

PCAOB Audit Quality Inspection Results

At BKD, audit quality does not just happen. Audit quality is a fundamental value—it is an intentional part of who we are and what we do. To ensure we are meeting our goals, BKD performs internal inspection procedures and participates in external inspection programs—required by professional standards—that allow us to identify opportunities to keep improving our audit quality. Senior management carefully reviews all inspection results, which are then disseminated to our audit teams. BKD continues to invest in training, resources and tools to sustain and further improve audit quality. One of our external inspectors, the Public Company Accounting Oversight Board (PCAOB), recently released general findings from its 2016 inspections of issuer audits performed by registered firms.

PCAOB inspections assess compliance with certain laws, rules and professional standards and include an in-depth examination of portions of audit work performed and elements of a firm’s quality control system over its audit processes. The PCAOB’s individual firm reports include public and nonpublic portions. The public portion (Part I) contains an overview of inspection procedures and observations on the engagements inspected. The nonpublic portion (Part II) contains observations and criticisms about a firm’s audit performance and quality control system, which are not made public if a firm adequately addresses the comments within 12 months.

The PCAOB most recently inspected BKD in 2014 and 2016. BKD carefully evaluated the Part I findings publicly disclosed in 2014 and 2016 and took appropriate actions to address each matter in accordance with PCAOB standards and our policies. The PCAOB was satisfied that the Part II findings in the 2014 nonpublic report were successfully addressed. Remediation efforts on the 2016 Part II findings are ongoing, and BKD is confident these will likewise demonstrate substantial, good faith progress toward achieving the relevant quality control criticisms and the findings thus will not be made public.

The remainder of this article summarizes the PCAOB’s general findings.

BKD supports the inspection program and monitors and analyzes the PCAOB’s reports and the application to our practice to fulfill our commitment to audit quality.

2016 Results

The PCAOB inspected 190 firms that audit public companies—out of a population of roughly 2,000—and reviewed more than 780 issuer audits. Auditing firms that perform more than 100 issuer audits each year (11 firms) are subject to annual inspection, and those that perform 100 or fewer issuer audits, like BKD, are inspected at least once every three years. More than 90 percent of findings are related to the documentation and extent of auditing procedures, while very few are associated with material misstatements of financial statements.

Audit firms continue to make incremental progress toward improving audit quality. However, three areas continue to have frequent and recurring audit deficiencies, notably:

- **Procedures performed related to the audit of internal control over financial reporting (ICFR)** – The most frequent ICFR deficiencies are related to insufficient testing of the design and operating effectiveness of controls that include a review element, primarily estimates related to revenue, business combinations, asset impairment and reserves.
- **Assessing and responding to risks of material misstatement** – Audit deficiencies were commonly identified in which the auditor did not perform substantive procedures, including tests of details, which were specifically responsive to the assessed fraud risks and other significant risks. Auditors should presume there is a fraud risk involving improper revenue recognition and evaluate the types of revenue, revenue transactions or assertions that may give rise to such risks.

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- **Auditing accounting estimates, including fair value measurements** – Accounting estimates usually warrant more audit attention because they include complex methods, models, subjective factors and judgments that make them susceptible to management bias. Deficiencies are common in goodwill impairment, business combination valuations and loan loss reserves.

The CPA Journal summarized the historical results:

PCAOB Inspection Results			
Measure	Mean		
	Big Four	Next Six	Triennially Inspected Firms
Number of audits reviewed	1,091	496	266
Percentage of audits inspected	4%	11%	20%
Percentage of audits with findings	36%	44%	35%
Percentage of audits that resulted in restatements	2%	1%	1%
Number of quality control releases (Part II findings not sufficiently remediated)	8	3	2
Time period covered is 2010 to 2014 for Big Four and next six; 2009 to 2015 for triennially inspected firms			

Looking Forward

The PCAOB also released a staff inspection brief providing information about its ongoing 2017 inspections that is intended to help investors, auditors and others understand the areas of significant audit risks targeted by PCAOB inspectors. The PCAOB will continue to focus on the recurring audit deficiencies noted above. Other key areas of 2017 inspection focus include:

- **Economic factors** – The PCAOB will target audit areas sensitive to certain economic risks, including Brexit, the high rate of mergers and acquisitions, the search for higher yielding investment returns in a low interest rate environment and oil and natural gas price volatility. For business combinations, the PCAOB will be looking for evidence of professional skepticism, especially where contradictory or inconsistent information is identified. For audits of energy companies, their suppliers and lenders, the PCAOB will be closely examining whether auditors have exercised professional skepticism in critically evaluating management’s assumptions.
- **Financial reporting areas** – Inspectors plan to focus on audit areas that may involve significant judgment from management and auditors. For going concern considerations, auditors should be documenting procedures to evaluate whether management’s plans can be effectively implemented.
- **New accounting standards** – Auditors will need to update their processes and procedures for the new revenue recognition and lease accounting standards. The PCAOB will review how auditors are addressing pending accounting changes with the issuer, communications related to management’s readiness or technical ability with the audit committee and the process to ensure the auditor maintains independence with respect to the issuer’s implementation of the new standards.

- **Technology** — The use of software audit tools continues to expand, primarily for risk assessment and substantive audit procedures. The PCAOB will focus on evaluating the controls auditors have in place to provide assurance that the tools meet the audit objective and how the engagement team is evaluating the risk of material misstatement associated with cybersecurity. Although there were no financial statement misstatements or material weaknesses in ICFR as a result of a cybersecurity incident for issuers inspected in 2016, this threat is an ongoing, high-priority focus area.
- **Firm’s quality control system** – The PCAOB will continue to review an auditor’s policies and procedures for identifying the “root causes” of audit deficiencies and positive quality events, monitoring and maintaining independence, performing engagement quality reviews with due professional care and applying professional skepticism throughout the audit. Some of these areas include a firm’s “tone at the top” as it relates to audit quality; policies, procedures and practices concerning audit performance; training; partner management; and the firm’s self-monitoring through internal inspections and responses. While inspections staff has observed improvement at some firms, this result is not the same across all firms.

BKD remains committed to the highest standards of audit quality and fully supports the PCAOB’s inspection process in improving audit quality to better meet investors’ needs and serve the public interest.

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