PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SPOTLIGHT

Staff Update and Preview of 2019 Inspection Observations

October 8, 2020

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OVERVIEW

The Public Company Accounting Oversight Board (PCAOB) is committed to improving audit quality and promoting compliance with professional standards and our rules. One of the ways in which we aim to do this is through our inspections. This staff update and preview shares certain observations from the 2019 inspections of audits of issuers prior to issuance of the inspection reports. This update includes information on our continued efforts to transform our inspections process, our most recent inspection observations, and perspectives from our target team work related to multi-location audits. Auditors may find this information useful as they plan and perform their audits, and audit committees may find it useful as they engage with their auditors. We previously provided initial observations from our review of the first phase of implementation of critical audit matters for large accelerated filers with a fiscal year ending on or after June 30, 2019.

In 2019, we inspected approximately 175 audit firms, reviewing portions of approximately 710 audits that generally had financial years ended during 2018. We also inspected key elements of audit firms' system of quality control. We conducted these inspections in the U.S. and in approximately 30 jurisdictions around the world. The results described here include our non-U.S. inspections of approximately 55 triennially inspected audit firms, where we reviewed portions of approximately 150 related audits.

Observations related to audits of broker-dealers are included in the ***Annual Report on the Interim Inspection Program Related to the Audits of Brokers and Dealers***.

INSPECTION TRANSFORMATION ACTIVITIES

In late 2018, we announced a number of interrelated projects to evaluate how we plan, conduct, and report on our inspections. In 2019, we began to transform certain aspects of our inspection process, including:

- Incorporating unpredictability into more areas of our inspections process;
- Deploying a team to target specific areas of focus or emerging risk across firms;
- Expanding our inspection procedures to compare approaches firms are taking to monitor their systems of quality control;
- Refining our inspection methodology to focus more on the firm's system of quality control;
- Designing a new format for our inspection reports; and
- Enhancing our engagement with audit committee chairs of certain U.S. issuers whose audits we inspected.

OBSERVATIONS OF GOOD PRACTICES

Through our inspections this past year, we identified good practices that we believe enhance audit quality. A good practice could be a procedure, technique, or methodology that is appropriately comprehensive and suitably designed in relation to an audit firm's size and the nature and complexity of the audit firm's practice.

Good practices we observed include:

- **Interactive meetings and coaching workshops.** Some firms implemented interactive engagement team meetings, often tied to particular audit milestones, and coaching workshops among engagement team members. These meetings and workshops assist auditors in (1) identifying how the financial statements might be materially misstated and (2) identifying and assessing the risks of material misstatement. The understanding of the business processes informs that identification and assessment of risks. We observed fewer deficiencies when auditors performed timely and rigorous risk assessments, along with appropriately designed and executed audit procedures to address the corresponding risks.
- **Earlier involvement of the engagement quality reviewer (EQR).** Some firms focused on emphasizing the importance of setting expectations for the EQR's involvement in planning discussions, while others required an EQR to review mandatory templates used by the engagement team in performing and documenting various aspects of the audit. Explicitly requiring the involvement of the EQR in the earlier stages of the engagement may result in earlier identification of potential audit challenges and more time for the engagement team to appropriately respond to any matters identified by the EQR for further follow-up.
- **Narrative descriptions of quality control.** Firms created narratives of their quality control process or prepared process flow maps that were tied to their quality objectives and controls, from which the firms could monitor engagement performance and enhance the effectiveness of their root cause analyses.
- **Increased partner involvement when planning tests of controls.** Some engagement team leaders held planning meetings with staff prior to performing tests of controls to specifically discuss the flow of transactions related to significant accounts and disclosures and the identified risks of material misstatement. These discussions, along with robust risk assessment procedures, improve the staff's ability to determine whether the controls identified for testing were designed effectively to meet the control objective and mitigate the risks of material misstatement.
- **Use of firm specialists during audit planning to assist with the risk assessment.** Involvement of firm specialists in audit planning may enhance the ability of auditors to more effectively identify and assess risks of material misstatement and develop overall audit responses and procedures to address the assessed risks. For example, when determining the allowance for loan losses (ALL), companies often use models, which can be complex and involve significant management judgment.

Depending on the complexity and size of the loan portfolio, issuers may design and operate controls over the model validation process in which the control owners are specialists themselves. Some firms involved auditor specialists in risk assessment activities, including in upfront discussions with the issuer's control owners, so that auditor specialists provided input to the identification and assessment of risks of material misstatement related to the ALL. Some firms also involved the specialist in the development of audit procedures to address such risks, including tests of relevant controls.

- **Implementing coaching programs and refining audit tools for specific audit areas.** We also observed positive results at firms that developed coaching programs or refined existing audit tools to target historical deficiencies identified. For example, we observed improvement in the auditing of estimates at firms that implemented coaching programs, made engagement teams accountable for engaging with the assigned coaches, and monitored the programs. In addition, in response to the new revenue accounting standard, ASC 606, *Revenue from Contracts with Customers*, certain firms developed templates and training tools to assist auditors in testing controls and performing substantive procedures.

TARGET TEAM ACTIVITIES

In 2019, we established a target team to perform inspection procedures across inspected firms. Their work focuses on current audit risks and emerging topics, including identifying good practices. Our target team focused on multi-location audits based in the U.S. and also on issuer audits at annually inspected firms in which the U.S. firm played a role but was not the principal auditor (referred work). The team evaluated topics relating to planning and risk assessment, principal auditor considerations, and communications between the principal auditor and the other auditor, including appropriate measures to ensure the coordination of activities, and independence.

We observed improved audit quality when there is regular, consistent communication between the principal auditor and the other auditors. Examples of how these communications have been done include clear referral instructions, site visits by the principal auditor, and involvement of an additional local EQR by the other auditors.

During our target team inspections, we observed areas where further improvements could be made between the principal auditor and other auditors. These include enhancing documentation of required procedures, complying with the requirements of PCAOB Rule 3211, *Auditor Reporting of Certain Audit Participants*, and improving engagement letter templates to exclude indemnification clauses.

The efforts of the target team revealed a number of good practices:

- **Performing engagement quality reviews of audits conducted by other auditors.** Certain firms have policies and procedures requiring the assignment of an EQR to review audit procedures performed when they are the other auditors. Although AS 1220, *Engagement Quality Review* does not require an additional EQR to be assigned specifically to review part of the audit performed by other auditors at an issuer's location or business unit, we observed that the performance of engagement quality review procedures over work performed by other auditors appeared to enhance audit quality.

- **Assigning a partner experienced in International Financial Reporting Standards (IFRS) as an additional reviewer on work referred to a U.S. firm.** Certain U.S. firms require the assignment of an additional IFRS reviewing partner when a portion of a non-U.S. audit is referred to a U.S. firm. The IFRS reviewing partner supplements the audit team's knowledge of and experience with IFRS particularly in performing risk assessment and resolving technical accounting matters.
- **Automating the collection of global hours to compile the information required for Form AP filings.** We observed some firms utilizing existing firm technology-based tools in the collection of global hours to compile and prepare the Form AP. This collection of relevant data from other accounting firm participants in a structured and consistent way appeared to enhance group audit monitoring.
- **Using site visits to obtain additional information.** We identified that some firms held planning meetings with the other auditors and reviewed audit work papers remotely or during site visits. Certain firms also met with local management during their site visits. In some instances, site visits provided the principal auditor with valuable insight into the quality of audit work performed by the other auditor and increased the principal auditor's knowledge of the issuer's location or business unit. Site visits remain an important part of the interaction between the principal and other auditors, as well as local management. In light of the travel restrictions and other constraints in place due to COVID-19, however, virtual visits could be considered an alternative.

The work of our target team is continuing and will help inform our future inspections. In 2020, the target team is focused on (1) obtaining an understanding of any changes in a firm's policies, procedures, or methodologies in response to COVID-19 and (2) reviewing June 30 audits and reviews of interim financial information for issuers affected by the pandemic.

RECURRING DEFICIENCIES

While the recurring deficiencies we observed in 2019 inspections are similar to those we observed in prior years, some firms have reduced the number or severity of deficiencies or eliminated deficiencies in these areas all together. The recurring deficiencies described below highlight potential areas of improvement for all firms, whether or not firms have been recently inspected.

Revenue

Despite the focus and attention by firms on the new accounting standard[1], as well as the training and/or tools firms provided to their auditors, we observed frequent deficiencies related to the design and performance of audit procedures that address the assessed risks of material misstatement related to revenue. For example, we identified audit deficiencies in testing revenue accounted for under the new accounting standard where:

- Auditors did not consider other relevant factors in conjunction with an underlying contract when validating performance obligations or allocating prices.

[1] On May 28, 2014, the Financial Accounting Standards Board completed its Revenue Recognition project by issuing Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (Topic 606). The new guidance establishes the principles to report useful information to users of financial statements about the nature, timing, and uncertainty of revenue from contracts with customers. The new guidance on revenue recognition is effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period.

- Auditors did not evaluate whether the issuer had an enforceable right to payment prior to recognizing revenue.
- In determining when revenue recognition was appropriate, auditors did not perform any procedures to test the issuer's evaluation about whether products created and sold to a specified customer had an alternative use.

Independence

Auditors are required to be independent of their audit clients—both in fact and in appearance. In our inspections, we continue to identify, among other matters, violations of financial relationship requirements of Rule 2-01 of SEC Regulation S-X. Certain inspected firms continue to report a high rate of noncompliance by firm personnel reporting their financial relationships during the confirmation process. In certain other inspected firms, deficiencies primarily relate to PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*, and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*.

Accounting Estimates

We continue to identify deficiencies related to auditing estimates, particularly in auditing the ALL and business combinations. Common audit deficiencies in auditing estimates included instances where:

- Auditors did not evaluate the reasonableness of qualitative factors considered by management in calculating the general reserve related to the ALL. In certain instances, the audit procedures were limited to inquiry of the issuer's personnel to understand the factors considered in computing the reserve and comparing the current reserve to the prior year to determine if the change in the reserve was in line with information auditors obtained orally through discussions held with the issuer's personnel without corroborating the information with appropriate audit evidence.
- Auditors did not sufficiently test the reasonableness of the projections used in later years of a forecasted period. When testing projections used in determining the valuation of acquired assets, auditors limited their procedures to inquiry of the issuer's personnel and comparing one year of forecasted projections to actual results.
- Auditors did not test the accuracy and/or completeness of the issuer's data used to develop the estimates.

Internal Control over Financial Reporting (ICFR)

Deficiencies in controls testing remain a common occurrence in both integrated audits and when controls are tested in a financial statement audit. Despite improvements observed at certain firms, we continue to observe deficiencies related to testing ICFR across firms. Common audit deficiencies in this area include instances where:

- Auditors did not sufficiently evaluate whether controls with a review element selected for testing operated at a level of precision that would prevent or detect material misstatements. In these instances, the auditors did not evaluate the review procedures the control owners performed, including the procedures to identify items for follow-up and the procedures to determine whether those items were appropriately resolved.
- Auditors did not identify and test controls that sufficiently addressed the risks of material misstatement related to relevant assertions of certain significant accounts. For example, the issuer may have multiple

streams of revenue, but the controls identified and tested by the auditor only addressed risks related to one of these streams.

- Auditors selected and tested management review controls over accounting estimates, but did not identify and test controls over the accuracy and completeness of system-generated reports which were used by control owners in the operation of these controls and were important to the effective operation of the controls.

TECHNOLOGY

A strategic goal of the PCAOB is to anticipate and respond to the changing environment, including emerging technologies and related risks and opportunities. As part of achieving this goal, we reviewed how auditors responded to the use of distributed ledger technology and cybersecurity incidents, where applicable. We also reviewed the firms' use of new software audit tools.

PCAOB staff regularly monitors technology-related developments and assesses their implications on PCAOB standards. We also have resources available on what we've observed, including our Spotlights: ***Audits Involving Cryptoassets: Information for Auditors and Audit Committees*** and ***Data and Technology Research Project Update.***

Distributed Ledger Technologies and Digital Assets

While we observed limited instances of the use of distributed ledger technology or recording of digital assets in our inspections of annually inspected firms during 2019, we did discuss with certain audit firms how the use of distributed ledger technology is influencing audit procedures. Some of the annually inspected firms have provided training to staff and implemented consultation processes when their audit clients use distributed ledger technology, receive consideration in the form of digital assets, or hold investments in digital assets.

In some triennially inspected firms, we have observed instances in which issuers used distributed ledger technology to support recording a digital asset in their general ledger. In some instances, we identified deficiencies where the auditor did not perform procedures to evaluate the relevance and reliability of audit evidence obtained over the existence and valuation of digital assets, more specifically cryptoassets, recorded at year-end. For example, we observed instances where the auditor relied on certain third party reports without performing procedures to test the reliability and accuracy of the reports.

Cybersecurity Risk

We continue to review audits of issuers that experienced a cybersecurity incident during the audit period. While not every incident we observed had an impact on the issuer's financial statements, we observed in our reviews how the auditor considered the cybersecurity incident in the auditor's risk assessment process and, if applicable, in the auditor's response to identified risks of material misstatement. In certain audits reviewed, the auditor evaluated the severity and impact of the cyber incident but did not consider whether the incident affected the auditor's identification or assessment of risks of material misstatement; whether modifications to the nature, timing, or extent of audit procedures were necessary; and whether the incident could be indicative of deficiencies in ICFR.

Software Audit Tools

Firms continue to develop and use software audit tools to enhance their audit procedures. Many firms maintain policies and procedures to test the design and operation of software audit tools before these are used by engagement teams. Certain firms allow engagement teams to use third-party tools that have not been tested for design and operation by the firm. In certain audits inspected, we observed instances where engagement teams using these tools failed to test the reliability of data used as audit evidence.

AUDIT COMMITTEE COMMUNICATIONS

In 2019, we reached out to the audit committee chairs of almost all of the U.S. issuers whose audits we selected for review to provide an opportunity to speak with our teams during the inspections process. In these discussions, we heard from audit committees that they have frequent and thorough communication with their auditor. Nevertheless, we found through our compliance testing during the inspections of certain triennially inspected firms that not all significant risks identified during audit planning—including changes to those risks—were communicated to the audit committee.

We Want to Hear from You

This staff update and preview provides a high-level overview of our observations in 2019 inspections. In addition to this publication, we release individual inspection reports for each applicable audit firm that will be posted on our website periodically as they are finalized and approved by the Board.

In an effort to continue to improve external communications and provide information that is timely, relevant, and accessible, we want to hear your views regarding this document. Please take two minutes to fill out our **short survey**.

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