

PCAOB Inspections Overview and Illustrative Examples: Issuers

Jack Griffith and Vic Rodriguez
Division of Registration and Inspections
June 5, 2024

DISCLAIMER

The views we express are in our official capacity as members of DRI but are our own and do not necessarily reflect the views of the Board, Board Members, or other members of the staff.

This slide intentionally left blank

OBJECTIVES

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

- Discuss some of the observations from the 2023 inspections
- Understand audit requirements, deficiency examples, and good practices for selected areas
- Understand our planned 2024 inspection procedures

2023 INSPECTIONS

- In 2023, the PCAOB completed inspections of 227 audit firms and reviewed portions of 795 public company audits.
- Audit deficiencies continued to increase in 2023. The trend is concerning because in nearly all categories the percentage of audit engagements reviewed that are expected to be included in Part I.A of an inspection report has increased for the third consecutive year.
- Noncompliance with PCAOB standards and rules increased in 2023, especially related to audit committee communications and fraud considerations. These observations are included in Part I.B of our inspection reports.

This slide intentionally left blank

2023 AREAS OF COMMON DEFICIENCIES

- **Internal Controls over Financial Reporting**
 - Risk Assessment
 - Selecting Controls to Test,
 - Testing Design Effectiveness
 - Testing Management Review Control
- **Financial Statement Areas**
 - Revenue and Related Accounts,
 - Inventory,
 - Accounts Impacted by Business Combinations, and
 - Investment Securities

2023 AREAS OF COMMON DEFICIENCIES

- **Other PCAOB Standards and Rules**
 - Fraud
 - CAMS
 - Auditor Tenure
 - Audit Committee Communications
 - Form AP
- **Quality Control Systems**
 - Independence
 - Engagement Quality Review (EQR)
 - Monitoring

This slide intentionally left blank

2024 INSPECTIONS

- We are continually improving our inspection program, using a data-driven and risk-based approach, with a focus on riskier engagements and certain audit areas
- Enhancements to our inspection program include:
 - Increasing the number of engagements reviewed
 - Expanding inspection procedures
 - Increasing focus on a firm's culture
 - Improving the timeliness of inspection reports
- For more information, please see Staff Priorities for 2024 Inspections and Interactions with Audit Committees



KEY REMINDERS - REMEDIATION

- Repeated or persistent criticisms require a new or enhanced response
- How the PCAOB considers subsequent inspection results
- How the PCAOB evaluates the design of new or revised guidance, tools, or policies from firms
- What the PCAOB considers when evaluating the design of training programs
- The PCAOB's expectations on the timing of remediation design and implementation
- The value of ongoing dialogue
- The importance of root cause analysis

SELECTED AREAS FOR ILLUSTRATIVE EXAMPLES

Areas selected for illustrative examples:

- Revenue and Related Accounts
- Fraud, including Journal Entry Testing
- Critical Audit Matters

This slide intentionally left blank

REVENUE PROCEDURES REQUIREMENTS - AS 2301, *THE AUDITOR'S RESPONSES TO THE RISKS OF MATERIAL MISSTATEMENT*

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

- Obtain **more persuasive** audit evidence the **higher** the auditor's assessment of **risk**
- Take into account the types of potential misstatements that could result from the identified risks and the **likelihood and magnitude of potential misstatement**

REVENUE PROCEDURES REQUIREMENTS - AS 2301, *THE AUDITOR'S RESPONSES TO THE RISKS OF MATERIAL MISSTATEMENT (CONT'D)*

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

- In an integrated audit, **design the testing of controls to accomplish the objectives of both audits simultaneously:**
 - To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements; and
 - To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end.

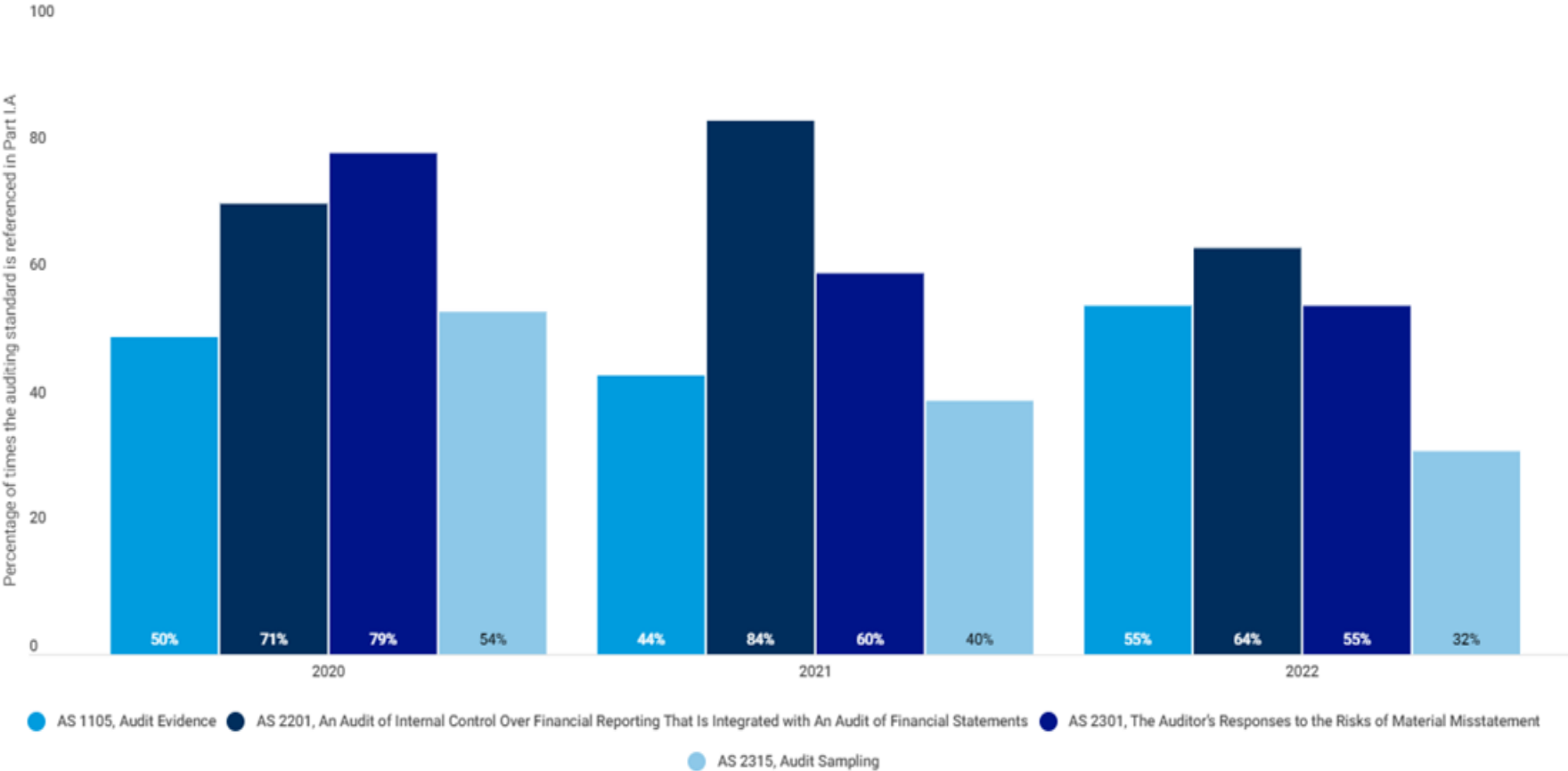
This slide intentionally left blank

REVENUE PROCEDURES REQUIREMENTS - AS 2401, *CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT*

If there is an **identified fraud risk** that involves **improper revenue recognition**, the auditor also may want to **consider**:

- Disaggregated substantive analytical procedures
- Confirmation of contract terms with customers
- Inquiries of sales and marketing personnel regarding period-end sales
- Observation of period-end shipments
- Tests of controls over revenue transactions

REVENUE PROCEDURES REQUIREMENTS

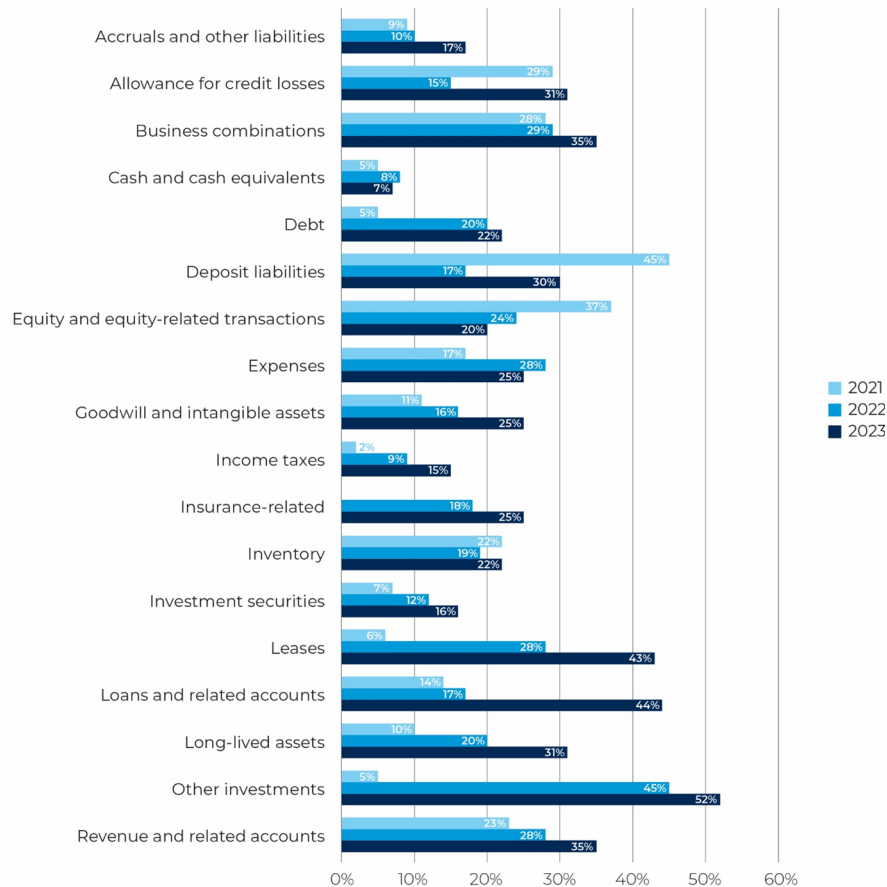


This graph reflects the auditing standards most frequently referenced in Part I.A by audit area for each inspection year.

REVENUE DEFICIENCIES

Revenue continues to be the most common financial statement area with deficiencies identified in 2023

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



EXAMPLES OF DEFICIENCIES

Example 1

- **Commission Revenue:** The engagement team did not perform any procedures to test the contractual arrangements to determine if revenue was recorded appropriately in accordance with FASB ASC Topic 606.
- **Subscription Revenue:** The engagement team did not perform any procedures to test whether the Issuer's performance obligation had been satisfied before revenue was recognized beyond obtaining contracts or purchase order for certain transactions, internally generated invoices, and customer payment support.
- **Disclosures:** The engagement team did not identify and evaluate the Issuer's omission of required disclosures related to (1) the methods used to recognize revenue and an explanation of why the methods used provide a faithful depiction of the transfer of goods or services, and (2) the allocation of the transaction price for contractual arrangements with multiple performance obligations.

EXAMPLES OF DEFICIENCIES (CONT'D)

Example 2

- The engagement team did not perform procedures to evaluate the relevance and reliability of the reports from external sources and test the accuracy and completeness of the Issuer-produced reports used in the testing of revenue.

EXAMPLES OF DEFICIENCIES (CONT'D)

Example 3

- The engagement team did not perform any substantive procedures to evaluate the reasonableness of the significant assumption related to estimated total project costs to be incurred that the Issuer used to determine amounts recognized as revenue.

This slide intentionally left blank

GOOD PRACTICES

- Disaggregated risk assessment at the revenue stream level, assertion level, or account level. For example, assignment of likely sources of potential misstatements to elements of an estimate or calculation
- Development of tailored risks by appropriately considering varying risks for different components, portfolios, locations, and revenue streams.
- Walkthrough documentation that is robust, including clear, easily understood description(s) of the likely sources of misstatement identified and the linkage to the control tested or audit response

GOOD PRACTICES (CONT'D)

- Firm risk assessment templates that help engagement teams better capture and clearly document linkage between likely sources of potential misstatements and the controls to be tested, including for data and data in reports used as evidence (sometimes referred to as “Information Provided by the Company” or “IPC”).
- Firm templates for testing estimates, such as a template that maps individual assumptions/inputs and related risks to control and substantive testing approach.
- Firm templates for testing controls with a review element.

This slide intentionally left blank

FRAUD PROCEDURES REQUIREMENTS

The auditor has a responsibility to **plan and perform** the audit to obtain **reasonable assurance** that the financial statements are **free of material misstatement**, whether **caused by error or fraud**.

- AS 2401, *Consideration of Fraud in a Financial Statement Audit*
- Paragraphs .14 and .15 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*
- Paragraphs .52 through .85 of AS 2110, *The Auditor's Responses to the Risks of Material Misstatement*

FRAUD PROCEDURES REQUIREMENTS (CONT'D)

- Identify fraud risk factors
 - Fraud risk factors are **events or conditions indicating**:
 - **Incentive or pressure** to perpetrate fraud
 - **Opportunity** to carry out the fraud
 - An **attitude or rationalization** that justify the fraudulent action
- Assess fraud risk factors
- Inquire
- Perform analytical procedures
- Respond to assessed fraud risk factors
- Communicate where applicable
- Document

This slide intentionally left blank

FRAUD PROCEDURES REQUIREMENTS (CONT'D)

Audit procedures performed to specifically address the risk of management override of controls (AS 2401.57 through .67A)

- Examine **journal entries and other adjustments** for evidence of possible material misstatement due to fraud
- Review **accounting estimates for biases** that could result in material misstatement due to fraud
- Evaluate whether the **business purpose for significant unusual transactions** indicates that the transactions may have been entered into to engage fraud

JOURNAL ENTRY TESTING REQUIREMENTS

Examine journal entries and other adjustments for evidence of possible material misstatement due to fraud:

- Obtain an **understanding** of the entity's **financial reporting process and the controls** over journal entries and other adjustments
- **Identify and select** journal entries and other adjustments **for testing**
- Determine the **timing of the testing**
- **Inquire** of individuals involved in the financial reporting process about **inappropriate or unusual activity** relating to the **processing** of journal entries and other adjustments

This slide intentionally left blank

EXAMPLES OF DEFICIENCIES – JOURNAL ENTRIES

Example 1

- The engagement team did not sufficiently support its fraud risk criteria used for identification and selection of journal entries for testing because the engagement team did not evidence an appropriate rationale for how certain factors in AS 2401 resulted in the identification of its fraud risk criteria

EXAMPLES OF DEFICIENCIES – JOURNAL ENTRIES (CONT'D)

Example 2

- The engagement team inappropriately excluded the journal entries from testing that met its identified fraud risk criteria without having an appropriate rationale for limiting its testing to those journal entries

EXAMPLES OF DEFICIENCIES – JOURNAL ENTRIES (CONT'D)

Example 3

- The engagement team did not obtain and review the supporting documentation and approvals for journal entries identified by its fraud risk criteria

This slide intentionally left blank

GOOD PRACTICES

- Training for all partners and professional staff on AS 2401, including journal entry testing
- Use of journal entry testing template that includes specific procedures for testing the journal entry population
- Pre-issuance review program with a focus on journal entry testing

Scenario

- During the firm's risk assessment procedures, the firm identified the following significant risks, including fraud risks: (1) management override of controls; (2) improper revenue recognition due to fraud; and (3) lack of proper segregation of duties for payroll
- The firm held a planning meeting with the audit committee on November 19, 2022, in which it discussed prior year findings and recommendations, significant risks identified, and an overview of the audit strategy and timing of the audit

continued on next slide

CASE STUDY (CONT'D)

Scenario (*continued*)

- The firm conducted interviews related to fraud risks with certain management and non-management employees
- The firm issued its audit report on February 26, 2023, and discussed the results of the audit in a meeting with the audit committee and management on March 12, 2023

Question

- Has the firm satisfied its obligations with respect to communications with the audit committee related to fraud risks?

CRITICAL AUDIT MATTERS DEFINED

AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, defines a CAM as 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.

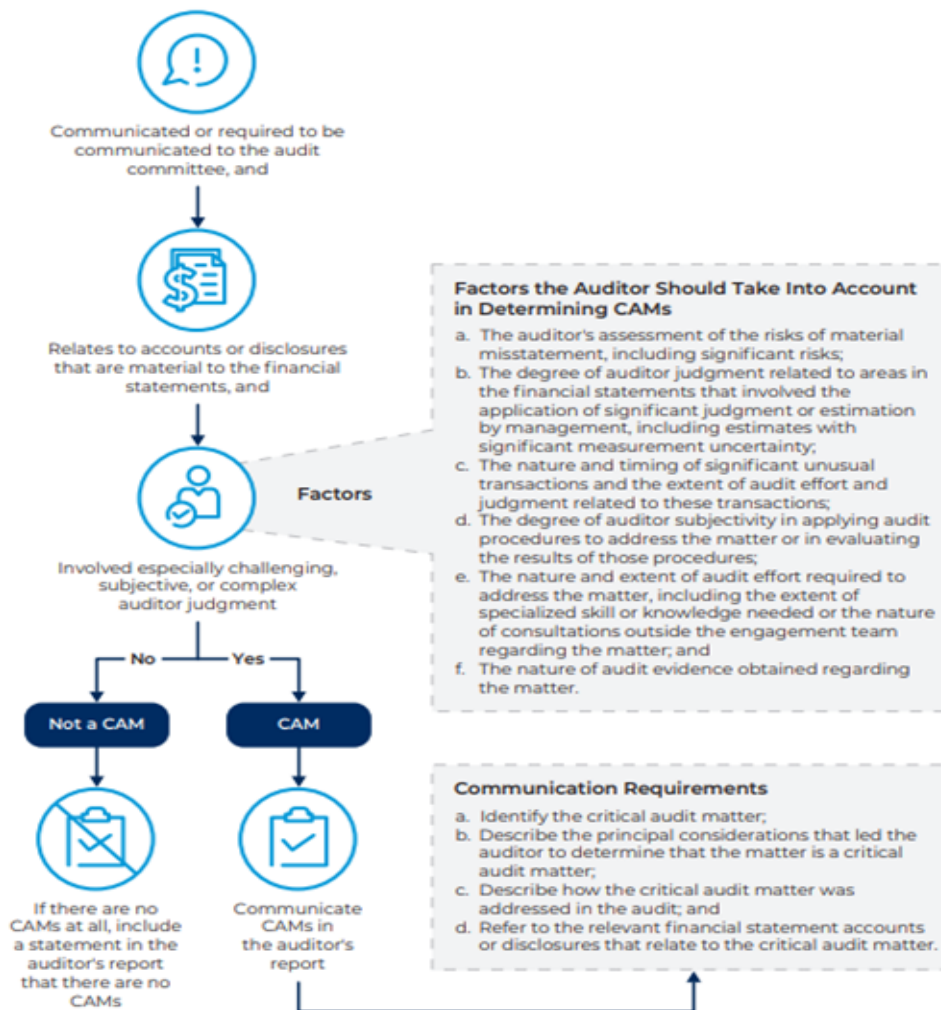
CAM DETERMINATION PROCESS

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

CAM DETERMINATION PROCESS (CONT'D)

Determining and Communicating Critical Audit Matters (CAMs)



This slide intentionally left blank

EXAMPLES OF DEFICIENCIES

Example 1

- The engagement team did not perform any procedures to determine whether matters, which were communicated to the audit committee and which related to accounts or disclosures that were material to the financial statements, were critical audit matters.

EXAMPLES OF DEFICIENCIES (CONT'D)

Example 2

- The engagement team did not accurately describe how the CAM was addressed in its audit, because the description in the audit report described audit procedures that were not in fact performed in the audit.

EXAMPLES OF DEFICIENCIES (CONT'D)

Example 3

- The engagement team did not describe in its auditor's report the principal considerations that led the auditor to determine that the matter was a CAM.

GOOD PRACTICES

- Use of templates to assist with the evaluation of all matters communicated to the audit committee and consideration of the factors outlined in AS 3101.12
- Involvement of others outside the engagement team for review of CAMs in the auditor's report

This slide intentionally left blank

QUESTIONS

