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REPORT ON THE PCAOB'S 2004, 2005, AND 2006 INSPECTIONS OF DOMESTIC TRIENNIALLY INSPECTED FIRMS[1/]	PCAOB Release No. 2007-010 October 22, 2007

Overview

This report discusses observations identified in the course of the Board's 2004, 2005, and 2006 inspections of registered U.S. firms that were subject to triennial Board inspections ("triennial firms").[2/] This report discusses areas of the audit where PCAOB inspectors have observed significant or frequent deficiencies in the first PCAOB inspections of triennial firms. The descriptions are included in this report in order to alert triennial firms to areas where they could improve performance and to inform the public about certain inspections findings for triennial firms over the past three years.

[1/] Information received or prepared by the Board in connection with any inspection of a registered public accounting firm is subject to certain confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Sarbanes-Oxley Act of 2002 ("the Act"). Under the Board's Rule 4010, however, the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such report may identify the firm or firms to which any quality control criticisms in the report relate.

[2/] Under the Act and Board rules, registered public accounting firms that audit no more than 100 issuers are subject to inspections at least once in every three calendar years. These firms will be referred to as either "the triennial firms" or simply "firms" throughout the remainder of this report. The Board's observations in this report regarding these U.S. triennial firms are based on information obtained in the course of 91 inspections of such firms during its 2004 inspection cycle, 257 inspections during its 2005 inspection cycle, and 149 inspections during its 2006 cycle. To date, 439 reports have been issued based on these 497 inspections.

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Background

Between 2004 and 2006, the PCAOB performed 497 inspections of U.S. triennial firms.[3/] Like the smaller public companies that they audit, triennial firms are located throughout the country and vary significantly in size. These firms range from multi-office firms with a centralized quality control function to single-office firms with only one CPA. Some of these firms audit a substantial number of issuers,[4/] while others audit only one issuer.[5/] To inspect these firms, the PCAOB uses inspection teams based in each of its eight regional offices.[6/]

As a group, the triennial firms audit thousands of public companies and employ thousands of CPAs. They audit companies of varying sizes, from young, small public companies to those with considerable operations.

The results of the PCAOB inspections have varied as widely as do the characteristics of the firms themselves. Of the 439 reports on the first inspections of U.S. triennial firms issued to date, 124 (approximately 28 percent) did not identify any

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[3/] As of the end of 2003, 735 firms had registered with the PCAOB. The number of registered firms has increased since then: 1423 firms (including 893 domestic firms) were registered at the end of 2004, 1591 firms (including 945 domestic firms) were registered at the end of 2005, and 1738 firms (including 986 domestic firms) were registered at the end of 2006. As of the end of the third quarter of 2007, 1805 firms (including 987 domestic firms) were registered with the PCAOB. Of the domestic registered firms, roughly 65 percent were subject to triennial inspection because they had issued an audit report on an issuer since registration with the PCAOB.

[4/] The term "issuer" encompasses, in general, public companies, investment companies, and certain employee benefit plans. The precise definition of "issuer" can be found in section 2(a)(7) of the Act.

[5/] Of the domestic firms inspected from 2004 through 2006, approximately four percent had from 51 through 100 issuer audit clients, six percent had from 26 through 50 issuer audit clients, 27 percent had from six through 25 issuer audit clients, and 62 percent had five or fewer issuer audit clients.

[6/] The Board has offices in Atlanta, Chicago, Dallas, Denver, New York City, Orange County, San Mateo, and Washington, D.C.

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audit performance deficiencies[7/] or concerns about potential defects in the firm's quality control system. Sixty-seven (approximately 15 percent) identified concerns about potential defects in the firm's quality control system, some of which are discussed below, but did not identify any audit performance deficiencies. The remaining reports identified audit performance issues ranging from a single audit deficiency to multiple, serious deficiencies in one or more audits, as well as criticisms of, or concerns about potential defects in, the firm's quality control system.[8/]

The Board has observed that the majority of triennial firms appreciate the formal and informal feedback they receive during the inspection process and are taking steps to improve the quality of their audits. In general, firms have been cooperative with the PCAOB inspections staff and have worked to address quality control defects described in inspection reports during the 12-month remediation period.[9/] Nevertheless, the Board has identified significant areas where firms should particularly strive to ensure that they are in compliance with applicable standards and requirements. These areas are discussed below.

[7/] The reports typically identify and discuss as "audit performance deficiencies" or "audit deficiencies" only those deficiencies that, in the inspection team's judgment, resulted in the firm failing to obtain sufficient competent evidence to support its opinion on the financial statements.

[8/] In some cases, when an inspection team identifies serious deficiencies, the matter is referred to the Board's Division of Enforcement and Investigations for its consideration and action, as appropriate.

[9/] For additional information about the Board's quality control remediation process, see PCAOB Release No. 104-2006-077, *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports* (March 21, 2006).

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The Board's Observations[10/]

This report describes certain deficiencies[11/] that were in the public and the non-public portions of certain of the reports on the 2004, 2005, and 2006 inspections of triennial firms. Accordingly, this report includes observations that the Board has previously made public, as well as observations that have not been made public but that were communicated to the applicable firms in their reports' discussions of their quality control systems.

This report does not constitute a comprehensive list of all of the deficiencies described in the inspection reports on these firms. Rather, it includes descriptions of deficiencies that the Board views as warranting emphasis in a general public report. The inclusion of a deficiency should not be taken to mean that the inspection teams found this deficiency in all of their inspections, or even a majority of them. Accordingly, while the Board hopes that this report provides useful information regarding areas where firms can enhance the quality of their audits, the Board cautions against using this report to draw broad conclusions about the quality of audits performed by any of these firms. The total number of audits reviewed during 2004, 2005, and 2006, while substantial, constituted only a portion of the total audits of issuers performed by these firms, and the selection of audits for review was not, and was not intended to be, a representative sample of the audits that the firms performed. Further, a review of an audit generally encompasses only certain aspects of the firm's performance of that audit, which aspects were selected based on perceived risk and other factors.

[10/] This report does not discuss deficiencies related to firms' compliance with AU 316, *Consideration of Fraud in a Financial Statement Audit*. This topic was discussed in PCAOB Release No. 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (Jan. 22, 2007).

[11/] The discussion in this report of any audit deficiency reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether any firm engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. For additional discussion of this distinction, see PCAOB Release No. 104-2004-001, *Statement Concerning the Issuance of Inspection Reports* (Aug. 26, 2004) at 8-9.

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Revenue

In most audits, revenue is an important area of focus. Material misstatements due to fraudulent financial reporting often result from a misreporting of revenue. For this reason, auditors ordinarily should presume that there is a risk of material misstatement due to fraud relating to revenue recognition[12/] and thus should respond with appropriate audit procedures. This heightened sensitivity may be especially important in the audits of smaller public companies where investors may perceive revenue as a key indicator of the company's prospects, particularly in situations where the company has yet to earn significant income. Firms should evaluate whether clients are complying with the accounting requirements for recognizing revenue, in that they do not recognize revenue until (a) persuasive evidence of an arrangement exists, (b) delivery has occurred or services have been rendered, (c) the seller's price to the buyer is fixed or determinable, and (d) collectibility is reasonably assured.[13/]

Inspection teams have identified deficiencies relating to firms' testing of issuers' recognition of revenue, including the firms' failure to (a) perform any or adequate substantive procedures to test the existence, completeness, and valuation of revenue; (b) review representative contracts or appropriately evaluate the specific terms and provisions included in significant contractual arrangements; or (c) test whether revenue was recorded in the appropriate period. In several instances, firms relied on testing performed in other audit areas (*e.g.*, accounts receivable and inventory) for testing the assertions related to revenue, but the testing performed did not address, or did not address sufficiently, whether the issuer was recognizing revenue appropriately and in the correct period. In other instances, firms relied on management representations for important evidence regarding the appropriateness of revenue recognition without obtaining corroboration of those representations.

Firms auditing smaller issuers need to keep in mind that the evaluation and testing of revenue could be complex or could involve specialized revenue-recognition principles, even for smaller public companies. Inspection reports on certain firms have included the firms' failure to address specific accounting pronouncements regarding whether (a) the presentation of revenue on a gross versus net basis was in accordance with Emerging Issues Task Force Issue ("EITF") No. 99-19, *Reporting Revenue Gross*

[12/] AU 316.41.

[13/] See Codification of SEC Staff Accounting Bulletins, Topic 13, *Revenue Recognition*.

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as a Principal versus Net as an Agent; (b) the issuer's recognition of revenue was in compliance with Statement of Financial Accounting Standards ("SFAS") No. 45, *Accounting for Franchise Fee Revenue*; or (c) the issuer's recognition of revenue regarding software transactions was in compliance with Statement of Position 97-2, *Software Revenue Recognition,* as amended*.* Firms need to be mindful of situations where these or other industry-specific or specialized accounting principles apply and ensure that their analyses take into account the applicable accounting and auditing requirements.

Firms sometimes use substantive analytical procedures to test revenue. In planning an audit that uses this approach, firms need to keep in mind that, where significant risks of material misstatement exist, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.[14/] In instances where a firm decides to use an analytical procedure as a substantive test, the firm should (a) develop an expectation at a sufficient level of precision to provide the desired level of assurance,[15/] (b) consider the amount of difference from the expectation that can be accepted without further investigation, and (c) evaluate significant unexpected differences. When the auditor uses management's responses to the auditor's inquiries to evaluate significant unexpected differences, the auditor ordinarily should obtain other evidence to corroborate the responses.[16/]

If analytical procedures are not performed appropriately, they will not provide the desired level of assurance. Inspection teams have frequently identified deficiencies in firms' performance of substantive analytical procedures related to revenue accounts. The deficiencies included the failure to (a) develop appropriate expectations, including in some instances the failure to appropriately disaggregate data in order to obtain the necessary level of precision for the expectation, (b) establish the range of differences that could be accepted by the firm without further investigation, (c) investigate significant unexpected differences, (d) obtain corroboration of management's explanations regarding significant unexpected differences, and (e) test the reliability of the underlying data used in the analytical procedures.

[14/] AU 329.09.

[15/] "Level of assurance" is related to the audit evidence the auditor needs to reach a conclusion about the account or assertion being tested.

[16/] AU 329.21.

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Related Party Transactions

Auditors should be aware of the possible existence of material related party transactions that could affect the financial statements, as well as of possible common ownership or management control relationships that should be disclosed in accordance with the accounting requirements. Procedures to address possible related party transactions normally are performed even if the auditor does not suspect that related party transactions or control relationships exist. Further, auditors of newer or smaller companies should be aware of the possibility that transactions with related parties may be motivated by, among other things, lack of sufficient working capital or credit to continue the business, or dependence on a single or relatively few products, customers, or transactions. Auditors should perform procedures to identify the existence of related parties and to identify material transactions with known related parties or material transactions that may be indicative of the existence of related parties.[17/] Although related party transactions normally do not entail different accounting from that for arms' length transactions, auditors encountering related party transactions need to be mindful both of applicable disclosure requirements and of the fact that the substance of particular transactions could be significantly different from their form and that accounting principles require that financial statements should recognize the substance of particular transactions rather than merely their legal form.

Inspection teams have observed deficiencies related to firms' failures to identify and address the lack of disclosure of related party transactions. They also have identified deficiencies relating to the effectiveness of firms' testing of the nature, economic substance, and business purpose of transactions with related parties. For example, firms have failed to sufficiently test (a) the validity and classification of expenditures made by a controlling shareholder on behalf of an issuer, (b) the collectibility of receivables due from entities owned or controlled by officers of an issuer, (c) the validity and accuracy of payables owed to related parties, and (d) the appropriateness of the accounting for the extinguishment of a note receivable from an officer of an issuer.

[17/] Auditors also should be aware that certain transactions may raise the possibility of the involvement of related parties, such as borrowing or lending on an interest-free basis or at interest rates significantly above or below prevailing rates, selling real estate at a price that differs significantly from its appraised value, exchanging property for similar property in a non-monetary transaction, and making loans with no scheduled terms for repayment.

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Equity Transactions

Newer or smaller companies that face difficulties raising capital or accessing credit often use equity instruments to fund their operations. Firms auditing these issuers need to evaluate whether their clients comply with the applicable accounting principles in accounting for equity transactions. The inspection teams noted instances where firms failed to test, or insufficiently tested, the accounting for equity transactions, including evaluating the adequacy of the disclosure of these transactions in the notes to the financial statements. For example, firms failed to (a) perform an appropriate evaluation of the substance, business purpose, or significant terms of the arrangements in order to conclude whether the issuers' accounting and disclosures were in conformity with generally accepted accounting principles ("GAAP"), or (b) consider the accounting principles that potentially were applicable to those transactions, or failed to obtain evidence to evaluate whether the transactions were recorded in the proper period.

The most common deficiencies in this area related to the failure of firms to evaluate whether issuer clients had appropriately determined the fair values assigned to equity-based transactions. SFAS No. 123,[18/] *Accounting for Stock-Based Compensation* addresses the financial accounting and reporting for transactions where goods or services are the consideration received for the issuance of equity instruments. Among other things, that standard provides that equity-based transactions with nonemployees should be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable.

Inspection teams have identified numerous deficiencies that resulted from firms failing to test the reasonableness of the fair values assigned to equity-based transactions. In certain instances, the stock exchanged for services was valued at a price that was significantly lower than the price the issuer had obtained in recent cash sales of the stock, or equity instruments issued as consideration for the cancellation of outstanding debt were valued at the carrying values of the debt even though there was evidence that the equity instruments' market values exceeded those carrying values. In other instances, (a) the procedures to test the valuation of stock options and warrants issued as compensation for services were deficient because the firms failed to evaluate the appropriateness of the expected volatility factors that the issuers had used; or (b)

[18/] SFAS No. 123(R), *Share-Based Payment* was not yet effective for issuers' financial statements that were the subjects of the audits reviewed in the inspections covered by this report.

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the firms did not obtain objective evidence of the fair value of equity-based transactions, instead accepting the issuer's management's decision to use the amounts contained in contracts with third parties or the minutes of board of directors' meetings, or the par values of preferred stock, to record equity-based transactions.

Business Combinations and Impairment of Assets

The accounting requirements for business combinations, and related auditing considerations, often are important to auditors of newer or smaller issuers because these issuers frequently may engage in business combinations. In particular, auditors of smaller issuers may encounter situations where the stockholders of a nonpublic operating company exchange their stock for that of a shell public company with nominal assets and operations, often as a vehicle to become a publicly traded entity. In such a situation, the accounting treatment is determined by which entity is the accounting acquirer, regardless of the legal identity of the surviving entity. Under SFAS No. 141, *Business Combinations,* an important factor in designating the accounting acquirer is which of the former shareholder groups retained or received the larger portion of the voting rights of the combined entity. Transactions in which the entity designated as the accounting acquirer is not the legal acquirer are termed "reverse acquisitions."

Comparative historical financial statements filed after a reverse acquisition should be those of the accounting acquirer, with appropriate financial statement disclosure concerning the change in the capital structure that was effective at the acquisition date. The inspectors have identified instances where the auditors of issuers involved in reverse acquisitions failed to identify the accounting acquirer, instead following the legal form of the combination. In other instances, auditors of issuers involved in reverse acquisitions failed to identify that the issuer did not adhere to all of the applicable accounting and disclosure requirements.

When auditing any business combination, the auditor should determine whether the transaction was accounted for in accordance with GAAP, including whether (a) the value assigned to the transaction was appropriate; (b) the purchase price was allocated appropriately to the individual assets acquired (tangible and identifiable intangible, with any excess purchase price designated as goodwill) and liabilities assumed, ordinarily based on their fair values at the date of the acquisition; and (c) the transaction was disclosed properly in the footnotes to the financial statements, if disclosure is made or required.

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Inspection teams encountered numerous instances of firms' failure to perform adequate audit procedures to test the allocation of the purchase price and the reasonableness of the estimated fair values assigned to the assets acquired. The inspectors also identified instances where firms failed to challenge issuers' incorrect accounting, when (a) the issuer treated parties to a merger as entities under common control when some of the acquired entities did not meet the criteria to be treated as being under common control, (b) the issuer recorded an asset acquisition as a business combination, (c) the issuer recorded assets or liabilities in connection with a business combination even though the business combination was contingent on future events and the outcome of the contingency could not be determined beyond a reasonable doubt, (d) the issuer determined the purchase price of an acquired entity by assigning an arbitrary discount to the value of the restricted shares that were issued, or (e) the issuer recorded the value of a consulting agreement as part of the purchase price of an acquisition rather than as compensation expense in the subsequent periods when the consulting services were rendered.

The need to perform a valuation of intangible assets and other long-lived assets can be a consequence of a business combination, but can also arise in other circumstances. An intangible asset that is not subject to amortization, such as goodwill, needs to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired.[19/] Other long-lived assets or asset groups are tested for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable.[20/]

Inspection teams observed instances where firms' procedures to test and conclude on the valuation of goodwill and other long-lived assets (both tangible and intangible) were inadequate. The inspectors observed instances where firms had not challenged managements' assertions that asset values were not impaired, despite evidence of impairment indicators, such as recurring losses and declining revenue prospects. Inspection teams also observed instances where firms had not tested the reasonableness of managements' significant assumptions and underlying data used to assess the recoverability of assets. In other instances, issuers calculated impairment

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[19/] Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets.*

[20/] SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.*

charges, but the firms failed to test the rationale for the charges and the analyses supporting the values of the assets.

Going Concern Considerations

Auditors have a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern.[21/] This may be especially important for auditors of smaller or newer public companies with limited operations and limited access to credit or capital because such companies can be susceptible to events or conditions giving rise to a going concern uncertainty. Auditors should consider such conditions or events and, if the auditor believes there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time (not to exceed one year from the date of the financial statements being audited), the auditor should consider management's plans for dealing with the adverse effects of the conditions and events causing such doubt. In instances where the auditor concludes, after considering management's plans, that there is substantial doubt about an entity's ability to continue as a going concern, the audit report should include an explanatory paragraph to reflect that conclusion.

The inspection teams observed that some firms failed to perform, or to perform adequately, one or more of the aforementioned audit procedures. Some of these firms failed to identify or evaluate the significance of conditions that indicated an entity may not have been able to continue as a going concern, such as cumulative losses since inception, accumulated capital deficits, and negative working capital. Other firms identified conditions that could affect the issuer's ability to continue as a going concern, but failed to evaluate management's plans to mitigate the effects of such conditions, or failed to obtain information about the likelihood that such plans could be implemented effectively. In addition, some firms failed to evaluate the adequacy of an entity's disclosure of the going concern conditions and managements' plans to mitigate them.

Loans and Accounts Receivable (including allowance accounts)

AU 330, *The Confirmation Process* provides direction on the use and evaluation of confirmation requests. For example, the standard establishes a presumption that the

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[21/] AU 341.02.

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auditor will confirm accounts receivable unless certain conditions are present.[22/] If the auditor determines that confirmations are not required or concludes that the evidence provided by confirmations alone would not be sufficient, the auditor should perform other substantive audit procedures, such as examining subsequent cash collections or relevant documentation of the transactions giving rise to the receivables. In some cases the inspection teams noted that firms failed to circulate requests for confirmation or obtain other evidence to assess the existence of accounts receivable. In other instances, firms circulated confirmation requests, but did not perform any, or did not perform sufficient, alternative procedures to address non-responses or responses with exceptions.

The inspection teams also observed instances where firms' audit procedures to test the allowances for doubtful accounts or loan losses were deficient. To audit such an estimate, a firm should perform one or a combination of the following: (a) review and test the process used by management to develop the estimate, (b) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate, or (c) review subsequent events or transactions occurring prior to the completion of fieldwork that may confirm or negate the reasonableness of management's estimate.

Inspectors identified instances where firms failed to perform sufficient procedures to conclude whether the allowance for loan losses was reasonable. Some of the deficiencies involved failures to adequately review and test the process that management had used to develop the allowance in situations where the firm involved had selected that method to audit the allowance. For example, firms failed to (a) obtain an understanding of the methodology management had used to develop the allowance, (b) test the reasonableness of management's key assumptions, or (c) test the accuracy of the data underlying management's calculation of the allowance. In other instances, firms developed independent expectations of the allowance for loan losses, but either relied on outdated appraisals of the property securing the loans or failed to evaluate the difference between the firm's expectation and the issuer's recorded balance. Finally, several firms failed to perform any procedures to test the allowance for loan losses.

The inspection teams also observed deficiencies related to the auditor's evaluation of management's estimate of the allowance for doubtful accounts. Inspection

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[22/] The auditor who does not request confirmations of accounts receivable should document how he or she overcame this presumption.

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teams observed instances where firms failed to (a) obtain an understanding of management's evaluation of the collectibility of accounts receivable, (b) evaluate differences between management's estimates and the firm's expectations, (c) assess the appropriateness of the percentages that management had applied to the aging categories, or (d) evaluate the completeness and accuracy of the information in the aging reports that management had used when calculating the allowance.

Service Organizations

Issuers in many industries use outside service organizations to process payroll or other routine transactions. The use of these outside servicers is particularly extensive for certain types of issuers, such as employee benefit plans and depository institutions. When an issuer uses the services of a service organization as part of its information system related to financial reporting, the auditor should consider the effects of the use of the service organization on the issuer's internal control when assessing control risk.[23/] In order for an auditor to reduce the assessed level of control risk below the maximum in such situations, the auditor should do one or more of the following: (a) test the issuer's controls ("user controls") over the activities of the service organization; (b) obtain a service auditor's report on the operating effectiveness of controls placed in operation at the service organization or a report on the application of agreed-upon procedures that describes the relevant tests of controls; or (c) test controls at the service organization.

The inspection teams observed deficiencies related to firms' reliance on controls over the information provided by service organizations as well as firms' use of information produced or processed by service organizations. These deficiencies included the failure (a) to perform any of the procedures listed in the preceding paragraph, or to test the reports or data, when relying on reports produced or data processed by service organizations, (b) to assess the operating effectiveness of the user controls identified in the service auditor's report as necessary to rely on the controls over the information processed by the service organization, or (c) to obtain evidence about the operating effectiveness of controls placed in operation at the service organization when the service auditor's report did not address the operating effectiveness of the controls. The deficiencies also included instances where firms relied on controls at service organizations and obtained service auditors' reports on those controls, but those reports did not cover a significant portion of the period of

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[23/] See AU 324.03-.21.

reliance and the firms failed to perform procedures regarding the service organizations' controls during the period not covered by the reports.

Use of Other Auditors

Firms with a few offices or, in some cases, a single office, may encounter the need to consider using the work of another auditor. This situation may arise as a result of a merger of an issuer client with a company with operations in distant locations, or following the expansion of an issuer client either domestically or internationally. If significant parts of the audit are performed by other auditors, the firm must determine whether its own participation is sufficient to enable it to serve as the principal auditor.[24/] A firm should consider, among other things, the materiality of the portion of the financial statements that it has audited in comparison with the portion audited by other auditors, the extent of the firm's knowledge of the overall financial statements, and the importance of the components the firm audited in relation to the enterprise as a whole.

In some instances involving the use of other auditors, the firm takes the position that the other auditors are acting as its own assistants. In such a circumstance, the firm assumes responsibility for the other auditors' work. Whether a firm uses its own employees or other auditors as its assistants, the firm's own involvement in the planning, supervision, review, and addressing of significant audit areas must be sufficient to meet PCAOB standards.

The inspection teams reported several deficiencies regarding the use of other auditors. These deficiencies included (a) firms' reporting on the financial statements as the principal auditor when their participation was not sufficient to enable them to serve in that capacity, and (b) insufficient planning, supervision, review, and addressing of significant audit areas by the firms when other auditors were used as assistants.

Use of the Work of Specialists

As companies grow or evolve, they may increasingly become involved in specialized areas or transactions, and the auditors of those issuers may increasingly encounter more subjective matters that potentially are material to the issuers' financial statements. Under these circumstances, auditors may determine that such matters require special skill or knowledge in a field other than accounting or auditing, such as

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[24/] AU 543.02.

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that of an actuary, appraiser, engineer, environmental consultant, or geologist. The auditor may seek to use the work of a specialist either that it engages for the specific purpose or that has been engaged by the issuer's management. In either case, in order for the firm to use the work of the specialist, the firm should, among other things, evaluate the professional qualifications of the specialist to determine whether the specialist possesses the necessary skill or knowledge in the particular field.[25/] The firm also should evaluate the relationship of the specialist to the issuer, including circumstances that might impair the specialist's objectivity.[26/] In addition, the firm should obtain an understanding of the methods and assumptions used by the specialist, make appropriate tests of the data the issuer provided to the specialist, and evaluate whether the specialist's findings support the related assertions in the financial statements.[27/] These procedures are a precondition to the auditor's use of the work of a specialist as audit evidence and should not be minimized out of any sense of deference to the specialist's expertise.

Inspectors have observed instances where firms have failed to perform the necessary procedures, including (a) the failure to evaluate the relationship of the specialist to the issuer in circumstances where the specialist has other business relationships with the issuer or otherwise has a relationship that may have a bearing on the specialist's objectivity; (b) the failure to obtain an understanding of the specialist's methods and assumptions; or (c) the failure to make appropriate tests of the data the issuer provided to the specialist.

Independence

The independence of the external auditor plays an important role in fostering high quality audits and promoting investor confidence in the financial statements of public companies. Consistent with its recognition of the importance of the independence of external auditors, the PCAOB reviews various aspects of firms' compliance with the independence requirements of the Securities and Exchange Commission ("SEC") and the Board. Inspection teams have identified several ways in which firms have failed to comply with those requirements.

25/ AU 336.08.

26/ AU 336.10.

27/ AU 336.12.

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Prohibited Non-Audit Services

The most common deficiency noted in the independence area involves preparation of an issuer's financial statements and related footnotes. Under the SEC's rules, an auditor is not independent of its audit client if the auditor maintains or prepares the audit client's accounting records, prepares source data underlying the audit client's financial statements, or prepares the audit client's financial statements that are filed with the SEC.[28/] Even when dealing with inexperienced accounting personnel in small public companies, auditors cannot provide these prohibited non-audit services to these issuer audit clients. In some cases, the deficiency consisted of the preparation of a portion of the issuer's financial statements (such as the statement of cash flows) or of the statements or disclosures in a single, specialized area (such as the income tax provision and the related deferred tax asset and liability balances). Even these more limited preparation services impair the firm's independence. Other identified deficiencies include instances in which firms provided bookkeeping services by, for example, maintaining the trial balance or the fixed asset subledger, classifying expenditures in the general ledger, preparing the consolidating schedules, or preparing and posting journal entries to record transactions or the results of calculations. In other instances, firms prepared source data underlying their issuer audit client's financial statements by, for example, determining the fair values assigned to intangible assets acquired in a business combination or to stock options and warrants, or calculating depreciation expense and accumulated depreciation.

Indemnification

Under the SEC's independence requirements, agreements between an auditor and its issuer audit client that provide certain types of limits on the auditor's potential liability impair the auditor's independence.[29/] For example, if an issuer audit client agrees to release, indemnify, and hold harmless its audit firm and the firm's personnel from liability arising out of knowing misrepresentations by management, the audit firm's independence is impaired. The SEC has noted that such limitations remove or greatly

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28/ 17 C.F.R. § 210.2-01(c)(4)(i).

29/ See Codification of Financial Reporting Policies, § 602.02.f.i. See also Application of the Commission's Rules on Auditor Independence (guidance from the Commission's Office of Chief Accountant) (December 13, 2004), Question 4 under "Other Matters." www.sec.gov/info/accountants/ocafaqaudind121304.htm.

weaken one of the major stimuli to objective and unbiased consideration of the problems encountered in the engagement, and that the existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed.[30/] Inspection teams observed several instances where firms had entered into such agreements with their issuer audit clients.

Firm Independence Policies and Procedures and Independence Confirmation with Audit Committees

PCAOB Rule 3400T(b) requires registered firms to comply with certain quality control standards, including having policies and procedures in place to comply with applicable independence standards.[31/] The inspection teams have observed instances where firms failed to comply with applicable requirements for independence policies and procedures. Deficiencies included (a) a lack of, or incomplete or inadequate, policies and procedures for the confirmation by firm personnel of compliance with the firm's independence policies; (b) a lack of procedures to verify the accuracy and completeness of information submitted by firm partners and managers regarding personal investments and other independence-related matters; (c) a failure to maintain updated lists of issuer audit clients from which the firm is required to be independent; and (d) a lack of an independence training program for firm personnel.

PCAOB Rule 3600T(b) requires registered firms to comply with certain independence standards, including Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*. Under that standard, the firm should at least annually: (a) discuss its independence with each issuer client's audit committee; (b) disclose in writing to the issuer's audit committee all relationships between the firm and its client (and their related entities) that, in the firm's professional judgment, may reasonably be thought to bear on independence; and (c) confirm in writing that, in the firm's professional judgment, it is independent of the issuer within the meaning of the securities laws Inspection teams encountered many instances where a firm's system of

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[30/] See Codification of Financial Reporting Policies, § 602.02.f.i (SEC staff interpretation).

[31/] Firms that were not members of the AICPA's SEC Practice Section are not subject to all of the interim quality control standards, including certain of the standards related to independence policies and procedures such as the ones discussed in this paragraph. The Board nonetheless encourages all registered firms to consider adopting such policies and procedures.

quality control did not appear to provide sufficient assurances that the firm would make or document all the required independence communications to its issuer audit client's audit committee.

Concurring Partner Review

While there may be many causes of the deficiencies identified above, including in some cases multiple factors contributing to a single deficiency, a recurrent contributing factor is the failure by some firms to ensure that their concurring partner reviews are effective. Such reviews should involve the performance of procedures as set forth in PCAOB standards.[32/] The responsibilities of the concurring partner should be carried out with objectivity and the application of due care, with the firm appropriately addressing the reviewer's findings before issuing the audit report.[33/] In some instances observed by inspection teams, the concurring partner did not have the appropriate level of expertise and experience. In other instances, the timing of the review (for example, after the issuance of the audit report) limited or negated its effectiveness. In other situations, there were apparent deficiencies in the documentation, which prevented a determination as to whether the scope of the review was appropriate, and which also may have contributed to the firm's failure to properly address the concurring partner's findings.

As concurring partner reviews are an important element of quality control, firms should ensure that they are allocating appropriate resources to the performance of effective concurring partner reviews. Firms should evaluate the scope of the review to assess its adequacy and should emphasize the need to conduct the review with objectivity and due care. Firms also need to ensure that they are selecting competent reviewers to perform the concurring partner reviews and, if necessary, a firm should

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[32/] Although firms that were not members of the AICPA's SEC Practice Section are not subject to the concurring partner review requirements included in the Board's interim standards, the Board nevertheless encourages these firms to obtain a concurring partner review as such a review can play an important role in ensuring that an audit is performed in accordance with PCAOB standards.

[33/] See PCAOB Rule 3400T(b) *Interim Quality Control Standards* (requiring compliance with the provisions of AICPA Practice Section Manual § 1000.08(f), as in existence on April 16, 2003).

consider engaging as the concurring partner an accountant who is not affiliated with the firm if the firm does not have a qualified individual with the appropriate level of expertise and experience to perform an effective review.

Conclusion

The Board has issued this report to highlight areas where firms can focus their attention in order to enhance the quality of their audits. Firms, however, should not assume that these are the only areas requiring attention; each firm should, in the course of monitoring its own audit performance, identify and address any specific impediments to compliance with PCAOB standards. Firms also should continually stress the critical need to conduct all aspects of issuer audits with due care and professional skepticism. The Board expects all firms to strive for a high level of audit quality.

Since Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits, this report necessarily focuses on areas where improvement can occur. In fact, many triennial firms have informed the Board's inspection staff that they have instituted improvements to their audit processes after dialog with PCAOB inspectors. Many of these firms have taken steps to address findings related to quality control deficiencies during the 12-month remediation period following the issuance of their inspection reports.[34/] Those firms have provided evidence that they have, for example:

- improved their methodologies, including audit programs and practice aids;
- arranged for annual technical training for personnel performing audits, including enhancing the training that is available to all personnel so that they are in a better position to attain and maintain a high level of technical competence and familiarity with SEC rules and regulations, PCAOB auditing standards, accounting standards, independence requirements, and specialized industry guidance;

[34/] As the Board has discussed elsewhere, the question that the Board addresses in considering a firm's remediation efforts is not whether a firm has completely and permanently cured any particular quality control defect but, rather, is whether the firm has demonstrated substantial, good faith progress toward achieving the relevant quality control objectives, sufficient to merit the result, under Section 104(g)(2) of the Act, that the relevant criticisms in the Board's inspection report remain nonpublic. See PCAOB Release No. 104-2006-077 (cited above at note 9).

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- improved the availability of appropriate technical resources, such as publications and research materials;
- encouraged or required personnel working on the audits of issuers to make appropriate use of external resources; and
- enhanced their own internal monitoring of audit performance.

The Board's inspection staff will assess the effects that these changes have had on the respective audit quality of triennial firms when it performs the second inspections of these firms, and the Board will issue further reports describing results of those efforts as soon thereafter as practicable.