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**REPORT ON 2007-2010 INSPECTIONS OF DOMESTIC FIRMS  
THAT AUDIT 100 OR FEWER PUBLIC COMPANIES**

**PCAOB Release No. 2013-001  
February 25, 2013**

## Executive Summary

The Public Company Accounting Oversight Board (the "PCAOB" or the "Board") is issuing this report to provide a summary of observations from its inspection program. This report covers domestic audit firms that audit the financial statements of issuers, and that regularly issue 100 or fewer audit reports each year. Such firms must be inspected at least once every three years ("triennially inspected firms"). This report describes inspection findings from 578 firms and 1,801 individual audits that were inspected in 2007-2010. The PCAOB has previously issued similar reports describing inspection-related observations for triennially inspected firms and other firms, which are available on the PCAOB's website at <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

### *PCAOB Inspections*

PCAOB inspections assess auditors' compliance with certain laws, rules, and professional standards in connection with audits of issuers. A PCAOB inspection of an audit firm examines in depth certain aspects of a limited number of audits performed by the audit firm as well as certain elements of the firm's system of quality control over its audit processes. Individual audits and areas of inspection focus within those audits are generally selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the areas of financial statements with the highest risk of material misstatement. In connection with their inspection of individual audits, PCAOB inspectors may identify significant audit performance deficiencies where the auditor did not obtain sufficient audit evidence to support its audit opinion. In addition, inspectors may identify deficiencies in the firm's overall system of quality control that increase the risk that the firm's system will not provide reasonable assurance that its personnel comply with professional standards.

### *General Observations from Inspections in 2007-2010*

This report summarizes observations resulting from inspections of triennially inspected firms that took place from 2007 through 2010. The Board previously issued a report in October 2007, addressing observations from inspections of triennially inspected firms from 2004 through 2006 ("the 2007 report"). Overall, the results in this report compared to the 2007 report show a reduced rate of reported significant audit performance deficiencies:

- Approximately 44 percent of the audit firms inspected between 2007 and 2010 had at least one significant audit performance deficiency compared to the 2007 report where approximately 61 percent of the audit firms

inspected between 2004 and 2006 were reported as having at least one significant audit performance deficiency.

- Of the 1,801 individual audits inspected between 2007 and 2010, 28 percent had at least one significant audit performance deficiency compared to 36 percent of the 1,589 audits inspected between 2004 and 2006.
- For the 455 firms that had a second inspection in the 2007- 2010 period, 36 percent had at least one significant audit performance deficiency in their second inspection, compared with a rate of 55 percent in their first inspection.

While reported significant audit performance deficiencies have decreased, the continued identification of these deficiencies in audits performed by a large number of triennially inspected firms is of concern. The Board and Inspections staff take a number of actions to encourage the firms to address these deficiencies. In each inspection, the staff discusses the findings with the firm to make sure that all of the facts are considered and to help the staff and firm understand the deficiency identified. Based on this understanding, the firms should design and implement any necessary changes to their quality control procedures. The Board encourages firms to initiate a dialogue with the Board's Inspections staff early on about how the firm intends to address quality control criticisms, including those identified as a result of these significant audit performance deficiencies. The Board encourages this dialogue so that a firm can receive timely feedback from the Inspections staff and enhance its efforts, if necessary, during the twelve-month remediation period. In addition, for a number of years, the Board has held a series of forums for auditors of smaller companies to share inspection results, remediation observations, and information about recently issued auditing standards.

As described in more detail in the report, the Board also encourages firms to identify and address the root causes of any audit performance deficiencies identified during the inspections process. The causes of these deficiencies are typically complex and are often the result of a combination of factors, including, among others:

- a lack of technical competence in a particular audit area;
- a lack of due professional care, including professional skepticism;
- ineffective or insufficient supervision, which at times may have been due to heavy partner and professional staff workloads;

- ineffective client acceptance and continuance practices that fail to consider technical knowledge called for in particular audits; or
- ineffective engagement quality reviews.

With respect to the inspections conducted from 2007 through 2010 that are the subject of this report, firms have remediated quality control deficiencies described in Part II of the inspection report to the Board's satisfaction in approximately 90 percent of those cases in which the Board has concluded on the firm's efforts. Firms' remediation activities to address specific quality control deficiencies have encompassed a range of actions, including enhancements of quality control policies and procedures, developing technical guidance targeted to specific issues, developing and requiring training targeted to specific issues, developing new audit tools, and requiring additional audit procedures.

#### *Observations of Audit Areas with Common Deficiencies*

Although audit deficiencies can occur in many different areas of an audit, Inspections staff have identified certain areas in which deficiencies occurred more frequently. This report includes general descriptions of deficiencies in certain such common problem areas, along with specific examples from inspection reports. Audit areas with frequent findings in the 2007-2010 period related to:

- auditing revenue recognition (deficiencies also discussed in prior reports);
- auditing share-based payments and equity financing instruments (deficiencies also discussed in prior reports);
- auditing convertible debt instruments (new category in this report);
- auditing fair value measurements (deficiencies also discussed in prior reports, but re-categorized);
- auditing business combinations and impairment of intangible and long-lived assets (deficiencies also discussed in prior reports);
- auditing accounting estimates (deficiencies also discussed in prior reports, but re-categorized);
- auditing related party transactions (deficiencies also discussed in prior reports);

- use of analytical procedures as substantive tests (deficiencies also discussed in prior reports, but re-categorized); and
- audit procedures to respond to the risk of material misstatement due to fraud (new category in this report, but previously the subject of a separate report).

Some categories above are identified as "deficiencies also discussed in prior reports, but re-categorized" from the presentation in our 2007 report. Specifically, auditing fair value measurements and use of analytical procedures as substantive tests were discussed in the equity transactions and revenue categories of the 2007 report, respectively. While auditing accounting estimates is a new category in this report, the 2007 report addressed auditing allowance for loan losses and allowance for doubtful accounts in the category on loans and accounts receivable. For fraud procedures, the Board released on January 22, 2007, a report titled "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud," which described observations by Inspections staff relating to procedures relevant to an auditor's consideration of fraud.

Categories of more frequent deficiencies in our 2007 report that are not included in this report are: auditors' going concern considerations, auditing loans and accounts receivable, auditors' consideration of issuers' use of service organizations, use of other auditors, use of the work of specialists, auditor independence, and concurring partner review. These categories are not included due to a lower frequency of these types of deficiencies reported during the 2007-2010 inspections that may have occurred for numerous reasons, including among others, lower frequencies in which certain audit areas were reviewed due to issuer audit selection and related matters, or improvements in auditing.

While observations of certain independence violations (e.g., services related to bookkeeping and preparation of financial statements and notes to financial statements, and inclusion of indemnification clauses in engagement letters) have declined, the Board continues to be concerned about, and continues to identify instances in which a firm has not complied with the relevant independence requirements. Although not separately discussed within the report, the Board emphasizes that firms should take steps to comply with the relevant PCAOB and SEC independence requirements.

All registered public accounting firms that participate in audits of issuers should consider whether the audit deficiencies described in this report might be present in audits they are currently performing, and should take appropriate action to reduce the likelihood of recurrence of similar deficiencies in the future. Audit committees may wish

to discuss this report with auditors they oversee to better understand whether any of the common deficiencies may be a concern they should consider in connection with the audits of their companies.



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capitalization (as of December 31, 2011). As shown in Exhibit 1 below, reflecting firm activity in 2011, the majority of domestic triennial firms that conduct audits of the financial statements of issuers do so for five or fewer issuers.

### *Exhibit 1*

#### **Summary of Domestic Triennial Firms that Issued Audit Reports**

For Year Ended December 31, 2011<sup>4/</sup>

	<b>Total</b>
Firms that issued audit reports for 1-5 issuers	287
Firms that issued audit reports for 6-10 issuers	69
Firms that issued audit reports for 11-25 issuers	59
Firms that issued audit reports for 26-50 issuers	34
Firms that issued audit reports for 51-100 issuers	18
<b>Totals</b>	<b>467</b>

The issues discussed in this report have been summarized from inspection reports of domestic triennial firm inspections conducted in the period from 2007–2010. For most domestic triennial firms, the 2007–2010 period included their second PCAOB inspection. For a portion of those firms, that period also included their third PCAOB inspection. The Board previously issued a general report on the results of inspections of domestic triennial firms in this category conducted in the period from 2004–2006. See Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms, PCAOB Release No.2007-010 (October 22, 2007).

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number of all common shares outstanding at year-end for the annual report filing, and as of the balance sheet date for the quarterly report filing.

<sup>4/</sup> The 467 firms that issued audit reports for the year ended December 31, 2011 differ from the 578 domestic triennial firms that were inspected at least once during the 2007-2010 period for numerous reasons, including among others, firms choosing to no longer audit issuers (possibly temporarily) and firm mergers.



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### II. Summary of Results

The Board has issued final reports on 748 inspections of 578 domestic triennial firms conducted in the 2007–2010 period, encompassing Inspections staff reviews of aspects of 1,801 audits. Approximately 44 percent of the audit firms inspected between 2007 and 2010 had at least one significant audit performance deficiency<sup>5/</sup> compared to approximately 61 percent of the audit firms inspected between 2004 and 2006. For the 2010 inspection year, the percentage of firms having such deficiencies reached 51 percent (while the overall rate for the 2007-2010 period was 44 percent); however, for the 2011 inspection year this percentage declined to 45 percent.

In 28 percent of the individual audits inspected, Inspections staff identified deficiencies of such significance that they found that the firm had not obtained sufficient appropriate audit evidence<sup>6/</sup> to support the firm's audit opinion.<sup>7/</sup> This compares to 36

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<sup>5/</sup> As used in this report, the term "significant audit performance deficiency" refers to a deficiency of such significance that it appeared to the Inspections staff that the firm had not obtained sufficient appropriate audit evidence to support the audit opinion it issued. Inspections staff findings do not necessarily mean there is a material error in the issuer's financial statements or a material weakness in the issuer's internal control over financial reporting. An Inspections staff observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. AS No. 3, *Audit Documentation*, provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9 and Appendix A to AS No. 3, paragraph A28.

<sup>6/</sup> For audits that were subject to inspections in the 2007–2010 period, see paragraph .01 of AU sec. 326, *Evidential Matter*. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraph 4 of PCAOB Auditing Standard ("AS") No. 15, *Audit Evidence*.

<sup>7/</sup> In some cases, the Inspections staff has sufficient available information to form a view that there is an apparent material misstatement to the financial statements that, due to insufficient audit work or improper assessment of GAAP, went undetected or unaddressed by the auditor. In cases where the Inspections staff reaches that

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percent of audits identified as having such significant audit performance deficiencies for the 2004–2006 period.<sup>8/</sup>

Exhibit 2 below shows a comparative summary of first and second inspection results of those firms' with second inspections during the 2007–2010 period categorized by those firms with significant audit performance deficiencies and those in which no significant audit performance deficiencies were identified (although defects in, or criticisms of, a firm's quality control system may have been identified). As shown in Exhibit 2, the Board has noted lower rates of significant audit performance deficiencies overall in the group of firms that had second inspections conducted during 2007–2010.

During that period, 455 firms had second inspections. In the firms' first inspections, 249 firms (or 55 percent) were determined by inspectors not to have obtained sufficient appropriate audit evidence to support their audit opinion in at least one audit. In the firms' second inspections, 164 firms (or 36 percent) were determined by inspectors not to have obtained sufficient appropriate audit evidence to support their audit opinion in at least one audit.

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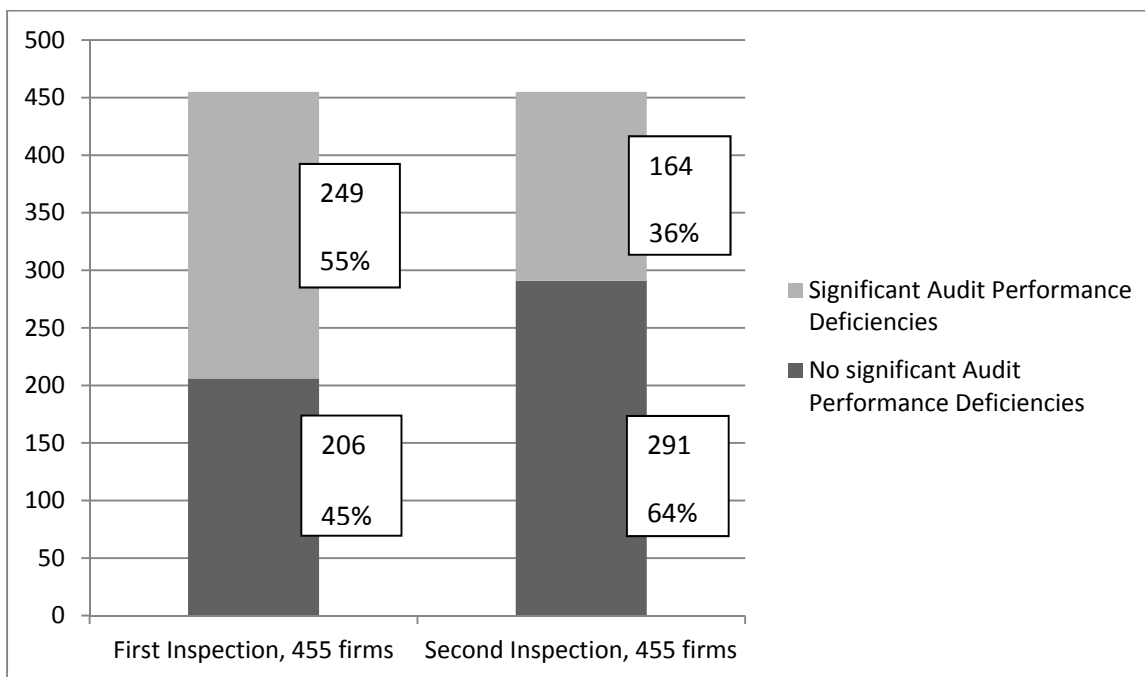
conclusion, the Board's practice is to report that information to the SEC, which has jurisdiction to prescribe the form or content of an issuer's financial statements. Any description in a PCAOB inspection report of a financial reporting error that the auditor did not appropriately address is a criticism of the auditing, based on information in the audit documentation, public information and the Inspections staff's understanding of the financial reporting requirements. An inspection report's description of such an audit deficiency is not an indication that the SEC has made or necessarily will make any determination concerning the financial reporting in question.

<sup>8/</sup> The data described here has limitations for concluding at a broad level about overall trends. There are many variables that can influence the comparability of inspection results. Nevertheless, PCAOB inspectors observed improvements at particular firms in the 2007-2010 period from what was observed in the 2004-2006 period.

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*Exhibit 2*

**Comparison of First vs. Second Inspection Results**



Despite the decrease in the rate of significant audit performance deficiencies noted in second inspections, the persistence of such deficiencies in audits performed by a large number of domestic triennial firms is of concern to the Board. The deficiencies represent instances in which the Inspections staff found that the auditor, at the time it issued its opinion that the financial statements were presented fairly in all material respects in conformity with U.S. generally accepted accounting principles ("GAAP"), had not fulfilled its fundamental responsibility to obtain reasonable assurance about whether that was the case. An auditor may express such a conclusion only when the auditor has formed that opinion on the basis of an audit performed in accordance with PCAOB standards,<sup>9/</sup> and those standards require the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for an opinion.

<sup>9/</sup> Paragraph .07 of AU sec. 508, *Reports on Audited Financial Statements*.

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Audit deficiencies can occur in various areas of an audit, but Inspections staff have identified areas where deficiencies are observed more frequently. Part III of this report discusses such deficiencies observed during the 2007–2010 period. In approximately 70 percent of the audits that were identified during this time to have significant audit performance deficiencies, the deficiencies that gave rise to the inspectors' findings related to at least one of the audit areas below.

- auditing revenue recognition (deficiencies also discussed in prior reports);
- auditing share-based payments and equity financing instruments (deficiencies also discussed in prior reports);
- auditing convertible debt instruments (new category in this report);
- auditing fair value measurements (deficiencies also discussed in prior reports, but re-categorized);
- auditing business combinations and impairment of intangible and long-lived assets (deficiencies also discussed in prior reports);
- auditing accounting estimates (deficiencies also discussed in prior reports, but re-categorized);
- auditing related party transactions (deficiencies also discussed in prior reports);
- use of analytical procedures as substantive tests (deficiencies also discussed in prior reports, but re-categorized); and
- audit procedures to respond to the risk of material misstatement due to fraud (new category in this report, but previously the subject of a separate report).

Some categories above are identified as "deficiencies also discussed in prior reports, but re-categorized" from the presentation in our 2007 report. Specifically, auditing fair value measurements and use of analytical procedures as substantive tests were discussed in the equity transactions and revenue sections of the 2007 report, respectively. While auditing accounting estimates is a new category in this report, the 2007 report addressed auditing allowance for loan losses and allowance for doubtful accounts in the category on loans and accounts receivable. For fraud procedures, the

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Board released on January 22, 2007, a report titled "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud," which described observations by Inspections staff relating to procedures relevant to an auditor's consideration of fraud.

Categories of more frequent deficiencies in our 2007 report that are not included in this report are: auditors' going concern considerations, auditing loans and accounts receivable, auditors consideration of issuers' use of service organizations, use of other auditors, use of the work of specialists, auditor independence, and concurring partner review. These categories are not included due to a lower frequency of these types of deficiencies reported during the 2007–2010 inspections that may have occurred for numerous reasons, including among others, lower frequencies in which certain audit areas were reviewed due to issuer audit selection and related matters, or improvements in auditing.

While observations of certain independence violations (e.g., services related to bookkeeping and preparation of financial statements and notes to financial statements, and inclusion of indemnification clauses in engagement letters) have declined, the Board continues to be concerned about, and continues to identify instances in which a firm has not complied with the relevant independence requirements. Although not separately discussed within the report, the Board emphasizes that firms should take steps to comply with the relevant PCAOB and SEC independence requirements.

The Board inspection process includes efforts to identify – and to encourage firms to identify and address – the root causes of audit performance deficiencies. Part IV of this report discusses several such potential root causes. In many cases the explanation for a deficiency may be a lack of technical competence in a particular area; however, the causes are frequently more complex and often involve a combination of factors. While auditors may have general technical competence, the auditors may have taken on issuer audits for which particularly complex accounting or industry specialization is involved. In other cases, deficiencies may occur in the work of auditors who may be technically capable but who do not apply due professional care, including professional skepticism. In other cases, deficiencies may result because the work of junior members of the engagement team is not appropriately supervised. Deficiencies sometimes may occur, at least in part, because auditors have undertaken workloads that exceed what can reasonably be accomplished with the requisite attention to those elements of the audit.

Any defects in, or criticisms of, a firm's quality control system are discussed in the nonpublic portion of the final inspection report and will remain nonpublic unless the

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firm fails to address them to the Board's satisfaction within 12 months of the date of the report.<sup>10/</sup> In approximately 90 percent of the cases in which the Board has concluded on a triennial firm's efforts to address quality control criticisms identified during inspections in the 2007–2010 period, the Board determined that the firm addressed each of the quality control criticisms to the Board's satisfaction. Although such a determination does not necessarily mean that the firm completely and permanently cured any particular quality control defect, it does mean that the Board believed that the firm, in the twelve-month period, made substantial, good faith progress toward achieving the relevant quality control objectives. Part V of this report briefly discusses some of the steps that triennial firms have taken to address quality control issues.

### III. Inspection Observations

This section of the report discusses each of the audit deficiency areas mentioned in the Summary of Results.<sup>11/</sup>

#### A. Auditing Revenue Recognition

Revenue is almost always an important focus area in audits given its general significance and the complexities and judgments that are often involved in its recognition. It is also frequently used as a key financial indicator by investors, analysts, and other users of financial statements. PCAOB standards state that the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.<sup>12/</sup>

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<sup>10/</sup> Section 104(g)(2) of the Act, 15 U.S.C. § 7214(g)(2).

<sup>11/</sup> The discussion in this report of any audit deficiency reflects information reported to the Board by the Inspections staff and does not reflect any determination by the Board as to whether any firm engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. For additional discussion of this distinction, see PCAOB Release No. 104-2004-001, *Statement Concerning the Issuance of Inspection Reports* (August 26, 2004) at 8-9.

<sup>12/</sup> For audits that were subject to inspections in the 2007–2010 period, see paragraph .41 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraph 68 of AS No. 12, *Identifying and Assessing Risks of Material Misstatement*.



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The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion on whether the financial statements are presented fairly, in all material respects, in accordance with GAAP.<sup>13/</sup> Examples of procedures related to revenue include obtaining an understanding of the arrangements and processes under which revenue is recognized, determining whether the terms and conditions have been met for revenue recognition and whether revenue was recognized in the correct period.

Inspections staff have found instances where firms failed to sufficiently test sales transactions to determine whether revenue recognition was appropriate. Further, Inspections staff have identified deficiencies relating to firms' testing of issuers' recognition of revenue that include the firms' failures to: (a) sufficiently test the occurrence, accuracy, and completeness of revenue; (b) read contracts or other supporting documentation and appropriately evaluate the specific terms and provisions included in significant contractual arrangements; (c) test whether revenue was recorded in the correct period; (d) assess whether the issuers' revenue recognition policies are consistent with GAAP; (e) apply sampling procedures appropriately in connection with determining sample sizes and selecting revenue transactions to test; and (f) perform sufficient tests to support the level of reliance placed on controls in determining the nature, timing, and extent of substantive procedures.

In some instances, firms relied on testing performed in other audit areas such as accounts receivable and cash for testing the assertions related to revenue, but that testing performed did not sufficiently address whether the issuer was recognizing revenue appropriately, including in the correct period. In other instances, firms relied on management representations or high-level analytical procedures for important evidence regarding the appropriateness of revenue recognition without obtaining corroboration of those representations or properly designing analytical procedures as substantive tests that were sufficiently precise to provide the necessary level of assurance. Refer to *Section H* for a discussion on applying analytical procedures as a substantive test.

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<sup>13/</sup> For audits that were subject to inspections in the 2007–2010 period, see AU sec 326.01. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraph 4 of AS No. 15.

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Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to issuers' recognition of revenue include:

- A firm failed to perform sufficient audit procedures to determine whether revenue was properly recognized in accordance with the terms of significant distribution agreements. In this instance, the issuer sold its products on a wholesale basis primarily through distributors. The issuer's financial statements disclosed that it had entered into four separate agreements with two distributors to sell its products. The firm's procedures were limited to performing a high-level year-over-year comparison of sales, performing certain cut-off procedures, confirming substantially all of the issuer's accounts receivable, and testing subsequent cash receipts in cases where confirmation responses were not returned. The firm also reviewed one distribution agreement, which corresponded to less than one percent of the issuer's total revenue, but did not review other significant distribution agreements or otherwise determine the terms were the same.
- A firm failed to perform sufficient audit procedures to determine whether revenues were recognized in the correct period. In this instance, the issuer generated revenue by providing consulting and strategic advisory services to customers. The issuer's financial statements disclosed that revenue is recognized based on the terms of specific contracts entered into by the issuer. The firm compared the amounts of revenue recorded to the contracts, inspected receipts throughout the year for payments received related to the contracts, and inspected subsequent receipts of accounts receivable balances. The firm did not, however, evaluate whether the period in which revenues were recognized corresponded to the period in which the issuer's services were provided in connection with the contracts.

Regardless of the size of an issuer, revenue recognition often involves industry-specific or specialized guidance. Examples of instances in which firms failed to sufficiently evaluate the issuer's application of specific accounting pronouncements include:

- Firms failed to sufficiently evaluate issuers' recognition of revenue derived from construction-type contracts and associated activities in accordance



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with GAAP.<sup>14/</sup> Examples of deficiencies observed by Inspections staff included: (a) the failure to test sufficiently the issuer's costs incurred to date, the estimated cost to complete, and the related gross profit margin percentages used to recognize revenue for uncompleted contracts using the percentage-of-completion method; and (b) the failure to evaluate the appropriateness of the issuer's determination of whether to use the percentage-of-completion method or the completed contract method.

- Firms failed to sufficiently evaluate issuers' recognition of revenue derived from software related transactions in accordance with GAAP.<sup>15/</sup> Examples of deficiencies observed by Inspections staff included: (a) the failure to sufficiently test the completeness, existence, and valuation of revenue and deferred revenue, including testing the effect of contract cancellations and renegotiations on an issuer's revenue recognition practices; (b) the failure to read software contracts; and (c) the failure to assess whether there was evidence of vendor-specific objective evidence of fair value for the undelivered elements of the contracts.
- Firms failed to sufficiently evaluate issuers' recognition of revenue derived from transactions involving the delivery of multiple elements in accordance with GAAP.<sup>16/</sup> Examples of deficiencies observed by Inspections staff

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<sup>14/</sup> At the time of the inspections, the applicable accounting principles were set out in American Institute of Certified Public Accountants Statement of Position ("SOP") 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. The provisions of SOP 81-1 have been largely codified in FASB ASC Subtopic 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*.

<sup>15/</sup> At the time of the inspections, the applicable accounting principles were set out in SOP 97-2, *Software Revenue Recognition*. The provisions of SOP 97-2 have been largely codified in FASB ASC Subtopic 985-605, *Software – Revenue Recognition*.

<sup>16/</sup> At the time of the inspections, the applicable accounting principles were set out in FASB Emerging Issues Task Force ("EITF") Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. The provisions of FASB EITF 00-21 have been superseded by FASB EITF 08-1 *Revenue Arrangements with Multiple*

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included: (a) the failure to evaluate each of the deliverables to determine whether they represented separate units of accounting, and (b) the failure to test the objective and reliable evidence of fair value of the undelivered elements.

- Firms failed to sufficiently evaluate issuers' presentation of revenue on a gross versus net basis in accordance with GAAP.<sup>17/</sup> Examples of deficiencies observed by Inspections staff included: (a) the failure to evaluate whether the issuer is a seller that has the primary obligation to the customer or whether the issuer is a seller that is acting in the capacity of an agent and to evaluate the effect that determination would have on presentation of revenue, and (b) the inappropriate acceptance of the issuer's presentation of revenues on a gross basis after determining that they should have been presented on a net basis.

### **B. Auditing Share-based Payments and Equity Financing Instruments**

The issuance of share-based payments and equity financing instruments to employees, vendors, and other third-parties is a common means of funding operations by newer or smaller companies that face difficulties raising capital or accessing credit markets. Share-based payments and equity financing instruments may contain terms and conditions that increase the risk of material misstatement in the accounting for such instruments. The measurement of the fair value of share-based payments and equity financing instruments may also involve a significant amount of judgment and assumptions.

The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion on whether the financial statements are presented fairly, in all material respects, in

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*Deliverables, the provisions of which have been codified in FASB ASC Subtopic 605-25, Revenue Recognition – Multiple-Element Arrangements.*

<sup>17/</sup> At the time of the inspections, the applicable accounting principles were set out in FASB EITF Issue No. 99-19 *Reporting Revenue Gross as a Principal versus Net as an Agent*. The provisions of FASB EITF 99-19 have been codified in FASB ASC Subtopic 605-45, *Revenue Recognition – Principal Agent Considerations*.

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accordance with GAAP.<sup>18/</sup> Examples of procedures related to share-based payments and equity financing instruments include obtaining an understanding of key terms and conditions contained in the arrangements or contracts.

Many of the reported audit deficiencies regarding equity financing instruments identified by the Inspections staff relate to auditing of equity transactions subject to Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-Based Payment*.<sup>19/</sup> SFAS 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods and services, and addresses transactions in which an entity, in exchange for goods and services, incurs liabilities that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

Inspections staff have identified deficiencies relating to firms' testing of issuers' accounting for share-based payments and equity instruments and/or issuers' determinations of fair value that include the firms' failures to: (a) perform procedures to obtain an understanding of the terms of the agreements relating to the issuance of the instruments in order to determine the appropriate accounting for those transactions, and (b) sufficiently test estimates of fair value for equity instruments, including the inputs, assumptions, and methodologies used in determining their fair value. Refer to *Section D* for a discussion on auditor requirements related to auditing fair value measurements used by management and for discussion on fair value related audit deficiencies.

Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to the issuance of share-based payments and equity financing instruments include:

- A firm failed to perform sufficient audit procedures related to the accounting and valuation of the shares of an issuer's common stock issued in exchange for services. In this instance, the firm failed to: (a)

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<sup>18/</sup> For audits that were subject to inspections in the 2007–2010 period, see AU sec 326.01. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraph 4 of AS No. 15.

<sup>19/</sup> The provisions of SFAS 123(R) have been largely codified in FASB ASC Topic 718, *Compensation—Stock Compensation*. Fair value measurement guidance for financial instruments subject to FASB ASC 718 are contained within this guidance and scoped out of FASB ASC Topic 820, *Fair Value Measurement*.

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determine if the per-share fair value assigned to the shares by the issuer was appropriate based on the closing share price on the date of issuance, (b) address certain differences between the number of shares of common stock disclosed in the issuer's statement of stockholders' equity and the shares of common stock reflected on the stock transfer agent's schedule, and (c) determine if the individuals and entities receiving the shares in exchange for services were employees or non-employees of the issuer to determine whether the share-based compensation was accounted for properly.

- A firm failed to perform sufficient audit procedures related to the accounting for the sale of common stock or convertible preferred stock in a private placement. Specifically, the firm failed to evaluate the effect on the financial statements of an issuer's failure to allocate any proceeds from the sale of shares of common stock or convertible preferred stock in private placements to warrants that were issued along with the shares of stock. The firm also failed to evaluate the settlement methods included in the warrant agreements to determine whether the warrants should have been classified as equity or as liabilities, including whether they met the conditions for the scope exception for classification as a derivative, considering EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*<sup>20/</sup> and other applicable standards.
- A firm failed to perform procedures to test equity financing transactions. In this instance, the firm failed to perform procedures such as: (a) obtaining an understanding of the terms of the equity agreements to determine whether the transactions were accounted for in conformity with GAAP, (b) reading board of directors meeting minutes to determine whether the equity transactions were authorized, (c) confirming with the stock transfer agent the number of shares issued and outstanding, and (d) evaluating whether the share-based transactions were properly presented and disclosed in the financial statements.

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<sup>20/</sup> The provisions of EITF Issue 00-19 have been largely codified in FASB ASC Subtopic 815-40, *Derivatives and Hedging – Contracts in Entity's Own Equity*.

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### C. Auditing Convertible Debt Instruments

The issuance of convertible debt can provide issuers with a financing source that is an alternative to traditional sources of credit. Similar to equity financing instruments, convertible debt instruments often contain features and other related instruments that increase the risk of material misstatement in the accounting for such instruments.

Standards for the accounting for convertible debt that may be settled in cash or converted into shares of the issuer's own stock are established in a number of places in GAAP. The issuer's accounting for debt that is convertible into the issuer's stock depends primarily upon the terms of the contract, which can result in a single debt instrument or an instrument with debt and equity components.

The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion on whether the financial statements are presented fairly, in all material respects, in accordance with GAAP.<sup>21/</sup> An example of a procedure related to convertible debt instruments include obtaining an understanding of key terms and conditions of the convertible debt instruments contained in the convertible debt agreements.

Inspections staff have identified deficiencies related to firms' testing of the issuer's accounting for transactions involving debt instruments with warrants and conversion features. Such deficiencies include firms' failures to sufficiently evaluate (a) the issuer's determination of fair value of the instruments, or components thereof; (b) the allocation of proceeds to the various components of the instruments; and (c) the adequacy of the presentation and disclosure of the transactions in an issuer's financial statements. Refer to *Section D* for a discussion on auditor requirements related to auditing fair value measurements used by management and for discussion on fair value related audit deficiencies.

Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to issuers' accounting for convertible debt instruments include:

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<sup>21/</sup> For audits that were subject to inspections in the 2007–2010 period, see AU sec 326.01. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraph 4 of AS No. 15.

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- A firm failed to evaluate certain key terms and conditions of the issuer's convertible debentures to determine whether it contained beneficial conversion features. In this instance, the convertible debenture agreements gave the holders the option to convert the debentures into shares of the issuer's common stock at fixed conversion prices. The issuer recorded the proceeds from the issuance of all instruments as convertible debenture liabilities without an allocation to a beneficial conversion feature.
- A firm failed to evaluate whether warrants that were contractually obligated to be issued under the terms of the debenture agreements were appropriately classified by the issuer in the financial statements, whether the issuer appropriately allocated proceeds received between debentures and the warrants issued during the year, and whether the issuer should have accounted for the warrants and embedded conversion options as derivative instruments.
- A firm failed to perform sufficient audit procedures to test the accounting for convertible debt instruments and associated stock-purchase warrants that were issued during the year under audit. Specifically, the firm failed to: (a) gain an understanding of the terms of a convertible debt refinancing to determine whether it had been accounted for in conformity with GAAP, (b) test whether the proceeds received by the issuer for a convertible debt transaction were allocated properly to the debt and warrants, and (c) evaluate the terms of the warrants issued in connection with the debt transactions entered into during the year under audit to determine whether the warrants were classified appropriately in the balance sheet.
- A firm failed to evaluate whether it was appropriate for an issuer not to assign any value to warrants or conversion features associated with convertible debt or whether subsequent modifications to the terms and conditions of the underlying debt were properly accounted for.



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### D. Auditing Fair Value Measurements

Fair value measurements are used to establish or evaluate the recorded values of many categories of assets and liabilities.<sup>22/</sup> PCAOB standards require that the auditor test management's fair value measurements and disclosures based on his or her assessment of the risk of material misstatement and consider using the work of a specialist in performing audit procedures related to fair value.<sup>23/</sup> The auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.<sup>24/</sup> Substantive tests of fair value measurements may involve: (a) testing management's significant assumptions, the valuation model, and the underlying data; (b) developing independent fair value estimates for corroborative purposes; or (c) reviewing subsequent events and transactions.<sup>25/</sup>

Certain financial instruments, including certain investments in debt and equity securities, are required to be reported in issuers' financial statements at fair value. In addition, fair value measurements for many equity and debt financing instruments may

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<sup>22/</sup> SFAS No. 157, the requirements of which have been codified in FASB ASC Topic 820, became effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years for assets and liabilities recognized and disclosed at fair value in financial statements on a recurring basis. Fair value measurement guidance prior to SFAS 157 was contained in the individual standards that required the fair value measurement. Fair value measurement guidance for financial instruments subject to FASB ASC Topic 718 are contained within FASB ASC Topic 718 and scoped out of FASB ASC Topic 820.

<sup>23/</sup> Paragraphs .20 and .23 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, and paragraph .06 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. PCAOB Staff Audit Practice Alert ("Practice Alert") No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (December 10, 2007), discusses auditors' responsibilities, under those standards, for auditing fair value measurements of financial instruments, including when using the work of specialists.

<sup>24/</sup> AU sec. 328.09.

<sup>25/</sup> AU sec. 328.23.

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require issuers to make significant judgments and assumptions due to a lack of liquidity for some of these instruments and a lack of observable market data. The valuation of certain instruments might be subject to an increased risk of material misstatement because, for example, the valuation methods used might be complex or it might be difficult to obtain observable market inputs for certain significant assumptions.

In some cases, an issuer's estimates of fair value may be based on fair values obtained from external pricing sources or other service providers such as custodians, record keepers and trustees. When testing management's process for determining fair value measurements or estimates, the auditor should perform procedures commensurate with the related risk. Auditors may develop independent fair value estimates, evaluate the appropriateness of the methods and the reasonableness of the assumptions the issuers and their pricing sources used to determine the fair value estimates, or review subsequent events and transactions.<sup>26/</sup> If the auditor develops independent fair value estimates by obtaining fair values from external pricing sources, it is important for the auditor to determine that the sources they use are different from those used by the issuers or the issuers' service providers. When there are no observable market prices and the auditor obtains fair values from pricing sources, it is important for the auditor to obtain an understanding of the methods and assumptions underlying the fair values obtained from the pricing sources.<sup>27/</sup> Inspections staff observed situations in which firms set out to test such estimates but failed to sufficiently perform certain necessary procedures.

In some cases, particularly in circumstances involving instruments with higher risk of material misstatement, the firm's approach to auditing fair value estimates involved testing the issuer's process for estimating fair value. This involves evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data.<sup>28/</sup> Inspections staff observed situations in which firms in these circumstances failed to sufficiently evaluate the appropriateness of the valuation methods and/or the reasonableness of the issuer's significant assumptions.

Examples of instances observed in which firms failed to obtain sufficient appropriate audit evidence related to testing fair value measurements include:

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<sup>26/</sup> Id.

<sup>27/</sup> AU sec. 328.40.

<sup>28/</sup> AU sec. 328.26.



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- A firm failed to perform sufficient audit procedures to test the reasonableness of the fair value estimates for a defined contribution plan's investments. Specifically, with respect to fair value estimates for investment contracts, the firm failed to evaluate the appropriateness of the valuation methods and the reasonableness of the significant assumptions. In addition, the firm failed to perform procedures to test the fair value of common collective trusts. The firm limited its testing to comparing the fair value of certain investments to fair value estimates reported by the defined contribution plan's record keeper in a valuation report.
- A firm failed to perform sufficient audit procedures to test the reasonableness of the fair value estimates for available-for-sale debt securities. In this instance, the firm compared fair value estimates on the issuer's detailed schedule of investment values to fair value estimates provided to the issuer by securities pricing sources. The firm should have performed additional audit procedures to test the fair value estimates, such as developing independent fair value estimates by obtaining fair values from an independent external source or evaluating the appropriateness of the methods and the reasonableness of the significant assumptions used by the issuer's securities pricing sources on individual securities on at least a sample basis.
- A firm failed to perform sufficient audit procedures to test the data and evaluate the reasonableness of the assumptions, including the expected term of the options, the risk-free interest rates used, and the stock price volatility used to determine the fair value of options issued to officers, directors, key employees, non-employees, and the issuer's primary lender in accordance with SFAS 123R.
- A firm failed to perform sufficient audit procedures to evaluate the reasonableness of the significant assumptions and appropriateness of the methodologies used by the issuer in determining the fair value of restricted common stock (purportedly with a three-year vesting period) issued to directors and officers as share-based compensation. The issuer concluded and the firm agreed that the common stock should be valued at a discount of 45 percent from the market trading price as a result of the resale restrictions based on a one-page letter from an investment banker, engaged by the issuer, dated nearly three years prior to the end of the year under audit. The firm failed to evaluate the reasonableness of the

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discount used to value the shares of common stock issued as share-based compensation.

In other cases, Inspections staff observed that firms evaluated issuers' estimates of fair value by developing an independent expectation of fair value for corroborative purposes. It is important to remember that, when an auditor's approach to evaluating an issuer's fair value estimate involves the auditor's development of an independent expectation as to that estimate, the auditor must have a reasonable basis, supported by audit evidence, for each of the significant assumptions it uses in developing its expectation.<sup>29/</sup>

### **E. Auditing Business Combinations and Impairment of Intangible and Long-Lived Assets**

Certain non-financial assets, such as certain long-lived assets acquired in business combinations, are required to be recorded at their fair values upon acquisition.<sup>30/</sup> In addition, for subsequent impairment testing, issuers are required to determine the fair values of reporting units to which goodwill has been assigned in order to identify potential goodwill impairment.<sup>31/</sup> Fair value measurements for non-financial assets, such as long-lived assets and reporting units, generally require issuers to make assumptions about the future, including market multiples, discount rates, and the amount and timing of future cash flows, which might be subject to greater uncertainty in times of economic distress.<sup>32/</sup>

In instances in which an issuer recognizes the effects of a business combination, including a reverse acquisition, in its financial statements or tests its goodwill, other indefinite-lived intangible assets, and other long-lived assets for impairment, it is the

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<sup>29/</sup> AU sec. 328.40.

<sup>30/</sup> FASB ASC Section 805-20-30, *Business Combinations – Identifiable Assets and Liabilities, and Any Noncontrolling Interest – Initial Measurement*.

<sup>31/</sup> FASB ASC Section 350-20-35, *Intangibles - Goodwill and Other – Subsequent Measurement*.

<sup>32/</sup> See Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment* (December 6, 2011).

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auditor's responsibility to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion regarding whether the fair value and other measurements and the related disclosures in the financial statements are presented, in all material respects, in conformity with GAAP.<sup>33/</sup> In doing so, the auditor is required to, among other things, obtain an understanding of the company's process for determining the fair value measurements and disclosures and of the relevant controls sufficient to assess the risk of material misstatement.<sup>34/</sup> Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures.<sup>35/</sup> The measurement of fair value may be less complex for certain assets and liabilities in which observable market transactions or data are available, but there may be a higher risk of material misstatement in the valuation of assets for which observable market transactions or data are not available,<sup>36/</sup> and an issuer may, for example, engage a valuation specialist to assist in estimating fair value. When using the work of a valuation specialist engaged by an issuer, the auditor is required to, among other things, evaluate the appropriateness of the valuation methods and the reasonableness of significant assumptions used or developed by the specialist.<sup>37/</sup>

### *Auditing Business Combinations*

Business combination transactions often present auditors with auditing challenges as they relate to fair value estimates. SFAS No. 141, *Business*

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<sup>33/</sup> For audits that were subject to inspections in the 2007–2010 period, see AU sec 326.01. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraph 4 of AS No. 15.

<sup>34/</sup> AU sec. 328.09 and AU sec. 328.13.

<sup>35/</sup> AU sec. 328.23.

<sup>36/</sup> FASB ASC Topic 820 provides guidance on measuring the fair value of assets acquired and liabilities assumed in business combinations.

<sup>37/</sup> AU sec. 328.26 and Footnote 2 to AU sec. 328, which states that "... management's assumptions include assumptions developed by management under the guidance of the board of directors and assumptions developed by a specialist engaged or employed by management."

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*Combinations*, in effect for a substantial number of the inspections conducted from 2007 to 2010<sup>38/</sup> required the purchase method of accounting for business combinations in which the acquiring entity allocates the cost of the acquired entity to the assets acquired and liabilities assumed, based on their estimated fair values or other appropriate value at the date of the acquisition. Refer to *Section D* for a discussion on auditor requirements related to auditing fair value measurements used by management.

Inspections staff have identified deficiencies relating to firms' testing of business combinations. Such deficiencies include the firms' failures to: (a) test the value of the purchase price or consideration given in the business combination, (b) evaluate whether all of the tangible and intangible assets acquired and all of the liabilities assumed have been identified and allocated an appropriate portion of the purchase price, (c) evaluate the reasonableness of estimated useful lives and appropriateness of the amortization methods applied to acquired intangible assets, and (d) evaluate the issuer's accounting for reverse merger transactions.

Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to business combinations include:

- A firm failed to perform audit procedures related to two acquisitions to determine whether the issuer had recorded all of the assets acquired and liabilities assumed, including any identifiable intangible assets, and that the purchase prices were appropriately allocated to the acquired net assets based on their appropriate valuations. In this instance, the issuer had recorded assets acquired and liabilities assumed at the amounts carried on the books of the acquired companies, without determining if the book values reflected their fair values.
- A firm failed to evaluate whether the issuer had appropriately allocated the purchase price to the tangible and intangible assets acquired and liabilities

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<sup>38/</sup> The guidance contained in SFAS No. 141 was superseded by SFAS No. 141(R), *Business Combinations*, which became effective for many companies in annual reporting periods beginning in 2009, and is included in FASB ASC Topic 805, *Business Combinations*. All business combinations within the scope of SFAS No. 141(R) are required to be accounted for under the acquisition method. SFAS No. 141(R) requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited specified exceptions.

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assumed. In addition, the firm failed to evaluate whether it was reasonable for the issuer to use a valuation of a building that was as of a date that was seven months subsequent to the effective date of the acquisition.

- A firm failed to identify and address the issuer's incorrect accounting for a reverse-merger transaction. In this instance, the historical financial statements for periods prior to the reverse merger transaction were not those of the accounting acquirer. In addition, the assets and liabilities of the entity that, for accounting purposes was the acquiree, were not recorded at their fair values at the date of the reverse-merger transaction.

### *Auditing Impairment of Goodwill, Other Indefinite-Lived Intangible Assets and Other Long-Lived Assets*

Goodwill and other intangible assets that are not subject to amortization are required to be evaluated for impairment annually, or more frequently when events or changes in circumstances indicate that the asset might be impaired or that the fair value of a reporting unit had fallen below its carrying value.<sup>39/</sup> Under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in effect during the 2007-2010 inspection period, issuers are required to evaluate other long-lived assets for recoverability whenever events or changes in circumstances indicate that their carrying amounts might not be recoverable.<sup>40/</sup> The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset.<sup>41/</sup>

Issuers might make judgments regarding the application of GAAP and might use fair value measurements or other estimates, such as projections of future cash flows, when assessing or measuring impairment of goodwill, other indefinite-lived intangible

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<sup>39/</sup> FASB ASC Section 350-20-35, *Intangibles – Goodwill and Other – Subsequent Measurement*, and FASB ASC Section 350-30-35, *Intangibles-Goodwill and Other – General Intangibles Other than Goodwill – Subsequent Measurement*.

<sup>40/</sup> SFAS No. 144 has been codified in FASB ASC Section 360-10-35, *Property, Plant, and Equipment – Overall – Subsequent Measurement*.

<sup>41/</sup> Id.

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assets, and other long-lived assets. An evaluation of impairment can be complex, and the auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP.<sup>42/</sup> Refer to *Section D* for a discussion on auditor requirements related to auditing fair value measurements used by management.

Inspections staff have observed instances where firms' procedures to test and conclude on the valuation of goodwill, other indefinite-lived intangible assets, and other long-lived assets were inadequate. In numerous cases in which the issuer was a small operating company or development stage enterprise, the firm concluded that there was substantial doubt regarding the issuer's ability to continue as a going concern, and the issuer had earned minimal revenues, incurred significant net losses, and/or reported negative cash flows from operations. Inspections staff observed instances in which, despite the presence of that combination of factors, firms accepted the issuers' conclusions that the intangible assets and/or long-lived assets were not impaired without performing procedures to test the process the issuer used to reach that conclusion or performing an independent impairment analysis.<sup>43/</sup>

Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to impairment of goodwill, other indefinite-lived intangible assets, or other long-lived assets include:

- A firm failed to sufficiently evaluate goodwill for possible impairment. The firm's procedures related to evaluating goodwill for possible impairment were limited to discussing with the issuer's management an issuer-prepared memorandum supporting management's determination that goodwill was not impaired, based on certain internal and external qualitative factors. The firm failed to evaluate whether other relevant information was inconsistent with management's determination and should have resulted in a determination that goodwill was impaired, including that: (1) the issuer had incurred net losses and negative cash flows from operations in the two most recent years, (2) revenue for the year under audit declined from the prior year, (3) the issuer recorded an impairment charge related to patents acquired from the same acquisition in which the

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<sup>42/</sup> AU sec. 328.03.

<sup>43/</sup> See, for example, paragraph 10 of AU sec. 342 *Auditing Accounting Estimates*.



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goodwill was recorded, and (4) conditions and events existed that led the firm to conclude that there was substantial doubt about the issuer's ability to continue as a going concern.

- A firm failed to test the issuer's projections and underlying assumptions in the issuer's determination that an intangible asset was not impaired. The firm concluded that the intangible asset was not impaired, based on obtaining management's projections of the issuer's future financial performance, which indicated substantial increases in revenue, net income, and cash flows in the subsequent three years, and discussing those projections with the issuer. The firm failed to evaluate whether other relevant information was inconsistent with management's determination and should have resulted in a determination that the intangible asset was impaired, including that: (1) the issuer had generated net losses and negative cash flows from operations; (2) the issuer, a developmental stage company, had minimal revenue from the time of its formation through the period under audit; and (3) the firm had concluded that there was substantial doubt about the issuer's ability to continue as a going concern.
- A firm failed to perform sufficient procedures in connection with its own goodwill impairment analysis. Specifically, the firm failed to obtain information to support the assumptions regarding expected cash flows used in its goodwill impairment calculation and failed to address the apparent inconsistency between the assumptions used in the firm's cash flow projection and the issuer's history of significant losses and negative cash flows. In this instance, the issuer did not prepare a goodwill impairment analysis as required by SFAS No. 142, *Goodwill and Other Intangible Assets*.<sup>44/</sup>
- A firm failed to test the values assigned to long-lived assets that were deemed to be impaired by the issuer, such as: (1) testing the significant assumptions, underlying data, and methodology used by the issuer, or (2) developing an independent fair value estimate to obtain corroboration of the reasonableness of the issuer's fair value estimate. The firm's procedures related to evaluating the impairment of the long-lived assets

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FASB ASC Section 350-20-35.

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were limited to reading of issuer-prepared documentation related to the impairment charge recognized by the issuer.

### F. Auditing Accounting Estimates

The preparation of financial statements involves making accounting estimates. Auditors are responsible for evaluating the reasonableness of accounting estimates made by issuers in the context of the financial statements taken as a whole, and their objective when performing this evaluation is to obtain sufficient appropriate audit evidence to provide reasonable assurance that: (a) all accounting estimates that could be material to the financial statements have been developed, (b) those accounting estimates are reasonable in the circumstances, and (c) the accounting estimates are presented in conformity with GAAP and are properly disclosed.<sup>45/</sup> Auditors are also responsible for assessing whether accounting estimates included in the financial statements indicate a possible bias on the part of management, and, if so, assessing the possible effects of that bias on the financial statements.<sup>46/</sup>

The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion on whether the financial statements are presented fairly, in all material respects, in accordance with GAAP.<sup>47/</sup> The risk of material misstatement of accounting estimates normally varies with the complexity and subjectivity associated with the process established by management for preparing the estimates, the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with the assumptions.<sup>48/</sup> To audit an estimate, the

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<sup>45/</sup> AU sec. 342.04 and .07.

<sup>46/</sup> For audits that were subject to inspections in the 2007–2010 period, see AU sec. 316.63. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraph 27 of AS No. 14, *Evaluating Audit Results* and see paragraph 26 of AS No. 14.

<sup>47/</sup> For audits that were subject to inspections in the 2007–2010 period, see AU sec. 326.01. For audits relating to fiscal years beginning on or after December 15, 2010, see paragraphs 4 of AS 15.

<sup>48/</sup> AU sec. 342.05.



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auditor should first gain an understanding of how management had developed the accounting estimate and then perform one or a combination of the following: (a) review and test the process management used to develop the estimate, (b) develop an independent expectation of the estimate to obtain corroboration for the reasonableness of management's estimate, or (c) review subsequent events or transactions occurring prior to the date of the auditor's report.<sup>49/</sup> Examples of procedures to test the process management used to develop the estimate include evaluating the reasonableness of management's significant assumptions and testing the data underlying management's estimate, including the completeness and accuracy of the underlying data, among others.<sup>50/</sup>

Inspections staff observed that firms often chose to evaluate accounting estimates by reviewing and testing management's process for developing the estimate. In these instances, deficiencies identified include firms' failures to: (a) sufficiently evaluate the reasonableness of management's significant assumptions, and (b) sufficiently test the data underlying management's calculation of the accounting estimate.

Some of the more common estimates for which Inspections staff observed instances where firms' audit procedures were deficient included allowances for loan losses, allowances for doubtful accounts receivable, and inventory reserves. Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to estimates include:

- A firm failed to sufficiently test the completeness and accuracy of the loan watch list report because it did not subject the loans determined by the issuer to be unclassified to testing of the risk grades, one criterion used for inclusion on the watch list. In addition, the firm failed to test the completeness and accuracy of the system-generated loan delinquency report that is used in the preparation of various credit quality management reports. The watch list and the various credit quality management reports were used by the issuer in the allowance for loan losses estimation process. Furthermore, the firm failed to perform audit procedures to test the loan-loss factors used by the issuer's management for either the qualitative or historical loss components of the allowance for loan losses

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<sup>49/</sup> AU sec. 342.10.

<sup>50/</sup> See AU sec. 342.11.

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beyond gaining an understanding of the issuer's process for developing such factors.

- A firm failed to perform sufficient procedures to test an issuer's allowance for loan losses. In this instance, the firm failed to perform audit procedures to test the issuer's grading of loans or test the loan-loss factors of the allowance used by the issuer's management or test the appropriateness of the related allowance percentages used for such loans.
- A firm failed to perform sufficient procedures to test an issuer's allowance for doubtful accounts receivable. To test the allowance for doubtful accounts receivable, the firm: (a) compared subsequent payments received to the individual accounts receivable for a portion of the year-end accounts receivable; (b) obtained an issuer prepared comparative analysis for the year under audit to the prior year of the gross accounts receivable balances, days sales outstanding, sales turnover, and accounts receivable as a percentage of current assets; (c) tested the clerical accuracy of the issuer prepared accounts receivable aging report and compared the aging report totals to the general ledger; and (d) obtained an email of the issuer's rationale for the balance in the allowance for doubtful accounts. The firm, however, failed to test the process used by management to develop the allowance for doubtful accounts receivable, or, in the alternative, to develop an independent expectation of the estimate to obtain corroboration of the reasonableness of the issuer's estimate or review subsequent events or transactions prior to the date of the auditor's report that would be relevant to evaluating the adequacy of the allowance for doubtful accounts receivable.
- A firm failed to perform sufficient procedures related to an issuer's valuation of inventory. In this instance, the issuer did not change its inventory valuation allowance during the year under audit from what was recorded at the end of the previous year. Inventory purchases and sales during the year under audit were minimal. At the end of the year under audit, the inventory balance included substantially all of the inventories that the issuer had held at the end of the previous year. The firm failed to perform procedures to determine whether the recorded value of the inventory at the end of the year under audit was realizable, or whether an additional valuation allowance was required.

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### G. Auditing Related Party Transactions

Auditors are responsible for performing procedures to identify related party relationships and material related party transactions.<sup>51/</sup> Audit procedures to address possible material related party transactions normally are performed even if the auditor does not suspect that related party transactions or control relationships exist.<sup>52/</sup> Auditors are required to exercise due professional care, which includes the exercise of professional skepticism,<sup>53/</sup> in the performance of their audit procedures.

Once an auditor has identified related party transactions, the auditor should apply procedures to obtain satisfaction concerning the purpose, nature, and extent of transactions with the related parties and the effect of those transactions on the financial statements.<sup>54/</sup> The procedures should be directed toward obtaining and evaluating sufficient appropriate audit evidence and should extend beyond inquiry of management.<sup>55/</sup> Finally, auditors should evaluate the adequacy of disclosures for each material related party transaction or common ownership or management control relationship.<sup>56/</sup>

Inspections staff have observed deficiencies related to firms' failures to test for undisclosed related parties or transactions with undisclosed related parties. Some of those firms failed to identify and address the lack of disclosure of related party transactions in the financial statements. Inspections staff have also identified deficiencies relating to the firms' failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflects their economic substance.

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<sup>51/</sup> See Paragraph .01 of AU sec. 334, *Related Parties*.

<sup>52/</sup> See AU sec. 334.04.

<sup>53/</sup> AU sec. 230.02.

<sup>54/</sup> See AU sec. 334.09.

<sup>55/</sup> AU sec. 334.09.

<sup>56/</sup> AU sec. 334.11. SFAS No. 57, *Related Party Disclosures* provides relevant disclosure requirements for related party transactions and have been codified in FASB ASC Topic 850, *Related Party Disclosures*.

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Examples of instances in which firms failed to obtain sufficient appropriate audit evidence related to related parties and material related party transactions include:

- A firm failed to perform sufficient procedures to test identified related party transactions and failed to perform procedures to identify undisclosed related parties or undisclosed related party transactions. In this instance, the issuer's financial statements disclosed related party transactions and payable balances, and the firm's work papers included a detailed listing of certain related party payables and the changes in the balances from the prior year. The firm's related party audit procedures were limited to inspection of the detailed listing of payables and reading a loan agreement with one of the related parties. Other than these procedures, the firm failed to perform procedures to test the existence, valuation, and completeness of related party balances and transactions.
- A firm failed to perform sufficient audit procedures in regard to related party transactions. Specifically, the firm failed to: (a) obtain an understanding of the nature, purpose, and extent of the issuer's transactions with related parties to determine whether they were properly accounted for and disclosed in the financial statements; (b) evaluate the appropriateness of offsetting amounts owed to other entities against the notes receivable due from related parties; and (c) evaluate the reasonableness of management's estimate of a reserve for the related party notes receivable balance. In this instance, the issuer recorded a provision for the full amount of notes receivables due from a joint venture partner of the issuer and an entity that was being operated by a subsidiary of the issuer.
- A firm failed to examine transactions with related parties and assess the adequacy of the issuer's accounting for related party transactions. There was no evidence in the audit documentation, and no persuasive other evidence, that the firm had performed procedures to test for related parties and related party transactions. In this instance, the issuer issued stock in order to extinguish debt, and certain of the recipients of this stock were related parties. The per-share value of the stock issued in the extinguishment of debt was calculated using the individual debts' carrying values and varied within a substantial range. Transactions involving certain related parties fell at or near the low end of this range.

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### H. Use of Analytical Procedures as Substantive Tests

Auditors often use analytical procedures in their audits as substantive tests of significant accounts or disclosures. Analytical procedures are an important part of the audit process and involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates.<sup>57/</sup>

In determining when to apply substantive analytical procedures, firms need to consider, among other things, that, where significant risks of material misstatement exist, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.<sup>58/</sup> Before using the results of substantive analytical procedures, auditors should test the completeness and accuracy of the underlying information used in the procedures or test the design and operating effectiveness of controls over the completeness and accuracy of the underlying financial information.<sup>59/</sup> When analytical procedures are used as a substantive test of a relevant financial statement assertion, the auditor should: (a) develop an expectation at a sufficient level of precision to provide the desired level of assurance,<sup>60/</sup> (b) consider the amount of difference from the expectation that can be accepted without further investigation,<sup>61/</sup> and (c) evaluate significant unexpected differences.<sup>62/</sup> Auditors should ordinarily perform procedures to obtain corroboration for management's explanations of significant unexpected differences with other audit evidence.<sup>63/</sup>

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<sup>57/</sup> See paragraphs .02 and .05 of AU sec. 329, *Analytical Procedures*.

<sup>58/</sup> AU sec. 329.09

<sup>59/</sup> AU sec. 329.16.

<sup>60/</sup> AU sec. 329.17.

<sup>61/</sup> AU sec. 329.20.

<sup>62/</sup> AU sec. 329.21.

<sup>63/</sup> Id.

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Inspections staff have identified deficiencies relating to firms' use of analytical procedures that include the firms' failures to: (a) develop appropriate expectations, including appropriately disaggregating data in order to obtain the necessary level of precision for the expectation; (b) investigate significant unexpected differences; (c) obtain evidence to corroborate management's explanations regarding significant unexpected differences; and (d) test the underlying data used in the analytical procedures.

Examples of instances in which firms failed to perform sufficient substantive analytical procedures include:

- A firm failed to: (a) develop expectations for use in its analytical procedures, (b) determine whether the explanations documented for a significant variance were at a level of precision sufficient to provide the necessary level of assurance that potential material misstatements would be identified, and (c) obtain corroboration of the explanation for a significant variance. In this instance, the substantive analytical procedures related to firm's testing of revenues, which consisted of revenue by month being compared to the prior month and total revenue for the year under audit being compared to the total for the prior year with a brief explanation obtained from management for the decrease in revenues.
- A firm failed to sufficiently perform substantive analytical procedures to test revenues of a diversified company that generated revenues primarily from five operating segments in two geographic areas. In this instance, the firm performed analytical procedures to test revenues by comparing revenues by geographic area for the year under audit to the prior year. The firm failed, however, to: (a) develop expectations of revenue amounts for the year under audit for use in the analytical procedures, (b) obtain corroboration for management's explanations for all significant variances that were identified, and (c) perform tests of reports and ledger accounts generated by the issuer that were relied upon for the firm's substantive analytical procedures in order to determine if the reports and ledger accounts were accurate and complete.
- A firm failed to develop expectations for its substantive analytical procedure by identifying plausible relationships that were reasonably expected to exist. In this instance, the issuer was an employee benefit plan. The firm's primary procedure to test the rollover contributions was a



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substantive analytical procedure in the form of a comparison of the account balances for the year under audit with the previous three years, and the firm obtained explanations for variances from the issuer.

### **I. Procedures to Respond to the Risk of Material Misstatement due to Fraud**

The consideration of the risk of material misstatement due to fraud is an integral part of the audit under PCAOB standards. PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.<sup>64/</sup>

Fraud risks may arise from a variety of sources, including external factors and internal factors. The auditor should evaluate whether the information obtained from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.<sup>65/</sup> As part of risk assessment procedures, the auditor should obtain an understanding of the company and its environment in order to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.<sup>66/</sup> In addition, when the auditor has determined that a

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<sup>64/</sup> Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

<sup>65/</sup> For audits that were subject to inspections in the 2007–2010 period, AU sec. 316.32 provided that "[w]hen obtaining information about the entity and its environment, the auditor should consider whether the information indicates that one or more fraud risk factors are present." For audits relating to fiscal years beginning on or after December 15, 2010, paragraph .65 of AS No. 12, provides that "[t]he auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks."

<sup>66/</sup> For audits that were subject to inspections in the 2007–2010 period, AU sec. 311.06 provided that "[t]he auditor should obtain a level of knowledge of the entity's business that will enable him to plan and perform his audit in accordance with generally accepted auditing standards. That level of knowledge should enable him to obtain an understanding of the events, transactions, and practices that, in his judgment, may have a significant effect on the financial statements." For audits relating to fiscal years

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significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control.<sup>67/</sup> Also, the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.<sup>68/</sup>

The auditor responds to risks of material misstatement due to fraud in the following three ways: (a) a response that has an overall effect on how the audit is conducted – that is, a response involving more general considerations apart from the specific procedures otherwise planned; (b) a response to identified risks involving the

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beginning on or after December 15, 2010, paragraph 7 of AS No. 12, provides that "[t]he auditor should obtain an understanding of the company and its environment ('understanding of the company') to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement."

<sup>67/</sup> For audits that were subject to inspections in the 2007–2010 period, AU sec. 316.44 provided that "[a]s part of the understanding of internal control sufficient to plan the audit, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation." For audits relating to fiscal years beginning on or after December 15, 2010, paragraph 72 of AS No. 12, provides that "[w]hen the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control."

<sup>68/</sup> For audits that were subject to inspections in the 2007–2010 period, AU sec. 316.41 provided that "[t]he auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition." For audits relating to fiscal years beginning on or after December 15, 2010, paragraph 68 of AS No. 12, provides that "[t]he auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks."



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nature, timing, and extent of the auditing procedures to be performed; and (c) a response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such overrides could occur.<sup>69/</sup> The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit.<sup>70/</sup>

Inspections staff have identified deficiencies relating to firms' consideration of fraud in a financial statement audit that include firms' failures to: (a) sufficiently test journal entries and other adjustments for evidence of possible material misstatement due to fraud, including assessing the completeness of the listing of journal entries and other adjustments that is used for testing purposes; (b) consider the risk of material misstatement due to fraud relating to revenue recognition or indicate why revenue recognition would not be considered a fraud risk; (c) make inquiries of the audit committee, management, and others as to their views about the risk of fraud; (d) conduct a brainstorming session by members of the engagement team to discuss fraud risks, (e) obtain an understanding of the issuer's controls over journal entries and other adjustments, and (f) assess the risk of management override of controls.

Firms should design and perform audit procedures that address the fraud risks, including reassessing risk and adjusting procedures as appropriate during the audit. The auditor should exercise professional skepticism, and conduct the audit engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present.<sup>71/</sup> In addition, in designing and performing its fraud-related audit procedures, firms should take into consideration that: (a) the current economic

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<sup>69/</sup> For audits that were subject to inspections in the 2007–2010 period, AU sec. 316.48 provided these requirements. For audits relating to fiscal years see AS No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>70/</sup> For audits that were subject to inspections in the 2007–2010 period, AU sec. 316.68 provided that "[t]he auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit." For audits relating to fiscal years beginning on or after December 15, 2010, paragraph 74 of AS No. 12, provides that "[t]he auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit."

<sup>71/</sup> AU sec. 316.13.

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environment may trigger certain risk factors that may affect the risk of misstatement due to fraudulent financial reporting,<sup>72/</sup> and (b) recent disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the Board's oversight activities highlight the need for heightened awareness of risks of misstatement due to fraud when performing audits of companies with operations in emerging markets.<sup>73/</sup>

### IV. Potential Root Causes Contributing to Audit Deficiencies

The Board has issued this report to highlight areas where firms can focus their attention in order to enhance the quality of their audits. Firms, however, should not assume that these are the only areas requiring attention; each firm should, in the course of monitoring its own audit performance, identify and address any challenges to compliance with PCAOB standards. Firms also should continually stress the critical need to conduct audits with due professional care, including professional skepticism. While audit performance issues can improve by changes to firm methodology, more or improved training, or reinforcement of existing policies and methodology, for some firms the need to avoid recurring deficiencies may call for them to consider the way they manage their practices, including their performance evaluation and compensation systems.

The Board's inspection program strives to identify the underlying causes of audit deficiencies, through its own analysis and by encouraging firms to identify potential root causes. The following potential root causes related to these audit deficiencies have been identified:

- Due Professional Care, including Professional Skepticism - AU sec. 230, *Due Professional Care in the Performance of Work*, provides, among other things, that an auditor must plan and perform audit work with due professional care.<sup>74/</sup> Due professional care encompasses a requirement to exercise, throughout the

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<sup>72/</sup> See Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (December 5, 2008).

<sup>73/</sup> See Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* (October 3, 2011).

<sup>74/</sup> AU sec. 230.02.

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audit process, professional skepticism which is "an attitude that includes a questioning mind and a critical assessment of audit evidence."<sup>75/</sup> The auditor should not to be "satisfied with less than persuasive evidence because of a belief that management is honest."<sup>76/</sup> Inspections staff continue to observe instances in which the circumstances suggest that auditors did not appropriately apply professional skepticism in their audits. The lack of appropriate application of professional skepticism appears to have occurred in some instances because auditors allowed their confidence or trust in management to cause them to accept assertions rather than sufficiently test them. In other instances, heavy partner and professional staff workloads, including those working in a supervisory capacity, appear to have contributed to time pressures that have led to an apparent lack of sufficient professional skepticism. Audit deficiencies such as the following raise concerns that a lack of professional skepticism was at least a contributing factor: (1) acceptance of client-prepared analyses or management's explanations without obtaining evidence to corroborate management's assertions, including instances when there was known contradictory audit evidence or when such evidence was reasonably available to the auditors but the auditors failed to obtain and evaluate such evidence; (2) insufficient testing of the completeness and accuracy of source documents; and (3) premature sign-offs on audit programs or the use of audit programs that either are insufficiently detailed to demonstrate work performed or are not accompanied by other work papers that demonstrate work performed.

- Technical Competence - AU sec. 230 provides that an auditor should possess "the degree of skill commonly possessed by other auditors," that auditors should be "assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability," and that the engagement partner "should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client."<sup>77/</sup> Domestic triennial firms audit issuers of varying sizes and complexity, and in a wide range of industries. Audit deficiencies sometimes appear to Inspections staff to result, at least in part, from engagement teams not having the level of technical knowledge called for by the

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<sup>75/</sup> AU sec. 230.07.

<sup>76/</sup> See AU sec. 230.09.

<sup>77/</sup> See AU sec. 230.05-06.

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particular audit or failing to consult with others who have the appropriate level of technical knowledge.<sup>78/</sup> This problem can arise for several reasons, including, among others, inadequate training and firm client acceptance and continuance processes that do not include careful and serious consideration of whether the firm possesses the necessary technical knowledge to perform the audit, particularly when complex accounting or industry specialization is involved.

- Partner and Professional Staff Work Load - Inspections staff have identified instances in which partner and professional staff heavy workloads may have contributed to poor audit quality. It is important for auditors to remember that excessive workloads, particularly for partners or other professional staff working in a supervisory capacity, may negatively affect their ability to properly supervise the work of junior members of the engagement team assisting in the performance of an audit. It may also contribute to insufficient professional skepticism and due care in the performance of an audit.
- Client Acceptance and Continuance – As described above, Inspections staff have identified potential root causes for poor audit quality related to engagement teams not having the level of technical knowledge called for by a particular audit and heavy partner and professional staff workloads. A firm should establish policies that provide reasonable assurance that a firm undertakes only those engagements that a firm can reasonably expect to be completed with professional competence, and appropriately considers the risk associated with providing professional services in the particular circumstances.<sup>79/</sup> This should include consideration given to the nature and complexity of accounting and the industry in which the issuer operates, including changes from prior years.

In addition, a firm should appropriately consider the risks associated with providing professional services in the particular circumstances. In doing so, a firm should take into account, among other things, the business environment in which the issuer operates. As described in Practice Alert No. 8, *Audit Risks in Certain Emerging Markets*, significant differences can exist between the business

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<sup>78/</sup> See Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010).

<sup>79/</sup> Paragraph .15 of QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

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environments faced by companies with operations in emerging markets, and those in developed markets, which may affect the risk of misstatement in the financial statements. In performing acceptance and continuance assessments for clients with operations in emerging markets, the auditor should consider his or her own ability to perform audits in emerging markets and, if using the work of accountants outside the auditor's own firm, the auditor's ability to supervise or assume responsibility for that work in accordance with PCAOB standards.

- Engagement Quality Control Reviews<sup>80/</sup> - In some cases where firms did not obtain sufficient appropriate audit evidence to support the firm's audit opinion, a contributing factor was that the firms did not ensure that their concurring partner reviews and engagement quality reviews were effective. The ineffectiveness of any such review, of course, is not the root cause of an audit performance deficiency in the sense of explaining why the deficiency occurred in the first place, but it can be a contributing cause to the firm ultimately issuing the insufficiently supported audit opinion. The responsibilities of the engagement quality reviewer should be carried out with objectivity and the application of due care, with the firm appropriately addressing the reviewer's findings before issuing the audit report. In some instances observed by Inspections staff, the reviewing partner did not have the appropriate level of expertise and experience. In other instances, the timing of the review (for example, after the issuance of the audit report) limited or negated its effectiveness.

### V. Firms' Efforts to Address Audit Quality Issues Identified in Inspections

Board inspection reports often include criticisms of the inspected firm's system of quality control. Those criticisms might flow from observations concerning particular audit performance deficiencies, including from the Inspections staff's consideration of potential root causes of the deficiency, and from matters unrelated to particular audits (for example, concerns about the design of a firm's practice monitoring policies and procedures). When a report includes such criticisms, the Act provides the firm with an incentive to address the criticism. Specifically, if the firm addresses the criticism to the

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<sup>80/</sup> AS No. 7, *Engagement Quality Review*, took effect toward the end of the 2007–2010 inspection period, and applies to all audits and interim reviews for fiscal years beginning on or after December 15, 2009. Before that, many, but not all, triennial firms were subject to a provision of the Board's interim quality control standards that required them to obtain in each audit a "concurring partner review" consistent with requirements of the former SEC Practice Section of the AICPA.

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Board's satisfaction within twelve months of the report date, the criticism must remain nonpublic. If the criticism has not been sufficiently addressed, the Board publicly discloses that fact and the criticism on its Web site.<sup>81/</sup>

The Board encourages firms to initiate a dialogue with the Board's Inspections staff about how the firm intends to address the criticisms. The majority of triennial firms who receive quality control criticisms take steps to address those criticisms within the twelve-month period, and many of those firms take advantage of the opportunity to obtain feedback from the Inspections staff in order to enhance and refine those efforts within the twelve-month remediation period. Domestic triennial firms' efforts have encompassed a range of actions, including, enhancements to quality control policies and procedures developing technical guidance targeted to specific issues, developing and requiring training targeted to specific issues, developing new audit tools, and requiring additional audit procedures. When evaluating these actions, the Board considers the timing, scope, and applicability of the remedial actions in light of the corresponding quality control criticisms.

In approximately 90 percent of the cases in which the Board has concluded on a domestic triennial firms' efforts to address quality control criticisms identified during inspections in 2007 through 2010, the Board determined that the firm had addressed all of the quality control criticisms to the Board's satisfaction. In the remaining approximate 10 percent of the cases where one or more of the quality control criticisms were made public, firm responses were received an average of 14 days prior to the end of the remediation period. Additionally, 20 firms did not provide any remediation response to the Board. As provided in the Board's rules, the Board made all quality control criticisms of those reports public.

A favorable Board determination concerning a firm's remediation efforts, however, is not a Board conclusion – and is not grounds for a firm to conclude – that the firm has completely or permanently eliminated the risk of significant audit performance deficiencies. It has not been unusual for Board inspectors to identify significant audit performance deficiencies in domestic triennial firms' second or third inspections even after the Board had determined the firm's efforts to address quality control criticisms in an earlier inspection to be satisfactory. The persistence of significant audit performance deficiencies in the audits of a significant portion of triennial firms points to the need for those firms to continue to focus on making improvements to their quality control systems.

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<sup>81/</sup> See Section 104(g)(2) of the Act; PCAOB Rule 4009(d).



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### Appendix PCAOB Inspections of Public Company Auditors

Under the Sarbanes-Oxley Act of 2002 ("the Act"), public accounting firms that provide audit reports for "issuers" (essentially, public companies with SEC reporting obligations) must be registered with the PCAOB. The Act charges the PCAOB to conduct regular inspections of such firms, whether located in the U.S. or elsewhere, for the purpose of assessing compliance with certain laws, rules, and professional standards in connection with a firm's audit work for issuers.

As of December 31, 2011, there are approximately 740 registered firms (including approximately 470 domestic triennial firms and approximately 260 non-U.S. firms) that provide audit reports for issuers, although the precise number fluctuates as some firms begin for the first time to issue audit reports for issuers and other firms cease doing so. 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 for 100 or fewer issuers (triennial inspection). At any time, the PCAOB might also inspect any other registered firm that does not issue audit reports but does perform work used by another firm in the audit of an issuer. The PCAOB has a practice of inspecting, in each year, some firms in that category.

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include evaluations of the design and operating effectiveness of a firm's quality control policies and of the firm's performance in selected audit engagements.

Audits are selected for inspection based on various risk factors, including: (1) the nature of the issuer or its industry; (2) audit issues likely to be identified; (3) market capitalization of the issuer; (4) whether the issuer has significant operations in certain emerging markets; (5) considerations related to the particular audit firm, practice office, or partner, including prior inspection results; and (6) any other relevant information that has come to the Board's attention. Usually, only higher-risk portions of an audit are evaluated in an inspection. It is not the purpose of an inspection to evaluate all of a firm's audits or to identify every respect in which a selected audit may be deficient.

The Board issues a report on every inspection and makes a portion of the report publicly available at <http://pcaobus.org/Inspections/Reports/Pages/default.aspx>. The Board has elsewhere described in detail its approach to making inspection-related

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information publicly available consistent with statutory restrictions.<sup>1/</sup> A substantial portion of the Board's criticisms of a firm, and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms.<sup>2/</sup> In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients.

The Board also issues general public reports on inspection-related findings from time to time. These reports do not address findings in terms of particular firms but, rather, discuss observations from the inspection program in a way intended to be informative and helpful for auditors. These reports also give investors, audit committees, and others the benefit of information and analysis concerning highlighted audit issues, or a summary and analysis of results from inspections of a specified category of firms over a particular period. Previous general reports, as well as other inspection-related documents such as those cited in the footnotes to this Appendix, are available on the Board's web site at <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

Observations from the inspection program play an important role in informing various other PCAOB activities. The Board's Office of the Chief Auditor takes inspection results into account in considering whether to recommend that the Board amend the standards that auditors must follow in connection with issuer audits. Inspection results also inform the content of PCAOB Staff Audit Practice Alerts, which highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits. Staff audit practice alerts are available at <http://pcaobus.org/Standards/Pages/Guidance.aspx>. The Board also regularly presents forums on auditing in the small business environment, at which inspection issues are discussed in an interactive format to help auditors of small public companies benefit from the PCAOB's assessment of audit problems identified through inspections. Information about these forums, which are presented at various locations, is available at <http://pcaobus.org/Featured/Pages/SmallBusinessForums.aspx>.

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<sup>1/</sup> See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

<sup>2/</sup> For additional information on this point, See The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports, PCAOB Release No. 104-2006-077 (March 21, 2006).

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In some cases, observations from Board inspections become the subject of an informal inquiry or a formal investigation by the Board's Division of Enforcement and Investigations. These inquiries and investigations can result in the institution of formal disciplinary proceedings and the imposition of disciplinary sanctions, which can include revoking a firm's PCAOB registration and barring an individual from association with a registered firm. In the case of most deficiencies identified by inspectors, however, the Board encourages its inspection dialogue, including the quality control remediation process, to foster and facilitate improvements in auditing, rather than invoke formal disciplinary authority.