PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Inspections Overview

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OBJECTIVES

At the end of this session participants will be able to:

- Discuss some of the observations from the 2021 inspections
- Understand examples of good practices for selected areas
- Understand our planned 2022 inspection procedures

2021 INSPECTION RESULTS

- In 2021, the PCAOB completed inspections of 141 audit firms and reviewed portions of 690 audits.
- For annually inspected audit firms, we identified a collective increase in the number of audits with deficiencies in 2021 compared to our 2020 inspections.
- In our triennially inspected audit firms, we noted a significant increase in deficiencies largely related to critical audit matters (CAMs).

POLLING QUESTION #1

Which audit area had the most financial statement deficiencies in 2021?

a. Revenue and Related Accounts
b. Inventory
c. Allowance for Loan Losses
d. Equity and Equity Related Transactions
e. Business Combinations

2021 COMMON DEFICIENCIES

Areas of common deficiencies in 2021 inspections:

- Internal Controls over Financial Reporting
- Revenue and Related Accounts
- Accounting Estimates
- Critical Audit Matters
- Auditor Tenure
- Independence

2021 COMMON DEFICIENCIES – INTERNAL CONTROLS OVER FINANCIAL REPORTING

- Auditors did not sufficiently evaluate whether controls with a review element selected for testing operated at a level of precision that would prevent or detect material misstatements.

- Auditors did not identify and test controls relevant to the assessed risk of material misstatement.

2021 COMMON DEFICIENCIES – REVENUE AND RELATED ACCOUNTS

- Auditors did not evaluate whether the performance obligations were satisfied to recognize revenue.

- Auditors did not sufficiently evaluate whether the allocation of the transaction price to separate performance obligations in multiple-element arrangements was based on the relative standalone selling prices.

- Auditors did not evaluate the public company's revenue recognition policy disclosures.

- Auditors did not perform any procedures to test, or in the alternative, identify and test any controls over, the company-produced information that the auditor used in its substantive testing of revenue.

2021 COMMON DEFICIENCIES – ACCOUNTING ESTIMATES

- Auditors did not evaluate the qualitative factors or evidence supporting certain assumption changes from the prior year, or lack of changes, when evaluating the reasonableness of such assumptions in determining the ALL.
- Auditors did not evaluate the reasonableness of significant assumptions used in a financial statement forecast to determine the fair value of certain acquired assets.
- Auditors did not evaluate the reasonableness of significant assumptions used when evaluating the recoverability of certain long-lived assets.

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2021 COMMON DEFICIENCIES – CRITICAL AUDIT MATTERS

- Auditor's procedures to determine CAMs did not include every matter that should have been analyzed, documentation of whether or not matters are CAMs, and the basis for those determinations;

- Auditors, when communicating a critical audit matter in their reports, did not accurately describe (1) how the CAM was addressed in the audit, or (2) the principal considerations that led the auditor to determine that the matter was a CAM.

- Auditors not accurately communicating CAMs in the auditors' report.

CRITICAL AUDIT MATTERS DEFINED

A CAM is any matter arising from the audit of the financial statements that:

- Was communicated or required to be communicated to the audit committee,
- Relates to accounts or disclosures that are material to the financial statements, and
- Involved especially challenging, subjective, or complex auditor judgment.

CAM DETERMINATION PROCESS

For each matter arising from the audit of the financial statements that:

a. was communicated or required to be communicated to the audit committee, and

b. relates to accounts or disclosures that are material to the financial statements.

The auditor must document whether or not the matter was determined to be a CAM (i.e., involved especially challenging, subjective or complex auditor judgment) and the basis for such determination.

DRAFTING CAMS

For each critical audit matter communicated in the auditor's report, the auditor must:

a. Identify the critical audit matter

b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter

c. Describe how the critical audit matter was addressed in the audit

d. Refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter

POLLING QUESTION #2

CAMs are grounded in the financial statement presentation and disclosures of the applicable financial reporting framework. Based on that criteria, which one of the following matters would **not** meet the definition of a CAM:

a. A potential illegal act disclosed by management

b. A potential loss contingency determined to be remote

c. A goodwill impairment assessment in which impairment did not exist

d. The auditor's evaluation of a company's ability to continue as a going concern

2021 COMMON DEFICIENCIES – AUDITOR TENURE

- Auditors did not report the year the auditor signed an engagement letter or began performing procedures, but rather the year the auditor signed its first auditor's report.

- Auditors did not appropriately reflect the entire relationship between the company and the auditor.

AUDITOR TENURE DETERMINED

- Auditor would look to the year when the firm signs an initial engagement letter to audit a company's financial statements, or

- When the firm begins performing audit procedures, whichever is earlier.

POLLING QUESTION #3

True or False?

If a company went public and maintained the same auditor, auditor tenure would **not** include the years the auditor served as the company's auditor **before** the company became subject to SEC reporting requirements.

a. True
b. False

SOURCES FOR DETERMINATION

- Auditor's own records, the company's records, or publicly available information (i.e., current and periodic reports on EDGAR); or

- Absent other evidence:

  - The year the auditor first issued an audit report on the company's financial statements or, if earlier;

  - Auditor's estimate of when work would have commenced to enable the issuance of such report.

OTHER CIRCUMSTANCES

- Tenure is calculated taking into account firm or company mergers, acquisitions, or changes in ownership structure:
  - Company acquires another company: The acquirer's current auditor continues serving as the combined company's auditor, auditor tenure would continue;
  - Acquired company's auditor is selected to serve as the combined company's auditor: Auditor tenure would begin at that time.

ADDITIONAL REPORTING CONSIDERATIONS

- Auditors have discretion to provide additional information in the auditor's report about tenure if the information would provide context or otherwise assist the reader's understanding of the relationship between the auditor and the company.

- Auditors may use other language to express uncertainty regarding when tenure began, as long as the statement effectively communicates the first year the firm knows that it served as the company's auditor and that it is uncertain of the specific year when tenure began.

- The explanatory language should not state or imply that the auditor did not make a tenure determination.

OBSERVATIONS RELATED TO QUALITY CONTROL - INDEPENDENCE

- Identified instances where audit committee approval was not obtained for certain audit-related services, non-audit services, or tax services prior to the auditor being engaged to perform such services.

- Certain inspected audit firms continue to report a high rate of noncompliance by audit firm personnel reporting their financial relationships into the audit firms' monitoring systems.

- Observed deficiencies related to PCAOB Rule 3524, *Audit Committee Preapproval of Certain Tax Services*, and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence.*

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GOOD PRACTICES

- We identified a number of good practices in our 2021 inspections that may influence overall audit quality

- A good practice could be a procedure, technique, or methodology that is appropriately comprehensive and suitably designed in relation to an audit firm's size, and the nature and complexity of the audit firm's practice that may contribute to the quality of audit services

GOOD PRACTICES – CRITICAL AUDIT MATTERS

- Some auditors developed tools to track every matter communicated or required to be communicated to the audit committee.

- When communicating a CAM in their audit report, some auditors involved others outside the engagement team.

GOOD PRACTICES – INDEPENDENCE

- Certain audit firms have increased the frequency for personnel to provide independence compliance representations to a quarterly or semi-annual basis.

- An audit firm also employed an improved process that walks professionals through their financial holdings.

- Audit firms have put in place policies and procedures providing for sanctions for personal independence violations.

2022 INSPECTIONS

- Many of our inspection plans for this year are presented in our ***Staff Overview for Planned 2022 Inspections.***

- Also in August, we released an ***Audit Committee Resource*** guide for **audit committees**, which may be useful for audit committees to shape informative conversations with their auditors.

INSPECTION PLAN HIGHLIGHTS

We focused on anticipated financial reporting and audit risks that were primarily driven by the recent economic environment:

- Increased initial public offerings (IPOs) and merger and acquisition (M&A) activities, including transactions with special purpose acquisition companies (SPACs)
- Widespread disruption in supply chains
- Continued negative effects of the COVID-19 pandemic, especially in high-risk industries

INSPECTION PLAN HIGHLIGHTS (CONT'D)

- Increased volatility in financial and commodity markets due to fluctuations in interest rates and inflationary trends

- Audit firm-wide risks, such as the heightened degree of staff turnover and risks arising from auditing in a remote environment, including the risk that auditors will not identify misstatements that could be material.

POLLING QUESTION #4

What auditing and accounting risks do you think our inspectors are focusing on in 2022?

a. Unreasonable assumptions affecting the timing and amount of revenue recognition.

b. Unreasonable assumptions used in projections.

c. Earnings manipulation.

d. Complexities regarding existence and valuation of inventory.

e. Financial, economic, and business uncertainty that impacts the required assessment to evaluate threats and uncertainties.

f. All of the above

2022 AREA OF INSPECTION FOCUS

As part of our inspections, we continue to:

- Perform procedures related to the auditor’s risk assessment;
- Maintain a focus on how the auditor evaluated internal controls addressing the completeness and accuracy of financial statement disclosures; and
- Review whether there was proper identification, assessment, and testing of internal controls, especially those controls that changed because of the current environment.

OTHER AREAS OF INSPECTION

We also focused on other areas when conducting our inspections including the following:

- Compliance with auditor independence requirements
- Determination and communication of critical audit matters
- Audit areas with continued deficiencies
- Compliance with existing QC standards
- Auditing of digital assets
- Responding to cyber threats
- Use of data and technology in the audit

KEY REMINDERS

- First, auditors need to exercise professional skepticism in evaluating the reasonableness of management's representations, estimates and forecasts, due to the uncertainty and volatility of the economic environment.

- Second, auditors should consider whether the remote or hybrid working environments at public companies creates new or increased risks of material misstatement, including any fraud risks.

- Third, auditors should remain alert to changes in the public company's or the auditor's circumstances which may give rise to situations that could impair auditor independence.

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QUESTIONS