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the public portion of those inspection reports. This report collects and summarizes, in a single document, audit deficiencies in areas that were significantly affected by the economic crisis. The deficiencies are provided as illustrative examples of the type of deficiencies that inspectors identified when inspecting audits. Identification of these deficiencies should not be construed as suggesting a pervasive issue exists in the particular audit areas.

The key points discussed in this report include –

- PCAOB inspectors identified instances where auditors sometimes failed to comply with PCAOB auditing standards in connection with audit areas that were significantly affected by the economic crisis, such as fair value measurements, impairment of goodwill, indefinite-lived intangible assets, and other long-lived assets, allowance for loan losses, off-balance sheet structures, revenue recognition, inventory, and income taxes.
- Firms have made efforts to respond to the increased risks stemming from the economic crisis. The deficiencies identified by inspectors in their reviews of issuer audits suggest that firms should continue to focus on making improvements to their quality control systems.
- The Board will focus on whether firms' actions to address quality control deficiencies described in Board inspection reports have, in fact, reduced or eliminated subsequent occurrences of the kinds of deficiencies described in this report.
- The observations described in this report will serve to inform future Board actions in connection with certain inspection, enforcement, and standard-setting activities. The Board will consider whether additional guidance is needed related to existing standards.
- PCAOB inspectors will continue to focus on firms' audits and quality control systems, particularly as they relate to audit risks posed by the ongoing effects of the economic crisis and any future similar events.

The Board's statutory mission is to protect the interests of investors and to further the public interest in the preparation of informative, fair and independent audit reports.

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The information in this report is intended to provide investors with insight into how the Board fulfills that mission. This report should also be useful to investors and other financial statement users as they review and evaluate audited financial statements that include disclosures in the areas discussed in this report.

In addition, registered firms, audit committees, and other standard setters might find the information in this report of use. For example –

- Registered Firms: Firms must determine how to strengthen their quality controls in order to minimize the likelihood of future audit deficiencies. The Board urges all registered public accounting firms to review this report and consider whether the auditing problems that the Board has observed could manifest themselves in the firms' practice. Firms should be proactive in considering how to prevent similar deficiencies in their own practices, both by strengthening firm quality controls and by anticipating and addressing risks that might arise in specific issuer audits.
- Audit Committees: Audit committees might find this report of interest in at least two respects. First, the auditing challenges discussed in this report parallel financial reporting challenges. Audit committees might want to consider, and discuss in detail or more detail with financial reporting management, how the issuer addresses such matters as fair value measurements, impairment determinations, and loan loss reserve calculations; how the issuer documents its decisions; and what type of information is available to the auditors with respect to these items. Second, the audit committee might wish to discuss with the issuer's auditor the auditor's assessment of audit risk in the areas discussed in the report, what the auditor's strategy will be for addressing those risks, and the results of audit procedures performed related to those risks.
- Other Standard Setters: The Board is mindful that the accounting standard setters, the Financial Accounting Standards Board and the International Accounting Standards Board, have embarked on an ambitious agenda to revise applicable accounting and financial reporting requirements. The accounting principles related to several of the challenging audit areas discussed in this report are on that agenda. The Board will provide a copy of this report to these standard setters for their consideration and will continue to communicate any

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issues in the implementation of accounting principles that it detects through its inspections program.

Background and Report Structure

As has been widely reported, businesses have suffered through an economic crisis over the past three years. The economic crisis quickly and significantly increased the risk of material misstatements in financial statements in certain industries, such as the financial services industry, and in certain audit areas, such as fair value measurements, asset impairments, allowance for loan losses, inventory valuation, revenue recognition and the consideration of an issuer's ability to continue as a going concern. The Board's inspection program focused on reviewing these areas when applicable to the audits of issuers. The Board's inspection program also focused on reviewing audits of issuers in numerous affected industries, with a particular attention to financial services industry issuers that were directly affected by the economic crisis, including some of the larger financial institution audit clients of domestic registered firms.

This report covers aspects of the Board's inspections from the 2007, 2008, and 2009 inspection cycles, which generally involved reviews of audits of issuers' fiscal years ending in 2006 through 2008. This report therefore includes observations regarding audits of issuers in the financial services industry for 2006 fiscal years, when delinquencies and charge-offs began to increase for certain categories of mortgage loans, as well as financial services industry issuers' 2007 and 2008 fiscal years, which were significantly affected by the economic crisis. This report also includes observations regarding audits of non-financial services industry issuers' 2008 fiscal years, when the economic crisis affected a broader range of business sectors.

This report contains four sections. First is a discussion of the Board's inspection process and how it responded to the increased audit risks presented by the adverse economic events. Following that, observations by the Board's inspection staff are presented, including a discussion of deficiencies identified by inspectors in certain audit areas and, for each area, examples of specific deficiencies.^{2/} The audit areas discussed

^{2/} The deficiencies are provided as illustrative examples of the type of deficiencies that inspectors identified when inspecting audits. Identification of these

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include areas that were significantly affected by the economic crisis. Next, this report discusses the Board's response to the identified areas of audit deficiencies. Finally, this report describes the Board's ongoing efforts to address additional audit risks posed by the economic crisis or any similar future events.

The Inspection Process

A key element of many of the Board's programs, including the inspection program, is the monitoring of economic events. The Board's inspection staff monitored developments and emerging audit risks related to the economic crisis by, among other things, interacting with other PCAOB offices and divisions, such as the Office of Research and Analysis ("ORA") and the Office of the Chief Auditor ("OCA"), and using the results of tools available through the PCAOB, such as the ORA market surveillance program. When the Board's inspection staff began to recognize the audit challenges that would be created by the financial market disruption, inspectors participated in dialogue with some of the larger registered firms to discuss those challenges and to make clear that inspectors would focus on auditor's adherence to all relevant standards.^{3/} Issues discussed included the challenges of measuring and auditing the fair value of complex financial instruments in an increasingly thin or illiquid market, including the availability and use of prices provided by brokers or pricing services. As the challenges grew and spread across financial market sectors and the broader economy, the inspection staff continued to discuss the issues with firms, monitored how firms were adjusting their 2007 and 2008 audit plans to respond to the risks, and continued to emphasize the need to comply with the auditing standards.

deficiencies should not be construed as suggesting a pervasive issue exists in the particular audit areas.

^{3/} In addition, to highlight audit challenges and risks posed by the economic crisis, the Board's staff issued Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, on December 10, 2007 ("Staff Audit Practice Alert No. 2") and Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment*, on December 5, 2008 ("Staff Audit Practice Alert No. 3").

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The Board's inspection process relies on two techniques to assess firms' audit quality during the period covered by an inspection. First, inspectors review a firm's work on numerous audits selected by the PCAOB, without any firm influence. Second, inspectors evaluate the design and effectiveness of a firm's quality control policies and procedures that could be expected to have an effect on audit performance.

The selection of issuer audits for review is influenced by an evaluation of the risk that issuers' financial statements could be materially misstated. This risk might relate to characteristics of the particular issuer or its industry; the audit issues likely to be encountered; firm-, practice office-, or individual partner-level considerations; prior inspection results; and other factors.

Given the effect of the economic crisis on the financial services industry, audits of larger, more complex financial institutions were an area of focus of the Board's inspection program during the 2007, 2008, and 2009 inspection cycles, which generally involved reviews of firms' audits of issuers' fiscal years ending in the 2006 through 2008 period. The Board's inspection staff used internally and externally prepared industry research as well as other data and analyses to identify and evaluate risk factors attributable to the overall financial services industry and to specific sectors within the financial services industry, such as the banking, securities, and insurance sectors. Within each of these sectors, other accounting and product risk factors were considered, such as subprime mortgage exposure, commercial mortgage exposure, complex transactions, complex financial instruments, complex or subjective fair value measurements, and asset impairment. In addition, information about issuers' operations was considered, such as recent financial performance, geographic concentrations, and changes in loan portfolio credit quality.

As the effects of the economic crisis spread to the broader economy, the Board's inspection staff considered additional audit risk factors, as well as audit risk factors previously considered that had become more significant, during the 2009 inspection cycle, which generally involved reviews of firms' 2008 audits. These additional or heightened risk factors were identified in audit areas such as fair value measurements, consideration of an issuer's ability to continue as a going concern, accounting for special purpose entities, contingencies, complex derivatives, compliance with debt obligations, valuation of deferred tax assets, valuation of goodwill, valuation of other intangibles and other long-lived assets, valuation of inventory, determination of other-than-temporary impairment of certain investments, pension and other post-employment

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benefit obligations, valuation of receivables, valuation of restructuring liabilities, and revenue recognition.^{4/}

Observations by the Board's Inspection Staff

In connection with audit areas that were significantly affected by the economic crisis, the Board's inspectors identified instances where in the inspection staff's view audits failed to comply with PCAOB auditing standards. This report describes some of the more significant or common deficiencies^{5/} in these audit areas.

The following observations related to audit performance are divided into four sections: (1) deficiencies identified in audits of both financial services industry issuers and non-financial services industry issuers, (2) deficiencies identified in audits of financial services industry issuers, (3) deficiencies identified in audits of non-financial services industry issuers, and (4) certain observations by the Board's inspectors regarding firms' responses to the economic crisis.

1. Deficiencies Observed in Audits of Both Financial Services Industry Issuers and Non-Financial Services Industry Issuers

Fair Value Measurements

Fair value measurements are used to establish or evaluate the recorded values of many categories of assets and liabilities.^{6/} The economic crisis increased uncertainty

^{4/} See Staff Audit Practice Alert No. 3.

^{5/} The discussion in this report of any audit deficiency reflects information reported to the Board by the inspection team and are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. For additional discussion of this distinction, see PCAOB Release No. 104-2004-001, *Statement Concerning the Issuance of Inspection Reports* (Aug. 26, 2004) at 8-9.

^{6/} Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("SFAS 157"), the requirements of which have been codified in FASB Accounting Standards Codification

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regarding issuers' estimates of fair value, which significantly increased audit risk. Issuers' fair value measurements and disclosures are often important to investors relying on issuers' financial statements. If auditors do not properly test issuers' fair value measurements and disclosures, auditors might fail to detect material misstatements in issuers' financial statements relating to such measurements and disclosures, and investors might be misled.

PCAOB standards require that the auditor test management's fair value measurements and disclosures and consider using the work of a specialist in performing audit procedures related to fair value.^{7/} 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.^{8/} The auditor's general approach to performing substantive tests of fair value measurements might include one or a combination of the following: (a) testing the significant assumptions, the valuation model, and the underlying data, (b) developing an independent estimate of fair value for corroborative purposes, or (c) reviewing

("ASC") 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. Certain of the deficiencies identified by inspectors related to audits of issuers that had early-adopted the provisions of SFAS 157 in the preparation of their 2007 fiscal year-end financial statements.

^{7/} 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*. Also, in December 2007, PCAOB staff issued Staff Audit Practice Alert No. 2 to remind auditors of their responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. The practice alert focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in the economic environment, including, in particular, factors related to the housing and mortgage markets.

^{8/} AU sec. 328.09.

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subsequent events or transactions occurring prior to the date of the auditor's report.^{9/} In certain cases, observable market prices might exist to assist in testing fair values. The market disruption during the economic crisis, however, reduced the availability of observable market prices for use in testing certain fair value measurements.^{10/}

Fair Value Measurements for Financial Instruments

Certain financial instruments, including certain investments in debt and equity securities, derivatives, and certain loans, are required to be reported in issuers' financial statements at fair value. The valuation of certain financial instruments might be subject to an increased risk of material misstatement because, for example, the valuation methods used might be complex and market participants might employ different valuation techniques. The market disruption during the economic crisis was characterized by significant decreases in the volume and level of trading activity for certain financial instruments. These events created challenges for many issuers in determining a reasonable estimate of fair value and increased the risk of material misstatement for the affected classes of financial instruments.

Inspectors observed that firms sometimes planned to test issuers' estimates of fair value for financial instruments by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. In some of these instances, deficiencies observed by inspectors included firms' failures to:

^{9/} AU sec. 328.23.

^{10/} Robert H. Herz, Chairman of the FASB, in testimony provided on March 12, 2009, before the U.S. House of Representatives Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, stated: "As the crisis has deepened and broadened, the values of many financial assets have fallen significantly, credit spreads have widened, and the markets for some complex instruments have become increasingly illiquid and virtually inactive. Those conditions pose significant challenges to the valuation process, often requiring additional data gathering and analysis and the use of sound judgment."
(http://www.fasb.org/testimony/03-12-09_prepared_statement.pdf).

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- Evaluate, or evaluate sufficiently, whether fair value measurements were determined using appropriate valuation methods or adequately test controls over issuers' valuation processes. In some instances, issuers used external valuations, and inspectors observed that firms failed to obtain a sufficient understanding of the valuation methods used by the parties providing these external valuations. In addition, in some instances, inspectors observed that firms failed to test, or test sufficiently, the operating effectiveness of internal controls over various aspects of issuers' valuation processes to support the degree of reliance placed by the firms on those controls.
- Evaluate, or evaluate sufficiently, the reasonableness of management's significant assumptions, including performing tests beyond inquiries of management. Examples of deficiencies observed by inspectors included the failure to: (a) appropriately evaluate the reasonableness of significant valuation assumptions such as discount rates, credit loss expectations, and prepayment assumptions, and (b) involve a valuation specialist to evaluate the reasonableness of certain assumptions despite the presence of risk factors suggesting that involvement of a valuation specialist was appropriate.
- Evaluate available evidence that was inconsistent with issuers' fair value estimates. For example, in some instances inspectors observed that firms failed to evaluate significant differences between values calculated by issuers and values obtained by issuers from external parties.

In other cases, inspectors observed that firms evaluated issuers' estimates of fair value for financial instruments by developing an independent expectation of fair value for corroborative purposes. In many of these cases, firms used external pricing services or external valuation specialists to corroborate the values used by management. Inspection teams observed instances in which firms sometimes failed to understand the methods or assumptions used by these external parties. In addition, inspection teams sometimes observed failures by firms to evaluate significant differences between independent estimates used or developed by firms and the fair values recorded by issuers.

Inspectors observed instances in which firms sometimes failed to test, or test sufficiently, significant, difficult-to-value securities. For example, in some situations firms' procedures were limited to inquiries of issuer personnel. Inspection teams also

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observed instances in which firms sometimes failed to perform sufficient procedures, in light of the volatile market conditions, to provide a reasonable basis for extending to year end the conclusions regarding the valuation of investment securities that were reached at an interim date.

Further, inspectors observed instances in which firms sometimes failed to perform sufficient tests to determine whether issuers' fair value disclosures were in conformity with the requirements of SFAS 157, *Fair Value Measurements*, the requirements of which have been codified in FASB ASC 820.

Fair Value Measurements for Non-Financial 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.^{11/} In addition, issuers are required to determine the fair values of reporting units to which goodwill has been assigned in order to identify a potential goodwill impairment.^{12/} Fair value measurements for non-financial assets such as long-lived assets and reporting units generally require issuers to make assumptions regarding 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.

Inspectors observed that firms often planned to test issuers' estimates of fair value for non-financial assets by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. Inspectors sometimes identified deficiencies in these instances that included firms' failures to:

- Evaluate, or evaluate sufficiently, the reasonableness of significant assumptions used by issuers to estimate the fair value of reporting units in their goodwill impairment assessments. For example, inspectors identified instances in which firms failed to test, or tested only through inquiry of management, issuers'

^{11/} Paragraph 37 of SFAS No. 141, *Business Combinations* (or FASB ASC 805-20-30-1 through 805-20-30-23).

^{12/} Paragraph 19 of SFAS No. 142, *Goodwill and Other Intangible Assets* (or FASB ASC 350-20-35-4 through 350-20-35-8).

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significant assumptions, such as forecasted revenue growth rates, operating margins, discount rates, implied control premiums, and weighted average cost of capital measures. In some of these instances, inspectors observed that firms failed to evaluate the effect of contradictory evidence when concluding on the reasonableness of certain significant assumptions. For example, inspectors identified some instances in which firms concluded without sufficient basis that issuers' assumptions that revenue or operating profit would increase in the near future were reasonable despite recent declines in revenue or despite historical operating losses, respectively.

- Evaluate, or evaluate sufficiently, the reasonableness of significant assumptions used by issuers in measuring fair value for other intangible assets and other long-lived assets acquired in business combinations. Specifically, inspectors identified some instances in which firms failed to test, or tested only through inquiry of management, issuers' significant assumptions, such as future revenue growth rates, customer attrition levels, and estimated useful lives.

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

The adverse changes in market conditions, which generally reduced issuers' profits and market capitalizations, increased the risk of impairment of goodwill, other indefinite-lived intangible assets and other long-lived assets. Goodwill and other indefinite-lived intangible assets are required to be evaluated for impairment annually or more frequently when events or changes in circumstances indicate an asset might be impaired or that the fair value of a reporting unit has fallen below its carrying value.^{13/} Other long-lived assets are required to be tested for recoverability whenever events or changes in circumstances indicate that their carrying amounts might not be recoverable.^{14/} The recorded values of goodwill, other indefinite-lived intangible assets, and other long-lived assets can be important to investors relying on issuers' financial

^{13/} SFAS 142, paragraph 17 (or FASB ASC 350-30-35-18 through 350-30-35-20) and SFAS 142, paragraph 28 (or FASB ASC 350-20-35-30).

^{14/} Paragraph 8 of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (or FASB ASC 360-10-35-21).

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statements. If auditors do not properly test issuers' decisions regarding the timing of impairment assessments or the measurement of impairment charges, auditors might fail to detect material misstatements in issuers' financial statements relating to the recorded values of goodwill, other indefinite-lived intangible assets, and other long-lived assets, and investors might be misled.

Issuers might make judgments regarding the application of generally accepted accounting principles ("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 assets, and other long-lived assets. PCAOB standards require the auditor to state in his or her report whether an issuer's financial statements are presented fairly in all material respects in conformity with GAAP and to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under audit.^{15/} To audit fair value measurements or other estimates used by management in impairment assessments, PCAOB standards require the auditor to (a) understand how management developed the fair value measurements or estimates,^{16/} (b) test management's fair value measurements or evaluate whether management's estimates are reasonable,^{17/} and (c) obtain sufficient competent evidential matter to provide reasonable assurance that management's fair value measurements or other estimates are presented and disclosed in conformity with GAAP.^{18/}

Certain deficiencies related to auditing the fair value measurements of reporting units that issuers used in their goodwill impairment assessments are described above under "Fair Value Measurements for Non-Financial Assets." Inspectors also observed that firms sometimes failed to challenge issuers' conclusions that goodwill did not need

^{15/} Paragraph 7 of AU Sec. 508, *Reports on Audited Financial Statements*, and paragraph 1 of AU Sec. 326, *Evidential Matter*.

^{16/} AU sec. 328.09 and paragraph .10 of AU sec. 342, *Auditing Accounting Estimates*.

^{17/} AU sec. 328.23, AU Sec. 342.04, and AU Sec. 342.07.

^{18/} AU sec. 328.03, AU Sec. 342.07.

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to be tested for impairment more frequently than annually despite the existence of impairment indicators, such as recent declines in issuers' stock prices or reduced estimates of future revenue in situations where such declines or reductions appeared to be potentially significant to issuers' most recent impairment analyses. In addition, inspectors observed that firms sometimes failed to test, or test appropriately, issuers' assessments that other indefinite-lived intangible assets or other long-lived assets were not impaired. For example, in some cases firms failed to evaluate the reasonableness of certain significant assumptions used by issuers in their impairment assessments.

2. Deficiencies Observed in Audits of Financial Services Industry Issuers

Allowance for Loan Losses ("ALL")

The ALL is one of the most significant estimates made by many issuers in the financial services industry. The economic crisis was accompanied by significant increases in credit losses, delinquencies, and non-performing assets of many financial services issuers, as well as an increase in bank failures. The economic crisis created additional uncertainty regarding issuers' estimates of the ALL and, therefore, increased the risk of material misstatement. Further, the significance of adverse changes in the economy and the financial markets might have caused factors different from those considered in the past to become significant to issuers' estimates. Information regarding the valuation of loan portfolios often can be important to investors relying on financial services issuers' financial statements. If auditors do not properly test issuers' estimates of the ALL, auditors might fail to detect material misstatements in issuers' financial statements relating to loan portfolio values, and investors might be misled.

To audit an estimate, auditors should first gain an understanding of how management 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 corroborate the reasonableness of management's estimate, or (c) reviewing subsequent events or transactions occurring prior to the date of the auditor's report.^{19/}

Inspectors observed that firms often planned to evaluate the reasonableness of the ALL by reviewing and testing management's process for developing the estimate.

^{19/} AU sec. 342.10.

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Inspectors sometimes identified deficiencies in these instances that included firms' failures to:

- Sufficiently test issuers' specific reserves on impaired loans. For example, firms sometimes failed to (a) sufficiently test issuers' conclusions regarding the identification and measurement of impaired loans, (b) perform procedures to establish a basis for relying on the work of certain issuer personnel, and (c) understand the methods and assumptions used by external parties engaged by issuers to perform appraisals of collateral underlying impaired loans.
- Evaluate, or evaluate sufficiently, the effect on the ALL of deficiencies identified in management's process and alter the nature, timing, and extent of the testing of the ALL in light of the identified deficiencies.
- Evaluate, or evaluate sufficiently, the reasonableness of management's significant assumptions used to develop the ALL, including assumptions about the nature or size of qualitative adjustments. For example, firms sometimes failed to evaluate, or evaluate sufficiently, the reasonableness of loss factors or other assumptions used to estimate the ALL that were not directionally consistent with negative credit quality trends in loan portfolio performance or significant adverse conditions in the economic environment.
- Test, or test sufficiently, the data underlying management's calculation of the ALL. Specifically, firms sometimes failed to test, or test sufficiently, the completeness and accuracy of the data in system-generated or manually-prepared reports used to develop the ALL. These reports often formed the basis for significant inputs for the calculation of the ALL, such as loan delinquency data, credit score information, value of loan collateral, and internally developed loan ratings.

In other cases, firms evaluated the reasonableness of issuers' ALL by developing an independent expectation of the ALL. Inspection teams observed that, when this approach was used, firms sometimes failed to obtain evidence to support the assumptions they used or test the completeness and accuracy of the issuer's data used by the firm in developing the independent expectation.

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Also, inspectors sometimes observed deficiencies with firms' procedures for auditing estimates when firms reviewed events or transactions that occurred subsequent to the balance sheet date but prior to the date of the auditor's report. In general, firms sometimes failed to determine whether information regarding loan losses that was discovered shortly after year end related to conditions that existed during the year under audit, such that the losses should have been reflected in the year-end ALL.

Off-Balance-Sheet Structures

In the financial services industry, commitments to provide financial support or guarantees might be in place between issuers and off-balance-sheet structures, including special purpose entities and variable interest entities, created through securitizations or other transactions. During the economic crisis, implicit or informal guarantees or other arrangements to provide financial support became explicit between some financial services issuers and off-balance-sheet structures. This in turn should have caused some issuers to re-evaluate the accounting for these off-balance-sheet structures.

Off-balance sheet arrangements might be complex and might require issuers to make judgments regarding the application of GAAP or to develop estimates, such as estimates of expected losses, for use in applying GAAP. PCAOB standards require the auditor to state in his or her report whether issuers' financial statements are presented fairly in all material respects in conformity with GAAP and to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under audit.^{20/} For estimates used by issuers in applying GAAP, the auditor's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that these estimates are reasonable in the circumstances and that they are presented and disclosed in conformity with GAAP.^{21/} In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimates.^{22/}

^{20/} AU sec. 508.07 and AU sec. 326.01.

^{21/} AU sec. 342.07.

^{22/} AU sec. 342.10.

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Inspectors sometimes observed deficiencies in firms' audit procedures related to off-balance-sheet structures. Specifically, firms sometimes failed to (a) sufficiently test issuers' transactions with external parties or special purpose entities to determine whether such transactions were appropriately accounted for as off-balance-sheet arrangements, and (b) test the ongoing compliance with accounting requirements for certain off-balance-sheet arrangements, including performing tests for the occurrence of events that would affect the accounting for these arrangements.

Other-Than-Temporary Impairment of Certain Investments

For certain investments in debt and equity securities, issuers are required to assess whether any declines in fair value below cost are other than temporary.^{23/} The economic crisis was accompanied by significant declines in the fair value of many debt and equity securities held by issuers. The declines in the fair values of certain of such securities were significant, causing their fair values to decline below their cost. The determination as to whether declines in fair value are other than temporary often involves consideration of the length of time and extent to which fair value has been below cost, the financial condition and near-term prospects of the issuers of the securities, and management's intent and ability to hold the securities for a period of time sufficient to allow for recovery of the securities' value.^{24/}

The auditor is required to evaluate an issuer's conclusion about the need to recognize an impairment loss when the fair value of the issuer's investments has declined below cost.^{25/} When an issuer has recognized an impairment loss, the auditor

^{23/} Paragraph 16 of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (or FASB ASC 320-10-35-18).

^{24/} FASB Staff Position ("FSP") FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, the requirements of which have been codified in FASB ASC 320, became effective for interim and annual reporting periods ending after June 15, 2009. As a result, the requirements of this FSP were not effective for audits discussed in this report.

^{25/} AU sec. 332.48.

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should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the issuer has appropriately followed GAAP.^{26/}

Inspectors sometimes observed that firms failed to adequately evaluate issuers' conclusions that a decline in the fair value of securities was not other than temporary. In these instances, inspection teams observed deficiencies that included firms' failures to: (a) evaluate, beyond inquiries of management, certain significant assumptions underlying issuers' assessments that investments in debt and equity securities were not other-than-temporarily impaired for significant classes of securities, including securities for which fair value had been below cost for a period greater than 12 months, (b) evaluate issuers' assertions regarding their intent and ability to hold securities for a period of time sufficient to allow for any anticipated recovery in fair value, and (c) consider contradictory evidence such as sales of securities or contractual agreements that would call into question whether issuers had the intent and ability to hold the investment until recovery.

3. Deficiencies Observed in Audits of Non-Financial Services Industry Issuers

Revenue Recognition

Many material misstatements due to fraudulent financial reporting involve inappropriate recognition of revenue. In the recent adverse economic environment, issuers might have been faced with increased pressure to meet revenue targets and analysts' expectations or increased difficulty in meeting these targets and expectations. These pressures increase the risk of material misstatement of the financial statements because they create incentives for management to fraudulently recognize revenue or could result in issuers changing their business practices as a means to affect the amount and timing of revenue recognition, which would require corresponding changes to audit procedures.

The arrangements pursuant to which issuers recognize revenue might be complex and might require issuers to make judgments regarding the application of GAAP or to develop estimates, such as the fair value of certain elements in multiple element arrangements, for use in applying GAAP. PCAOB standards require the auditor to state in his or her report whether issuers' financial statements are presented

^{26/} Ibid.

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fairly in all material respects in conformity with GAAP and to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under audit.^{27/} To audit fair value measurements or other estimates used by management, PCAOB standards require the auditor to (a) understand how management developed the fair value measurements or estimates,^{28/} (b) test management's fair value measurements or evaluate whether management's estimates are reasonable,^{29/} and (c) obtain sufficient competent evidential matter to provide reasonable assurance that management's fair value measurements or other estimates are presented and disclosed in conformity with GAAP.^{30/}

Inspectors sometimes observed deficiencies in firms' procedures to test revenue recognition. In these instances, inspection teams observed deficiencies that included firms' failures to: (a) appropriately respond to specific risks, including fraud risk, related to revenue recognition by, for example, evaluating whether the timing of revenue recognition was appropriate, sufficiently testing the estimated fair values of all elements in arrangements with multiple deliverables, identifying and testing relevant internal controls, or adequately responding to test exceptions, and (b) appropriately test issuer-generated reports or schedules used to record revenue.

Valuation of Inventory

In many industries, inventory is required to be stated at the lower of cost or market.^{31/} In some instances, the reduction in the level of consumer and business spending that occurred during the recent adverse economic environment resulted in increased inventory in relation to sales levels, reductions in inventory turnover, and

^{27/} AU sec. 508.07 and AU sec. 326.01.

^{28/} AU sec. 328.09 and AU sec. 342.10.

^{29/} AU sec. 328.23, AU Sec. 342.04, and AU Sec. 342.07.

^{30/} AU sec. 328.03 and AU Sec. 342.07.

^{31/} Chapter 4 of Accounting Research Bulletin No. 43: *Restatement and Revision of Accounting Research Bulletins* (or FASB ASC 330-10).

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declining sales prices. These factors, in turn, might have resulted in excess or obsolete inventory or inventory with carrying amounts in excess of market values.

To audit estimates used by issuers in assessing or measuring the carrying value of inventory, the auditor's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that these estimates are reasonable in the circumstances and that they are presented and disclosed in conformity with GAAP.^{32/} In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimates.^{33/}

Inspectors sometimes observed deficiencies in firms' procedures to test the valuation of inventories. In these instances, inspection teams observed deficiencies that included firms' failures to: (a) sufficiently evaluate the reasonableness of reserves established by management for excess and obsolete inventory, (b) adequately test whether impaired inventory had been appropriately identified or measured by issuers, and (c) consider whether markdowns were recorded when necessary to support the proper valuation of inventory accounted for using the retail method.

Income Taxes

When accounting for income taxes, issuers recognize deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in their financial statements or tax returns. At times, the outcome of a tax position might be uncertain and sometimes it might be unclear if a deferred tax asset will ultimately result in tax benefits. In an adverse economic environment, issuers might need to record valuation allowances because, for example, future taxable income might be insufficient to support the realization of the deferred tax assets. Further, estimates made by issuers regarding the recoverability of deferred tax assets as well as the outcome of uncertain tax positions might require significant management judgment, which increases the risk of material misstatement, particularly in times of economic distress.

^{32/} AU sec. 342.07.

^{33/} AU sec. 342.10.

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To audit an estimate, including estimates relating to income taxes, auditors should first gain an understanding of how management developed the accounting estimate and then evaluate whether management's estimate is reasonable and has been accounted for in accordance with GAAP.^{34/} GAAP requires issuers to weigh available evidence in assessing the likelihood that deferred tax assets will be realized.^{35/} GAAP also requires issuers to consider available information in assessing the likelihood that uncertain tax positions will be sustained upon examination^{36/} and to consider the amounts and probabilities of outcomes in measuring the benefits from uncertain tax positions that might be realized upon settlement.^{37/}

Inspectors sometimes observed deficiencies in firms' procedures to test the valuation of deferred tax assets and tax contingency reserves. In these instances, inspection teams observed deficiencies that included firms' failures to: (a) evaluate whether issuers placed appropriate weight on forecasts of taxable income in light of the uncertainty created by the adverse economic environment and the existence of recent losses, (b) adequately test reductions in issuers' deferred tax asset valuation allowances because, for example, the firm did not test whether there was sufficient positive evidence to outweigh substantial negative evidence, and (c) test the reasonableness of the assumptions used by issuers in estimating tax contingency reserves.

4. Firms' Responses to the Economic Crisis

Inspectors observed that firms responding to the increased risks resulting from the economic crisis took various actions, including issuing technical guidance, requiring

^{34/} AU sec. 342.07 and 342.10.

^{35/} Paragraph 17e of SFAS No. 109, *Accounting for Income Taxes* (or FASB ASC 740-10-30-5).

^{36/} Paragraph 6 of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* ("FIN 48") (or FASB ASC 740-10-25-6).

^{37/} FIN 48, paragraph 8 (or FASB ASC 740-10-30-7).

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additional training, developing new audit tools, requiring additional audit procedures, and increasing monitoring of audit engagement personnel. The Board's inspection staff evaluated firms' responses to the economic crisis by considering, among other things, the results of the inspections of issuer audits, including the audit deficiencies described in this report. While firms have made efforts to respond to the increased risks stemming from the economic crisis, the deficiencies identified by inspectors in their reviews of issuer audits suggest that firms should continue to focus on making improvements to their quality control systems.

The Board's Response to Audit Deficiencies Described in this Report

While this report is primarily intended to provide information concerning the Board's inspection program and inspection observations in audit risk areas affected by the economic crisis, the observations described in this report will also serve to inform Board actions in the future. These actions include –

- Future Inspections: The current economic environment continues to exhibit many of the same risk factors present during the past three years. Therefore, in planning future inspections, the Board's inspection staff will focus on audit areas in which deficiencies related to the economic crisis were uncovered during the 2007-2009 inspection cycles.
- Remediation Determinations: In discharging its responsibility to evaluate whether firms have satisfactorily addressed deficiencies in their quality controls, the Board will be mindful of the deficiencies discussed in this report. In many cases, Board inspection reports link audit deficiencies described in this report to firm quality control deficiencies. The Act requires the Board to assess whether firms have addressed such quality control deficiencies. The majority of the deficiencies discussed in this report were identified by inspectors during the 2009 inspection cycle and included in 2009 inspection reports, which were issued by the Board in 2010. Further, firms' actions to address quality control deficiencies described in 2007 and 2008 inspection reports have either been subject to a Board determination based on the inspection staff's evaluation or are in the process of being evaluated by the inspection staff. In making future remediation determinations, the Board will focus on whether firms' remedial actions have, in fact, reduced or eliminated subsequent occurrences of the kinds of deficiencies described in this report. If remediation does not appear to have had the

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anticipated effect, the Board will seek to understand the reasons and evaluate the implications of the continued deficiencies.^{38/}

- **Standard Setting:** The Board will use the observations in this report concerning risks and audit deficiencies associated with the economic crisis to inform its standard setting. The Board will consider whether additional guidance is needed related to existing auditing standards. For example, the audit deficiencies identified with respect to fair value and impairment determinations are relevant to the Board's ongoing projects related to auditing fair value measurements and other accounting estimates, as well as to the Board's consideration of revisions to the standards regarding the auditor's use of specialists.
- **Enforcement:** Some of the audit deficiencies described in this report are under review by the Board's Division of Enforcement.^{39/} It is, however, important to recognize that the considerations that underlie a decision to include an audit deficiency in an inspection report are different than those on which a decision to bring an enforcement action could be based. The Board must allocate its limited

^{38/} Certain audit deficiencies, or repeated instances of a similar deficiency, might support the conclusion that a defect in a firm's quality control system might exist. Pursuant to the Act, if an inspection gives rise to concerns about a firm's quality control system, the issues are described in a nonpublic portion of the Board inspection report. Section 104(g)(2) of the Act, 15 U.S.C. § 7214(g)(2), states that no portions of an inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report. The process for addressing the criticisms or defects is referred to as remediation.

^{39/} Since the economic crisis began, the Board's inspections have resulted in increased referrals to its enforcement program. For example, through the Board's inspection process, referrals related to audits of the financial statements of financial services issuers have been made. The Board's investigative process might lead to disciplinary proceedings arising out of these referrals. In connection with such proceedings, the Board might find that some auditors have failed to adhere to applicable standards, laws and rules and should be sanctioned.

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enforcement resources to cases that will have the greatest effect on audit quality and investor protection. Where appropriate, however, the Board will not hesitate to bring enforcement action with respect to matters discussed in this report.^{40/}

In addition, the Board's inspection staff takes actions in connection with individual audit deficiencies described in this report, many of which have been described in public portions of inspection reports. For example, inspectors and the Board's inspection reports have reminded firms of their responsibility under PCAOB standards to take appropriate actions in connection with deficiencies identified by inspectors.^{41/} In addition to engaging in rigorous dialogue to attempt to focus the firms on addressing the factors that contributed to what the inspection teams viewed as deficient auditing, the inspection staff takes other actions, such as reviewing evidence of remedial actions

^{40/} By law, the Board's investigations and any contested disciplinary proceedings arising out of those investigations are nonpublic unless and until they result in a final disciplinary sanction taking effect. Many of the Board's investigations involve, among other things, extensive fact-gathering, including review of relevant documents and taking of relevant testimony. The completion of those investigative processes affords the Division of Enforcement a sufficient evidentiary basis to preliminarily determine what, if any, violations of applicable law occurred. Moreover, before the Division of Enforcement recommends to the Board any disciplinary proceeding arising out of an investigation, it typically offers potential respondents the chance to submit in writing their disagreements about the facts, law and conclusions underlying the Division of Enforcement's preliminary determination. Those submissions are carefully considered by both the Division of Enforcement and the Board in connection with any disciplinary recommendation by the Division of Enforcement.

^{41/} When audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions, and failure to take such actions could be a basis for Board disciplinary sanctions. See AU 390, *Consideration of Omitted Procedures After the Report Date*, AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T), and PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, ¶ 98.

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taken by firms and reviewing subsequent-year audits of issuers where deficiencies were found.

Other Ongoing Efforts and Initiatives

The Board's inspection program has other ongoing efforts and initiatives that might be used to respond to any additional risks posed by the current crisis or similar future events. Examples of such efforts and initiatives include the following:

- The Board's inspection staff will continue to monitor the ongoing effects of the economic crisis on auditor performance, including the effects of the economic crisis on audits performed by registered firms located in jurisdictions outside of the United States.
- The Board's inspection program continues to use a risk-based approach by adapting to emerging issues. This enables the Board to redirect resources, where necessary, and change the focus of inspections, when appropriate.
- The Board's inspection staff continues to interact with other PCAOB programs to identify emerging risk areas. In addition, the Board's inspection staff continues to work with OCA to identify opportunities for improving auditing standards or topics for which additional guidance might be needed in light of inspection observations.
- The Board's inspection staff continues to monitor developments related to auditing fair value measurements. For example, the Board's inspection staff has continued to monitor firms' audit approaches and continued to work closely with other PCAOB divisions and offices, such as ORA and OCA, regarding auditors' use of pricing services and other vendors of securities valuation services.
- The Board's inspection staff is in the process of evaluating how certain firms use their internal specialist resources to assist in testing fair value measurements and other estimates.
- The Board's inspection staff is aware that as a result of the economic crisis and other factors, auditors might be pressured to significantly reduce their audit fees. Confronted with reduced revenues, some auditors might make inappropriate reductions in the extent of audit procedures in order to achieve cost savings, or

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firms might take certain cost cutting actions that could negatively affect a firm's investment in training, audit tools and methodology, or other aspects of its quality control systems. The Board's inspection staff continues to monitor whether audit quality and the firms' quality control systems have been compromised due to reduced revenues.

Summary and Conclusion

The Board's inspection staff noted firms making efforts to address the risks associated with the economic crisis. Nonetheless, the Board's inspection staff noted a number of deficiencies in audit areas that were significantly affected by the economic crisis. Accordingly, continued focus on firms' audits and quality control systems remains critical, particularly as they relate to audit risks posed by the ongoing effects of the economic crisis and any future similar events. The Board will continue to direct inspection efforts to monitor the performance of audits and the adequacy of the quality control systems of registered firms so as to achieve its mission of "protecting the interests of investors and furthering the public interest in the preparation of informative, fair, and independent audit reports."