A Brief Overview of Trends in PCAOB Inspection Reports:
What Every Practitioner Should Know

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I. INTRODUCTION

With the passage of the Sarbanes-Oxley Act of 2002 (the "Act"), accounting firms which audit public companies were required to register with and became subject to periodic inspection by a private-sector, non-profit corporation created by Congress for the purpose: the Public Company Accounting Oversight Board ("PCAOB" or "Board").[2] The frequency of PCAOB review depends on the volume of audit business conducted by the firm. Specifically, Section 104 of the Act requires annual inspections for any registered accounting firm that regularly provides audit reports on more than one hundred public issuers (hereinafter referred to in this paper as "annual firms"), while registered accounting firms providing audit reports on at least one, but no more than one hundred, issuers are subject to PCAOB review only once every three years (hereinafter referred to in this paper as "triennial

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[2] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002), *available at* http://pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf (hereinafter "Sarbanes-Oxley Act of 2002").

firms").[3] Regardless of the frequency, however, the PCAOB issues a report on each inspection it performs, and each report has two parts. The first portion describes the inspection procedures performed and summarizes the results of the PCAOB's review of the inspected firm's specific audit engagements. The second portion of each report contains certain additional detail, which may include (among other content) a discussion of potential defects identified by the PCAOB in the firm's system of quality control. Any quality control criticisms remain nonpublic if the firm addresses them to the PCAOB's satisfaction within twelve months. Otherwise, the portion of the report discussing the particular quality control criticisms is made publicly available by the PCAOB.[4] From time to time, the PCAOB also issues additional information and publications, including reports to inform the public of trends, deficiencies, or other issues identified through its inspection process.[5]

The authors of this article have reviewed several PCAOB inspection reports which covered the annual firms and were released from 2008 through 2010. The reports issued by the PCAOB in 2008 through 2010 typically pertain to inspections

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[3] Sarbanes-Oxley Act of 2002, at §104(b).

[4] *See* Public Company Accounting Oversight Board, "Firm Inspection Reports," http://pcaobus.org/Inspections/Reports/Pages/default.aspx.

[5] *See, e.g.*, PCAOB Release No. 2010-006, "Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis."

conducted in 2007 through 2009, the subject of which is generally audit engagements performed for fiscal years ending in 2006 through 2008, respectively.[6] Despite the time lag between the date of each auditor's report and the PCAOB review of that report, the PCAOB inspection reports are nonetheless collectively instructive to the practitioner. For one thing, the inspections by the PCAOB identify deficiencies in the application of generally accepted accounting principles ("GAAP"), generally accepted auditing standards ("GAAS"), and the execution of audit procedures by the registered accounting firms.[7] Since it employs a risk-based assessment approach in conducting its inspections, the PCAOB also provides the profession with insights, based on its cumulative experience of examining firms and interviewing professionals, into the areas of audit work that it considers to involve a heightened possibility for error. Thus, we believe that most practitioners will find the PCAOB examination reports instructive. The reports provide an independent reminder of the accounting and auditing issues, both perennial and newly emerging, that may warrant further consideration during audits.

[6] The PCAOB inspection report for each firm indicates the dates on which it performed its field work but does not indicate the date of the financial statements on which its review was based.

[7] It should be noted that, while the PCAOB may characterize certain findings as deficiencies, it is not always the case that the auditor concurs with either the PCAOB's findings or its characterization of those findings.

Given the large number of inspection reports issued by the PCAOB each year, however, even the most diligent practitioner may find it difficult to stay informed of the key trends and findings. For that reason, we have endeavored in this article to recount several insights we developed as a result of our recent analysis of inspections conducted by the PCAOB during 2007-2009 on the eight annual firms.[8] In the sections below, we first discuss audit trends the PCAOB has recently identified as involving "higher risk areas for review," and we then summarize the various deficiencies identified by the PCAOB by GAAP/GAAS subject area and by audit firm.

II. TRENDS PERTAINING TO PCAOB-IDENTIFIED "HIGHER-RISK AREAS FOR REVIEW"

As previously mentioned, the PCAOB has adopted a risk-based assessment process for its inspections. The specific approach taken by the PCAOB is articulated in Appendix A or B of each

[8] There were in total nine such annual firms reviewed by the PCAOB over the 2007-2009 period, but for one of these – Malone & Bailey PC – the PCAOB only makes data available for a single year. For the sake of comparability, we have thus omitted the PCAOB results pertaining to Malone & Bailey from the discussion presented here of the other annual firms. Specifically, this paper focuses on the remaining eight annually audited firms examined by the PCAOB over the years 2007 through 2009: BDO Seidman LLP; Crowe Horwath LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; McGladrey & Pullen LLP; and PricewaterhouseCoopers LLP.

report, which describes its procedure for selecting audits for review based on certain criteria established by the Board. For each selected audit, the PCAOB then reviews the financial statements and the Securities and Exchange Commission ("SEC") filings of each issuer, highlighting as it does so the areas of audit work that it considers involving "higher risk." This work is subjected to an inspection of the working papers and interviews of the engagement team. For its reviews performed over the three year period from 2007-2009 (i.e., those discussed in the PCAOB reports issued in 2008-2010), six areas of audit work were consistently inspected by the PCAOB. These six areas of focus were commonly addressed across the reviews of all eight annual firms and in each of the review years. They were broadly described by the PCAOB as follows:[9]

- "Fair value/fair value measurements"
- "Financial instruments" and "derivatives"
- "Consideration of fraud"
- "Inventories"
- "Revenues"
- "Assessment of risk by engagement team"

[9] As these areas are included in each inspection report, the six areas following this footnote are taken from PCAOB Release No. 104-2008-125, Inspection of PricewaterhouseCoopers LLP, June 27, 2008, p. B-1, Appendix B. The Inspection Process, Section 1. Review of Selected Audits, paragraph 2.

While these issues were common to all of the eight annual firm reviews for each year, there were a number of other topics frequently mentioned by the PCAOB as well, most notably audit work pertaining to both income taxes and reserves/estimated liabilities. Similarly, related-party transactions and the supervision of work performed by foreign affiliates were repeatedly identified as areas involving relatively higher risk. Occasionally, the PCAOB will also raise certain topics for increased scrutiny within the audit work of one or more specific firms. For instance, in 2009, the inspections of two firms (PricewaterhouseCoopers and McGladrey & Pullen) specifically considered the accounting treatment and auditing of going concern, impairment, pension and postretirement benefits, and allowance for loan losses.

III. SPECIFIC FINDINGS OF DEFICIENCIES BY THE PCAOB

A. Engagements with Alleged Audit Deficiencies Inspected by the PCAOB

Each PCAOB inspection report presents findings from the staff's scrutiny of audit engagements. Each contains a critical section that documents observed occurrences of "audit deficiencies," which the PCAOB defines to include "failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures." According to the PCAOB, these deficiencies may also include "failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP." In some cases, the PCAOB adds a further caution that such "errors… appeared likely to be material to the issuer's financial statements."[10]

Beginning with its reports for inspections performed of the eight annual firms in 2009, the PCAOB disclosed information regarding both the total number of audits undertaken by the firm and the number of those audits exhibiting a PCAOB-identified deficiency.[11] Consequently, one could determine for the first time in 2009 the audit deficiency rate for particular firms based on the PCAOB examination process. Though admittedly a simple estimate, the reliability of which is open to debate, the audit deficiency rate was a revelation to some in the profession.[12] Were one to equate a PCAOB cited deficiency with an audit deficiency (which is not necessarily a given, as the reviewed firms sometimes contest the PCAOB's findings and its interpretation of them), the 2009 examination results suggest that a sizeable portion of all

[10] *See, e.g.*, PCAOB Release No. 104-2010-130, Inspection of Grant Thornton LLP (August 12, 2010), at 3.

[11] In its reports for inspections performed in 2007 and 2008, the PCAOB only noted the number of engagements with a deficiency. It did not provide information regarding the total number of audits reviewed.

[12] The PCAOB specifically cautions against drawing conclusions about the comparative merits of the annually inspected firms based on the number of reported deficiencies in any given year. The Board notes that the total number of audits reviewed is a small portion of the total audits performed by these firms and that the frequency of deficiencies identified does not necessarily represent the actual frequency of deficiencies throughout the firm's practice.

audits selected for review by the PCAOB contain some type of deficiency.

This is illustrated in the table below, which summarizes for each of the eight annually inspected firms in 2009 the number of audit deficiencies identified by the PCAOB and the percentage of all audits implicated by these deficiencies. Again, were one to accept for the sake of argument that each PCAOB cited deficiency in fact represents an actual auditing deficiency, a consequence as follows: When the audit work of the eight annual firms is subjected to the professional scrutiny of the PCAOB as an independent third party, approximately 15 percent of the selected audits on average are seen to contain some type of audit deficiency. For certain individual firms, the rate is much higher. For three of the leading firms, roughly one-fifth to one-fourth of audits reviewed in 2009 was allegedly compromised by a defect identified by the PCAOB.

Annual Firm (in Inspection Year 2009)	Number of Audits with a PCAOB Deficiency	Number of Audits Reviewed by the PCAOB	Percentage with Deficiency
BDO	8	33	24%
Crowe	2	13	15%
Deloitte	15	73	21%
Ernst & Young	5	58	9%

Grant Thornton	5	39	13%
KPMG	8	60	13%
McGladrey & Pullen	4	19	21%
PriceWaterhouseCoopers	9	76	12%
Average	**7**	**46**	**15%**

Again, we caution against making inferences or drawing conclusions regarding the overall quality of any particular audit firm based on this simple statistic, as there is subjectivity in both the audit process and the PCAOB reviews of it. Moreover, the auditor may disagree with the PCAOB inspection results. Still, the results cannot be dismissed altogether. Based on the PCAOB data, certain firms clearly had a lower deficiency rate than others in 2009, with the frequency of deficiency varying among individual firms from a low of 9 percent to a high of 24 percent. Furthermore, given the risk-based approach to the examination process adopted by the PCAOB, it is important to note that the observed deficiencies are in areas of audit work deemed "higher-risk" by the PCAOB. Theoretically, these are areas that should have received *heightened* attention by the auditors during their field work.

B. Engagements Examined by the PCAOB with Errors in GAAP

The PCAOB reports for examinations conducted in 2007, 2008, and 2009 generally contain standard “conclusion” or “opinion” language that reflects the results of the reviews and that facilitates further comparisons, both peer-to-peer as well as year-to-year.[13] The PCAOB opinion can also contain negative assurance language suggestive of a “clean” opinion. For example, the following statement is from the second paragraph of one such report for a reviewed firm and is representative of the type of negative assurance language typically appearing there: “The review did not identify any audit performance issues that, in the inspection team’s view, resulted in the Firm failing to obtain sufficient competent evidential matter to support its opinion on the issuer’s financial statements.”[14]

Depending on the outcome of the review, of course, the PCAOB’s opinion language may instead reflect alleged deficiencies found in the audit work of a firm. Over the three year review period of 2007-2009, the PCAOB issued a total of 24 inspection opinions collectively encompassing the eight annual firms. None of these

[13] This language is contained within the first two paragraphs of Part I.A. (“Review of Audit Engagements”).

[14] While we did not observe this paragraph in any reports of the eight annual firms, it does appear for other firms. For an example, see PCAOB Release No. 104-2010-030, Inspection of Battelle & Battelle LLP (March 31, 2010), at 3.

24 reports was entirely free from a PCAOB identified defect, although the number and nature of the specific deficiencies varied considerably across the disclosures. The table below highlights some of the more common deficiency language offered by the PCAOB and relates for each particular criticism the number and frequency of its appearance across the 24 annual firm reports. (As is suggested by the numbers in the table, an individual firm may have received an opinion that recounted some or all of the deficiencies listed here.)

Deficiencies Cited in the PCAOB Reports	Occurrences in the 24 Annual Firm Reports for 2007-2009	
	Number of Occurrences	Percentage of Occurrences Out of the 24 Reports
"…failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures."	24	100%
"…failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP."	18	75%
"…failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP, including, in some cases, errors that appeared likely to be material to the issuer's financial statements."	8	33%

Based upon our review of these 24 inspection reports in the 2007-2009 periods, there were 18 in which the PCAOB identified at least one occurrence in which an annually inspected firm failed to identify an error in GAAP in the financial statements of one or more issuers. Eight reports further noted that the annual firms failed to identify an error in the application of GAAP that could be material. In other words, fully one-third of the total number of annual firm inspections over the period raised concerns that the PCAOB considered to have been potentially material to the issuer's financial reporting. In such instances, the PCAOB sometimes describes the specific GAAP departure. Over the three year period from 2007-2009, the deviations from GAAP noted by the PCAOB were associated with a wide range of accounting issues. While the most common GAAP departures involved hedge accounting, goodwill impairment and estimated future product returns at time of sale, a variety of other GAAP departures were observed with less frequency. According to the PCAOB, one or another of the eight annual firms in 2007-2009 failed to identify departures from GAAP relating to the following:[15]

- Gain on extinguishment of debt;
- Capitalization of deferred costs;
- Recognition of deferred tax asset for goodwill;
- Reserve for deferred tax assets;

[15] The following listing of alleged GAAP departures is not a comprehensive listing.

- Gain on intangible assets in joint venture;
- Improper accounting for a loan modification;
- Loss recorded in incorrect period.

C. Engagements Inspected by the PCAOB with Failures to Perform Sufficient Audit Procedures to Support the Audit Opinion

During their review of selected engagements over the 2007-2009 periods, the PCAOB inspection teams identified instances in which the annual firms allegedly failed to perform sufficient audit procedures in specific areas of work to support the audit opinions. Sometimes, the PCAOB deemed these deficiencies of "such significance that it appeared to the inspection team that *the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements or internal control over financial reporting ('ICFR')*."[16] The table below summarizes the PCAOB's findings on this subject with respect to the eight annual firms reviewed in 2007, 2008, and 2009. Based on the language explicitly appearing in the PCAOB inspection reports, the table indicates not only the number of engagements in which the Board identified an alleged failure on the part of the reviewed firm to perform sufficient audit procedures, but also the number and percentage of those failures considered to be "significant" by the PCAOB investigators.

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[16] *See*, *e.g.*, PCAOB Release No. 104-2010-050, Inspection of Deloitte & Touche LLP (May 4, 2010), at 4. (emphasis added).

Firm	PCAOB Identified Instances of Auditors' Failure to Perform Sufficient Procedures to Support an Opinion					
	2007		2008		2009	
	Sig. Def.	Tot. Def.	Sig. Def.	Tot. Def.	Sig. Def.	Tot. Def.
BDO	1	5	5	6	4	8
Crowe	2	2	0	1	0	2
Deloitte	3	9	1	7	1	15
E&Y	2	4	1	8	3	5
GT	4	5	5	9	0	5
KPMG	2	10	6	9	4	8
McGladrey	3	5	2	7	1	4
PWC	1	6	4	6	4	9
Total	**18**	**46**	**24**	**53**	**17**	**56**

The table above provides some insight into PCAOB inspection outcomes among the eight annual firms. For example, of the 46 audits identified during the 2007 reviews that contained alleged defects, 18 (or approximately 39 percent) contained deficiencies of such severity that the PCAOB concluded that the firms had not obtained sufficient evidential matter to issue their opinions. In 2008 and 2009, the occurrence rate across the eight annual firms of such “significant” deficiencies was approximately 45 percent and 30 percent, respectively.

We further studied the 2007-2009 examination reports of the eight annual firms in an attempt to understand for which topics, if any, the PCAOB consistently observes a failure on the part of the auditor to obtain “sufficient competent evidential matter” [17] (or “SCEM”) to support its opinion. We observed that, within the 24 annual firm inspection reports for the period, the PCAOB identified 155 separate occurrences in which the auditor allegedly failed to obtain SCEM. Many of these 155 instances involve similar issues and can be grouped in broad categories. In particular, six areas of audit work were repeatedly and notably cited by the PCAOB as containing SCEM deficiencies:

- Fair value of financial instruments/derivatives (both assets and liabilities);
- Revenue;
- Allowance for loan loss/adequacy of loan loss reserves;
- Impairment in goodwill;
- Fair value of assets held in pension plans; and
- Valuation of deferred income tax assets/liabilities

[17] *See*, *e.g.*, PCAOB Release No. 104-2009-064, Inspection of McGladrey & Pullen, LLP (May 6, 2009), at 4.

The six areas of defect identified (with their general themes of fair value, impairment, and valuation) generally align with the "higher risk" areas on which the PCAOB has chosen to focus its inspections. Such emphasis is not surprising in light of the prevalence of company disclosures, news and trade press commentary, and debate within the industry regarding these topics over the course of the recent crisis in U.S. and worldwide financial markets. Indeed, a September 2010 special report was issued by the PCAOB specifically to address the observations of its inspectors related to audit risk areas affected by the economic crisis, and that publication prominently features discussions regarding the same areas of risk highlighted here.[18]

In the inspection report sections made public on the eight annual firms, the PCAOB further describes specific flaws observed in audit testing surrounding the valuation of financial instruments. The reports note that certain of the reviewed firms planned to test an issuer's estimates of fair value by, among other methods, evaluating the reasonableness of the issuer's significant assumptions and then testing the valuation model and underlying data. However, the PCAOB observed that, in evaluating the reasonableness of significant assumptions, the auditor sometimes failed to perform audit procedures and due diligence beyond making inquiries of the issuer's management. The PCAOB's

[18] *See* PCAOB Release No. 2010-006, "Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis," (September 29, 2010), at 10.

commentary surrounding several particular audits is instructive on this point regarding the fair value of derivatives and other financial instruments and provides a number of examples illustrating the larger concern. In one situation recounted by the PCAOB, for instance, the auditor "failed to test indicators of fair value, such as broker quotes, that the issuer used to determine the fair values of certain financial liabilities," and it then "failed to adequately test the models, inputs, and indicators of fair value that the issuer used." Specifically, "the firm failed to identify certain existing flaws in the models . . . and failed to evaluate whether the issuer's data were reasonable and not inconsistent with market information."[19] The PCAOB observed similar difficulties in another instance in which an auditor was working with an issuer that "estimated the fair values of certain investment securities . . . not actively traded using a weighted average of two fair value estimates." One of the estimates comprising the weighted average was reportedly "determined using a discounted cash flow model" while "the other was obtained from an external pricing service," and the PCAOB concluded that the auditor not only failed to test each separate estimate adequately, it failed also to support the manner in which the two were combined.[20] Such deficiencies do

[19] PCAOB Release No. 104-2010-091, Inspection of Ernst & Young LLP (July 2, 2010), at 4.

[20] In the first case, when the estimate was based on the discounted cash flow model, the PCAOB investigators found that the audit firm had "failed to test certain key assumptions underlying the cash flow projections." In the second case, when the estimate was based on information collected from an external pricing service, the PCAOB investigators concluded that the firm also "failed to evaluate the

not appear to have been uncommon, as is suggested by the PCAOB's discussion of yet another of the eight annual firms. When reviewing an instance in which a particular issuer had "used a service organization to account for its investments and mortgage-backed securities and engaged a pricing specialist to validate values received from the service organization," the auditor "failed to perform sufficient procedures concerning the valuation," at least in the estimation of the PCAOB. Specifically, according to the PCAOB's critique of the auditor, the firm "failed to obtain an understanding of the methods and to evaluate the reasonableness of the assumptions used by either the service organization or the pricing specialist to value the issuer's investments and mortgage-backed securities."[21]

Another major subject that the PCAOB reviewers identified is the auditing of revenue. Audit deficiencies regarding the testing of revenue recognition include, for example, one occurrence highlighted by the PCAOB in which "certain of the issuer's contracts involve multiple phases" but in which the auditor failed to test the assumptions and practices specifically employed with regard to the different phases. As the PCAOB explained, the

reasonableness of the assumptions the external pricing service had used in its models." Finally, the PCAOB discovered that the firm "failed to resolve its specialist's questions regarding the appropriateness of the weighting of the two estimates." PCAOB Release No. 104-2010-131, Inspection of PricewaterhouseCoopers LLP (August 12, 2010), at 4-5.

[21] PCAOB Release No. 104-2010-081, Inspection of McGladrey & Pullen LLP (June 24, 2010), at 6.

practice of allocating revenue to various phases results in certain cases “in different profit margins for each phase,” yet the audit firm “failed to test the reasonableness of the issuer’s assertion” that the particular revenue figure “allocated to each phase was representative of the fair value of the delivered elements of that phase.”[22] In the review of another of the eight annual firms, the PCAOB found that an audit conducted by the firm “failed to perform sufficient procedures to test the issuer’s recognition of revenue from contracts accounted for under the percentage-of-completion method.” In that particular audit, the PCAOB considered the audit firm’s efforts to be insufficient, since the firm “failed to test costs incurred to date, including indirect cost allocations, beyond comparing certain costs to reports that were not tested” and since it “failed to sufficiently test the estimated costs to complete.“ Indeed, as far as the PCAOB was able to determine, the firm’s procedures in this particular audit were simply “limited to inquiries of management.”[23] Furthermore, such difficulties with the testing of revenue recognition appear not to have been isolated instances within just one or two audit firms. As the PCAOB related in its September 2010 report on audit risk areas affected by the recent economic crisis, there were a number of such issues raised throughout its reviews. These included the failure of auditors to do such things as: align audit tests to specific

[22] PCAOB Release No. 104-2008-125, Inspection of PricewaterhouseCoopers LLP (June 27, 2008), at 5.

[23] PCAOB Release No. 104-2010-130, Inspection of Grant Thornton LLP (August 12, 2010), at 6.

risks appropriately (including fraud risks); perform sufficient testing of estimated fair values of each element in arrangements characterized by multiple deliverables; respond appropriately to testing exceptions; and test appropriately the underlying reports or schedules by management used in recording revenue.[24]

Deficiencies in auditing allowances for loan losses and assessing the adequacy of loan loss reserves are instructive. In one instance, the PCAOB inspectors observed that auditors in the firm being reviewed "failed to evaluate whether the issuer's process for developing the [loan loss allowance] estimate captured fully the effects of then-current trends and factors including recent changes in the composition and quality of the loan portfolio, concentrations, increases in loan delinquencies and losses, the result of the issuer's survey of its borrowers, and deteriorating economic conditions."[25] In a different review, involving another of the eight annual firms, the PCAOB inspectors noted that the auditor "determined its sample size based on the Firm's guidance for achieving low control risk for a control that operates multiple times daily." This was so despite the apparent fact that "there was no evidence in the audit documentation, and no persuasive other evidence" that the audit firm ever evaluated certain factors "for

[24] *See* PCAOB Release No. 2010-006, "Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis," (September 29, 2010), at 19.

[25] PCAOB Release No. 104-2008-146, Inspection of KPMG LLP (August 12, 2008), at 5.

their effect on sample size." The PCAOB further criticized this auditor for not considering "the work performed by internal loan review, the increasing credit risk in the loan portfolio, and the Firm's lack of prior knowledge of the loan portfolio."[26] In reviewing a variety of events or transactions that occurred subsequent to the date of the balance sheet at issue, PCAOB inspectors also observed that auditors sometimes failed to determine whether or not the information they obtained was indicative of conditions that existed during the year under audit (and therefore whether or not it should have been reflected in year-end estimates).[27]

Although we do not provide similar excerpts here from the specific criticisms offered by the PCAOB with regard to auditing impairment in goodwill, the fair value of assets held in pension plans, and the valuation of deferred income tax assets and liabilities, we note that such examples occur with some frequency throughout the 24 annual firm reviews performed over the years 2007-2009.

[26] PCAOB Release No. 104-2010-074, Inspection of Crowe Horwath LLP (June 10, 2010), at 4.

[27] *See* PCAOB Release No. 2010-006, "Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis," (September 29, 2010), at 16.

D. Sufficiency of Audit Procedures Related to Controls Testing

In describing the failure of auditors to obtain "sufficient competent evidential matter," the PCAOB has noted that such faults at times are related to insufficient testing of internal controls. Indeed, the PCAOB inspection reports have concluded in several circumstances that important controls were not sufficiently understood by the auditors or else were understood but not appropriately tested. At least five such topics arose more than once during the 2007-2009 PCAOB reviews of annual firms, and these are identified in the table below.

PCAOB Identified Area of Deficiency in Testing of Internal Controls	No. of Instances
Existence, valuation, completeness, or accuracy of revenue	11
Fair valuation of financial instruments	7
Allowance for loan losses	3
Valuation of assets held in pension plan	2
Foreign entity over revenue transactions	2

As with the discussion in the previous section, the auditing of revenue is again a leading theme with regard to deficiencies in auditors' testing of the internal controls. In this area, a major and recurring audit concern involves instances in which auditors choose to rely on system-generated data or reports but either fail to test the completeness and accuracy of the data or otherwise fail to test the operating effectiveness of the controls over recording revenue ultimately supported by such system-generated information. Other, similar concerns relate to failure of the auditors to appropriately understand revenue models and to test the effectiveness of controls related to financial statement assertions made by the issuers.

Weaknesses in the auditors' testing of internal controls relating to the fair value of financial instruments have also been cited relatively frequently by the PCAOB (as indicated by the seven instances we count in the table above). Upon closer review of the discussion of these deficiencies in the PCAOB reports, we note that these particular concerns appear to be concentrated among audits of issuers with financial instruments that are "difficult-to-value,"[28] which is perhaps not surprising. In one instance identified by the PCAOB, the auditor employed a "maximum controls-reliance" approach when considering the fair valuation of a particular financial instrument, but nevertheless did not test any

[28] *See* PCAOB Release No. 2010-006, "Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis," (September 29, 2010), at 10.

controls "specifically related" to the instrument.[29] In another example, the PCAOB concluded that the auditor relied to an inappropriate degree on an issuer's controls, primarily because the auditor had "failed to test certain important aspects of the price verification controls and failed to complete its testing of the model validation controls."[30]

Although less numerous than the identified deficiencies in auditing revenue and the valuation of financial instruments, a few instances of deficiencies in controls testing relating to the allowance for loan losses were also cited by the PCAOB in its 2007-2009 reviews of the annual firms. In two of the three cases we identified in which the PCAOB offered a specific criticism of internal controls testing related to auditing the allowance for loan losses, information technology systems played a part. In the first case, the PCAOB observed that the auditor "relied on these systems" but that it "failed to test the information-technology general controls . . . over certain of these systems" and that it "failed to test certain of the application controls over these systems." The PCAOB further concluded that the firm's "testing of the controls over the assignment and monitoring of loan grades was insufficient."[31] In

[29] PCAOB Release No. 104-2010-050, Inspection of Deloitte & Touche LLP (May 2, 2010), at 10.

[30] PCAOB Release No. 104-2010-132, Inspection of KPMG LLP (October 5, 2010), at 7.

[31] PCAOB Release No. 104-2010-091, Inspection of Ernst & Young LLP (July 2, 2010), at 5.

the second case, the PCAOB faulted the auditor for failing "to adequately test the accuracy and completeness of the data that the issuer had used in its estimate of the allowance," noting that the firm "did not test certain of the necessary controls over the transfer of these data between the issuer's information technology systems, nor did it test the loan delinquency data. [32]

IV. CONCLUSION

This article has provided a brief overview of the PCAOB inspection reports issued for the eight annually reviewed registered accounting firms during the years 2007-2009. We have reviewed each of the 24 reports, both to relate specific audit deficiencies identified by the PCAOB as well as to emphasize broader trends and issues during this period. In particular, we have striven through our aggregation and summary of the PCAOB report data to develop a better understanding in two broad areas of inquiry: (1) the audit areas that the PCAOB inspectors have focused on in their own investigations as likely involving heightened levels of audit risk; and (2) the alleged deficiencies among leading audit firms that have been identified by the PCAOB in either the application of GAAP or GAAS procedures, including controls testing. To our viewing, clear trends emerge from the information provided in the inspection reports, some of which have been further elaborated upon by the PCAOB in a number of special

[32] PCAOB Release No. 104-2009-096, Inspection of KPMG LLP (August 12, 2008), at 5.

reports. These reports (all of which are readily available through the PCAOB's website), include the following:

- "Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis;"
- "Report on the PCAOB's 2004, 2005, 2006 and 2007 Inspections of Domestic Annually Inspected Firms;"
- "Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms;" and
- "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud."[33]

While we believe that the PCAOB report information discussed throughout this article is informative and instructive to accounting and auditing professionals, we conclude with a final caution against placing too strong an emphasis on these discussions of alleged deficiencies. It is important to remember that all of the deficiencies, defects, and other faults cited by the PCAOB throughout the inspection reports discussed here are but a subset of the thousands of accounting transactions, pieces of audit evidence, consultations, and judgments rendered by the eight annual firms in any given year. We note that, oftentimes, the deficiencies cited by the PCAOB ultimately resulted in no changes to the auditor's

[33] All reports listed above can be found on the PCAOB's website. See Public Company Accounting Oversight Board, "Board Public Reports," http://pcaobus.org/Inspections/Pages/PublicReports.aspx

opinions and no restatements of the financial statements constituting the subject of those opinions. It is not uncommon for the audit firm reviewed by the PCAOB to disagree with the findings and opinions of the PCAOB. Nevertheless, the body of information reflected in the PCAOB reports is informative and, we believe, highly instructive to even the most seasoned practitioner. The PCAOB reports collectively provide an independent reminder of the audit risks, both perennial and newly emerging, that require from accounting professionals continuing technical focus, audit vigilance, and professional skepticism.