PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SPOTLIGHT

Observations From the Target Team's 2021 Inspections

August 2022

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OVERVIEW

The PCAOB's Division of Registration and Inspections includes a target team consisting of inspectors who focus on emerging audit risks and topics that staff believes could have important implications for audits performed by the firms we inspect.

The target team executes in-depth reviews across audit firms using information-gathering inspection procedures that extend beyond traditional inspection procedures. This inspection approach has enabled us to (1) develop observations across audit firms, (2) provide timely insights to inspected audit firms, and (3) inform and shape our future inspection focus areas.

The results of the target team's procedures, as well as the good practices and improvement opportunities identified during those procedures, are communicated to the inspected audit firms. Any deficiencies identified by the target team that resulted in a comment form being issued to the audit firm may be included in that audit firm's Inspection Report.

In its first year, 2019, the target team completed tailored procedures on audit work related to multi-location audits and referred work inbound to U.S. audit firms. In 2020, the target team focused on audit firms' quarterly reviews of interim financial information, as well as inspections of off calendar year end financial statement audits, to understand how audit firms' procedures were impacted by the COVID-19 pandemic.

This Spotlight provides investors and other stakeholders a view into the target team's work in 2021, including perspectives on the auditor's responsibilities, observations (which may include deficiencies that resulted in the issuance of comment forms), and good practices. The Spotlight is organized by the target team's four core focus areas for 2021 (1) fraud, (2) interim reviews of special purpose acquisition companies (SPACs), (3) going concern, and (4) cash and cash equivalents.

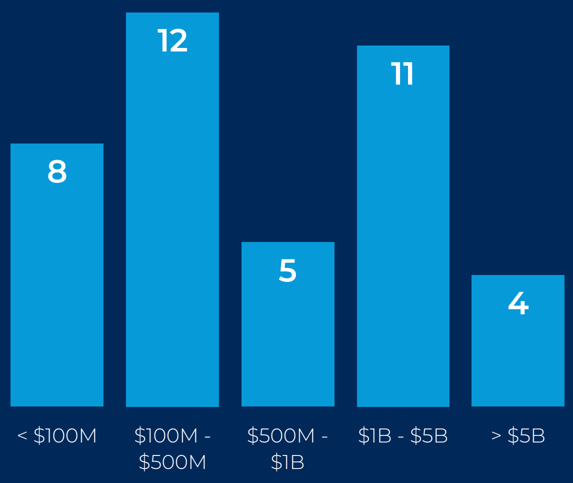
PCAOB Target Team in 2021: Audits

In 2021, the target team reviewed 40 audits of public companies across the following industry sectors (number of each industry sector reviewed):

- Industrials (7)
- Healthcare (4)
- Energy (4)
- Real Estate (2)
- Materials (3)
- Communication services (3)
- Information technology (2)
- Consumer staples (3)
- Consumer discretionary (12)

Number of audits reviewed by market capitalization of the public companies:

Total Market Cap (USD)



FOCUS AREAS FOR THE TARGET TEAM IN 2021

Fraud

The audit team's response to the risk of fraud was a key area of focus for every audit the target team reviewed in 2021, given the potential increased risk of fraudulent financial reporting due to the current economic environment. This risk may manifest, for example, in management's use of more aggressive assumptions and estimates, improper revenue recognition, and/or misleading disclosures.

Auditor's Responsibility

1. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. AS 2401, *Consideration of Fraud in a Financial Statement Audit*, in addition to other standards, establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements.
2. The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.
3. AS 2401 provides, among others, the following examples of auditors' responses via the nature, timing, and extent of audit procedures to assessed fraud risks:
   a. Performing procedures at locations on a surprise or unannounced basis (e.g., unpredictability).
   b. Making oral inquiries of major customers and suppliers in addition to sending written confirmations or sending confirmation requests to a specific party within an organization.
   c. Performing substantive analytical procedures with disaggregated data that are designed to be specifically responsive to the identified fraud risk, in addition to the tests of details.
   d. Interviewing personnel involved in activities in areas in which a fraud risk has been identified to obtain their insights about the risk and how controls address the risk.

Observations

Generally, in the 2020 fiscal year-end audits, our target team observed instances where professional skepticism was demonstrated by auditors in designing thoughtful responses to the increased fraud risk. However, we observed audits where the engagement team did not:

1. Perform sufficient procedures to understand the public company's whistleblower program when it was a key component of their audit response to fraud, including how tips are received, escalated, and resolved; or
2. Consider the factors, with due professional care, relevant to the particular public company when identifying and selecting journal entries for testing and in performing other fraud procedures, particularly when contradictory documentation existed in other parts of the work papers; or
3. Document sufficiently their assessment and evaluation factors related to:
   a. The basis for the criteria used to select journal entries for testing, including their system source.
   b. Procedures performed over journal entries selected for testing.
   c. Procedures performed to understand individuals who can initiate entries to the general ledger.
   d. Procedures performed to understand the journal entry approval process.
   e. Considerations for revised risk assessments.

Good Practices

Through the target team's inspections, we observed the following additional procedures performed in response to perceived heightened fraud risks that we believe may have enhanced audit quality in those particular circumstances:

1. **Incorporating additional procedures** — An engagement team attempted to identify potential related party transactions by querying a database of companies registered as businesses in a particular state to determine if any other businesses were associated with the company's employees. The engagement team then compared any identified companies associated with the company's employees to the company's check register and vendor list to identify related party transactions.

2. **Expanding fraud inquiries** — An engagement team expanded inquiries to include 20 questions addressing a particular company's specific facts and circumstances. The inquiries included open-ended questions on the interviewees' views on the financial reporting process, vendor relationships, the public company's internal compliance policy, interactions with immediate supervisors, and the impact of COVID-19 on controls and/or resources.

3. **Use of forensic staff** — Many audit firms implemented a new requirement to involve the audit firm's forensic staff in the engagement team's fraud risk-assessment procedures for all public company audits in the consumer discretionary sector (e.g., retail, lodging, etc.) with a perceived fraud risk related to revenue recognition.

Interim Reviews of SPACs and De-SPACs

In the recent economic environment, there have been increased levels of initial public offerings (IPOs) and merger and acquisition (M&A) activities, including transactions with special purpose acquisition companies (SPACs). The target team sought to gain an understanding of the emerging risks related to SPACs through inspection of interim reviews of those companies' quarterly financial information. The target team focused on audit firms' interim reviews of certain financial statement accounts and/or assertions for SPACs and de-SPAC transactions such as (1) accounting treatment and valuation of warrants, (2) accounting treatment for reverse mergers, (3) interim financial statement presentation and disclosures, and (4) restatements related to redeemable shares, warrants, and other related accounts.

Auditor's Responsibility

1. The objective of a review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles (GAAP). AS 4105, *Reviews of Interim Financial Information*, provides guidance on the application of the field work and reporting standards to a review of interim financial information.

2. A review consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters and performing other review procedures, including:

    a. Obtaining evidence that the interim financial information agrees or reconciles with the accounting records;

b. Reading the available minutes of meetings of stockholders, directors, and appropriate committees, and inquiring about matters dealt with at meetings for which minutes are not available, to identify matters that may affect the interim financial information; and

c. Reading the interim financial information to consider whether, based on the results of the review procedures performed and other information that has come to the accountant's attention, the information to be reported conforms with GAAP.

A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be identified in an audit.[1]

Observations

We observed the audit firms' interim reviews of certain financial statement accounts and/or assertions for SPACs and de-SPAC transactions where engagement teams did not:

1. Identify that the public company's equity statement did not agree with its accounting records; or
2. Consider whether presentation and disclosures of the interim financial statements conformed with GAAP; and/or
3. Identify an error in the public company's financial statement fair value disclosure where public warrants were incorrectly included in the Level 3 fair value roll-forward.

Good Practices

Through our 2021 inspections, we observed the following good practices we believe may enhance audit quality:

1. **Use of specialists** — Engagement teams used auditor-employed valuation specialists to review the work of the companies' specialists in determining the valuation of the warrant liability, intangible assets, and purchase price accounting.
2. **Consultation on materiality** — An audit firm required consultations when evaluating quantitative factors for establishing materiality for start-up entities to provide guidance on the appropriate benchmarks to use, as well as the suggested ranges to apply to various benchmarks.
3. **Involvement of financial instrument specialists** — An audit firm's national office tracked de-SPAC transactions and reached out to engagement teams to facilitate discussions on financial instruments that may require engagement teams to involve auditor-employed specialists with financial instrument expertise. The audit firm identified available specialists and connected them to the engagement teams.

[1] The Securities and Exchange Commission (SEC) does not require an auditor to issue a written report on a review of interim financial information, although the SEC requires that an auditor's review report be filed with the interim financial information if, in any filing, the entity states that the interim financial information has been reviewed by an independent public accountant.

Going Concern

Assessing a public company's ability to continue as a going concern requires judgment on the part of the auditor. In 2021, the target team scrutinized this area to assess whether auditors appropriately evaluated whether there was substantial doubt about a public company's ability to continue as a going concern in light of the economic environment.

Auditor's Responsibility

1. The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a reasonable period of time). AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* provides guidance to the auditor on evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.
2. AS 2415 provides that the auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:
    a. The auditor considers whether the results of his or her procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
    b. If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, he or she should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events and (2) assess the likelihood that such plans can be effectively implemented.
    c. If, after evaluation of management's plans, the auditor concludes there is substantial doubt, he or she should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time and (2) include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), in his or her audit report to reflect his or her conclusion. If the auditor concludes that substantial doubt does not exist, he or she should consider the need for disclosure.

Observations

In 2021, we observed multiple audits where engagement teams either did not perform procedures or the procedures performed were not sufficient to evaluate whether there could be substantial doubt about the public company's ability to continue as a going concern. The following are some examples of situations we observed in which the engagement team did not perform or sufficiently perform procedures to support the conclusions reached. The engagement team did not:

1. Perform sufficient procedures to evaluate the reasonableness of a public company's forecasted cash outflows used in management's assessment; or
2. Perform any procedures to assess the reasonableness of the forecasted available borrowings used in management's going concern assessment; or
3. Evaluate the specific review procedures that the control owner performed to assess the reasonableness of forecasted earnings before interest, taxes, depreciation, and amortization (EBITDA) used in management's going concern assessment; or
4. Evaluate the relevance and reliability of information from sources external to the company used in management's EBITDA projections in connection with the auditor's evaluation of whether there could be substantial doubt about the public company's ability to continue as a going concern; and/or
5. Obtain sufficient appropriate audit evidence for a significant element of management's plan to alleviate substantial doubt because the engagement team did not obtain evidence to support adjustments to net income reflected in management's calculation of the public company's leverage ratio.

Good Practices

Through our inspections, we observed the following good practices we believe may enhance audit quality:

1. **Consultations** — Many audit firms required consultations in connection with their evaluation of the public company's liquidity position and management's going concern assessment, particularly related to assumptions regarding COVID-19 and its anticipated duration. In several instances, consultations were performed throughout the audit firms' evaluation of management's going concern assessment, which included quarterly reviews, debt or equity offerings, and the year-end going concern assessment performed in connection with the public company's reporting.
2. **Staffing assignments** — As a practice, audit firms assigned experienced staff members (i.e., managers and above) to evaluate management's going concern assessment, given the increased risk.
3. **Collaboration through industry groups** — Members of the engagement teams were active participants in their audit firm's public company industry group (e.g., transportation and financial services) and engaged other auditor-employed specialists (e.g., valuation and restructuring) to assist with the procedures performed. The industry group collaborated regularly through quarterly and ad-hoc meetings to discuss pertinent current events and risks impacting the industry (e.g., COVID-19).

Cash and Cash Equivalents

Elevated audit risk could arise from arrangements for holding cash and cash equivalents, such as those involving the use of trustees, restrictions on cash balances, offshore accounts, and complex terms and conditions. In 2021, the target team focused on fact patterns seen in recent high-profile events involving cash, which can raise questions about audit firms' procedures to address the audit risks associated with cash and cash equivalents.

Auditor's Responsibility

The auditor uses their risk assessment in determining the nature, timing, and extent of audit procedures to be applied, including the use of confirmations.

Observations

We observed audits where:

1. The engagement team did not perform sufficient procedures to support the validity of confirmations received, such as contacting the purported sender telephonically or by other means to confirm the cash confirmation e-mail response was actually sent by an authorized respondent; and/or
2. The work papers did not adequately document the confirmation procedures.

Good Practices

Through our inspections, we observed the following good practices we believe may enhance audit quality:

1. **Audit firm guidance** — In light of several recent high-profile financial reporting frauds involving cash, certain audit firms updated their confirmation guidance for engagement teams. The updated guidance addresses confirmations of bank accounts, including determining the individual bank accounts to confirm.

2. **Evaluating relevant controls at the service provider** — Many audit firms used service providers to facilitate direct electronic transmission of confirmations. In some instances, audit firms have developed software audit tools to interface with the third-party vendors; or established procedures for evaluating relevant controls at a service provider which are meant to address reliability. (For more information, see our Spotlight "Observations and Reminders on the Use of a Service Provider in the Confirmation Process.")

Stay Tuned and in Touch

The work and observations of the target team will continue to shape the PCAOB's oversight activities. During 2022, the target team will focus on audits of public companies that include risks related to climate change that would affect a company's financial statements, IPOs/de-SPACs, and use of firm designated shared service centers (including the audit firm's centers of excellence and other service delivery centers). Observations from the target team will be shared in future Spotlight documents.

For more perspectives from the PCAOB, including publications with our inspection observations and overview of planned inspections, visit the **Staff Publications** page on our website. To receive periodic updates, please **join our mailing list**.

The PCAOB welcomes your questions and comments, and we invite you to fill out our short reader survey and/or to contact us at **info@pcaobus.org**.