SPOTLIGHT

Staff Overview for Planned 2022 Inspections

June 2022

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The PCAOB is committed to promoting compliance with our professional standards and rules. The primary means by which we do this is through our inspections program.

This Spotlight highlights selected areas of planned 2022 inspection focus.[1] Audit committees, auditors, investors, and other stakeholders may also use this information to inform constructive communication.

2022 INSPECTION PLAN HIGHLIGHTS

We developed our 2022 inspection procedures to focus on anticipated financial reporting and audit risks that are primarily driven by the recent economic environment, including:

- Increased initial public offerings (IPOs) and merger and acquisition (M&A) activities, including transactions with special purpose acquisition companies (SPACs);
- Widespread disruption in supply chains;
- Continued negative effects of the COVID-19 pandemic, especially in high-risk industries;
- Increased volatility in financial and commodity markets due to fluctuations in interest rates and inflationary trends; and
- Audit firm-wide risks, such as the heightened degree of staff turnover and risks arising from auditing in a remote environment, including the risk that auditors will not identify misstatements that could be material.

SELECTED AREAS OF INSPECTIONS FOCUS

As discussed below, in 2022, the PCAOB's planned inspection focus includes:

Fraud and Other Risks

The current economic environment changes the risk landscape and may increase existing financial reporting and audit risks or create new ones — including fraud risks — for public companies and broker-dealers ("companies").

We continue to place emphasis on audit procedures addressing the risks of material misstatement, including the risk of fraud at companies due to the accounting complexities, significant judgments, and changes involved in audits of financial statements and internal controls, including, among others, those related to:

1. An IPO or significant M&A activities, including transactions with SPACs.
2. Negative effects due to the supply chain disruption (e.g., electronic components and equipment, automobile, retail, and materials) and/or the COVID-19 pandemic (e.g., airlines, hospitality, and entertainment); and
3. Volatility in the financial market due to fluctuations in interest rates and inflationary trends.

Also, we will select for inspection audits of public companies in industries — such as banking, energy, and information technology — that inherently pose higher audit risks due to the complexity and judgmental nature of the financial statement accounts and related internal controls. For example, assets and liabilities of public companies in these

[1] We generally select audits of public companies most recently completed by the audit firm but may also select audits of public companies completed in prior years if, for example, there are no recently completed audits.

industries, such as allowance for loan losses and contingencies, may involve subjective assumptions and measurement uncertainty.

The auditor's (1) assessment of the risks of material misstatement and (2) identification and testing of the design and operation of controls are critical to designing the appropriate audit response (i.e., nature, timing, and extent of testing) in an audit of internal controls over financial reporting. As part of our inspections, we will continue to:

- Perform procedures related to the auditor's risk assessment for each financial statement focus area selected for review;
- Maintain a focus on how the auditor evaluated internal controls addressing the completeness and accuracy of financial statement disclosures for the areas selected; and
- Review whether there was proper identification, assessment, and testing of internal controls, especially those controls that changed because of the current environment.

We will continue to focus on the auditor's assessment of fraud risk when planning and performing the audit, including evaluating whether:

1. The auditors performed an assessment of whether the company's controls sufficiently prevent, deter, detect, and mitigate the identified risks of fraud, including the risk of management override.
2. Any deficiencies identified in the company's controls were evaluated to determine whether the control deficiency was indicative of a fraud risk factor; and
3. Procedures were performed to address the identified fraud risk and any other fraud-related matters (e.g., matters identified through fraud inquiries) for the audit of the financial statements and internal controls.

Auditing and Accounting Risks

Our inspectors will focus on how auditors addressed the following auditing and accounting risks:

- **Unreasonable assumptions affecting the timing and amount of revenue recognition** due to the negative effects of the COVID-19 pandemic and supply chain disruptions (e.g., delivery delays in the supply chain, reduced demand for services, for example in the hospitality industries, and contract modifications and estimation of contract costs);
- **Unreasonable assumptions used in projections** to account for business combinations (M&A), or impairment of goodwill and intangible assets due to changing economic conditions (e.g., evaluating whether assumptions based on historical results are reasonable, changes to useful lives of assets, cost and revenue projections reflect the effect of supply chain disruption and inflation, and discount rate and cost of capital assumptions have been adjusted for interest rate fluctuations);
- **Earnings manipulation** as a reaction to, as an example, margin pressures driven by rising costs;
- **Complexities regarding existence and valuation of inventory**, for example, challenges with observing in-transit inventory and its valuation due to supply chain disruptions and rising costs; and
- **Financial, economic, and business uncertainty that impacts the required assessment to evaluate threats and uncertainties** concerning a public company's ability to continue as a going concern.

IPOs and M&A Activity

There have been increased levels of financing activities (since 2020 and continuing into 2021) through IPOs, in both traditional and SPAC formats. Heightened M&A activity (in traditional and de-SPAC transactions) presents increased financial reporting and audit risks. These risks are increased due to the complexity of the transactions and the degree of the subject company's readiness and ability to comply with the financial statement reporting and internal control requirements for publicly held companies. In addition, valuation risk remains high, as newly public companies may use acquisitions to mask underperforming revenues from legacy businesses. They may also apply aggressive valuation assumptions to support high purchase prices or overvalue acquired intangible assets.

For SPAC and de-SPAC transactions, we plan to select focus areas to address the auditor's work on the following: (1) valuation of financial instruments using complex valuation models, (2) the determination of whether a business combination should be accounted for as a reverse merger, (3) internal control over financial reporting, (4) financial statement presentation and disclosures, and (5) restatements related to warrants or other issues.

Audit Firms' Execution Challenges

Audit firms are currently experiencing challenges in attracting and retaining skilled personnel. Some audit firms are addressing these staffing challenges by: (1) using personnel from other lines of business, affiliated member firms, and/or contract auditors; and (2) focusing on attracting experienced hires. Without appropriate supervision and training for new personnel in these situations, an adverse effect on audit quality could arise. We will review the policies and procedures the audit firms have implemented to assign professionals with appropriate qualifications to audit engagements. We will evaluate whether audit firms are modifying the nature and extent of their supervision and review procedures appropriately. We also plan to select engagements where the lead engagement partner is new to the engagement, including those resulting from partner turnover and/or unplanned partner rotations.

Broker-Dealer-Specific Considerations

We plan to continue to inspect how auditors have addressed the risk of fraud at broker-dealers. One priority will be examining how auditors address the industry-specific risk of misappropriation of customer assets at the broker-dealers who file compliance reports. These broker-dealers hold customer funds, maintain control over the custody of customer securities, and provide account statements to customers.

We plan to select focus areas and assertions to evaluate how auditors have addressed risks at broker-dealers, including risks associated with compliance with the financial responsibility rules and internal control over compliance.

We will also make selections to assess how auditors have addressed the risk of fraud at smaller broker-dealers, such as introducing brokers who provide customers with various investment opportunities.

Independence

Auditors are required to be independent of their audit clients — both in fact and in appearance. In our inspections, we continue to identify a high rate of deficiencies that suggest some audit firms may not have appropriate quality control (QC) systems in place to provide reasonable assurance to prevent violations of Securities and Exchange Commission (SEC) and PCAOB independence rules. Given the importance of auditor independence to the public's trust in the quality of audit services, and the historical deficiencies identified, independence will remain an area of focus in 2022.

The high levels of IPOs and M&A activity, including transactions with SPACs, in 2021 led to an increased risk that auditors may not be independent. For example, an auditor may have provided non-audit services to a client prior to it becoming a public company and had to reassess their independence under PCAOB and SEC rules.

Our inspections may focus on the following, and include other areas at the direction of the Board:

1. Analyzing the audit firm's assessment of and threats to independence, including the emergence of relationships that present threats to objectivity and impartiality, and audit firm-identified violations of independence rules for possible QC concerns;
2. Evaluating compliance with the independence rules for significant non-audit services, and their preapproval, where permissible, including PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*;
3. Reviewing audit firms' communications with audit committees concerning independence (PCAOB Rule 3526, *Communications with Audit Committees Concerning Independence*);
4. Reviewing the audit firms' responses to QC concerns in past inspections (e.g., high rates of exceptions noted by the audit firms' personal independence compliance testing); and
5. Increasing our attention on evaluating an audit firm's independence with respect to the sale and delivery of non-audit services.

Use of Service Providers in the Confirmation Process

We plan to focus on the auditor's procedures for maintaining control over confirmation requests and responses in upcoming inspections. Auditors might arrange for service providers to assist them during the confirmation process by electronically sending and receiving confirmations. However, the use of a service provider does not relieve the auditor of the responsibility under PCAOB standards to maintain control over the confirmation requests and responses. For more information, see our Spotlight, "Observations and Reminders on the Use of a Service Provider in the Confirmation Process."

Target Team Focus

We established a target team in 2019 to focus on audit risks and emerging issues across inspected audit firms. During 2022, the target team will focus on interim financial information (e.g., quarterly reviews) and audits of public companies that include risks related to climate change that would affect a company's financial statements, IPOs/de-SPACs, and the use of shared service centers (including the audit firm's designated centers of excellence and other service delivery centers.)

Key Reminders for Auditors

As auditors during the course of 2022 continue to plan and perform their audits, we remind them of the following:

1. Exercise professional skepticism in evaluating the reasonableness of management's representations, estimates and forecasts, due to the uncertainty and volatility of the economic environment.
2. Consider whether the remote or hybrid working environments at public companies and broker-dealers creates new or increased risks of material misstatement, including any fraud risks.
3. Remain alert to changes in the public company's, the broker-dealer's, or the auditor's circumstances which may give rise to situations that could impair auditor independence.
4. Consider implications arising from the current economic environment while performing procedures for acceptance and continuance of clients and engagements.
5. Consider the nature of the public company or broker-dealer, the risks of material misstatement, and each audit engagement team member's knowledge, skill, and ability when assigning work to engagement team members and determining the necessary extent of supervision.

In addition, Russia's invasion of Ukraine has the potential for far-reaching economic impacts on companies operating across different jurisdictions. As a result of the military action, companies located in, or with significant business ties to, Ukraine are experiencing major disruptions of their operations, including the loss of some or all of their physical assets, and products (such as wheat that Ukraine produces for the world market) that may not be available in pre-war amounts. Finally, in response to Russia's actions, many governments and international organizations continue to impose various types of economic sanctions against Russia, certain Russian companies and products, and specific individuals.

As the situation in Ukraine continues to evolve, auditors should remain aware of these developments and the potential for broader economic issues that could in turn affect more companies. Auditors may also be faced with certain challenges in completing audits of affected companies, in some cases because obtaining sufficient appropriate audit evidence to support the auditor's opinion on the financial statements may take longer or require more audit effort than under normal circumstances. Nonetheless, auditors are required to comply with PCAOB standards and exercise due professional care and professional skepticism. For more information, refer to our Spotlight, "**Auditing Considerations Related to the Invasion of Ukraine**."

Critical Audit Matters

We plan to continue to focus on the implementation of critical audit matters (CAMs) by triennially inspected audit firms. For some of these firms, our 2022 inspection will be the first inspection since the implementation of CAMs. For annually inspected audit firms, we will continue to evaluate the procedures the auditor performed relating to CAMs.

Our inspection procedures will include: (1) engaging in discussions about CAMs with engagement teams and certain audit committees; (2) reviewing communications of CAMs in the auditor's report; (3) reviewing whether certain matters communicated to the audit committee were included in the audit firm's procedures to determine CAMs; and (4) for focus areas, reviewing the engagement team's determination of matters as a CAM.

Audit Areas With Continued Deficiencies

We will also focus on areas of continued audit deficiencies. This will allow us to evaluate the effectiveness of audit firms' remedial actions in these areas.

Areas where audit deficiencies commonly recur include:

- Revenue recognition and related risk assessment;
- Allowance for loan losses and other accounting estimates; and
- Internal control over financial reporting, particularly controls with a review element.

Firms' Quality Control Systems

An effective QC system provides an audit firm with reasonable assurance that its personnel comply with the applicable professional standards and its standards of quality. While any system has inherent limitations, it is important that the system be effective in preventing — in addition to detecting — audit deficiencies.

In 2022, we will continue assessing audit firms' compliance with existing QC standards. Inspection teams will continue to evaluate each firm's QC system and gain additional insights through supplemental information gathering procedures. In addition, any new or continued impact of the COVID-19 pandemic and the current economic environment will be considered as part of gaining and/or updating an understanding of the design of the firms' QC systems.

Technology

One of the potential challenges whenever new technologies are adopted is ensuring that auditors have the appropriate knowledge and skills to efficiently and, perhaps more importantly, effectively incorporate these new technologies into the audit. Certain key elements of technology management are part of our inspections. Some of these include governance, hardware, software, communications, training, and the experience level of personnel. We perform quality control procedures at both the audit firm level and at the audit engagement level to assess the firms' use of technologies in the audit. In addition, given the rapid pace of technological evolution in financial reporting and auditing, our inspectors will also focus on the following technology-related areas:

- **Auditing digital assets:** The use of digital assets presents unique audit risks to companies and requires an appropriate risk assessment and audit response by audit firms. We will continue to focus on identifying companies that have material digital asset holdings and significant activity related to digital assets. Audits of these identified companies will be selected for inspection, where appropriate, with an emphasis on selecting relevant focus areas and assertions related to existence, valuation, rights and obligations, and financial statement disclosures.

- **Responding to cyber threats:** Cyber threats continue to present unique risks to companies. We will perform inspection procedures to evaluate the auditor's response to identified cybersecurity breaches and known security vulnerabilities (e.g., Log4j).[2]
- **Use of data and technology in the audit:** During our inspections, we may inquire about changes in the use of technology in auditing and financial reporting and obtain a more in-depth understanding of how auditors are using technology in identifying and responding to risks of material misstatement.

AUDIT COMMITTEE OUTREACH

Our ongoing dialogues with audit committee chairs continue to provide valuable insights on a range of topics related to oversight of external auditors. (For more information, read our "2021 Conversations With Audit Committee Chairs" Spotlight.)

We remain committed to seeking views and feedback from audit committees on how to further drive improvements in audit quality and will continue our activities to obtain such views and feedback. In 2022, we will continue to engage with the audit committee chairs of the U.S. public companies whose audits we inspect.

We Want to Hear from You

The PCAOB strives to improve our external communications and provide information that is timely, relevant, and accessible. We invite you to share your views on this document by filling out **our survey**, which should take no more than two minutes to complete.

[2] On December 22, 2021, the Cybersecurity and Infrastructure Security Agency, along with the Federal Bureau of Investigation, National Security Agency, Australian Cyber Security Centre, Canadian Centre for Cyber Security, Computer Emergency Response Team New Zealand, New Zealand National Cyber Security Centre, and the United Kingdom's National Cyber Security Centre issued a joint cybersecurity advisory to address known vulnerabilities in the Apache Log4j software library. For more information, please refer to Alert (AA21-356A).

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