

LEARN FROM PCAOB INSPECTION REPORTS

Your Prescription for Better Audits

Fourth Edition

A learning experience from



GAAP
Dynamics

Foreword BY ADIGEO CONSULTING

While it can be one of the most stressful times in an auditor's career, engagement inspections are a valuable part of how the PCAOB carries out its mission. As noted throughout this eBook, inspections have identified several deficiencies in the audits of public companies. The PCAOB and its inspectors use the results of its inspections to drive firms and their audit professionals to improve in all aspects of how they perform audits. Firms have made significant improvements in their methodologies and their systems of quality control in the last 15 years. Many of these improvements have come from firms performing a robust root cause analysis of the underlying reasons for deficiencies, which has led to meaningful changes in how they approach their top-down risk-based audits. We are proud to have been a part of that progress in the 14 years that we were leaders in the Inspection Division at the PCAOB.

For the first time since its inception, the PCAOB has five new board members. Through their speeches and communications, the Board has expressed a renewed focus on evaluating firms'

systems of quality control through the inspections process. While this has always been a part of the inspection of a firm, an increased focus on a firm's system of quality control will also mean that there will be an increased expectation of the role an effective system of quality control will play in performing quality audits. We applaud the board on this initiative and look forward to hearing from them all the areas of best practices they have determined. Even with this new focus, you should still expect inspectors to dig deep into your audit work papers – which is why understanding the deficiencies discussed in this eBook will continue to be part of the auditor's journey toward improving audit quality.

ADIGEO Consulting is proud to partner with GAAP Dynamics in providing our insights to the key areas discussed in this eBook. It allows us to use our experience from years of leading PCAOB inspections and initiatives to help auditors improve and to continue our focus on improving audit quality.



Preface

What do trust and confidence have to do with our nation's securities markets? Well, everything! Confidence in public company financial reporting is essential to the strength and vitality of these markets. William Duhnke eloquently explained that "the underlying assumption of a well-functioning capital market is trust. When companies report their results, investors expect and deserve to rely on the completeness and accuracy of an issuer's financial statements. An informative, accurate, and independent audit report provides the basis for an investor's confidence in those statements."

He should know. He is the chairman of the Public Company Accounting Oversight Board ("PCAOB" or "the Board"), the "watchdog" of the external auditors of SEC registrants. 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.

*Trust us;
with this kind of power
and authority, you do
not want to be on their
"naughty list!"*

The PCAOB began operations in April 2003 and has four main responsibilities:

- 1 Register public accounting firms that audit public companies or broker-dealers;
- 2 Inspect registered public accounting firms;
- 3 Set standards for the audits of public companies and broker-dealers; and
- 4 Investigate and discipline auditors that violate certain provisions of the securities laws or applicable standards or rules.



This eBook focuses on PCAOB inspections. These inspections identify deficiencies in how accounting firms perform their audits and detect weaknesses in quality controls over their audits of public companies. Some deficiencies are deemed so significant that the audit firm did not obtain sufficient appropriate audit evidence at the time it issued its audit report to support its opinion that:

- The financial statements were presented fairly, in all material respects, in accordance with the applicable reporting framework
- The issuer had maintained, in all material respects, effective internal control over financial reporting ("ICFR")

The PCAOB takes a risk-based approach in selecting engagements for inspection, and you can bet that it will continue to focus on areas it believes to be the highest risk. You do not need a doctorate to figure out that the Board will continue to pummel audit firms in the areas where they've made mistakes in the past.

PCAOB inspection reports describe audit deficiencies noted during inspections of accounting firms and are made public for all to see!

"Those who do not remember the past are condemned to repeat it."

George Santayana wrote this quote in his book, *The Life of Reason*, in 1905. Here we are, over 100 years later, and audit firms would be wise to heed his words!

We published this eBook to help auditors:

- Learn from findings in recent PCAOB inspection reports,
- Improve audit training,
- Prevent recurring audit deficiencies, and
- Strengthen the quality of their audits.

Table of Contents

pg. 1	Front Cover
pg. 2	Foreword
pg. 3	Preface
Ch 1 pg. 6	Executive Summary: A Diagnosis of PCAOB Inspection Reports
Ch 2 pg. 8	Give It To Me Straight, Doc! Audit Deficiency Statistics
Ch 3 pg. 13	Get a Shot in the AS 5: Internal Control Over Financial Reporting
Ch 4 pg. 19	Not Enough Meat on the Bone: Risk Assessment Standards
Ch 5 pg. 25	Beware the Placebo of (Only) Inquiry: Accounting Estimates
Ch 6 pg. 30	Warning! Assumptions May Cause Unintended Side Effects: Fair Value Measurements and Disclosures
Ch 7 pg. 35	Premature Extrapolation: Audit Sampling
Ch 8 pg. 40	Follow-Up Visit: Results from Most Recent PCAOB Inspections
Ch 9 pg. 44	It's Time for A Check-Up: Issues Inspecting Foreign Firms in Certain Locations
Ch 10 pg. 47	Our Prescription: Alleviate the Pain of Inspection Findings
pg. 49	About the Authors
pg. 50	About GAAP Dynamics
pg. 51	About ADIGEO Consulting
pg. 52	Sources
pg. 53	Footnotes
pg. 54	Contact Us

Executive Summary

A Diagnosis of PCAOB Inspection Reports

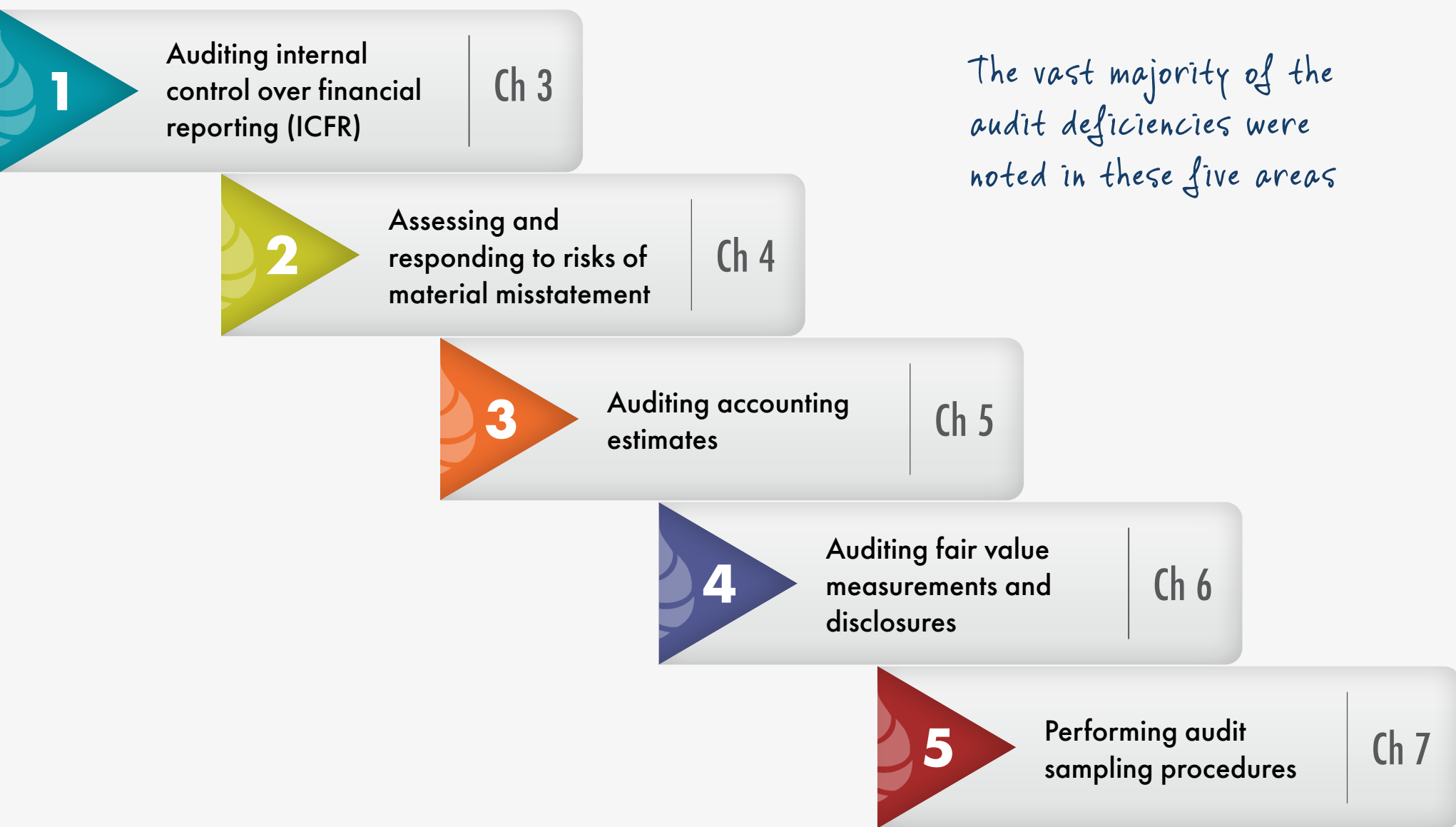


This statement sounds alarming, but it is accurate based on our in-depth analysis of the PCAOB inspection reports of annually inspected firms over the past eight inspection cycles (2010-2017).

Our analysis of the 11 annually inspected firms' 2017 inspection reports ([Chapter 2](#)) shows:

- The combined audit deficiency rate is 31%, a level that has remained steady for three years.
- The difference between combined audit deficiencies of Big 4 firms (31%) as compared to other annually inspected firms (30%) represents a shift – as historically Big 4 firms have had a significantly lower deficiency rate than other annually inspected firms.
- The lowest audit deficiency rate of the annually inspected firms was 13%! The highest was 73%.
- Unfortunately, the types of audit deficiencies noted remain unchanged.

Note: See [Chapter 8](#) for results from 2018 received thus far.



In [Chapter 8](#), we talk about the results of the 2018 inspections received thus far. Good news! The PCAOB has noted a decrease in the number of audit deficiencies in most of the annually inspected firms. However, the causes of the deficiencies remains unchanged.

The PCAOB also inspects non-U.S. firms and, to date, the PCAOB has inspected firms in 50 non-U.S. jurisdictions. However, as we discuss in [Chapter 9](#), there are still certain locations where PCAOB inspections cannot take place for various reasons.

In the final chapter ([Chapter 10](#)), we discuss treatment options firms can take now to improve the quality of their audit training and, ultimately, the quality of their audits.

Without further ado, we present the fourth edition of our PCAOB eBook!

