

# SPOTLIGHT

## Bank Financial Reporting Audits

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September 2024



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## OVERVIEW

Inspecting registered public accounting firms (“audit firms” or “firms”) is one of the most important activities the PCAOB engages in to protect investors in public companies and customers of brokers and dealers (“broker-dealers”). This is particularly true in times of economic volatility and rapid change. In addition to reviewing auditor compliance with PCAOB rules and standards in particular audits, inspections inform our standard-setting and enforcement programs as PCAOB staff (“we”) work together to advance our mission.

This Spotlight provides a summary of our inspections of bank audits in recent years. We believe this publication is important given certain disruptions in the banking industry, including impacts from rising interest rates. In certain recent audits we reviewed, we saw instances of engagement teams not revisiting initial risk assessments performed earlier in the year as interest rates continued to rise. In some instances, the interest rate volatility was documented as an operational or business issue with no financial reporting or internal control over financial reporting (ICFR) considerations. As a result, some engagement teams did not identify in their audits certain risks of material misstatement despite changes in bank-specific or macroeconomic conditions that indicated increased risk in certain audit areas. We have been encouraging firms to consider potential risks, including increased volatility in financial and commodity markets due to fluctuations in interest rates and inflationary trends, since we published our Spotlight, [“Staff Overview for Planned 2022 Inspections.”](#)

During the COVID-19 pandemic we observed during our planning and inspection activities that government support payments, and issues with the supply chain (e.g., delayed fulfillment

of orders and, as such, payment delays), were contributing factors to increased deposits at many banks. This increase in deposits was more than many banks seemed to be able to effectively use in their primary lending and investing activities, and deposit interest rates remained low. Loan demand in historically profitable sectors slowed, and banks sought other avenues to deploy deposits and increased their purchases of debt instruments and government bonds.

As supply chain issues abated and employment continued to be strong, pent-up demand for goods and services contributed to inflation. To control inflation, the Federal Open Market Committee of the Federal Reserve System began a program of increases to the Federal Funds rate. Rising interest rates affected banks as follows:

- Securities paying lower interest rates declined in value. The decline in value for available-for-sale (AFS) securities affected banks’ regulatory capital and liquidity.
- In order to maintain liquidity, banks had to increase interest rates on deposits, to attract funds.
- Increasing rates for variable rate loans created increased credit risk as borrowers’ ability to pay was impacted.

Subsequently we saw deposits decline at many banks. Contributing factors included: (1) cessation of government support payments as employment began to rebound, (2) the impact of inflation, (3) managed run-off of deposits (e.g., certain banks maintained lower interest rates), and (4) depositors moving cash to more advantageous opportunities. These factors magnified the impact of the increase in interest rates, increasing the pressure on banks to raise deposit rates and use more short-term borrowings and manage the impact of declines

in investment security valuations on earnings, liquidity, and regulatory capital. The following impacts were noted:

- Earnings declined due to losses in trading portfolios whose valuations affect income directly.
- Liquidity was reduced by the reluctance of banks to sell AFS securities at a loss, which would convert unrealized losses to realized losses.
- Regulatory capital ratios declined as a result of trading portfolio and AFS portfolio valuation declines.
- Banks transferred AFS securities to held-to-maturity (HTM) status to protect regulatory capital; however, these securities were eligible to be pledged for borrowing, and thus liquidity was maintained.

Some banks began reclassifying AFS securities to HTM to avoid recognizing in stockholders' equity any related unrealized losses. Additionally, during 2023 we saw that the continued increase in interest rates – combined with downturns in certain sectors of the market – generated concerns among financial institutions and other companies in many industries with commercial real estate exposure. For more information, please see our Spotlight, [“Auditing Considerations Related to Commercial Real Estate.”](#)

As indicated above, this publication describes our inspection response to the banking events in early 2023 and the continued effects of these bank failures on the banking industry and provides common observations along

with a description of good practices from our inspection activities.

As described in the Spotlight, [“Staff Priorities for 2024 Inspections and Interactions with Audit Committees,”](#) related primarily to review of 2023 fiscal year-end audits, we calibrated our 2024 inspection risk-based selection factors to select more audits of regional public company banks and mutual funds with Level 3<sup>1</sup> investments.<sup>2</sup>

## SUMMARY OF BANK INSPECTIONS

The objective of the audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, the company's financial position, its results of operations, and its cash flows in conformity with generally accepted accounting principles.<sup>3</sup> Our inspections are designed to review portions of selected audits of public companies, including banks, and to evaluate elements of a firm's quality control (QC) system. You can find a comprehensive description of our inspections program on our [Inspections Procedures](#) page.

For the purposes of this Spotlight, we include an institution as a bank if it accepts deposits and accounts for an allowance for credit losses (ACL). Inspections of bank audits range from small community banks to large international financial institutions.

Consistent with Goal 2 in the Board's [Strategic Plan 2022-2026](#), we are working continuously to enhance the PCAOB's inspection program.

<sup>1</sup> Level 3 fair values are based on valuation techniques that require inputs that are both unobservable and are significant to the overall fair value measurement under the fair value hierarchy established in applicable accounting standards.

<sup>2</sup> Mutual funds pose inherently greater risk due to their significance to the average investor and the amounts under management. Given the recent environment of increasing interest rates we plan to select mutual funds with Level 3 investments which may be more complex and challenging to audit.

<sup>3</sup> When effective, AS 1000, [General Responsibilities of the Auditor in Conducting an Audit](#), will amend certain PCAOB standards that address responsibilities fundamental to the conduct of an audit.

During 2023, vulnerabilities in the banking sector were exposed and we revised our inspection plan in response. In April 2023 – responding to turmoil in the banking sector (“banking events”) – we incorporated additional procedures into our inspection strategy for the remaining part of the year in light of these developments. Some enhancements are described below.

## EFFECT OF BANKING EVENTS ON OUR INSPECTIONS ACTIVITIES

### Enhanced Planning

We took a new approach to gathering information to inform our planning activities and sent a questionnaire to survey 40 U.S. firms that audit at least one bank asking about their audit response to the banking events. For 13 U.S. firms that audit 10 or more banks, we also asked for specific information about the most recent bank audits performed by the firm. Specifically, we wanted to better understand how firms evaluated emerging and evolving risks in the sector. We were particularly interested in understanding firms’ responses to the rapidly rising interest rate environment, and the firms’ analysis of and work surrounding risks, such as duration risk (exposure to changes in the interest rates) related to investments, concentration risk, and liquidity risk.

In the survey of the 40 U.S. firms, we asked firms to provide:

- Any new firm guidance issued to audit engagement teams, from March 8, 2023, a point in time just before the first bank failure, to the date of the response, related to the banking events, rising interest rates, and/or liquidity events.

- o Twenty-four firms issued new guidance.
- A list of all public company audit clients that the firm identified as having heightened risks because of the banking events.
  - o Seven firms indicated they had identified audit clients with heightened risk.
- Any new internal consultation requirements related to audit engagements the firm may have implemented because of recent macroeconomic conditions (e.g., rising interest rates, liquidity concerns), and auditing or reporting considerations related to the banking events.
  - o Three firms implemented new formal consultation requirements.
- Other changes relevant to the firm’s quality control system that may have been implemented or were currently being designed in response to the banking events.
  - o Four firms indicated they made other changes to their QC system.

For 13 firms that audit 10 or more banks, we also asked for specific additional information related to each of the most recent bank audits performed by the firm (nearly all were for December 31, 2022) regarding:

- General information from the most recent audits of each bank (issuer name, market capitalization, total assets).
- Risk of material misstatements (RoMM) identified by the engagement team, and related audit response related to rising interest rates.
- RoMM identified by the engagement team, and related audit response, related to liquidity, if applicable.
- Concentration risks identified by the engagement team and related audit response, if applicable.

- Risk of fraud identified by the engagement team related to investments, including AFS and HTM securities, or related disclosures and related audit response, if applicable.
- Procedures related to the public company's risk governance process and a description of the respective public company control(s), audit procedures performed, and related conclusions. Additionally, if any deficiencies related to the design and effective operation of the controls were identified, we asked for a copy of the engagement team's evaluation of the control deficiencies.
- Procedures to evaluate the bank's intent and ability to hold HTM securities until maturity, including classification transfers from AFS to HTM.
- Whether the bank had any Federal Home Loan Bank (FHLB) funding advances, and, if yes, quantification of such.
- Whether the engagement team identified conditions or events that raised substantial doubt about the bank's ability to continue as a going concern.
- Whether the engagement team consulted internally with respect to any of the aforementioned areas of potential risks and if yes, we asked for a copy of the consultation and a brief description.
- Whether a specialist was used as part of the bank audit. If the answer was yes, we asked for a brief description of the specialist's work and for the number of hours incurred by the specialist.
- Whether a critical audit matter related to investment securities or liquidity was reported. If the answer was yes, we asked for a copy of the audit committee communication(s) made during the audit.

- Whether there were any audit adjustments, recorded or unrecorded, related to the audit of the bank. If the answer was yes, we asked for a copy of the summary of audit adjustments.
- Whether the bank reported a subsequent event related to liquidity. If the answer was yes, we asked for a brief summary of the event including quantification.

We used the responses from the questionnaire, as well as information about ongoing macroeconomic changes, to help inform our engagement selections and review procedures performed during our 2023 target team interim review selections (see "Target Team Inspections" below), as well as selections for both the 2023 and 2024 inspection cycles.

## Survey Highlights

As indicated above, many firms responding to our survey reported newly-issued guidance and/or implementation of formal consultation requirements as a result of the banking events. A few of the firms made changes to their QC systems, such as modifications to their policies and procedures related to client acceptance and continuance. The data we received informed our understanding of the audit response and procedures being performed by firms in certain areas, such as ICFR, the transfer of investment securities between AFS and HTM categories, and FHLB funding advances.

We received responses from firms related to 325 bank audits. Highlights from the survey include:

- **Risk Assessment and Fraud.** Over 70% of the engagement teams did not identify a RoMM due to rising interest rates. Over 95% did not identify a RoMM related to liquidity. Over 95% did not identify a RoMM

through reviewing information from short sellers, analysts, or other publicly available information, and over 65% did not identify any RoMM related to concentration risks. Finally, over 95% of the engagement teams did not identify a risk of fraud related to investments or related disclosures. A few firms indicated rising interest rates were a “business-only” risk relating to the operations of the bank without directly influencing financial reporting.

- **ICFR.** The firms identified that most (over 75%) of the banks had entity-level controls in place, including those related to their asset-liability committees (ALCO) overseeing on- and off- balance sheet risks. Additionally, other governance committees and oversight functions of their audit committees were identified as key components of these controls.
- **HTM Investments.** Approximately half of the banks had HTM investments. The nature, timing, and extent of the audit procedures performed to assess the banks’ intent and abilities to continue to hold these investments to maturity, as described by the firms, varied but generally included: performing management inquiries, reviewing related investment meeting notes from the bank, obtaining quarterly representations from management, considering the bank’s ability to continue as a going concern, and testing any sales and/or reclassifications of these investments.
- **AFS Transfers.** Approximately 25% of the banks reported classification transfers from AFS to HTM classifications. The nature, timing, and extent of the audit procedures performed by the firms to evaluate these reclassifications varied but generally included: performing management inquiries, reviewing related investment meeting notes from the bank, substantive testing, and obtaining management written representations.

- **FHLB Advances.** Over 75% of the banks had FHLB advances as of their fiscal year-end.
- **Going Concern.** None of the firms reported that the engagement teams identified conditions or events that raised substantial doubt on the public company’s ability to continue as a going concern.
- **Specialists.** Over 95% of the engagement teams used a specialist as part of the audit, primarily related to valuations of collateral and investment securities.
- **Critical Audit Matters.** None of the firms reported that the engagement teams identified a critical audit matter related to investment securities or liquidity.
- **Adjustments.** The firms reported that over 70% of the engagements had audit adjustments, recorded or unrecorded, related to the audit.
- **Subsequent Events.** The firms reported that over 95% of the engagements did not report a subsequent event related to liquidity.

## Next Steps

In June 2023, we reviewed the responses received from the firms and adjusted our inspection plan to have our target team perform procedures on interim reviews of banks in order to provide real-time perspective on important risks, including low capital ratio, significant share price decline, and unrealized loss. We also selected additional bank audits for inspection to ensure emerging banking and economic trends, and banking issues or common deficiencies, were appropriately considered by our selections.

As a reminder, the target team focuses on emerging audit risks and other topics that we believe could have important implications for audits performed by firms. The target team executes in-depth reviews across audit firms using information-gathering procedures



that extend beyond traditional inspection procedures.

## Target Team Inspections

We identified that some auditors did not appropriately respond to risks from current economic changes. In response, we modified our original plan for the target team and included interim reviews of 10 banks, under AS 4105, *Reviews of Interim Financial Information*, to ensure these risks were appropriately considered. We selected interim reviews because they allowed us to inspect the work of engagement teams shortly after the banking events occurred.

**Scope and Approach.** To assess auditors' compliance with AS 4105, we selected interim filings from the 10 banks selected and reviewed the associated audit firms' procedures. The first- or second-quarter filings the bank submitted to the U.S. Securities and Exchange Commission on Form 10-Q in 2023 were selected for our procedures.

**Specific Inspection Procedures.** We focused on the auditor's consideration of:

- An entity's ability to continue as a going concern.
- Disclosures in the interim financial statements.
- Disclosures in the Form 10-Q section "Management's Discussion and Analysis (MD&A) of Financial Conditions and Results of Operations", under AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.
- Indicators or triggers that portend a heightened risk of impairment to assets.
- Interim procedures performed related to ACL.

- Revision of risk assessment to account for changing market conditions and risks.

## Interim Review Observations

The inspection results of audit firms' reviews of interim financial information under AS 4101 and AS 4105 included a variety of observations.

We observed that auditors:

- Increased communication with bank management and those charged with governance.
- Consulted informally with their firm's professional practice or banking industry groups on various matters.
- Performed risk assessment procedures to identify and evaluate whether risks that led to the banking events were present at the bank. We reviewed memoranda prepared by the firms that compared asset ratios and conditions of their bank audits to those of banks that failed during the banking events. None of the interim reviews we assessed were determined by the firms to be in the same risk category as the failed banks.
- Made no significant changes to the nature, timing, or extent of planned interim 2023 ICFR and substantive audit procedures.

We observed during the review of interim financial information included in Form 10-Q, that:

- Enhanced management risk disclosures were made in the MD&A.
- No significant changes to management's ICFR assessment were identified related to the banking events.
- One bank corrected a prior-year MD&A disclosure.



Certain observations were included in a firm's inspection report:

- Two engagement teams did not obtain evidence that the interim financial information reported in Form 10-Q agrees or reconciles with the accounting records, such as the general ledger of the bank, as required by AS 4105.18(d).

In addition to the target team observations described above, we executed our 2023 inspection program. The results of our inspections will be included in firm inspection reports. We provide a description below of some common deficiencies and good practices related to those bank audits reviewed.

## INSPECTION OBSERVATIONS AND GOOD PRACTICES

The purpose of a PCAOB inspection is to assess compliance with PCAOB standards and rules, to drive improvement in audit quality, and to communicate audit quality. Each firm inspection results in an inspection report. We initially communicate inspection observation matters through the issuance of a comment form to the firm that includes observed deficiencies from our inspections. Any deficiencies identified through an inspection are evaluated for inclusion in the firm's inspection report. The following observations are from inspections conducted over the last two years.

Inspections of bank audits generally include focus on areas related to investment securities, ACL, deposit liabilities, and loans and related accounts. We have provided a brief description of the accounts in each focus area and area of potential audit risks, including examples of deficiencies identified, and good practices observed.

## Investment Securities

Investment securities usually represent the second largest asset class for banks, following loans, which are the largest. Investment securities provide banks with earnings, liquidity, and potential capital appreciation. The purpose of holding an investment will determine its classification on the balance sheet. Key risks presented by investments include interest rate risk, duration risk, market risk, liquidity risk, and credit risk.

## Examples of Deficiencies

### Risk Assessment

We have observed deficiencies related to risk assessment resulting in inappropriately designed audit procedures. Specifically, we have noted inappropriate risk assessments related to the fair value hierarchy level disclosures, which provide information related to the source and reliability of the inputs to fair value measurements used in reporting the bank's assets and liabilities. Such inappropriate risk assessments resulted in no testing being performed. We have also seen inappropriate assessments related to AFS debt securities in a continuous loss position resulting in the engagement team not appropriately designing or performing sufficient audit procedures to address the risk.

### Sampling

We have observed sample selections that could not be expected to be representative of the entire population. This is either because of the way items were selected from the population or because certain items did not have an equal chance of selection.

### Tests of Controls

Most of our observations come from the testing of management review controls, a result that is consistent with inspections of

audits across various industries. Specifically, we have observed instances where differences were identified for follow-up or resolution of exceptions, yet the engagement team did not perform sufficient testing to conclude on whether the control was designed and operating effectively.

## Fair Value Measurements

We have observed deficiencies related to fair value measurements not being sufficiently tested. These shortcomings arose because the auditor relied on the same pricing sources that the bank used when preparing its financial statements, and the auditor did not independently evaluate the reasonableness of the significant assumptions used by the bank and its pricing services.

## Good Practices

In auditing both trading assets and liabilities, and AFS securities, auditors establish a clear linkage between the risks of material misstatement identified and their responses to those risks. This linkage not only demonstrates the auditor's understanding of the issues in the audit but also aids in the formulation of an appropriate audit response. Further, in many cases, performing a disaggregated risk assessment for each specific type of security and derivative product will assist with the auditor's identification and development of an effective audit response.

When auditing securities with pricing from an independent pricing vendor, the engagement team is more effective when it appropriately assesses the nature of the securities and separates them into distinct product types. By designing additional substantive procedures specific to these categories and involving professionals with the appropriate technical experience – especially those with experience in using fair value principles to independently estimate the fair value of a sample of the

related securities – the outcome is generally appropriate.

## Allowance for Credit Losses

The estimation of a bank's ACL can involve significant management judgment as well as the use of complex models. Therefore, it is common for an auditor to identify heightened levels of risk related to the ACL, and if those risks are significant, it leads to the inclusion of critical audit matters in its audit opinion. Given its complexity and degree of judgement, the auditor's procedures to test the ACL are frequently selected as a focus area of our reviews of bank audits. Historically, the auditor's procedures to test the ACL is the area where we identify the most deficiencies in our reviews of bank audits.

## Examples of Deficiencies

### Risk Assessment

In our inspections, we have observed deficiencies related to risk assessment of the ACL. For example, auditors did not obtain a sufficient understanding of the flow of transactions, including all relevant systems used in the ACL processes, which resulted in the auditor not identifying all likely sources of potential misstatement and important controls. This included not identifying controls over the accuracy and completeness of information used in the loan grading process.

### Underlying Data

We observed several instances of engagement teams not evaluating the accuracy and completeness of the underlying data used in a control or substantive test, including data sent to an auditor-engaged specialist.

### Problem Loan Identification

Another common area of identified deficiencies is auditors' testing of the design

and operating effectiveness of controls over the performance of loan reviews.

For example, a loan officer evaluated important quantitative and qualitative information relevant to a specific borrower and assigned a loan grade. The control consisted of a review of that grade by a credit supervisor or a credit review group (i.e., the control owner) to evaluate whether the grade issued by the loan officer was in accordance with the bank's loan grading policy. To test this control, we have observed that auditors reviewed the documentation obtained by the control owner, but some auditors did not:

- Obtain a sufficient understanding of the activities performed and factors considered by the control owner to verify important information, such as collateral, financial ratios, or credit history, used in the loan grading process.
- Identify or sufficiently test, if identified, other controls over reports providing this information, including completeness and accuracy.
- Obtain a sufficient understanding of the bank's loan grading policy regarding criteria used for the various loan grade classifications to identify appropriate key controls and design an appropriate audit response.
- Obtain a clear understanding of what would require additional follow-up by the control owner.

In some instances, auditors did not identify that the controls they selected for testing did not operate over certain types of loans in the portfolio they believed were in scope, or perhaps over other loans with elevated risk profiles.

## Models and Assumptions

We found recurring deficiencies in the auditor's testing of controls over models and assumptions. For example, we observed that

some auditors limited their testing of the control owners' evaluation of key assumptions to reading the banks' model validation reports and related information. This approach failed to provide a sufficient understanding of the processes behind the development of the assumptions, the important procedures performed to validate the models, and the judgments made by the control owners.

In addition, we observed that some auditors' testing of review controls related to the consideration of qualitative factors, such as changes in economic conditions and industry trends, was limited to inquiries of management, reading relevant bank policies, tracing the quantitative basis supporting certain qualitative factors to underlying data, and/or comparing the basis point adjustments assigned to qualitative factors with those of prior periods. In these cases, auditors did not test the review procedures performed by control owners to assess the appropriateness of how qualitative factors were considered in their estimates.

In other instances, auditors identified and tested an omnibus-type control involving review by a senior executive (such as the Chief Credit Officer or Chief Financial Officer), or a credit committee involving multiple individuals, over the entire ACL estimate. Similar to the deficiencies noted above, we observed deficiencies where auditors failed to evaluate the depth and thoroughness of the review performed by the control owner. For example, in testing the operating effectiveness of a credit committee's review, some auditors limited their review to obtaining and reading copies of committee meeting minutes that did not provide sufficient detail to allow the auditor to evaluate the design and operating effectiveness of the control.

## Sampling

We have found instances of auditors not selecting a sample that could be expected to

be representative of the total population. In some cases, the basis to support the number of items the auditor selected in its sample did not consider all the relevant factors, including the tolerable misstatement level for the population, the allowable risk of incorrect acceptance, and the specific characteristics of loans, including credit risk ratings. In certain other cases, the selected sample population could not be expected to be representative because the loans were not homogeneous.

## Good Practices

Through our inspections in this area, we have identified several good practices that we believe will be helpful to share for purposes of audits of a bank's ACL. Additionally, we believe many of these good practices are equally applicable to audits of a bank's investment securities.

### Risk Assessment

- **Meaningfully integrating engagement team members with specialized skills or knowledge.** Given that transactions at a bank tend to be highly automated, we have observed positive effects on audit quality when auditors integrated engagement team members with information technology expertise during planning and throughout the audit process.
- **Developing process flowcharts and narratives.** We have observed that the use of process flowcharts and narratives seemed to help facilitate a thorough understanding of the flow of transactions, determining likely sources of potential misstatements, and identifying controls to address those potential misstatements.
- **Reassessing previous risk assessment determinations.** As new information about risks emerged during the audit, we have observed increased audit quality when auditors promptly considered the effect of

these risks on their previous risk assessment determinations.

### Problem Loan Identification

- **Understanding how control owners assess certain information.** We have observed enhanced audit quality when auditors place increased emphasis on understanding whether loan grades were assigned in accordance with the bank's grading policy, how exceptions or items that required follow-up were identified by the control owner, and how they were ultimately resolved.
- **Using more experienced auditors or engagement team members with specialized skills to perform the procedures.** We have observed that firms using senior members of the audit team and/or engagement team members with specialized skills to identify risks or test controls related to the loan grading process leads to improved audit quality.
- **Observing credit review – or similar – meetings.** Some auditors have observed credit review – or similar – meetings, which helped them in obtaining an understanding of the procedures performed by the control owners in reaching their conclusions regarding the design and operating effectiveness of the controls selected for testing.

### Models and Assumptions

- **Establishing robust walkthroughs.** We have observed that testing the design of the controls becomes more effective when the walkthroughs involve inquiry, inspection of documents, and observations. This approach enables auditors to gain a better understanding of how to test the operating effectiveness of controls.
- **Obtaining a thorough understanding of the procedures performed by control**

**owners.** We have seen positive outcomes when auditors obtained a thorough understanding of the procedures control owners performed to evaluate the model's structure, the accuracy and completeness of data used to calculate significant assumptions, the underlying model code, monitoring and resolution of important follow-up items, and the reasonableness of judgments made by bank management. For example, where we observed improved audit quality outcomes, in addition to performing inquiries of control owners, auditors obtained and evaluated evidence that went beyond a signoff, which evidenced the detail and accuracy of the control owners' reviews. This includes evaluating how the use of thresholds triggered further investigations by control owners and obtaining evidence on how these investigations were followed up on and resolved by the control owners.

- **Use of auditor-employed or auditor-engaged specialists.** We have observed that auditors have improved audit quality by using auditor-employed or auditor-engaged specialists to assist in testing the design and operating effectiveness of controls. This includes controls over the reasonableness of loan grades, appropriateness of models, evaluation of collateral valuations for collateral-dependent loans, and the reasonableness of significant assumptions. In these instances, auditors based these decisions on their assessments of risk and the identification of areas involving technical complexity and/or significant judgment. We observed that the involvement of these specialists in the judgmental aspects of the audit process had a positive effect on audit quality.

## Deposit Liabilities

Deposits are the primary funding source for most banks and, as a result, have a significant

effect on a bank's liquidity. Banks use deposits in a variety of ways, primarily to fund loans and investments. Presentation and disclosure of deposit liabilities is an audit risk to be considered.

## Examples of Deficiencies

### Underlying Data

Deficiencies in auditing deposit liabilities are generally related to completeness, existence, and valuation or accuracy of deposits. These issues often result from the auditor's failure to appropriately test the accuracy and completeness of the underlying data used in reports generated by the bank's internal controls over deposit liabilities or in the auditor's substantive tests.

### Maturities of Time Deposits

Deficiencies have also been observed in auditors not conducting sufficient procedures to test the presentation and disclosure of the maturities of time deposits (a type of bank deposit that has a fixed term or maturity date). Without such procedures, auditors did not have an adequate basis for determining whether the banks were accurately reporting when time deposits would become due for payment, which can affect the bank's liquidity.

## Good Practices

In the audit of deposit liabilities, data analytics have been used to enhance the review of interest and service charge calculations, compile demographic information about depositors, and disaggregate interest-bearing deposits by maturity date to assist in the analysis of interest rate risk.

## Loans and Related Accounts

Loans are usually the largest asset class on a bank's balance sheet, with the interest and fees generated from lending constituting the primary source of revenue for the bank. It is

important to note that common valuation risks associated with loans are credit risk, interest rate risk, market risk, and liquidity risk.

## Examples of Deficiencies

### Sampling

In auditing loans and related accounts, we have observed sample sizes that were insufficient to provide appropriate audit evidence. This was due to the sample sizes being calculated based on an assumed level of reliance on other procedures that was not supported, given the nature and scope of those other procedures performed.

### Confirmations

Deficiencies have also been identified when the engagement team encounters positive confirmations that were not returned and negative confirmations that were undelivered. When borrower confirmations are not returned or are undelivered, auditors should perform alternative procedures to verify information concerning loans and related accounts. We have observed that in some cases the alternative procedures were either insufficient (they did not provide enough evidence to support the existence of loans) or were inappropriate (they were not relevant or effective for the purpose of confirming the loan details), leading to a deficient audit of loans and related accounts.

## Good Practices

Generally, we have observed that engagement teams using a template or tool to manage confirmation requests and responses, including alternative procedures for handling non-responses, tends to achieve compliance with AS 2310 and the engagement team's planned audit response to address the RoMM associated with loans and related accounts.

## Confirmation

Information obtained by the auditor directly from external sources, including through confirmation, can be an important source of evidence obtained as part of an audit. Although this Spotlight does not expressly discuss observations related to confirmation, in September 2023, the PCAOB approved a new standard, AS 2310, ***The Auditor's Use of Confirmation***, that will replace the existing auditing standard on the confirmation process. This new standard emphasizes the auditor's responsibilities for obtaining relevant and reliable audit evidence through the confirmation process. Additionally, the new standard states that the use of negative confirmation requests alone does not provide sufficient appropriate audit evidence. The new standard will apply for audits of financial statements for fiscal years ending on or after June 15, 2025.

## FIRM INSPECTION REPORTS

The public portion of every inspection report is accessible with the aid of search and filtering tools. In addition, data from the public portion of all inspection reports has been compiled in a data set that is available for download in three formats: CSV | XML | JSON. Please visit our website at [Firm Inspection Reports](#) for more information.

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