

# SPOTLIGHT

## Staff Outlook for 2021 Inspections

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April 2021

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## OVERVIEW

The PCAOB is committed to driving improvement in audit quality and promoting compliance with our professional standards and rules. The primary means by which we do this is through our inspections program. This Spotlight provides an overview of the principal changes we are making to inspections in 2021 and highlights important areas of planned inspection focus. Auditors may find this information valuable as they plan and perform current and upcoming audits. Audit committees may also use this information, including the accompanying [Audit Committee Resource: 2021 Inspections Outlook](#), to inform constructive dialogue with their auditors.

## OVERVIEW OF PRINCIPAL CHANGES TO INSPECTIONS IN 2021

To further our goals of driving improvements in audit quality and promoting compliance with our professional standards and rules, we developed our 2021 inspection plans with two primary objectives: (1) respond to the financial reporting and audit risks posed by the COVID-19 pandemic, and (2) reduce the predictability of our inspections.

Given the COVID-19 pandemic, we expect to continue to conduct inspections remotely for the foreseeable future.

First, the COVID-19 pandemic has had a substantial impact on preparers, auditors, audit committees, and others involved in the financial reporting process. Recognizing this change in the environment, we designed our 2021 inspection plans to directly focus on the effects of the pandemic on public companies'

## Six Reminders for Auditors

Given the environment caused by the COVID-19 pandemic, we remind auditors to:

1. Exercise due professional care and professional skepticism.
2. Identify and assess the risks of material misstatement due to error or fraud throughout the audit. New challenges may arise, and auditors have a responsibility to adjust their audits to respond to new or evolving risks of material misstatement, including fraud risks.
3. Establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, and reevaluate as circumstances evolve.
4. Understand the public company's processes to develop its accounting estimates, including the methods, data, and assumptions used, and the extent to which the processes involve the use of third parties.
5. When assigning work to engagement team members and determining the necessary extent of supervision, take into account the nature of the public company, the nature of assigned work for each engagement team member, the risks of material misstatement, and each team member's knowledge, skill, and ability. Consider the need for changes in approach due to remote work environments.
6. Comply with PCAOB and Securities and Exchange Commission (SEC) auditor independence rules. Changes in the public company's and auditor's circumstances may give rise to situations that could threaten auditor independence.

financial reporting. We plan to select audits for review in industries experiencing particularly significant disruptions or elevated risks during the pandemic, such as transportation, entertainment, hospitality, manufacturing, certain aspects of the retail segment, and commercial real estate (including real estate investment trusts).

When selecting individual areas of audits to review, our inspections will focus also on certain financial statement items and other reporting matters that have been particularly affected by the pandemic, such as impairments, going concern assessments, allowance for loan losses, and the increased risk of fraud. When conducting our reviews, we will evaluate how auditors completed and documented procedures in compliance with our standards, considering such factors as remote work, time constraints, availability of information, and access to public companies' management. We will also evaluate auditors' compliance with the new requirements relating to auditing accounting estimates, and if applicable, the use of specialists.

The COVID-19 pandemic has increased risks related to internal control over compliance for brokers and dealers that are responsible for custody and control of customers' funds and securities, particularly when processes and supervisory procedures have changed. We plan to inspect a greater number of audits of custodial broker-dealers in 2021 than we have in prior years.

Second, we believe that, over time, the manner in which we select engagements to review and the focus areas we select in those reviews may have become increasingly predictable. To address this, we have adopted an inspections approach in 2021 that we believe will enhance the overall unpredictability of our inspections.

More specifically, although we plan to select roughly the same number of audits to review as in recent years, we plan to significantly increase

the percentage of audits we select randomly, especially for the largest audit firms.

We also plan to select more non-traditional focus areas for inspection. Over time, the selection of inspection focus areas may have become more predictable such that firms are able to better anticipate areas to be inspected and place more audit emphasis on those areas, potentially at the risk of reducing attention to other important audit areas. We therefore plan to increasingly select certain non-traditional financial statement areas for review. We will, of course, also continue to target areas that we believe pose higher risks of material misstatement in particular audits, or that are the subject of recurring audit deficiencies.

We believe this approach will encourage firms to consistently strive for the performance of quality audits on all public companies, and discourage an approach that might only focus on those audits or areas that may be perceived as more likely to be selected for review as part of a PCAOB inspection.

## OTHER AREAS OF INSPECTION

In conducting inspections in 2021, we plan to place emphasis on the following: (1) how firms address audit areas with continued deficiencies; (2) firms' quality control (QC) systems; (3) auditor independence; (4) fraud procedures; (5) critical audit matters; (6) firms'

In addition to the information contained in this Spotlight, the PCAOB issued additional reminders for auditors, including those of broker-dealers, to consider as they plan and conduct audits and reviews. Those publications, focused on the COVID-19 pandemic, were issued in April and December 2020.

implementation of new auditing standards; and (7) other areas such as supervision of audits involving other auditors, responding to cyber threats, and auditing digital assets.

In 2019, we launched a target team to perform inspection procedures across firms focused on current audit risks and particular industries. In 2021, the target team will primarily focus on areas that have greater risk due to the COVID-19 pandemic.

## Audit Areas with Continued Deficiencies

Our inspection activities will include procedures to assess how firms are addressing areas with recurring deficiencies. Such procedures may include reviewing:

- Firm-specific methodologies and policies within the quality control system that are designed to identify and remediate deficiencies;
- The tools, techniques, and approaches firms use to identify the underlying causes of audit deficiencies; and

## Audit Areas with Continued Deficiencies and Opportunities for Potential Improvement

- Revenue
- Accounting estimates
- Internal control over financial reporting (ICFR)
- Independence

- Firms' timely evaluation and consideration of remedial actions to prevent deficiencies from recurring.

Although auditors have no responsibility to retrospectively review their work after a report is issued, working papers relating to particular engagements may be subjected to a PCAOB inspection or other review, whereby an omission of a necessary auditing procedure may be identified. We will continue to review how firms respond to deficiencies identified in our comment forms, including, if applicable, how the firm assessed the importance of any omitted procedures under AS 2901, *Consideration of Omitted Procedures After the Report Date*, or AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

## Firms' Quality Control Systems

During 2021, we plan to continue our enhanced focus on firms' quality control systems as part of our goal to move towards a more preventative regulatory approach. Our QC procedures are scalable and involve tailoring our approach to evaluating the firm's QC system based on the size, nature, structure, and complexity of the firm. Our procedures consist of gaining or updating our understanding of the design of a firm's QC system through inquiry and reviewing documented policies and procedures. In addition to our QC procedures, we plan to gather information on changes firms are making to their QC systems, which may be in response to new or changing regulatory, environmental, or firm-specific factors. Collectively, our QC procedures will inform our understanding of how each firm we inspect designs and operates its QC system to obtain reasonable assurance that firm personnel comply with the PCAOB standards and the firm's standards of quality. The information we gather will also aid our ongoing effort to adopt revised QC standards and our efforts to transform our inspections approach.

In 2020, we refined our planned inspection procedures for annually inspected firms to increase our focus on areas most likely to be affected by the COVID-19 pandemic and related economic uncertainty. These areas included, for example, leadership communications, consultation requirements, client acceptance and continuance procedures, real-time monitoring, and pre-issuance reviews. We will build upon this work in 2021 and will evaluate how firms' ongoing modifications to their QC systems are affecting audit quality.

We will also tailor our approach to inspecting QC systems at smaller firms, including triennially inspected firms and non-U.S. affiliates to be proportional with our annual firm inspections, to the extent practical. We piloted our approach to certain smaller firms in 2020, and we plan to continue this approach to additional smaller firms in 2021.

In our inspection of a firm's QC system, we may devote increased attention to:

- How a firm's leadership and governance structures impact audit quality;
- The approaches a firm uses to promote a culture that emphasizes audit quality;
- How a firm proactively identifies and responds to audit risks (including when circumstances change);
- A firm's monitoring of the effectiveness of its QC system; and
- How a firm designs and monitors the effectiveness of actions to remediate deficiencies.

## How Firms Comply with Auditor Independence Requirements

Auditor independence remains foundational to the ability of investors to trust audited financial statements. Current SEC and PCAOB independence requirements related to audits of public companies and broker-dealers require that auditors be independent of their audit clients—both in fact and in appearance. In our inspections, we continue to identify deficiencies that suggest some firms may not have appropriate quality control systems in place to prevent and/or detect violations of applicable independence rules. Our inspections in 2021 will continue to focus on auditor independence and, specifically, the following four areas:

1. Firm-identified violations of independence rules (as indicators of possible firm quality control concerns);
2. Compliance with pre-approval independence requirements governing the provision of significant non-audit services to audit clients;
3. Communications from engagement teams to audit committees concerning independence matters; and
4. Firms' responses to past quality control criticisms, including those relating to high rates of non-compliance with internal policies and procedures.

## Fraud Procedures

Our 2021 inspection procedures will assess how auditors identified and assessed the risk of material misstatement due to fraud, and how auditors designed and implemented appropriate audit responses. We also plan to increase our focus on other fraud-related procedures, including how auditors incorporate an element of unpredictability in the selection

of auditing procedures to be performed year over year. For example, incorporating unpredictability could involve (1) performing audit procedures on an unannounced basis, (2) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters, or (3) in multi-location audits, varying the location or the nature, timing, and extent of audit procedures at locations or business units from year to year.

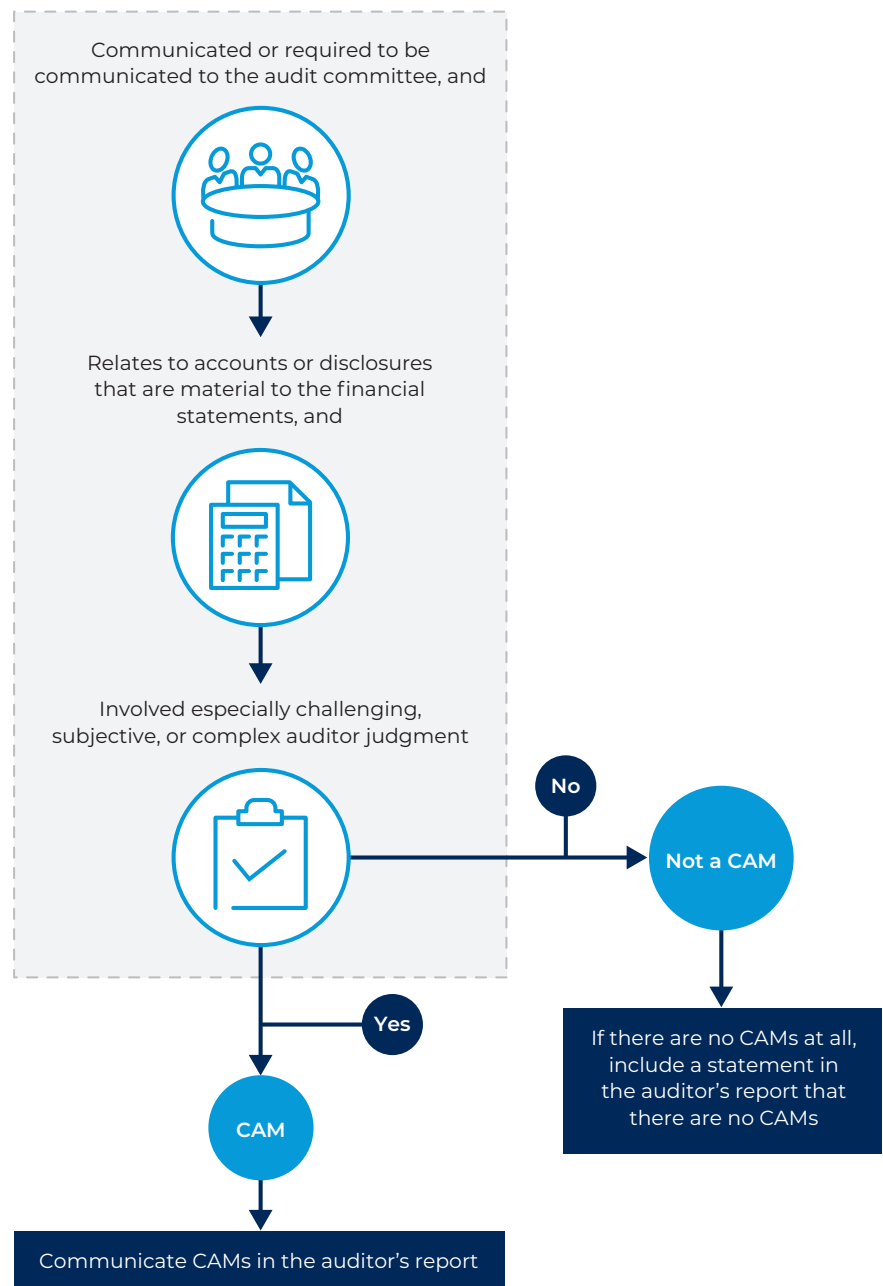
## Critical Audit Matters

The requirements in AS 3101 to determine and communicate critical audit matters (CAMs) are now effective for audits of all public companies to which the requirements apply. CAM communications are intended to inform investors and other financial statement users generally about matters that required especially challenging, subjective, or complex auditor judgment, and the auditor’s response to those matters.

In 2021, we plan to continue updating our understanding of the methodology and tools that are in place at the firm level, and how individual engagement teams applied the requirements related to CAMs in their audits. Some firm-level discussions will include understanding the tools the firm is using, the training the firm provided to its staff, and the level of assistance the firm provides to individual engagement teams as they determine, communicate, and document CAMs.

For additional resources and information on CAM requirements, please visit our [Auditor Reporting implementation page](#).

## Determining and Communicating Critical Audit Matters (“CAMs”)



## How Firms Implement New Auditing Standards

At the end of 2018, the Board approved new requirements for the auditing of accounting estimates and the auditor's use of the work of specialists. These requirements are effective for audits of financial statements for fiscal years ending on or after December 15, 2020. During 2020, we made inquiries to understand changes annually inspected firms have made to their methodologies, guidance, and/or tools, including any changes to the QC system, in preparing to implement the new requirements. In 2021, we will review how firms monitored compliance with the new requirements. We will also seek to understand how the new requirements have been complied with on individual audit engagements we select for review, and to which the new requirements are applicable.

For additional resources and information on the new requirements, please visit our [Auditing Accounting Estimates, Including Fair Value Measurements and Auditor's Use of the Work of Specialists](#) implementation pages.

## Supervision of Audits Involving Other Auditors

With increasingly global operations of public companies, other auditors, often in other jurisdictions, play a significant role in an audit. Restrictions on travel and in-person interactions in 2020 created certain challenges for the supervision and review of work performed by other auditors. Our inspections will assess how auditors executed their responsibilities for supervising the work of other auditors.

## Responding to Cyber Threats

We plan to continue to understand any updates to existing firm guidance related to cyber incidents. If there was a cyber incident affecting a public company or broker-dealer selected for review, we will evaluate how engagement teams applied that guidance. For example, where an incident has occurred, we will evaluate whether and how the engagement team reevaluated its risk assessment or modified planned audit responses to address effects on relevant controls, including, if applicable, evaluation of control deficiencies in ICFR.

## Auditing Digital Assets

As more public companies and broker-dealers venture into the realm of digital assets, such as through the holding of cryptoassets, we will select certain audits for review where transactions in such assets are material to the financial statements. We will review how firms identify and assess the risks of material misstatement, including valuation issues, and how the related audit responses are designed and performed.

Throughout 2020, PCAOB staff continued to conduct research and outreach as part of assessing whether regulatory action is necessary in response to the increasing use of technology by auditors and preparers. We gathered information from PCAOB oversight activities, reviewed changes to firms' methodologies, and studied relevant academic research. Early in 2020, we issued a **Data and Technology Research Project Update** that summarizes our work in this area, as well as a **Spotlight focused on Audits Involving Cryptoassets**.



## AUDIT COMMITTEE OUTREACH

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. An integral part of this engagement is our interaction with audit committees during the inspection process. In 2021, we will continue to invite the audit committee chairs of most of the U.S. public companies whose audits we inspect to speak with us.

To learn more about what we have heard from audit committee chairs, please visit our [Information for Audit Committees](#) web page.

### We Want to Hear from You

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