



Guide to PCAOB Inspections

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CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

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Since 2002, a new regulator, the Public Company Accounting Oversight Board (PCAOB), has had responsibility for overseeing auditors of public companies. Regular inspections of public company audits and audit firm quality control systems are a key part of the PCAOB's mission.

The Center for Audit Quality (CAQ) prepared this Guide to provide an overview of the PCAOB's inspection program. The Guide describes the PCAOB's inspection responsibilities, how it conducts inspections, the content of inspection reports, and the remediation of deficiencies identified in PCAOB inspections.

A Guide to PCAOB Inspections

Confidence in public company financial reporting is essential to the strength and vitality of our nation’s securities markets. Company management, audit committees, and internal and external auditors all play important roles in providing investors with reliable financial reports. These roles are reinforced by regulators, including the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB).

By law, public companies must have their financial statements audited each year by independent auditors—accountants who examine, on a test basis, evidence supporting the amounts and disclosures in the financial statements. They provide a written opinion on whether the company’s financial statements are, in all material respects, fairly presented in accordance with U.S. Generally Accepted Accounting Principles (GAAP). In the case of larger public companies, the auditor must also express an opinion on whether the company maintained, in all material respects, effective internal control over its financial reporting, as of a specified date. The auditor’s work helps to maintain investor confidence in financial reporting.

ROLE OF THE PCAOB

Congress created the PCAOB to protect investors and to further the public interest by overseeing the work of accounting firms that audit publicly-traded companies. The law requires the PCAOB to periodically inspect firms that audit public companies for compliance with the securities laws and with the PCAOB’s rules and auditing standards. Each year, the PCAOB conducts several hundred inspections. At the end of each inspection, the PCAOB is required to issue an inspection report, part of which is available to the public.

Since 2010, the PCAOB also has had oversight responsibility for auditors of securities broker-dealers registered with the SEC. PCAOB inspections of broker-dealer audits are outside the scope of this Guide.

PCAOB Inspection Process

Which Firms Does the PCAOB Inspect and How Often?

About 2,500 accounting firms are registered with the PCAOB. The PCAOB annually inspects firms that audit more than 100 public companies. Firms that audit fewer public companies are inspected at least once every three years. The PCAOB also can inspect a registered firm that does not issue audit reports, but that plays a substantial role in public company audits by performing work used by another firm in an audit.

The PCAOB's inspection program also covers foreign accounting firms that audit, or participate in audits of, U.S. public companies. Over 800 foreign firms are registered with the PCAOB, and these firms may audit foreign companies that have issued U.S.-traded securities or foreign subsidiaries of U.S.-based companies. Such firms are subject to the same inspection requirements as U.S. accounting firms, and the PCAOB has entered into agreements with many jurisdictions around the globe that permit it to perform inspections of registered firms in those countries. The PCAOB's website provides information about the countries in which it can and cannot inspect and about foreign registered firms that have not been inspected.



Objectives of an Inspection

PCAOB inspections focus on how a firm conducted selected audits and on the effectiveness of the firm's quality control policies and procedures. Inspections are designed to identify whether there are deficiencies in how the accounting firm performs public company audits and whether there are weaknesses in its quality controls over public company auditing.

How Does an Inspection Begin?

Before the start of an inspection, the PCAOB staff notifies the accounting firm of when it plans to conduct the inspection. It also requests information about the firm's public company engagements, the personnel performing those audits, and the firm's quality control program.

Generally, inspection fieldwork occurs at the firm. In some cases, especially for smaller firm engagements, the PCAOB performs "PCAOB-based" inspections in which the firm's work papers and other firm documents are reviewed at the PCAOB's offices and interviews are conducted by telephone.

How Does the PCAOB Select Audits to Inspect?

In the case of the largest accounting firms, the PCAOB generally takes a risk-based approach to selecting audit engagements to review. As a result, inspections do not involve a random or representative sample of a firm's public company practice. The PCAOB has developed a variety of tools to identify audits that may pose difficult or complex issues. Risk factors include the nature of the company, including its industry and market capitalization; audit issues likely to be encountered; and whether the company has significant operations in emerging markets. Other factors that influence engagement selection are specific to the inspected firm, such as the type and range of its public company engagements, the results of prior PCAOB inspections, and findings from the firm's internal risk management and inspections processes. The inspection staff also considers the assignments and inspection history of the partners who audit public companies.

For firms with only a small number of public company engagements, the PCAOB may review all of those audits. Otherwise, the PCAOB generally focuses on audits of companies with the largest market capitalizations. Further, when a smaller firm has several partners that lead public company audits, the PCAOB will try, over time, to inspect at least one audit performed by each partner. The inspection staff also considers audit risk in selecting small firm engagements. For example, when a small, U.S.-based firm performs an overseas audit that requires knowledge of a foreign language or of local business practices, the engagement may be more likely to be reviewed.



Importance of Work Papers

The audit work papers are central to the inspection of an audit engagement. Under the PCAOB's standards, the work papers should permit an experienced auditor who was not involved in the engagement to understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached.

How Does the PCAOB Inspect an Audit?

Except in the case of audits of very small companies, an inspection does not cover the entire engagement, but rather concentrates on areas that appear to the inspectors to present significant challenges or difficulties. The PCAOB informs the firm in advance of the inspection of the audits it intends to review and of the specific aspects of those audits on which it plans to focus. The firm is requested to provide PCAOB inspectors with information regarding those areas.

For each audit selected, the inspection team meets with the audit engagement team and examines the firm's work papers. The inspectors' goal is to analyze how the audit was performed and to answer key questions, such as—

- Whether the firm followed the procedures required under the PCAOB's auditing standards.
- Whether the firm identified any areas in which the financial statements did not conform to GAAP in a material respect.
- How the firm handled potential adjustments to the financial statements.
- Whether there is any indication that the firm was not independent, as required under SEC and PCAOB rules.

If the work papers do not indicate that the auditor performed a particular procedure that the inspectors believe was required, they will give the firm an opportunity to describe any work that was performed, but not documented.

What Happens if PCAOB Inspectors Believe There Is an Audit Deficiency?

If the inspection team identifies a facet of an audit that it believes may not have been performed in accordance with PCAOB standards, it initiates a dialogue with the firm. If the inspectors' concerns cannot be resolved through discussion, the team will issue a "comment form" requesting the firm to respond in writing to those concerns.

The comment form process provides an opportunity for the firm to present its views on aspects of the audit that the inspectors have questioned. After considering the firm's response, the inspection team will determine whether the firm has adequately addressed the concern or, if not, whether to include the matter as a deficiency in the inspection report.

Does the PCAOB Consider the Role Professional Judgment Plays in Auditing?

While audits must, of course, follow PCAOB standards, the auditor necessarily uses professional judgment in applying those standards to the circumstances of the audit. In many situations, several different audit approaches are possible, and determining how best to obtain the necessary audit evidence can be challenging. In some situations, reasonable professionals may reach different conclusions about what the standards require. In these cases, PCAOB inspectors look for evidence that explains how the auditor reached his or her judgment. The PCAOB generally expects that evidence supporting auditor judgments will be documented in the work papers.



Interpretations of GAAP

Sometimes issues raised by the inspectors involve how GAAP was applied in the audited company's financial statements. If the auditor informs the company that the PCAOB raised a potential GAAP issue, the company may choose to discuss the question with the SEC.

The SEC has final authority to decide how GAAP should be applied in a public company's financial statements.

How Are Audit Committees Involved in PCAOB Inspections?

An inspection of an audit includes a review of the communications between the accounting firm and the company's audit committee. As part of that review, the inspection team may interview the audit committee chair, usually by telephone.

Interviews with the audit committee chair deal with such matters as the frequency and nature of discussions between the auditor and the audit committee; the audit committee's expectations and evaluation of the auditor; and the auditor's communications to the audit committee regarding critical accounting judgments, audit adjustments, related party transactions, and sensitive management estimates. The PCAOB does not regulate audit committees and does not assess their performance.

Except for audit committee chair interviews, the PCAOB inspection staff does not communicate with the company as part of an inspection of its audit. The PCAOB has published information about its inspection process for audit committees on its website, including suggestions about how to discuss the firm's inspection with the auditor.

How Does the PCAOB Inspect Accounting Firm Quality Controls?

As is the case in engagement selection, quality control reviews are tailored to the size of the firm and the nature of its practice. The PCAOB's review focuses on how these systems operate in practice and on how they impact audit engagements.

The scope and emphasis of quality control reviews vary somewhat from year to year. Examples of the types of issues that are addressed include—

- **Review of management structure and processes, including the tone at the top.** Procedures in this area focus on how management operates the firm's business and whether it instills in the professional staff a culture of commitment to integrity, independence, and audit quality.
- **Review of partner management.** This aspect of the inspection seeks to determine whether the firm's partner oversight encourages an appropriate emphasis on audit quality and technical competence. The management processes that inspectors review include partner evaluation, compensation, admission to partnership, and disciplinary actions.

Inspectors also review the firm's processes for allocating partner resources and the accountability and responsibilities of different levels of firm management.

- **Review of engagement acceptance and retention.** The inspection team evaluates compliance with the firm's policies and procedures for identifying and assessing the risks involved in accepting or continuing public company audit engagements. The inspectors also seek to determine whether audit procedures are responsive to the risks identified during the acceptance and retention process.
- **Review of the use of audit work performed by foreign affiliates.** Quality control with respect to cross-border audits is a focal point in many large firm inspections. The inspection team reviews the firm's policies and procedures related to supervision and review of work performed by foreign affiliates as part of firm audits.
- **Review of the firm's processes for monitoring audit performance.** Inspection procedures in this area assess how the firm identifies, evaluates, and responds to possible indicators of deficiencies in its performance of audits. These include processes for identifying and assessing audit deficiencies, independence policies and procedures, and processes for responding to weaknesses in quality control.



The Difference Between a PCAOB Inspection and an Enforcement Proceeding

In addition to its inspection program, the PCAOB has an enforcement program. If the PCAOB believes that a serious violation has occurred, it may initiate an enforcement case in which testimony can be heard and evidence presented in a trial before a hearing officer. If the hearing officer finds that a violation has occurred, the firm or individual involved can be sanctioned, such as by a monetary penalty or by being suspended or barred from public company auditing. Findings by the hearing officer can be appealed to the Board of the PCAOB, and Board decisions can be appealed to the SEC. SEC orders are reviewable in the federal courts.

PCAOB Inspection Reports

What Steps Lead to Issuing a PCAOB Inspection Report?

After the conclusion of the inspection fieldwork and after receiving comment form responses, the PCAOB inspection staff prepares a draft report containing its findings. Draft reports are subject to several layers of internal PCAOB review and may be revised. After the internal review process, the draft report is provided to the firm for review. Any firm written response becomes part of the final inspection report. In some cases, the PCAOB staff modifies the draft report as a result of the firm's response.

The inspection staff presents the report and the firm's response to the PCAOB Board. The Board discusses the inspection with staff and may direct the inspection staff to make changes to the draft report. The draft report becomes final when it is approved by a majority vote of the Board.

After Board approval, the final inspection report is sent to the firm, which has an opportunity to request SEC review of the report. If the firm does not seek SEC review, the PCAOB releases the public portion of the report on its website. If the firm asks for an SEC review, release of the report is delayed until the review is completed.



Public and Nonpublic Portions of an Inspection Report

Each PCAOB inspection results in the issuance of a written inspection report. The inspection report is a record of what the inspectors concluded based on their work. All reports have a public portion (Part I). Most reports also include a nonpublic portion discussing firm quality controls (Part II). If the inspection did not result in any criticisms of the firm's quality control system, Part I states that fact. In those cases, there is no nonpublic portion of the report.

What Is in the Public Portion (Part I) of a PCAOB Inspection Report?

Part I, the public portion of an inspection report, describes matters that the PCAOB regards as significant audit deficiencies. Audit deficiencies can include failures to perform required audit procedures and failures to identify or appropriately address potential GAAP misapplications in the financial statements. Inclusion of a deficiency in Part I does not necessarily mean that the financial statements were materially misstated.

Part I only includes audit deficiencies that were of such significance that it appeared to the PCAOB that the firm did not, at the time it issued its audit report, have sufficient evidence to support its opinion on the financial statements. If no significant audit deficiencies were found, Part I so states. Part I deficiencies do not include the identity of the companies whose audits were inspected; they are referred to as “Issuer A,” “Issuer B,” etc.

The public portion of the report also includes explanatory information about PCAOB inspection reports. For example, the PCAOB acknowledges that inspection reports are not necessarily a representative sample of the firm’s work and that “inspection reports are not intended as balanced report cards or overall rating tools.” Further, all inspection reports state that descriptions of financial statement misstatements or failures to comply with SEC disclosure requirements (including GAAP) should not be understood to indicate that the SEC has considered the issue. Similarly, reports state that references to audit deficiencies are not based on a formal trial-type process and therefore are not conclusive.

In the case of the largest firms, the public portion contains an appendix describing the inspection process. The PCAOB does not disclose specific inspection procedures, and this description is therefore fairly high level.

Finally, the public portion of an inspection report includes any written response from the inspected firm to the draft inspection report.

What Is in the Nonpublic Portion (Part II) of a PCAOB Inspection Report?

If the inspection identifies quality control criticisms, the inspection report includes a Part II. Part II is not made public when the report is released.

Part II contains the PCAOB’s views on areas in which a firm should improve the quality controls over its audit practice. The quality control

areas addressed in Part II may include such things as the firm’s procedures for assuring independence, the “tone at the top” reflected by firm management, or the firm’s internal inspection program. Quality control concerns also may be based on matters identified in particular audit engagements, such as concerns about the failure of the firm’s system of quality control to assure compliance with the auditing standards in a particular area. Part II also may include additional detail about Part I audit deficiencies.

An inspection report also may include other nonpublic parts, such as a discussion of less significant audit deficiencies not included in Part I and a discussion of the firm’s obligation to consider the need to perform additional audit work to address the audit deficiencies described in Part I.



Where to Find PCAOB Inspection Reports

The PCAOB makes Part I of each final report available on its website (www.pcaobus.org). To find a list of all inspection reports the PCAOB has issued, click on the Inspections tab on the PCAOB’s home page. The list of inspection reports appearing under that tab can be sorted by the firm’s name, the date the report was issued, or by the country in which the firm is located.

Remediation

Inspections are intended to improve audit quality, and firms are expected to respond to the issues raised in their inspection reports. After the inspection report is received—and, in many cases, even before the final report is issued—the inspected firm considers how to address any audit deficiencies and any PCAOB criticisms of its quality controls.

Audit Deficiencies

The auditing standards provide that, when an auditor learns that an auditing procedure necessary at the time of the audit was not performed, the auditor should consider the impact of the omitted procedure on his or her ability to support the audit opinion. In addressing Part I audit deficiencies, the firm may therefore find it necessary to perform additional audit work. The firm may also decide to supplement the work papers with additional information about procedures previously performed or to add other information supporting the audit opinion. In some cases, the firm may have to withdraw or modify its audit opinion. PCAOB inspections sometimes raise issues that lead the company to issue a restatement of its financial statements.

Quality Control Criticisms

A firm has 12 months to satisfactorily “remediate” the PCAOB’s quality control criticisms described in Part II of the inspection report. Failure to do so results in public disclosure of Part II. By encouraging firms to address the PCAOB’s quality control criticisms, remediation links the results of the inspection process to improvements in controls over future audits.

The types of remediation steps that a firm undertakes depend on the nature of the underlying quality control issues identified by the PCAOB. Examples of remediation include changes in firm audit procedure manuals and additional training. For larger firms with complex audits, the PCAOB generally expects that the firm will conduct an analysis of the causes of any identified issues, and tailor its remediation measures to the results of that inquiry.

While some quality control issues can be addressed relatively quickly through additional audit guidance or training, others require more time.

The PCAOB staff encourages dialogue throughout the 12-month remediation period so that the firm will understand what the PCAOB expects it to do and can obtain staff input on its efforts before the deadline. Along these lines, the PCAOB has stated that, for the largest firms, it identifies certain quality control issues that are of greatest concern and asks the firm to submit, within 60 days after the report date, a written plan for remediating those issues.

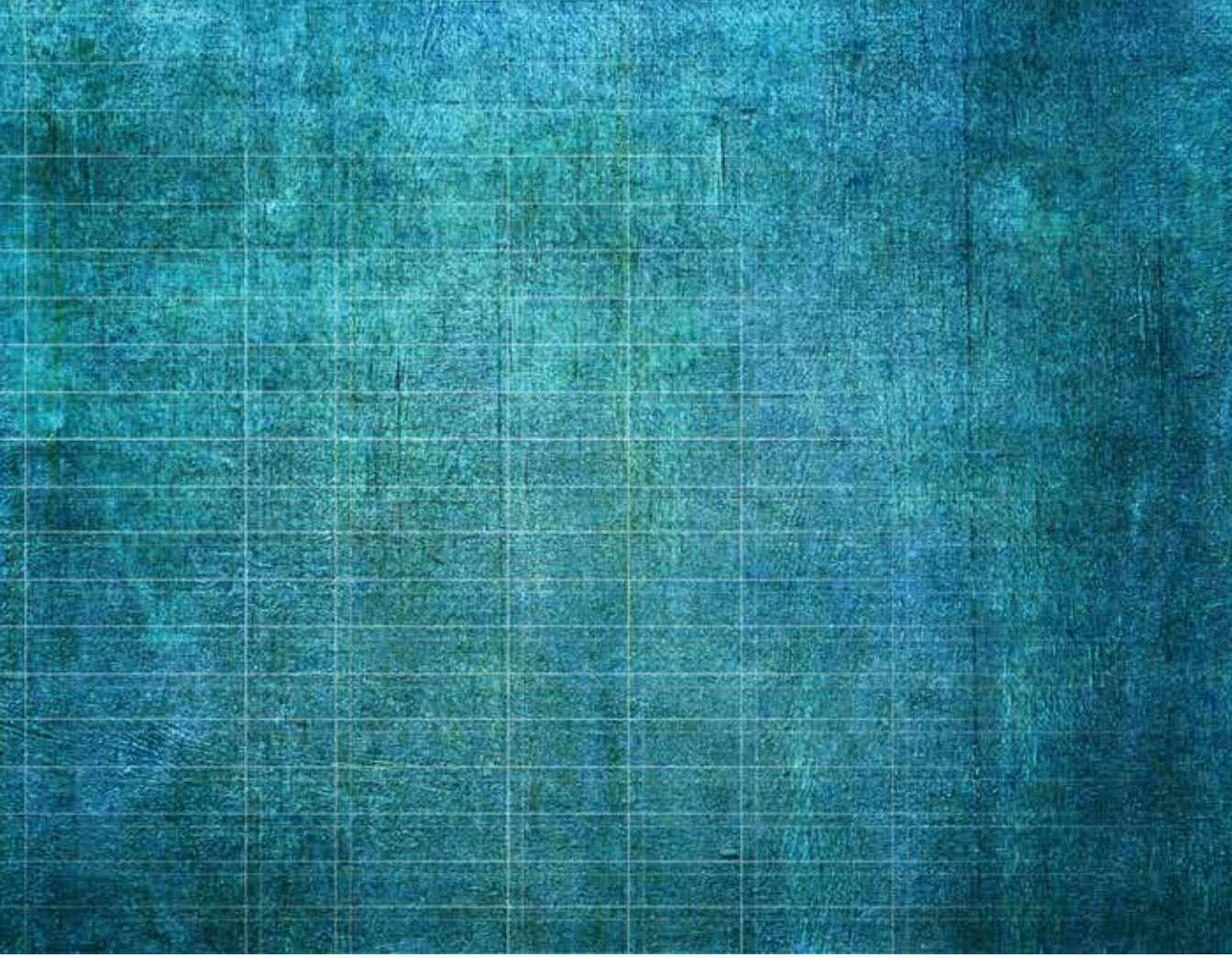
If the PCAOB is not satisfied with a firm's remediation, it will publish on its website the portion of the inspection report that discusses the quality control criticism that has not been satisfactorily remediated. Determinations regarding whether a firm has satisfactorily remediated quality control deficiencies described in an inspection report are made by majority vote of the PCAOB Board.

A PCAOB determination that a firm has not remediated to the PCAOB's satisfaction can be reviewed by the SEC. If the firm seeks SEC review, disclosure of Part II is delayed until the review is completed. The PCAOB's website includes a list of firms that have had Part II of their inspection reports published.



Promoting Investor Confidence

Investors can take comfort from the fact that audit firms are subject to rigorous and regular PCAOB inspections. The PCAOB's review of audit engagements and of firm quality control systems has a significant influence on audit quality. While some of the PCAOB inspection process is nonpublic, understanding the objectives and processes underlying the PCAOB's inspections program is an important step in promoting investor confidence in the integrity of audited financial statements of public companies.



ABOUT THE CAQ

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. The CAQ is based in Washington, D.C. and is affiliated with the American Institute of Certified Public Accountants.





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