PCAOB
Public Company Accounting Oversight Board

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Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards (No. 8 through No.15)

PCAOB Release No. 2015-007
October 15, 2015

PCAOB
Public Company Accounting Oversight Board

Executive Summary

Public Company Accounting Oversight Board ("PCAOB" or "Board") Auditing Standards ("AS") No. 8 through No. 15 ("Risk Assessment Standards") are designed to address the auditor's assessment of audit risk, responses to the risks of material misstatement, and evaluation of the results of procedures performed in an audit. The Risk Assessment Standards became effective for audits for fiscal years beginning on or after December 15, 2010. The procedures required by these standards underlie the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. For that reason, non-compliance with these standards can have serious implications for the audit of internal control over financial reporting ("ICFR") or the audit of the financial statements and may affect whether the auditor performs enough work to support the auditor's opinion.

This report provides information regarding the implementation of, and compliance with, the Risk Assessment Standards that was observed during the 2012-2014 PCAOB inspections of registered public accounting firms ("firms" or "registered firms") and reflects the Board's concern about the number and significance of deficiencies related to the Risk Assessment Standards.

Overview of Findings

The 2012 and 2013 inspections are complete, and virtually all reports have been issued. Based on a review in 2012 of the implementation by firms of the Risk Assessment Standards, the Board's Inspections staff found that firms generally made appropriate adjustments to their audit methodologies to implement the new standards. The staff also found, however, that in 26 and 27 percent of audits inspected for compliance with the Risk Assessment Standards in 2012 and 2013, respectively, the firms had not complied with one or more of those standards ("Risk Assessment Deficiency" or "Risk Assessment Deficiencies") and the Risk Assessment Deficiencies were a significant element of an observation that the audit opinion was not supported when it was issued ("Part I Finding").

The most frequently identified Risk Assessment Deficiencies related to AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, AS No. 14, *Evaluating Audit Results*, and AS No. 15, *Audit Evidence*.

The 2014 inspection fieldwork is complete and preliminary evaluation of the results shows that the number of audit deficiencies related to the Risk Assessment Standards remains high. While audit deficiencies related to AS No. 13 decreased at certain firms during 2014 as compared to 2013, Inspections staff continued to have similar concerns as in prior years about these firms' compliance with AS No. 14 and AS No. 15.

Examples of common Part I Findings identified by Inspections staff included:

- Firms did not perform substantive procedures, including tests of details, that were specifically responsive to fraud risks and other significant risks that were identified. (AS No. 13)

- Firms did not perform sufficient testing of the design and operating effectiveness of controls to support their planned level of control reliance, including testing controls over the system-generated data and reports that were used to support important controls or substantive procedures performed in response to the assessed risks of material misstatement. (AS No. 13 and AS No. 15)

- Firms did not evaluate the accuracy and completeness of financial statement disclosures. (AS No. 14)

- Firms did not take into account relevant audit evidence that appeared to contradict certain assertions in the financial statements. (AS No. 14)

In addition to the Part I Findings discussed above, Inspections staff reported other common Risk Assessment Deficiencies during 2013 and 2012 that did not rise to the level of a Part I Finding but nevertheless constituted a departure from the requirements of the Risk Assessment Standards and indicated a potential defect in firms' systems of quality control. These quality control criticisms, which were included in Part II of the relevant firms' inspection reports, included concerns related to supervision of the audit, identification and assessment of the risks of material misstatement, and audit responses to the risk of management override of controls.

Focus on Improving Audit Quality

All registered firms should review this report and consider whether the types of Risk Assessment Deficiencies observed by the Board could manifest themselves in their practices. Firms also should analyze their internal and external inspection results to determine whether other types of audit deficiencies are the result of non-compliance with the Risk Assessment Standards. Detailed and comprehensive root cause analyses should be performed by firms for the deficiencies identified in this report, if applicable, and appropriate corrective action should be taken. Monitoring the effectiveness of corrective actions taken to address deficiencies in the application of these standards should also be incorporated into firms' systems of quality control in an effort to sustain improved audit quality.

In response to the deficiencies identified by Inspections staff, firms have taken various remedial actions, including enhancing their quality control policies and procedures, changing their audit guidance and processes, developing and requiring training targeted to specific issues, developing new audit tools, and requiring additional audit procedures to provide reasonable assurance of compliance with PCAOB standards. Inspections staff has observed promising improvements, including better application of the Risk Assessment Standards at firms that had responded to previously identified deficiencies with meaningful, carefully considered actions to address underlying issues.

Firms need to continue to evaluate whether their audit guidance and related tools are sufficient to provide reasonable assurance of compliance with these standards. Based on the continuing deficiencies in compliance with these standards and the overall importance to the audit of robust risk assessments, firms should make improvements in their risk assessment processes a significant priority.

This report may be useful to audit committees in fulfilling their oversight responsibilities, including by helping to prepare them for meaningful discussions with their auditors about the auditor's assessment of risks and the responses thereto. This report offers some suggested questions that may be helpful for audit committees to consider in preparing for discussions with their auditors about the application of the Risk Assessment Standards.

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INSPECTION OBSERVATIONS RELATED TO AUDITING STANDARDS NO. 8 THROUGH NO. 15

PCAOB Release No. 2015-007

October 15, 2015

I. Background

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is issuing this report to provide information regarding firms' compliance with Auditing Standards ("AS") No. 8 through No. 15 ("Risk Assessment Standards"), based on the PCAOB's 2013, and preliminary 2014 inspection results relating to domestic and non-U.S. registered firms ("firms" or "registered firms"). It also provides information regarding firms' implementation of, and compliance with, the Risk Assessment Standards based on the 2012 inspections. The 2012 inspections included reviews of the first audits for which firms were required to implement the Risk Assessment Standards. These Standards became effective for audits for fiscal years beginning on or after December 15, 2010.

Based on the results of inspections of firms from 2012 to 2014, the Board is concerned about the number and significance of deficiencies related to the Risk Assessment Standards. Recurring audit deficiencies related to these standards suggest that audit quality challenges remain and that more should be done to improve the quality of audits.

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. The eight Risk Assessment Standards were adopted to establish audit requirements to enhance the effectiveness of the auditor's assessment of and response to the risks of material misstatement in an audit. Proper application of these standards is important for performing effective audits of internal control and audits of financial statements.

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The Risk Assessment Standards include the following:

PCAOB Auditing Standard	Objective of the Auditing Standard
Auditing Standard No. 8, *Audit Risk*	Conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level
Auditing Standard No. 9, *Audit Planning*	Plan the audit so that the audit is conducted effectively
Auditing Standard No. 10, *Supervision of the Audit Engagement*	Supervise the audit engagement, including supervising the work of engagement team members, so that the work is performed as directed and supports the conclusions reached
Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*	Apply the concept of materiality appropriately in planning and performing audit procedures
Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*	Identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement
Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*	Address the risks of material misstatement through appropriate overall audit responses and audit procedures
Auditing Standard No. 14, *Evaluating Audit Results*	Evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report
Auditing Standard No. 15, *Audit Evidence*	Plan and perform audit procedures to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report

This report describes the most common deficiencies identified between 2012 and 2014 in audits where the Risk Assessment Standards were applicable and the deficiencies in the application of these standards were considered to be a primary driver of the concerns related to the auditors' procedures. This report also includes information on the potential root causes of the deficiencies.

II. Preliminary 2014 Inspection Observations

In 2014, PCAOB Inspections staff ("Inspections staff") inspected 789 audits and the Risk Assessment Standards were applicable in 780 of those audits based on the effective date of the Risk Assessment Standards. The results of those inspections, while not yet fully and finally quantified, include a high number of audit deficiencies related to the Risk Assessment Standards.

The most frequently identified audit deficiencies where the Risk Assessment Standards were applicable relate to AS No. 13, AS No. 14, and AS No. 15. Inspections staff identified deficiencies in firms' execution of processes for responding to assessed risks, evaluating audit results, and obtaining sufficient appropriate audit evidence to support the audit opinion. Audit deficiencies related to AS No. 13 decreased at certain firms during 2014 as compared to 2013; however, Inspections staff continued to have similar concerns as in prior years with these firms' compliance with AS No. 14 and AS No. 15.

Inspections staff has observed that some firms have made changes to their audit guidance in response to deficiencies identified through inspections. While some firms may currently use audit guidance that complies with the Risk Assessment Standards, due to significant recurring findings related to the application of these standards, it appears that firms need to continue to evaluate whether their audit methodologies and related tools are appropriately designed to assist engagement teams in performing risk assessments in accordance with PCAOB standards. In addition, policies and procedures should be established to provide firms with reasonable assurance that the work performed by engagement personnel complies with the Risk Assessment Standards.

Developing, implementing, and executing effective remedial actions require a firm's careful thought and attention. Certain remedial actions may address a particular deficiency or defect, but they may not address the underlying causes of the audit deficiencies and more systemic quality control deficiencies. Therefore, particularly with respect to findings that recur year after year, it is important for audit firms to take steps to gain an understanding of the causes that underlie these recurring deficiencies and then take appropriate remedial actions.

III. Observations from 2013 and 2012 Board Inspections

In 227 (or 27 percent) of the 848 audits inspected in 2013 and 165 (or 26 percent) of the 632 audits inspected in 2012 by Inspections staff against the Risk Assessment Standards, Inspections staff found audit deficiencies related to one or more of those standards ("Risk Assessment Deficiency" or "Risk Assessment Deficiencies") that contributed in a significant respect to a Part I Finding.

Each Part I Finding in a PCAOB inspection report could relate to several provisions of the standards that govern the conduct of audits. The standards cited in PCAOB inspection reports for each finding are those that most directly relate to the finding. Findings may also relate to other paragraphs of the cited standards or to other auditing standards.

Risk Assessment Deficiencies spanned a wide variety of issuers and firms and most frequently related to AS No. 13, AS No. 14, and AS No. 15. Inspections staff identified deficiencies in firms' execution of processes for responding to assessed risks, evaluating audit results, and obtaining sufficient appropriate audit evidence to support the audit opinion.

Observations of Common Part I Findings Related to Risk Assessment Deficiencies

In a firm inspection report, a Part I Finding is an auditing deficiency identified by Inspections staff that is of such significance that it appeared to the Inspections staff that a firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support (1) its opinion that the financial statements were presented fairly, in all material respects, in accordance with the applicable financial reporting framework and/or (2) its opinion about whether the issuer had maintained, in all material respects, effective internal control over financial reporting ("ICFR"). In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement and/or the issuer maintained effective ICFR.[1]

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[1] The fact that one or more deficiencies in an audit reach this level of significance does not necessarily indicate that the financial statements are misstated or that there are unidentified material weaknesses in ICFR.

As discussed in more detail below, the Risk Assessment Standards were intended to improve the auditing standards and to benefit investors by establishing requirements that enhance the effectiveness of auditors' assessment of and response to risk through: (1) performing procedures that provide a reasonable basis for identifying and assessing risks of material misstatement, whether due to error or fraud, (2) tailoring the audit to respond appropriately to the risks of material misstatement, and (3) making a comprehensive evaluation of the evidence obtained during the audit to form the opinion(s) in the auditor's report. Improper application of the Risk Assessment Standards may result in audit deficiencies that rise to the level of Part I Findings and affect the reliability of the auditor's opinion and the quality of the audit. This report provides additional detail below regarding common Risk Assessment Deficiencies that were considered a primary driver of the concerns with the auditor's procedures identified in Part I Findings.

AS No. 13, The Auditor's Responses to the Risks of Material Misstatement

This standard establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.[2] To meet the objectives set forth in this standard, the audit responses must address the risks of material misstatement that are identified and assessed in accordance with AS No. 12.[3] An auditor should design and perform audit procedures in a manner that addresses the assessed risk of material misstatement for each relevant assertion of each significant account and disclosure.[4] In the audit of the financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks.[5] If the auditor selects certain controls intended to address the assessed fraud risks for testing, the auditor should perform tests of those controls.[6]

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2 See paragraph 1 of AS No. 13.

3 See paragraph 3 of AS No. 13.

4 See paragraph 8 of AS No. 13.

5 See paragraph 13 of AS No. 13.

6 See paragraph 13 of AS No. 13.

Inspections staff identified that the Part I Findings resulting from a lack of compliance with AS No. 13 in 2013 and 2012 predominantly occurred in connection with the auditing of revenue, where risk of fraud is presumed, followed by inventory. Further, Inspections staff identified deficiencies arising from non-compliance with AS No. 13 in both the testing of controls, as well as substantive procedures.

A. Testing Controls in an Audit of Financial Statements[7]

AS No. 13 establishes requirements regarding testing and evaluating controls in an audit of financial statements. AS No. 13 requires that, if the auditor plans to assess control risk at less than the maximum by relying on controls, and the nature, timing, and extent of planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.[8]

In 2012 and 2013, Inspections staff observed a significant number of Part I Findings in controls testing. Auditors often rely on controls to reduce their substantive testing of financial statement accounts and disclosures. Thus, deficiencies in testing and evaluating internal control can lead to inadequate testing of accounts and disclosures in the financial statement audit. The Part I Findings in both 2013 and 2012 inspections related to AS No. 13 often included instances in which auditors did not obtain the evidence necessary to support the auditor's control reliance approach.

Examples in which firms did not effectively respond to the risk of material misstatement when testing controls include:

- A firm did not perform sufficient procedures to test the occurrence and allocation of revenue and the existence of accounts receivable because it designed its substantive procedures based on a level of control reliance that was not supported due to insufficient procedures performed to test the issuer's controls. Specifically, the sample sizes used by the firm were too small given that the level of reliance on the issuer's controls was not supported.

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7 See paragraphs 16 to 34 of AS No. 13.

8 See paragraph 16 of AS No. 13.

- One issuer used inventory cycle counting procedures to assist in the determination of physical inventory on hand. The issuer's cycle counting procedures included the use of certain parameters within its automated inventory system to determine the inventory items and frequency in which counts should be performed. While the firm planned to rely upon the issuer's controls over the inventory cycle counting process to reduce its substantive tests of details at year end, it did not perform sufficient procedures to test those controls. Specifically, the firm did not design and perform procedures to test whether the automated inventory system had identified the inventory subject to the cycle count procedures in accordance with the issuer's cycle counting policies. As a result, the firm was unable to support its control reliance approach and did not perform sufficient substantive procedures to test the existence of inventory.

- A firm designed its substantive procedures to test certain assets, including determining sample sizes, based on a level of control reliance that was not supported due to insufficient procedures performed to test the issuer's internal controls. As a result, the firm's sample sizes were too small to provide sufficient evidence for the valuation and existence of these assets.

B. Substantive Procedures

The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.[9] As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases.[10] The auditor should perform substantive procedures, including tests of details, that are specifically responsive to fraud risks and other significant risks.[11]

Examples in which firms did not sufficiently respond to the risk of material misstatement when performing substantive procedures include:

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[9] See paragraph 36 of AS No. 13.

[10] See paragraph 37 of AS No. 13.

[11] See paragraphs 11 and 13 of AS No. 13.

- A firm identified risks of fraud related to improper revenue recognition without evaluating which types of revenue, revenue transactions, or assertions may give rise to such risks and thus did not appropriately tailor its procedures to address the risks that were specific to the issuer.

- A firm identified the valuation and existence assertions for revenue and deferred revenue as areas of significant risk. The firm performed only substantive analytical procedures to test revenue; it did not perform any substantive tests of details that were specifically responsive to the significant risks that it identified related to revenue. The firm's procedures related to deferred revenue were limited to management inquiry and review of information produced by the company.

- One issuer acquired a business during the year and this business maintained inventory at multiple locations. The firm assessed the risk of material misstatement related to inventory valuation as high and did not plan to rely on controls testing. While the firm performed tests of details on inventory as of the acquisition date, its audit procedures related to the pricing of inventory at year end were limited to a recalculation of certain information produced by the company and a comparison of the acquired business' current year gross margins to gross margins of certain other inventory. Further, the firm did not perform procedures to support its expectation that the gross margins of the issuer's inventory held at various locations should be comparable. As a result, the firm did not perform sufficient procedures to test the valuation of inventory.

In addition, Inspections staff identified in both 2013 and 2012 inspections that some firms did not perform sufficient procedures to extend their audit conclusions from the date of interim procedures to the end of the year under audit. Performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.[12]

The auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period

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12 See paragraph 43 of AS No. 13.

end.[13] For example, to test existence of inventory, a firm performed physical inventory observations at various locations on various interim dates in the ninth month of the issuer's fiscal year. To extend its conclusions from the date of this testing to the end of the year under audit, the firm compared the monetary balances of the inventory as of year or month end to the balances as of the previous year or months and obtained explanations of the fluctuations. The comparison of interim and year or month end inventory balances did not provide substantive evidence of inventory existence at year end, and the firm did not perform any other substantive procedures to extend its interim testing conclusions.

AS No. 14, Evaluating Audit Results

This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.[14] Auditors are required to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, including whether the financial statements contain the information essential for a fair presentation in conformity with that framework.[15] Also, auditors are required to conclude on whether sufficient appropriate audit evidence has been obtained to support their opinions on the financial statements.[16]

The most frequent findings identified by Inspections staff related to AS No. 14 related to instances in which auditors did not (1) evaluate the presentation of the financial statements, including disclosures and (2) evaluate the sufficiency and appropriateness of audit evidence.

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13 See paragraph 45 of AS No. 13.

14 See paragraph 1 of AS No. 14.

15 See paragraphs 30 and 31 of AS No. 14.

16 See paragraph 33 of AS No. 14.

A. Evaluate the presentation of the financial statements, including the disclosures[17]

Inspections staff identified some instances in which firms did not perform sufficient audit procedures to evaluate whether an issuer's accounting for certain transactions or events was in conformity with the applicable financial reporting framework. Additionally, some firms did not perform a sufficient evaluation as to whether the financial statements contained the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.

The Part I Findings related to the evaluation of the presentation of the financial statements, including the disclosures, were identified in all sizes of firms and related to a wide variety of accounting topics, including revenue, financial instruments (including convertible debt), equity instruments (including share-based compensation), and non-financial assets. Examples of these findings include:

- An issuer recognized revenue using the percentage-of-completion method of accounting and used total estimated costs at the inception of each contract in connection with construction services of a long-lived asset that was a material portion of total revenue for the year under audit. To test revenue, the firm used information produced by the company to recalculate amounts used by the issuer in its computation of revenue, including billings in excess of costs and estimated earnings in excess of billings. The firm did not evaluate whether it was appropriate for the issuer to use the percentage-of-completion method to account for the contracts, including evaluating the issuer's ability to make reasonable estimates in connection with its determination of revenue.

- An issuer and the holders of the issuer's convertible notes payable agreed to extend the maturity dates of such notes by several years. In its evaluation of the issuer's accounting and whether the convertible notes had been appropriately accounted for as an extinguishment rather than a modification, the firm did not determine whether the modifications to the convertible notes represented substantial modifications, as specified by GAAP.[18]

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[17] See paragraphs 30 and 31 of AS No. 14.

[18] See FASB ASC Section 470-50-40, *Debt - Modifications and Extinguishments – Derecognition*.

- An issuer's operations included one business that recognized revenue under the percentage-of-completion method, and another that recognized revenue under the completed-contract method. The issuer disclosed in its financial statements for the year under audit that all revenue was recognized under the completed-contract method. The firm did not evaluate the accuracy of the issuer's disclosure of its revenue recognition policy in light of the varying revenue recognition policies of the businesses.[19]

- An issuer had payment terms with customers that extended beyond 12 months from the balance sheet date, and a firm did not evaluate whether any portion of the issuer's receivable balance should have been classified as non-current assets instead of current assets in the balance sheet.[20]

- A firm did not evaluate the adequacy of the issuer's disclosures regarding share-based compensation, including a description of the plans and methods and significant inputs used during the year to estimate the value of share-based compensation awards.[21]

- For a number of the transactions selected for revenue testing, the firm's procedures were insufficient, as it did not test whether the issuer had met the following criteria for recognizing revenue: that there was persuasive evidence of an arrangement, that services had been rendered at the time revenue was recognized, or that collectability was reasonably assured. As a result, the firm did not perform sufficient procedures to determine that revenue was properly recognized.

B. Evaluate the Sufficiency and Appropriateness of Audit Evidence

In forming an opinion on whether the financial statements are presented fairly, in all material respects, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the

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[19] See FASB ASC Section 605-35-50, *Revenue Recognition—Construction-Type and Production-Type Contracts – Disclosure*.

[20] See FASB ASC Topic 210, *Balance Sheet*.

[21] See FASB ASC Section 718-10-50, *Compensation-Stock Compensation-Employee Stock Ownership Plans - Disclosure*.

financial statements.[22] If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.[23]

The 2013 and 2012 Part I Findings related to this aspect of AS No. 14 were identified in auditing management estimates (such as identifying and evaluating indicators of impairment), auditing fair value measurements related to intangible assets, and auditing revenue. Examples of these findings include:

- A firm did not properly evaluate the reasonableness of revenue and net income growth rate assumptions in a goodwill impairment analysis because it did not consider contradictory information such as (1) the significant difference between the issuer's current and prior year's reported results and the projected revenue and net income used in the issuer's valuation model, and (2) the projected flat revenue and decrease in net income for the next year that was publicly disclosed.

- An issuer generated net losses and negative cash flows from operations for the year under audit and the prior year and had negative working capital as of the end of the year under audit. As a result, the firm concluded there was substantial doubt about the issuer's ability to continue as a going concern. In performing an impairment analysis for certain intangible assets, the issuer demonstrated that at least one of its intangible assets had a carrying value that exceeded its fair value. In its testing of the intangible assets valuation assertion, the firm did not consider and evaluate whether the conditions described above were indicators of impairment.

- An issuer derived the majority of its revenue from certain product sales, and during the year under audit, the issuer initiated a plan to offer rebates and incentives to its customers to be applied to future sales of these products. The firm identified a fraud risk due to improper revenue recognition from these product sales. In addition, during the year under audit, the issuer identified instances in which previously undisclosed side arrangements had

[22] See paragraphs 3 and 34 of AS No. 14.

[23] See paragraph 29 of AS No. 15.

been entered into with customers to offer additional rebates or changes to contract terms. The firm did not sufficiently evaluate whether revenue was recognized appropriately as it did not consider whether the issuer's prices were fixed and determinable, in light of the issuer's plan to offer certain rebates and incentives to customers and of the noted instances of side arrangements.

AS No. 15, Audit Evidence

Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.[24] The most frequent findings identified by Inspections staff related to AS No. 15 related to instances in which auditors did not (1) evaluate information produced by the company that was used as audit evidence in performing substantive tests of accounts and disclosures and (2) sufficiently meet the objective of the audit procedure when selecting specific items for testing.

A. Evaluate Information Produced by the Company

When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to 1) test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information, and 2) evaluate whether the information is sufficiently precise and detailed for the purposes of the audit.[25]

During the 2013 and 2012 inspections, these deficiencies were observed across firms of all sizes. While the 2013 and 2012 Part I Findings were most frequently associated with auditing revenue and inventory, improper evaluation of information produced by the company can result in audit deficiencies in other financial statement accounts. Examples in which Inspections staff has observed deficiencies include instances in which firms did not:

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[24] See paragraph 2 of AS No. 15.

[25] See paragraph 10 of AS No. 15.

- Test the accuracy and completeness of data used in performing substantive audit procedures.

- Perform procedures to validate all material types of transactions within a report that was used in performing substantive audit procedures (e.g., verify transactions within the report related to the account tested).

- Test the IT General Controls ("ITGCs") that were necessary for the effective operation of the controls over system-generated data or reports that the firm relied on for substantive audit procedures.

- Address control deficiencies that were identified with respect to the ITGCs over either the applications that process the data used in the reports or the applications that generated the reports that were relied upon for substantive audit procedures.

B. Selecting Specific Items for Testing

Auditors sometimes select specific items for testing based on a specified characteristic, such as key items or items reflecting transactions over a certain amount.[26] Such a selection approach can allow the auditor to focus testing on items that are important to the objective of the test. However, that approach does not involve audit sampling, and the results of that testing cannot be projected to the remaining items in the account or class of transactions.[27]

Inspections staff has identified situations in which firms selected specific items for testing, and they either (1) inappropriately projected the results of those audit procedures to the entire population or (2) did not perform other audit procedures to address the risks of material misstatement in the rest of the account or transaction class. Deficiencies identified were primarily related to auditing revenue, inventory, and allowance for loan losses. Examples of these deficiencies include:

- A firm adopted a fully substantive audit approach to test inventory for which a fraud risk was identified and which represented a material portion of total assets. The firm's testing was limited to a selection of high-value inventory

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[26] See paragraphs 25 through 27 of AS No. 15.

[27] See paragraph 27 of AS No. 15.

items that represented an insignificant portion of the total inventory balance at year end. The firm did not perform any procedures to test the remaining portion of inventory, which was material.[28]

- When performing tests of details over revenue, for which a fraud risk was identified, a firm tested only sales contracts that exceeded a certain dollar amount. The firm did not perform any audit procedures to test the remaining sales contracts, which represented a material amount of revenue recognized and represented a risk of fraud.

- A firm did not perform sufficient tests of details over revenue at a subsidiary for an issuer, which represented more than 10 percent of the issuer's revenue, and was accounted for using the percentage-of-completion method. Specifically, the firm's testing was limited to performing audit procedures on the largest contract within the population. These procedures included recalculating the contract's percentage-of-completion calculation and obtaining supporting documentation for one project cost item. The firm's approach did not constitute audit sampling, and more than 90 percent of the revenue recognized at the subsidiary was not subject to testing that addressed the identified risks of material misstatement.

Additional Observations Informing the Evaluation of Firms' Compliance with the Risk Assessment Standards

PCAOB inspections sometimes identify audit deficiencies that, while not reported in Part I of a firm's inspection report, inform the evaluation of the sufficiency of a firm's system of quality control. While quality control criticisms are distinct from observations of audit-specific deficiencies, they are sometimes derived from those observations. In considering whether firms' quality control systems provide reasonable assurance of compliance with the Risk Assessment Standards, the Board has identified quality control issues based not only on deficiencies that appeared to contribute to insufficiently supported opinions (Part I Findings), but also based on additional audit deficiencies that did not appear to rise to that level. Criticisms of, and potential defects in, a firm's system of quality control that are identified by PCAOB inspectors are included in Part II of the firm's inspection report, which is not made public unless the firm fails to address those criticisms or potential defects to the satisfaction of the Board within twelve months of the date of the inspection report.

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[28] See paragraphs 27 of AS No. 15, and 8, 13, and 37 of AS No. 13.

In addition to the Part I Findings discussed above, Inspections staff found additional common Risk Assessment Deficiencies during 2013 and 2012 that did not themselves rise to the level of a Part I Finding but nevertheless constituted a departure from the requirements of the Risk Assessment Standards and indicated a potential defect in firms' systems of quality control. These quality control criticisms, which were included in Part II of the relevant firms' inspection reports, included concerns related to supervision of the audit engagement, identifying and assessing the risks of material misstatement, and audit responses to the risk of management override of controls. Ineffective quality controls related to the Risk Assessment Standards may result in auditors performing insufficient or ineffective audit procedures in an audit, diminished audit quality at a given firm, and serious implications for the reliability of a firm's audit opinion.

The following discussion describes commonly observed audit deficiencies relating to the firm's compliance with the Risk Assessment Standards that did not themselves rise to the level of a Part I Finding but were relevant in the evaluation of the sufficiency of a firm's system of quality control and may have contributed to some Part I Findings.

AS No. 10, Supervision of the Audit Engagement

This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members. Supervision of audit staff, including review of staff work, is essential to effective audits. Inspection observations in both 2013 and 2012 at some firms have indicated that improvements need to be made in the sufficiency, rigor, and efficacy of the supervision activities of the firm's engagement partners and engagement managers. Inspections staff identified audit deficiencies most frequently in more complex or subjective audit areas, in which the heightened risk of material misstatement warranted more extensive supervision, and in which Inspections staff frequently observed that the supervision, including review of relevant audit work, appeared to be insufficient. Examples of such audit areas include: (1) auditing complex revenue transactions, (2) auditing fair value measurements, (3) evaluating control deficiencies, and (4) auditing management estimates such as the allowance for loan losses.

AS No. 12, Identifying and Assessing Risks of Material Misstatement

The procedures outlined in AS No. 12 are fundamental to providing the auditor with a basis for designing and implementing responses to the risks of material misstatement in an audit. A lack of understanding of the company and the factors that may drive the risks of material misstatement can have serious implications for the reliability of the auditor's opinion and quality of the audit. For example, inappropriate identification or assessment of risks of material misstatements can lead the auditor to overlook relevant risks, including fraud risks, to the financial statements and to perform inadequate audit procedures to address these risks. Frequent and significant audit deficiencies related to AS No. 12 may indicate that a firm does not have the appropriate policies and procedures in place to ensure that its auditors can appropriately identify and assess the risks of material misstatement. Inspections staff identified deficiencies in firm methodologies or audit guidance during 2012 that may have contributed to quality control concerns. Specifically, at one firm, the audit methodology did not require engagement teams to separately identify significant risks. At another firm, the audit tools were not designed to encourage engagement teams to tailor their risk assessments to the specific risks for the accounts for the individual audits.

The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud.[29] The auditor should obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.[30] The auditor also should obtain a sufficient understanding of each component of internal control over financial reporting to (1) identify the types of potential misstatements, (2) assess the factors that affect the risks of material misstatement, and (3) design further audit procedures.[31] Obtaining an understanding of internal control over financial reporting includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.[32] AS No. 12 Inspection findings in 2013 and 2012 that were not included in Part I of firm reports were most frequently observed in the identification and assessment of fraud risks.

Inspections staff identified in some audits, in which the firm had not audited the issuer in the previous year, the firm had not obtained a sufficient understanding of the company, its environment, or its internal control over financial reporting. For example,

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29 See paragraph 4 of AS No. 12.

30 See paragraph 7 of AS No. 12.

31 See paragraph 18 of AS No. 12.

32 See paragraph 20 of AS No. 12.

one firm identified a significant risk with respect to the valuation of certain assets but did not obtain an understanding of how the issuer developed its estimated value for these assets. The firm did not obtain an understanding of the key elements, such as the inputs and assumptions, that may have had a significant effect on the risks of material misstatement, which resulted in a deficiency in that the firm did not design appropriate audit procedures to test the valuation of these assets in compliance with AS No. 13.

Some firms identified a risk of fraud related to revenue recognition, sometimes based only on the presumption that revenue presents a fraud risk, without evidencing that they had identified which types of revenue, revenue transactions, or assertions may give rise to such risks. In some cases, it appeared that the firms did not obtain a sufficient understanding of how fraud could be perpetrated or concealed by the issuer to be able to appropriately tailor their testing to the risks that were specific to the issuer. The failure to identify fraud risks that are specific to the issuer may also lead to deficiencies in audit procedures intended to address the risk of management override of controls, including risk factors related to manual journal entries.

Inspections staff identified frequent concerns in firms' assessment of fraud risk related to manual journal entries.[33] These findings were observed more often in smaller firms. For example, one firm did not appropriately consider the risks of management override of controls and did not perform procedures to test journal entries and other adjustments for evidence of possible material misstatements due to fraud. On another audit, the firm did not obtain an understanding of the company and its environment, as it did not understand the company's controls over journal entries and it did not evaluate whether the controls were appropriately designed. In addition, the firm did not perform sufficient procedures to identify and assess the specific risks of fraud related to journal entries or other adjustments when selecting entries for testing.

<u>AS No. 13, The Auditor's Responses to the Risks of Material Misstatement</u>

In addition to the Part I observations discussed above related to AS No. 13, Inspections staff identified deficiencies in firms' responses to the risk of fraud that evidenced defects in firms' systems of quality control of such significance that in the Board's view they require remediation. For example, a firm may have an ineffective

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[33] AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* includes additional requirements to those in AS No. 12, for consideration of fraud in a financial statement audit.

system of quality control if it does not implement appropriate audit guidance for its auditors to address the risk of management override of controls.

Inspections staff identified frequent deficiencies related to audit procedures designed to address the risk of management override of controls in both 2013 and 2012 inspections, and these were also frequently identified along with deficiencies in AS No. 12 and AU sec. 316. Specifically, some firms performed procedures to select a sample of journal entries for testing from some or all of the categories that were identified as presenting a greater risk of fraud, without tailoring the audit response to the specific nature of the fraud risk.[34] Additionally, some firms in 2012 used Computer-Assisted Audit Techniques ("CAAT") to identify specific journal entries in those categories but did not appropriately evaluate the CAAT results, as they arbitrarily limited their testing to subsets of some or all of the categories.

IV. Observations Related to the Implementation of the Risk Assessment Standards

In 2012, Inspections staff reviewed portions of 300 audits performed by nine firms subject to annual inspection in 2012, and portions of 624 audits performed by 244 firms subject to inspection at least every three years ("firms inspected triennially").

Of the 924 audits inspected during 2012, the Risk Assessment Standards were applicable[35] in 632 (or 68 percent) of those audits. In addition to the inspection procedures performed on those 632 audits to evaluate compliance with those standards, Inspections staff performed specific inspection procedures on 354 individual audits (or 56 percent of the applicable audits) to evaluate firms' actions taken to implement those standards during the 2012 inspection cycle.

These procedures varied by the size and nature of the firm, and included inquiring about or reviewing the following firm actions or materials with respect to the Risk Assessment Standards:

- Changes that were made to firms' audit methodologies;

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[34] See paragraphs 58 and 61 of AU sec. 316.

[35] The audit inspected was for the fiscal year beginning on or after December 15, 2010.

- Materials that were provided to firms' staff during training;

- Implementation guidance prepared by firms;

- Firms' implementation tools, such as practice aids; and

- Quality control procedures performed pursuant to the implementation of the Risk Assessment Standards, such as internal monitoring procedures that firms performed over engagement teams' execution of the requirements of these standards on individual audits.

Inspections staff found that, generally, firms incorporated the Risk Assessment Standards into their existing audit methodologies, introduced audit tools, and trained their partners and staff. Firms' methodologies were broadly consistent with the Risk Assessment Standards, but Inspections staff did identify that some firms had not changed their methodology to comply with all of the new standards. While the deficiencies identified by Inspections staff in firm methodologies were not pervasive across firms, it is important to note that methodologies or guidance that do not comply with relevant auditing standards may increase the risk that auditors may not perform sufficient audit procedures to address the risks of material misstatement in an audit. Firms should continue to evaluate whether their audit guidance and related tools provide reasonable assurance of compliance with the Risk Assessment Standards.

Some firm methodologies did not comply with the Risk Assessment Standards because their methodology:

- Established a pre-defined threshold for auditors to determine the amount of tolerable misstatement for purposes of assessing the risk of material misstatement and planning and performing audit procedures, without directing engagement teams to consider the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods, as required by AS No. 11.[36]

- Did not require engagement teams to separately identify significant risks, as required by AS No. 12.[37]

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[36] See paragraph 9 of AS No. 11.

[37] See paragraphs 70 to 71 of AS No. 12.

- Did not require the auditor to perform tests of details that were specifically responsive to all of the identified significant risks, as required by AS No. 13.[38]

- Allowed engagement teams to establish thresholds in excess of financial statement materiality for accumulating and evaluating identified misstatements related to misclassifications among accounts within the same financial statement (e.g., balance sheet reclassification) or within the same category of cash flows on the statement of cash flows. This methodology did not comply with AS No. 14.[39] Consequently, some engagement teams did not accumulate and evaluate all of the misstatements identified during the audit that were not clearly trivial, and were unable to properly evaluate whether uncorrected misstatements were material individually or in combination.

- Implemented audit tools that pre-populated the audit work papers with pre-defined lists of generic risks of material misstatement for certain accounts, rather than encouraging engagement teams to tailor their assessments to the specific risks for the accounts for the individual audits. While the audit tools allowed engagement teams to add separate risks for these accounts, the use of the tool may have contributed to engagement teams not identifying all of the specific risks for those accounts.

V. Potential Root Causes of Non-Compliance with the Risk Assessment Standards

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Consequently, as noted above, when an auditor fails to comply with one of the Risk Assessment Standards, it may cause or be related to non-compliance with another of the Risk Assessment Standards and deficiencies in other aspects of audit testing.

During the inspection process, Inspections staff performed procedures to identify potential root causes of the auditing deficiencies that were identified. Such procedures included, among other things, analysis of inspection findings, discussions with

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[38] See paragraph 11 of AS No. 13.

[39] See paragraph 10 of AS No. 14.

engagement teams and firms' leadership, and reviews of firms' audit methodologies and guidance. As a result of these procedures, Inspections staff identified several factors that may have contributed to the deficiencies related to the Risk Assessment Standards as follows:

- The firm did not have an adequate understanding of the issuer and its processes and related internal control over financial reporting. Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. In some audits, the firms' lack of understanding may have been a result of the firm placing excessive reliance on issuers' documentation of processes, rather than reviewing these processes independently to gain a sufficient understanding of those processes and to be able to identify important points at which a necessary control was missing or was not designed effectively and at which a material misstatement could have arisen.

- Firm tools had not been appropriately designed to enable engagement teams to tailor their risk assessment procedures on the audit. The auditor is required to identify and assess the risks of material misstatement at the financial statement level and the assertion level.[40] Once the risks have been identified the auditor is required to design and implement audit procedures to address those risks.[41] Having pre-defined risks within audit tools or failing to encourage engagement teams to be as specific as possible when documenting such risks and designing procedures to address those risks may lead to inadequate testing of financial statement accounts and internal controls.

- The firm did not adequately design and perform audit procedures to address identified and assessed risks of material misstatement. In some audits, engagement teams did not appear to have a complete understanding of the Risk Assessment Standards and, when applicable, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*. Specifically, a contributing factor to

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[40] See paragraph 59 of AS No. 12.

[41] See paragraph 8 of AS No. 13.

deficiencies in the Risk Assessment Standards may be a lack of understanding of the extent of audit procedures required to ensure that sufficient appropriate audit evidence has been obtained to support the audit opinion. For example, some firms did not design their tests of controls to support their planned control risk assessments. Consequently, when the results of the tests of controls did not support their planned control risk assessments, the firms did not understand that modifications should have been made to their planned substantive procedures to obtain additional audit evidence.

- Senior members of the engagement team, including the engagement partner, may not devote sufficient attention to the performance of risk assessment procedures or the supervision, including review of the work of engagement team members. Factors that may have contributed to the lack of attention in this area may include insufficient staffing of manager resources and the heavy workload of the partners assigned to these audits. Further, in some audits it appeared that the senior members of the engagement team may not have had the appropriate technical skill set to perform the review or may have conducted the review through discussion without reviewing audit documentation.

- Some firm professionals may not exercise due care, including professional skepticism (e.g., overreliance upon management assertions, reliance on perceived knowledge of the issuer, and insufficient evaluation of contradictory evidence). For example, Inspections staff identified that some engagement teams may have focused more on risk factors that would have supported a lower risk of material misstatement for an issuer rather than critically assessing all factors, including those that may have indicated a higher risk of material misstatement existed. In another example, a firm did not sufficiently evaluate the effectiveness of a management review control and relied on limited audit procedures, such as inquiry of management and reviewing and comparing certain information produced by the company to supporting documentation, in assessing whether the control had been designed and operating effectively. These audit procedures were not sufficient as the firm did not perform procedures on certain other issuer-prepared schedules that the issuer relied upon to support material fair value measurements.

- Firms may not place the appropriate level of importance on, or may not provide adequate training with respect to, testing journal entries. In some audits, it appeared that engagement teams viewed the testing of journal entries as a routine audit procedure and as such they did not perform a critical assessment of the specific risks of fraud presented by the journal entries.

Firms should perform their own root cause analyses for the deficiencies identified in this report, if applicable, and take appropriate corrective action. Firms also need to monitor and evaluate whether their corrective actions adequately address the deficiencies.

VI. Focus on Improving Audit Quality

All registered firms should review this report and consider whether the types of Risk Assessment Deficiencies observed by the Board could manifest themselves in their practices. Firms also should analyze their internal and external inspection results to determine whether other types of audit deficiencies are the result of non-compliance with the Risk Assessment Standards.

Detailed and comprehensive root cause analyses should be performed by firms for the deficiencies identified in this report, if applicable, and appropriate corrective action should be taken. Root cause analysis of not only negative events, but also positive quality events, may improve the firms' ability to appropriately remediate systemic issues.

In response to the identification of audit and quality control criticisms that related to non-compliance with the Risk Assessment Standards, firms have taken various remedial actions to address these criticisms. Examples of remedial actions taken by firms in an effort to promote sustained audit quality improvements include enhancing audit methodologies and processes, developing technical guidance targeted to specific issues, developing and requiring training targeted to specific issues, developing new audit tools, and requiring additional audit procedures to provide reasonable assurance of compliance with PCAOB standards.

Some firms have developed automated audit tools, templates, or additional guidance for their auditors to better understand the flow of business transactions and to identify the risks of material misstatement and related business controls that may mitigate those risks. In one firm, a tool was developed to provide auditors with specific examples of business risks that they may encounter and guidance to assist in the identification and assessment of the risks of material misstatement and the identification of controls that may be tested in an effort to mitigate these risks. Another firm revised its audit tools to summarize the planned level of substantive evidence for each audit procedure for certain types of risks so that audit engagement leadership may better review and evaluate whether the substantive procedures were appropriate based on the engagement team's planned reliance on controls and risk assessments. Some of the revised audit tools are required and use is monitored by firm leadership.

Several firms have also developed targeted training for audit professionals based upon firm-specific quality control criticisms related to the Risk Assessment Standards. For example, one firm required its professionals to attend a course on identifying and assessing the risks of material misstatement due to fraud. Course content included a focus on the consideration of fraud in determining the nature, timing, and extent of audit procedures.

Real-time monitoring of the effectiveness of corrective actions taken to address deficiencies in the application of these standards should also be incorporated into firms' systems of quality control in an effort to sustain improved audit quality. For example, Inspections staff has observed certain firms have been effective in reducing audit deficiencies on some audits when they perform timely and targeted pre-issuance reviews of the audit work performed. These firms follow up on the audits that have been subjected to these reviews to ensure that changes in audit procedures suggested by these reviews were made prior to the issuance of the audit reports.

Firms should make it a priority to evaluate engagement partner and manager workloads in an effort to ensure that partners and managers have adequate capacity to devote the time needed to perform quality audits, including supervision of the engagement team.

Firms also should take actions to avoid other basic audit problems that could also affect compliance with the Risk Assessment Standards (for instance, lack of understanding of the issuer and its processes, insufficient supervision, including review of the audit, and lack of professional skepticism). Maintaining an appropriate tone at the top of the firm, supported by actions, is also essential to achieve the necessary improvements in audit quality.

Firms with significant and high rates of audit deficiencies related to the Risk Assessment Standards should make improvements in their risk assessment processes a significant priority. Finally, due to the importance of these standards to the effectiveness of the audit, firms may want to review whether their audit methodologies and related tools are sufficient to provide reasonable assurance regarding compliance with these standards.

Audit committees may find this report useful in fulfilling their responsibilities with respect to independent auditors. Audit committees may consider inquiring of the Issuer's auditor:

- Have the PCAOB's inspections or firm's internal inspections identified any significant deficiencies in the firm's compliance with the Risk Assessment Standards, and if so, what actions has the firm taken to address these?

- Which audit areas have been identified by the auditor as having significant risks of material misstatement and, at a high level, how does the audit plan address those risks?

- In the auditor's view, how have the areas of significant risk of material misstatement changed since the prior year and why? What new risks has the auditor identified?