

SPOTLIGHT

Staff Observations and Reminders during the COVID-19 Pandemic

December 2020

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OVERVIEW

The COVID-19 crisis and related economic uncertainty present unique and ongoing challenges for auditors of public companies and broker-dealers. Although the effects of these challenges vary widely and are not yet fully known, auditors continue to be responsible for conducting audits in accordance with PCAOB standards and rules, as well as other regulatory and professional standards.

While the staff observations in this Spotlight relate to audits of public companies, many of the reminders, even where the term public company is used, may also be applicable to audits of broker-dealers.

This Spotlight highlights select staff observations from recent inspections of reviews of interim financial information and audits. It also shares important reminders for auditors to consider as they plan and conduct audits and reviews of interim financial information in the current environment. This publication supplements and builds on our previous Spotlight, *COVID-19: Reminders for Audits Nearing Completion*, issued in April 2020.

New challenges may arise, and auditors have a responsibility to adjust their audits to respond to new or evolving risks of material misstatement due to error or fraud. Our inspections of audits affected by the pandemic are ongoing. Any new observations will be included in the *Staff Update and Preview of 2020 Inspection Observations* or the *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*.

PCAOB STAFF OBSERVATIONS

Consistent with our strategic objective to conduct inspection activities to facilitate more timely and relevant feedback to our stakeholders, we adjusted our 2020 inspections approach at the onset of the pandemic so that we could consider the impact of COVID-19.

We adjusted our overall inspection approach to include review engagements of interim financial information of public companies and selected additional audits of public companies with an off-calendar year end. Specifically, for the U.S. affiliate firms of the largest global networks, we:

- Obtained and read the firms' internal guidance and publications regarding issues affecting audits and reviews of interim financial information related to COVID-19.
- Selected a sample of 25 reviews of interim financial information with periods ending on or before June 30, 2020 and performed inquiries and reviewed documentation to understand how COVID-19 affected the performance of the procedures performed.
- Selected and are reviewing a sample of 25 audits of public companies with fiscal years primarily ending between March 31 and June 30, 2020 to gain an understanding of how COVID-19 affected the performance of procedures in audits.

Observations from our inspection procedures are summarized in this section.

Observations Related to the Firms' Quality Control Systems

In our review of firms' quality control systems, we observed that firms took a number of early steps to address the risks and challenges of COVID-19 at the onset of the pandemic.

- While recognizing the challenges caused by the current environment, firm leadership generally emphasized in communications to all personnel the importance of performing quality audits, exercising professional skepticism, and maintaining integrity.
- As firms moved to a remote work environment, they conducted training sessions focused on addressing the challenges of performing audits in a remote environment. They established resource centers specific to the unique challenges brought on by a remote working environment and developed practice aids and other guidance to assist audit teams.
- Firms emphasized the importance of consultation and, in some cases, established supplemental consultation requirements for issues including government assistance, changes to materiality, market changes impacting accounting, and going concern.
- Certain firms modified monitoring programs to target engagements in industries more likely to be affected by COVID-19 such as travel, entertainment, and leisure; certain segments of the retail industry; energy; and information technology. For example, approaches included proactive outreach by national office personnel and others involved in engagement monitoring programs to understand challenges and how they were being addressed and to encourage engagement teams to perform consultations as necessary.
- Some firms are monitoring the kinds of questions being asked by engagement teams to national office resources and evaluating the need for additional guidance or training.
- In addition, we also noted that certain triennially inspected firms and auditors

of broker-dealers, using purchased methodologies, implemented new guidance developed by the content developers.

Observations from Reviews of Interim Financial Information and Audits

The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with PCAOB standards. A review of interim financial information consists principally of the auditor performing analytical procedures and making inquiries. If the auditor becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with Generally Accepted Accounting Principles in all material respects, the auditor should make additional inquiries or perform other procedures that he or she considers appropriate to provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information.

The selected reviews considered firms' procedures performed in accordance with AS 4105, *Reviews of Interim Financial Information* (AS 4105). Our inspection procedures for the reviews of interim financial information included performing inquiries about, and reviewing documentation of, the procedures performed by the auditor to comply with our standards for a review of interim financial information.

To date, we did not identify any instances of non-compliance with AS 4105 through our inspections of reviews of interim financial information. The observations below are from our inspections of the reviews of interim financial information and approximately half of the additional inspections of public company audits with fiscal years primarily ending between March 31 and June 30, 2020. As we

continue our inspections activities, we may identify instances of non-compliance with our standards or rules or other observations.

Our observations to date include:

- In addition to formally consulting in accordance with firm policies and procedures, many engagement teams increased their interactions with firm industry leaders, national office personnel, or other engagement teams regarding COVID-19 related accounting and auditing issues.
- Engagement teams' interactions with audit committees have increased in frequency during the reviews of interim financial information. Many of these communications with audit committees relate to the effects of the pandemic on the public company's interim financial statements, including accounting policies and practices and its internal control over financial reporting.

We summarized our conversations with audit committee chairs on how they are considering the effects of COVID-19 on financial reporting and the audit as they perform their oversight duties in a July 2020 publication, ***Conversations with Audit Committee Chairs: COVID-19 and the Audit.***

- Engagement teams considered various methodologies to establish materiality in response to changes in key metrics for both their interim financial information reviews, and to plan the nature, timing, and extent of audit procedures. In addition, engagement teams consulted when quantitative and qualitative factors previously used to determine materiality changed significantly.
- Certain engagement teams expanded their use of fraud and forensic specialists during fraud brainstorming sessions and planning.
- As engagement teams performed reviews of interim financial information, they have, in many instances, focused their analytical procedures, inquiries, and other procedures on the public company's ability to continue as a going concern and the potential for impairment of goodwill and other long-lived assets. Engagement teams often involved auditor specialists, including forensic specialists, to assist in reviewing certain higher risk areas, including significant assumptions in accounting estimates such as those related to projected financial information. Some engagement teams also engaged in discussions with the company's specialists regarding valuations performed.
- Many engagement teams began planning for inventory observations early in the audit process, including by consulting with national office resources on an appropriate audit strategy and engaging with the public company's management. In one instance, an engagement team performed a real-time virtual inventory observation, using known landmarks to verify the location. In another instance, an engagement team conducted a "dry run" virtual inventory observation with the public company's management in advance of the year-end physical inventory observation to test the technology they intended to use.
- Engagement teams used virtual meetings, screen-sharing tools, instant messaging, and related technologies to communicate with one another. In some cases, team members were connected through an all-day virtual meeting to simulate a "work room" environment that enabled ad hoc communication and facilitated supervision of the work of engagement team members.

REMINDERS AND KEY TAKEAWAYS

Overarching Reminders

Our [April 2020 Spotlight](#) includes important reminders about the responsibilities of auditors for (1) identifying, assessing, and responding to risks of material misstatement, (2) audit committee communications, (3) the auditor's report, and (4) quality control considerations. These reminders continue to be applicable for all audits performed in the current environment. In addition, the following section contains select reminders and key takeaways, including insights gained during recent inspection activities, to keep in mind as auditors conduct reviews of interim financial information and audits in the current environment.

Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.

Reviews of Interim Financial Information

When planning and performing reviews of interim financial information in accordance with the requirements of AS 4105, auditors should have sufficient knowledge of the public company's business and its internal control. In the current environment, due to the impact of COVID-19 and the transition to remote working arrangements, auditors may have to perform

procedures beyond those historically performed to obtain the requisite knowledge.

As the U.S. Securities and Exchange Commission (SEC) staff has noted, the accounting and financial reporting implications of COVID-19 may require public companies to make significant judgments and estimates that can be challenging in an environment of uncertainty.¹ In performing reviews of interim financial information, we remind auditors that evolving circumstances or new information may surface from one quarter to the next. If auditors become aware of information that leads them to believe that the interim financial information may not be in conformity with the applicable financial reporting framework, the auditors have a responsibility to make additional inquiries or perform other procedures considered appropriate to provide a basis for communicating whether they are aware of any material modifications that should be made to the interim financial information. For instance, in the current environment, inquiries regarding the impairment of assets or compliance with debt covenants and the auditor's updated knowledge of the public company's business and internal control may lead the auditor to consider if additional inquiries and/or procedures are necessary.

Many public companies have also had to adapt financial reporting processes, which may have implications on internal control over financial reporting (ICFR). The SEC staff has reminded public companies that if any change materially affects, or is reasonably likely to materially affect, a public company's ICFR, such change is required to be disclosed in the public company's periodic reporting.² We remind auditors that interim reviews include limited procedures regarding management's quarterly

¹ *Statement on the Importance of High-Quality Financial Reporting in Light of the Significant Impacts of COVID-19* (April 3, 2020).

² *Statement on the Continued Importance of High-Quality Financial Reporting for Investors in Light of COVID-19* (June 23, 2020).

certifications about ICFR. Those limited procedures provide a basis for the auditor's determination as to whether they have become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in ICFR in order for management's certifications to be accurate and comply with the requirements of Section 302 of the Sarbanes-Oxley Act.

Changes in judgments regarding materiality may also affect the planning and performance of reviews of interim financial information and the related review conclusions, such as when evaluating whether a material modification should be made to the interim financial information for it to conform with the applicable financial reporting framework.

Risk Assessment and Materiality

Auditors are required to identify and assess the risks of material misstatement, including fraud risks, throughout the audit. The ongoing effects of COVID-19 and related economic uncertainty may exacerbate previously identified risks or result in the identification of new risks. Auditors may need to revisit their initial assessment of risks and modify planned procedures accordingly as circumstances evolve.

Specifically, the current economic environment could increase the potential for error or fraud. Opportunities, incentives, or pressures may exist to make financial results appear more favorable or unfavorable. Further, the uncertain nature of the pandemic and related effects on personnel (e.g., salary reductions or imminent layoffs) might create an environment for employees to rationalize actions that would not be appropriate.

Areas where risks of error or fraud might be elevated include, for example:

- Estimates that are largely based on forecasts of future events, given uncertainties in available information.

- Management override of ICFR in areas where due to changes in staffing, reporting structure, and assignments there is reduced segregation of duties.

Auditors should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the public company's earnings and other relevant factors. As the audit progresses, the effects of COVID-19 on the public company's financial condition, earnings, and cash flows may result in auditors having to reevaluate the established materiality level or levels and tolerable misstatement. If the reevaluation results in a lower amount for the materiality level or levels and tolerable misstatement than initially established, auditors should (1) evaluate the effect, if any, of the lower amount or amounts on risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

Changes in materiality can also affect the auditor's evaluation of audit results (including evaluation of accumulated misstatements, and in particular uncorrected misstatements) and the determination as to whether sufficient appropriate audit evidence has been obtained.

Internal Control over Financial Reporting

Furloughs, new technologies, and other workforce changes may affect certain processes and the flow of transactions, and related controls. In some cases, the public company's changes may include reassigning control owners and designing "workarounds" that provide alternative means for executing existing processes and controls. The public company's response to the pandemic may also affect the operation of IT-related controls and monitoring or review-type controls. These changes may have potential effects on the

auditor's understanding and evaluation of ICFR, including:

- In some cases, changes to the operation of relevant controls may only be temporary in nature, whereas in other cases, changes may be permanent. This may affect the auditor's approach to selecting controls to test, the nature, timing, and extent of procedures performed to support the ICFR opinion, and the auditor's control reliance strategy in the financial statement audit.
- Changes to the frequency of the performance of certain controls, including whether the operation of controls has been affected by business disruptions, may inform the timing and extent of the auditor's tests of operating effectiveness.

Accounting Estimates

New requirements for auditing accounting estimates, including fair value measurements, and for using the work of public company and auditor specialists are effective for 2020 calendar year-end audits.

Auditors should understand the public company's processes used to develop its accounting estimates, including the methods, data, and assumptions used, and the extent to which the public company uses third parties. In testing the public company's process, auditors should identify which of the assumptions used by the public company are significant assumptions to the accounting estimate and evaluate the reasonableness of such assumptions used by the public company to develop the estimate, both individually and in combination. With respect to significant

assumptions, we remind auditors of the following:

- Auditors should evaluate whether the public company has a reasonable basis for the significant assumptions used and, when applicable, for its selection of assumptions from a range of potential assumptions.
- Auditors should also evaluate significant assumptions to determine whether they are consistent with relevant industry, regulatory, and other external factors, including economic conditions, and with other significant assumptions used by the public company in other estimates tested.
- The auditor's assessment of significant assumptions involves considering whether management considered relevant evidence, regardless of whether it corroborates or contradicts the public company's assumption.
- In the COVID-19 environment, assumptions based on past experience and management expectations may not reflect current market information or be representative of expected future conditions or events. Such assumptions may include, for example, those related to revenue projections, cash flow estimates, charge-off rates, or projected rate of return assumptions.
- In some cases, significant assumptions may be based on the public company's intent and ability to carry out a particular course of action. Economic uncertainties may limit a public company's means to carry out a planned action.

Uncertainties surrounding the effects of the pandemic have heightened the subjectivity and measurement uncertainty of many accounting estimates. Some estimates also involve complex processes and methods. Public companies may

involve specialists to assist in the development of accounting estimates, and auditors may also need to involve specialists to help engagement teams sufficiently evaluate assumptions in light of the pandemic. Auditors are reminded that amended and revised AS 1210, *Using the Work of an Auditor-Engaged Specialist*, is effective for audits of financial statements for fiscal years ending on or after December 15, 2020, when specialists are not employed by the firm, but engaged by the auditor.

Supervision, Staffing, and Review

Given the uncertainties of the economic effects of COVID-19, auditors may need to adjust the extent of supervision, particularly for audit areas that have become more complex in the current environment. Similarly, auditors may need to adjust the assignment of work to engagement team members. For example, it might be necessary to increase the involvement of more senior or experienced members of the engagement team in the performance of procedures related to evaluating significant assumptions in a judgmental estimate.

Alternative approaches to assigning, informing, directing, and reviewing the work of engagement team members may be needed, including for other auditors in different locations and jurisdictions. When previous plans involved travel, physical observation, and in-person interactions, the auditor will need to use other means to effectively supervise the work of engagement team members and to review that work.

When the work performed by other auditors involves significant judgments, it may be useful to engage with the engagement quality reviewer about the assignment and supervision of work performed by the other auditors.

Auditor Independence

Auditors must comply with PCAOB and SEC auditor independence rules. Challenges of the current economic environment might give rise to situations that could threaten auditor independence (e.g., unpaid professional fees or increased calls for non-audit services). We remind auditors to carefully evaluate potential threats to auditor independence and maintain compliance with the applicable rules.

Other Information

The SEC staff has indicated that public companies should consider the need for COVID-19-related disclosures and that disclosures of such risks and COVID-19-related effects may be necessary or appropriate in other information and the financial statements contained in annual and quarterly reports.³

Auditors have a responsibility with respect to other information contained in certain documents that contain audited financial statements or interim financial information that has been reviewed. Auditors should read the other information to consider whether such information or the manner of its presentation is materially inconsistent with the financial statements or interim financial information. In doing so, auditors may, for example, consider the consistency of the public company's disclosures about the effects of COVID-19 included in sections such as Risk Factors and Management's Discussion and Analysis with the information presented in the financial statements or interim financial information. In reading and considering the other information, auditors may also become aware of information that they believe is a material misstatement of fact.

³ *Statement on Continued Dialogue with Audit Firm Representatives on Audit Quality in China and Other Emerging Markets; Coronavirus — Reporting Considerations and Potential Relief* (February 19, 2020).

Broker-Dealers

In addition to the risks described above for auditors of public companies, the effects of the pandemic present unique risks for auditors of broker-dealers. For example, recent market volatility and the resulting effect on investor assets and the related fees collected by broker-dealers may cause increased financial pressures for broker-dealers to compensate for lost revenue. This potentially increases the risk for misconduct regarding fees and expenses charged to customers; and calculation and asset valuation errors.

In addition, a number of regulatory developments may affect risks associated with compliance with the financial responsibility rules. Broker-dealers have adjusted controls over net capital, reserve requirements, and possession or control of securities, as well as supervision of customer accounts and trade orders, to adapt to a remote working environment. When controls over compliance are modified during the year, the auditor should obtain evidence regarding the design and operating effectiveness of new and superseded controls. Certain broker-dealers may need to consider modification to

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their normal operating practices regarding collecting and processing customer checks in light of the current environment, potentially increasing risks associated with SEC requirements regarding prompt transmittal of customer funds. Auditors have a responsibility to understand changes in the broker-dealer's operations that are relevant to compliance with the exemption provisions as they plan the nature, timing, and extent of the necessary inquiries and other review procedures. The SEC issued FAQs on COVID-19 and broker-dealer financial responsibility rules, which included an FAQ on prompt transmittal of customer funds.⁴

⁴ *Frequently Asked Questions Concerning the COVID-19 Pandemic and the Broker-Dealer Financial Responsibility Rules* (June 26, 2020, updated November 24, 2020).

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