

# Staff Preview of 2018 Inspection Observations

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## Overview

The Division of Registration and Inspections staff (“we”) are providing this document to preview observations related to the 2018 inspections of audits of public companies. Auditors may find this information useful as they plan and perform current and upcoming audits. We also expect this information may be useful to audit committees as they engage with their auditors. Observations related to audits of brokers and dealers will be provided in future publications.

PCAOB inspections assess compliance with certain laws, rules, and professional standards in connection with firms’ audits of public companies. In 2018, we inspected more than 160 audit firms and reviewed portions of approximately 700 audits of public companies. We also inspected key elements of audit firms’ quality control systems. We conducted these inspections in the U.S. and in 30 jurisdictions abroad. Our non-U.S. work included inspections of more than 60 triennially inspected audit firms, where we reviewed portions of approximately 170 audits of public companies. As in 2017, China remains one of the last jurisdictions to restrict our access to work papers and other information to conduct inspections pursuant to our statutory mandate.

As part of our inspection efforts in 2018, we also observed how audit firms used technology in their audits, prepared for the implementation of new accounting and auditing standards and rules, and communicated with audit committees.

Our inspectors found that the most common deficiencies occurred in areas of auditing internal control over financial reporting (ICFR), assessing and responding to identified risks of material misstatement particularly in the area of revenue, and auditing accounting estimates, including fair value measurements.

## Observations and good practices regarding efforts to improve audit quality

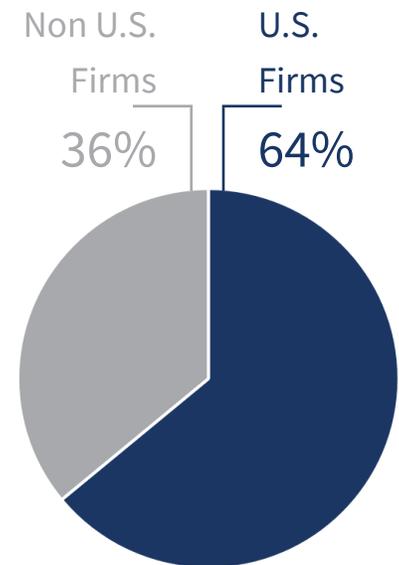
We observed that many audit firms continue to take steps intended to improve audit quality. These audit firms are achieving improvements by performing root cause analyses to understand the primary factors that contributed to positive and negative audit quality. Root cause analyses coupled with effective design and implementation of remedial actions can drive audit quality.

Through our inspections, we identified several good practices that we believe influence continued improvement in audit quality. We have observed fewer inspection findings at audit firms with an engaged leadership team that provides their staff with effective tools, training, and guidance. It is important for these good practices to be appropriately comprehensive and suitably designed in relation to the audit firm’s size and the nature and complexity of the audit firm’s practice.

These good practices include the following:

- ④ **Expanding accountability for audit quality beyond the lead engagement partner.** Some firms have established accountability programs for the engagement quality reviewer (EQR) and other partners in leadership roles to reward or penalize these individuals depending on whether the audits in which they participated are found by external or internal inspections to have deficiencies. We saw positive behaviors where firms have placed an emphasis on the importance of audit quality through extending accountability to other key leaders at the firm such as audit quality leaders, technical experts, and office leaders.
- ④ **Developing and refining guidance to help auditors identify and assess risks of material misstatement.** Some audit firms are developing and refining their internal guidance to assist auditors with identifying and assessing risks of material misstatement at the company. Specifically, these audit firms have articulated steps that the auditor should take, including having focused team discussions, to identify more effectively the types of potential misstatements that could occur. When auditors performed rigorous risk assessments, along with appropriately designed and executed audit procedures to address the assessed risks identified, audit quality improved.
- ④ **Revising training programs.** Some audit firms have revised their training programs to use real-world examples to more effectively illustrate where things might go wrong in an audit. For example, training programs may include case studies utilizing audit work papers that contain deficiencies in the audit testing. Participants reviewed these work papers and identified points in the process that resulted in the deficiencies.
- ④ **Providing additional support from experienced personnel not assigned to the audit.** We have seen positive results when these individuals have worked directly with auditors to evaluate planned responses to identified risks, specifically in areas of frequently occurring deficiencies. We have also observed positive results when these experienced personnel assess the effectiveness of the audit work performed in response to the assessed risks. These independent reviews serve as preventive measures to identify potential audit deficiencies before audit reports are issued.
- ④ **Establishing a network of specialized professionals to address emerging risks.** We have observed increased audit quality and improved application of professional judgment when audit firms use subject matter experts to address new and emerging risks as well as complex and challenging areas, such as technology and new accounting standards. For example, some audit firms have established a group of cybersecurity experts to serve as specialists if a company they are auditing has experienced a cybersecurity incident. Specialized resources provide audit teams with the experience needed to evaluate and address new and emerging risks. Some audit firms may hire outside specialists to fill this role.
- ④ **Providing new or enhanced audit tools in areas of significant judgment.** Some audit firms have provided tools to their auditors focused on how to avoid deficiencies that frequently occur. For example, some audit firms have provided audit teams with examples illustrating the nature and extent of evidence necessary to effectively audit areas of significant judgment. These illustrations facilitate improved audit quality, especially when auditors tailor these tools to the facts and circumstances of each audit and don't approach them as checklists.

## Mix of Firms Inspected in 2018



## Areas of common audit deficiencies observed in 2018

### Internal Control over Financial Reporting

In many audits inspected, we observed deficiencies related to testing ICFR. Common audit deficiencies in this area included instances where:

- Auditors did not sufficiently test the design and operating effectiveness of controls that include a review element. We observed that auditors did not obtain an understanding or evaluate the activities performed and factors considered by the control owner when reviewing the reasonableness of certain estimates and assumptions.
- Auditors did not select controls for testing that address the specific risks of material misstatement. We observed that auditors did not obtain a sufficient understanding of whether the control addressed the assessed risk of material misstatement.

Testing controls is critical to an audit as it is used to support the audit firm’s opinion of the effectiveness of ICFR in an integrated audit and to modify the nature, timing, and extent of substantive testing in financial statement and integrated audits.

### Risk Assessment and Revenue

We observed frequent deficiencies related to the design and performance of audit procedures that address the assessed risk of material misstatement, particularly when auditing revenue. For example, we identified audit deficiencies in testing revenue where:

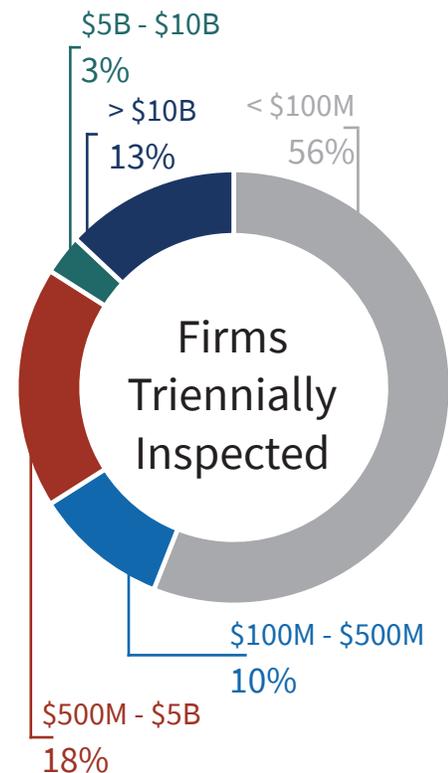
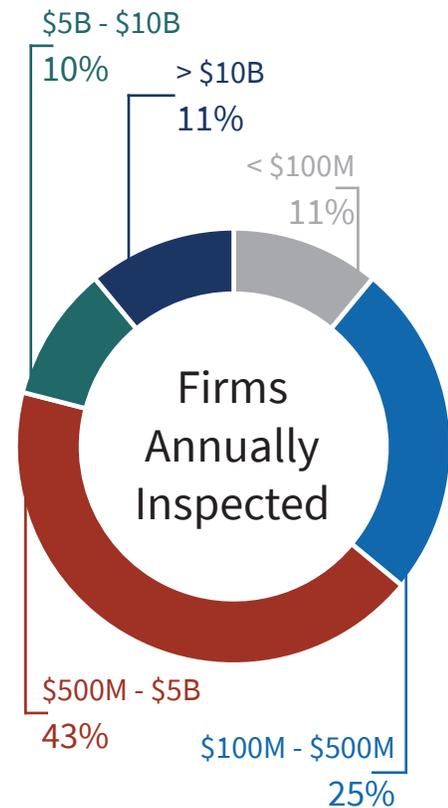
- Auditors agreed the revenue transaction to the company-prepared invoice without testing whether the invoice agreed to the terms of the contractual arrangement and without obtaining evidence that the services or products had been delivered.
- Auditors limited their testing to revenue transactions exceeding a certain amount or transactions recorded near year-end without considering the need to test the remainder of the population.

Based on our observations, auditors should apply due professional care in areas of significant risks, including the risk of fraud. Auditors should also perform sufficient risk assessment procedures to identify the risks of material misstatement and to design procedures responsive to the assessed risks.

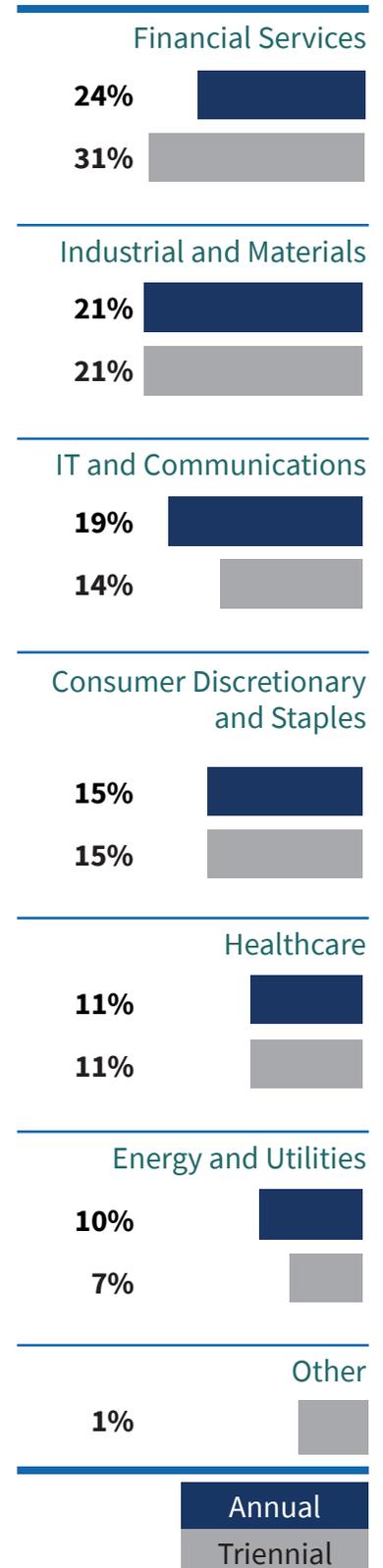
### Accounting Estimates

We continue to identify deficiencies in areas involving accounting estimates such as allowance for loan and lease losses (ALLL), accounting for business combinations, and the fair value of financial instruments. Developing these estimates often involves unobservable inputs, complex valuation models, and/or subjective judgments. To test accounting estimates effectively, auditors should exercise professional skepticism and involve senior engagement team members throughout the audit process.

## Revenues of audits inspected in 2018



## Industries of company audits inspected in 2018



### Allowance for Loan and Lease Losses

We commonly observed audit deficiencies in financial services audits including instances where:

- Auditors did not evaluate the reasonableness of significant assumptions used in determining the ALLL of impaired loans either individually or collectively.
- Auditors did not sufficiently test certain significant inputs used in developing the ALLL.

### Accounting for Business Combinations

When auditing the fair value of assets acquired in a business combination, we commonly observed deficiencies where:

- Auditors did not evaluate the reasonableness of certain significant assumptions underlying forecasts that management used in determining the fair value of assets acquired, including evidence that may corroborate or contradict those assumptions or conclusions.
- Auditors did not test the accuracy and/or completeness of company data used to develop the estimates.

### Financial Instruments

We continue to find frequent deficiencies in auditing unobservable inputs used to measure the fair value of certain financial instruments. Common audit deficiencies include instances where:

- Auditors did not obtain an understanding of the specific methods and assumptions underlying fair value measurements obtained from pricing services and used in the auditors' testing.
- Auditors did not test the accuracy and/or completeness of company data used to determine the fair value.
- Auditors, when developing an independent estimate, did not appropriately corroborate the fair value measurement determined by the company because the auditor used the same pricing source the company used.

It is important for auditors to use professional skepticism when evaluating management's views because they can be susceptible to bias.

### Engagement Quality Review

Many of the deficiencies we identified during our inspections occurred in areas reviewed by EQRs who failed to identify relevant deficiencies. In some instances, EQRs may have placed too much reliance on discussions with the engagement team. In other instances, EQRs may have limited their review by reading summary memos that did not provide sufficient detail to allow for a review with due professional care.

# Observations on technology, implementation of new accounting and auditing standards and rules, and audit committee communications

In our 2018 inspections, we reviewed auditors' response to cybersecurity risks, their use of software audit tools, the implementation of new accounting and auditing standards and rules, and communications between auditors and audit committees.

## Cybersecurity Risk

In approximately 10 percent of the audits we inspected, the company had experienced a cybersecurity incident during the audit period, many of which related to malware and email phishing scams.

Not every incident we observed had a financial statement impact. Nevertheless, auditors generally considered the cybersecurity incident in their risk assessments and modified their audit procedures, as needed, to address the potential impact on relevant controls and the data generated by the company's information technology systems. As part of the risk assessment process, it is important for auditors to take steps to become aware of cybersecurity incidents at the companies they audit.

## Software Audit Tools

We gained insights into software audit tools currently used by audit firms and tools that are under development. Although we did not observe the use of emerging technologies on audits inspected in 2018 — such as artificial intelligence and robotic process automation— we observed that audit firms are actively considering these technologies when developing their future software audit tools.

We observed, for example, the use of data analytics tools in certain audits. These tools were used primarily as part of risk assessment and typically involved analysis of large volumes of transactions, such as revenue and journal entry testing. Such tools identified outliers that could potentially warrant audit attention. The use of such analytical tools enhanced auditors' identification of higher risk transactions.

## Implementation of new standards and rules

As companies prepare to adopt new accounting standards and audit firms prepare to implement new auditing standards and rules, we discussed these areas with firm leadership, engagement teams, and audit committee members.

### Accounting Standards

In preparation for the adoption of new accounting standards related to revenue, leases, current expected credit loss, and financial instruments, we observed that audit firms have revised their audit methodologies and conducted specific trainings.

Firms continue to have regular interaction with management on the implementation of the new accounting standards. Companies are also making changes to both their accounting processes and related controls in anticipation of the new standards. As companies adopt these new accounting standards, auditors will need to evaluate the impact on the financial statements.

### Form AP

In an effort to enhance transparency to investors and other financial statement users, [PCAOB rules](#) require registered firms to disclose on Form AP the name of the engagement partner and certain other accounting firms that participated in the audit. To assess compliance with this requirement, we performed procedures to evaluate whether information presented by the firms contradicted the disclosures included in Form AP.

We observed that many triennially inspected audit firms had not submitted Form AP in a timely manner. In addition, we found some incomplete disclosures pertaining to the use of other accounting firms. Without complete and accurate information, investors, audit committees, and other stakeholders will not know which accounting firms participated in the audit.

### Changes in the Auditor's Report

Auditors were required to implement certain requirements of the auditor's reporting model (ARM), including those related to auditor tenure. Our preliminary inspection results indicate that most firms effectively implemented the first phase of the new ARM requirements.

In addition, we discussed with audit firms how they are preparing for the implementation of critical audit matters (CAMs), which is the last new ARM requirement that will go into effect beginning in 2019 for audits of certain companies. A CAM is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. Audit firms have been performing pilot testing, and creating methodologies to assist their auditors with identifying and communicating CAMs in the auditor's report. The [PCAOB staff recently issued](#) guidance related to the implementation of these requirements.

### Audit Committee Communications

In our inspection of triennially inspected audit firms we continue to identify deficiencies related to auditors failing to communicate to the audit committee significant risks identified in the audit, including changes to those risks throughout the audit. Some of these deficiencies arose because the auditor failed to communicate the fraud risks related to management override of controls. Communicating significant risks to audit committees is required by PCAOB standards and assists audit committees in exercising their oversight responsibilities. Such communications may also help audit committees better understand the external and company-specific factors considered by the auditor in assessing whether all significant risks have been identified.

This Staff Preview highlights some of the factors observed in 2018 inspections to be considered by auditors throughout the audit. In addition to this Preview, we plan to periodically provide information based on our inspection observations that we believe would be helpful in driving improvements in audit quality.

*Revenue and industry graphic information obtained from Standard & Poor's.*

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