Floyd Advisory

Audit Quality in America Remains Historically High

Big 4 PCAOB Audit Inspection Deficiencies Increase in 2021 Reports, But Audit Quality Remains High

Introduction

In December 2022, the Public Company Accounting Oversight Board ("PCAOB") published the 2021 Inspection Reports for the "Big 4" US public accounting firms (Deloitte, PwC, EY, and KPMG). Of note, PCAOB audit inspections are required annually for any public accounting firm that issues audit reports for more than 100 issuers in a year.[1, 2]

Of concern to investors, the PCAOB defines an inspection deficiency as a failure to comply with generally accepted auditing standards ("GAAS"), which is "**of such significance that [the PCAOB] believes the firm, at the time it issued its audit report(s), had not obtained sufficient appropriate audit evidence to support its opinion(s) on the issuer's financial statements and/or ICFR [Internal Controls over Financial Reporting]**."[3] Given the importance of these issues, the objective of this article is to provide:

i. Deficiency rate observations for the Big 4 as a group and by firm,
ii. The nature of deficiencies over the last three available years of data (2019-2021),
iii. The audit areas in which deficiencies were noted over the same last three years, and,
iv. Key considerations for audit committee members to better understand and ask questions about the audit function and process.

Deficiency Rates Remain "Low," But 2021 Was a Small Step in the Wrong Direction

The frequency of deficiencies for the Big 4 accounting firms increased on average to 16% in 2021, up from 12% in the 2020 inspection year. Despite the increase, the 2021 deficiency rate is lower than the rates in 2019 (22%), 2018 (25%), and 2017 (31%).[4]

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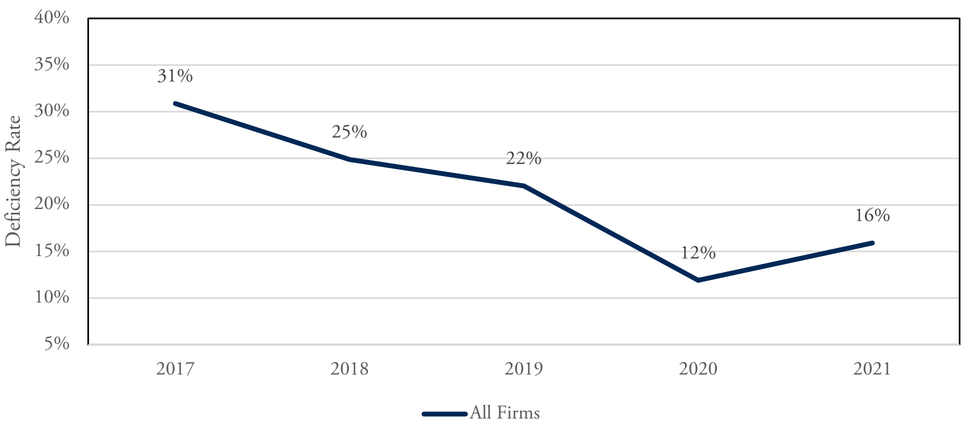
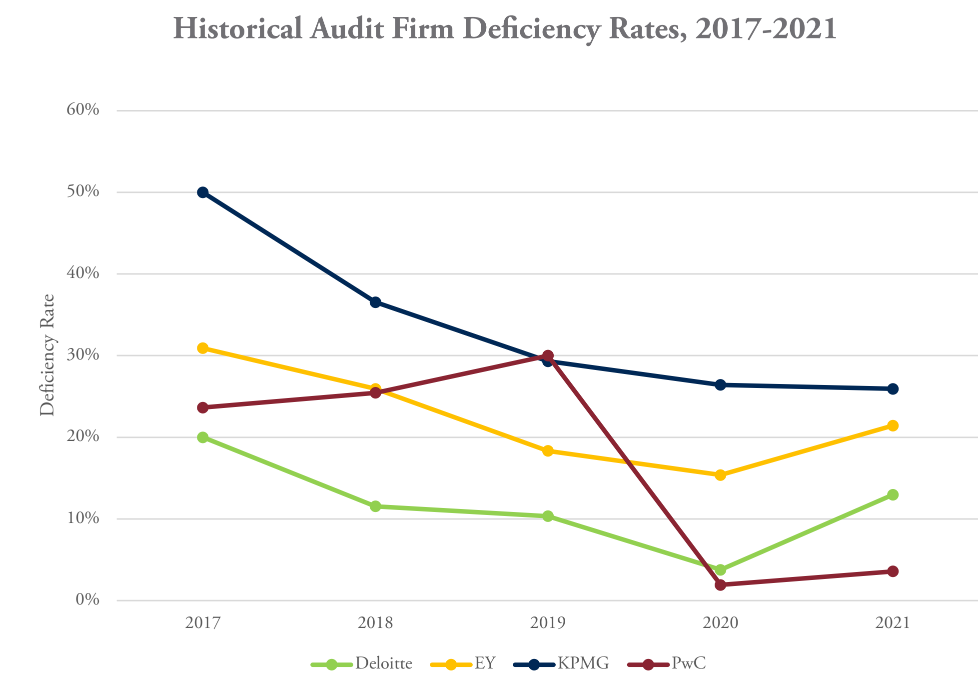
Audit Deficiency Rates, 2017-2021



[1] *See* PCAOB's paragraph regarding which firms are required to report annually (https://pcaobus.org/oversight/inspections/firm-inspection-reports).
[2] The purpose of these inspections is to assess the audit firm's compliance with PCAOB standards and rules as well as other applicable regulatory and professional requirements. *See* https://pcaobus.org/oversight/inspections.
[3] Referred to as "Part I.A Deficiencies" by the PCAOB. *See* https://pcaobus.org/Inspections/Documents/Inspections-Report-Guide.pdf.
[4] "Inspection year" refers to the year in which the PCAOB conducted its inspection.

The following graph illustrates the deficiency rates for the Big 4 firms on a firm-by-firm basis over the same time period:



We observed the following trends:

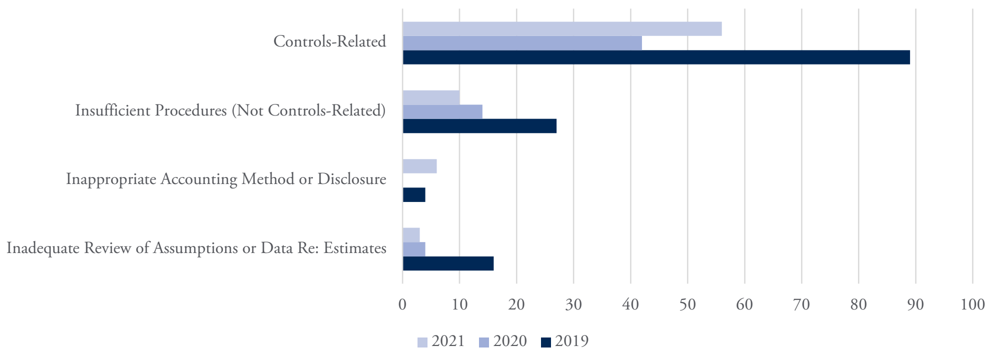
- PwC had the lowest deficiency rate in both 2020 and 2021, with deficiency rates of 2% and 4%, respectively. It has also showed the greatest level of improvement since 2019, when it had a deficiency rate of 30%.
- Deloitte had the 2nd lowest deficiency rate for 2021 at 13%, and its results for the five-year period from 2017 to 2021 reflect the lowest average annual deficiency rate at 12%.
- KPMG demonstrated consistent improvement in each of the five years from 2017 to 2021, improving from a deficiency rate of 50% in 2017 to 26% in 2021.
- EY had an overall improvement in the five-year period, dropping from a deficiency rate of 31% in 2017 to 21% in 2021.

Controls-Related Deficiencies Continue to be Most Common

The deficiency rates discussed herein are based on audits selected by the PCAOB for inspection. Per the PCAOB, audits are selected for testing based on risk for financial statement errors. The risk assessment includes the PCAOB's evaluation of the registrant, accounting firm considerations, and audit areas for each registrant that the PCAOB believes has heightened risk of material misstatement. The PCAOB also makes random selections; for the 2021 inspections, random selections comprised approximately 45% of the total selections for the four largest US public accounting firms.

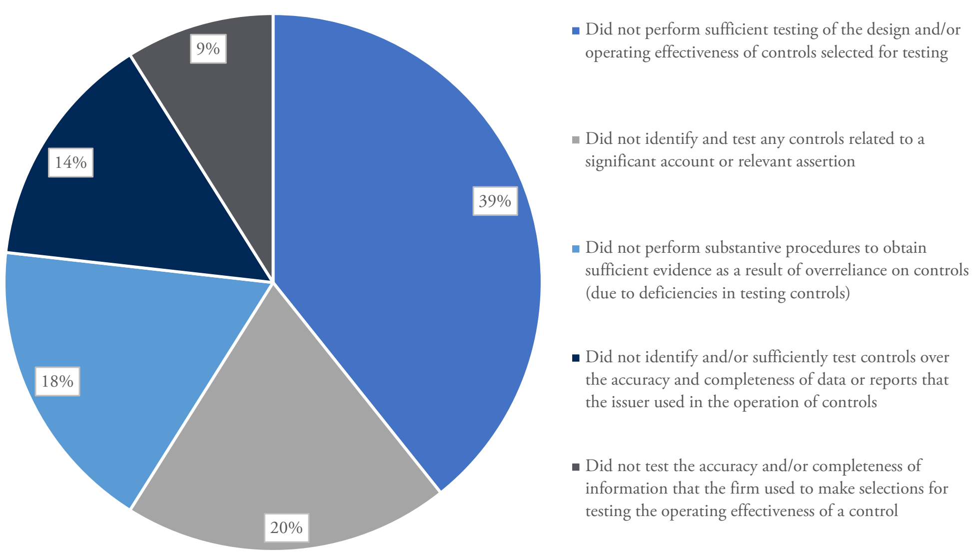
Each year, the PCAOB provides the "Most Frequently Identified Part I.A Deficiencies" in audits of financial statements and ICFR audits. For our reporting purposes, we compiled the data of these deficiencies over the last three years and categorized them into four types as shown in the following graph:

Types of Deficiencies for Big 4, 2019-2021



Over the last three years, the majority of deficiencies identified for the Big 4 firms were "Controls-Related," which we have defined as deficiencies involving the performance of procedures, testing, or evaluation of internal controls over financial reporting.[5] Within the "Controls-Related" category, the most prevalent specific deficiency was that the auditor "did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing" as shown in the graph below, representing approximately 40% of the "Controls-Related" deficiencies.

Controls-Related Deficiencies for Big 4, 2021



Each of the "Controls-Related" deficiencies depicted in the graph above are similar and/or interconnected. The first, second, fourth, and fifth most prevalent "Controls-Related" deficiencies listed in the graph are due to an insufficient level of testing by the accounting firm of an issuer's internal controls and represent over 80% of the population. The third is a by-product of the other four deficiencies in that the accounting firm relied too heavily on potentially unreliable controls, and therefore did not perform adequate alternative substantive procedures.

"As audit firms expand their operations, and as the technical complexity of financial statements and audits increases, the effectiveness of an audit firm's quality control system continues to be critical. Additionally, emerging trends – such as new approaches to raising capital, digital assets, the war for talent, and increased remote work at public companies, broker-dealers, and audit firms – are transforming auditing and financial statement preparation while creating additional risks."

PCAOB Strategic Plan (2022-2026)

[5] We have defined "Insufficient Procedures (Not Controls-Related)" as deficiencies that involve testing or performing procedures that are not controls-related. "Inadequate Review of Assumptions or Data Re: Estimates" is related to deficiencies that involve evaluating a significant assumption or developing an estimate. Lastly, "Inappropriate Accounting Method or Disclosure" deficiencies are those where one did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.

Revenue is the Most Commonly Reviewed Audit Area; Lesser Reviewed Areas Reflect Potential Concerns

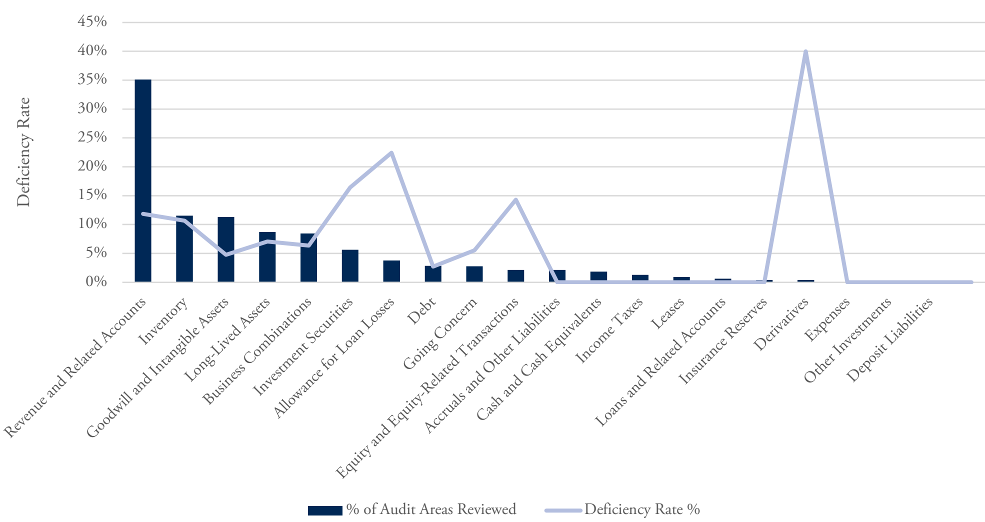
The PCAOB includes data in its reports regarding areas of the financial statements that were most reviewed and whether these areas had deficiencies.[6] Over the last three years, the PCAOB focused the most attention on audit procedures related to "Revenue and Related Accounts," accounting for 35% of its inspections for the four firms. Of significance, revenue recognition-related issues ranked among the top five audit challenges in a survey conducted by the AICPA.[7]

Other prevalent inspection areas included Inventory (12%), Goodwill and Intangible Assets (11%), Long-Lived Assets (9%), Business Combinations (8%), Investment Securities (6%), Allowance for Loan Losses (4%), Debt (3%), Going Concern (3%), and Equity and Equity-Related Transactions (2%).[8]

The table below depicts the most commonly reviewed audit areas for the Big 4 firms over the last three years and their respective deficiency rates.

"[T]he two areas with the highest deficiency rates were Derivatives and Allowance for Loan Losses, with deficiency rates of 40% and 22%, respectively, which were lesser reviewed areas compared to areas like Revenue, Inventory, and Goodwill and Intangible Assets."

Audit Areas Reviewed and Associated Deficiency Rates, 2019-2021



Interestingly, the two areas with the highest deficiency rates were Derivatives and Allowance for Loan Losses, with deficiency rates of 40% and 22%, respectively, which were lesser reviewed areas compared to areas like Revenue, Inventory, and Goodwill and Intangible Assets. One possible explanation is that audit firms focused less time and resources on these lesser reviewed audit areas, increasing the likelihood of deficiencies.

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[6] Please note that the PCAOB reports only the five most frequently reviewed audit areas and deficiencies each year and reports on the frequency of these top five audit areas and deficiencies for a trailing three-year period. As such, the data released by the PCAOB does not include every audit area reviewed and deficiency identified.

[7] *See* AICPA's article where peer reviewers discuss top audit challenges in 2021 (https://www.aicpa.org/news/article/top-audit-challenges-in-2021-peer-reviewers-weigh-in).

[8] The remaining reviewed audit areas from the 2019-2021 period represent 2% and below of the total audit areas reviewed and were categorized for presentation purposes.

The Importance of Inspection Report Results to Audit Committees

Audit committees play a critical role through their oversight of the financial reporting process, including ICFR, and over the external audit process. Effective oversight by an active, experienced, independent, and knowledgeable audit committee significantly furthers the collective goal of providing high quality, reliable financial information to the public. However, audit deficiencies, which highlight areas that do not meet GAAS, add significant risk to the financial reporting process.

Based on the PCAOB Inspection Report observations noted herein, audit committees should consider the following questions to ensure audit quality is maximized:

- Does the audit committee fully understand the auditor's procedures to ensure that audit testing and workpapers are adequate in all areas, not just those where inspections are prevalent?
- What percent of the audit budget is allocated to testing ICFR to ensure internal controls are adequate and effective, and how has the budget allocation differed from prior years?
- To the extent that audit deficiencies existed in prior PCAOB audits, what steps were taken by the auditor to ensure that these are not problem areas moving forward?
- Has the auditor considered changes to the business and industry that could give rise to new high-risk audit areas, and what changes to the scope and focus areas of the audit were made, if any?

We look forward to reviewing future PCAOB Inspection Reports and sharing the results and our observations.

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ABOUT Floyd Advisory
Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of SEC reporting, transaction advisory, investigations and compliance, litigation services, as well as business strategy and valuation.

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