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**Inspection of  
Arnett & Foster, P.L.L.C.**

**Issued by the  
Public Company Accounting Oversight Board  
July 13, 2006**

**THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT**

**PORTIONS OF THE COMPLETE REPORT ARE OMITTED  
FROM THIS DOCUMENT IN ORDER TO COMPLY WITH  
SECTIONS 104(g)(2) AND 105(b)(5)(A)  
OF THE SARBANES-OXLEY ACT OF 2002**

PCAOB RELEASE NO. 104-2006-140



### **Notes Concerning this Report**

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. Board inspections encompass, among other things, whether the firm has failed to identify departures from Generally Accepted Accounting Principles ("GAAP") in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("SEC" or "Commission"). Any description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.

## **INSPECTION OF ARNETT & FOSTER, P.L.L.C.**

The Public Company Accounting Oversight Board ("PCAOB" or "the Board") has conducted an inspection of the registered public accounting firm Arnett & Foster, P.L.L.C. ("the Firm"). The Board is issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report and portions of Part IV of the report. Part IV of the report consists of the Firm's comments, if any, on a draft of the report.<sup>1/</sup>

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.<sup>2/</sup> A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

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<sup>1/</sup> The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

<sup>2/</sup> See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

**PART I**

**INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS**

Members of the Board's inspection staff ("the inspection team") conducted fieldwork for the inspection from October 17, 2005 to October 19, 2005. The fieldwork included procedures tailored to the nature of the Firm, certain aspects of which the inspection team understood at the outset of the inspection to be as follows:

Number of offices	2 (Charleston and Lewisburg, West Virginia)
Ownership structure	Professional limited liability company
Number of partners	11
Number of professional staff <sup>3/</sup>	52
Number of issuer audit clients <sup>4/</sup>	1

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system.

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<sup>3/</sup> "Professional staff" includes all personnel of the Firm, except partners or shareholders and administrative support personnel. The number of partners and professional staff is provided here as an indication of the size of the Firm, and does not necessarily represent the number of the Firm's professionals who participate in audits of issuers or are "associated persons" (as defined in the Act) of the Firm.

<sup>4/</sup> The number of issuer audit clients shown here is based on the Firm's self-reporting and the inspection team's review of certain information for inspection planning purposes. It does not reflect any Board determination concerning which, or how many, of the Firm's audit clients are "issuers" as defined in the Act.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.<sup>5/</sup> It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.

A. Review of Audit Engagement

The scope of the inspection procedures performed included a review of aspects of the performance of the Firm's audit of the financial statements of its issuer audit client. Those aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

The inspection team identified matters that it considered to be audit deficiencies.<sup>6/</sup> The deficiencies identified included a deficiency of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements. That deficiency was the failure to perform and document sufficient audit procedures regarding the allowance for loan losses.

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<sup>5/</sup> When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations or cash flows of the issuer in conformity with GAAP, the Board reports that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

<sup>6/</sup> PCAOB standards require a firm to take appropriate actions to assess the importance of audit deficiencies identified after the date of the audit report to the firm's present ability to support its previously expressed opinions. See AU 390, *Consideration of Omitted Procedures After the Report Date*, and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T). Failure to comply with these PCAOB standards could be a basis for Board disciplinary sanctions.

B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on a specific audit, the inspection included review of certain of the Firm's practices, policies and procedures related to audit quality. This review addressed practices, policies and procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures. As described above, any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I



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PARTS II AND III OF THIS REPORT ARE NONPUBLIC  
AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

## **PART IV**

### **RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT**

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that identify factually inaccurate statements in the draft that the Board corrects in the final report.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report. In any version of this report that the Board makes publicly available, any portions of the Firm's response that address nonpublic portions of the report are omitted.



April 3, 2006

Mr. George Diacont  
Director  
Division of Registration and Inspections  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

**Response to Report on 2005 Inspection  
of Arnett & Foster, P.L.L.C.**

Dear Mr. Diacont:

We are pleased to provide our response to the Public Company Accounting Oversight Board ("PCAOB") regarding its report ("the Report") on the 2005 Inspection of Arnett & Foster, P.L.L.C. ("A&F").

We appreciate the PCAOB's initiatives to improve the overall quality of the audit process within the public sector and totally support all actions to that end. We cooperated fully with the inspection team before, during and after their inspection of A&F and look forward to working with the PCAOB in the future to further enhance the quality of the audit processes within the industry and our Firm. We felt the process was both informative as to expectations placed on firms engaged to audit public companies and constructive in the stated purpose of looking at our processes and procedures in a totally unbiased fashion, long after the audit work has been completed. A&F has always approached the peer review, and now the PCAOB inspection process, as a way to improve our Firm and thereby benefit our clients, as well as the public.

We appreciate the amount of professional judgment that is involved in any audit and how that judgment can be questioned as part of this inspection process by inspection team members who have a very limited time to review selected engagements. However, we respectfully disagree with the conclusions that "the Firm had not, at the time it issued its audit report, obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements." We felt the work performed was adequate in the context of the audit as a whole and therefore such Report findings represent good faith differences of opinion in the application of professional judgment.

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Appropriate testing was done during the performance of our audit, however we agree the documentation in the work papers may not have completely captured all of our testing and/or the rationale and our knowledge behind all conclusions. However, considering the totality of the work performed in the context of the entire audit and our cumulative knowledge of the issues related to the financial operations and control environment of the issuer, we believe the documentation was adequate to support the conclusions reached during the audit. While we feel we had performed appropriate audit procedures, we recognize the need to enhance our documentation of certain areas within the audit to meet the increased PCAOB requirements. We are committed to more fully adhere to the recently enacted and more stringent documentation requirements contained in PCAOB Auditing Standards.

Further, in connection with the PCAOB's initial inspection findings and in the spirit of fully addressing all of the Inspection Team concerns, we requested the issuer to perform additional procedures in order to address the Inspection Team's preliminary findings. We then applied additional audit procedures to the information subsequently provided to us under the Guidance in AU 390 – *Consideration of Omitted Procedures after the Report Date* and AU 561 – *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. As a result of these actions and additional audit procedures performed, no new facts came to our attention that caused us to believe that our previously issued auditors' report should have been withdrawn or that our work, as originally documented and performed, was not sufficient to support the conclusions reached.

In connection with our 2005 year end audits, we issued guidance relating to the two areas raised in the Report to the engagement team in order to specifically address the concerns raised by the Inspection Team, especially as it relates to more fully documenting our procedures and conclusions. In addition, we obtained the updated guidance made available as part of the year end planning from our national network affiliation partner, whom we have had a technical support relationship for over 20 years. However, with respect to the Inspection Team's comment on the Allowance for Loan Losses, we wish to point out that existing accounting and bank regulatory guidance allows for "unallocated" components of the allowance for loan losses that are reasonably and consistently determined and adequately documented estimates of probable loss. This guidance fundamentally recognizes that significant professional judgment is required in the process. We welcome further guidance from the PCAOB and the SEC on this area and encourage the PCAOB and SEC to continue its dialogue with the requisite Bank regulatory agencies and their field examiners to enhance and enable a consistent understanding and application of this GAAP issue among all stakeholders.

We appreciate the opportunity to provide our response to the Report and look forward to continuing to work with the PCAOB on matters of interest to our public company audit practice. We believe that future inspections will continue to enhance our audit philosophy and strengthen the accounting profession.

ARNETT & FOSTER, P.L.L.C.  
*Arnett + Foster, P. L. L. C.*