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UPDATE: A BRIEF OVERVIEW OF TRENDS IN PCAOB INSPECTION REPORTS

WHAT EVERY PRACTITIONER SHOULD KNOW

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I. BACKGROUND

In a May 2011 article, we reviewed the trends in the Public Company Accounting Oversight Board ("PCAOB" or "Board") inspection findings of registered accounting firms as described in Inspection Reports which had been issued through 2010. This article updates that review by providing a summary of our analysis of Inspection Reports issued by the PCAOB during 2011 and 2012.

II. INTRODUCTION

The Sarbanes-Oxley Act of 2002 (the "Act") requires accounting firms that audit public companies to register with and be subject to periodic inspection by the PCAOB. The Act requires annual inspections for registered accounting firms that provide audit reports for more than 100 issuers ("Annual Firms"), while those firms providing audit reports on at least one, but no more than 100 issuers, are subject to PCAOB review once every three years. The Dodd-Frank Act, which became law in July 2010, gave the PCAOB new responsibilities for the oversight of brokers and dealers registered with the Securities and Exchange Commission ("SEC"), and, in 2011, the PCAOB began to inspect firms that audit them.

Regardless of the frequency, however, the PCAOB issues a report on each inspection it performs ("Inspection Reports") and each report has two parts. Part I describes the inspection procedures performed and summarizes the results of the inspected firm's specific audit engagements. Audit deficiencies, if any, are documented in this section. Part II contains additional detail, which may include (among other content) a discussion of potential defects identified by the PCAOB in the auditing firm's system of quality control. Quality control criticisms, if any, remain nonpublic as long as the firm addresses the criticisms to the PCAOB's satisfaction within twelve months. Otherwise, the portion of the report discussing particular quality control criticisms is made publicly available by the PCAOB.[2] From

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

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.[3]

Given the large number of initiatives undertaken by the PCAOB in recent years, and the number of Inspection Reports issued by the PCAOB each year, even the most diligent practitioner may find it difficult to stay informed of key trends and findings. For that reason we have endeavored in this article to provide an overview of both. We first describe the Board's more recent initiatives, areas of focus, and key findings with respect to the inspection process. We then describe the insights we developed as a result of our recent analysis of the Inspection Reports issued by the PCAOB in calendar years 2011 and 2012 on eight of the Annual Firms. (These reports typically pertain to inspections of audit engagements with opinions issued on financial statements for fiscal years ending in 2010 and 2011.)[4] Lastly, we focus our analysis on the trends that have emerged in the 2011 and 2012 Inspection Reports specific to the "Big Four" firms − Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP.

This analysis is further limited to deficiencies identified by the PCAOB in the Inspection Reports that pertain to alleged failures by the Big Four firms to obtain sufficient appropriate audit evidence to support their *opinions on the financial statements*. The PCAOB also identified failures by the Big Four firms to obtain sufficient appropriate audit evidence to support their opinions on the effectiveness of Internal Controls over Financial Reports (ICFR). This article does not address alleged deficiencies pertaining to ICFR since such findings, as discussed further below, were the subject of a December 2012 report issued by the PCAOB.[5]

We should note that despite the time lag that exists between the date of each auditor's report and the PCAOB inspection of that report, we believe that the PCAOB Inspection Reports are nonetheless highly instructive to the practitioner. The inspections by the PCAOB identify deficiencies in the application of generally accepted accounting principles ("GAAP") and generally accepted auditing standards ("GAAS").[6] Since the Board 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 Inspection Reports informative. The reports provide an independent reminder of the accounting and auditing issues, both perennial and emerging, that may warrant further consideration in future audits.

[3] See PCAOB Release No. 2012-006, Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting, (December 10, 2012).

[4] 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 is based.

[5] See PCAOB Release No. 2012-006, Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting, (December 10, 2012).

[6] 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 the deficiency.

III. PCAOB TRENDS AND INTIATIVES-2011 TO PRESENT

Since the date of our previous article, there have been several developments, both external and internal, to the PCAOB. Under the Sarbanes-Oxley Act, the PCAOB has four primary responsibilities: register public accounting firms that audit public companies or broker-dealers; establish auditing, independence, ethics and quality control standards; conduct and report on regular inspections of registered public accounting firms that audit public companies or broker-dealers; and conduct investigations and disciplinary proceedings in cases where registered public accounting firms or persons associated with those firms may have violated PCAOB standards, or rules of the PCAOB and SEC, or the Act.[7] Below is a summary of the recent trends and initiatives in the PCAOB's broad areas of responsibility.

BROKERS AND DEALERS

As noted above, the Dodd-Frank Act gave the PCAOB the responsibility to oversee the audits of brokers and dealers that are registered with the SEC. Per the PCAOB, there were approximately 4,400 brokers and dealers that filed audited financial statements for fiscal years ended in 2011 with the SEC and approximately 800 firms that audited them.[8] This change, therefore, substantially expands the oversight role and responsibilities of the PCAOB.

The PCAOB issued its first summary report on the interim inspections of audits of brokers and dealers registered with the SEC in August 2012. The report describes the findings from the inspections of ten audit firms and portions of 23 audits conducted by those firms. Audit *deficiencies* were identified in three broad categories:

- Audit procedures over customer protection and net capital requirements;
- Financial statement audit deficiencies, including consideration of risk of material misstatement due to fraud, related party transactions, revenue recognition, basis for reliance on records and reports, fair value measurements, evaluation of control deficiencies, and financial statement disclosures; and
- Failures to satisfy independence requirements.[9]

This PCAOB interim inspection program for brokers and dealers will continue until the rules for a permanent inspection program become effective. During 2012, the PCAOB planned to inspect 40 audit firms and portions of approximately 60 audits.[10]

[7] PCAOB 2011 Annual Report, at 1.

[8] PCAOB Release No. 2012-005, Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 20, 2012) at i.

[9] PCAOB Release No. 2012-005, Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 20, 2012) at ii-iv.

[10] PCAOB Release No. 2012-005, Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 20, 2012) at iv.

AUDITS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

In December 2012, the PCAOB issued a report detailing observations regarding deficiencies in audits of ICFR. These observations were gleaned from the 2010 inspections of domestic Annual Firms, which generally covered reviews of audits for fiscal years ending in 2009. The report states that the "Board is concerned about the number and significance of deficiencies identified in firms' audits of internal control during the 2010 inspections," and, while not covered in the report, "the Board is also concerned that the rate of these deficiencies increased during the Board's 2011 inspections."[11]

Overall, the PCAOB found that in 46 of the 309 integrated audits (15 percent) inspected in 2010, at the time the audit firm issued its audit report on the effectiveness of ICFR, the firm had "failed to obtain sufficient audit evidence to support its audit opinion." Further, in 39 of the 46 audits (85 percent), "the firm also failed to obtain sufficient audit evidence to support the financial statement audit opinion."[12]

The PCAOB notes that these deficiencies were typically related to audit execution issues of individual engagement teams where the teams failed to follow the requirements of the firms' audit methodologies. The most pervasive deficiencies were failures to:

- Identify and test sufficiently controls intended to address the risk of material misstatement;
- Test sufficiently the design and operating effectiveness of management review controls, such as monthly comparisons of budget and actual results to forecasts, and review of quarterly balance sheets;
- Obtain sufficient evidence to update the results of interim date testing of controls to year end;
- Test sufficiently "system-generated data and reports" that support important controls;
- Sufficiently perform procedures regarding the use of work of others; and
- Sufficiently evaluate identified control deficiencies and consider their effect on the audit of both the financial statements and internal control.

Based upon this analysis, the PCAOB believes that firms need to perform more thorough analyses of both the risk of material misstatement and the approach to auditing internal control, and should perform their own root cause analyses for these types of deficiencies.[13]

AUDIT COMMITTEES

The PCAOB issued two new releases dealing with audit committees during 2012, one aimed at audit committees − "Information for Audit Committees about the PCAOB Inspection Process," and the other providing guidance to the auditors − "Auditing Standard No. 16—Communications with Audit

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[11] PCAOB Release No. 2012-006, Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting (December 10, 2012) at i.

[12] PCAOB Release No. 2012-006, Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting (December 10, 2012) at ii.

[13] PCAOB Release No. 2012-006, Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting (December 10, 2012) at ii.

Committees."

The release directed to audit committees recognizes their important role in corporate governance through the oversight of financial reporting and the independent audit. The release describes the contents of PCAOB Inspection Reports, including the public portion (Part I) and the nonpublic portion (Part II), and also describes the PCAOB inspection process. In addition, the release provides possible questions that audit committees may want to ask their audit firms about the PCAOB inspections. The suggested questions include:

- Was the company's audit selected for PCAOB inspection?
- Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues present in the company's audit?
- What were the audit firm's responses to the PCAOB findings?
- What topics are included in Part II findings?[14]

The new Auditing Standard No. 16 updates what an auditor is required to tell audit committees about its audit. Communication requirements include:

- Key issues about the overall audit strategy, timing, and significant risks;
- Audit results related to critical accounting policies and estimates;
- An evaluation of the quality of the company's financial reporting;
- Uncorrected and corrected misstatements;
- Disagreements with management; and
- Difficult issues encountered during the audit.[15]

Additionally, the new standard requires the auditor to inquire of the audit committee about whether it is aware of matters relevant to the audit, including violations of laws and regulations.[16]

INTERNATIONAL AUDIT REGULATOR COOPERATION

To conduct inspections around the world, the PCAOB attempts to work closely with local regulators. To facilitate information sharing and promote collaboration and consistency in audit regulation, several national regulators, including the PCAOB, formed the International Forum of Independent Audit Regulators ("IFIAR") in 2006. IFIAR membership has grown to over 40 regulators.

The PCAOB has adopted a cooperative framework that allows PCAOB inspectors to rely, to a degree deemed appropriate by the Board, on inspection and enforcement work performed by local country audit regulators. Many countries have adopted audit regulatory regimes modeled on the Sarbanes-Oxley Act

[14] PCAOB Release No. 2012-003, Information for Audit Committees About the PCAOB Inspection Process (August 1, 2012) at ii-iii.

[15] PCAOB Auditing Standard No. 16, Communications with Audit Committees, paragraphs 9 – 23.

[16] PCAOB Auditing Standard No. 16, Communications with Audit Committees, paragraph 8.

and the PCAOB. IFIAR members meet semi-annually and have the common goal of improving audit quality globally. The activities of the forum include:

- Sharing knowledge of the audit environment and practical experiences;
- Promoting collaboration and consistency in regulatory activity; and
- Providing a platform for dialogue with other organizations that have an interest in audit quality.[17]

FIRMS THAT FAIL TO ADDRESS QUALITY CONTROL CRITICISMS SATISFACTORILY

As described above, Part II of the PCAOB's Inspection Report may include a discussion of potential defects identified by the PCAOB in the audit firm's system of quality control. This section remains non-public if the firm addresses alleged defects to the PCAOB's satisfaction within twelve months after the report date. If the firm fails to satisfactorily address any of the quality control criticisms within twelve months, the portion of the report discussing the particular criticisms is made publicly available.

Since the inception of the PCAOB, several Part II portions have been made public for smaller accounting firms and for certain international affiliates of some of the Annual Firms.[18] However, in October 2011, for the first time, the PCAOB made public a portion of Part II for one of the Big Four firms−the 2007 Inspection Report for Deloitte & Touche LLP, which covered audits for fiscal years ended in 2006.

This report discusses various specific audit procedures related to certain issuers. In a summary section of Part II, the report states, "The inspection results provide cause for concern that the Firm's system of quality control may not do enough to assure that accounting and auditing issues are evaluated with the objectivity that is contemplated in the auditing standards. In too many instances, the inspection team observed that the engagement team's support for significant areas of the audit consisted of management's views or the results of inquiries of management."[19] The report also raises issues related to independence with respect to foreign affiliated firms; internal engagement team consultations in relation to complex matters being raised to an appropriate level; and communicating results of its internal inspections of foreign member firms to U. S. engagement partners for use in assessing the qualifications of the foreign member firms.[20]

While Deloitte & Touche LLP was the first Big Four firm to have a portion of its Part II Inspection Report made public, it will likely not be the last as the PCAOB continues its focus on improving audit quality.

MAINTAINING AND APPLYING PROFESSIONAL SKEPTICISM IN AUDITS

The PCAOB is placing increased focus on auditors' use of professional skepticism in audits. The PCAOB has noted that recurring observations from its inspections continue to raise concerns about

[17] IFIAR website, www.ifiar.org.

[18] PCAOB website, "Firms that Failed to Address Quality Control Criticisms Satisfactorily," pcaobus.org/Inspections/Reports/Pages/FirmsFailedToAddressQCSatisfactorily.aspx.

[19] See PCAOB Release No. 104-2008-070A, Inspection of Deloitte & Touche LLP (May 19, 2008) at 16.

[20] See PCAOB Release No. 104-2008-070A, Inspection of Deloitte & Touche LLP (May 19, 2008) at 17-19.

whether auditors consistently and diligently apply professional skepticism. A speech by one board member states that this "issue has been of such prevalence that [the PCAOB has] identified the apparent failure to appropriately apply professional skepticism as a systemic quality control issue in some firms."[21]

In December 2012, the PCAOB issued "Staff Audit Practice Alert No. 10−Maintaining and Applying Professional Skepticism in Audits," to emphasize and remind auditors to appropriately apply professional skepticism throughout the audit process.[22] This Audit Practice Alert provides specific examples of audit deficiencies in which a lack of professional skepticism was deemed to be at least a contributing factor. These examples include situations where audit teams did not:

- Obtain an understanding of the specific methods or assumptions underlying estimates;
- Evaluate the significance of evidence that supported values other than those closest to the issuers recorded prices;
- Test beyond inquiry of management the significant assumptions underlying valuations;
- Question whether certain assets were potentially impaired, despite evidence that the carrying amount may not be recoverable; and
- Question an issuers use of a GAAP exception even though doing so conflicted with the plain language of the exception and with the firm's internal accounting literature.[23]

The Audit Practice Alert also identifies possible impediments to the application of professional skepticism and provides guidance on how firms can promote the appropriate application of professional skepticism on audits through an appropriate system of quality control. Such a quality control system might include:

- Tone-at-the-top messaging;
- Performance appraisal, promotion, and compensation processes;
- Professional competence and assigning personnel to engagement teams;
- Documentation; and
- Monitoring.[24]

The Audit Practice Alert goes on to note that while the engagement partner and senior members of the engagement team can contribute to an environment that supports professional skepticism, the ultimate responsibility rests with each individual auditor to appropriately apply professional skepticism throughout

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[21] PCAOB speech, "Protecting Investors by Seizing the Opportunity to Strengthen Audit Quality," Jeannette M. Franzel, Board Member (January 18, 2013).

[22] PCAOB Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits (December 4, 2012).

[23] PCAOB Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits (December 4, 2012) at 4-6.

[24] PCAOB Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits (December 4, 2012) at 8-10.

the audit, including work in the following areas:

- Identifying and assessing risks of material misstatement;
- Performing tests of controls and substantive procedures; and
- Evaluating audit results to form the opinion to be expressed in the auditor's report. [25]

The Audit Practice Alert concludes that due to the fundamental importance of the appropriate application of professional skepticism in performing an audit, the PCAOB will continue to explore whether additional actions might be meaningful.[26] Professional skepticism will be a key focus of the PCAOB in upcoming inspections.

IV. AUDIT DEFICIENCIES IDENTIFIED BY THE PCAOB

ENGAGEMENTS INSPECTED BY THE PCAOB WITH ALLEGED AUDIT DEFICIENCIES

Each PCAOB Inspection Report presents findings from the staff's scrutiny of audit engagements. 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 report, which describes its procedure for selecting audits for review based on certain criteria established by the Board. For each selected audit, the PCAOB reviews the financial statements and the SEC filings of each issuer, highlighting as it does so the areas of audit work that it considers "higher risk." This work is subjected to an inspection of the working papers and interviews of the engagement team. If the Board identifies deficiencies that "exceed a certain significance threshold in the audit work it reviews, those deficiencies are summarized in the public portion of the Board's inspection report."[27] In its reports issued on the Big Four firms (or "Firms") in 2011 and 2012, the description of these deficiencies included the following illustrative language:

- "[F]ailures by the Firm to identify, or to address appropriately, financial statement misstatements"[28]
- "[F]ailures to comply with disclosure requirements"[29]
- "[F]ailures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures"[30]

[25] PCAOB Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits (December 4, 2012) at 11.

[26] PCAOB Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits (December 4, 2012) at 15.

[27] See PCAOB Release No. 104-2012-199, Inspection of KPMG LLP (August 15, 2012) at 2.

[28] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 3.

[29] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 3.

[30] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 4.

- "The inspection team considered certain of the deficiencies that it observed to be audit failures."[31]
- "Certain of the identified deficiencies were of such significance that it appeared that the Firm, at the time it issued its audit report, had failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting ("ICFR")."[32]
- "[D]epartures from GAAP that it [the Firm] should have identified and addressed before issuing its audit report"[33]
- "[D]eficiencies…relate[d] to auditing aspects of the issuers' financial statements that the issuers either restated or announced an intention to restate after the primary inspection procedures"[34]
- "[O]ne of the identified deficiencies…was of such significance that it appeared that the Firm had not obtained sufficient appropriate audit evidence to fulfill the objectives of its role in the audit."[35]

It should be noted that conclusions by the PCAOB that a Big Four firm had failed to perform an appropriate audit procedure were sometimes based on the absence of documentation in the audit work papers. In such cases, and in the absence of other persuasive audit evidence, the PCAOB did not give weight to claims by the Firms that the appropriate audit procedure had been performed.

Beginning with its reports for inspections performed on eight of the Annual Firms in 2009, the PCAOB disclosed information regarding both the total number of issuer audits reviewed by the PCAOB and the number of those audits exhibiting a PCAOB-identified deficiency.[36] Consequently, beginning in 2009, one can determine the audit deficiency rate for particular firms based on the PCAOB examination process. Though admittedly a simple statistic, the audit deficiency rate was a revelation to some in the profession.[37] Were one to equate a PCAOB cited deficiency with an audit deficiency, the 2009-2011 Inspection Reports results indicate that a sizeable percentage of audits selected for review by the PCAOB contain some type of deficiency.

This is illustrated in the tables below which summarize the available inspection results for eight of the Annual Firms for inspections performed in 2009, 2010, and 2011. The tables show the number of issuer

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[31] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 4.

[32] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 4.

[33] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 4.

[34] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 4.

[35] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 4.

[36] 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.

[37] 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 inspected, the number of deficiencies identified by the PCAOB, and the relative percentage of all audits implicated by these deficiencies. These data show that when the audit work of eight Annual Firms is subjected to the professional scrutiny of the PCAOB inspection process, on average, approximately 15 percent of the 371 inspected audits in 2009 contain some type of audit deficiency. In 2010 and 2011, the PCAOB inspected the audits of fewer issuers, 346 and 277, respectively. And yet, the deficiency rate in 2010 and 2011 is double that of 2009, averaging 34 percent and 38 percent, respectively. For certain individual firms, the rate is much higher. For example, 43 percent of the PricewaterhouseCoopers audits reviewed in 2011 were allegedly compromised by a defect identified by the PCAOB; 42 percent of the Deloitte & Touche audits reviewed in 2011 had an alleged deficiency.

Firm Name	2011		
	Issuers Reviewed	**Audits with Deficiency**	**% with Deficiency**
BDO USA	23	9	39%
Crowe Horwath	n/a	n/a	n/a
Deloitte & Touche	52	22	42%
Ernst & Young	55	20	36%
Grant Thornton	35	15	43%
KPMG	52	12	23%
McGladrey & Pullen	n/a	n/a	n/a
PricewaterhouseCoopers	60	26	43%
Total / Average	**277**	**104**	**38%**
Big Four Total / Average	**219**	**80**	**37%**

Firm Name	2010		
	Issuers Reviewed	**Audits with Deficiency**	**% with Deficiency**
BDO USA	31	8	26%
Crowe Horwath	13	8	62%
Deloitte & Touche	57	26	46%
Ernst & Young	62	13	21%
Grant Thornton	41	15	37%
KPMG	52	12	23%
McGladrey & Pullen	19	9	47%
PricewaterhouseCoopers	71	28	39%
Total / Average	**346**	**119**	**34%**
Big Four Total / Average	**242**	**79**	**33%**

Firm Name	2009		
	Issuers Reviewed	**Audits with Deficiency**	**% with Deficiency**
BDO USA	33	8	24%
Crowe Horwath	13	2	15%
Deloitte & Touche	73	15	21%
Ernst & Young	58	5	9%
Grant Thornton	39	5	13%
KPMG	60	8	13%
McGladrey & Pullen	19	4	21%
PricewaterhouseCoopers	76	9	12%
Total / Average	**371**	**56**	**15%**
Big Four Total / Average	**267**	**37**	**14%**

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 and judgment in both the audit process and the PCAOB reviews of it. Indeed, the PCAOB specifically cautions readers of its reports that their "focus on weaknesses and deficiencies necessarily carries through to reports on inspections and accordingly, Board Inspection Reports are not intended to serve as balanced report cards or overall rating tools."[38] 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 2011, the frequency of deficiency varied among individual firms from a low of 23 percent (KPMG) to a high of 43 percent (Grant Thornton and PricewaterhouseCoopers); for 2010 inspections, deficiency rates ran from a low of 21 percent (Ernst & Young) to a high of 62 percent (Crowe Horwath).

Given the risk-based approach to the examination process adopted by the PCAOB, it is important to note that the observed deficiencies are generally in areas of audit work deemed "higher-risk" by the PCAOB, work that is arguably more susceptible to identification of audit failures. Still, it is the higher-risk audit areas that should have received *heightened* attention by the Big Four firms during their field work—heightened planning, testing, supervision and review—and conversely, one might expect that such work would be less susceptible to findings of audit deficiencies by the PCAOB.

BIG FOUR AUDITS INSPECTED BY THE PCAOB WITH FAILURES TO PERFORM SUFFICIENT APPROPRIATE AUDIT PROCEDURES TO SUPPORT THE OPINION ON THE FINANCIAL STATEMENTS

We reviewed the detailed comments provided by the PCAOB to the Big Four firms on their 2010 and 2011 Inspection Reports. Collectively, these reports identified 159 issuer audits that contained alleged audit deficiencies. We analyzed the deficiency comments in an attempt to identify and understand concentrations in the types of audit failures in which the PCAOB asserts the auditor did not obtain appropriate audit evidence to support its opinion on the financial statements. This analysis necessarily involves judgment; reasonable minds may disagree as to our characterization of a particular audit failure and its impact on related trends. Our categories of deficiencies are not necessarily mutually exclusive; a particular audit deficiency may align with more than one category of audit failure. Moreover, our understanding of any alleged audit failure necessarily depends upon and is limited to the information provided by the PCAOB in its Inspection Reports.

Still, as we analyzed trends across the Big Four firms and inspection periods, the patterns were compelling. These concentrations, not surprisingly, involved the following common and timeless types of audit execution failures:

- Overreliance on management assertions or representations;
- Failure to design or perform appropriate substantive procedures on accounts, transactions or financial statement disclosures that the PCAOB deems material or significant;
- Inappropriate reliance on issuer controls that have not been sufficiently tested;

[38] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 2.

- Inappropriate reliance on data, reports, methods and assumptions, including information from third parties or service organizations, that the auditor insufficiently tests or understands;
- Failure to update audit procedures or testing between interim and year end field work;
- Failure to update audit procedures or testing when additional material information or contradictory evidence comes to the attention of the auditor; and
- Analytical procedures that are not sufficiently precise to provide the necessary level of assurance or detect a material misstatement in the financial statements.

<u>Overreliance on management assertions or representations</u>

Our review of audit deficiencies described in the PCAOB Inspection Reports included numerous occurrences wherein the Big Four firms were criticized for audit procedures that reflected an overreliance on representations by management. In fact, about 30 percent of the deficiencies in 2010 Inspection Reports of the Big Four firms, and 40 percent in the 2011 Inspection Reports, included instances when the PCAOB was critical of an audit because the audit procedures relied too heavily, or sometimes exclusively, on inquiry, conversation, representations or documentation by management. In these instances, the PCAOB often noted that the auditor should have sought additional corroborative evidence to gain comfort in its audit testing. Sometimes, it appeared that the auditor merely performed auditing by conversation.

Given that the PCAOB takes a risk-based approach to reviewing the audit work of select issuers—focusing on high-risk audit issues and/or high risk issuers, this finding is of particular concern. In general, the auditing standards make clear that the higher the auditor's assessment of risk, the more reliable and relevant the audit evidence that should be sought by the auditor. Therefore, the prevalence of findings by the PCAOB of audit failures attributable to overreliance on management assertions in high risk areas is particularly troubling. Below, we provide illustrative examples from the Inspection Reports:

"In this audit, the Firm failed to perform sufficient procedures to evaluate whether the issuer's investment in another entity was accounted for properly. Specifically, the Firm failed to perform any procedures, beyond inquiry of management.[39]

- "The Firm, however, failed to perform procedures, beyond inquiry of management, to assess the appropriateness of the change in the weighting between these [fair value] models."[40]
- "Further, the Firm failed to obtain corroboration of management's explanations of significant unexpected differences between expected and actual revenues."[41]
- "The Firm failed to sufficiently test the ALL [Allowance for Loan Losses], as its testing of this [new unallocated reserve] component was limited to obtaining a general understanding of how management developed the unallocated reserve, without testing any of the specific assumptions

[39] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 8.

[40] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 5-6.

[41] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 11.

used in determining the recorded amount."[42]

- "The Firm concurred with the issuer's conclusion that no allowance was required for certain loans classified as troubled debt restructurings based on the issuer's assumption that it was probable that the issuer would receive all payments in accordance with the restructured terms of the loans. The Firm, however, failed to test this assumption beyond inquiry of management."[43]
- In testing the valuation of goodwill, "the Firm failed to evaluate, beyond inquiry of management, the reasonableness of the issuer's revenue and earnings projections."[44]
- In testing the valuation of goodwill, "the Firm failed to sufficiently test important controls related to the development of certain key assumptions used in the issuer's impairment analysis, as it limited its procedures to observing evidence of management's review and evaluating whether the reviewers had the appropriate expertise."[45]
- "The Firm failed to perform procedures, beyond reading a management-prepared memo and inquiring of management, to test the residual value of returned leased equipment."[46]
- "For certain impaired loans that the Firm selected for testing, the Firm failed to test the specific reserves, beyond inquiring of management."[47]
- "The Firm failed to adequately test a significant adjustment to the issuer's inventory and cost of sales in that it tested only certain elements of the adjustment and limited its procedures on those elements to inquiry."[48]
- "Further, the Firm relied on management's uncorroborated representations to determine whether the issuer was in compliance with certain debt covenants."[49]
- "[T]he Firm failed to perform sufficient procedures to test the valuation of contract revenue and costs, as it failed to perform procedures beyond inquiry to evaluate the changes in certain contract reserves."[50]

<u>Failure to design or perform appropriate substantive procedures on accounts, transactions or financial statement disclosures that the PCAOB deems material or significant</u>

When an auditor determines that an assessed risk of material misstatement at the assertion level is

[42] See PCAOB Release No. 104-2011-199, Inspection of KPMG LLP (August 15, 2012) at 5.

[43] See PCAOB Release No. 104-2011-199, Inspection of KPMG LLP (August 15, 2012) at 9.

[44] See PCAOB Release No. 104-2012-271, Inspection of Deloitte & Touche LLP (November 28, 2012) at 4.

[45] See PCAOB Release No. 104-2012-271, Inspection of Deloitte & Touche LLP (November 28, 2012) at 18.

[46] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 13.

[47] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 14.

[48] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 12.

[49] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 8.

[50] See PCAOB Release No. 104-2012-271, Inspection of Deloitte & Touche LLP (November 28, 2012) at 6.

significant, the auditor should perform substantive audit procedures that are specifically responsive to this risk. This category of deficiencies in the PCAOB Inspection Reports refers to basic errors in the nature, timing and extent of audit procedures performed on material amounts of transactions or balances that are recorded or disclosed in the financial statements. Sometimes, the deficiency involved a failure by the Firm to appropriately test transactions that it singled out for testing, often through sampling. These failures included deficiencies to test transactions or balances that exceeded levels of materiality set by the Firm, as well as circumstances where materiality levels were set so high that it was unlikely that any exceptions would result during testing. In one example, the PCAOB noted that the Firm designed a flawed audit test because of its circular nature.

Numerous examples exist and the simplicity, yet severity of the deficiencies speak for themselves. In hindsight, these failures seem preventable; one would think that appropriate planning, supervision and review by the Firms would cure many of these alleged deficiencies. These examples include:

- "The Firm failed to substantively test the valuation of inventory at certain of the issuer's units, which represented almost half of the issuer's inventory."[51]
- "The Firm failed to sufficiently test the completeness and valuation of inventory, as the nature, timing, and extent of its substantive procedures did not take into account exceptions it identified in its testing of inventory costs and inventory cut-off."[52]
- "In addition, the Firm identified a specific risk of fraudulent journal entries, but failed to include journal entries recorded in the general ledgers of these units in its population of journal entries subject to testing."[53]
- "The Firm's approach to testing one of the issuer's categories of revenue included testing the largest revenue transactions in order to achieve certain levels of coverage. The Firm failed to perform substantive testing on the remaining population of transactions, which totaled approximately one-third of this category of revenue and was many times the Firm's established materiality level."[54]
- "For certain of the issuer's other locations that represented approximately 40 percent of its revenue, the Firm failed to perform sufficient substantive tests of revenue. Specifically, the Firm placed significant reliance on substantive procedures over the balance sheet accounts related to revenue, but failed to perform any substantive tests to obtain evidence with respect to the relevant assertions for revenue for the entire year."[55]
- "In its contract testing, [the Firm] failed to sufficiently test the issuer's contract costs, in that it failed to test the costs incurred to date, estimated costs to complete, and the completeness of the

[51] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 7.

[52] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 8.

[53] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 17.

[54] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 14.

[55] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 14.

issuer's provision for loss contracts."[56]

- "The Firm failed to perform sufficient substantive procedures to test certain accounts receivable and revenue. Specifically, the Firm...[f]ailed to test whether revenue was recognized in the appropriate period."[57]
- "In this audit, the Firm failed to sufficiently test the valuation of investments. Specifically, the Firm…failed to test the valuation of certain investments included in the Firm's sample selection."[58]
- "The Firm excluded from its tests of the valuation of securities at year end securities purchased during two of the last three months of the issuer's fiscal year, whose aggregate recorded value was approximately ten times the Firm's established level of materiality."[59]
- "The Firm failed to test journal entries recorded at the issuer's individual locations, despite ineffective controls over access to the locations' general ledger systems, instances of fraud at the locations, and a significant volume of journal entries processed at the locations."[60]
- "In all five audits, the Firm failed to adequately test the issuer's disclosures of certain hard-to-value financial instruments as level 2 or level 3 because it failed to obtain an understanding of whether significant inputs used to value the financial instruments were observable or unobservable."[61]
- "The Firm failed to sufficiently test accounts receivable and revenue for this acquired business…[T]he Firm failed to identify the circular nature of the tests performed, as the accounts receivable roll-forward procedures relied upon reported revenue, and the test of revenue relied upon the accounts receivable balance."[62]
- "The Firm failed to evaluate the implications of significant differences in fair value measurements from different sources for individual financial instruments, as follows: [i]n one of these audits, the Firm established thresholds to identify pricing differences for further testing; however, the Firm set the thresholds at a level that caused the Firm not to identify significant differences in prices for individual financial instruments."[63]

<u>Inappropriate reliance on issuer controls that have not been sufficiently tested</u>

The PCAOB identified numerous occurrences of alleged audit failures that involved reliance on the

[56] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 16.

[57] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 13.

[58] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 17.

[59] See PCAOB Release No. 104-2012-199, Inspection of KPMG LLP (August 15, 2012) at 20.

[60] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 6.

[61] See PCAOB Release No. 104-2011-288, Inspection of KPMG LLP (November 8, 2011) at 6.

[62] See PCAOB Release No. 104-2012-199, Inspection of KPMG LLP (August 15, 2012) at 13.

[63] See PCAOB Release No. 104-2011-288, Inspection of KPMG LLP (November 8, 2011) at 5.

controls of the issuer in which the auditor failed to obtain, or failed to document, audit evidence about the operating effectiveness of the control in the current period. In analyzing the Big Four firms' audit deficiencies cited by the PCAOB, we found that the prevalence of this type of alleged audit failure occurred in over 20 percent of the issuer audits, though there was a high degree of variability among the Big Four firms; indeed, for one Firm in one particular year, perhaps as much as two-thirds of the issuer deficiencies included a discussion by the PCAOB that described this type of audit failure. Sometimes, the cited failures involved reliance on important controls or compensating controls that were not tested in any way or for which there was no documentation of testing. Sometimes, the criticism was that the control was tested, but not by sufficient means. One theme involved reliance on controls in which such testing of controls was limited to inquiry or relied on reviews of such information, reports and/or transactions performed by management of the issuer. In this latter situation, the PCAOB often noted that the testing of these controls by the auditor was inappropriate, as the testing was often limited to observing documentation that such a review of information had taken place without considering whether the review was robust as designed and executed by the issuer to ensure that the control operated with sufficient precision. Examples include:

- "For certain of the issuer's locations that in the aggregate presented a reasonable possibility of material misstatement, the Firm had planned to rely on certain entity-level controls that consisted of reviews performed during management meetings. The Firm had determined that these entity-level controls were also compensating controls for a significant deficiency related to inadequate segregation of duties. The Firm, however, failed to sufficiently test these entity-level controls because the Firm's testing of the operating effectiveness of the controls was limited to obtaining evidence that such reviews had occurred and performing inquiries of management."[64]

- "The Firm failed to perform sufficient procedures to test the issuer's revenue and cost of sales (and certain related balance sheet accounts) for transactions accounted for under the percentage-of-completion method. The Firm designed its procedures based on a level of reliance on internal control, but the Firm's testing of important controls on which it relied was insufficient."[65]

- "The Firm relied on one of the issuer's entity-level controls, but failed to sufficiently test the operating effectiveness of the control. Specifically, there was no evidence in the audit documentation, and no persuasive other evidence, that the Firm had tested whether the entity-level control operated at the level of precision that would prevent or detect misstatements that could be material."[66]

- "The Firm failed to perform procedures beyond inquiry to test controls over the issuer's analysis of historical losses in its loan portfolio, which the issuer used to develop a critical assumption used in the ALL [Allowance for Loan Loss] calculation."[67]

[64] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 14.

[65] See PCAOB Release No. 104-2012-271, Inspection of Deloitte & Touche LLP (November 28, 2012) at 5.

[66] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 9.

[67] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 14.

- "The Firm relied on controls over revenues but its testing of those controls was inadequate for the following reasons…The Firm failed to identify and test controls over the entry of customer contract terms into the issuer's systems" and "[t]he Firm failed to identify and test controls over the identification and valuation of post-delivery obligations contained in multiple-element arrangements."[68]

- "The Firm failed to adequately test the issuer's controls over the estimation of the allowance for loan losses, as it failed to adequately test the monitoring process performed by the issuer's internal loan review function, an important control over the accuracy of the loan risk ratings and the timely identification of problem loans."[69]

- "The Firm failed to perform sufficient substantive procedures related to inventory additions and inventory cutoff. The Firm designed its procedures based on a level of reliance on internal control that was excessive, because the Firm: [f]ailed to sufficiently test the operating effectiveness of an important manual control related to inventory costs, as it limited its procedures to a sample of one item…"[70]

- "The Firm failed to adequately test system-related controls over revenue and accounts receivable and inventory, as it failed to test the effectiveness, as a control, of the issuer's segregation of duties and failed to test controls intended to mitigate the risk of management override."[71]

- "The Firm failed to support the extent of its use of the work of others, as it failed to obtain an understanding of control test procedures performed by IA [internal audit], and it relied on work performed by IA to test important controls related to multiple processes in areas of higher risk, including inventory, revenue, and accounts receivable, without performing any independent testing or re-testing of these controls."[72]

- "The issuer's revenue was produced from numerous locations, each with its own accounting personnel and general ledger systems…The Firm and the issuer's internal audit [department] identified multiple control deficiencies, including deficiencies at several locations tested, but these control deficiencies were not the same at all locations. In planning and performing tests of controls, the Firm assumed that risks and controls were the same across all locations and, therefore, reduced the number of locations selected for testing. As these assumptions were incorrect, the Firm's testing was insufficient."[73]

- "Another control the Firm selected for testing was management's review and investigation of variances between recorded and forecasted amounts of revenue over a certain threshold amount.

[68] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 11.

[69] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 7-8.

[70] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 12.

[71] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 8.

[72] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 9.

[73] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 4-5.

The Firm, however, failed to sufficiently test this review control as its testing was limited to verifying that management had signed off as having completed certain review procedures."[74]

Inappropriate reliance on data, reports, methods and assumptions, including information from third parties or service organizations that the auditor insufficiently tests or understands

In designing substantive audit procedures, the auditor considers, among other factors, the reliability of data and reports on which the testing is based. To do this, the auditor must obtain an understanding of the issuer's information system(s) relevant to financial reporting, including the documents, records, and processing steps related to material account balances and classes of transactions involved in such system(s). In the 2010 and 2011 Inspection Reports issued by the PCAOB on the Big Four firms, about 40 percent of the issuers with identified audit deficiencies involved situations where the PCAOB concluded that the Firm placed reliance on financial reporting information that the auditor failed to understand or test. Like inappropriate reliance on controls that have not been tested, this type of audit deficiency involves circumstances in which the testing methodology is deemed insufficient because the auditor relies on issuer data, reports, information feeds and/or models for which the PCAOB determines the working papers do not demonstrate that the auditor understands the integrity, reliability or accuracy of this information. This type of deficiency also extends to circumstances in which the auditor relies on third party information, including reports and data provided by service organizations. Furthermore, the deficiencies include reliance by the Big Four firms on audit evidence provided in reports issued by other auditors. In these cases, the Big Four firms were criticized by the PCAOB for failing to assess the professional reputation and standing of the other auditor(s). Many of the PCAOB identified audit deficiencies in this category pertained to testing the fair value of financial instruments without readily determinable fair values. Examples include:

- "In four of these audits, the Firm failed to obtain an understanding of the specific methods and/or assumptions underlying fair value measurements that were obtained from pricing services or other third parties and used in the Firm's testing of the fair value of certain of the hard-to-value financial instruments."[75]
- "The Firm failed to perform sufficient substantive procedures to test the existence, completeness, and valuation assertions related to significant amounts of inventory and cost of sales. Specifically, the Firm…[f]ailed to test the completeness and accuracy of certain computer-generated information that it relied upon in certain of its inventory and cost of sales audit procedures."[76]
- "In six…audits, the Firm failed to obtain an understanding of the specific methods and/or assumptions underlying certain fair value measurements obtained from pricing services or other third parties and used in the Firm's testing of the fair value of the hard-to-value financial

[74] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers (November 8, 2011) at 23.

[75] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers (September 27, 2012) at 7.

[76] See PCAOB Release No. 194-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 13.

instruments."[77]

- "With respect to traditional investments…[t]he Firm used the most recent audited investee financial statements to evaluate the reliability of the investees' interim data. The Firm, in certain cases, failed to determine whether the reports of the investees' auditors were satisfactory, as it failed to assess the professional reputation and standing of the investees' auditors."[78]
- "In this audit, the Firm's planned approach for auditing revenue included the performance of substantive analytical procedures. The Firm failed to test the completeness and accuracy of a system-generated report that it used to developed its expectations."[79]
- "When designing analytical procedures [in tests of revenue]…the Firm failed to sufficiently investigate the significant differences because it failed to test the issuer-supplied data that is used in its investigations of the differences."[80]
- "The issuer used two service organizations to process customer transactions and used certain of the data and reports produced by these service organizations in the performance of several of the controls that the Firm selected for testing…The Firm failed to perform sufficient procedures to test the completeness and accuracy of these data and reports as follows[: t]he Firm obtained a service auditor's report on controls at one of the service organizations, but this report addressed controls over only some of the reports produced by the service organization. The Firm failed to test, or otherwise obtain evidence of the design and operating effectiveness of, controls over the completeness and accuracy of the other data and reports identified above[; t]he Firm failed to perform procedures to obtain evidence regarding the design and operating effectiveness of any of the controls at the other service organization."[81]

<u>Failure to update audit procedures or testing between interim and year end field work</u>

For certain of the Big Four firms, we noted that there were a high percentage of audit deficiencies that included instances where the auditor failed to update its audit testing between an interim date of field work and the issuer's year end. Sometimes, the auditor failed to obtain updated information about important model assumptions and inputs; sometimes, the auditor failed to expand the scope of its audit testing to include transactions after its preliminary date of field work. There were instances where the design of the audit procedures, whether to roll forward interim findings to year end or to make inquiries of the issuer, were deemed insufficient. Audit failures also, sometimes, included reliance on reports, third party data and/or service organization reports in which a significant period of time elapsed from the issuance date until year end. In perhaps the worst-case scenario, the auditor simply failed to perform any year end procedures on significant accounts or transactions and, in the view of the PCAOB, did not appear to have had a reasonable basis to do so. Some illustrative examples are instructive and include:

[77] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 4.

[78] See PCAOB Release No. 104-2012-199, Inspection of KPMG LLP (August 15, 2012) at 16-17.

[79] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 23.

[80] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 23.

[81] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 21-22.

- "In three of these audits, the Firm performed substantive testing at an interim date, but failed to perform sufficient procedures to provide a reasonable basis for extending its conclusions to year end regarding valuation of hard-to-value financial instruments for which the Firm had identified a fraud risk and/or other significant risk."[82]
- "The Firm's procedures to extend the interim conclusions on accounts receivable to year end were insufficient, as the Firm failed to identify that the roll-forward analysis that the issuer prepared included an incorrect adjustment that was in excess of the Firm's established level of materiality and excluded certain other adjustments that should have been included."[83]
- "The Firm failed to perform sufficient substantive procedures to test the existence, completeness, and valuation assertions related to significant amounts of inventory and cost of sales. Specifically the Firm…[f]ailed to perform sufficient procedures to extend to the year end the audit conclusions that it reached at the interim testing date (three months before year end), because the Firm limited its roll-forward procedures to comparing the net inventory balances at the interim date to those at the year end."[84]
- "Despite the varying degrees of risk associated with the controls, the Firm's procedures to update its testing of controls for the five-month period between its interim testing and year end were limited to obtaining a memorandum from IA [internal audit] summarizing the results of IA's inquiries of the control owners."[85]
- "The Firm's procedures to update its tests of controls over processes related to revenue and the valuation of derivatives for the three-to-five-month period between its interim testing and year end were limited to general inquiries as to whether any controls had changed, despite the varying degrees of risk associated with the controls, including, in some cases, high inherent risks or heightened fraud risks."[86]
- "In addition, although the Firm performed confirmation procedures at an interim date to test the existence of inventory held off-site, the Firm did not update this testing, or perform other procedures, to test the existence of this inventory at year end."[87]

<u>Failure to update audit procedures or testing when additional material information or contradictory evidence comes to the attention of the auditor</u>

According to AU Section 230, "Due Professional Care in the Performance of Work," the auditor is required to exercise professional skepticism. "Professional skepticism is an attitude that includes a

[82] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 5.

[83] See PCAOB Release No. 104-2012-199, Inspection of KPMG LLP (August 15, 2012) at 13.

[84] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 13-14.

[85] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 5-6.

[86] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 12-13.

[87] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 11.

questioning mind and a critical assessment of audit evidence." [88] Throughout the audit process, this standard requires that the auditor use "the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence."[89] Thus, it is troubling when deficiencies cited in the PCAOB Inspection Reports include circumstances where, in the opinion of the PCAOB, it appears that the auditor failed to sufficiently evaluate or respond to the evidential matter that came to its attention. Root causes may vary, but generally suggest a lack of diligence by the auditor, a lack of supervision of the auditor, a failure to exercise professional skepticism, or a lack of appropriate skills.

Based on the documentation provided in the Inspection Reports, such deficiencies include failures by the auditors to take into account or evaluate contradictory evidence, failures to evaluate the reasons for or implications of significant differences between auditing expectations and findings, and failures to adequately respond to fraud risk indicators. In some circumstances, the auditor is criticized for failing to respond to the audit information by modifying the nature, timing and extent of substantive audit procedures to address the risk of material misstatement. In reviewing the 2010 and 2011 Inspection Reports for the Big Four firms, it appeared that about 40 percent of the allegedly deficient audits involving 159 issuers included at least one observation by the PCAOB that the auditor had failed somehow to appropriately evaluate and respond to audit evidence. Examples include:

- "In planning the audit, the Firm determined that certain types of journal entries, including manual transaction-level journal entries, had defined characteristics that could potentially be indicative of fraud. For reporting units that represented almost half of the issuer's net sales, however, the Firm failed to include manual transaction-level journal entries meeting these predefined characteristics in its population that was subject to testing."[90]
- "The Firm had identified a risk of fraud related to improper revenue recognition due to sales cut-off issues. The Firm, however, did not perform any substantive tests for sales cut-off."[91]
- "In addition, when establishing its thresholds for investigation of significant differences for revenue, the Firm failed to consider the possibility that a combination of misstatements could aggregate to an unacceptable amount. As a result, the aggregated uninvestigated differences exceeded the Firm's established materiality level by a significant amount."[92]
- "In addition, in five of the seven audits, the Firm failed to evaluate the implications of significant differences in fair value measurements from different sources for individual financial

[88] AU Section 230, Due Professional Care in the Performance of Work, http://pcaobus.org/Standards/Auditing/Pages/AU230.aspx at paragraph 7.

[89] AU Section 230, Due Professional Care in the Performance of Work, http://pcaobus.org/Standards/Auditing/Pages/AU230.aspx at paragraph 7.

[90] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 10.

[91] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 19.

[92] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 13.

instruments."[93]

- "The issuer identified a significant deficiency related to the lack of oversight by investment accounting professionals with the necessary expertise regarding the valuation process for hard-to-value financial instruments. The Firm failed to appropriately evaluate the severity of the deficiency in the following respects[: t]he Firm failed to evaluate all of the risk factors that affected whether there was a reasonable possibility that the deficiency would result in a material misstatement[; t]he Firm identified that the issuer had no controls over the inputs used to value certain hard-to-value financial instruments, but the Firm failed to include these financial instruments in its consideration of the magnitude of the potential misstatement."[94]
- "Specifically, the Firm failed to perform procedures, beyond inquiry of management, to evaluate the issuer's conclusion that its investment in, and receivables from, [another] entity were not impaired even though the Firm's work papers included a number of potential impairment indicators, including indications that the entity lacked sufficient cash to fund its operations for the next 12 months."[95]
- "The Firm failed to evaluate the implications of significant differences in fair value measurements from different sources for individual financial instruments, as follows: [i]n three of these audits, for certain financial instruments, the Firm obtained multiple prices and used the price closest to the issuer's recorded price in testing the fair value measurements, without evaluating the significance of differences between the other prices obtained and the issuer's prices."[96]
- "The Firm failed to sufficiently test the issuer's model for developing the fair value estimate for the loan portfolio, which the issuer used in its goodwill impairment analysis, as the Firm…[f]ailed to take into account in its evaluation an analysis that the issuer had obtained from an outside party that indicated a significantly lower fair value for a substantial portion of the loan portfolio."[97]
- "The Firm…[f]ailed to sufficiently evaluate the reasonableness of certain assumptions used in the issuer's interim analysis of goodwill and other indefinite-lived intangible assets, as it failed to take into account certain contradictory information, consisting of the issuer's failure to attain previously projected results and the fact that forecasts of revenue growth in the issuer's industry (which were included in the work papers) were generally not as optimistic as the issuer's projections."[98]

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[93] See PCAOB Release No. 104-2011-319, Inspection of Ernst & Young LLP (November 30, 2011) at 5.

[94] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 15.

[95] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 4-5.

[96] See PCAOB Release No. 104-2011-288, Inspection of KPMG LLP (November 8, 2011) at 5.

[97] See PCAOB Release No. 104-2011-290, Inspection of Deloitte & Touche LLP (December 7, 2011) at 7.

[98] See PCAOB Release No. 104-2012-271, Inspection of Deloitte & Touche LLP (November 28, 2012) at 8.

- "[T]he Firm failed to sufficiently test the valuation of certain types of the issuer's derivative contracts. The Firm tested these derivative contracts by selecting a sample and independently calculating the fair values of the selected contracts. For most of the derivative contracts in the sample, the issuer's fair value measurement was significantly higher than the fair value measurement the Firm determined; the total of the differences approximated 50 percent of the recorded value of those contracts. The Firm, however, failed to evaluate the implications of these significant differences."[99]

<u>Analytical procedures which are not sufficiently precise to provide the necessary level of assurance or detect a material misstatement in the financial statements</u>

The PCAOB identified deficiencies specifically related to analytical procedures. Often, the deficiency pertained to a flaw in the design of the audit procedures. Examples include tests that make illogical comparisons between two time series of data; utilizing information, reports or data which the auditor has not appropriately tested; and performing analytical procedures at a level that is not sufficiently disaggregated to provide the necessary level of assurance. Another common theme was failing to follow up appropriately on unexpected differences, often because the only information sought for the variance was an explanation from management. In our analysis of the Big Four firms, we noted significant variability in the occurrence rate of flawed analytical procedures as described by the PCAOB. For example, for one Firm, only 5 percent of the deficiencies in a given year pertained to flawed analytical procedures; for another, almost 40 percent of the deficiencies involved mention of a flawed analytical procedure. Some examples of these deficiencies are:

- "When designing its analytical procedures, the Firm planned to use forecasted data prepared by management for its expectation for revenue. Instead of identifying differences between current-period revenue and its expectations, the Firm identified differences between current- and prior-period revenue."[100]
- "The Firm's planned approach for auditing revenue included the performance of substantive analytical procedures[. O]ther than by reading certain reports that management had provided to the issuer's Board of Directors, the Firm failed to obtain corroboration of management's explanations for approximately half of the significant unexpected difference between the Firm's expectation and the issuer's recorded revenue. Further, the Firm failed to investigate the remaining half of the significant unexpected difference."[101]
- "The Firm failed to test the completeness and accuracy of the data used to calculate one of the issuer's significant categories of income. In addition, the Firm failed to sufficiently test liabilities associated with this income. Specifically, the Firm's planned approach to audit these liabilities included the performance of substantive analytical procedures. The Firm, however, failed to obtain evidence that a plausible and predictable relationship existed between its expectations and

[99] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 24.

[100] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 23.

[101] See PCAOB Release No. 104-2011-289, Inspection of PricewaterhouseCoopers LLP (November 8, 2011) at 6.

the recorded amounts."[102]

- "The Firm intended its primary substantive tests of the year-end inventory balances to be substantive analytical procedures. For certain inventory, the Firm determined its expectation based largely on a fluctuation in certain historical data, but the Firm failed to determine that the fluctuation had a plausible and predictable relationship with the recorded inventory amounts. In addition, the Firm failed to evaluate significant unexpected differences identified through these analytical procedures…In addition, [for certain other inventory] the thresholds that the Firm used in these latter analytical procedures were not precise enough to identify potential misstatements that could be material."[103]

- "[T]he Firm failed to perform sufficient substantive procedures to test [a significant] component of revenue. Specifically, in performing analytical procedures that the Firm intended as its primary substantive tests, the Firm failed to (1) appropriately develop its expectations, as it failed to obtain support for its expectation that revenue would be consistent with revenue in prior periods; (2) for some analytical procedures, set a threshold for investigation of unexpected differences at a level that would detect a material misstatement; (3) test the completeness and accuracy of certain data used in certain of the analytical procedures; and (4) obtain corroboration of management's explanations for significant differences."[104]

- "For certain types of investment securities, the Firm's substantive procedures to extend its conclusions from the first interim date to year end were limited to an analytical procedure disaggregated by type of investment security...The analytical procedures for certain of the investment securities were insufficient since, for some of the investment securities, the Firm failed to establish an expectation, and for others, the Firm's expectation was expressed as a range that was too wide to detect a potential misstatement that could be material."[105]

V. CONCLUSION

In this article we have provided an overview of the activities of the PCAOB since the issuance of our article in 2011. We have described the Board's recent initiatives and areas of focus. The Board's activities have been significantly expanded by the addition of broker-dealers to its scope of responsibilities. We have described the insights we developed as a result of our recent analysis of the PCAOB Inspection Reports issued in calendar years 2011 and 2012 on eight Annual Firms. Finally, we focused our analysis on the trends that have emerged in calendar year 2011 and 2012 Inspection Reports specific to the "Big Four" firms. Our analysis concentrated on deficiencies identified by the PCAOB in the Inspection Reports pertaining to alleged failures by the Big Four firms to obtain sufficient appropriate audit evidence to support their opinion on the financial statements.

[102] See PCAOB Release No. 104-2012-235, Inspection of PricewaterhouseCoopers LLP (September 27, 2012) at 13.

[103] See PCAOB Release No. 104-2012-271, Inspection of Deloitte & Touche LLP (November 28, 2012) at 20.

[104] See PCAOB Release No. 104-2012-272, Inspection of Ernst & Young LLP (December 6, 2012) at 6.

[105] See PCAOB Release No. 104-2012-199, Inspection of KPMG LLP (August 15, 2012) at 20.

In particular, we have attempted through our aggregation and summary of the PCAOB Inspection 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. In our view, 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 reports. These reports (all of which are readily available through the PCAOB's website) include the following:

- "Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies" (Feb. 25, 2013);
- "Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting" (Dec. 10, 2012);
- "Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers" (Aug. 20, 2012); and
- "Information for Audit Committees About the PCAOB Inspection Process" (Aug. 1, 2012).[106]

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 large registered accounting firms in any given year. We note that, oftentimes, the deficiencies cited by the PCAOB ultimately resulted in no changes to the auditor's 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.

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Elizabeth Kroger Davis has over 20 years of experience providing litigation consulting, forensic accounting, and expert testimony services. A former large accounting firm partner, she specializes in complex commercial disputes typically involving finance, accounting, valuation and economics. She has

[106] All reports listed above can be found on the PCAOB's website. See Public Company Accounting Oversight Board, "Board Public Reports".

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