2022 Inspection Pannell Kerr Forster of Texas, P.C.

(Headquartered in Houston, Texas)

September 14, 2023

<u>THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT</u>

PORTIONS OF THE COMPLETE REPORT ARE OMITTED FROM THIS DOCUMENT IN ORDER TO COMPLY WITH SECTIONS 104(g)(2) AND 105(b)(5)(A) OF THE SARBANES-OXLEY ACT OF 2002

PCAOB RELEASE NO. 104-2023-163

PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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2022 INSPECTION

In the 2022 inspection of Pannell Kerr Forster of Texas, P.C., the Public Company Accounting Oversight Board (PCAOB) assessed the firm's compliance with laws, rules, and professional standards applicable to the audits of public companies.

We selected for review two audits of issuers. For each issuer audit selected, we reviewed a portion of the audit. We also evaluated elements of the firm's system of quality control.

2022 Inspection Approach

In selecting issuer audits for review, we use a risk-based method of selection. We make selections based on (1) our internal evaluation of audits we believe have a heightened risk of material misstatement, including those with challenging audit areas, and (2) other risk-based characteristics, including issuer and firm considerations. In certain situations, we may select all of the firm's issuer audits for review.

When we review an audit, we do not review every aspect of the audit. Rather, 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. We may also select some audit areas for review in a manner designed to incorporate unpredictability.

Our selection of audits for review does not necessarily constitute a representative sample of the firm's total population of issuer audits. Additionally, our inspection findings are specific to the particular portions of the issuer audits reviewed. They are not an assessment of all of the firm's audit work or of all of the audit procedures performed for the audits reviewed.

View the details on the scope of our inspections and our inspections procedures.

OVERVIEW OF THE 2022 INSPECTION AND HISTORICAL DATA BY INSPECTION YEAR

The following information provides an overview of our 2022 inspection as well as data from the previous inspection. We use a risk-based method to select audits for review and to identify areas on which we focus our review. Because our inspection process evolves over time, it can, and often does, focus on a different mix of audits and audit areas from inspection to inspection and firm to firm. Further, a firm's business, the applicable auditing standards, or other factors can change from the time of one inspection to the next. As a result of these variations, we caution that our inspection results are not necessarily comparable over time or among firms.

Firm Data and Audits Selected for Review

	2022	2019
Firm data		
Total issuer audit clients in which the firm was the principal auditor	6	5
Total engagement partners on issuer audit work[1]	4	3
Audits reviewed		
Total audits reviewed	2	2
Audits in which the firm was the principal auditor	2	2
Integrated audits of financial statements and internal control over financial reporting (ICFR)	1	2
Audits with Part I.A deficiencies	2	1
Percentage of audits with Part I.A deficiencies	100%	50%

If we include a deficiency in Part I.A of our report, it does not necessarily mean that the firm has not addressed the deficiency. In many cases, the firm has performed remedial actions after the deficiency was identified. Depending on the circumstances, remedial actions may include performing additional audit procedures, informing management of the issuer of the need for changes to the financial statements or reporting on ICFR or taking steps to prevent reliance on prior audit reports.

[1] The number of engagement partners on issuer audit work represents the total number of firm personnel (not necessarily limited to personnel with an ownership interest) who had primary responsibility for an issuer audit (as defined in AS 1201, *Supervision of the Audit Engagement*) during the twelve-month period preceding the outset of the inspection.

Our inspection may include a review, on a sample basis, of the adequacy of a firm's remedial actions, either with respect to previously identified deficiencies or deficiencies identified during the current inspection. If a firm does not take appropriate actions to address deficiencies, we may criticize its system of quality control or pursue a disciplinary action.

If we include a deficiency in our report — other than those deficiencies for audits with incorrect opinions on the financial statements and/or ICFR — it does not necessarily mean that the issuer's financial statements are materially misstated or that undisclosed material weaknesses in ICFR exist. It is often not possible for us to reach a conclusion on those points based on our inspection procedures and related findings because, for example, we have only the information that the auditor retained and the issuer's public disclosures. We do not have direct access to the issuer's management, underlying books and records, and other information.

Audit Areas Most Frequently Reviewed

This table reflects the audit areas we have selected most frequently for review in the 2022 inspection and the previous inspection. For the issuer audits selected for review, we selected these areas because they were generally significant to the issuer's financial statements, may have included complex issues for auditors, and/or involved complex judgments in (1) estimating and auditing the reported value of related accounts and disclosures and (2) implementing and auditing the related controls.

2022		2019	
Audit area	**Audits reviewed**	**Audit area**	**Audits reviewed**
Revenue and related accounts	2	**Revenue and related accounts**	2
Long-lived assets	1	**Long-lived assets**	2
Certain assets	1	**Debt**	1

PART I: INSPECTION OBSERVATIONS

Part I.A of our report 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 issuer's financial statements and/or 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.

Consistent with the Sarbanes-Oxley Act ("Act"), it is the Board's assessment that nothing in Part I of this report deals with a criticism of, or potential defect in, the firm's quality control system. We discuss any such criticisms or potential defects in Part II. Further, you should not infer from any Part I deficiency, or combination of deficiencies, that we identified a quality control finding in Part II. Section 104(g)(2) of the Act restricts us from publicly disclosing Part II deficiencies unless the firm does not address the criticisms or potential defects to the Board's satisfaction no later than 12 months after the issuance of this report.

Classification of Audits with Part I.A Deficiencies

Within Part I.A of this report, we classify each issuer audit in one of the categories discussed below based on the Part I.A deficiency or deficiencies identified in our review.

The purpose of this classification system is to group and present issuer audits by the number of Part I.A deficiencies we identified within the audit as well as to highlight audits with an incorrect opinion on the financial statements and/or ICFR.

Audits with an Incorrect Opinion on the Financial Statements and/or ICFR

This classification includes audits where a deficiency was identified in connection with our inspection and, as a result, an issuer's financial statements were determined to be materially misstated, and the issuer restated its financial statements. It also includes audits where a deficiency was identified in connection with our inspection and, as a result, an issuer's ICFR was determined to be ineffective, or there were additional material weaknesses that the firm did not identify, and the firm withdrew its opinion, or revised its report, on ICFR.

This classification does not include audits where, unrelated to our review, an issuer restated its financial statements and/or an issuer's ICFR was determined to be ineffective. We include any deficiencies identified in connection with our reviews of these audits in the audits with multiple deficiencies or audits with a single deficiency classification below.

Audits with Multiple Deficiencies

This classification includes audits where multiple deficiencies were identified that related to a combination of one or more financial statement accounts, disclosures, and/or important controls in an ICFR audit.

Audits with a Single Deficiency

This classification includes audits where a single deficiency was identified that related to a financial statement account or disclosure or to an important control in an ICFR audit.

PART I.A: AUDITS WITH UNSUPPORTED OPINIONS

This section of our report discusses the deficiencies identified, by specific issuer audit reviewed, in the audit work supporting the firm's opinion(s) on the issuer's financial statements and/or ICFR.

We identify each issuer by a letter (e.g., Issuer A). Each deficiency could relate to several auditing standards, but we reference the PCAOB standard that most directly relates to the requirement with which the firm did not comply.

We present issuer audits below within their respective deficiency classifications (as discussed previously). Within the classifications, we generally present the audits based on our assessment as to the relative significance of the identified deficiencies, taking into account the significance of the financial statement accounts and/or disclosures affected, and/or the nature or extent of the deficiencies.

Audits with an Incorrect Opinion on the Financial Statements and/or ICFR

None

Audits with Multiple Deficiencies

Issuer A – Real Estate

Type of audit and related areas affected

In our review, we identified deficiencies in the financial statement and ICFR audits related to **Revenue** and **Rental Properties**.

Description of the deficiencies identified

With respect to **Revenue**, for which the firm identified a fraud risk, and **Rental Properties**:

The issuer used an information-technology (IT) system that was hosted by a service organization to initiate, process, and record transactions related to (1) revenue and (2) rental properties. In its testing of controls over these accounts, the firm selected for testing various automated and IT-dependent manual controls that used data and reports generated by this IT system. The firm obtained the service auditor's report and identified for testing certain complementary user entity controls (CUECs) that the service auditor's report described as necessary. As a result of the following deficiencies in the firm's testing of the CUECs, the firm's testing of these automated and IT-dependent controls was not sufficient. (AS 2201.46)

- The firm selected for testing a control that included the periodic review of user access. The firm did not evaluate the specific review procedures that the control owners performed to determine whether access granted was, and continued to be, appropriate. (AS 2201.42, .44, and .B22)

- The firm did not identify and test any controls over change management that addressed changes to automated controls or system-generated reports. (AS 2201.39 and .B22)

- The firm did not identify and test any controls over the accuracy and completeness of the asset acquisitions recorded into this IT system. (AS 2201.39 and .B22)

The issuer also used an IT system that was hosted by a service organization to perform account reconciliations using data manually uploaded from the IT system discussed above. The firm selected for testing the automated control over these account reconciliations. As a result of the following deficiencies in the firm's testing of CUECs, the firm's testing of this automated control was not sufficient. (AS 2201.46)

- The firm did not identify and test any controls over user access that addressed newly hired and terminated employees. (AS 2201.39 and .B22)

- The firm did not identify and test any controls over change management. (AS 2201.39 and .B22)

- The firm did not identify and test any controls over the accuracy and completeness of the data uploaded into this IT system. (AS 2201.39 and .B22)

With respect to **Revenue**, for which the firm identified a fraud risk:

For revenue, which was affected by the audit deficiencies discussed above, the following additional deficiencies related to the firm's testing of controls were identified:

- The firm selected for testing a control over the review of revenue by property. The firm did not evaluate the review procedures that the control owner performed, including the procedures to identify items for follow up and the procedures to determine whether those items were appropriately resolved. (AS 2201.42 and .44) In addition, the firm did not identify and test any controls over the accuracy and completeness of certain issuer-prepared information used in the operation of this control. (AS 2201.39)

- The firm did not identify and test any controls over the recognition of the amount of straight-line rent and related revenue. (AS 2201.39)

- The firm selected for testing a control over the review of lease classifications. The firm did not identify and test any controls over the accuracy of certain issuer-prepared information used in the operation of this control. (AS 2201.39)

With respect to **Rental Properties**:

For rental properties, which were affected by the audit deficiencies discussed above, the following additional deficiencies related to the firm's testing of controls were identified:

- The firm did not identify and test any controls over the calculation of depreciation expense. (AS 2201.39)

- The firm selected for testing controls over the review of the acquisition of rental properties and the evaluation of impairment. The firm did not evaluate the review procedures that the control owners performed, including the procedures to identify items for follow up and the procedures to determine whether those items were appropriately resolved. (AS 2201.42 and .44) In addition, the firm did not identify and test any controls over the accuracy and completeness of certain issuer-prepared information used in the operation of these controls. (AS 2201.39)

During the year, the issuer acquired certain rental properties that it accounted for as asset acquisitions. The issuer allocated the purchase price in each acquisition primarily to land and buildings. The following deficiencies were identified:

- The firm did not perform substantive procedures, beyond obtaining and reading an issuer memorandum, to evaluate the appropriateness of the issuer's accounting for these transactions. (AS 2301.08)

- The firm did not perform any substantive procedures to evaluate the issuer's conclusions that these acquisitions did not result in any intangible assets. (AS 2301.08)

- The firm did not evaluate whether the method used by the issuer to allocate the purchase price and estimate the fair value for the acquired land and buildings was in conformity with the requirements of the applicable reporting framework and appropriate for the nature of the account, taking into account the firm's understanding of the issuer and its environment. (AS 2501.10)

- The firm did not evaluate the relevance and reliability of information that was used to determine the fair value of the acquired land and buildings. (AS 1105.04 and .06)

The issuer performed certain quantitative analyses to evaluate whether there were events or changes in circumstances that indicated that its rental properties' carrying values may not be recoverable. The following deficiencies were identified:

- The firm did not perform substantive procedures to test the accuracy of certain data the issuer used in these analyses. (AS 1105.10)

- The firm did not perform substantive procedures to evaluate the reasonableness of certain significant assumptions that the issuer used in these analyses, beyond comparing them to the assumptions used in the prior year analyses. (AS 2501.16)

- The firm did not perform substantive procedures to evaluate the reasonableness of certain other significant assumptions, beyond comparing certain information used in the issuer's analyses to determine these assumptions to an external source. (AS 2501.16)

Issuer B

Type of audit and related area affected

In our review, we identified deficiencies in the financial statement audit related to **Certain Assets**.

Description of the deficiencies identified

The issuer engaged an external specialist to determine the fair value of certain assets. The company's specialist used discounted cash flow models in its valuation. The following deficiencies were identified:

- The firm did not evaluate the relevance and/or reliability of certain data from sources external to the issuer that the company's specialist used to develop significant assumptions. (AS 1105.A8a)

- The firm did not perform substantive procedures to evaluate the reasonableness of significant assumptions related to the time periods that were developed by the company's specialist and used in the discounted cash flow models, beyond comparing them to certain issuer documentation that indicated shorter time periods and concluding that the shorter time periods were more conservative. (AS 1105.A8b)

- The firm did not perform any substantive procedures to evaluate the reasonableness of certain other significant assumptions developed by the company's specialist. (AS 1105.A8b)

- The firm did not perform any substantive procedures to evaluate the reasonableness of the significant assumptions developed by the issuer. (AS 2501.16)

The firm did not perform any procedures to test an estimate related to these assets, including consideration of certain contrary evidence that was included in the firm's work papers. (AS 2501.07; AS 2810.03)

To test certain other assets, the firm selected balances that exceeded a monetary threshold and then selected one item for each of the selected balances for testing. The firm did not perform procedures to test the remaining population. (AS 1105.27; AS 2301.08) In addition, the firm did not perform any substantive procedures to test an estimate related to these assets. (AS 2501.07)

Audits with a Single Deficiency

None

PART I.B: OTHER INSTANCES OF NON-COMPLIANCE WITH PCAOB STANDARDS OR RULES

This section of our report discusses certain deficiencies 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.

When we review an audit, we do not review every aspect of the audit. As a result, the areas below were not necessarily reviewed on every audit. In some cases, we assess the firm's compliance with specific PCAOB standards or rules on other audits that were not reviewed and include any instances of non-compliance below.

The deficiencies below are presented in numerical order based on the PCAOB standard or rule with which the firm did not comply. We identified the following deficiencies:

- In one audit reviewed, the firm, when testing journal entries for evidence of possible material misstatement due to fraud, did not perform procedures to determine whether the journal entry population from which it made its selections was complete. In this instance, the firm was non-compliant with AS 1105, *Audit Evidence*.

- In one of two audits reviewed, the firm's communication of certain critical audit matters in the audit report included language that was inconsistent with information in the firm's audit documentation. In this instance, the firm was non-compliant with AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*

PART I.C: INDEPENDENCE

In the 2022 inspection, we did not identify, and the firm did not bring to our attention, any instances of potential non-compliance with SEC rules or instances of non-compliance with PCAOB rules related to maintaining independence. Although this section does not include any instances of potential non-compliance that we identified or the firm brought to our attention, there may be instances of non-compliance with SEC or PCAOB rules related to independence that were not identified through our procedures or the firm's monitoring activities.

While the firm did not bring to our attention any instances of potential non-compliance, the number, large or small, of firm-identified instances of potential non-compliance may be reflective of the size of the firm, including the number of associated firms; the design and effectiveness of the firm's independence monitoring activities; and the size and/or complexity of the issuers it audits, including the number of affiliates of those issuers. Therefore, we caution against making any comparison of firm-identified instances of potential non-compliance across firms.

PART II: OBSERVATIONS RELATED TO QUALITY CONTROL

Part II of our report discusses criticisms of, and potential defects in, the firm's system of quality control.

We include deficiencies in Part II if an analysis of the inspection results, including the results of the reviews of individual audits, indicates that the firm's system of quality control does not provide reasonable assurance that firm personnel will comply with applicable professional standards and requirements. Generally, the report's description of quality control criticisms is based on observations from our inspection procedures.

This report does not reflect changes or improvements to the firm's system of quality control that the firm may have made subsequent to the period covered by our inspection. The Board does consider such changes or improvements in assessing whether the firm has satisfactorily addressed the quality control criticisms or defects no later than 12 months after the issuance of this report.

When we issue our reports, we do not make public criticisms of, and potential defects in, the firm's system of quality control, to the extent any are identified. If a firm does not address to the Board's satisfaction any criticism of, or potential defect in, the firm's system of quality control within 12 months after the issuance of our report, we will make public any such deficiency.

APPENDIX A: FIRM'S RESPONSE TO THE DRAFT INSPECTION REPORT

Pursuant to Section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the firm provided a written response to a draft of this report. Pursuant to Section 104(f) of the Act and PCAOB Rule 4007(b), the firm's response, excluding any portion granted confidential treatment, is attached hereto and made part of this final inspection report.

The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In some cases, the result may be that none of a firm's response is made publicly available.

In addition, pursuant to Section 104(f) of the Act, 15 U.S.C. § 7214(f), 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 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.

Pannell
Kerr
Forster
of Texas, P.C.

5847 San Felipe St., Suite 2600
Houston, Texas 77057-3000
Ph: (713) 860-1400
Fax: (713) 355-3909
www.PKFTexas.com

July 13, 2023

Mr. George Botic
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street NW, Suite 800
Washington, DC 20006

Re: Response to Part I of the Draft Report on the 2022 Inspection of Pannell Kerr Forster of Texas, P. C.

Dear Mr. Botic:

We are pleased to provide our response to the Public Company Accounting Oversight Board's ("PCAOB") report on the 2022 inspection of Pannell Kerr Forster of Texas, P.C. dated June 13, 2023 (the "Draft Report"). We support the PCAOB inspection process to help us identify areas where we may improve our audit performance. We believe the inspection process is a fundamental mission of the PCAOB and intend to use the process to identify areas where we should improve and enhance our audit quality.

We have evaluated each of the matters described in Part I.A and I.B of the Draft Report. In that regard, we have taken appropriate actions under both PCAOB standards and our policies, including all necessary steps to comply with AS 2901, *Consideration of Omitted Procedures After the Report Date,* and where applicable, AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

We remain committed to improving our audit performance and underlying quality control systems. We appreciate the opportunity to respond to the report and look forward to future constructive dialogue.

Sincerely,

Pannell Kerr Forster of Texas, P.C.

Pannell Kerr Forster of Texas, P.C.