



PCAOB annual check-up of audit firms says “health” of audits deteriorating

The mission of the U.S. Public Company Accounting Oversight Board (PCAOB) is to protect investor rights and the interest of the public. To accomplish this, the PCAOB uses a vital tool, inspection of audits and quality control systems of registered public accounting firms. This tool assists the PCAOB to determine whether audit firms are complying with the applicable laws, rules, and standards to ensure accurate financial reporting.

A recent staff report issued by the PCAOB called the ‘Spotlight: Staff Update and Preview of 2022 Inspection Observations’ highlights a disturbing year-over-year increase in audit deficiencies. The report also highlights good practices that the staff has observed, which are not prescriptive and revolve around documentation. The report presents the aggregate observations from the inspections of 157 audit firms and reviews portions of 710 audits.

The staff report by the PCAOB has three parts:

Part I. A	Highlights deficiencies that are so significant that it is believed the audit firm at the time of issuance of audit report has not obtained sufficient appropriate audit evidence to support its opinion on the financial statements and or internal control over financial reporting.
Part I. B	Highlights deficiencies that relate to instances of non-compliance with PCAOB standards and rules.
Part I. C	Highlights instances of potential non-compliance with rules set by SEC or PCAOB related to maintaining independence.

The staff report by the PCAOB has three parts:

Expected Deficiencies			
Category	2022	2021	2020
Part I. A	40%	34%	29%
Part I. B	46%	40%	26%
Both	61%	55%	44%

This trend shows an increase in 2022 as compared to 2021 and 2020, which is unsettling. Chair Erica Williams of the PCAOB has called the findings ‘absolutely unacceptable’ and demanded audit firms to ‘make changes to turn things around and live up to their responsibility to investors.’

The numbers indicate the percentage of audit engagements reviewed that will be included in Part I. A or Part I.B. or both, which signifies:

- 40% of the audits reviewed in 2022 will have one or more deficiencies that are significant, up from 34% in 2021 and 29% in 2020.
- 46% of the audits reviewed in 2022 will have instances of non-compliance with standards, up from 40% in 2021 and 26% in 2020.
- 61% of the 710 audits reviewed in 2022 will have one or more, Part I. A and Part I. B deficiencies, up from 55% in 2021 and 44% in 2020.

KNAV Guidance for Quality Audits

AS 1105, an audit standard issued by PCAOB, explains what constitutes audit evidence and the procedures to be designed and performed to obtain sufficient appropriate audit evidence. Audit evidence justifies an audit opinion. The sufficiency of audit evidence is based on the quantity and quality of the evidence. The quantity will depend on the risk assessment, and the quality is measured by relevance and reliability.

The following are some of the procedures to ensure obtaining of sufficient audit evidence:

Internal Controls	Ensure adequate controls while testing a review element, say management review, to prevent or detect material misstatements.
	Test the completeness and accuracy of the data provided, as it will form the basis for testing controls or substantive testing.
	Identify and test the control over the accuracy and completeness of the data used by the control owner in the operation of the control.
	Give due importance to testing internal controls as they determine the nature, extent, and timing of substantive testing.
Revenue and related accounts	<ul style="list-style-type: none"> • Pay attention to sampling transactions. • Devise a proper response to significant fraud risk. • Ensure sufficiency of testing of data in a software-assisted analysis procedure. • Ensure sufficient procedures to test presentation and disclosure.
Accounting Estimate	For accounting estimates, ensure adequate risk assessment procedures, evaluation, and testing, mainly when an assumption exists.
Business Combinations	<ul style="list-style-type: none"> • Ensure sufficient risk assessment procedures related to the acquisition. • Ensure sufficient financial statement disclosures. • Establish relevance and reliability of the company's specialist report. • Evaluate and ensure documentation of auditor-engaged specialists. • Evaluate adherence to accounting standards.
Inventory	Ensure sufficient procedures to test the existence of inventory, completeness of issuer-prepared reports, test conversion factors, and conformation with accounting standards.

Besides sufficiency of audit evidence, some other factors that improve the quality of audits include reporting critical matters, strong communication with the audit committee, prompt filing of Form APs, an appropriate response to fraud findings, involvement of senior leadership, continuous review, monitoring, and maintaining independence.

Ensuring the quality of audits is the responsibility of the audit firm. It must be done proactively so that the findings of an inspection report do not become the eye-opener that sets this in motion.

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