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Staff Inspection Brief

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

Preview of Observations from 2016 Inspections of Auditors of Issuers

The PCAOB Division of Registration and Inspections has developed this Brief to provide a preview of observations from PCAOB inspections of issuer audits during the 2016 inspection cycle, and to highlight certain requirements related to those audits. This Brief is intended to highlight certain observations from inspections to assist registered public accounting firms ("firms") that audit issuers in complying with PCAOB Auditing Standards, independence rules, and other PCAOB rules when performing their audits. It is also intended to provide insights from these inspections to auditors, audit committees, investors, issuers, and others.

This Brief describes the three key areas with the most frequent audit deficiencies observed in the 2016 inspection cycle: assessing and responding to risks of material misstatement; auditing internal control over financial reporting ("ICFR"); and auditing accounting estimates, including fair value measurements. This Brief also highlights inspection results and observations related to other areas of inspection focus that were previously discussed in the July 2016 Brief,[1] which described important aspects of the inspection plan, scope, and objectives of the 2016 inspection cycle.

Overview

Inspections staff examined portions of over 780 issuer audits in 2016 and reviewed the system of quality control at more than 190 firms. The audit work inspected was selected based largely on an analysis of risk with a focus on audit areas that presented auditing challenges and significant audit risk, including risks of material misstatement in the financial statements, as well as areas of recurring audit deficiencies both within and across firms.

The audits inspected varied in size and complexity and spanned a number of industries. A significant number of the audits inspected were also multinational audits that used the work of auditors in both domestic and non-U.S. locations.

The Board has issued inspection reports for firms on many of the 2016 inspections, and Inspections staff is in the evaluation and drafting stages for the remaining inspection reports.

1 See Staff Inspection Brief, *Information about 2016 Inspections*, Vol. 2016/3, issued in July of 2016 ("July 2016 Brief").

Highlights from Inspections staff observations that are discussed in more detail in this Brief are included below.

Audit Areas with Frequent Audit Deficiencies

The 2016 inspection results indicate the most frequent audit deficiencies identified continued to be in three key areas of inspection focus: assessing and responding to risks of material misstatement, auditing ICFR, and auditing accounting estimates, including fair value measurements.

Observations in Other Areas of Inspection Focus

The 2016 inspection results also indicate continued audit deficiencies in certain other areas of focus, although those deficiencies are not pervasive. These areas of inspection focus include audit areas affected by certain economic risks, audit work regarding certain financial reporting areas, audit work regarding multinational audits, and certain aspects of a firm's system of quality control.

Information Technology

Inspections staff continued to review and gather information related to firms' approaches to information technology risks in the audit. Inspections staff has also focused on obtaining a better understanding of auditors' use of data analytics in audits.

The software audit tools used by the firms vary, and some firms have customized purchased tools or have internally developed their own tools. Most software audit tools are being used for performing substantive audit procedures, while some tools may also be used for risk assessment.

Actions Taken

Many firms continue to make incremental progress towards improving audit quality, including taking specific actions to address recurring auditing deficiencies. Some firms have implemented a combination of actions designed to work collectively, including enhanced messaging from firm leadership, development of audit milestone completion requirements, engagement-team based learning events, enhanced audit methodology, new or enhanced audit tools and related guidance, additional coaching and support from experienced firm personnel, and monitoring of the effectiveness of firm remedial actions.

Continued Action Required

The number and significance of the recurring audit deficiencies identified, however, suggest that firms need to consider whether additional or different steps need to be taken in order to improve and sustain audit quality.

Firms should continue to evaluate the effectiveness of their systems of quality control, which may include an evaluation of whether the remedial actions the firms have implemented in areas with recurring audit deficiencies are producing significant or lasting change.

Performing detailed and comprehensive root cause analyses of recurring deficiencies may contribute to a firm's ability to appropriately remediate systemic issues.

Processes for root cause analysis are in varying phases of development at different firms. Some firms have been challenging their own previous assessments of the causes of these recurring audit deficiencies, and are also evaluating factors that may contribute to positive audit quality in an effort to improve the effectiveness of their remedial actions.

Auditors should take note of the matters discussed in this Brief in planning and performing their audits. It is particularly important for the engagement partners and senior engagement team members to remain vigilant when planning and performing procedures in these areas on upcoming audits and for engagement quality reviewers ("EQRs") to keep these matters in mind when performing their engagement quality reviews.

Observations in Key Areas of Inspection Focus

Recurring Audit Deficiencies

Assessing and Responding to Risks of Material Misstatement

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to obtain evidence to support the opinion expressed in the auditor's report. Proper application of the auditing standards for assessing and responding to risk ("risk assessment standards")[2] is important for performing effective audits of ICFR and integrating the audit of ICFR with the audit of financial statements. When an auditor fails to comply with one of the risk assessment standards, the result may be inadequate audit testing, including testing of ICFR and accounting estimates.

During 2016, Inspections staff continued to identify audit deficiencies related to procedures an auditor performs to assess and respond to the risks of material misstatement. Audit deficiencies in this area related most frequently to non-compliance with AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and AS 2810, *Evaluating Audit Results*.[3]

Responding to Risks of Material Misstatement

Audit deficiencies were commonly identified in which the auditor did not perform substantive procedures, including tests of details, that were specifically responsive to the assessed fraud risks and other significant risks.[4]

The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.[5] Auditors should also presume that there is a fraud risk involving improper revenue recognition and evaluate the types of revenue, revenue transactions, or assertions that may give rise to such risks.[6]

2 See AS 1101, 1105, 1201, 2101, 2105, 2110, 2301, and 2810.

3 Inspections staff encourages auditors to read *Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards (No. 8 through No. 15)*, PCAOB Release No. 2015-007 (October 15, 2015), which highlights audit requirements and provides examples of recurring deficiencies in auditors' compliance with these standards. The report also provides insight into potential root causes of these deficiencies and potential remedial actions that firms may consider to further improve audit quality.

4 See AS 2301.11 and .13.

5 See AS 2301.08.

6 See AS 2110.68.

Sample Inspection Finding – Responding to Significant Risks

The auditor identified a fraud risk involving revenue recognition. To test revenue, the auditor (1) performed substantive analytical procedures, (2) confirmed a sample of the issuer's accounts receivable as of an interim date, (3) performed roll-forward testing of the accounts receivable balance from the interim date to year end, and (4) tested sales cut-off.

The auditor did not perform sufficient procedures, as the auditor limited tests of details to revenue recorded between the interim date and year end, and to those balances included in accounts receivable balance testing at interim, even though the fraud risk was not confined to those portions of revenue.

The audit procedures that are necessary to address the assessed significant risks, including fraud risks, depend on the types of risks and the relevant assertions that might be affected.[7]

Evaluating Audit Evidence

Inspections staff identified some instances in which auditors did not take into account relevant audit evidence that appeared to contradict certain assertions in the financial statements.[8] For example, an auditor agreed with management's conclusion that there were no indicators of impairment related to certain intangible assets, but the auditor did not consider whether the issuer's significant historical losses could be an indicator of impairment. The auditor's procedures were limited to reading management's analysis of the potential impairment of these assets.

Inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.[9]

Evaluating Presentation and Disclosure

Inspections staff also identified instances in which auditors did not sufficiently evaluate the presentation of the financial statements, including the accuracy and completeness of the disclosures.

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.[10]

As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements, in conformity with the applicable financial reporting framework.[11]

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7 See AS 2301.08-.09 and .11-.12.

8 See AS 2810.03 and .34.

9 See AS 2301.39.

10 See AS 2810.30.

11 See AS 2810.31.

Sample Inspection Finding – Evaluating Presentation and Disclosure

An issuer reported a convertible note payable as a current liability in its financial statements at year end. The issuer disclosed that (1) the convertible note payable agreement was amended such that the due date was extended to a date more than one year after the end of the year under audit and (2) the issuer entered into a security agreement related to the convertible note payable.

The auditor confirmed with the noteholder the outstanding principal balance, interest rate, and whether there was a security agreement related to the convertible note payable.

The auditor, however, did not perform procedures to evaluate whether (1) the convertible note payable, which had a due date more than one year after the end of the year under audit, was properly classified as a current liability in the issuer's financial statements and (2) the disclosures of the terms of the convertible note agreement and the related security agreement included in the issuer's financial statements were accurate and complete.

ICFR

Audit deficiencies related to non-compliance with AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, continue to be the most frequently identified deficiencies.

Controls that include a Review Element

The most frequent ICFR deficiencies identified related to insufficient testing of the design and operating effectiveness of selected controls, particularly those controls that include a review element.[12]

Many of these deficiencies involved testing controls over management's cash-flow forecasts or other assumptions that the issuer used in determining estimates related to revenue, business combinations, asset impairments, and reserves.

Specifically, some auditors did not evaluate the nature and/or the appropriateness of the procedures performed by management during the review, including the criteria used to identify matters for investigation and the actions taken in investigating and resolving such matters.[13]

Sample Inspection Finding – Review Control Deficiency

An auditor selected for testing certain issuer controls related to the assessment of possible impairment of the issuer's long-lived assets. These controls consisted of the preparation and review of quarterly impairment memoranda and meetings to discuss various matters that could have an effect on accounting for these assets.

The auditor limited the procedures to test these controls to obtaining evidence of management approval of the memoranda, attending certain issuer meetings, and reading the issuer's

12 See AS 2201.42 and .44.

13 Inspections staff encourages auditors to read Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control over Financial Reporting*, which discusses requirements in PCAOB auditing standards related to testing controls and the frequently identified deficiencies in this area.

memoranda, which did not include detailed information such as the relevant indicators of possible asset impairment that management reviewed.

The procedures performed by the auditor were not sufficient, as the auditor did not obtain an understanding of the actions performed by management during the review, which was necessary to evaluate whether the control was designed and operating to prevent or detect on a timely basis misstatements that could cause the financial statements to be materially misstated.

A contributing factor to these deficiencies may be auditors' lack of understanding of PCAOB standards and firm methodology related to testing and evaluating ICFR, including the need to understand and test the relevant aspects of a control to evaluate whether the control addressed the assessed risks of material misstatement. In other cases, auditors may have approached the testing of this area with a bias that the controls were effective, impacting the extent of audit work conducted. This bias may have resulted in some auditors not appropriately exercising professional skepticism when testing controls and placing too much reliance on management inquiry when testing the precision of controls.

Identifying and Selecting Controls for Testing

Audit deficiencies related to identifying and selecting controls that addressed the specific risks of material misstatement[14] continued to be observed, and many of these deficiencies appear to have occurred because the auditor did not obtain a sufficient understanding of the likely sources of potential misstatement.

Auditors should evaluate whether the control they have selected for testing satisfies the corresponding control objective, including whether it addresses the risks of material misstatement to the relevant assertion of the significant account or disclosure.[15]

Sample Inspection Finding – Identifying and Selecting Controls

The auditor identified a fraud risk involving improper revenue recognition.

The auditor identified and tested certain controls over the occurrence, completeness, and valuation of revenue.

The auditor, however, did not identify and test controls over the data input into the issuer's system maintaining the contract terms, including various fees that were used to determine the amount of revenue recognized.

Testing Controls over the Accuracy and Completeness of Financial Information

Inspections staff has continued to observe instances in which auditors selected controls for testing but did not sufficiently test the controls over completeness and accuracy of system-generated data or reports used in the operation of those controls.

14 See AS 2201.39.

15 See AS 2201.42.

In an audit of ICFR, if the auditor selects an IT-dependent control for testing, the auditor should test that control and the IT controls on which the selected control relies to support a conclusion about whether those controls address the risks of material misstatement.[16]

> *Sample Inspection Finding – Testing Controls over the Accuracy and Completeness of Financial Information*
>
> In a financial statement audit, the auditor planned to rely on an entity-level control for testing revenue recognition that included management review of variances between actual, budgeted, and forecasted revenue, as well as various business metrics that may have influenced changes in the amounts recorded.
>
> The information reviewed by management in this control included system-generated data. As a result, the effectiveness of the entity-level control depended in part on the issuer's controls over the accuracy and completeness of these data.
>
> The auditor, however, did not perform procedures to test the controls over the data.

Auditing Accounting Estimates, including Fair Value Measurements

Accounting estimates continued to be a focus of inspections and continued to be an area in which Inspections staff frequently identify audit deficiencies.

Audit deficiencies in this area have commonly related to evaluating impairment analyses for goodwill and other long-lived assets and the valuations of assets and liabilities acquired in business combinations.

Other areas where deficiencies were identified include revenue-related estimates and reserves, the allowance for loan losses ("ALL"), inventory reserves, and financial instruments.

Accounting estimates usually warrant more audit attention because they often involve complex methods, including models, subjective factors, and judgments, which make them susceptible to management bias.[17]

The risk of material misstatement of accounting estimates normally varies with the complexity and subjectivity associated with the process, the number and significance of assumptions that are made, the availability and reliability of relevant data, and the degree of uncertainty associated with the assumptions.[18]

During 2016, Inspections staff continued to identify instances in which auditors did not fully understand how the issuers' estimates were developed or did not sufficiently test the significant inputs and evaluate the significant assumptions used by management.

16 See AS 2201.39-.42 and .46-.47.

17 See AS 2501.03-.04.

18 See AS 2501.05.

Sample Inspection Finding – Evaluation of Management Assumptions

In performing substantive procedures to test the valuation of an issuer's goodwill, the auditor reviewed the issuer's impairment analysis and (1) compared the forecasted revenue growth rates to the historical growth rate of the company and (2) compared the issuer's fourth-quarter forecasted revenue to the actual results for that quarter.

Based on these procedures, the auditor identified significant differences between the issuer's analysis and the historical and actual results. The auditor inquired of management about the reason for these differences, but did not obtain corroboration of management's explanations with other audit evidence.

Additionally, the auditor did not evaluate whether the differences identified should have an effect on its conclusions about management's ability to prepare reasonable forecasts.

Auditors should obtain an understanding of company processes, including the related controls, for the development of estimates. Based on that understanding, auditors should then test the data and evaluate the assumptions that are significant to the estimate, develop an independent expectation of that estimate, or review subsequent events or transactions that occurred prior to the audit report date.[19]

Auditors should also take into account all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements.[20]

Observations in Other Areas of Inspection Focus

The following discussion highlights recent inspection results and observations related to other areas of inspection focus that were also noted in the July 2016 Brief. Audit engagements and areas of inspection focus are generally not selected randomly, and audits inspected by the PCAOB in a particular year are not necessarily representative of all audits performed that year.[21]

While in some cases the audit deficiencies described below were not pervasive across firms, auditors should take note of these matters when planning and performing their audits to further improve and sustain audit quality.

Audit Areas Potentially Affected by Economic Risks

Inspections staff considered the economic environment during the relevant fiscal periods when selecting audits and financial accounting areas for inspection. Inspections staff specifically considered, among other things, the high pace of merger and acquisition activity, the search for higher-yielding investment returns, and fluctuations in oil and natural

19 See AS 2501.09-.14 and 2502.09-.14 and .23.

20 See AS 2810.03.

21 See the July 2016 Brief for additional information regarding the Inspections staff's risk-weighted approach.

gas prices and their varying effects on the financial reporting risks of different industries.

Business Combinations

Inspections staff continued to identify frequent deficiencies related to the testing of estimates associated with business combinations.

Audit deficiencies in this area commonly related to testing significant inputs and evaluating significant assumptions used to value acquired assets, such as projected financial information developed by the issuer.

Examples of audit deficiencies identified by Inspections staff included instances in which auditors did not:

- Sufficiently test the design and operating effectiveness of auditor-selected controls over the valuation of the purchase price consideration, and acquired assets and liabilities. This included, particularly, controls that contained a review element and controls over the accuracy and completeness of information used in the operation of controls with the review element.
- Perform sufficient substantive testing of significant inputs and evaluate significant assumptions used to determine the fair values of certain acquired assets, including projected financial information developed by the issuer.[22]

It is important for auditors to understand company processes for developing forecasted information and other significant assumptions used in estimates - a critical step for determining the nature and extent of the procedures that should be performed to test the assets acquired, liabilities assumed, purchase price consideration, and, if applicable, the related controls.

Auditors are required to apply professional skepticism throughout the audit,[23] including when performing procedures to evaluate management's estimates, especially in situations in which contradictory or potentially inconsistent information is identified.

Investments

Inspections staff continued to identify concerns with auditors' testing of investment portfolios.

Audit deficiencies identified in this area largely related to testing of internal control, evaluating significant assumptions used to value the investments, and developing independent estimates.

Audit deficiencies identified by Inspections staff included instances in which auditors did not sufficiently test the design and operating effectiveness of controls that the auditors selected for testing, including those related to valuing hard-to-value investment securities and management's review of valuation models.

For example, an auditor's testing of the issuer's review controls over fair value measurements and disclosures of investments did not include understanding and evaluating the criteria used by management to identify items for investigation and the steps involved in resolving these matters.

22 See AS 2502.29-30 and footnote 2. In addition, when either management or the auditor engages a specialist and the auditor uses that specialist's work as evidential matter, the auditor should (1) obtain an understanding of the methods and assumptions used by the specialist, (2) test the data provided to the specialist, and (3) evaluate whether the specialist's findings support the assertions in the financial statements. See AS 1210.12.

23 See AS 1015.08.

Because of the wide range of possible fair value measurements from relatively simple to complex and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent.[24]

For example, substantive tests of the fair value measurements may involve developing independent estimates for corroborative purposes.[25]

A common audit deficiency related to this approach that was identified by Inspections staff was that the estimate developed by auditors was not independent because the auditors ultimately used the same pricing source underlying the issuer's own estimate.

Sample Inspection Finding – Developing an Independent Estimate

Investment securities without readily observable values composed a significant portion of an issuer's assets at year end. The issuer used an external pricing source to determine the fair values of these securities.

The auditor assessed the risk of material misstatement as high for the valuation of investment securities, and its planned audit approach was to determine independent estimates of fair value for a sample of these securities, using an external pricing source.

The auditor did not develop an independent estimate because it used the same external pricing source that the issuer used for the majority of its sample.

When using its own assumptions to develop independent fair value estimates, the auditor understands management's assumptions to ensure that its independent estimate takes into consideration all significant variables and to evaluate any significant difference from management's estimate.[26]

Fluctuation in Oil and Natural Gas Prices

Inspections staff continued to identify some audit deficiencies with auditors' testing of oil and natural gas properties and related reserves.

These audit deficiencies often related to instances in which auditors did not sufficiently test the design and operating effectiveness of internal controls that they relied on or did not perform sufficient procedures to evaluate management's assumptions used in asset impairment tests.

When economic conditions deteriorate, the auditors' assessment of expected future cash flows used to evaluate assets for potential impairment is especially important. Asset impairments may not be limited

24 See AS 2502.23.

25 See AS 2502.40.

26 *Id*.

to companies in the oil and gas industry; they may also occur in other companies, including lenders and suppliers to the oil and gas industry.

Determining the fair value of oil and gas properties involves significant judgment about their expected future performance. Auditors should exercise professional skepticism,[27] and critically evaluate management's assumptions related to cash flow projections, pricing differentials, and other risk factors.

Auditing of Certain Financial Reporting Areas

Inspections staff selects a variety of financial reporting areas for inspection, and the types of audit deficiencies related to these areas varied among inspected audits.

Audit deficiencies were most frequently observed in auditing of the following inspected financial reporting areas: debt, ALL, inventory, business combinations, revenue, and impairment of long-lived assets.

Going Concern

Audit deficiencies related to the consideration of a company's ability to continue as a going concern were also identified. Auditors should continue to consider all available information about relevant conditions and events when evaluating financial statement disclosures and the effects on the auditor's report.[28]

Sample Inspection Finding – Going Concern

An issuer's financial statements reported continued operating losses over multiple years that resulted in an accumulated deficit as of the end of the year under audit. Additionally, the cash used in operating activities exceeded the cash balance reported in the issuer's balance sheet as of the end of the year.

The issuer represented that it planned to raise additional capital in the upcoming year to cover operating expenses. At the time the auditor issued its audit report, it did not perform procedures to evaluate whether the issuer's plan to raise additional capital could be effectively implemented. As a result, the auditor had no basis on which to evaluate the issuer's related disclosures.

Auditors' going concern evaluations, including their assessment of management's mitigating plans, should take into account the requirements of PCAOB standards and the applicable financial reporting framework.

Related Party Transactions

In June 2014, the Board adopted a new auditing standard, AS 2410, *Related Parties*, to strengthen auditor performance requirements with respect to related parties, among other areas. Inspections staff performed specific procedures to evaluate auditors' compliance with the new standard and firms' actions to implement the standard in their audits.

27 See AS 1015.08.

28 See AS 2415.02-.03.

Inspections staff observed that many of the firms inspected had implemented AS 2410 effectively by incorporating the new requirements into their audit methodologies, including in many cases introducing new practice aids and/or providing training to partners and staff on the requirements of the new standard.

The audit deficiencies identified by Inspections staff on issuer audits related to compliance with AS 2410 were infrequent and were more often identified in audits performed by firms other than global network firms.

Inspections staff observed some instances in which auditors did not evaluate, or sufficiently evaluate, that related party transactions were properly identified, accounted for, and disclosed.

Information Technology

Inspections staff continued to obtain an understanding of how firms develop and use firm software tools to test large data populations effectively and efficiently, and how engagement teams evaluate risks of material misstatement of the financial statements associated with cybersecurity and related controls.

Inspections staff did not identify audit deficiencies related to these areas; however, Inspections staff continued to evaluate how firm processes are evolving and how firms are responding to information technology risks.

The following discussion provides insight into the information gathered during the 2016 inspection cycle.

Firm Software Audit Tools

Some firms are continuing to move in the direction of developing and using software audit tools with the intended objectives of performing audit work more effectively and efficiently.

These include software audit tools to analyze full populations of accounting and financial reporting transactions to select transactions for testing that are considered to be higher risk rather than selecting a random sample of transactions for testing, or to assess the effectiveness of segregation of duties established across the organization.

Inspections staff continued to perform procedures to review and understand the controls that firms have in place to provide assurance that the software audit tools used to analyze the data meet the audit objectives.

A significant number of audits inspected during 2016 included the use of at least one software audit tool by the auditor.

Inspections staff observed the software audit tools used by the firms during 2016 varied, and many tools are being used for performing risk assessment or substantive audit procedures.

Examples of audit areas in which these tools are being used include testing manual journal entries for fraud indicators, assisting the auditor in evaluating the appropriate sample size for testing a population of transactions, and assisting the auditor in evaluating pricing of investment securities.

While some firms are investing heavily in newer and more advanced software audit tools, including tools with artificial intelligence, Inspections staff has not observed these in use on audits inspected throughout 2016.

Some firms enhanced their monitoring procedures and firm quality controls related to the development and deployment of these tools within their practice and have enhanced internal training and/or firm support resources for auditors when using certain audit tools.

Firms should continue to evaluate whether their systems of quality control are designed to provide reasonable assurance that these tools operate effectively, are properly implemented by audit teams, and assist auditors in complying with applicable auditing standards.

Cybersecurity

Continued high profile and high impact data breaches have focused regulatory attention on cybersecurity risks.

Inspections staff continued to review and develop an understanding of how firms evaluate the risks of material misstatement associated with cybersecurity and any impact to the related ICFR and financial statements.

For the issuers that were identified as having experienced a cybersecurity incident and whose audits were reviewed by Inspections staff during 2016, it appears that these cybersecurity incidents have not been related to the risks of material misstatement of financial statements, including disclosures, or led to the identification of material weaknesses in ICFR.

Risks remain, however, that future cyber-attacks may affect issuer financial statement reporting, and as a result, Inspections staff views this as an evolving risk area that requires ongoing focus.

It is important for auditors to consider whether there are cybersecurity risks that pose risks of material misstatement to the financial statements and, if so, whether modifications to the planned audit approach, including for testing IT General Controls, are necessary.

Additionally, if cybersecurity incidents have occurred during the audit period, it is important for auditors to assess whether there are any effects on the financial statements, including disclosures, or implications for ICFR. Inspections staff plans to continue to obtain and evaluate information in this area.

Multinational Audits

Inspections staff routinely inspects portions of multinational audits, including the audit work performed by both domestic and non-U.S. firms that played a role in the audit, but were not the principal auditor (“referred work engagements”). The quality of the work performed by other auditors may be critical when determining whether the financial statements are free of material misstatement and, if required, whether the company’s internal control over financial reporting is effective.

Inspections staff inspected audit firms in 27 non-U.S. jurisdictions during 2016, and in some cases inspected the work of more than one firm that was involved in a particular multinational issuer audit.

Inspections staff observed that, generally, audit deficiencies identified in referred work engagements were similar in nature to the risks of material misstatement, ICFR, and accounting estimates deficiencies described in this report.

Audit Committee Communications

The 2016 inspection results indicate that deficiencies in audit committee communications continue to relate to omissions of communications of the audit strategy, the timing of the audit, and significant risks identified by the audit firm.

The nature of these deficiencies is consistent with those identified in the 2014 and 2015 inspection cycles. The deficiencies most frequently were identified at triennially inspected firms that were inspected for the first time under the relevant standard.[29]

Audit Firm's System of Quality Control

Root Cause Analysis

Inspections staff continued to evaluate the potential root causes of audit deficiencies and positive quality events through an analysis of specific events, as well as the results of those firms that also perform their own internal root cause analyses.

Inspections staff has observed significant diversity in root cause analysis practices across firms, depending largely on firm size. Some firms perform little or no root cause analysis, while other firms perform more extensive root cause analysis procedures.

Root cause analysis can be an important process for improving audit quality. When firms can properly understand why a deficiency is occurring, they can better design remedial actions that are sufficiently targeted to address the root of the problem.

Matters Relating to Auditor Independence

Auditors must be independent of their audit clients throughout the audit and professional engagement period.[30]

Inspections staff continued to identify deficiencies related to non-compliance with PCAOB rules and/or SEC rules and regulations related to auditor independence. Examples include instances in which auditors:

- Misapplied Rule 2-01(d) of SEC Regulation S-X to conclude inappropriately that a covered person's lack of independence (due to, for example, financial relationships with the audit client or its affiliates) had not resulted in impairment of the firm's independence;
- Insufficiently communicated to the audit committee the scope of tax consulting services

29 In 2016, the PCAOB issued a general report, *Inspection Observations Related to PCAOB Rules and Auditing Standards on Communications with Audit Committees*, PCAOB Release No. 2016-001 (April 5, 2016), which highlights audit requirements related to audit committee communications and provides examples of deficiencies in auditors' compliance with these rules and standards observed during 2014 inspections. The report also provides examples of potential remedial actions that firms may consider.

30 PCAOB Rule 3520, *Auditor Independence*, requires auditors to satisfy all independence criteria applicable to an engagement, including the criteria in PCAOB rules and the criteria in the rules and regulations of the SEC.

services performed and the potential effects of those tax services on the independence of the firm;[31]

- Entered into agreements through which their audit client agreed to indemnify the auditor against any liability or expense arising out of the engagement;
- Provided impermissible non-audit services during the period under audit, including bookkeeping services and management functions performed during the audit period, but prior to the auditor being engaged;[32] and
- Did not make the required communications to the audit committee concerning independence.[33]

Some deficiencies were also identified that indicated certain firms did not have a quality control system that provided sufficient assurance that outside firms or auditors involved in issuer audit engagements or the firm's personnel were in compliance with the independence requirements.[34] For example, some auditors did not report, or timely report, investments acquired or sold during the year, which may have impacted the firm's ability to evaluate its independence. In other instances, some firms did not perform procedures to determine whether other firms, or other personnel from outside the firm, that participated in the audit engagement were independent.[35]

Auditors should continue to assess their personal and professional activities in evaluating compliance with the applicable independence rules and standards.

Engagement Quality Reviews

Properly executed engagement quality reviews serve as important safeguards against erroneous or insufficiently supported audit opinions because they can identify, and can result in correcting, significant audit deficiencies before the audit report is issued.

Inspections staff continued to focus on whether auditors complied with AS 1220, *Engagement Quality Review*.

Inspection results from the 2016 inspections cycle indicate the engagement quality review continues to be an area of frequent deficiencies.

Inspections staff observed instances in which certain individuals were not qualified to serve as the EQR because the EQR served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review.[36]

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31 See PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*.

32 With certain narrow exceptions applicable to bookkeeping services, this conduct is inconsistent with the Commission independence criteria, see Rule 2-01(c)(4)(i) and 2-01(c)(4)(vi) of Regulation S-X, 17 C.F.R. 210.2-01(c)(4), and is prohibited by Section 10A(g) of the Securities Exchange Act of 1934 and Commission Exchange Act Rule 10A-2.34.

33 Certain communications concerning independence are required by PCAOB Rule 3526.

34 See PCAOB QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

35 See AS 2101.06.

36 See AS 1220.08.

Many of the recurring audit deficiencies described above occurred in areas of significant judgments that were subject to engagement quality reviews. Inspections staff continued to evaluate the potential root causes of the inadequate reviews of the audit work by EQRs. Factors that appeared to contribute to deficient EQRs included instances in which the reviewer:

- Lacked the knowledge, skills, and abilities to evaluate the appropriateness of the audit procedures performed and the extent of audit evidence retained in the audit documentation;
- May not have devoted sufficient attention to the review; and
- Conducted the review based solely on inquiry with the engagement team without review of audit documentation.

EQRs should consider whether they have obtained a sufficient understanding of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the audit.[37]

EQRs should also consider whether they have planned for sufficient time to perform their reviews properly and in a timely manner. Inspections staff have observed that attention to the engagement quality review not only during the year-end audit procedures but throughout planning, execution, and completion of the audit may contribute to the effectiveness of the review.

Engagement teams should document sufficient information, as required by AS 1215, *Audit Documentation*, for the EQR to gain a thorough understanding of the significant findings or issues.[38]

Continued Action Required

Monitoring procedures taken as a whole should enable a firm to obtain reasonable assurance that its system of quality control is effective. This may include determining remedial actions in response to negative quality events. Monitoring positive quality events may also provide additional insight to indicators of audit quality.

As part of firms' efforts to improve audit quality, some firms monitor audit deficiencies identified and perform root cause analysis on a continual basis. Some firms also link their remedial actions with root causes and the relevant quality control objectives and monitor the progress of the actions taken.

As a result, these firms obtain information that allows them to react more timely and implement remedial actions to reduce recurring deficiencies in other audits. For example, certain firms have:

- Implemented pre-issuance reviews to help auditors understand the required procedures to audit accounting estimates and test the design and operating effectiveness of controls with a review element, including their level of precision;

37 See AS 1220.09-.11.

38 See AS 1215.03.

- Enhanced or modified audit guidance and tools for engagement teams to enforce a more detailed understanding of the issuer's processes, transactions, and controls, and the associated risks of material misstatement;
- Developed interactive training sessions to reinforce professionals' understanding of the auditing standards and facilitate discussion among auditors regarding audit challenges and solutions through case studies;
- Provided additional real-time coaching and assistance to auditors in areas of recurring deficiencies;
- Increased supervision, including review, of other auditors through onsite visits and/or review of audit documentation; and
- Set interim milestones for completion of certain audit work, including timely supervisory reviews by senior engagement team members, to encourage timely reviews and feedback to auditors.

Each firm's processes are unique and, therefore, actions implemented by one firm may not contribute to audit quality when implemented by another firm. Firms should evaluate whether auditors have a sufficient understanding of PCAOB standards in these areas of recurring deficiencies, whether engagement team leadership is providing appropriate supervision of audit work performed by less experienced staff, and whether EQRs have evaluated the significant judgments made by the audit team and the related conclusions reached in forming the overall conclusion on the audit and preparing the report.

Conclusion

Inspections staff is encouraged by the additional focus some firms have placed on performing robust root cause analysis and progress in some areas of audit practice discussed in this Brief. Nevertheless, frequent findings continue to be observed in a number of important audit areas, including assessing and responding to risks of material misstatement, auditing ICFR, and auditing accounting estimates, including fair value measurements.

All registered firms should review this report and consider whether the types of audit deficiencies observed by Inspections staff could manifest themselves in their practices.

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