



## STAFF INSPECTION BRIEF

The staff of the Public Company Accounting Oversight Board (“PCAOB” or “Board”) prepares Inspection Briefs to assist auditors, audit committees, investors, and preparers in understanding the PCAOB inspection process and its results. The statements contained in Staff Inspection Briefs do not establish rules of the Board or constitute determinations of the Board and have not been approved by the Board.

### Information about 2016 Inspections

The PCAOB Division of Registration and Inspections has prepared this Inspection Brief to provide information about the plan, scope and objectives of PCAOB inspections in 2016 of registered audit firms and their audits of issuers.

Key areas of inspection focus in 2016 include:

- Audit areas where deficiencies have been identified in previous inspection cycles, including internal control over financial reporting, assessing and responding to risks of material misstatement, and accounting estimates, including fair value measurements.<sup>1</sup> Recurring audit deficiencies continue to be identified in the most frequently selected financial reporting areas, such as revenue, non-financial assets, inventory, financial instruments and other areas that are discussed in this brief.
- Audit areas affected by economic trends, including the effect of the strengthening U.S. dollar, the increasing merger and acquisition activity, the search for higher-yielding investment returns in a low interest rate environment, and the effect of the fluctuations in oil and natural gas prices.
- Audits of certain areas that may involve significant judgment from management and/or auditors, including the auditor’s evaluation of segment identification and disclosures, the auditor’s consideration of an entity’s ability to continue as a going concern, and evaluation of income tax accounting and disclosures.
- The implementation of the PCAOB Auditing Standard (“AS”) 2410, *Related Parties* (currently AS No. 18).<sup>2</sup>
- Audit procedures involving information technology, particularly auditors’ use of software tools, and procedures to assess and address risks of material misstatement posed by cybersecurity.
- A firm’s system of quality control, including its policies and procedures for (i) identifying the

1 See Staff Inspection Brief, *Preview of Observations from 2015 Inspections of Auditors of Issuers*, Vol. 2016/1, issued in April of 2016 (“2015 Inspection Results Brief”).

2 On March 31, 2015, the PCAOB adopted amendments that reorganize and renumber its auditing standards, effective December 31, 2016. (See PCAOB Release No. 2015-002.) The new numbering may also be used in advance of that date, and this report uses the prospective numbering. The first time a standard is cited, this document also parenthetically indicates the current number.

“root causes” of audit deficiencies and positive quality events, (ii) complying with required audit committee communications, including those communications related to independence, (iii) monitoring and maintaining independence, (iv) performing engagement quality reviews with due professional care, and (v) applying professional skepticism throughout the audit.

## Overview of Inspection Plan and Scope

PCAOB Inspections staff plans each year’s inspections by selecting issuer<sup>3</sup> audits to inspect based largely on an analysis of risk. Risks may emanate, for example, from economic trends, company or industry developments, size of and changes between years in issuer market capitalization, and the audit firm, including audit partner and inspection history. Inspectors typically focus on audit areas that present auditing challenges and significant audit risk, including risks of material misstatement in the financial statements, as well as areas of recurring audit deficiencies both within and across firms.

During the 2016 inspection cycle, Inspections staff will primarily review portions of selected audit work performed by firms on the 2015 financial statements of issuers (including referred work engagements where a firm played a role in the audit but was not the principal auditor). Where relevant, audit work related to internal control over financial reporting will also be selected.

Audit engagements and areas of inspection focus are usually not selected randomly, and selections of audits are not necessarily representative samples of a firm’s audits. Rather, audits and areas of focus are generally selected on a risk-weighted basis. Accordingly, areas of focus vary among selected audits and firms, but often involve audit work on the most difficult or inherently uncertain areas of financial statements that often require a higher degree of management judgment.

### 2016 Inspections by the Numbers\*



**210 firms**

Planned to be reviewed by our inspectors, which includes:



**10 U.S. firms**

with more than 100 issuer audit clients in 2015, and



**60 non-U.S. firms**

in 25 jurisdictions.

\*Numbers are approximate

Additional information about the inspection program, along with certain characteristics of audits inspected and areas of past inspection focus, is provided in the Appendix.

Information gathered as a result of inspection procedures performed is expected to further inform PCAOB standard setting activities.

3 For purposes of the PCAOB’s inspection authority, the term “issuer” is defined in Section 2(a)-(7) of the Sarbanes-Oxley Act of 2002 and essentially includes public companies with Securities and Exchange Commission (“SEC”) reporting obligations.

# Key Areas of Inspection Focus

## Recurring Audit Deficiencies

Inspectors consider deficiencies cited in previous inspection cycles to evaluate how an audit firm performed in those areas in the current inspection cycle, including reviewing remedial actions taken in response to past inspection findings and information about the potential root causes of those findings. The most frequent and recurring audit deficiencies identified in recent inspection cycles (at firms that were the principal auditor and at firms that performed referred work engagements at the request of the principal auditor) were in the following audit areas:



- **Internal Control Over Financial Reporting (“ICFR”).** Inspections staff continued to identify frequent audit deficiencies in 2015 related to non-compliance with AS 2201, *An Audit of Internal Control Over Financial Reporting That is*

*Integrated with An Audit of Financial Statements* (currently AS No. 5). During the 2016 inspection cycle, Inspections staff will, among other things, consider the sufficiency of auditors’ procedures performed to identify, test and evaluate controls that address the auditors’ assessed risk of material misstatement, and auditors’ testing of controls that contain a review element.

- **Assessing and Responding to Risks of Material Misstatement.** During the 2015 inspection cycle, Inspections staff frequently identified audit deficiencies related to AS 2301, *The Auditor’s Responses to the Risks of Material Misstatement* (currently AS No. 13), AS 2810, *Evaluating Audit Results* (currently AS No. 14), and AS 1105, *Audit Evidence* (currently AS No. 15). Specific areas of inspections focus in the current year will include consideration of: (1) the sufficiency of testing the design and operating effectiveness of controls to support the auditors’ planned level of control reliance, including testing the controls over the accuracy and completeness of system-generated data and reports;<sup>4</sup> (2) whether the substantive procedures, including tests of details, were specifically responsive to fraud risks and other significant risks that were identified;<sup>5</sup> (3) the evaluation of the presentation of the financial statements, including the accuracy and completeness of the disclosures<sup>6</sup> for those focus areas included in the inspection; and (4) the evaluation of relevant audit evidence that appeared to contradict certain assertions in the financial statements.<sup>7</sup>

4 Paragraph 10 of AS 1105, provides that when used as audit evidence, auditors should test the accuracy and completeness of information produced by the company or test the controls over such information.

5 See paragraphs 11 and 13 of AS 2301.

6 See paragraphs 30 and 31 of AS 2810.

7 See paragraphs 3 and 34 of AS 2810.

- **Auditing Accounting Estimates, including Fair Value Measurements.** In 2015, Inspections staff continued to take a close look at audit work performed on a range of complex estimates and frequently identified audit deficiencies in this area. During the 2016 inspections cycle, Inspections staff will consider the auditors' procedures performed to understand how estimates were developed, as well as the auditor's testing of data and evaluation of the assumptions used by management that are significant to the estimate.

During the 2014 and 2015 inspection cycles, Inspections staff observed some improvements in the audit work performed at some firms in these areas, but continued to find high numbers of deficiencies at many firms.

Further discussion of the audit deficiencies identified during the 2015 inspection cycle is included in the 2015 Inspection Results Brief.

## Audit Areas Potentially Affected by Economic Factors

Inspectors consider the current economic environment and related developments in planning their inspections. Certain economic developments that will factor into the 2016 selections include:

- **Effect of strengthening U.S. dollar on multinational issuers.** The significant appreciation in the U.S. dollar Index<sup>8</sup> that occurred during 2014 and 2015 has created challenges for U.S. producers of domestic goods and their international subsidiaries, as sales and

*How has the auditor considered the effect of a strengthening U.S. dollar on the issuer's business and the risk of material misstatement of the issuer's financial statements?*

related earnings from these goods may have declined resulting in pressure on consolidated earnings. Other challenges resulting from the strengthening of the U.S. dollar may include potential loss of market share to foreign competition, and negative effects on foreign currency translations. These challenges could present risks of material misstatement to the financial statements in areas, such as revenue, inventory valuation, and foreign currency accounting, for example, as a result of pressure for management to meet revenue goals or more complex re-measurement and translation adjustments.

- **Increasing merger and acquisition activity.** Deal values are increasing as acquirers are willing to pay more, and the high pace of mergers and acquisitions activity continues.

*How did auditors approach auditing merger and acquisition transactions?*

This environment may increase the risk of improper valuation of assets acquired and liabilities assumed given the large deal sizes, complexity of the transactions and fair value

8 The U.S. dollar Index is an index of the U.S. dollar relative to a basket of foreign currencies based upon relative trade weighting.

measurements, and high purchase prices. Additional risks of material misstatement may also be associated with the identification of all intangible assets, assignment of goodwill to reporting units, and contingent consideration measurements. Fair value measurements and other accounting estimates involve the potential for management bias, and the frequency of inspection findings in these areas suggests that in too many cases auditors do not appropriately apply professional skepticism when testing estimates. Specifically, Inspections staff has observed in previous inspection cycles instances in which auditors limited their audit procedures to inquiry or did not sufficiently evaluate or consider contradictory or potentially inconsistent information.

- **Search for higher-yielding investment returns in a low interest rate environment.** A number of issuers invest in higher-risk instruments, such as high-yield and covenant-lite leveraged loans (loans that may remove traditional protective covenants for the benefit of the lending party) issued by entities with below investment grade credit rating and declining revenues.

***How did auditors address the financial reporting risks (e.g., risks of overvalued assets, errors in valuing “hard-to-value” securities, etc.) associated with issuers’ investment portfolios?***

Further, some of the investments in higher-yielding securities that issuers seek in their search to boost investment returns may be complex and harder to value.

- **Effect of the continued fluctuations in oil and natural gas prices.** Debt defaults and bankruptcies are occurring in the oil and gas industry, and some issuers have implemented reduced capital expenditure programs in response to the downturn. Specific areas of focus related to this economic trend include impairment and valuation risks, the collectability of loans and receivables, and the issuer’s ability to continue as a going concern.

***In periods of decline in oil and natural gas prices, how did auditors respond to this risk where oil and natural gas prices are below production costs for many producers?***

These risks are not isolated to companies in the oil and gas industry, but may also apply to other companies. For example, the reduced capital expenditure by oil and gas companies has also spread risk to other companies, such as those in the industrial, materials and financials sectors. Sustained low commodity prices also may impact corporate lending and underwriting for banks, as the energy sector cuts back on spending and development plans or acquisitions. If banks decrease lending, declining loan supply could lower aggregate commercial loan demand and collateral values related to oil and gas properties and industries that support the oil and gas industry, weakening economic activity and increasing loan losses. Some emerging market countries and developing economies heavily dependent on commodities are in recession or experiencing slower growth due to the continued periods of decline in metal, oil and natural gas

prices triggered by weaker demand and higher production capacity. These developments have also increased asset valuation risks and the potential for not recording asset impairments on a timely basis or if impairment is recorded the impairment loss is understated for commodity producers and related industries located in these countries.

## Financial Reporting Areas

Inspectors select certain financial reporting areas for inspection using a risk-based approach, and these areas vary for each inspected audit. Some areas are selected due to commonly identified risks while other areas represent new or emerging developments or risk factors.

The most frequently selected financial reporting areas in 2015 included revenue and receivables, non-financial assets (assets acquired in business combinations, including goodwill and other intangible assets, and other long-lived assets), inventory, financial instruments, the allowance for loan losses, income taxes, benefit related liabilities, and equity transactions. These audit areas will continue to be frequently selected for inspection in 2016.

Certain economic developments and other factors also result in additional financial reporting focus areas for 2016 that include:

- **Evaluation of segment identification and disclosure.** To evaluate whether an issuer's segment disclosures are in conformity with

*How has the auditor evaluated the issuer's segment disclosures to determine compliance with the applicable financial reporting framework? How has the auditor evaluated controls with respect to segment reporting?*

the applicable financial reporting framework, it is important for auditors to understand and evaluate how the issuer identified the chief operating decision maker ("CODM") and determined the operating segments, including performing sufficient procedures to understand the information the CODM regularly reviews in order to allocate resources and assess performance. It is also important to understand and evaluate how the issuer determined its reportable segments, as well as the characteristics an issuer considered when deciding whether or not operating segments should be aggregated, including when segments have similar economic characteristics, or where there is a range of products or services and the characteristics of each drive differing economic performance. This may involve subjective factors for which it is important for auditors to apply professional skepticism, considering all of the relevant facts, regardless of whether they support or contradict management's assertions. When testing controls over segment disclosures, it is important to consider both controls over the preparation of these disclosures and controls over the monitoring of events that might require changes in segment determinations and disclosures from one period to the next.

- **Auditor’s consideration of the entity’s ability to continue as a going concern.**

***Has the auditor considered current economic factors that might impact the issuer’s ability to continue as a going concern?***

Economic factors may include the risks discussed within this document, such as the strengthening U.S. dollar, periods of decline in oil and natural gas prices, and the risk of debt defaults. Auditors should be particularly mindful about the impact of economic factors when evaluating a company’s ability to continue as a going concern. This area often involves consideration of subjective factors, so it is important for auditors to apply professional skepticism and consider all of the relevant facts, regardless of whether they support or contradict management’s assertions. Auditors should continue to look to the existing requirements in AS 2415, *Consideration of an Entity’s Ability to Continue as a Going Concern* (currently AU sec. 341) when evaluating whether substantial doubt regarding the company’s ability to continue as a going concern exists for purposes of determining whether the audit report should be modified to include an explanatory paragraph regarding going concern.

- **Evaluation of income tax accounting and disclosures.** For issuers who have large and growing undistributed earnings in foreign jurisdictions, how did the auditor evaluate and test management’s assertion regarding

***Did the auditor appropriately test the income tax accounting and related disclosures?***

the indefinite reinvestment of those earnings, including the impact of events, such as significant cash transfers from a foreign subsidiary to the U.S. parent on that assertion? It is also important for the auditor to critically evaluate the design and operating effectiveness of controls related to income taxes. Income tax accounting is also an area that often involves testing and evaluation of prospective financial information which may involve a high degree of subjectivity by management.

## **Implementation of AS 2410, *Related Parties***

AS 2410, *Related Parties*, became effective for fiscal year ends beginning on or after December 15, 2014. The standard and related amendments to other PCAOB standards address: (i) relationships and transactions with related parties, (ii) significant unusual transactions, and (iii) financial relationships and transactions with executive officers. The standard also imposes new requirements relating to the auditor’s communications with the company’s audit committee regarding related party transactions. The new standard and related amendments are intended to strengthen auditor performance requirements in these critical areas that historically have represented increased risks of material misstatement in issuer financial statements.

Consistent with the implementation of previously issued standards, the 2016 inspection program will include procedures to assess the effectiveness of firms’ implementation of AS 2410, including by reviewing firms’ systems of quality control in this area and determining compliance with the new standard in particular audit engagements.

For certain firms that are required to be inspected at least once every three years (“triennially inspected firms”), the first year that Inspections staff will evaluate their implementation of this standard may occur in 2017 or 2018.

## Information Technology

### Firm software audit tools

Some firms are developing and using software audit tools to provide opportunities to perform audit work more effectively and efficiently, and to increase the likelihood of identifying and testing audit areas associated with higher risk. As discussed in the 2015 Inspection Results Brief, Inspections staff observed that the software audit tools used by the firms vary, and some firms have customized purchased tools or have internally developed their own tools. Further, most software audit tools are being used for performing substantive audit procedures, while some tools may also be used for risk assessment.

Inspections staff will continue to gain an understanding of the systems of quality control that firms have in place to provide assurance that (1) the tools used to analyze the data meet the audit objectives, (2) engagement teams are effectively using these tools and evaluating the results of screening large data populations, and (3) engagement teams’ are applying due care, including professional skepticism, when using these tools during the performance of the audit work, including the evaluation of results of that work.

### Cybersecurity risks

Cybersecurity incidents and breaches have continued to be prominent. Many auditors and companies alike see cybersecurity as an overall business risk, as compared to just an information technology risk.

Inspections staff has observed that some firms have provided guidance to their auditors to consider cybersecurity as similar to any other business and technology risk. This includes considering cybersecurity when performing risk assessment procedures and addressing risk in the audit of internal control over financial reporting and in the audit of the financial statements.

During 2016, Inspections staff will continue to perform information gathering procedures that seek to understand the procedures performed and documentation prepared by engagement teams to determine whether certain cybersecurity risks pose risks of material misstatement to the company’s financial statements. Inspections staff will also seek to understand whether modifications to the engagement team’s risk assessments and planned audit approach occurred or were necessary in response to these risks, including modifications to the procedures to test the design and operating effectiveness of relevant internal controls over financial reporting and substantive procedures.



## Multinational Audits

Inspections staff routinely inspects portions of multinational audits, including the audit work performed by both domestic and non-U.S. firms that played a role in the audits, but were not the principal auditors. Inspection selections may include work performed by other firms at the request of the principal auditor (“referred work engagements”) as well as the audit work performed by the principal auditor with respect to the decision to use the work of the other auditor.

Inspections staff has identified inspection deficiencies when some firms used the work of other auditors. In recent years, Inspections staff has observed that some firms have enhanced their methodology or tools for multi-location audits and moved to greater levels of supervision, including review, of the work of other audit firms participating in the engagement. While it is too early to judge how effective these changes are, these efforts may have contributed to the recent decrease in audit deficiencies observed in inspected referred work engagements at some firms. Other firms, however, that have not made significant improvements may have greater risk of lower quality audits when they use other auditors.

Inspections staff will continue to review referred work to evaluate the quality of the work performed. Inspections staff will also continue to evaluate how a firm that is using the work of another auditor in its audit evaluated the competence of, and the work performed by, the other auditor.

## Audit Firm’s System of Quality

### Control

Inspections staff will also assess each firm’s quality control system for weaknesses or deficiencies that could lead to deficiencies in audit performance. Some of these areas will include: the firm’s “tone at the top” as it relates to audit quality; policies, procedures, and practices concerning audit performance; training; partner management; and the firm’s self-monitoring through internal inspections and responses thereto.

### Root cause analysis

Inspections staff continues to focus on identifying the potential root causes of audit deficiencies and positive quality events through analysis of specific events, as well as evaluating the results of those firms that also perform their own internal root cause analyses. The specific procedures performed by Inspections staff to evaluate the root causes of audit deficiencies and positive quality events vary according to the size of the firm.

Root cause analysis is important to understand why audit deficiencies have not been detected prior to the issuance of an audit report and should remain a key focus area for firms. While Inspections staff has observed improvement in root cause analysis at some firms, this result is not consistent across all firms, since firms are in varying stages of development of their root cause analyses. Firms that have responded to recurring audit deficiencies with meaningful, carefully considered actions to address underlying issues and causes are beginning to see improved results.

Inspections staff has observed that, in addition to analyzing identified deficiencies, certain firms have recently begun to analyze their own positive quality events in order to identify the underlying reasons for those positive quality events and determine their most effective actions aimed at improving audit quality. As firms begin to get a better understanding of what drives audit quality, Inspections staff expect that firms will be able to more effectively drive their remedial efforts, and ultimately improve and sustain audit quality.

### **Audit committee communications**

Inspections staff evaluated firms' implementation of AS 1301, *Communications with Audit Committees* (currently AS No. 16), during the 2014 and 2015 inspection cycles. Inspections staff observed that most of the inspected firms had incorporated the requirements of AS 1301 into their audit methodologies, introduced relevant practice aids, and provided training to their partners and staff. Implementing appropriate methodologies, however, did not always translate into auditors communicating to the audit committee all of the information required under the standard. For example, several deficiencies identified in 2015 were due to the auditor's failure to communicate an overview of the overall audit strategy, timing of the audit, and all of the significant risks the auditor had identified.

For certain triennially inspected firms, 2016 is the first year that Inspections staff is evaluating their implementation of this standard. Inspections staff will also continue to evaluate audit committee communications required by AS 1301 at other firms in 2016 inspections.

In addition to the audit committee communication requirements included in AS 1301, other PCAOB standards and rules require the auditor to communicate specific matters to the audit committee and are referenced in Appendix B to AS 1301. Due to recurring deficiencies in audit committee communications related to PCAOB Rule 3526, *Communications with Audit Committees Concerning Independence*, Inspections staff will also continue to focus on this area.

The PCAOB recently issued a general report, *Inspection Observations Related to PCAOB Rules and Auditing Standards on Communications with Audit Committees*, PCAOB Release No. 2016-001 (April 5, 2016), which highlights audit requirements related to audit committee communications, and provides examples of deficiencies in auditors' compliance with these rules and standards observed during 2014 inspections. The report also provides potential remedial actions that firms may consider.

### **Independence**

Deficiencies observed in 2015 included instances in which some auditors provided impermissible non-audit services during the period under audit, and instances in which auditors did not obtain pre-approval from the audit committee prior to performing non-audit services.

In 2016, Inspections staff will continue to assess how a firm's independence monitoring systems provide reasonable assurance that the firm maintains independence from its audit clients, including whether and how those systems address the growth in consulting and other non-audit services, such as through acquisition of consulting firms.

## Engagement quality review

Inspections staff continues to focus on whether auditors complied with AS 1220, *Engagement Quality Review* (currently AS No. 7). Preliminary 2015 inspection results indicate the engagement quality review continues to be an area of frequent deficiencies. Deficiencies were observed in areas of the audit in which the auditor identified significant risks of material misstatement and where an engagement quality reviewer reviewed, or should have reviewed, the audit work and related conclusions, but those reviews were ineffective at identifying significant engagement deficiencies.

It is important for engagement quality reviewers to devote sufficient time to their reviews not only during the year-end audit procedures, but throughout the planning, execution and completion of the audit. In the 2016 inspection cycle, Inspections staff will continue considering the engagement quality reviewer's evaluation of significant judgments, identification and responses to fraud risks and other significant risks assessed by the engagement team. This will include consideration of whether the engagement quality reviewer evaluates if the audit documentation indicates appropriate audit responses and supports the conclusions reached.

## Professional skepticism

Inspection observations continue to raise concerns about whether some auditors appropriately apply professional skepticism in the course of their audits, particularly in those areas that involve significant management judgments or transactions outside the normal course of business, as well as the auditor's consideration of fraud. For example,

Inspections staff continues to observe situations in which auditors seek to obtain only evidence that would support significant judgments or representations made by management, rather than to critically assess the reasonableness of management's judgments or representations, taking into account all relevant evidence, regardless of whether it confirmed or contradicted management's assertions.

Inspections staff will continue to evaluate whether auditors appropriately apply professional skepticism throughout audits and whether firms' systems of quality control provide reasonable assurance that a firm's engagement teams will do so. This may include an evaluation of whether firms are assigning personnel with the necessary competencies to engagement teams; establishing policies and procedures to assure appropriate audit documentation, especially in areas involving significant judgments; and appropriately monitoring the quality control system and taking necessary corrective actions to address deficiencies, such as instances in which engagement teams do not apply professional skepticism.

# Appendix

## Inspections of Registered Firms that Audit Issuers

The PCAOB oversees the audits of issuers in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. PCAOB inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Inspections staff evaluates a firm's performance in selected audit engagements and the design and other matters related to a firm's quality control system.

The PCAOB regularly inspects U.S. and non-U.S. firms that issue audit reports opining on the financial statements of issuers. The actual number of firms that the PCAOB regularly inspects fluctuates since certain registered firms cease to issue audit reports while other firms will begin to issue audit reports for the first time. In general, the PCAOB inspects each firm in this category either annually or triennially, depending upon whether the firm provides audit reports for more than 100 issuers (annual inspection) or 100 or fewer issuers (triennial inspection). At any time, the PCAOB might also inspect any other registered firm that plays a role in the audit of an issuer, and the PCAOB has a practice of inspecting, in each year, some firms in that category.<sup>9</sup>

For operational purposes in administering the inspection program, Inspections staff groups firms that audit issuers into two programs:

<sup>9</sup> For more information and individual firm inspection reports see <http://pcaobus.org/Inspections/Pages/default.aspx>. Many PCAOB-registered firms perform no work that is within the scope of the PCAOB's statutory responsibility and authority to assess. The PCAOB does not inspect those firms.

## Global Network Firms

This program encompasses inspections of registered audit firms that are members of BDO International Limited, Deloitte Touche Tohmatsu Limited, Ernst & Young Global Limited, Grant Thornton International Limited, KPMG International Cooperative, and PricewaterhouseCoopers International Limited. In terms of the number of non-U.S. firms registered with the PCAOB, these networks are currently the six largest. Each member firm is a separate legal entity in the global network for which individual firm inspection reports are issued. The six largest U.S. member firms of these networks are required to be annually inspected. Approximately 145 other member firms of these networks regularly issue audit reports for issuers and are required to be inspected at least triennially.

## Non-Affiliate Firms

This program encompasses inspections of registered firms that are not covered by the Global Network Firm program. Many of the firms in this program, however, are members of other international networks, alliances or affiliations.

The firms subject to inspection in this program vary widely in the number of issuers they audit, or the role they play in the auditing, and those issuers vary widely in size and nature. Four of these firms are required to be inspected in 2016 because they issued audit reports for more than 100 issuers

in 2015. These firms are Crowe Horwath LLP, MaloneBailey, LLP, Marcum LLP, and RSM US LLP. Approximately 405 other domestic and non-U.S. Non-Affiliate Firms regularly issue audit reports for issuers and are required to be inspected at least triennially.

The summary of all registered and inspected firms is shown below (numbers are approximate).<sup>10</sup>

	Total	Global Network Firms	Non-Affiliate Firms
Registered Firms	2,105	340	1,765
Firms Required to Be Inspected Annually	10	6	4
Firms Required to Be Inspected At Least Triennially	550	145	405

## Characteristics of Audits Inspected

An inspection typically does not involve reviewing all of a firm’s audits or all aspects of the audits selected for review. Inspections staff selects specific portions of those audits for review. The inspected firms do not have the ability to limit or influence the selections.

Each year, Inspections staff with the assistance of the PCAOB Office of Research and Analysis, performs a risk analysis to identify higher risk audits and audit areas for closer consideration. Audit engagements are selected based on this analysis, and the nature of the audits selected, the portions of the audits selected, and the related inspection focus areas will vary over inspection cycles and among firms. Below is an overview of selected characteristics of issuer audits inspected during the 2013 - 2015 inspection cycles.

## Issuer Market Capitalization of Audits Inspected

Inspections staff considers the market capitalization<sup>11</sup> of an issuer, including the size and the changes between years, when selecting engagements for inspection. Issuer audits inspected each year are depicted below by market capitalization range.<sup>12</sup>

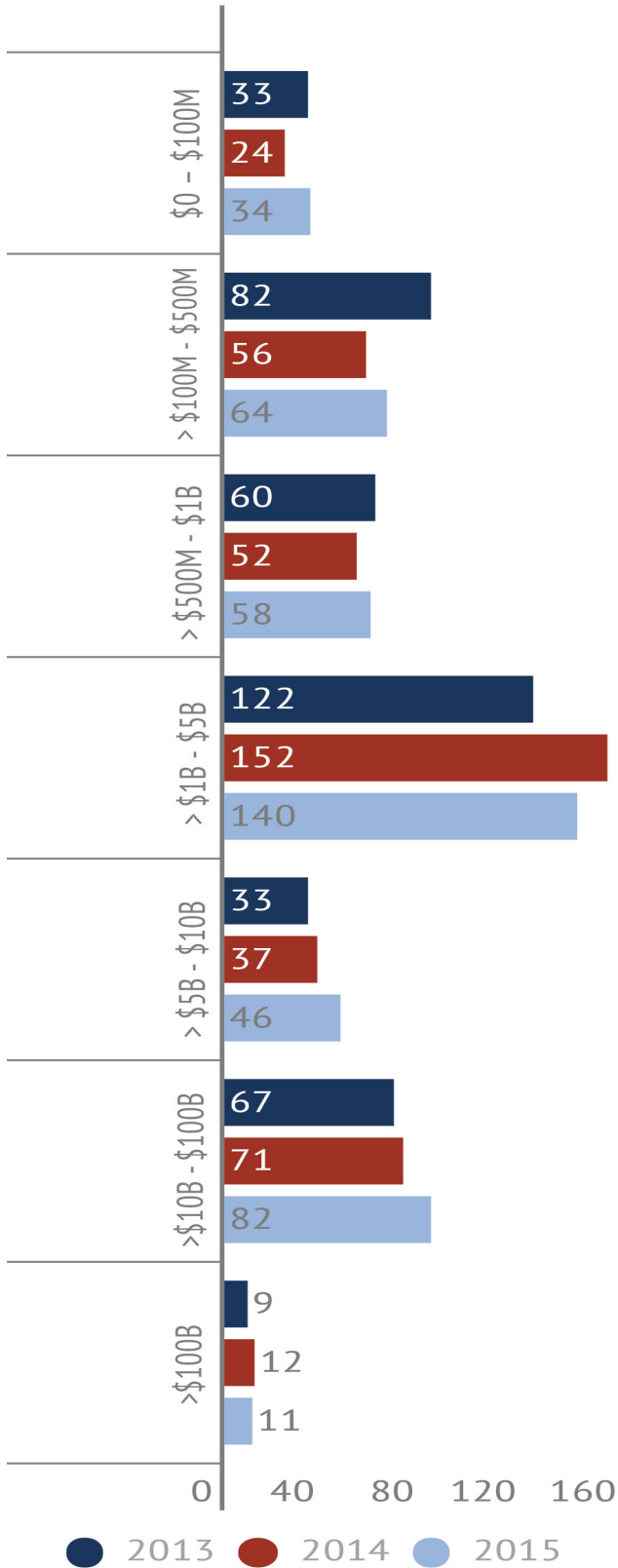
Global Network Firms audited approximately 99 percent of the total market capitalization of issuers audited by firms registered with the PCAOB during the 2013 – 2015 inspection cycles.

10 Data as of December 31, 2015. Some of the non-U.S. firms included in this data are located in jurisdictions where the PCAOB is currently denied access to the information necessary to conduct inspections, due to asserted restrictions under local law or objections based on national sovereignty.

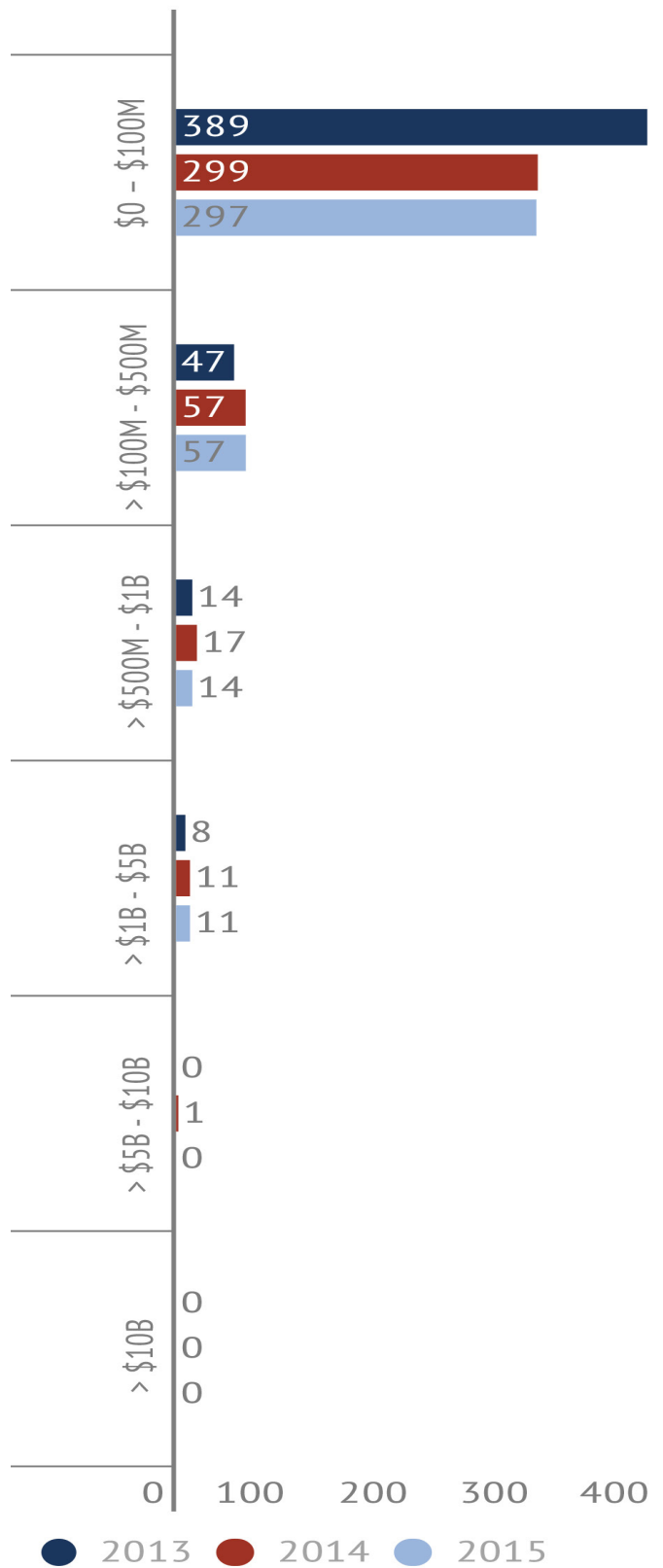
11 Market capitalization (as shown in Exhibits 1 and 2 in millions (M) or billions (B)) is derived from data provided by Standard and Poor’s, Reuters, and FactSet. Market capitalization is calculated as the common stock price multiplied by common shares outstanding. Issuer market capitalization is as of the last trading day for the calendar year preceding the inspection year.

12 Market capitalization information does not include the net assets held by employee benefit plans, mutual funds and certain other investment companies. These types of audits are included in the “\$0 - \$100M” market capitalization range in Exhibits 1 and 2. These types of audits also tend to be more significant to the audit practice of Non-Affiliate Firms than to the audit practice of Global Network Firms, thus inspections of such audits occur more frequently in the Non-Affiliate Firm program.

**Exhibit 1: Number of Audits Inspected at Global Network Firms by Year and Market Capitalization Range**



**Exhibit 2: Number of Audits Inspected at Non-Affiliate Firms by Year and Market Capitalization Range**

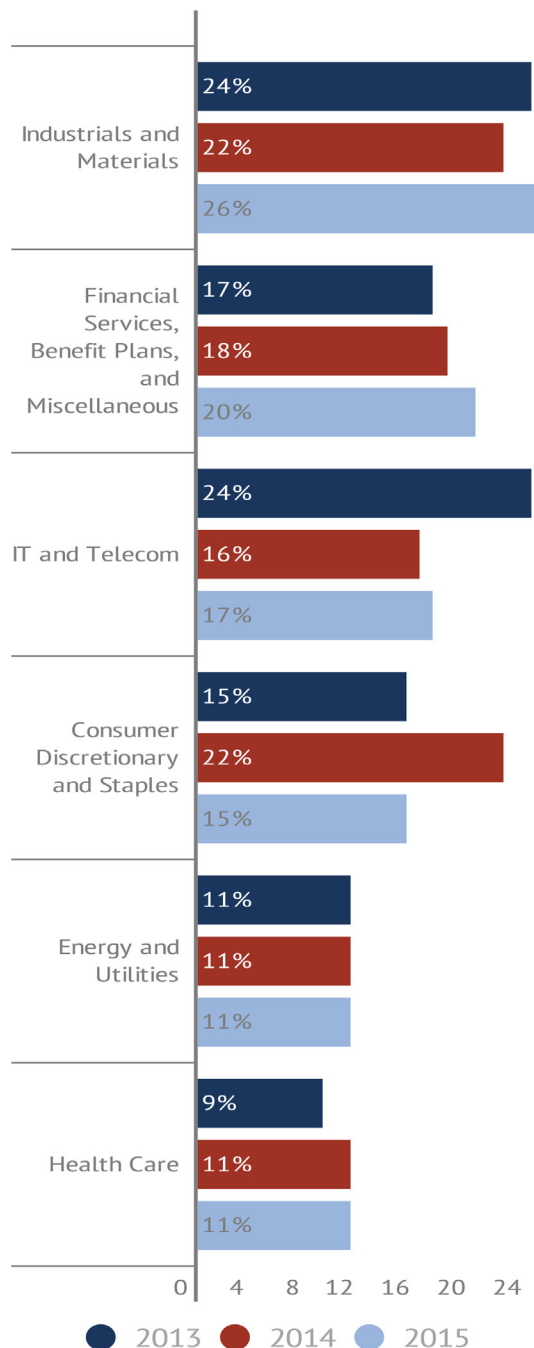


## Issuer Industry Sector of Audits Inspected<sup>13</sup>

Inspections staff considers the industry sector and any related industry developments since the firm's last inspection when selecting engagements for inspection.

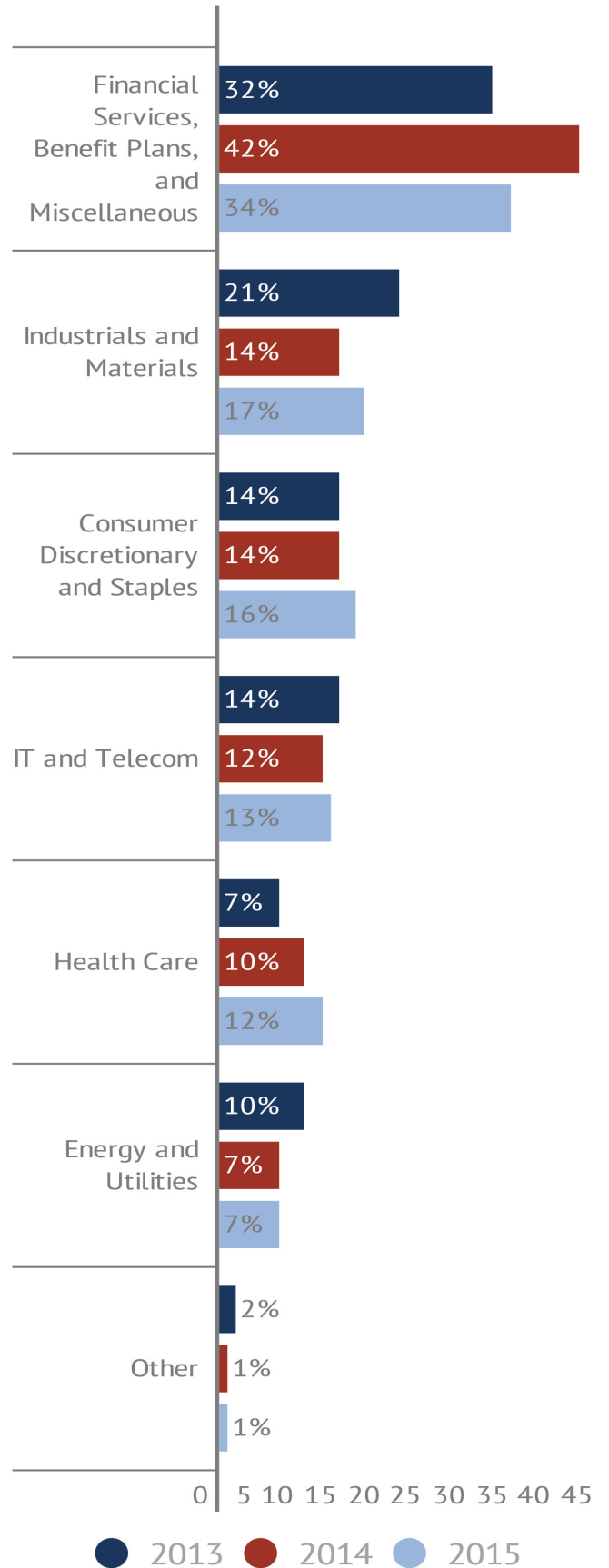
The different population of domestic and non-U.S. triennially inspected firms (and the different concentration of industry sectors associated with their respective issuer audit practices and referred work engagements) partly affects the overall annual concentration of audits inspected by industry sector.

## Exhibit 3: Global Network Firm Audits Inspected by Industry Sector by Year (as a percentage of the total number of audits inspected)



13 The majority of industry sector data is based on Global Industry Classification Standard (“GICS”) data obtained from Standard & Poor’s (“S&P”). In instances where GICS for an issuer is not available from S&P, classifications were assigned based upon industry sectors utilizing North American Industry Classification System data. Further, as benefit plan audits are separate and distinct from the plan sponsors’ audits, benefit plans are classified as a separate industry sector and are presented with the Financial Services sector for the purposes of this report.

**Exhibit 4: Non-Affiliate Firm Audits Inspected by Industry Sector by Year (as a percentage of the total number of audits inspected)**



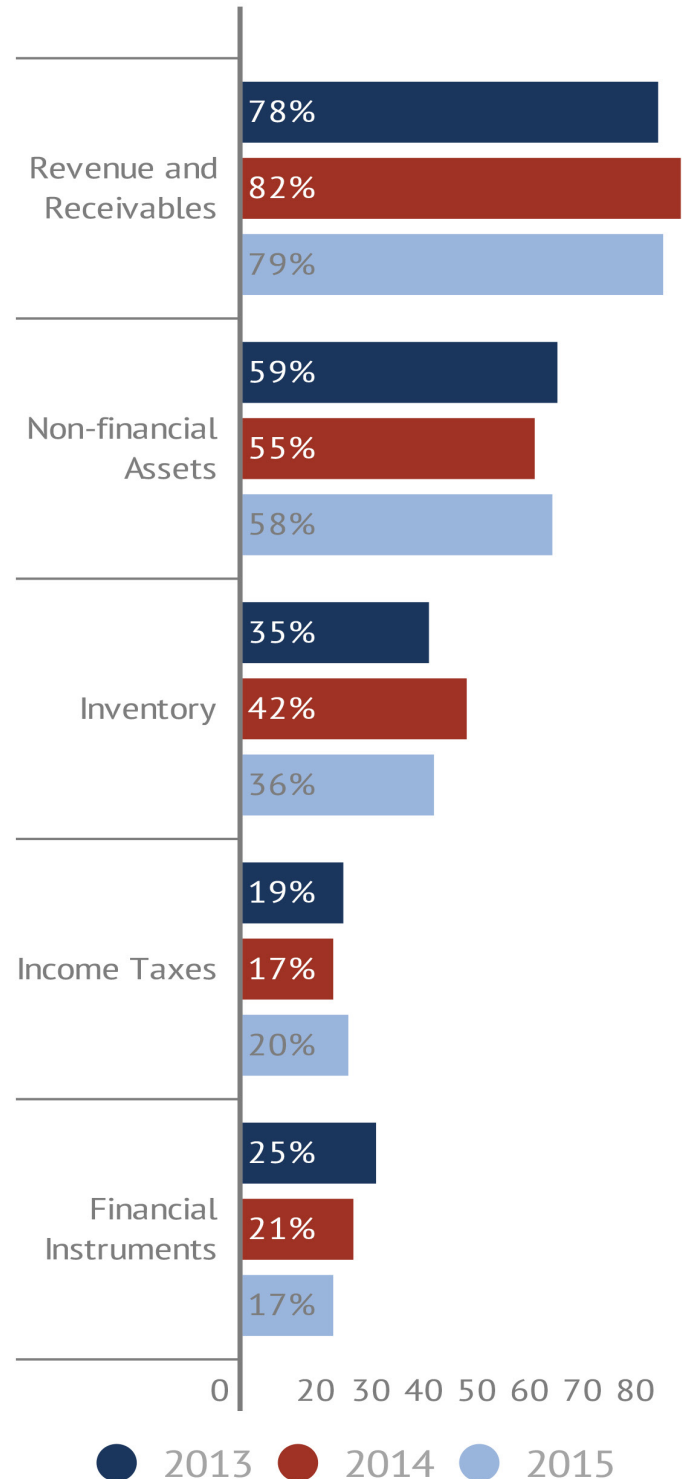


## Financial Reporting Areas Inspected

Revenue is the most frequent auditing area selected for inspection as it often is one of the largest accounts in the financial statements and an important driver of a company’s operating results. Revenue is also frequently associated with significant risk (including fraud risk).

Exhibits 5 and 6 summarize the audited financial reporting areas most frequently inspected, by inspection program, for the 2013 through 2015 inspection cycles. Other commonly inspected financial reporting areas included the allowance for loan losses, other liabilities (e.g., accounts payable and accrued liabilities), debt, other investments (e.g., equity method, joint ventures, variable interest entities, etc.) and others (e.g., discontinued operations, various income statement items, other assets, etc.).

**Exhibit 5: Top 5 Audited Financial Statement Reporting Areas Selected for Inspection in Global Network Firms by Year (as a percentage of total number of audits inspected)**

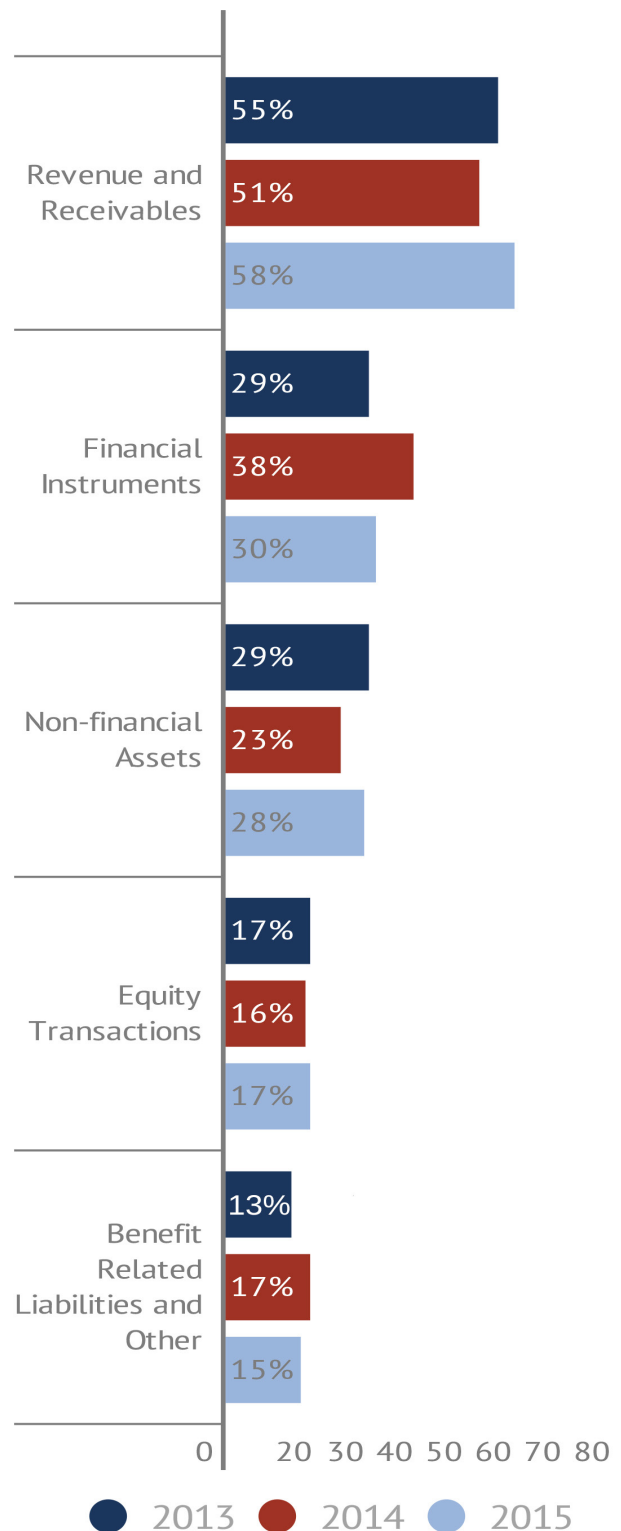


The nature of the issuer audits inspected at Non-Affiliate Firms contributed to selecting revenue, non-financial assets, inventory, and income taxes less frequently when compared to inspections of Global Network Firms. For example, many of the Non-Affiliate Firm audits that were inspected were of employee benefit plans, development stage, or shell companies, and therefore had little or no revenue and inventory, fewer or immaterial non-financial assets, and deferred tax assets with full valuation allowances.

Debt and equity instruments were more frequently selected as an area of focus in Non-Affiliate Firms because of the common use of convertible debt and share-based payments by smaller issuers that Non-Affiliate Firms typically audit.

Although not reflected in Exhibits 5 and 6, additional inspection procedures were generally performed on cash and cash equivalents for inspected audits of non-U.S. firms, and certain domestic Non-Affiliate Firms.

**Exhibit 6: Top 5 Audited Financial Statement Reporting Areas Selected for Inspection in Non-Affiliate Firms by Year (as a percentage of total number of audits inspected)**



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