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Staff Inspection Brief

The staff of the Public Company Accounting Oversight Board ("PCAOB" or "Board") prepares Inspection Briefs to assist auditors, audit committees, investors, and preparers in understanding the PCAOB inspection process and its results. The statements contained in Staff Inspection 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 2015 Inspections of Auditors of Issuers

The PCAOB Division of Registration and Inspections has developed this Inspection Brief to provide a preview of observations from PCAOB inspections of issuer audits during the 2015 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 ("AS"), independence rules and other PCAOB rules when performing their audits. It is also intended to provide insights from these inspections to audit committees, investors, issuers, and others.

Overview of Preliminary Inspection Findings

The 2015 inspection fieldwork is complete. The Board has issued inspection reports for some firms, and Inspections staff is in the evaluation and drafting stages for the remaining inspection reports.

Preliminary 2015 inspection results of the annually inspected firms indicate the overall number of audit deficiencies identified has decreased compared to the results from the 2014 inspection cycle.[1] Inspections staff has observed indications of improved audit quality over time in some of these firms inspected, and some of the contributing factors to these improvements may include changes in areas such as new practice aids and checklists, coaching and support to teams, and monitoring the quality of audit work performed. For firms that are required to be inspected at least once every three years ("triennially inspected firms"), Inspections staff observed an overall high number of audit deficiencies in preliminary 2015 inspection results.

The most frequent audit deficiencies continue to be in the key areas related to auditing internal control over financial reporting, assessing and responding to risks of material misstatement, and auditing accounting estimates, including fair value

1 Inspections staff inspected ten annual firms and 321 audits in the 2015 inspection cycle compared to nine annual firms and 315 audits in the 2014 inspection cycle.

measurements. Inspections staff focused on audit work in these three areas for many firms during the 2015 inspection cycle because Inspections staff found significant deficiencies in the past several years across firms (including in referred work engagements where a firm played a role in an audit but was not the principal auditor).[2]

This Brief also highlights recent inspection results and observations related to other areas of inspection focus, that were previously discussed in the October 2015 Brief which described important aspects of the inspection plan, scope and objectives of the 2015 inspection cycle. These areas of inspection focus include audit areas affected by certain economic risks, auditing of certain financial reporting areas, audit work regarding financial reporting risks and controls related to information technology, multinational audits, and certain aspects of a firm's system of quality control.

Audit engagements and areas of inspection focus are not selected randomly, and selections of audits are not necessarily representative samples of the firm's audits.[3] The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. PCAOB inspections are a tool used to help protect the interests of investors by assessing and encouraging firms' compliance with auditing standards, with a goal of improving audit quality and strengthening firm quality control systems.

Auditors should take note of the matters discussed in this Inspection Brief in planning and performing their audits. It is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews.

Due to the continued number and significance of the audit deficiencies identified in these key audit areas, firms should continue to focus their efforts on improving their systems of quality control, which may include performing detailed and comprehensive root cause analyses for these deficiencies. Root cause analysis of both audit deficiencies and positive audit quality events is expected to improve the firms' abilities to appropriately remediate systemic issues. Establishing appropriate processes for root cause analysis at the firms is in varying phases of development at different firms. For example, certain firms are analyzing positive quality indicators in addition to audit deficiencies.

2 See the Staff Inspection Brief, *Information about 2015 Inspections*, Vol. 2015/2 issued in October of 2015 ("October 2015 Brief").

3 See the October 2015 Brief for additional information regarding the Inspections staff risk-weighted approach.

Observations in Key Areas of Inspection Focus

Recurring Audit Deficiencies

Internal Control Over Financial Reporting ("ICFR")

Inspections staff continued to identify frequent 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* (currently AS No. 5).[4]

While Inspections staff has seen improvement in 2015 in the nature and extent of the audit issues in this area at certain firms, continued focus on testing controls is needed to improve and sustain audit quality.

Examples of frequently recurring deficiencies include:

- Inspections staff observed, in some audits, that auditors did not identify and test controls or important aspects of controls (e.g., the criteria used by management to identify items for investigation and/or the resolution of such items) that addressed the specific risks of material misstatement that the auditor had identified.[5]

Some firms showed improvement in this area with fewer deficiencies in which auditors did not identify and test controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion. Some firms enhanced or modified their audit guidance and audit tools for engagement teams to perform more effective walkthroughs and develop a better understanding of the issuer's processes, transactions, controls, and the associated risks. These efforts may have contributed to fewer deficiencies in this area at some firms.

Inspections staff continued, however, to frequently identify audit deficiencies related to insufficient testing of the design and operating effectiveness of selected controls, particularly when there was high risk associated with the control. Auditors should obtain a sufficient understanding of the company and its internal control over financial reporting to plan and perform the necessary tests of controls to address risks of material misstatement.[6] Understanding a company's internal control includes, among other things, understanding the information system(s) relevant to financial reporting (e.g., the procedures by which transactions are initiated, authorized, processed, recorded, and reported), including the related business processes.[7]

4 On March 31, 2015, the PCAOB adopted amendments that reorganize and renumber its auditing standards, effective December 31, 2016. (See PCAOB Release No. 2015-002.) The new numbering may also be used in advance of that date, and this Inspection Brief uses the prospective numbering. The first time a standard is cited, this document also parenthetically indicates the current number.

5 See paragraphs 21 to 41 of AS 2201.

6 See paragraphs 9 to 12 of AS 2201.

7 See paragraphs 34 and 36 of AS 2201.

- Inspections staff continued to identify audit deficiencies related to auditors' testing of controls that contain a review element. Such management reviews might be performed to monitor the results of operations, such as (1) monthly comparisons of actual results to forecasted revenues or budgeted expenses; (2) comparisons of other metrics, such as gross profit margins and expenses as a percentage of sales; and (3) quarterly balance sheet reviews. These reviews typically involve comparing recorded financial statement amounts to expected amounts and investigating significant differences from expectations.

  In several instances, auditors did not sufficiently evaluate the effectiveness of the controls. In some cases, this was due to the fact that they did not obtain an understanding of the actions performed by management during the review, the criteria used to identify deviations requiring investigation, or the actions taken to investigate and resolve those deviations, in order to address the risk of material misstatement. In addition, some auditors did not adequately understand the issuer's process and likely sources of potential misstatements, and some auditors also pointed to their tests of details as evidence of the effectiveness of the control without directly testing the control.[8]

  AS 2201 provides that entity-level controls vary in nature and precision and that some entity-level controls might operate at a level of precision that would adequately prevent or detect misstatements on a timely basis.[9] When testing controls that contain a review element, auditors need to evaluate whether the control is designed and operating to prevent or detect on a timely basis misstatements that could cause the financial statements to be materially misstated.[10]

- Inspections staff has observed improvement at some firms over the past two years in the area of testing controls over the accuracy and completeness of system-generated data and reports used in the performance of important controls that they were testing.[11] Certain firms developed new tools to address these deficiencies, including detailed examples of how to apply firm guidance and use the tools effectively. At other firms, however, Inspections staff continued to identify deficiencies where auditors did not sufficiently test these types of controls.

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.[12]

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8 See paragraph B9 of AS 2201.
9 See paragraph 23 of AS 2201.
10 See paragraphs 42 to 52 of AS 2201.
11 Paragraph 39 of AS 2201 provides that the auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.
12 Staff Audit Practice Alerts do not establish or modify rules of the Board, but rather highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws.

Assessing and Responding to Risks of Material Misstatement

The number of the deficiencies identified in 2015 related to non-compliance with the Risk Assessment Standards[13] decreased at certain firms when compared to inspections from 2012 to 2014, but these deficiencies continue to be commonly identified. As in prior years, the risk assessment deficiencies observed during the 2015 and 2014 inspection cycles were most frequently related to AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* (currently AS No. 13), AS 2810, *Evaluating Audit Results* (currently AS No. 14), and AS 1105, *Audit Evidence* (currently AS No. 15).

Assessing and responding to risks of material misstatement are two critical components of an audit. Improper application of these standards may result in audit deficiencies that contribute to an unsupported audit opinion or, in some cases, unnecessary or excessive audit work.

Examples of deficiencies identified in this area included instances where auditors did not:

- Perform substantive procedures, including tests of details, that were specifically responsive to fraud risks and other significant risks that were identified.[14] Some auditors performed only imprecise analytical procedures comparing current period financial statement amounts to corresponding amounts in prior periods without performing any test of details, or limiting procedures to inquiry and review of information produced by the issuer, whereby these audit procedures were not sufficiently responsive to the identified significant risks.
- Perform sufficient testing of the design and operating effectiveness of controls to support their planned level of control reliance, including testing the controls over the accuracy and completeness of system-generated data and reports[15] used to support important controls or substantive procedures performed in response to the assessed risks of material misstatement.[16] In some instances, auditors relied on controls to reduce their substantive testing of certain financial statement accounts and disclosures. Due to deficiencies in evaluating and testing internal control, the level of control reliance was not supported, and the sample sizes used by the auditors were too small to provide sufficient evidence to meet the objectives of the test.
- Take into account relevant audit evidence that appeared to contradict certain assertions in the financial statements.[17] For example, an auditor concluded there were no indicators of impairment related to certain long-lived assets, but the auditor did not consider and evaluate if the net losses, negative cash flows from operations and substantial doubt about an issuer's ability to continue as a going concern could be indicators of impairment.
- Sufficiently evaluate the presentation of the financial statements, including the accuracy and completeness of the disclosures.[18] An auditor did not test whether the issuer had met the U.S. Generally Accepted Accounting

13 AS 1101, 2101, 1201, 2105, 2110, 2301, 2810 and 1105 (currently AS Nos. 8 through No. 15).
14 See paragraphs 11 and 13 of AS 2301.
15 Paragraph 10 of AS 1105, provides that when used as audit evidence, auditors should test the accuracy and completeness of information produced by the company or test the controls over such information.
16 See paragraph 16 of AS 2301.
17 See paragraphs 3 and 34 of AS 2810.
18 See paragraphs 30 and 31 of AS 2810.

Principles criteria for recognizing revenue and if the revenue recognition policy as disclosed was complete and accurate. Another auditor did not identify that disclosures in the notes to the financial statements for share issuances and stock option-related expense amounts were overstated and inconsistent with the amounts reported in the financial statements.

Other audit deficiencies related to the Risk Assessment Standards included deficiencies in complying with AS 2110, *Identifying and Assessing Risks of Material Misstatement* (currently AS No. 12), in the identification and assessment of fraud risks. These deficiencies commonly related to auditors not having a sufficient understanding of the revenue recognition process, the types of revenue, revenue transactions, or assertions that may give rise to such risks. AS 2110 deficiencies were primarily observed at triennially inspected firms.

The PCAOB recently issued a general report, *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 deficiencies in auditors' compliance with these standards observed during the 2012 to 2014 inspection cycles. The report also provides insight into potential root causes of these deficiencies and potential remedial actions that firms may consider.

Accounting Estimates, including Fair Value Measurements

In 2015, Inspections staff continued to take a close look at audit work performed on a range of complex estimates and frequently identified audit deficiencies in this area. 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.[19]

The audit deficiencies frequently identified during the 2015 inspection cycle related to testing estimates arising from the valuation of assets and liabilities acquired in a business combination and evaluating impairment analyses for goodwill and other long-lived assets. Other areas where deficiencies were identified include financial instruments, revenue-related estimates and reserves, the allowance for loan losses ("ALL"), inventory reserves, and tax-related estimates.

Inspections staff continued to identify instances in which auditors did not fully understand how estimates were developed or did not sufficiently test the significant inputs and evaluate the significant assumptions used by management. For example, there were instances where auditors did not evaluate the issuer's credit risk ratings that formed part of the basis for management's qualitative assessment of the ALL. These auditors also did not test the accuracy and completeness of the underlying loan data that the issuer used to derive default assumptions to estimate the ALL ranges and midpoints.

19 See paragraphs 3 and 4 of AS 2501, *Auditing Accounting Estimates* (currently AU Section 342).

Inspections staff also continued to see instances in which auditors did not perform testing beyond inquiry of management in both tests of controls and substantive tests.

Auditors should obtain an understanding of the company's processes and methods, including the related controls, for the development of estimates. Auditors then should test the data and evaluate the assumptions that are significant to the estimate.[20]

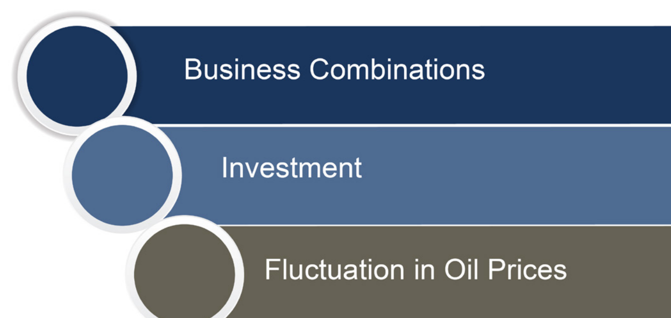
Auditors should also take into account audit evidence that appears to contradict management assumptions, even when the auditor has obtained information that supports management's assumptions.[21]

Additional examples of deficiencies related to testing accounting estimates are provided in the Audit Areas Affected by Economic Risks section that follows.

Observations in Other Areas of Inspection Focus

In addition to the areas of recurring audit deficiencies, the following discussion in this Brief highlights recent inspection results and observations related to other areas of inspection focus that were also noted in the October 2015 Brief. 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 Affected by Economic Risks



Inspections staff considered the current economic environment 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 recent fluctuations in oil prices and their varying effects on the financial reporting risks of different industries.

Business Combinations

As discussed above in testing accounting estimates, Inspections staff continued to identify concerns with auditors' testing of fair value measurements associated with business combinations. Preliminary inspection results indicate that the number of audit deficiencies increased in this area when compared to 2014. Inspections staff inspected more instances of these transactions in the 2015 inspection cycle as compared to the 2014 inspection cycle which may have contributed to the increased number of audit deficiencies identified. These deficiencies related to testing of internal controls and/or substantive tests, including evaluating the accounting for these transactions. For example, Inspections staff identified instances where auditors did not:

20 See paragraphs 9 through 14 of AS 2501 and paragraphs 9 through 14, and 23 of AS 2502, *Auditing Fair Value Measurements and Disclosures* (currently AU Section 328).

21 See paragraph 3 of AS 2810 and paragraph 2 of AS 1105.

- 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 value certain assets, including projected financial information developed by the issuer.[22]

Investments

Audit deficiencies were also identified related to the testing of investment portfolios. These 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 pricing hard-to-value investment securities and management's review of valuation models. For example, one auditor performed only a walkthrough of the controls. In another audit, the auditor's testing of the issuer's review controls over fair value measurements and disclosures did not include understanding and evaluating the criteria used by management to identify items for investigation and/or determine whether specific items that were investigated were resolved.

In addition, auditor's substantive tests of fair value measurements usually involve (i) testing management's significant assumptions, the valuation model, and the underlying data, or (ii) developing independent fair value estimates for corroborative purposes.[23] Deficiencies related to these procedures included instances in which auditors did not:

- Perform sufficient procedures to obtain an understanding of the specific methods and assumptions underlying the fair value measurements.[24] In some instances, auditors merely compared the fair values of certain securities without readily observable market inputs to other information such as trustee reports or prior audit work papers, or limited their procedures to inquiry of management. The auditors did not evaluate the appropriateness of the valuation methods and the reasonableness of the significant assumptions used by the issuer to determine the fair value of the securities.
- Appropriately develop an independent fair value estimate to test management's estimate because the pricing source the auditor used was the same as the company's source.[25]

Other deficiencies in this area included where auditors did not evaluate the adequacy of the fair value disclosures, including the categorization of financial instruments by level under the fair value hierarchy.[26]

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22 See paragraphs 29 and 30 and footnote 2 of AS 2502. 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 (a) obtain an understanding of the methods and assumptions used by the specialist, (b) test the data provided to the specialist, and (c) evaluate whether the specialist's findings support the assertions in the financial statements. See paragraph 12 of AS 1210, *Using the Work of a Specialist* (currently AU Section 336).

23 See paragraph 23 of AS 2502.

24 See paragraphs 26, 33 and 39 of AS 2502.

25 Paragraph 40 of AS 2502. Paragraph 23 of AS 2502 also provides that one method for testing fair value measurements involves developing independent estimates for corroborative purposes.

26 See paragraphs 43 to 46 of AS 2502.

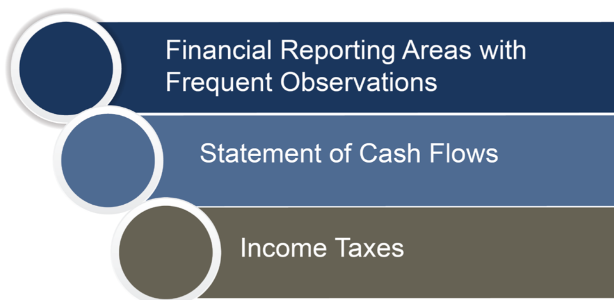
Fluctuation in Oil Prices

For some issuers selected for inspection in the oil and gas industry, Inspections staff identified instances in which auditors failed to sufficiently test the design and operating effectiveness of controls that were selected by the auditors for testing and that related to the identification of triggering events that may indicate asset impairment. Inspections staff also identified instances in which auditors did not perform sufficient procedures to evaluate management's assumptions used in asset recoverability and impairment tests. In one audit, the auditor failed to sufficiently evaluate the adverse effects of certain events and conditions, which included falling oil prices, on the issuer's ability to continue as a going concern and whether the issuer should have tested for impairment its assets related to oil and natural gas properties.

Deteriorating economic conditions heighten the importance of critically assessing expected future cash flows when evaluating assets for potential impairment in an audit. Impairment risk is not limited to companies in the oil and gas industry; it also applies to other companies. Auditors should consider whether a company has controls in place to identify events that may trigger impairment of assets on a timely basis.

While the audit deficiencies related to economic risks discussed above were not pervasive across firms inspected, auditors should take note of these deficiencies and, if applicable, evaluate whether their audit plan is designed to address these concerns.

Auditing of Certain Financial Reporting Areas



Financial Reporting Areas with Frequent Observations

Inspections staff selects a variety of financial reporting areas for inspection, and the types of findings related to these financial reporting areas varied among inspected audits. During the 2015 inspection cycle, audit deficiencies (including in multinational audits involving other auditors) were most frequently observed in auditing of the following inspected financial reporting areas: revenue and receivables, non-financial assets (e.g., assets acquired in business combinations, including goodwill and other intangible assets, and other long-lived assets), inventory, financial instruments, and the allowance for loan losses. The audit deficiencies in those areas included deficiencies in auditors' testing and evaluation of internal controls, auditing estimates (including fair value measurements), and assessing and responding to the risks of material misstatement which are discussed in the Recurring Audit Deficiencies section above.

In addition to frequently inspected areas related to recurring audit deficiencies, Inspections staff also performed focused inspections of the auditing of the statement of cash flows and income taxes on certain issuer audits. Although audit deficiencies related to these areas were not frequently identified during the

2015 inspection cycle, auditors should consider these items when planning and performing procedures in their audits given the risks described below. Inspections staff continues to consider these areas for future inspections.

Statement of Cash Flows

Audit deficiencies in this area included instances where auditors did not sufficiently test the design and operating effectiveness of the controls that they selected for testing and that contained a review element over the statement of cash flows. For example, auditors did not obtain an understanding of the actions performed during the review, the criteria used to identify deviations requiring investigation, or the actions taken to investigate those deviations to identify and correct misstatements. Additionally, one auditor did not perform any procedures to evaluate the presentation and disclosure of the amounts reflected in the company's statement of cash flows.

Income Taxes

Income taxes continue to be an area of interest to investors, companies, audit committees, auditors, and regulators alike. Audit deficiencies identified in 2015 related to income taxes included the procedures performed to test the design and operating effectiveness of controls that were selected by the auditors for testing. In some instances, deficiencies also related to the test of controls and/or substantive tests over the valuation allowance of the net deferred tax assets. Auditors should remain focused on this area, including the testing of selected controls over the completeness and valuation of income taxes and the related disclosures.

Audit Committee Communications

Preliminary 2015 inspection results indicate the number of inspection findings related to audit committee communications has remained consistent with the 2014 inspection cycle, and most firms were in compliance with AS 1301, *Communications with Audit Committees* (currently AS No. 16). In 2015, the deficiencies identified by Inspections staff related to audit committee communications are similar to those identified during the 2014 inspection cycle. For example, several deficiencies identified in 2015 are due to the auditors' failure to communicate an overview of the overall audit strategy, timing of the audit, and all of the significant risks the firms had identified.

The PCAOB recently 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.

Matters Relating to Auditor Independence

Auditors must be independent of their audit clients throughout the audit and professional engagement period.[27]

Inspections staff identified deficiencies related to non-compliance with PCAOB rules and/or SEC rules and regulations related to auditor independence. The majority of the deficiencies described below were identified in triennially inspected firms. Examples include instances in which auditors:

- 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;[28]
- Provided services to the issuer as the lead engagement partner for more than five consecutive years;[29]
- Did not obtain pre-approval from the audit committee prior to performing non-audit services;[30]
- Insufficiently communicated to the audit committee the scope of tax consulting services performed and the potential effects of all tax services on the independence of the firm;[31]
- In required communications with audit committees about independence, inaccurately described PCAOB rules as requiring that the firm describe to the audit committee those relationships that, in the auditor's professional judgment, bear on independence, when, in fact, the relevant rule is not qualified by reference to an auditor's professional judgment;[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 provides sufficient assurance that the firm's personnel understand the independence requirements and that the firm and its personnel comply with independence requirements.[34] For example, some auditors did not report, or did not timely report, investments acquired or sold during the year, which may have impacted the firm's

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27 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.

28 With certain narrow exceptions, this conduct is inconsistent with 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.

29 Subject to an exception for small firms that meet certain criteria, this conduct is inconsistent with Commission independence criteria, see Rule 2-01(c)(6)(i) of Regulation S-X, and is a violation of Section 10A(j) of the Exchange Act and Commission Exchange Act Rule 10A-2.

30 With certain narrow exceptions, this conduct is inconsistent with Commission independence criteria, see Rule 2-01(c)(7)(i) of Regulation S-X, and is a violation of Section 10A(h) of the Exchange Act and Commission Exchange Act Rule 10A-2.

31 Such communications are required by PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*.

32 PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, requires the auditor annually to provide the audit committee with a written description of relationships that "may reasonably be thought to bear on independence." While auditors must exercise sound judgment in carrying out their responsibilities, the determination necessary under Rule 3526 requires the auditor to consider how a reasonable third party, not the auditor, would view the relationship. (See PCAOB Release No. 2008-003, Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence, (April 22, 2008)).

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*.

ability to evaluate its independence. Additionally, in some instances auditors appear to have concluded inappropriately that certain financial or employment relationships with the respective firm issuer audit client did not impair independence.[35]

While deficiencies with auditor independence requirements were not pervasive across firms, auditors should continue to assess their personal and professional activities to ensure 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.

Firms should remain focused on this area in their audits, as Inspections staff continued to identify deficiencies with engagement quality reviews, including, for example, instances where:

- Engagement quality reviewers did not evaluate the significant judgments made by the engagement team related to planning, including the engagement team's assessment of, and audit responses to, identified significant risks, including fraud risks;
- Engagement quality reviewers did not evaluate whether the audit documentation reviewed provided sufficient evidence to support that the engagement team responded appropriately to the significant risks they identified and the conclusions reached;
- Engagement quality reviewers did not perform the review required with due professional care. For example, some reviewers may have conducted the review through discussion without reviewing audit documentation; and
- Individuals assigned to perform the engagement quality review did not satisfy the "cooling off" qualification requirement, because of having served as engagement partner on the audit in one or both of the two preceding audits.[36]

In addition, in some audits inspected at triennially inspected firms, no engagement quality review was performed at all.

Engagement quality reviewers should consider whether they have obtained a sufficient understanding of the significant judgments made by the engagement team and the related

35 For example, Rule 2-01(d) of Regulation S-X provides that under certain conditions a covered person's lack of independence will not impair the firm's independence. Those conditions include that the covered person did not know of the circumstances giving rise to the lack of independence (such as a spouse's financial interest) and that it was corrected as promptly as possible after the covered person became aware of it. In some circumstances, firms' internal analyses have treated the Rule 2-01(d) conditions as satisfied even where the covered person knew of the circumstances, as long as the covered person did not know that the circumstances violated independence requirements, which is an inappropriate application of the rule. In other circumstances (not involving Rule 2-01(d)), firms have internally identified conduct that they recognized as an independence impairment specified in Rule 2-01(c), but then proceeded as if there were no impairment based on their own analysis that they nevertheless satisfied the general standard of independence in Rule 2-01(b). Rule 2-01(c), however, sets forth the Commission's "specification of circumstances inconsistent with" the general standard of Rule 2-01(b). Thus it is not appropriate for the firm to conclude that independence impairments under Rule 2-01(c) can be cured by applying the general standard of independence in Rule 2-01(b).

36 This requirement is included in paragraph 8 of AS 1220, *Engagement Quality Review* (currently AS No. 7).

conclusions reached in forming the overall conclusion on the audit and whether they have planned for sufficient time to perform their reviews.[37]

Engagement teams should document sufficient information, as required by AS 1215, *Audit Documentation* (currently AS No. 3), for the engagement quality reviewer to gain a thorough understanding of the significant findings or issues.[38]

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. Preliminary 2015 inspection results of work performed by other firms at the request of the principal auditor ("referred work engagements") indicates the overall number of audit deficiencies was similar to 2014 and decreased when compared to the 2013 inspection cycle.

Inspections staff has observed that some accounting firms, particularly the largest firms that work extensively and frequently with other auditors, have taken targeted actions to address audit quality criticisms in these areas and have enhanced their methodology or tools for multi-location engagements and for using the work of other auditors. These enhancements at some firms encourage a greater level of supervision, including review, by the principal auditor (e.g., site visits, detailed review of other auditor work papers in significant risk areas, and frequent comprehensive communications). Inspections staff has observed that these actions may have contributed to the decline in audit deficiencies identified in referred work engagements in the 2014 and 2015 inspection cycles.

Information Technology Risks

As indicated in the October 2015 Brief, Inspections staff planned 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 and related controls associated with cybersecurity. While Inspections staff did not identify audit deficiencies in the 2015 inspection cycle related to these areas, Inspections staff continues to evaluate how firm processes are evolving and how firms are responding to these risks. The following discussion provides insight into the information gathered during the 2015 inspection cycle.

Firm Software Audit Tools

Some firms are moving in the direction of developing and using software audit tools with the intended objectives of performing audit work more effectively and efficiently and increasing the likelihood of testing audit areas associated with higher risk. 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

37 See paragraphs 9 to 11 of AS 1220.
38 See paragraph 3 of AS 1215.

than selecting a random sample of transactions for testing, or to assess the effectiveness of segregation of duties established across the organization.

Inspections staff performed procedures to obtain an understanding of controls that firms have in place to provide assurance that the software audit tools used to analyze the data meet the audit objectives. Inspections staff observations include:

- Software audit tools used by firms vary and some firms have customized purchased tools or have internally developed these tools; and
- Most of the firm software audit tools are being used for performing substantive audit procedures, while some tools may also be used for risk assessment.

Firms should continue to evaluate whether their systems of quality control are designed to provide reasonable assurance that these tools operate effectively and meet the audit objectives, including assisting auditors in complying with applicable auditing standards. Audit methodology or tools that do not comply with relevant auditing standards may increase the risk that auditors may not perform sufficient procedures to address the risks of material misstatement in an audit.

Inspections staff plans to continue to obtain and evaluate information in this area, including the steps taken by the firms to (i) determine the audit engagement teams' understanding of effective use of these tools and (ii) ensure that engagement teams are applying due care, including professional skepticism in using these tools.

Cybersecurity

Cybersecurity incidents, such as breaches related to the theft of company software, patents, secrets, or other intellectual property, and breaches that compromise software, have continued to be prominent. Both auditors and companies see this as an overall business risk, as compared to just an information technology risk.

Inspections staff has observed that certain firms have provided guidance to their auditors to consider cybersecurity risks as similar to any other business and technology risk. This includes considering cybersecurity risks when performing procedures in accordance with the requirements of AS 2201 and AS 2110.

It is important for auditors to consider whether there are cybersecurity risks that pose risks of material misstatement and, if so, whether modifications to the planned approach, including in testing Information Technology 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 internal control over financial reporting. Inspections staff plans to continue to obtain and evaluate information in this area.

Conclusion

Inspections staff is encouraged by the improvement in audit quality in many of the firms inspected during 2015. The additional focus by certain firms in performing robust root cause analysis is also promising. Nevertheless, frequent findings continue to be observed in a number of important audit areas, including auditing internal control over financial reporting, assessing and responding to risks of material misstatement, and auditing accounting estimates (including fair value measurements), and others.

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 and firms are encouraged to consider conducting a rigorous root cause analysis related particularly to repeated findings in the same audit areas.