing this information at any time, though there may be other reasons they decline to do so.

Possible Questions Audit Committees May Wish to Ask Their Audit Firms about PCAOB Inspections

1. *Was the company's audit selected for PCAOB inspection?* Committees may want real time updates about whether their audit has been selected, what is being looked at, and any deficiencies identified by the PCAOB in the audit. The release provides additional information about specific areas for possible further inquiry in this regard.

2. *Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues presented in the company's audit?* Committees may wish to understand whether similar deficiencies exist in the company's audit and, if so, what has been done in response.

3. *What were the audit firm's responses to the PCAOB findings?* Committees may want to understand whether the audit firm agreed with the PCAOB's findings and, if not, why not. If the firm agreed, what did the firm do in response? The PCAOB is aware of certain audit firm responses that should be viewed with skepticism, such as:

A. *"It was just a documentation problem."* The PCAOB bases deficiency findings on an absence of available evidence in the audit files or elsewhere to support that adequate work was done to support an audit opinion, not just a failure to document work that was in fact done. Audit firms are provided an opportunity to describe the details of work that was done but not documented.

B. *"There was a difference in professional judgment."* The PCAOB bases deficiency findings only on failures to obtain sufficient audit evidence, not on disagreements when reasonable judgments appear to have been made about such matters.

C. *"The firm has addressed the criticisms in accordance with PCAOB standards."* Professional standards require that when a required auditing procedure was omitted, certain remedial steps must be taken. Ask whether

the firm performed more work in response to the finding or in subsequent audits, or whether the firm concluded that no additional steps were required – in other words, that the firm disagrees with PCAOB inspection conclusions.

4. *What topics are included in Part II findings?* Firms may be reluctant to share the details of Part II findings in an inspection report for a number of reasons, but even in that case, audit committees may want to ask for certain generic information about the findings such as:

A. what changes the firm is making to address any quality control deficiencies;

B. what is the progress of the quality control remediation process, including a discussion of any submissions the audit firm made to the PCAOB as part of that process;

C. the inspected years about which the PCAOB has made a final determination about the firm's remediation efforts and the nature of that determination; and

D. whether the PCAOB has provided initial indications that the audit firm may not have sufficiently remediated any items.

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It is the Board's understanding that the nature and amount of inspection-related information that audit firms provide to audit committees vary. The Board has heard from audit committee members about some instances in which they received from their audit firm nonpublic inspection information that was significant to the audit committee in its oversight role, and the Board has also heard, from those and other audit committee members, that audit committees would benefit from access to more inspection information.^{1/}

Although the Board cannot provide audit committees with nonpublic information about specific inspections, this release provides information about the inspection process, and the meaning of reported results, in a way that may better equip audit committees to engage in meaningful discussion with audit firms about the results of inspections. Part I of the release discusses the meaning and significance of audit deficiencies described in the public portion of an inspection report. Part II provides a basic description of the way that quality control criticisms are framed in portions of reports that are, at least initially, nonpublic. Part III of the release suggests some specific approaches that an audit committee might consider for initiating or enhancing inspection-related discussions with an audit firm. The appendix to this release provides additional detailed background concerning the PCAOB inspection process and additional details on other related matters.

I. The Public Portions of Inspection Reports and Firms' Responses

For every inspection, the Act requires the Board to prepare a written report, to allow the inspected firm an opportunity to respond in writing to a draft of the report, and to include the firm's written response as part of the final report. As required by the Act, the Board makes a portion of each inspection report publicly available. If a firm submits a response to the draft report, the Board makes public, as part of the final report, any portion of the response that the firm chooses to have made public.

PCAOB inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include, among other things, reviews of certain aspects of selected audits performed by the firm. It is not the purpose of an inspection, however, to review all of a

^{1/} Examples of the views of audit committee members on these points can be found in recent panel discussions at PCAOB Public Meetings on Firm Independence and Rotation, including Session Four of the Board's June 28, 2012 public meeting (see http://pcaobus.org/News/Events/Pages/06282012_PublicMeeting.aspx for archived webcast and transcript), and Session Nine of the Board's March 21-22, 2012 public meeting (see http://pcaobus.org/News/Events/Pages/03212012_PublicMeeting.aspx for archived webcast and transcript).

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firm's audits or to identify every respect in which a reviewed audit is deficient. As described in more detail in the appendix, audit work is selected for inspection largely on the basis of an analysis of factors that, in the PCAOB inspection staff's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample of the audit firm's work.

Accordingly, the Board cautions against extrapolating from the results presented in the public portion of the report to broader conclusions about the frequency of deficiencies throughout a firm's practice. The Board also cautions against judging the relative quality of firms' audit practices solely on the basis of the number of deficiencies described in the public portions of inspection reports. Nevertheless, the public portion of a report can be a useful starting point for discussion between an audit committee and the audit firm it oversees about the inspection. For a report to be most useful for that purpose, the meaning of the published criticisms should be properly understood.

A. Criticisms in the Public Portion of a PCAOB Inspection Report

The public portion of a PCAOB inspection report does not describe every audit deficiency observed in an inspection. Nor does it describe concerns that relate solely to the adequacy of documentation of audit procedures. If the public portion of an inspection report describes a deficiency in a firm's audit of financial statements, it is because the inspection staff considered all available evidence regarding the audit procedures performed by the firm and found that the deficiency had a specific and significant consequence: the firm did not satisfy its fundamental responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement.^{2/}

In other words, in the inspection staff's view the audit firm did not have a sufficient basis for an audit opinion and, absent obtaining additional audit evidence, could not have such a basis. That finding does not mean that the financial statements are misstated, and it is usually not possible for the inspection staff, based only on the information available from the firm, to reach a conclusion about whether the financial

^{2/} An inspection might also identify deficiencies in a firm's audit of an issuer's internal control over financial reporting ("ICFR"), in which case the significance threshold for inclusion in the public report relates to the firm not having obtained reasonable assurance about whether effective ICFR was maintained in all material respects. In some cases, inspections identify deficiencies in audit work that a firm performed for an audit in which it played a role but was not the firm that issued the audit report. In those cases, the significance threshold for inclusion in the public report relates to the firm not having obtained sufficient audit evidence to fulfill the objectives of its role in the audit.

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statements are misstated. Auditors that have performed additional procedures in response to such criticisms, however, have sometimes discovered that there was a material misstatement that they had not detected before issuing the audit report, and those discoveries have led to restatements.

In some cases, the available information is sufficient for the inspection staff to form a view that there is an apparent material misstatement that, due to insufficient audit work or improper assessment of the application of the relevant accounting framework, went undetected or unaddressed by the auditor. In cases where the inspection staff reaches that conclusion, the public portion of the inspection report summarizes the criticism of the auditing in terms that reflect the inspection staff's view that the financial statements are misstated.^{3/}

With respect to every deficiency described in the public portion of a report, the inspection staff will have formed its conclusion after a rigorous process. As described more fully in the appendix, that process involves opportunities for the firm to respond in detail to the initial assessment made by the team that performed the inspection procedures. That inspection team and other inspection staff carefully consider all evidence presented by the firm that may bear on the matter. Depending upon the issue, the inspection staff might also consult with staff in the Board's Office of the Chief Auditor.^{4/}

^{3/} The authority to prescribe the form or content of a public company's financial statements rests with the Securities and Exchange Commission ("Commission" or "SEC"), not the Board. Any description in a PCAOB inspection report of a financial reporting error that the auditor did not appropriately address is a criticism of the auditing based on information in the audit documentation, public information such as the company's SEC filings, and the inspection staff's understanding of financial reporting requirements. The inspection staff does not engage with a company's management about financial reporting matters, and an inspection report's description of such an audit deficiency is not an indication that the Commission has made or necessarily will make any determination concerning the financial reporting in question.

^{4/} An inspection report's description of audit deficiencies reflects findings of the PCAOB inspection staff as reported to the Board, as distinct from Board findings of the type that may be grounds for the imposition of disciplinary sanctions. Findings of that nature would be made only in the context of an adjudicative process in which the firm is afforded procedural rights that do not apply in the inspection context.

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B. The Public Portions of Firms' Responses

The public portion of a report describes audit deficiencies in terms intended to make clear the significance described above. The public portion of a report also includes, however, any portion of a firm's response to the draft report that the firm chooses to have made public, and those responses sometimes describe the firm's perspective on the inspection results or the firm's actions in response to the results. In some cases, those public portions of firms' responses make assertions that may create uncertainty or confusion in the reader's mind concerning the nature and significance of the reported deficiencies. Although not all audit firms make such assertions in their responses, variations on three such assertions occur with sufficient frequency in firms' written responses – and possibly in discussions with audit committees – that audit committees may benefit from the Board's perspective on them.

1. Assertions that Characterize Criticisms as Documentation Deficiencies Rather than as Deficiencies in the Performance of Procedures to Obtain Audit Evidence

In addressing inspection report criticisms, firms' responses sometimes characterize the deficiency in terms of audit documentation. That is, firms sometimes assert or imply that the firm performed procedures to obtain the necessary audit evidence and that the criticism arises only because the firm did not sufficiently document its procedures.

In the Board's view, such assertions should be viewed with skepticism.^{5/} In reaching its conclusions, the inspection staff considers whether audit documentation or any persuasive other evidence that a firm might provide to the inspection team supports a firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter cited in the public portion of a final

^{5/} The Audit Inspection Unit ("AIU") of the Professional Oversight Board in the United Kingdom publicly addressed a similar point in a 2011 report. Noting that comments received by the AIU from audit committee chairs indicated that they "sometimes had difficulty in assessing the significance" of AIU inspection issues communicated to the audit committee by the firm, the AIU observed that "[t]his difficulty could be caused by firms characterising some of the AIU's findings as relating to the sufficiency of documentation rather than the underlying audit evidence and judgments and therefore of less significance." The AIU noted that it "disagrees with this characterisation of its findings." Audit Inspection Unit Annual Report 2010/11 (July 19, 2011) at 9, available at <http://www.frc.org.uk/Our-Work/Publications.aspx>. (As part of a restructuring in July 2012, the AIU has been superseded by the Audit Quality Review team of the Financial Reporting Council's Conduct Division.)

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inspection report, the inspection staff has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection staff has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.^{6/}

2. Assertions that Characterize Criticisms as Differences in Professional Judgment

Firms' responses also sometimes characterize deficiencies in terms of professional judgment. Specifically, firms sometimes assert or imply that audit deficiencies cited by PCAOB inspectors reflect differences of professional judgment between the inspection staff and the audit firm within a range of acceptable professional judgments.

In the Board's view, these assertions too should be viewed with skepticism. For each audit deficiency included in the public portion of a report, the inspection staff has considered any suggestions by the firm that a reasonable judgment could be made that, despite the deficiency cited in the inspection report, the omitted procedures were unnecessary and that the firm had a reasonable basis for its audit opinion. For each audit deficiency included in the report, the inspection staff has rejected any such suggestion and found that the firm had failed to obtain sufficient audit evidence to support its audit opinion.

3. Assertions that the Firm Has Addressed the Criticisms in Accordance with PCAOB Standards

The Board's auditing standard AU sec. 390, *Consideration of Omitted Procedures After the Report Date*, applies, as described in AU sec. 390.04, "[w]hen the auditor concludes that an auditing procedure considered necessary at the time of the audit in the circumstances then existing was omitted" In that situation, AU sec. 390

^{6/} By emphasizing that deficiencies described in the public portion of a report relate to the inspection staff's findings about the performance of auditing procedures and not about inadequate documentation, the Board does not mean to suggest that inadequate documentation in and of itself is of little significance. Adequate documentation, in accordance with PCAOB Auditing Standard No. 3, is important, and concerns about a firm's documentation practices sometimes form the basis for quality control criticisms included in the nonpublic portion of an inspection report.

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provides that the auditor should assess the importance of the omitted procedure to the auditor's present ability to support the previously expressed opinion.^{7/}

Firms' responses to draft inspection reports sometimes assert or imply that they have taken necessary steps to address a publicly reported deficiency, without being specific about whether the firm performed procedures to obtain additional audit evidence. For instance, in response to an inspection report criticism that a firm had not obtained sufficient evidence to support an audit opinion, firms sometimes assert broadly that they have considered and complied with AU sec. 390. Such broad assertions of consideration and compliance with AU sec. 390 could mean that the firm takes the position – contrary to the inspection staff's finding – that no additional procedures were necessary beyond those the firm had performed at the time it issued its audit report. Frequently, however, in asserting that they have complied with AU sec. 390, firms do not indicate whether they performed additional procedures in response to the finding or in subsequent audits, or whether they disagreed with the finding that additional procedures were necessary.^{8/}

^{7/} AU sec. 390.04 identifies, as things that may be helpful in making that assessment, a review of working papers, discussion of the circumstances with engagement personnel and others, and re-evaluation of the overall scope of the audit. AU sec. 390.04 also notes in connection with that assessment that the results of other procedures that were applied may tend to compensate for the one omitted or make its omission less important and that subsequent audits may provide audit evidence in support of the previously expressed opinion. With respect to a deficiency cited in the public portion of a PCAOB inspection report, however, audit committees should understand that the inspection staff found that the auditor, at the time it issued its audit report, had not performed other procedures that sufficiently compensated for the deficiency.

^{8/} Whether stated or unstated in a firm's response to a draft report, if a firm takes a position contrary to the criticism described in the public portion of a report, the matter may not end there as a matter of the Board's processes. While a firm is entitled to disagree with an inspection criticism, the substance of that disagreement can influence various Board judgments, including judgments relating to the firm's quality controls, the timing or scope of the next inspection of the firm, or the possibility of a disciplinary proceeding to adjudicate the disagreement and, if determined against the firm, to impose sanctions for the failure in the inspected audit.

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II. Quality Control Criticisms

Many PCAOB inspection reports include content that, consistent with restrictions in the Act, the Board does not make public. Any criticisms of a firm's system of quality control are included in the nonpublic portion of the report. The Act restricts the Board from making those criticisms public, although the Act lifts that restriction and the Board makes the criticism public if the firm does not address the criticism to the Board's satisfaction within 12 months after the issuance of the inspection report.^{9/}

Some quality control criticisms are based on inspectors' observations of deficiencies in the performance of audit procedures. A firm's system of quality control should, among other things, provide reasonable assurance that the firm's audit work will meet professional standards. In considering how a firm's system measures up to that standard, PCAOB inspections take into account not only deficiencies described in the public portion of the report, but also other auditing deficiencies that do not cross the same significance threshold as the publicly reported deficiencies. Some deficiencies may indicate a potentially significant defect in a firm's quality control system even if the deficiency has not resulted in an insufficiently supported audit opinion.

An audit performance quality control criticism typically focuses on a specific aspect of the firm's audit work – for example, auditing management's estimates, auditing revenue recognition, using substantive analytical procedures, or procedures relating to consideration of fraud – that appears from the inspection staff's review to be in need of improvement. But a report may also include a discussion of issues that, at a more general level, affect audit performance across various aspects of the firm's audits, such as concerns about the firm's approach to supervision and review, or concerns about the sufficiency of the firm's emphasis on the application of due care and professional skepticism.

Other quality control criticisms may relate less to the performance of audit procedures and more to other aspects of the firm's management of its audit practice. Criticisms may result from the inspection staff's review of matters such as how the firm's management structure and processes, including the tone at the top, affect audit quality; how the firm's partner management practices, including evaluation, compensation, admission, and disciplinary practices, affect audit quality; how the firm considers and

^{9/} See section 104(g)(2) of the Act and PCAOB Rule 4009. Before the Board may make any such criticism public concerning a firm that has submitted evidence of its remedial action under PCAOB Rule 4009, the firm has the opportunity to seek Commission review of the Board's determination that the firm did not satisfactorily address the criticism. See section 104(h) of the Act and Rule 140 of Regulation P, 17 C.F.R. § 202.140.

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addresses risks in connection with client acceptance and retention decisions; how the firm seeks to ensure compliance with independence rules; and other matters.

The quality control remediation process – involving the firm's actions to address the criticisms to the Board's satisfaction within 12 months and thereby avoid publication of the criticisms – is central to the Board's efforts to cause firms to improve the quality of their audits. It is not unusual for an inspection report, particularly a report on one of the large, annually inspected firms, to include nonpublic criticisms of several aspects of a firm's system of quality control, and the Board takes seriously the importance of firms making sufficient progress in addressing those criticisms in the 12-month period. A firm describes its efforts to do so in a written submission, and firms often provide those submissions at or near the 12-month deadline. Considerable time and resources are devoted to evaluating the steps described in those submissions, and in some cases the Board's determination may not be made until well after the end of the firm's 12-month remediation period. Unless and until that process results in a determination that a firm has not addressed a criticism to the Board's satisfaction, there is no public notice concerning the status of the process. In addition, as described more fully in the appendix, the process could also include the firm seeking nonpublic Commission review of the Board's negative determination.

III. Audit Committee Discussions with Firms about Inspection Results

Each audit committee will judge for itself the extent to which it wishes to explore PCAOB inspection issues with its auditor.^{10/} In the Board's view, an audit firm's candid discussion of its PCAOB inspection results with an audit committee can have value for an audit committee not only in relation to the audit committee's oversight and evaluation of the audit engagement generally, but also in relation to the audit committee's role in the oversight of the company's financial reporting process.^{11/}

^{10/} Existing Commission rules, PCAOB rules and auditing standards, and a pending proposed standard, address the question of what communications an audit firm must have with an audit committee, but they do not include requirements for firms to disclose inspection information to audit committees. The Board cannot compel an audit firm to disclose nonpublic inspection information to an audit committee.

^{11/} In addition, audit committees of New York Stock Exchange listed companies must annually obtain and review a report by the auditor describing, among other things, "any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry . . . by governmental or professional authorities, within the preceding five years, respecting one or more independent audits

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An audit committee might wish to ask the audit firm to keep it informed if the company's audit is selected for review in an inspection. If the audit is selected, the audit committee might wish to ask the audit firm to keep it informed – during the course of the inspection, in addition to when the Board issues the final inspection report – about which areas of the audit are reviewed and about any concerns inspectors raise concerning the audit or the company's financial reporting.^{12/} Audit committees should also understand that the Board routinely communicates inspection information to the Commission, on an issuer-specific basis,^{13/} including information about auditing deficiencies, possible material misstatements, potential auditor independence violations, and other issues, all of which inspectors usually will have first raised with the inspected firm, and which the firm is free to discuss with the audit committee.

The Board encourages firms to communicate effectively with audit committees about inspection matters. The Act does not prohibit inspected firms from disclosing nonpublic inspection information, and the Board cautions audit committees against accepting any audit firm's assertion otherwise. The Board is aware that some firms, without purporting to be prohibited from disclosing the information, have nevertheless expressed reluctance to disclose to audit committees nonpublic portions of reports and other nonpublic inspection information, for fear of waiving any privilege that the Act might be construed to afford the firm against compelled disclosure in a different context, such as a private civil lawsuit. But the Board has also been told that some firms do provide nonpublic inspection information to audit committees.

In any event, without necessarily framing discussions in terms of an inspection or an inspection report, an audit committee might benefit from having an understanding with its audit firm through which the audit committee receives timely information (both during the conduct of the inspection and when the Board has issued a final inspection report) about –

carried out by the firm, and any steps taken to deal with any such issues" NYSE Listed Company Manual, Section 303.A.07(b)(iii).

^{12/} Usually, the audit being reviewed during an inspection will be the audit firm's most recently completed audit for that company. The audit committee would likely benefit more from learning about the inspection observations at that time than by waiting until the issuance of the final inspection report, by which time the audit in question may no longer be the most recent audit performed for the company by the firm.

^{13/} The Act's provisions restricting Board disclosure of inspection information make exceptions for Board disclosure to certain law enforcement and regulatory authorities, including the Commission. See section 105(b)(5)(B)-(C) of the Act.

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- whether anything has come to the firm's attention suggesting the possibility that an audit opinion on the company's financial statements is not sufficiently supported, or otherwise reflecting negatively on the firm's performance on the audit, and what if anything the firm has done or plans to do about it;
- whether a question has been raised about the fairness of the financial statements or the adequacy of the disclosures;
- whether a question has been raised about the auditor's independence relative to the company;
- whether any of the matters described in the public portion of an inspection report on the firm, whether or not they involve the company's audit, involve issues and audit approaches similar to those that arise or could arise in the audit of the company's financial statements;
- to the extent any such similarity exists, whether and how the firm has become comfortable that the same or similar deficiencies either did not occur in the audit of the company's financial statements or have been remedied; and
- how issues described by the Board in general reports summarizing inspection results across groups of firms relate to the firm's practices, and potentially the audit of the company's financial statements, and how the firm is addressing those issues.

An audit committee may also wish to learn from its audit firm what changes the firm has been making to its policies and procedures to address quality control issues indicated by deficiencies in the audit of the company's financial statements or to reduce the chance that types of deficiencies identified in other audits will arise in audits of the company's financial statements. An audit committee might also ask its audit firm to keep it apprised of the status of the quality control remediation process, including whether the firm made a submission to the Board responding to inspection report quality control criticisms by the 12-month deadline, and whether the Board has made a final determination, including a negative determination that has not yet become public.

To the extent that an audit committee's discussions with an audit firm on the topics suggested above encompass audit deficiencies described in the public portion of an inspection report, an audit committee may benefit from consideration of Part I of this release. For example, although not every audit firm takes this position in response to a reported deficiency, if an audit firm contends that a publicly reported audit deficiency of interest to the audit committee can be explained as an instance of the audit firm having inadequately documented its audit work, an audit committee may want to bear in mind

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that any such contention by the firm has been considered and rejected by the inspection staff. In response to such a contention, an audit committee may want to explore how, or on the basis of whose representation, the audit firm determined that the procedures were performed; why the procedures were not documented; and whether and how the procedures could have been adequately performed and reviewed without documentation necessarily being created.

Similarly, if an audit firm contends that an inspection criticism of interest to the audit committee can be explained as a difference of professional judgment, between the inspection staff and the audit firm, within a range of reasonable professional judgments, the audit committee should understand that that possibility was considered and rejected by the inspection staff. The audit committee may want to explore with the audit firm what point of professional judgment the audit firm contends is at issue, how the audit firm would defend its judgment on that point, and what the audit firm understands about why the inspection staff rejected the firm's position.

Finally, if, with respect to an inspection criticism of interest to the audit committee, an audit firm explains in broad terms that it has addressed the criticism as required under PCAOB standards and believes that its previously expressed opinion is supported, an audit committee may want to consider requesting additional details. An audit committee may want to seek clarification about whether the audit firm's position is that its opinion was sufficiently supported at the time it was originally issued (i.e., that the audit firm disagrees with the inspection report's description of a deficiency), or whether the audit firm has obtained additional audit evidence through additional auditing procedures, possibly including procedures performed in subsequent audits, that informs its position that the previously expressed opinion is supported.

Appendix PCAOB Inspections of Public Company Auditors

Under the Sarbanes-Oxley Act of 2002 ("the Act"), public accounting firms that provide audit reports for "issuers" (essentially, public companies with SEC reporting obligations^{1/}) must be registered with the PCAOB. The Act charges the PCAOB to conduct regular inspections of such firms, whether located in the U.S. or elsewhere, for the purpose of assessing compliance with certain laws, rules, and professional standards in connection with a firm's audit work for issuers.

In general, each registered firm that provides audit reports for issuers is inspected by the PCAOB either annually or triennially, depending upon whether the firm provides audit reports for more than 100 issuers (annual inspection) or for 100 or fewer issuers (triennial inspection).^{2/} At any time, the PCAOB might also inspect any other registered firm that does not issue audit reports but performs work used by another firm in the audit of an issuer.

I. The Inspection Process

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include evaluation of the firm's performance in selected audit engagements and evaluation of the design and operating effectiveness of a firm's quality control policies and procedures.

The review of a firm's work on issuer audit engagements typically focuses on the firm's engagements, and areas of those engagements, that PCAOB staff have identified

^{1/} As defined in section 2(a)(7) of the Act, the term "issuer" means an issuer (as defined in section 3 of the Securities Exchange Act of 1934), the securities of which are registered under section 12 of the Exchange Act, or that is required to file reports under section 15(d) of the Exchange 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.

^{2/} With respect to certain registered firms that are subject to the triennial inspection requirement, the Board has been denied access to the information necessary to conduct inspections because of asserted restrictions under non-U.S. law or objections based on national sovereignty. These registered firms include firms that are affiliated with large global networks and that not only provide audit reports for foreign private issuers, but also play substantial roles in audits performed by U.S. firms. Information related to these inspection obstacles is available at <http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>.

as presenting the more significant risks of financial reporting misstatements, related auditing challenges, and audit deficiencies. Risk factors include (1) the nature of the issuer or its industry, (2) audit issues likely to be encountered, (3) market capitalization of the issuer, (4) whether the issuer has significant operations in certain emerging markets, (5) considerations related to the particular audit firm, practice office, or partner, including prior inspection results, and (6) any other relevant information that has come to the Board's attention.

Generally, higher-risk portions of an audit are reviewed in an inspection. It is not the purpose of an inspection to review all of a firm's audits or to identify every respect in which a reviewed audit may be deficient. Accordingly, a PCAOB inspection report should not be understood to provide any assurance that the firm's audit work, or the relevant issuer's financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

Reviews of selected engagements include evaluation of the audit of financial statements and, where applicable, usually also include the audit of internal control over financial reporting (ICFR). For each audit selected, the inspection team considers the issuer's SEC filings, reviews the engagement team's audit documentation regarding the selected areas of the audit, and may discuss questions about the work with engagement personnel. The inspection team also analyzes potential adjustments to the issuer's financial statements that were identified during the audit but not made. For some engagements, particularly some of the engagements selected in inspections of the largest firms, the inspection team reviews written communications between the firm and the issuer's audit committee and, in some cases, may seek to interview the chairperson of the issuer's audit committee.

Evaluation of a firm's system of quality control typically includes review of policies, procedures, and practices concerning audit performance, training, compliance with independence requirements; client acceptance and retention, and the establishment of policies and procedures. Other areas reviewed may include the firm's "tone at the top" as it relates to audit quality; partner management, including evaluation, compensation, admission, and discipline; use of the work performed by foreign affiliates; and the firm's self-monitoring of its practice through the firm's internal inspections and analyses of, and responses to, identified weaknesses.^{3/}

^{3/} Reports on inspections of the largest annually inspected firms typically include a publicly available appendix providing details on the process and on some of the quality control areas covered in such inspections. See, e.g., Appendix C to each of the most recent PCAOB inspection reports on Deloitte & Touche LLP (December 7, 2011), Ernst & Young LLP (November 30, 2011), KPMG LLP (November 8, 2011), and PricewaterhouseCoopers LLP (November 8, 2011).

If, through its review of filings and audit documentation and any discussion with engagement team members, the inspection team identifies concerns on a particular audit, it provides the firm with written "comment forms" describing each concern in detail. The firm has an opportunity to respond in writing and to provide any additional information or perspective that the firm believes is relevant to assessing the audit work fairly. The process for evaluating the firm's responses may include – and with the largest firms typically does include – dialogue involving not only the firm's engagement team and the inspection team, but also senior personnel in the firm's audit practice and senior PCAOB staff. Through that dialogue, the staff seeks to ensure that the criticisms are understood and considered by firm personnel beyond the engagement teams and, to the extent the firm disagrees with the staff's position, to ensure that the staff understands the firm's stated reasons for disagreeing. Through that dialogue, the staff also seeks to understand what steps, if any, the firm has undertaken or intends to undertake to obtain audit evidence sufficient to determine whether it can support its previously expressed audit opinion.^{4/}

A similar process applies when the inspection team identifies concerns with respect to the firm's quality control policies and procedures relating to the various areas of the firm's management of its practice described above. Depending upon the nature of the issue, there may be substantial dialogue to ensure that the firm has a clear understanding of the inspection staff's concern and that the staff has a clear understanding of the information that the firm believes is relevant to the issue.

II. Inspection Reports

Informed by its consideration of the firm's responses, the inspection team prepares a preliminary draft inspection report. The inspection team's comment forms, the firm's responses, and the preliminary draft report go through multiple levels of

^{4/} The description of an audit deficiency in an inspection report means that the inspection staff found that the deficiency existed and had not been remedied at the time the firm originally issued its audit report. It does not necessarily mean, however, that the deficiency remained unaddressed by the firm at the date of the inspection report or that the financial statements were misstated. When audit deficiencies are identified after the date of an audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions. Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on previously expressed audit opinions. Inspections of most annually inspected firms typically include substantial dialogue with the firm (not just the engagement team) concerning steps to be taken by the firm regarding particular audits in which the inspection staff identified deficiencies.

internal PCAOB review and evaluation, including by inspection staff, staff in the Office of the Chief Auditor, and staff in the Office of the General Counsel. As a result of this review, the preliminary draft report may change. Criticisms that were included in comment forms might not appear in the draft report or might be articulated differently from how they were articulated in comment forms.

Following that process, the inspection staff provides the draft report to the firm. The firm then has an opportunity, but is not required, to provide a written response to the draft report. If it does so and takes issue with any criticism, the inspection staff considers whether, in light of any new information or contention in the firm's response, the report should be modified. As required by the Act, any written response that the firm submits to a draft report in accordance with the Board's rules is attached to, and made part of, the final report, except to the extent that the response is redacted to protect information reasonably identified by the firm as confidential.^{5/}

When the inspection staff has settled on a proposed final version of the report, it recommends the report to the Board for issuance. The Board considers the proposed report and the firm's response to the draft report and discusses details of the inspection and the proposed report with the staff. Before determining to issue a report, the Board might direct that the proposed report be modified or that the staff gather more information or perform additional evaluation.

When the Board is satisfied with the content, it issues a final report and transmits it to the firm. If the firm disagrees with any of the assessments contained in the final report, whether relating to audit deficiencies or quality control criticisms, the firm has the opportunity to seek nonpublic review by the Securities and Exchange Commission ("Commission").^{6/}

^{5/} Under section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those firm comments in the final report. The Board routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report. Other than on those grounds, requests for confidential treatment are rare and, pursuant to Rule 4007(b), are granted only if it is reasonable to characterize the information as confidential.

^{6/} See section 104(h) of the Act; Rule 140 of Regulation P, 17 C.F.R. § 202.140.

III. Disclosure of Reports and Information to Other Authorities

After the Board issues an inspection report, the Board promptly transmits a copy of the report to the Commission. It also transmits either a copy of the report or notice of the report's availability to the accountancy board in any U.S. state where the firm is licensed.^{7/}

The Board also transmits to the Commission certain information concerning issuers. For example, although audit-specific criticisms in inspection reports refer to the audited company only by code letter, the Board's staff identifies those companies to the Commission staff.^{8/} In addition, usually no later than – and sometimes well before – the issuance of an inspection report, the Board provides separate detailed reports to the Commission if, among other things, it appears from inspection observations that an issuer –

- may have filed with the Commission financial statements that are materially misstated,
- may have a material weakness in internal control over financial reporting that has not been disclosed by the company or its auditor,
- may be in violation of Commission rules because of the auditor's apparent failure to maintain independence,^{9/} or

^{7/} The Act requires the Board to transmit a copy of the final report to such state boards "in appropriate detail." The Board's practice is to transmit the entire report to the board in any state where the firm is licensed if that state board has provided written acknowledgment of its awareness of the statutory restrictions on disclosure of nonpublic portions of the report.

^{8/} Some have questioned the Board's practice of not publicly disclosing which issuers' financial statements are the subject of audits that are criticized in an inspection report. The Board does not believe, however, that such disclosure is an option that is consistent with the disclosure restrictions in section 105(b)(5)(A) of the Act.

^{9/} An issuer fails to comply with Commission reporting requirements if its auditor is not independent consistent with the provisions of rule 2-01 of Commission regulation S-X (17 C.F.R. § 210.2-01). PCAOB inspections sometimes identify circumstances, including circumstances that may not be known to the issuer or audit committee, indicating that the auditor is not independent under the criteria of rule 2-01.

- may otherwise have violated laws or rules administered by the Commission.^{10/}

The Act authorizes the Board to transmit nonpublic inspection information to certain domestic regulatory or law enforcement authorities, subject to the provision that those authorities "shall maintain such information as confidential and privileged."^{11/} In addition to the Commission and state accountancy boards, the Act authorizes Board disclosure of information to the Attorney General of the United States; state attorneys general in connection with any criminal investigation; federal functional regulators (as defined in the Gramm-Leach-Bliley Act) and the Director of the Federal Housing Finance Agency, with respect to an audit report for an institution subject to the jurisdiction of such regulator; and a self-regulatory organization, with respect to an audit report from a broker or dealer that is under the jurisdiction of such self-regulatory organization. Under certain conditions, the Board may also transmit to a foreign auditor oversight authority nonpublic inspection information concerning a firm that is subject to the foreign authority's oversight.^{12/}

IV. Public Disclosure

The Board issues a report on every inspection and makes a portion of the report publicly available.^{13/} If the firm has provided a timely written response to a draft of the report, the Board makes public, as part of the final report, any portion of the response that the firm chooses to have made public.

^{10/} Both the Exchange Act and PCAOB auditing standards specify steps an auditor must take upon becoming aware that an illegal act has or may have occurred. See section 10A(b) of the Exchange Act and AU sec. 317, *Illegal Acts by Clients*. PCAOB inspections sometimes identify that the firm failed to react appropriately to indications of illegal acts.

^{11/} Section 105(b)(5)(B) of the Act.

^{12/} See section 105(b)(5)(C) of the Act.

^{13/} The Board's web site provides, with respect to each registered firm, a summary page that includes the public versions of any inspection reports on the firm, as well as the firm's registration application, annual and special reports filed by the firm pursuant to PCAOB reporting rules, and any PCAOB disciplinary sanction orders relating to the firm or associated persons of the firm. A firm's summary page may be accessed by clicking on the firm's name on the list of firms at <http://pcaobus.org/Registration/Firms/Pages/RegisteredFirms.aspx>. A separate list of all PCAOB inspection reports on all registered firms is available at <http://pcaobus.org/Inspections/Reports/Pages/default.aspx>.

The Board makes that portion of the response public whether it is signed only in the firm's name or is signed in the name of an individual. In the Board's view, however, the public aspect of the inspection report process may benefit when responses submitted by firms are personally signed by the firm's chief executive or another individual with significant responsibility for the firm's issuer audit practice. This approach, taken by some registered firms, may, in the Board's view, provide helpful public confirmation that those individuals are aware of the issues in the report.

The Act requires the Board to make inspection reports available to the public "in appropriate detail."^{14/} The Act also, however, limits the Board's discretion to determine what detail may be included. The Act does so in two significant respects, discussed below.

A. Criticisms of, or Potential Defects in, the Firm's Quality Control Systems

Board inspection reports address quality control issues and may discuss criticisms of, and potential defects in, the firm's quality control systems. The Act, however, limits the public availability of those discussions. Specifically, the Act provides that no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.^{15/}

The public portion of a report, when initially issued, therefore does not include any discussion of criticisms of, or potential defects in, a firm's quality control systems. This limitation led the Board to decide, as a policy matter, that the public portion generally would also not include any other discussion of a firm's quality control systems.^{16/} The Board believes that discussing aspects of a firm's quality controls, in a context where criticisms and potential defects cannot be discussed, could create a distorted and misleading impression.^{17/}

^{14/} Section 104(g)(2) of the Act.

^{15/} See id.

^{16/} See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004) ("2004 Statement") at 5.

^{17/} For the same reason, in the event that other persons make excerpts from any nonpublic portions of a report public, the Board cautions the public to be aware of the possibility that the full report may include discussions of criticisms or potential defects that may be relevant to a full understanding of the Board's view of the firm's quality control systems. See id.

B. Other Information Prepared or Received by or Specifically for the Board

In providing for the Board to make some portion of the report public, the Act also expressly restricts the Board from making public any information that is subject to the protection of section 105(b)(5)(A) of the Act.^{18/} Section 105(b)(5)(A) provides for the confidentiality of "all documents and information prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents, in connection with an inspection under section 104" ^{19/}

Because of this restriction, the Board does not publicly disclose otherwise nonpublic information that the Board obtains in an inspection. This restriction does not prevent the Board from publicly describing, in sufficiently general terms, its inspection staff's findings about apparent failures or deficiencies in a firm's performance of audits. Because of this restriction, however, the Board does not provide details that would identify such things as any individuals involved, the audits at issue, or specific transactions to which an audit deficiency relates.^{20/}

V. The Process for Firms to Address Quality Control Criticisms

Not every Board inspection results in criticism of a firm's quality control system. If a Board inspection does identify a quality control problem of significance, Board inspectors address the matter with the firm, and the final inspection report includes a description of the problem. When that happens, section 104(g)(2) of the Act provides the firm with an incentive to correct the problem. If a firm addresses the criticism to the Board's satisfaction within 12 months, the criticism will remain nonpublic. If the firm fails to address it to the Board's satisfaction within 12 months, it is made public.

The Board seeks through constructive dialogue to encourage firms to improve their practices and procedures. Every Board inspection report that includes a quality control criticism alerts the firm to the opportunity to prevent the criticism from becoming public. The inspection report specifically encourages the firm to initiate a dialogue with the inspection staff about how the firm intends to address the criticisms. In the case of the largest, annually inspected, firms, the Board has begun a practice of articulating for firms the firm's quality control issues that are of greatest concern to the Board and encouraging the firms to provide within 60 days after the report date a written plan for remediating those issues within the 12-month period.

^{18/} See section 104(g)(2) of the Act.

^{19/} Section 105(b)(5)(A) of the Act.

^{20/} See 2004 Statement at 6.

The quality control remediation process is central to the Board's efforts to cause firms to improve the quality of their audits and thereby better protect investors. The Board's process includes a careful evaluation, after the close of that 12-month period, of a firm's efforts to address the criticisms during the 12-month period. Often, that process involves substantial dialogue with the firm throughout the 12-month period, followed by a thorough evaluation, after the 12 months, of the firm's reported improvements made during the 12 months.

If, through that evaluation, the Board finds a firm's efforts within that 12-month period to be unsatisfactory concerning any particular criticism, the Board notifies the firm of that determination. The firm then has the option of seeking Commission review of that determination through a process that, under SEC rules, is nonpublic.^{21/} If a firm does not request SEC review, or if a firm requests SEC review and the SEC does not object to the Board's determination on any particular criticism, the Board publicly discloses the portions of the original inspection report that discuss the relevant criticisms.^{22/}

In some cases, the Board's evaluation process can take considerable time, and a Board determination may not be made until well after the end of the firm's 12-month remediation period. In some circumstances, the process may include requesting, after the 12-month deadline, that the firm provide additional evidence relating to steps it reported taking during the 12-month period. Unless and until the Board makes public the portion of a report that includes a quality control criticism, however, there is no publicly available information concerning the status of the process.

It is not unusual for an inspection report to include nonpublic criticisms of several aspects of a firm's system of quality control. Any Board judgment that results in later public disclosure is a judgment about whether the firm made sufficient effort and progress to address the particular criticisms articulated in the report on that firm in the 12 months following the report date. It is not a broad judgment about the effectiveness of a firm's system of quality control compared to those of other firms, and it does not signify anything about the merits of any additional efforts a firm may have made to address the criticisms after the 12-month period. The Board does expect, however, that firms will take meaningful remedial steps promptly and that implementation of remediation will be observable in the firm's practice and not merely pro forma.

^{21/} See Rule 140 of Regulation P.

^{22/} When a firm fails satisfactorily to address a particular quality control criticism, the version of the inspection report available on the Board's web site is expanded to disclose the previously redacted criticism, and a note is added, adjacent to the link to the report, indicating that quality control criticisms are now disclosed in the public report. For a list of all such reports, see <http://pcaobus.org/Inspections/Reports/Pages/FirmsFailedToAddressQCSatisfactorily.aspx>.

VI. General Public Reports

In addition to reports on inspections of individual firms, the Board also issues general public reports on inspection-related issues from time to time. These reports do not address issues in terms of particular firms but, rather, discuss observations from the inspection program in a way intended to be informative and helpful for auditors. These reports also give investors, audit committees, and others the benefit of information and analysis concerning highlighted audit issues, or a summary and analysis of results from inspections of a specified category of firms over a particular period. Previous general reports, available at <http://pcaobus.org/Inspections/Pages/PublicReports.aspx/>, cover, among other topics, auditors' implementation of PCAOB standards relating to auditors' responsibilities with respect to fraud; first-year implementation of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; observations related to audit risk areas affected by the economic crisis; a summary report on inspections of domestic triennially inspected firms; and a summary report on inspections of domestic annually inspected firms.

VII. The Relationship Between Inspections and Other PCAOB Functions

Observations from the inspection program play an important role in informing various other PCAOB activities. The Board's Office of the Chief Auditor takes inspection results into account in considering whether to recommend that the Board amend the standards that auditors must follow in connection with issuer audits. Inspection results also inform the content of PCAOB Staff Audit Practice Alerts, which highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits. Staff audit practice alerts are available at <http://pcaobus.org/Standards/Pages/Guidance.aspx>. The Board also regularly presents forums on auditing in the small business environment, at which inspection issues are discussed in an interactive format to help auditors of small public companies benefit from the PCAOB's assessment of audit problems identified through inspections. Information about these forums, which are presented at various locations, is available at <http://pcaobus.org/Featured/Pages/SmallBusinessForums.aspx>.

In some cases, observations from Board inspections become the subject of an informal inquiry or a formal investigation by the Board's Division of Enforcement and Investigations. These inquiries and investigations can result in the institution of formal disciplinary proceedings and the imposition of disciplinary sanctions, which can include revoking a firm's PCAOB registration and barring an individual from association with a registered firm. In the case of most deficiencies identified by inspectors, however, the Board relies on its inspection dialogue, including the quality control remediation process, to encourage and facilitate improvements in auditing, rather than invoke formal disciplinary authority.