PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8433
www.pcaobus.org

# Report on

# 2014 Inspection of Pannell Kerr Forster of Texas, P.C.
**(Headquartered in Houston, Texas)**

**Issued by the**

## Public Company Accounting Oversight Board

**July 2, 2015**

**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. 104-2015-158

PCAOB Release No. 104-2015-158

PCAOB
Public Company Accounting Oversight Board

# 2014 INSPECTION OF PANNELL KERR FORSTER OF TEXAS, P.C.

## Preface

In 2014, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Pannell Kerr Forster of Texas, P.C. ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

Inspections are designed and performed to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. For a description of the procedures the Board's inspectors may perform to fulfill this responsibility, see Part I.C of this report (which also contains additional information concerning PCAOB inspections generally). Overall, the inspection process included reviews of portions of selected issuer audits completed by the Firm. These reviews were intended to identify whether deficiencies existed in those portions of the inspected audits, and whether such deficiencies indicated defects or potential defects in the Firm's system of quality control over audits. In addition, the inspection included a review of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

The Board is issuing this report in accordance with the requirements of the Act. 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. If the nonpublic portions of the report discuss criticisms of or potential defects in the firm's system of quality control, those discussions also could eventually be made public, but only to the extent the firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report.

## PROFILE OF THE FIRM[1]

| | |
|---|---|
| Number of offices | 1 (Houston, Texas) |
| Ownership structure | Professional corporation |
| Number of partners | 10 |
| Number of professional staff[2] | 86 |
| Number of issuer audit clients | 4 |

[1] The information presented here is as understood by the inspection team, generally as of the outset of the inspection, based on the Firm's self-reporting and the inspection team's review of certain information. Additional information, including additional detail on audit reports issued by the Firm, is available in the Firm's filings with the Board, available at http://pcaobus.org/Registration/rasr/Pages/RASR_Search.aspx.

[2] 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.

## PART I

## INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from September 15, 2014 to September 19, 2014.[3]

### A. Review of Audit Engagements

The inspection procedures included a review of portions of two issuer audits performed by the Firm. The inspection team identified matters that it considered to be a deficiency in the performance of the work it reviewed.

The description of the deficiency in Part I.A of this report includes, at the end of the description of the deficiency, references to specific paragraphs of the auditing standard that relates to that deficiency. The text of those paragraphs is set forth in Appendix A to this report. The references in this sub-Part include only the standard that primarily relates to the deficiency; it does not present a comprehensive list of every auditing standard that applies to the deficiency. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in any references to the auditing standards in this sub-Part, unless the lack of compliance with these standards is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

One of the deficiencies identified was of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion about whether the issuer had

[3] For this purpose, "primary procedures" include field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. Primary procedures do not include (1) inspection planning, which is performed prior to primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which extend beyond the primary procedures.

maintained, in all material respects, effective internal control over financial reporting ("ICFR"). In other words, in this audit, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the issuer maintained effective ICFR.

The fact that the deficiency reaches this level of significance does not necessarily indicate that there are undisclosed material weaknesses in ICFR. It is often not possible for the inspection team, based only on the information available from the auditor, to reach a conclusion on those points.

Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.[4]

The audit deficiency that reached this level of significance is described below–

Issuer A

> the failure, in an audit of ICFR, to perform sufficient procedures to test design and operating effectiveness of controls related to revenue. (AS 5, paragraphs 39, 42 and 44).

B. Auditing Standards

The deficiency described above could relate to several applicable provisions of the standards that govern the conduct of audits, including both the paragraphs of the standard that is cited at the end of the description of the deficiency included in Part I.A of this report and one or more of the specific paragraphs discussed below.

---

[4] Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the Firm's attention. Depending upon the circumstances, compliance with PCAOB standards may require the Firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on its previously expressed audit opinions. The Board expects that firms will comply with these standards, and the inspections staff may include in its procedures monitoring or assessing a firm's compliance.

Many audit deficiencies involve a lack of due professional care. AU 230, *Due Professional Care in the Performance of Work* ("AU 230"), paragraphs .02, .05, and .06, requires the independent auditor to plan and perform his or her work with due professional care and sets forth aspects of that requirement. AU 230, paragraphs .07 through .09, and Auditing Standard ("AS") No. 13, *The Auditor's Responses to the Risks of Material Misstatement* ("AS No. 13"), paragraph 7, specify that due professional care requires the exercise of professional skepticism. These standards state that professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS No. 13, paragraphs 3, 5, and 8, requires the auditor to design and implement audit responses that address the risks of material misstatement, and AS No. 15, *Audit Evidence* ("AS No. 15"), paragraph 4, requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the audit opinion. Sufficiency is the measure of the quantity of audit evidence, and the quantity needed is affected by the risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of ICFR) and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in support of the related conclusions.

The table below lists the specific auditing standard that is referenced for the deficiency included in Part I.A of this report. See the description of the deficiency in Part I.A for identification of the specific paragraphs, in addition to those noted above, that relate to that deficiency.

| PCAOB Auditing Standard | Issuer |
|---|---|
| AS No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* | A |

C. Information Concerning PCAOB Inspections Generally Applicable to Triennially Inspected Firms

Board inspections include reviews of certain portions of selected audit work performed by the inspected firm and reviews of certain aspects of the firm's quality control system. The inspections are designed to identify deficiencies in audits and defects or potential defects in the firm's system of quality control related to the firm's audits. The focus on deficiencies, defects, and potential defects necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools. Further, the inclusion in an inspection report of certain deficiencies, defects, and potential defects should not be construed as an indication that the Board has made any determination about other aspects of the inspected firm's systems, policies, procedures, practices, or conduct not included within the report.

C.1. Reviews of Audit Work

Inspections include reviews of portions of selected audits of financial statements and, where applicable, audits of ICFR. For these audits, the inspection team selects certain portions of the audits for inspection, and it reviews the engagement team's work papers and interviews engagement personnel regarding those portions. If the inspection team identifies a potential issue that it is unable to resolve through discussion with the firm and any review of additional work papers or other documentation, the inspection team ordinarily provides the firm with a written comment form on the matter and the firm is allowed the opportunity to provide a written response to the comment form. If the response does not resolve the inspection team's concerns, the matter is considered a deficiency and is evaluated for inclusion in the inspection report.

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,[5] as well as a firm's failures to perform, or to perform sufficiently, certain necessary audit procedures. The inspection may not involve the review of all of a firm's audits, nor is it designed to

[5] 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 applicable accounting principles, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), which has jurisdiction to determine proper accounting in issuers' financial statements. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

In some cases, the conclusion that a firm did not perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. AS No. 3, *Audit Documentation* ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion, must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. In reaching its conclusions, the inspection team considers whether audit documentation or any persuasive other evidence that a firm might provide to the inspection team supports a firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter cited in the public portion of a final inspection report, the inspection team has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection team has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.[6]

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. Thus, the audit work is generally selected for inspection

6 The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. In addition, any references in this report to violations or potential violations of law, rules, or professional standards are not a result of an adversarial adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability.

based on factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

C.2. Review of a Firm's Quality Control System

QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, provides that an auditing firm has a responsibility to ensure that its personnel comply with the applicable professional standards. This standard specifies that a firm's system of quality control should encompass the following elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of issuer audit engagements; (4) engagement performance; and (5) monitoring.

The inspection team's assessment of a firm's quality control system is derived both from the results of its procedures specifically focused on the firm's quality control policies and procedures, and also from inferences that can be drawn from deficiencies in the performance of individual audits. Audit deficiencies, whether alone or when aggregated, may indicate areas where a firm's system has failed to provide reasonable assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion may indicate a defect or potential defect in a firm's quality control system.[7] If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;[8] related firm methodology, guidance, and practices; and possible root causes.

---

[7] Not every audit deficiency suggests a defect or potential defect in a firm's quality control system.

[8] An evaluation of the frequency of a type of deficiency may include consideration of how often the inspection team reviewed audit work that presented the opportunity for similar deficiencies to occur. In some cases, even a type of deficiency that is observed infrequently in a particular inspection may, because of some combination of its nature, its significance, and the frequency with which it has been observed in previous inspections of the firm, be cause for concern about a quality control defect or potential defect.

Inspections also include a review of certain of the firm's practices, policies, and processes related to audit quality, which constitute a part of the firm's quality control system. This review addresses practices, policies, and procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures.

END OF PART I

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 Firm provided a written response to a draft of this 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.[9]

[9] The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In some cases, the result may be that none of a firm's response is made publicly available. 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 routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

PANNELL
KERR
FORSTER
OF TEXAS, P.C.

CPAs & Professional Advisors
5847 San Felipe, Suite 2400
Houston, Texas 77057-3092
Main: (713) 860-1400
Fax: (713) 355-3909
www.pkftexas.com

May 7, 2015

Helen A. Munter
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Re: Pannell Kerr Forster of Texas, P.C. Response to Draft Report on Inspection – Part I

Dear Ms. Munter:

Pannell Kerr Forster of Texas, P.C. ("PKF") is pleased to submit its response to the April 7, 2015 draft report of the Public Company Accounting Oversight Board ("the Board") inspection of PKF. We are supportive of the inspection process of the Board and believe that inspections bring considerable value and help us identify areas in which we can improve our performance.

PKF is committed to the highest quality audits. We continually monitor our audit practice and make changes where improvements are necessary. Although we may not always agree with the Board comments and findings, we have given them careful consideration. None of the findings resulted in a change of our original overall audit conclusions or affected our report on the issuer's financial statements.

We have evaluated the matter described in Part 1 of the draft report. In that regard, we have considered whether it was necessary to perform additional procedures in accordance with 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."

Regarding the revenue controls testing for issuer A, while we understand that the Board may have a different opinion in the manner of testing procedures that should have been performed, we respectfully disagree with your commentary that states "[the firm] *failed to understand how the control owner selected the new leases for testing and results of such testing*," as the process was a very simple random selection of a specified percentage of all new leases and newly acquired property leases. Our process to test the controls relating thereto involved making an independent sample and determining the success rate at which our sample included a review by the control owner. In our diligence discussions regarding these controls, by selecting a sample from only the population of leases that were actually reviewed by the control owner, a false positive outcome of the control testing could be present. As discussed previously with the inspection team, during our testing, we had at our disposal a complete listing of all new leases (whether newly entered into, or acquired) from which we selected our sample. Our testing proved that the target percentage of new leases which the control stated was reviewed, had in fact been achieved.

Additionally, we find that the statement made stating "...*the Firm failed to identify and test any controls that would prevent or detect errors or fraud that could result in a material misstatement to the issuer's financial statements for the approximately 79 percent and 77 percent of new leases from existing properties and acquired properties...*" to be misleading. Due to the amount of new leases versus existing leases in place, the population of total leases over which the Board suggests that our procedures were inadequate is actually 30% in total. We would like to direct your attention to two additional controls identified for testing (of the seven mentioned in the draft report): (i) a review of revenue in detail performed quarterly by the CFO or Controller and (ii) a review of the AR aging for delinquent account status performed monthly by the CFO and controller. The draft letter indicates that these controls are dependent in part upon the verification controls over new leases input into the system. We disagree with this conclusion and believe that these two controls are independent of the verification controls mentioned, designed purposefully in that manner, and therefore operate in the capacity of compensating controls which do serve to detect and prevent material misstatement in the financial statements for all leases, existing as well as new, input into the system.

As a final point, the overall premise of AS No. 5 is that an audit of internal controls should be integrated with an audit of the financial statements, and the procedures performed should be designed to accomplish the objectives of both audits simultaneously. While performing various substantive procedures in the areas of revenue and receivables, certain of our procedures required that we review lease documents to substantively test the validity of certain lease figures included in the financial statements. Specifically, outside of our tests of internal controls, a total of 59 leases were reviewed based on various sampling techniques, which covered the entire spectrum of all leases in place, both new and existing. Our testing of these leases included a component to verify accuracy of lease input, whether it was or was not reviewed for accuracy by the issuer, of which, zero discrepancies were noted. We understand that substantive testing does not determine the effectiveness of the issuer's internal control over financial reporting. It does, however, give indication whether an issue with incorrect lease inputs may be present should any discrepancies be found in the testing, as errors discovered in substantive testing procedures could give rise to control failures. As mentioned earlier, while the board may have a different opinion on the manner in which certain tests of controls should be performed, none of our testing, whether control related or substantive related, gave any indication that the controls over revenue were not operating effectively. Had errors been found, additional procedures would have been conducted.

We appreciate this opportunity to respond to the draft report and look forward to continued constructive communications with the Board.

Pannell Kerr Forster of Texas, P.C.

## APPENDIX A

## AUDITING STANDARD REFERENCED IN PART I

This Appendix provides the text of the auditing standard paragraphs that are referenced in Part I.A of this report. Footnotes that are included in this Appendix, and any other Notes, are from the original auditing standard that is referenced. While this Appendix contains the specific portions of the relevant standard cited with respect to the deficiency in Part I.A of this report, other portions of the standards (including those described in Part I.B of this report) may provide additional context, descriptions, related requirements, or explanations; the complete standards are available on the PCAOB's website at http://pcaobus.org/STANDARDS/Pages/default.aspx.

| AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* | | |
|---|---|---|
| **USING A TOP-DOWN APPROACH** | | |
| **Selecting Controls to Test** | | |
| AS No. 5.39 | The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion. | Issuer A |
| **TESTING CONTROLS** | | |
| **Testing Design Effectiveness** | | |
| AS No. 5.42 | The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.<br><br>Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the | Issuer A |

| **AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*** | | |
|---|---|---|
| | company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective. | |
| **Testing Operating Effectiveness** | | |
| AS No. 5.44 | The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.<br><br>Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting. | Issuer A |