



STAFF INSPECTION BRIEF

The staff of the Public Company Accounting Oversight Board (“PCAOB” or “Board”) prepares Inspection Briefs to assist auditors, audit committees, investors, and preparers in understanding the PCAOB inspection process and its results. The statements contained in Staff Inspection Briefs do not establish rules of the Board or constitute determinations of the Board and have not been approved by the Board.

Information about 2015 Inspections

The PCAOB Division of Registration and Inspections plans to prepare Inspection Briefs periodically to inform the public of inspections related activities. This Inspection Brief provides information about PCAOB inspections of registered audit firms and their audits in 2015 and highlights important aspects of the inspection plan, scope and objectives. The Appendix provides a general description of the inspections program and highlights certain characteristics of audits inspected and areas of past inspection focus. It is intended to assist auditors, audit committees, investors and preparers in further understanding the inspection process and its results.¹

The PCAOB inspects registered public accounting firms to assess compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the Securities and Exchange Commission, and professional standards, in connection with the firm’s performance of audits, issuance of audit reports, and related matters involving issuers.² PCAOB inspections include reviews of selected audit engagements and evaluations of the sufficiency of a firm’s quality control system in its issuer audit practice.

PCAOB Inspections staff plans each year’s inspections by selecting issuer audits to inspect based largely on an analysis of risk, including risk emanating from economic trends, company or industry developments, and the audit firm inspection history. Inspectors typically focus on audit areas that present auditing challenges and significant audit risk, including significant financial reporting risks, as well as areas of recurring audit deficiencies both within and across firms.

1 For additional information on recurring areas of concern and new risks that the PCAOB is monitoring, see the [Audit Committee Dialogue](#).

2 For purposes of the PCAOB’s inspection authority, the term “issuer” is defined in Section 2(a) (7) of the Sarbanes-Oxley Act of 2002 and essentially includes public companies with SEC reporting obligations.

This year, Inspections staff is again taking a close look at audit work in three general areas across firms: internal control over financial reporting; assessing and responding to risks of material misstatement; and accounting estimates, including fair value measurements. These are areas where inspectors found significant deficiencies in the past several years (including in referred work engagements where a firm played a role in an audit but was not the principal auditor).

Recurring Audit Deficiencies



Beyond focusing on these recurring deficiencies, inspectors select audit engagements and focus areas within the inspected audits based on risk factors that include:

- The characteristics of the particular issuer or its industry, such as the size of market capitalization, the nature of the issuer's operations and related developments in relevant industry sector risks;
- Potential audit or accounting issues likely to be encountered, such as revenue recognition that involves more complex considerations (e.g., construction-type contracts and multiple-element arrangements);

- Considerations related to the geographic regions in which significant operations are located, including in certain emerging markets;
- Considerations related to the particular audit firm, practice office, or partner, including prior inspection results; and
- Any other relevant information that has come to the Inspection staff's attention.

More detailed information about the characteristics of audits inspected in the last four inspection cycles and the primary focus areas selected is provided in the Appendix. The Appendix highlights areas of past inspection focus and details where Inspections staff has seen many of the recurring deficiencies over time.

Inspection Program for Audits of Issuers

For operational purposes, Inspections staff administers issuer audit firm inspections through two programs: Global Network Firms and Non-Affiliate Firms. Additional information on each program is provided in the Appendix.

Overview of Inspection Plan and Scope

The 2015 inspection cycle is in progress, and inspectors are reviewing portions of selected audit work performed by firms primarily related to 2014 financial statements of issuers (including referred work engagements). Inspectors are also evaluating the sufficiency of certain aspects of

firms' systems of quality control by reviewing relevant policies and procedures.

2015 Inspections by the Numbers*



220 firms

Planned to be reviewed by our inspectors, which includes:



10 U.S. firms

that are annually inspected, and



60 non-U.S. firms

in 25 jurisdictions.

*Numbers are approximate

Audit engagements and areas of inspection focus are not selected randomly, and selections of audits are not necessarily representative samples of the firm's audits. Rather, audits and areas of focus are generally selected on a risk-weighted basis.

Accordingly, areas of focus vary among selected audits and firms, but often involve audit work on the most difficult or inherently uncertain areas of financial statements, including complex financial statement areas and/or areas that require a higher degree of management judgment, and therefore present a higher risk of material misstatement.

The PCAOB Office of Research and Analysis assists Inspections Staff in identifying higher risk audits and audit areas for closer consideration. It

also provides risk and data analysis to support the inspection planning process.

Some of the key planning considerations are discussed in more detail below.

Key Areas of Inspection Focus

Recurring Audit Deficiencies

Inspectors consider deficiencies cited in previous inspection cycles to evaluate how an audit firm performed in those areas in the current inspection cycle (including reviewing remedial actions taken in response to past inspection findings and root cause analysis information). The most frequent and recurring audit deficiencies identified in the 2013 and 2014 inspection cycles (at firms that were the principal auditor and at firms that performed referred work engagements) were in the following audit areas:

- Internal control over financial reporting, particularly related to the testing of the design and/or operating effectiveness of controls.
- Assessing and responding to risks of material misstatement. Some auditors did not always sufficiently identify the risks or respond effectively to existing risks that they have identified, such as performing tests that are not sufficiently responsive to the assessed risks.
- Accounting estimates and fair value measurements, particularly related to testing of key data and significant assumptions used by management to develop estimates.

Economic Risks

Inspectors consider the current economic environment and related developments. For example, economic uncertainty stemming from the financial crisis and the sluggish global economy has, in the past, factored into the audits and the areas selected for inspection.

Certain economic developments that factor into the 2015 selections include:

- **The high pace of mergers and acquisitions activity.** How did auditors approach auditing these transactions in response to the related financial reporting risks when auditing the acquirer? For example, risks of material misstatement associated with business combinations may include complex fair value measurements of acquired assets and liabilities assumed, identification of all intangible assets, assigning goodwill to reporting units, and contingent consideration measurements.

High cash levels, low interest rates, and shareholder pressure for growth have stimulated merger and acquisition activity not seen for some time. Accordingly, some auditors may lack sufficient experience in this area. In addition, for some auditors, this may be the first time they evaluate a company's application of the business combination accounting rules that became effective for financial statements generally in 2009.

- **The search for higher-yielding investment returns.** How did auditors address the financial reporting risks (e.g., risks of overvalued assets, errors in valuing "hard-to-value" securities, etc.) associated with issuers' investment portfolios?

For example, issuers may invest in higher-yielding "hard-to-value" securities as they search to boost investment returns in a low interest rate environment. These types of instruments often are more complex, have a higher risk of being incorrectly valued, and are generally more susceptible to significant future credit losses when interest rates rise.

- **The recent fluctuation in oil prices and its varying effects on the financial reporting risks of different industries.** How did auditors respond to this risk? Specific areas of focus include impairment and valuation risks and the collectability of loans and receivables. These risks are not solely applicable to companies in the oil and gas industry, but also to other companies, regardless of whether they are directly or indirectly part of the supply chain to the oil and gas industry.

Issuer Industry Sector Risks

Risks within industry sectors also factor into inspection selections. The PCAOB Office of Research and Analysis analyzes each sector to identify industry risks related to economic conditions, industry developments, and restatement history that could affect financial reporting and audit risks.

Similar to 2014, the 2015 selections span a cross-section of industry sectors. Audits within the consumer and industrial products, financial services, information technology and telecom sectors represented approximately 70 percent of the 2014 selections. See the Appendix for a summary by industry sector of the 2011 – 2014 audits inspected.

Financial Reporting Areas

Inspectors select certain financial reporting areas for inspection, and these areas vary for each inspected audit.

The most frequently selected financial reporting areas in 2014 included revenue and receivables, non-financial assets (assets acquired in business combinations, including goodwill and other intangible assets, and other long-lived assets), inventory, financial instruments, the allowance for loan losses, income taxes, benefit related liabilities, and equity transactions. These audit areas will continue to be frequently selected for inspection in 2015.

Additional financial reporting focus areas for 2015 include the statement of cash flows, and additional focus on income tax accruals.

Statements of cash flows

Errors in the statement of cash flows continue to be a frequent factor in restatements. The reasons for the restatements vary, but many do not involve complex determinations. Inspections staff is evaluating the auditor's testing of the statement of cash flows in certain areas for some inspections, including the testing of controls over the preparation of the statement of cash flows. Did the auditor appropriately identify and address the risks of material misstatement in the preparation of the cash flow statement?

Income taxes

Inspections staff is placing additional focus on the audit of income taxes in light of growing risks highlighted in this area (e.g., as U.S.

issuers continue to grow their profits in lower tax jurisdictions, undistributed earnings and cash held overseas raise risk in this area). Did the auditor appropriately test the income tax accounting and disclosures?

Inspectors have identified deficiencies in the auditing of management's assertion that undistributed foreign earnings will be indefinitely reinvested outside the U.S., including the failure to evaluate the impact on that assertion of significant cash transfers from a foreign subsidiary to the U.S. parent. Inspectors have also identified deficiencies in auditing controls over income tax accounting, generally, and related disclosures.

Also see the Appendix for a summary of 2011 - 2014 financial reporting areas that were selected for inspection.

Audit Committee Communications

The 2014 inspections of 2013 audits were the first opportunity to inspect the implementation of the new auditing standard, AS No. 16, *Communications with Audit Committees*. Among other things, the new standard requires auditors to discuss certain matters with audit committees.

Most firms that were inspected implemented the new standard effectively. Inspections staff did find that some engagement teams needed to improve their documentation of matters required by AS No. 16, and some had not communicated all of the matters required by AS No. 16 to audit committees, including overview of the audit strategy, timing of the audit, and all of the significant risks identified during the auditor's risk assessment procedures (primarily within Non-Affiliate Firms). Inspections

staff continues to evaluate audit committee communications in 2015 inspections. Additionally, for certain firms inspected triennially (i.e., at least once every three years), 2015 is the first year that Inspections staff is evaluating their implementation of this standard.

Information Technology

Firm audit tools

Firms are moving in the direction of developing and using software audit tools to analyze full populations of accounting and financial reporting transactions to select transactions for testing rather than selecting a random sample of transactions for testing. The objective of these efforts is to provide opportunities to perform audit work more effectively and efficiently, and to increase the likelihood of testing transactions associated with higher risk.

Inspections staff seeks to understand:

- The controls that firms have in place to provide assurance that the software audit tools used to analyze the data meet the audit objectives.
- The steps that firms have taken to determine whether the audit engagement teams understand how to effectively use these software audit tools to test large data populations and evaluate the results of those tests.
- The steps that firms are taking to maintain professional skepticism and to develop professional judgment skills of their audit engagement teams in light of the technology advancement.

Cyber-security risks

Cyber-security incidents, for example, breaches related to the theft of issuers' software, patents, secrets, or other intellectual property, and breaches that compromise software, have continued to be prominent.

Inspections staff is reviewing how engagement teams evaluate the risks of material misstatement associated with cyber-security and the related controls in the integrated audit.

Multinational Audits

Inspections staff routinely inspects portions of multinational audits, including the multi-firm audit work performed by both domestic and non-U.S. firms that played a role in the audit, but were not the principal auditor. Inspection selections may include work performed by other firms at the request of the principal auditor ("referred work engagements") as well as the audit work performed by the principal auditor with respect to the decision to use the work of the other auditor.

Between 2011 and 2013, inspectors identified significant findings in more than a third of referred work engagements inspected. The majority of these findings related to the testing of revenue and receivables, inventory, non-financial assets, financial instruments, and the allowance for loan losses (including testing controls over those accounts), and the performance of insufficient substantive procedures in response to risks of material misstatement. In other instances, the referred work firm did not communicate to the principal auditor matters required under the principal auditor's instructions.

Communication between the principal auditor and the other auditor is important to ensure a proper review of matters affecting the consolidating or combining of accounts in the financial statements.

Inspections staff reviews some of the referred work to evaluate the quality of the work performed. Inspections staff also evaluates how a firm that is using another auditor in its audit evaluated the competence of, and the work performed by, the other auditor.

Audit Firm's System of Quality Control

Inspections staff also assesses each firm's quality control system for weaknesses or deficiencies that could lead to deficiencies in audit performance. Some of these areas include: the firm's "tone at the top" as it relates to audit quality; policies, procedures, and practices concerning audit performance; training; client acceptance and retention procedures; partner management; and the firm's self-monitoring through internal inspections and responses thereto.

Root cause analysis

Inspections staff continues to focus on identifying the "root causes" of audit deficiencies through analysis of known deficiencies identified in selected audits at the six largest U.S. firms included in the Global Network Firm inspection program, as well as evaluating the results of the firms' root cause analyses. Inspections staff has begun to expand this analysis to include the non-U.S. members of the global networks. Inspections staff also performs an analysis of known deficiencies identified in the Non-

Affiliate Firm inspection program. Root cause analysis further aids both the Inspections staff and the firms in their efforts to develop and articulate what constitutes audit quality.

Understanding why audit deficiencies have not been detected prior to the issuance of an audit report should remain a key focus area for audit firms.

As an example, some firms conduct targeted reviews in addition to the firms' annual internal inspections. These reviews are sometimes performed during audit planning only, while others may be performed throughout the audit process. Some firms have assigned certain teams (which are not part of the core engagement team) to perform these targeted reviews as part of their various audit quality initiatives and remedial action plans. Inspections staff has noted that reviews performed early in the audit process, targeted to specific areas of recurring deficiencies, and followed-up on to ensure criticisms provided to engagement teams (including steps to understand and address the root causes of the deficiencies) were addressed, generally have experienced improved audit quality results.

Inspections staff recognizes that establishing appropriate root cause analysis processes at the firms is in various phases of development at different firms.

Independence and non-audit services

Recently, several firms have acquired significant consulting firms to grow certain consulting services. Inspections staff continues to assess how those firms ensure that their independence monitoring systems keep pace with the consulting and other non-audit services and practices to maintain their independence from their audit clients.

Even when an audit firm does not provide significant non-audit services to a particular issuer audit client, inspectors are concerned about the effects such business developments may have on the firm's attention to audit quality. Depending upon how a firm manages that growth, there is a risk that the culture within a firm could tend to drift from a focus on audit quality to a focus that subordinates audit quality to other business opportunities and challenges.

Engagement quality review

Inspections staff continues to focus on whether auditors complied with Auditing Standard No. 7, *Engagement Quality Review*, including the reviewer's evaluation of significant judgments, identification of and responses to significant risks, and identification of significant engagement deficiencies.

Inspections staff continues to be concerned with the number of audit deficiencies noted in areas where an engagement quality reviewer reviewed, or should have reviewed, the audit work and related conclusions in the specific areas involved.

Professional skepticism

Previous years' inspection observations have raised concerns about whether some auditors appropriately apply professional skepticism in the course of their audits.

In many of the audits reviewed, it appeared that firms sought to obtain only evidence that would support significant judgments or representations made by management, rather than to critically assess the reasonableness of management's judgments or representations, taking into account

all relevant evidence, regardless of whether it confirmed or contradicted management's assertions. Similar concerns are raised by other audit deficiencies, such as accepting the reliability of issuer-produced data and reports as audit evidence without sufficiently testing the accuracy and completeness of such information.

As a result, Inspections staff continues to focus on whether auditors are maintaining and applying professional skepticism in all areas of their audits, particularly those that involve significant management judgments or transactions outside the normal course of business, as well as how it relates to the auditor's consideration of fraud.

Related parties

Auditing Standard No. 18, *Related Parties*, became effective for audits of fiscal years beginning on or after December 15, 2014. The standard supersedes AU Section 334, *Related Parties*, and amends other PCAOB standards. The standard and amendments address: (i) relationships and transactions with related parties, (ii) significant unusual transactions, and (iii) financial relationships and transactions with executive officers. The standard also imposes new requirements relating to the auditor's communications with the company's audit committee. In 2015, Inspections staff is reviewing firms' plans to implement the new standard.

Further Information

The Inspections staff plans to prepare further Inspection Briefs to provide additional information about inspection results identified in recent inspections of registered audit firms.

Appendix

Inspections of Registered Firms that Audit Issuers

The PCAOB oversees the audits of issuers in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. PCAOB inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Inspections staff evaluates a firm's performance in selected audit engagements and the design and other matters related to a firm's quality control system.

The PCAOB regularly inspects those U.S. and non-U.S. firms that issue audit reports opining on the financial statements of issuers. The actual number of firms that the PCAOB regularly inspects fluctuates since certain registered firms cease to issue audit reports while other firms will begin to issue audit reports for the first time. In general, the PCAOB inspects each firm in this category either annually or triennially, depending upon whether the firm provides audit reports for more than 100 issuers (annual inspection) or 100 or fewer issuers (triennial inspection). At any time, the PCAOB might also inspect any other registered firm that plays a role in the audit of an issuer, and the PCAOB has a practice of inspecting, in each year, some firms in that category.³

For operational purposes in administering the inspection program, Inspections staff groups firms that audit issuers into two programs:

Global Network Firms

This program encompasses inspections of registered audit firms that are members of BDO International Limited, Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Limited, KPMG International Cooperative, and PricewaterhouseCoopers International Limited. In terms of the number of firms registered with the PCAOB, these networks are currently the six largest. Each member firm is a separate legal entity in the global network for which individual firm inspection reports are issued. The six largest U.S. member firms of these networks are required to be annually inspected. Approximately 145 other member firms of these networks (primarily non-U.S. firms) regularly issue audit reports for issuers and are required to be inspected at least triennially.

Non-Affiliate Firms

This program encompasses inspections of registered firms that are not covered by the Global Network Firm program. Many of the firms in this program, however, are members of other international networks, alliances or affiliations.

The firms subject to inspection in this program vary widely in the number of issuers they audit, or play a role in the auditing, and those issuers vary widely in size and nature. Four of these firms are required to be inspected in 2015 because they issued audit reports for more than 100 issuers in 2014. These

³ For more information and individual firm inspection reports see <http://pcaobus.org/Inspections/Pages/default.aspx>. Many PCAOB-registered firms perform no work that is within the scope of the PCAOB's statutory responsibility and authority to assess. The PCAOB does not inspect those firms.

firms are Crowe Horwath LLP, MaloneBailey, LLP, Marcum LLP, and McGladrey LLP. Approximately 445 other domestic and non-U.S. Non-Affiliate Firms regularly issue audit reports for issuers and are required to be inspected at least triennially.

The summary of all registered and inspected firms is shown below (numbers are approximate).⁴

	Total	Global Network Firms	Non-Affiliate Firms
Registered Firms	2,200	340	1,860
Firms Required to Be Inspected Annually	10	6	4
Firms Required to Be Inspected At Least Triennially	590	145	445

Characteristics of Audits Inspected

An inspection typically does not involve reviewing all of a firm’s audits or all aspects of the audits selected for review. Inspections staff selects specific portions of those audits for review. The inspected firms do not have the ability to limit or influence the selections.

Each year, Inspections staff with the assistance of the PCAOB Office of Research and Analysis, performs a risk analysis to identify higher risk audits and audit areas for closer consideration. Audit engagements are selected based on this analysis and the nature of the audits selected, the portions of the audits selected, and the related inspection focus areas will vary over inspection cycles and among firms. Below is an overview of selected characteristics of issuer audits inspected during the 2011 - 2014 inspection cycles.

Market Capitalization of Audits Inspected

Inspections staff considers the market capitalization⁵ of an issuer, including the size and the changes between years, when selecting engagements for inspection. Issuer audits inspected each year are depicted below by market capitalization range.⁶

Global Network Firms audited approximately 99 percent of the total market capitalization of issuers audited by firms registered with the PCAOB during the 2011 – 2014 inspection cycles.

⁴ Data as of December 31, 2014. Some of the non-U.S. firms included in this data are located in jurisdictions where the PCAOB is currently denied access to the information necessary to conduct inspections, due to asserted restrictions under local law or objections based on national sovereignty.

⁵ Market capitalization (as shown in Exhibits 1 and 2 in millions (M) or billions (B)) is derived from data provided by Standard and Poor’s, Reuters, and FactSet. Market capitalization is calculated as the common stock price multiplied by common shares outstanding. Issuer market capitalization is as of the last trading day for the calendar year preceding the inspection year.

⁶ Market capitalization information does not include the net assets held by employee benefit plans, mutual funds and certain other investment companies. These types of audits are included in the “\$0 - \$100M” market capitalization range in Exhibits 1 and 2. These types of audits also tend to be more significant to the audit practice of Non-Affiliate Firms than to the audit practice of Global Network Firms, thus inspections of such audits occur more frequently in the Non-Affiliate Firm program.

Exhibit 1: Number of Audits Inspected at Global Network Firms by Year and Market Capitalization Range

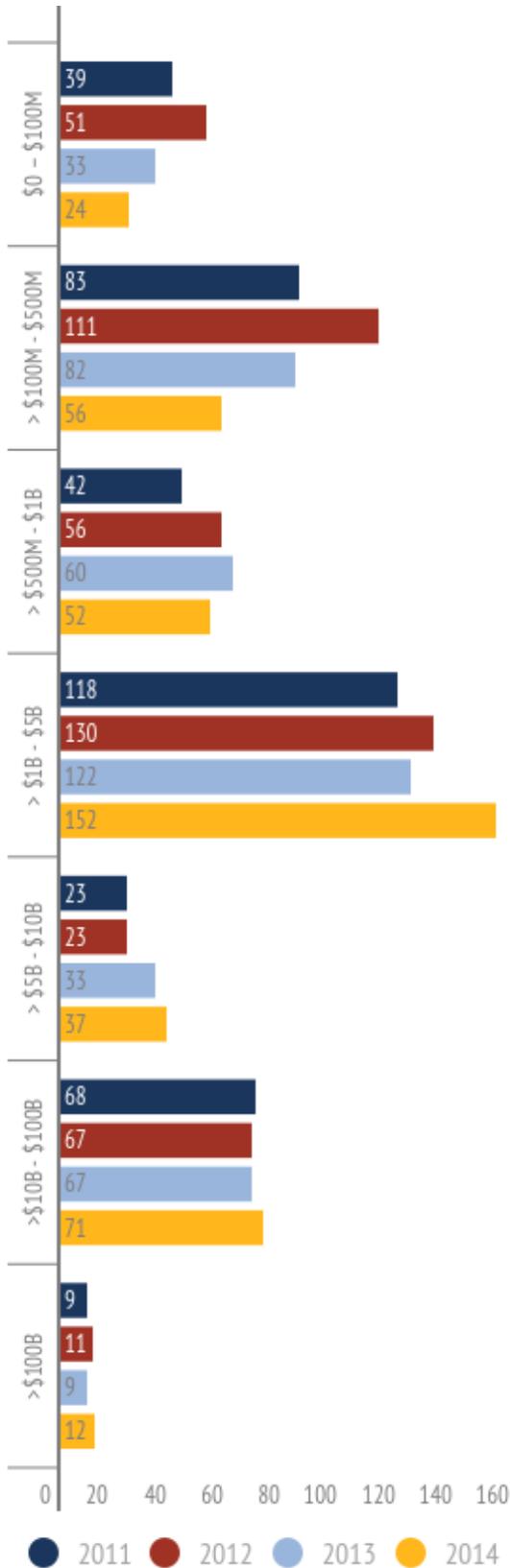
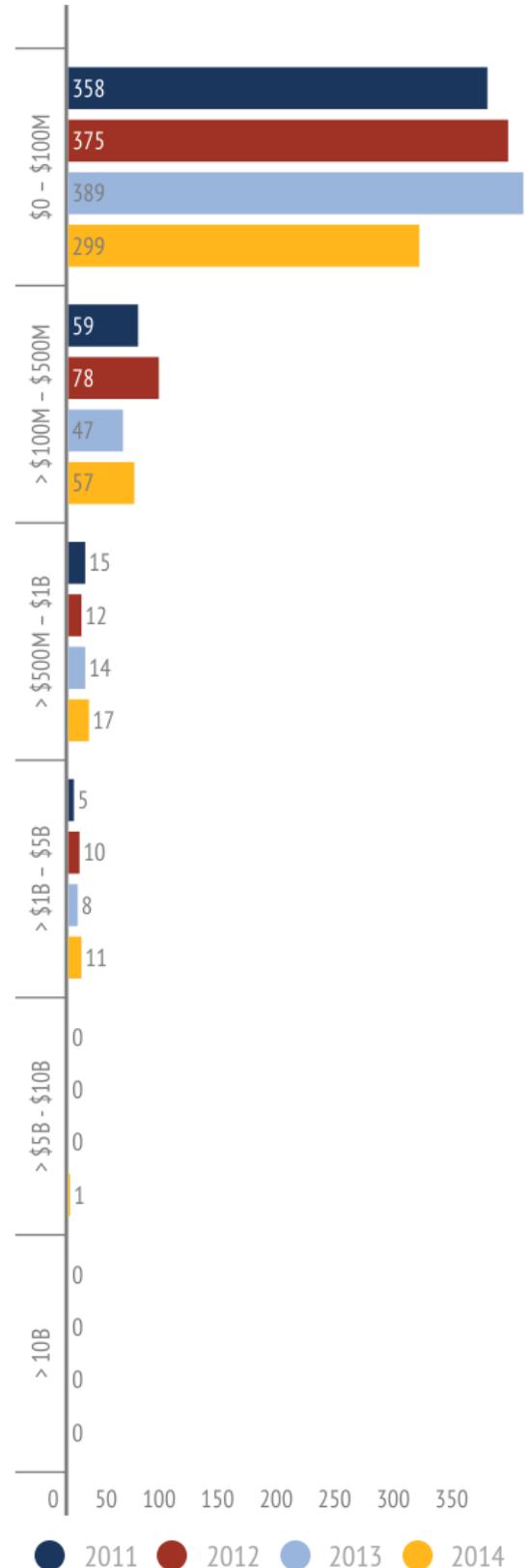


Exhibit 2: Number of Audits Inspected at Non-Affiliate Firms by Year and Market Capitalization Range

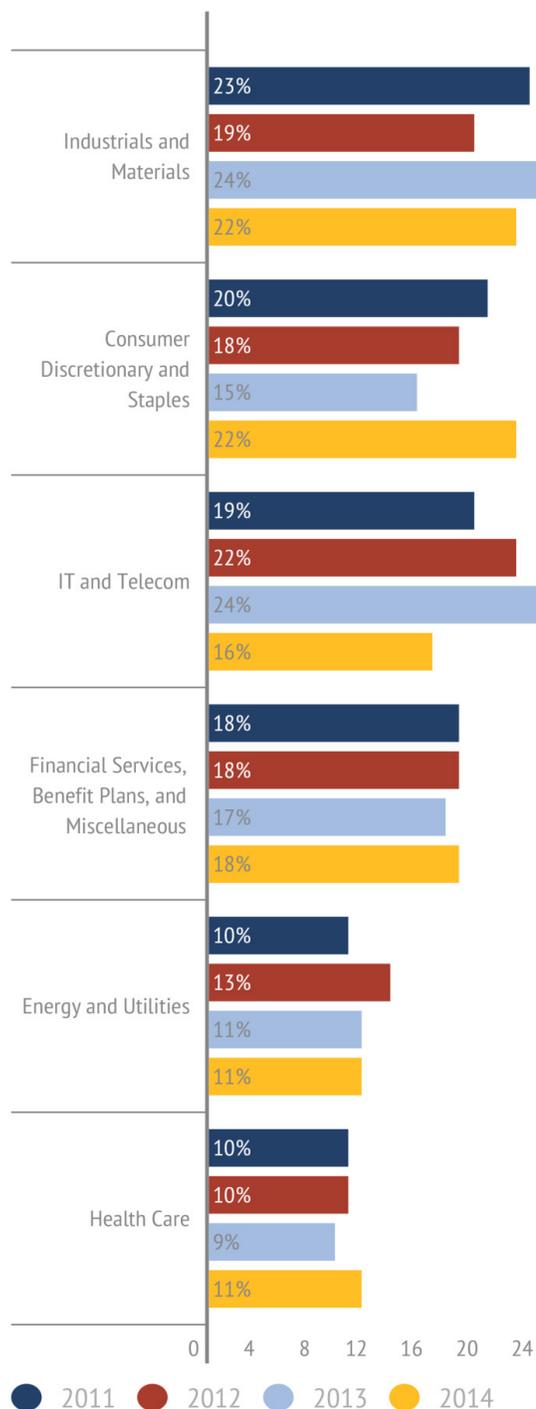


Issuer Industry Sector of Audits Inspected⁷

Inspections staff considers the industry sector and any related industry developments since the firm's last inspection when selecting engagements for inspection.

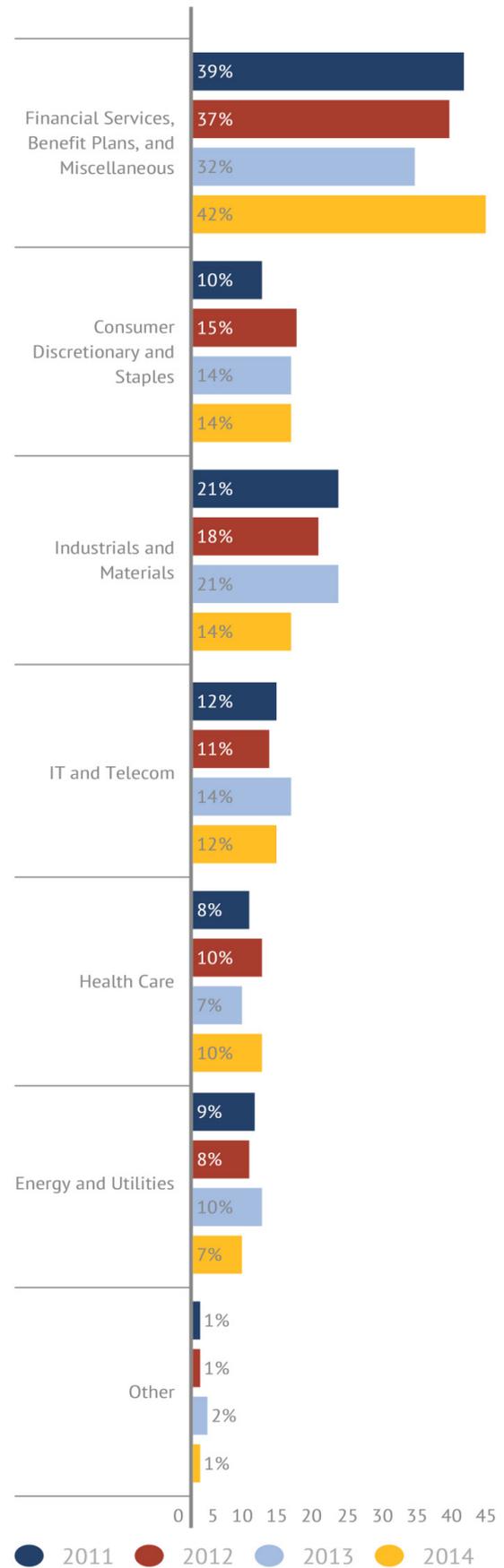
The different population of domestic and non-U.S. triennially inspected firms (and the different concentration of industry sectors associated with their respective issuer audit practices and referred work engagements) partly affects the overall annual concentration of audits inspected by industry sector.

Exhibit 3: Global Network Firm Audits Inspected by Industry Sector by Year (as a percentage of the total number of audits inspected)



⁷ The majority of industry sector data is based on Global Industry Classification Standard (“GICS”) data obtained from Standard & Poor’s (“S&P”). In instances where GICS for an issuer is not available from S&P, classifications were assigned based upon industry sectors utilizing North American Industry Classification System data. Further, as benefit plan audits are separate and distinct from the plan sponsors’ audits, benefit plans are classified as a separate industry sector and are presented with the Financial Services sector for the purposes of this report.

Exhibit 4: Non-Affiliate Firm Audits Inspected by Industry Sector by Year (as a percentage of the total number of audits inspected)

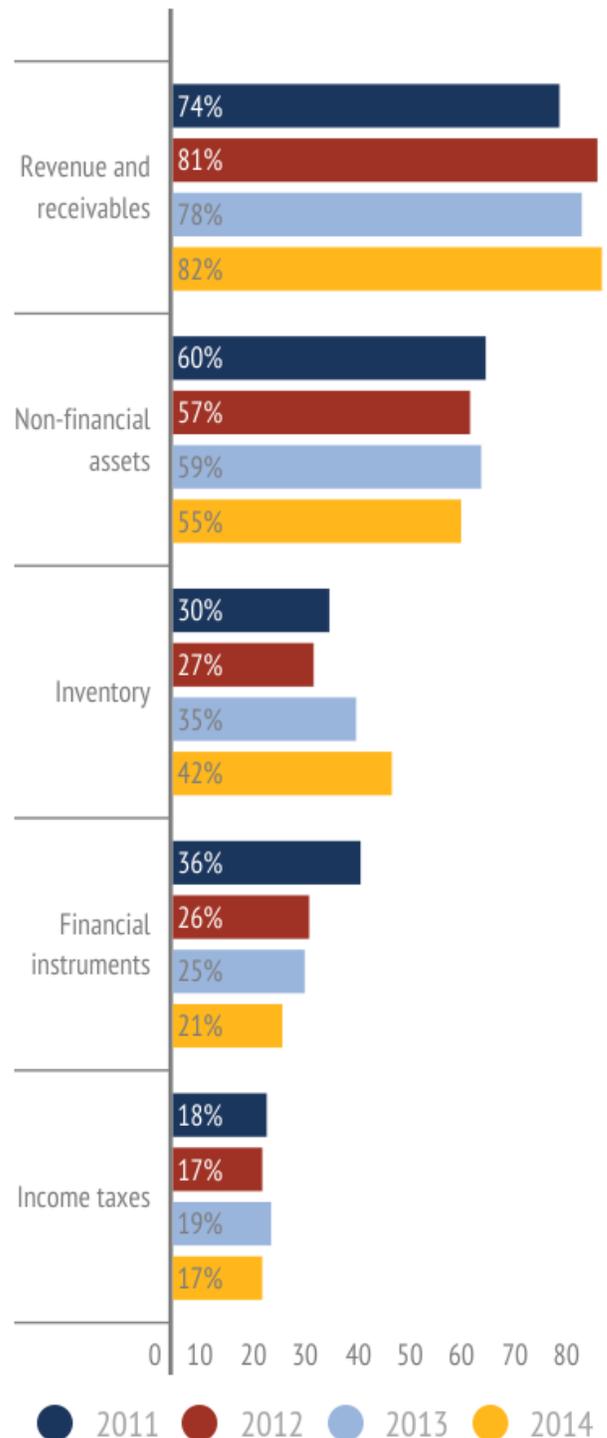


Financial Reporting Areas Inspected

Revenue is the most frequent auditing area selected for inspection as it often is one of the largest accounts in the financial statements and an important driver of a company's operating results. Revenue is also frequently associated with significant risk (including fraud risk).

Exhibits 5 and 6 summarize the audited financial reporting areas most frequently inspected, by inspection program, for the 2011 through 2014 inspection cycles. Other commonly inspected financial reporting areas included the allowance for loan losses, other liabilities (e.g., accounts payable and accrued liabilities), debt, other investments (e.g., equity method, joint ventures, variable interest entities, etc.) and other (e.g., discontinued operations, various income statement items, other assets, etc.).

Exhibit 5: Top 5 Audited Financial Statement Reporting Areas Selected for Inspection in Global Network Firms by Year (as a percentage of total number of audits inspected)

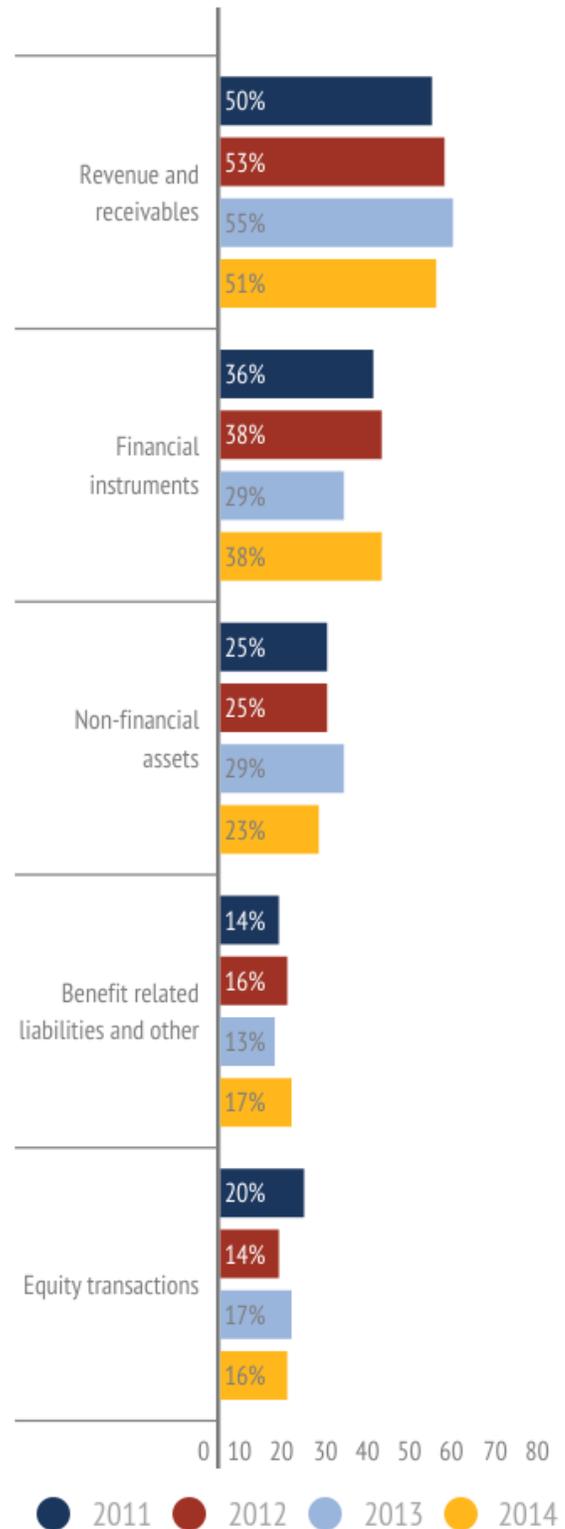


The nature of the issuer audits inspected in Non-Affiliate Firms contributed to selecting revenue, non-financial assets, inventory, and income taxes less frequently when compared to inspections of Global Network Firms. For example, many of the Non-Affiliate Firm audits that were inspected were of employee benefit plans, development stage, or shell companies, and therefore had little or no revenue and inventory, fewer or immaterial non-financial assets, and deferred tax assets with full valuation allowances.

Debt and equity instruments were more frequently selected as an area of focus in Non-Affiliate Firms because of the common use of convertible debt and share-based payments by smaller issuers that Non-Affiliate Firms typically audit.

Although not reflected in Exhibits 5 and 6, additional inspection procedures were generally performed on cash and cash equivalents for inspected audits of non-U.S. firms, and certain domestic Non-Affiliate Firms.

Exhibit 6: Top 5 Audited Financial Statement Reporting Areas Selected for Inspection in Non-Affiliate Firms by Year (as a percentage of total number of audits inspected)



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