PCAOB
Public Company Accounting Oversight Board

Forum on Auditing in the Small Business Environment

July 18, 2013

New York, NY

Caveat

One of the benefits of today's session is that you will hear firsthand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff.

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Opening Remarks and Board Member Interview

Lewis H. Ferguson, Board Member

Mary M. Sjoquist, Director, Office of Outreach and Small Business Liaison, Interviewer

The Board's Near-Term Priorities for 2013

- Improving the timeliness, content and readability of inspection reports;
- Improving the timeliness of remediation determinations and providing additional information about the PCAOB's remediation process;
- Initiating a project to identify audit quality measures, tracking such measures, reporting collective measures over time;
- Enhancing the PCAOB's processes and systems to improve analysis and usefulness of PCAOB inspections findings, including comparative analysis across firms and over time, in order to better understand audit quality in firms and better inform the PCAOB's standard-setting and other regulatory activities;
- Enhancing the framework for the PCAOB's standard-setting process in order to improve the effectiveness of the process as well as the standard-setting project tracking information provided to investors and the public; and
- Enhancing PCAOB's outreach to and interaction with audit committees to constructively engage in areas of mutual interest, including auditor independence and audit quality.

Global Environment and PCAOB International Inspections

- Approximately 40% of PCAOB-registered firms are located outside the U.S. in 85 countries.
- More than 240 registered non-U.S. firms issue audit reports for at least one issuer client, and must be inspected at least once every 3 years.
- Non-U.S. firms play a substantial role in audits of issuers.
- The top five countries with registered firms are: India (67), United Kingdom (62), Germany (42), China (96- including HK), and Canada (46).
- PCAOB must register and inspect non-U.S. audit firms conducting audits of U.S.-listed public companies.
- The PCAOB has inspected firms in 40 non-U.S. jurisdictions;
  - Joint inspections have been conducted with local regulators in 12 of these jurisdictions.
- During 2012, almost one-third of the triennial inspections were for non-U.S. firms.

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Panel: Fraud and Professional Skepticism

Moderator: Mary Sjoquist, Director of Outreach

Greg Scates, Office of Chief Auditor

George Botic, Division of Inspections

Rebecca Rhodes, Division of Enforcement

Staff Audit Practice Alert No. 10 – *Maintaining and Applying Professional Skepticism in Audits*

- Practice Alert No. 10 was issued on December 4, 2012.
- PCAOB oversight activities continue to raise concerns about whether some auditors consistently and diligently apply professional skepticism.
- Reminds auditors of the critical importance of professional skepticism to effective audits.
- Describes potential impediments to professional skepticism.
- Describes steps that audit firms, engagement partners and auditors can take to enhance professional skepticism in audits.

Staff Audit Practice Alert No. 10 (continued)

- When developing conclusions on the root causes of audit failures, consideration should be given to various behavioral issues described in the Alert:
  - Unconscious human biases and other circumstances can cause auditors to gather, evaluate, rationalize and recall information in a way that is consistent with client preferences rather than the interests of external users.
  - Incentives and pressures to build or maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer's filing deadline, achieve high client satisfaction ratings, keep audit costs low, or cross-sell other services can all serve to inhibit professional skepticism.
  - Scheduling and workload demands can put pressure on partners and other engagement team members to complete their assignments too quickly, impeding professional skepticism.

Promoting Professional Skepticism

What steps could your firm take to promote and support professional skepticism?

- Establish an appropriate "Tone at the Top"
  - Provide incentives to be skeptical
  - Message importance to staff
- Provide training
- Robust "brainstorming" session – don't just "check the box"
- QC procedures that monitor compliance

Assessing Fraud Risks

Information you should consider in assessing the risk of fraud include, but are not limited to:

- Company's industry
- Nature of the company (i.e., size and complexity, organizational structure)
- Effectiveness of internal controls
- Compensation agreements
- Earnings pressure or debt covenant compliance
- Results from analytical procedures

See AS No. 12 ¶ 5 for other examples of information that should be considered in assessing the risk of fraud.

Risk Assessment Standards-Changes in Your Audits

- Assessing and responding to the risk of fraud are an ongoing, integral part of the audit process rather than a separate, parallel process
  - Any changes in planning?
  - Any changes in documentation?
  - Any changes in review and supervision?
- Consideration of management bias in selection of accounting principles and in adequacy of disclosures
  - Any changes in assessing significant accounts or processes?
  - Any changes in documentation or in review and supervision?
- Evaluating Audit Results
  - Any changes in documentation or in review and supervision?

Responding to Identified Fraud Risks

After you identify a fraud risk, what procedures might you perform to address the risk?

A. Perform procedures at locations on a surprise or unannounced basis
B. Make inquiries of major customers and suppliers in addition to sending confirmations
C. Perform substantive analytical procedures using disaggregated data (for example, gross profit or operating margin by location)
D. All of the above

See AU § 316.53 for other examples of procedures that could be performed to address identified fraud risks.

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Questions

SEC CF Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

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Agenda

- Overview of the Division of Corporation Finance
- Recent Developments
- The CF Staff Review Process
- Frequent CF Staff Comment Areas for SRC's
- Resources

Overview of the Division of Corporation Finance

Overview of the Division of Corporation Finance

What we do

- Selectively review the disclosure documents filed by public companies (including initial registrations)
- Provide interpretive assistance on SEC rules and forms
- Recommend new and revised rules to the Commission

Organization

- Disclosure Operations (12 industry groups)
- Legal and Regulatory Policy
  - Office of Chief Accountant
- Policy and Capital Markets

Recent Developments

Key SEC Developments

Commission Actions

- ***Dodd-Frank Act Rulemaking and Studies***
- ***JOBS Act Rulemaking and Studies***

The JOBS Act

Title I – Reopening American Capital Markets to Emerging Growth Companies ("EGC")

Title II – Access to Capital for Job Creators – General Solicitation

Title III – Crowdfunding

Title IV – Small Company Capital Formation - Regulation A+

Title V – Private Company Flexibility and Growth - 12(g)

Title VI – Capital Expansion - 15(d)

Title VII – Outreach on Changes to the Law

Question

Do you audit a company that qualifies as an emerging growth company?

A. ***Yes***
B. ***No***
C. ***Not sure***
D. ***What is an emerging growth company?***

EGC Eligibility Criteria

- ***<u>Less than</u> $1 billion in total annual gross revenue during its most recently completed fiscal year***

- ***First sale of common equity pursuant to an effective registration statement under the 1933 Act has either (1) not yet occurred or (2) occurred after December 8, 2011***

- ***Not yet disqualified***
  - **Test EGC status continuously**
  - **Once lost, "generally" cannot get back**

EGC Eligibility Criteria

- ***Disqualification provisions:***
  1. **Last day of the first fiscal year in which revenue is $1 billion or more**
  2. **Last day of the fiscal year following the fifth anniversary of the first registered sale of common equity securities**
  3. **Date on which the company has issued more than $1 billion in non-convertible debt securities in the preceding rolling 3-years**
  4. **Date on which the company becomes a large accelerated filer**

Accommodations Available to EGCs

- ***Confidential submission***
  - **'33 Act registration statements; and**
  - **Has never done an IPO of common equity securities**

- ***Financial reporting accommodations***
  - **Number of years of financial statements presented**
  - **MD&A**
  - **Selected financial data**
  - **Ratio of earnings to fixed charges (if a debt offering) [FAQ 27]**

- ***Delay in adoption of new or revised accounting standards***

- ***Exemption from auditor attestation on internal controls over financial reporting (SOX 404(b))***

- ***Other***

Resources – JOBS Act

- **Frequently Asked Questions of General Applicability on Title I of the JOBS Act**
  - **September 28, 2012 (Questions 42-54)**
  - **May 3, 2012 (Questions 18-41)**
  - **April 16, 2012 (Questions 1-17)**

- ***Link to JOBS Act page on CF website***

The CF Staff Review Process

Filings Subject to CF Staff Review

- Selected by the CF staff using screening criteria not publically disclosed and Sarbanes-Oxley Section 408 requirements
- IPOs
- Other registration statements
- Proxy statements
- Form 8-K
- Other

Types of Comments

- Request for additional supplemental information
- Provide additional or different disclosure in a future filing
- Amend filing to revise financial statements or disclosure
- Completion of review letter

Best Practices

- ✓ **Submit all correspondence with the Staff on EDGAR**
- ✓ **Document accounting decisions contemporaneously with the transaction**
- ✓ **Respond promptly**
- ✓ **Make responses comprehensive**
- ✓ **Pick up the phone and give us a call**

CF Staff Focus Areas For Smaller Reporting Companies ("SRCs")

Question

Has your client received a comment letter from the SEC in the past 12 months?

A. ***Yes***
B. ***No***
C. ***Not sure***
D. ***What's a comment letter?***

CF Staff Focus Areas For SRCs

- Reverse Mergers
- Equity Transactions
- Stock Compensation
- Liability or Equity
- Deferred Tax Asset Valuation Allowance
- Disclosure Controls and Procedures
- Internal Control over Financial Reporting
- Form 8-K
- Audit Reports
- Smaller Reporting Company Status

Reverse Mergers

Frequent Areas of Comment:

- **Form 10-type information in Form 8-K**
  - **Financial Statements due within 4 business days (no 71-day extension)**
- **Financial Statement updates on Form 8-K**
  - **Staff Interpretation of Exchange Act Rule 13a-1**
- **Required Form 8-K items not filed**
  - **Including Item 4.01 Form 8-K (Change in Accountants)**
- **Internal Control over Financial Reporting**
  - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

Illustration of CF Staff Interpretation of Rule 13a-1

- Reverse merger occurs on February 1, 2013
- Non-accelerated shell (accounting acquiree) and private operating company (accounting acquirer) have calendar year-ends
- Audited f/s of the private op co for the y/e 12/31/11 and the unaudited f/s for the interim period ended 9/30/12 and comparable prior periods would be filed on Form 8-K (within 4 business days of the transaction - no 71-day extension)
- Registrant would file its annual report on Form 10-K for the y/e 12/31/12 within 90 days after 12/31/12
- Registrant would file the same info required in a Form 10-K of the private op co in an amended Form 8-K by the same Form 10-K due date – 90 days after 12/31/12.
- See FRM Section 12220.1

Reverse Mergers & "Back Door" Registrations

Accounting acquirer's audited F/S presented for all historical periods in subsequent reports

- **Earnings per share recast to reflect exchange ratio**
- **Eliminate retained earnings of shell or legal acquirer**
- **Common stock of shell or legal acquirer continues**

Audit Issues

- **PCAOB registered audit firm**
- **PCAOB Standards**

Reverse Mergers & "Back Door" Registrations

Recapitalization Example:

- **The transaction was consummated 2/1/13**
- **Shell has 100,000 shares o/s @ 12/31/12 ($1 par)**
- **Shell has stockholders equity of $125,000 @ 12/31/12**
- **OpCo has 100,000 shares o/s @ 12/31/12 ($2 par)**
- **Shell issues 400,000 shares for 100% of OpCo**
- **Post-recap entity has no other equity transactions from 2/1/13 – 3/31/13**
- **Post-recap entity has net income of $300,000 for the period from 2/1/13 – 3/31/13**

Reverse Mergers & "Back Door" Registrations

OpCo SSE 1/1/11 - 12/31/12

	Number of Shares	Shares at Par ($2)	APIC	Retained Earnings (Deficit)	Total
1/1/11	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/11	20,000	40,000	110,000		150,000
Net Income				250,000	250,000
12/31/11	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/12	20,000	40,000	190,000		230,000
Net Income				200,000	200,000
12/31/12	100,000	200,000	900,000	750,000	1,850,000

Reverse Mergers & "Back Door" Registrations

Post-Recapitalization Continuing Entity SSE
1/1/11 – 3/31/13

	Number of Shares	Shares at Par ($1)	APIC	Retained Earnings (Deficit)	Total
1/1/11	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/11	80,000	80,000	70,000		150,000
Net Income				250,000	250,000
12/31/11	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/12	80,000	80,000	150,000		230,000
Net Income				200,000	200,000
12/31/12	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 02/01/13	100,000	100,000	25,000		125,000
Net Income				300,000	300,000
03/31/13	500,000	500,000	725,000	1,050,000	2,275,000

Equity Transactions

***Fair Value Determination** – ASU 2011-04*

- **If publicly traded in an active market, use quoted market price**
  - **If discounts are appropriate under the circumstances, they should be supported by objective evidence**
- **If stock not publicly traded in active market**
  - **a) Use quoted price in an active market for the identical item held by another party**
  - **b) Use observable inputs, such as quoted market price in a market that is not active**
  - **c) If (a) and (b) not available, valuation technique (e.g. income approach or market approach)**

Disclosure

- **A description of the significant factors, methods and assumptions used to value stock options, warrants and other equity instruments**
  - **Footnotes**
  - **MD&A (critical accounting estimates)**

Stock-Based Compensation

- Disclosure requirements under ASC 718-10-50-1 and 2
- Valuation prior to IPO ("cheap stock")
  - AICPA Practice Aid – valuation and disclosure guidance
  - FRM Section 9520 – provides guidance on critical accounting estimates and MD&A disclosure
  - FRM Section 7520.1 – disclosures when estimated fair value of stock is less than IPO price

Liability or Equity?

Instruments Where Guidance Often Misapplied

- **Freestanding warrants on an Issuer's shares**
- **Conversion options embedded in debt**

Two Questions Where Mistakes Are Often Made

- ***Indexed to company's own equity? (ASC 815-40-15)***
- ***If indexed, qualify for classification in equity? (ASC 815-40-25)***

Common Pitfalls (that may cause fair value accounting)

- **Indexed > Certain clauses that adjust the exercise or conversion price ("Ratchet" /"Down Round")**
- **Classification > Insufficient authorized shares or no limit on the number of shares to be delivered**

Liability or Equity?

Valuation Issues

- **Inappropriate model being used to value certain derivatives**
  - **Black-Scholes may not be appropriate in many situations given complex features and terms of conversion option (e.g., combined embedded derivatives)**

Evaluate the provisions of your agreements carefully (anti-dilution provisions, warrant, registration rights, etc.)

Deferred Tax Asset Valuation Allowance

- Decision to establish or reverse a valuation allowance – an area of significant judgment
- Cumulative losses in recent years – negative evidence that is difficult to overcome
- Continual evaluation of all positive and negative evidence
  - How much and how long?
  - Significant drivers?
  - Impact of economic uncertainty?
  - Ability to forecast?
- Disclosures
- Consistency of assumptions and disclosures

Disclosure Controls & Procedures (DC&P)

Conclusions

- **Disclosure should state DC&P conclusion in clear and unqualified language – effective or not effective**
- **"Adequate" or "Effective except for…" are inappropriate**
- **"Effective" DC&P conclusion when ICFR conclusion is "ineffective"**
- **Consider reassessing conclusions upon the filing of any amendments**

Incomplete definition of DC&P

- **If definition is included, should conform exactly to Exchange Act Rule 13a-15 (note definition is not required)**

Internal Control over Financial Reporting (ICFR)

Management Reports under Item 308(a) of S-K

- **Separate evaluation and assessment from evaluation of disclosure controls and procedures**
- **Item 308 (a) disclosures**
  - **Large accelerated and accelerated filers that are not EGCs– comply with all 4 elements**
  - **Non-accelerated filers and EGCs – comply with first 3 elements unless voluntarily include auditor report under Item 308(b) of S-K, in which case comply with all four elements.**

Auditors Reports under Item 308(b) of S-K

- **Only required for non- EGCs that are accelerated or large accelerated filers**

SOX Section 302 Certifications should not deviate from specific form and content in Item 601(b)(31)(i) of Regulation S-K

- **Include all paragraphs (including paragraph 4(b))**

Internal Control over Financial Reporting (ICFR)

Disclosures that companies should consider when material weakness exists (see SEC Release No. 33-8810)

- **Nature of the material weakness (i.e., identification of the deficiency)**
- **Impact of material weakness on the company's financial reporting and its ICFR**
- **Disclosures should be detailed and specific for each material weakness identified**

Material changes in ICFR

- **Changes in circumstances without disclosures of changes in internal controls**
- **Change in conclusion on effectiveness**
- **Avoid boilerplate disclosure**

ICFR For Registrants With Substantially All Their Operations Outside U.S.

Background and training of CFO or other person(s) responsible for maintaining books and records and preparing financial statements

***Seek information*:**

- **U.S. GAAP education and ongoing training**
- **Professional qualifications**
- **Specific nature of U.S. GAAP experience**
- **Specific roles / duties of person with U.S. GAAP experience**
- **Services performed by a third party CPA or consultants – specific nature, extent, and qualifications**

Form 8-K – Item 4.01 (S-K 304)

- **Item 4.01 8-K required:**
  - **Change in auditor**
  - **Reverse merger**
  - **Accounting firm mergers**

- **Frequent compliance issues:**
  - **Exhibit 16 letter**
  - **Disagreements and reportable events through the termination date**
  - **Subsequent interim period**
  - **Failure to specify whether former accountant resigned, declined to stand for re-election, or was dismissed**

Form 8-K – 4.02

Frequent Compliance Issues:

- **Triggering event other than non-reliance conclusion (e.g., completion of restatement)**
- **Unclear statement regarding non-reliance**
- **Brief description of facts lacking or unclear**
- **"Stealth Restatements"**
  - ✓ **See Exchange Act Form 8-K Compliance and Disclosure Interpretation 215.01**

Audit Reports

- ***Audit report signatures***
- ***PCAOB "auditing standards" vs. "standards"***
- ***Development stage***
  - **Cumulative amounts**
  - **Waiver process**
- ***Revoked registration with PCAOB***

Smaller Reporting Company Status

Transition from Other Reporting Company Status to SRC Status

- **Public float < $50 million on last business day of Q2**
- **If public float = $0, < $40 million annual revenues**
- **Considered an accelerated filer through the end of the fiscal year**
  - **May elect SRC reporting immediately for disclosure purposes, but subject to accelerated filer deadlines**
  - **Attestation report on ICFR is not required in 10-K**

Smaller Reporting Company Status

Transition from SRC to Other Reporting Company Status

- **Public float ≥ $75 million on last business day of Q2**
- **If public float = $0, ≥ $50 million annual revenues**
- **Remain an SRC through fiscal year end; larger filer disclosure required starting with Q1 10-Q**
- **May elect SRC disclosure for 10-K and proxy statement relating to exit year BUT**
- **Accelerated filer for purposes of 10-K, including inclusion of attestation report on ICFR**

Key CF Staff Resources for Registrants

- **Division of Corporation Finance Financial Reporting Manual Updates (FRM)**
- **Corporation Finance Compliance and Disclosure Interpretations (CDI)**
- **CF Disclosure Guidance Topics**
  - **Staff Observations in the Review of Forms 8-K Filed to Report Reverse Mergers and Similar Transactions**
  - **Staff Observations Regarding Disclosures of Smaller Financial Institutions**
- **SEC CF Staff Review of Common Financial Reporting Issues Facing Smaller Issuers (Dec. 2012) slides**

Resources

Resources

www.sec.gov/divisions/corpfin.shtml

- **Staff Guidance and Interpretations**
  - **Filing Review Process**
  - **Compliance & Disclosure Interpretations**
- **Disclosure Program Updates**
- **Division Announcements**
- **Statutes, Rules, and Forms**

- **Information for Small Businesses**
  www.sec.gov/info/smallbus.shtml

Resources

Information for Accountants

www.sec.gov/divisions/corpfin/cfreportingguidance.shtml

- **Division of Corporation Finance Financial Reporting Manual**
- **Division of Corporation Finance Compliance & Disclosure Interpretations**
- **Staff Accounting Bulletins**
- **Corporation Finance Comment Letters**
- **Corporation Finance Filing Review Process**
- **Other Frequently Requested Material**
  - **Presentation from last year's Forums**
  - **Dear CFO Letters and Other Disclosure Guidance**
  - **CF Disclosure Guidance Topics**

Resources

Whom do I contact for assistance and how?

- **Comment process - Disclosure Operations CF Staff**
  - **Names and number will be on comment letter**

- **Informal staff interpretation or informal question**
  - **Financial Reporting - CF Office of Chief Accountant at (202) 551-3400 or submit request through online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive**
  - **U.S. GAAP - SEC Office of the Chief Accountant at 202-551-5300 or OCA@sec.gov**
  - **Small Business Policy - CF Office of Small Business Policy (202) 551-3460**
  - **Interpretive legal questions - CF Office of Chief Counsel at 202-551-3500**
  - **EDGAR questions - EDGAR Filer Support at 202-551-8900**

Resources

Formal Requests related to financial reporting

- **Pre-filing accommodations/waivers/interpretations of reporting requirements**
- **Address to the CF Chief Accountant**
- **Mail or email to *dcaoletters@sec.gov***
- **Clearly state issue and relief sought**
- **Clearly state facts and relate them to analysis of issue**
- **Clearly state the basis for relief**

Formal consultations on the application of GAAP should be sent to - OCA@sec.gov

- **www.sec.gov/info/accountants/ocasubguidance.htm**

Questions

Key Telephone Numbers:

Corporation Finance Office of Chief Accountant (202) 551-3400

Corporation Finance Office of Chief Counsel (202) 551-3500

Corporation Finance Office of Small Business Policy (202) 551-3460

SEC Office of the Chief Accountant (202) 551-5300

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Update on PCAOB Standard-Setting Activities

Greg Scates
Deputy Chief Auditor
July 18, 2013
New York, NY

Topics for Discussion

- AS No. 16 – *Communications with Audit Committees*
- Related Parties Reproposal
- Audits of Broker-Dealers
- Reorganization of PCAOB Auditing Standards
- Auditor's Reporting Model
- Auditor Independence and Audit Firm Rotation
- The JOBS Act and Standard-Setting

AS No. 16 - *Communications with Audit Committees*

- On August 15, 2012, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*, and related amendments.
  - AS No. 16 is effective for audits of fiscal years beginning on or after December 15, 2012.
- AS No. 16 requires communications with the audit committee to be made in a timely manner and prior to the issuance of the audit report.
- Auditing Standard No. 16:
  - Provides a definition of audit committee;
  - Retains or enhances existing communication requirements;
  - Incorporates certain SEC auditor communication requirements to audit committees; and
  - Adds new communication requirements that are generally linked to performance requirements in other PCAOB standards.

Related Parties Reproposal

- On May 7, 2013, the Board reproposed for comment an auditing standard on related parties and related amendments, including amendments regarding significant unusual transactions.
  - An original proposal was issued for public comment on February 28, 2012. The Board received 37 comment letters and discussed the proposal at the May 17, 2012 SAG meeting.
- The reproposed standard and amendments address:
  - Evaluating a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.
  - Identifying and evaluating a company's significant unusual transactions.
  - Obtaining an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment process.
- The reproposed standard and amendments are designed to improve audit quality in areas that pose significant risks of material misstatement, including misstatement arising from fraud.
- The comment period closed on July 8, 2013.

Reproposed Auditing Standard – Related Parties

- The reproposed standard would strengthen existing audit procedures for identifying, assessing, and responding to risks of material misstatement associated with related party transactions.
- The reproposed standard would require the auditor to:
  - Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties.
  - Perform specific procedures for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.
  - Perform specific procedures if the auditor determines that a related party, or relationship or transaction with a related party, previously undisclosed to the auditor exists.
  - Evaluate whether the company has properly identified its related parties or relationships or transactions with related parties.
  - Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

Reproposed Amendments Regarding Significant Unusual Transactions

- The reproposed amendments to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and other PCAOB auditing standards would strengthen the auditor's identification and evaluation of significant unusual transactions.
- Among other things, the reproposed amendments would:
  - Require the auditor to perform specific procedures to identify significant unusual transactions.
  - Require the auditor to perform specific procedures to obtain an understanding of the business purpose (or the lack thereof) of identified significant unusual transactions.
  - Enhance the auditor's evaluation of the business purpose of significant unusual transactions.
  - Require the auditor to evaluate whether significant unusual transactions have been properly accounted for and disclosed in the financial statements.

Other Reproposed Amendments to PCAOB Auditing Standards

- The other reproposed amendments include new requirements that would complement the reproposed standard on related parties and significant unusual transactions.
- Among other things, the other reproposed amendments would:
  - Require the auditor to perform specific procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment process.
  - Require the auditor to obtain representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor.
  - Emphasize the auditor's existing responsibilities to communicate possible fraud to management, the audit committee, and under certain conditions, the SEC and others.

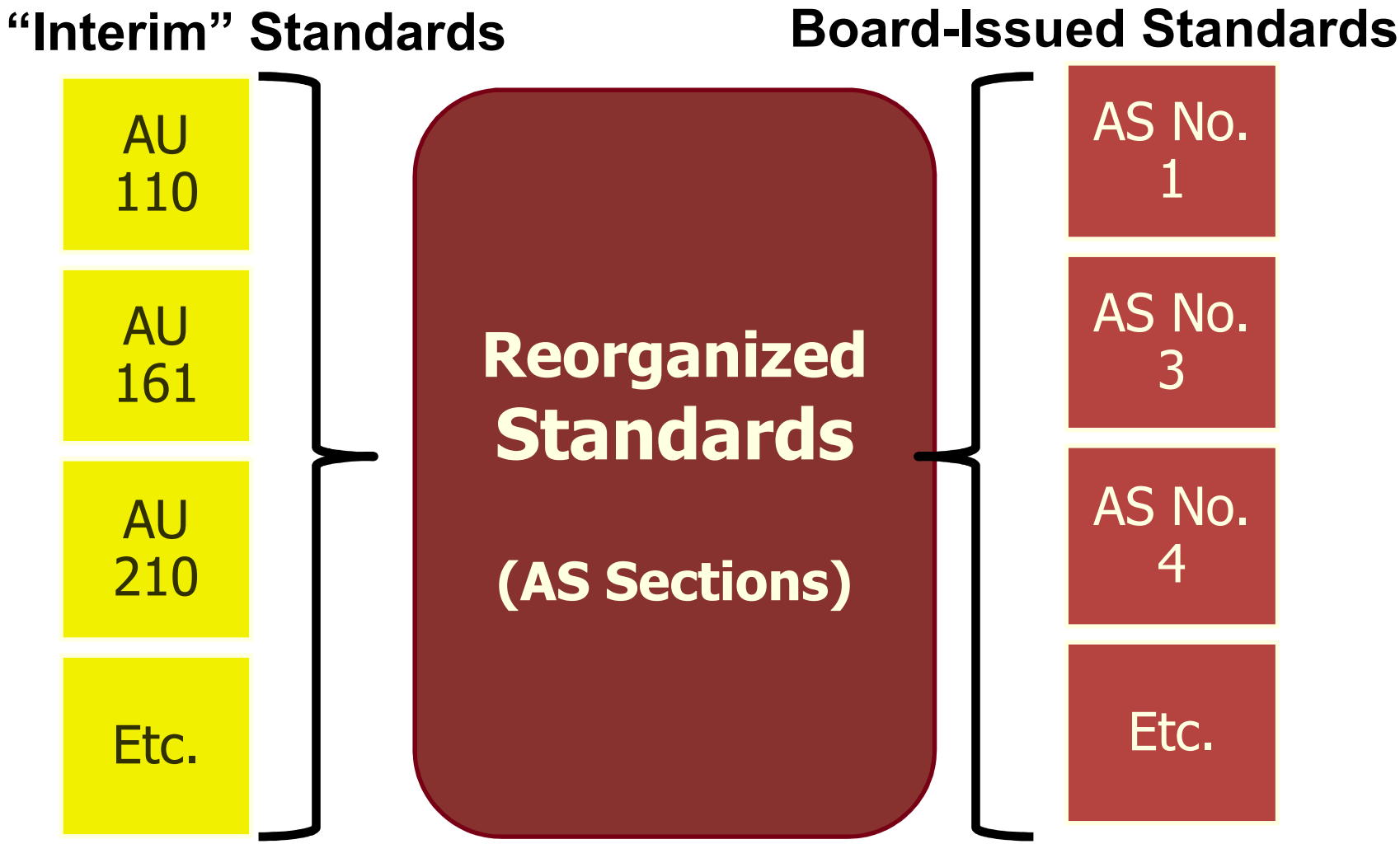
Audits of Broker-Dealers

- Audits of brokers and dealers continue to be conducted pursuant to the auditing standards of the AICPA.
- Audits will transition to and be conducted pursuant to PCAOB standards upon the SEC's adoption of the amendments to their Rule 17a-5.
- OCA is working to develop "Day-One" guidance which may include topics such as transitioning to PCAOB standards from AICPA standards and key considerations about applying PCAOB standards on first-year engagements.

Audits of Broker-Dealers (continued)

- Working with Office of Chief Accountant/Division of Trading and Markets to develop standards supporting objectives of SEC's amendments to Rule 17a-5 for broker-dealers.
  - Includes PCAOB standards for (1) examination engagements, and (2) review engagements, as required by SEC rulemaking.
- Standards will be designed:
  - To be scalable based on size and complexity of the individual broker-dealer.
  - To coordinate with financial statement audit so evidence from both engagements is properly considered and duplication of work is avoided.

Reorganization of PCAOB Auditing Standards



Reorganization of PCAOB Auditing Standards (continued)

- **Categories in the proposed framework for the reorganization:**
  - AS 1000 General Auditing Standards
  - AS 2000 Audit Procedures
  - AS 3000 Auditor Reporting
  - AS 4000 Matters Relating to Filings under Federal Securities Laws
  - AS 6000 Other Matters Associated with Audits

Reorganization of PCAOB Auditing Standards (continued)

- Intended to:
  - Renumber and reorder existing standards without redrafting or making substantive changes.
  - Present standards in a logical order that generally follows the flow of the audit process.
  - Enhance usability through improved navigation.
  - Provide structure for future standard-setting.
- Next steps include:
  - Consideration of comments received on the proposing release.
  - Release for public comment all amendments necessary to implement the reorganization of the auditing standards.
  - Release an online version of the proposed reorganized auditing standards.
  - Undertake reorganization of other PCAOB professional practice standards.

Auditor's Reporting Model

- On June 21, 2011, the Board issued a concept release on possible changes to the auditor's reporting model which discusses four alternatives for changing the auditor's reporting model. The Board received 155 comment letters.
- The Board hosted a roundtable to discuss the alternatives in the concept release and has discussed the auditor's reporting model with the SAG on several occasions.
- SAG members indicated that they were most interested in hearing about the audit from the auditor, including the auditor's significant judgments in forming the audit opinion.
- The IAASB has a similar project regarding changes to the auditor's report. The IAASB is considering communicating matters that were of most significance to the audit.
- Both the PCAOB and IAASB are scheduled to propose standards in the summer of 2013.

Auditor Independence and Audit Firm Rotation

- In August 2011, the Board issued a concept release to solicit public comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced, including through audit firm rotation.
- The concept release invited comment on specific questions, including, for example, whether the Board should consider a rotation requirement only for audit tenures of more than 10 years or only for the largest issuer audits.
- The Board also sought comment on whether there are other measures that could meaningfully enhance auditor independence.
- The Board hosted three public meetings in 2012 that engaged prominent and thoughtful commenters with various, often conflicting, viewpoints:
  - Panelists included investors, senior executives and audit committee chairs of major corporations, CEOs of audit firms, academics and former regulators.
- Next steps under consideration:
  - Analyzing more than 680 comment letters and the discussion at public meetings.
  - Monitoring activities of other regulators, standard setters, and legislative bodies.

Audit Reform: European Developments

- Europe:
  - November 2011: European Commission adopted proposals intended to strengthen the independence of auditors and introduce greater diversity into the audit market.
  - April 2013: the European Parliament's Legal Affairs Committee voted to send a revised text for negotiation with the European Council and Commission.
  - Next Steps: "Trialogue" among the European Commission, European Parliament and European Council.
- United Kingdom:
  - September 2012: FRC announced changes to UK Corporate Governance Code:
    - FTSE 350 companies to put the external audit contract out to tender at least every ten years.
    - Audit Committees to provide shareholders with information on how they carried out their responsibilities.
    - Applies on a "comply or explain" basis.
  - February 2013: UK Competition Commission publishes preliminary findings on supply of audit services to large companies in the UK.

The JOBS Act and Standard-Setting

- Jumpstart Our Business Start-ups Act (enacted April 2012).
  - Defined a new category of companies – emerging growth companies ("EGCs").
  - Requires SEC to make an additional finding that application of a new PCAOB auditing standard to audits of EGCs is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation ("ECCF").
  - As a result of this new SEC requirement, PCAOB is providing information to the SEC to help inform its approval of new PCAOB standards:
    - Includes discussion of ECCF factors as applied to audits of EGCs.
    - Working with ORA to develop data, understanding of EGC population.

Keeping Current with Standard-Related Activities

- Our website – http://www.pcaobus.org/Standards/Pages/default.aspx
  - PCAOB standards and related rules, including interim standards.
  - PCAOB proposed standards.
  - Staff Questions and Answers.
  - Staff Audit Practice Alerts.
  - Standing Advisory Group.
- Contact us at info@pcaobus.org
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our website at: http://pcaobus.org/About/Pages/RSSFeeds.aspx

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Questions

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Lunch

(70 minutes)

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Inspection Findings, Relevant Standards, and Case Studies

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Presenters

George Botic, Deputy Director, Division of Registration and Inspections

Rebecca Rhodes, Assistant Director, Division of Enforcement and Investigations

Greg Scates, Deputy Chief Auditor, Office of Chief Auditor

Ellen Graper, Associate Director, Division of Registration and Inspections

Agenda

- Summary of Domestic Small Firm Program
- Division of Enforcement and Investigations – Recent Disciplinary Proceedings
- Inspection Findings, Relevant Standards, and Case Studies

Summary of Domestic Small Firm Program

- Issued "Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies" on February 25, 2013 ("2010 report")
- Previously issued "Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms" on October 22, 2007 ("2007 report")
- Comparison of the two reports shows a reduced rate of reported significant audit performance deficiencies:
  - 61 percent of firms in 2007 report compared to 44 percent in 2010 report
  - 36 percent of audits in 2007 report compared to 28 percent in 2010 report
  - 55 percent of firms in first inspection compared to 36 percent in second inspection (for firms with second inspection in 2010 report)

Top Inspection Findings

Audit areas with frequent findings in the 2007-2010 period related to –

- revenue recognition
- share-based payments and equity financing instruments
- convertible debt instruments
- fair value measurements
- business combinations and impairment of intangible and long-lived assets
- accounting estimates
- related party transactions
- use of analytical procedures as substantive tests
- procedures to respond to the risk of material misstatement due to fraud

Potential Root Causes

Potential root causes contributing to audit deficiencies identified in the 2007-2010 period include –

- Due professional care, including professional skepticism
- Technical competence
- Partner and professional staff work load
- Client acceptance and continuance
- Engagement quality control review

Division of Enforcement and Investigations - Recent Settled Disciplinary Proceedings

- P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA and Sundeep P S G Nair, CA
- Dale Arnold Hotz, CPA, Jyothi Nuthulaganti, CPA, and Michael Jared Fadner, CPA
- Jewett, Schwartz, Wolfe & Associates, P.L.
- Lawrence H. Wolfe, CPA
- Uma D. Basso, CPA
- Michael T. Studer, CPA, P.C. and Michael T. Studer, CPA
- Brock, Schechter & Polakoff, LLP
- James R. Waggoner, CPA

Division of Enforcement and Investigations - Settled Disciplinary Proceedings

P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA and Sundeep P S G Nair, CA

- Mumbai, India small firm and two partners and a manager
- Engagement team had no training in PCAOB standards or U.S. GAAP
- Firm's policies and procedures did not ensure that staff performed procedures necessary to comply with PCAOB standards and regulatory requirements
- Lack of independence by providing internal audit outsourcing services
- Failed to comply with securities laws, PCAOB rules, quality control standards, and auditing standards
- Sanctions:
  - Firm: Censure, registration revoked with right to reapply two year after date of Order and $10,000 civil money penalty
  - Partner (Rajagiri): permanent bar
  - Partner (Parikh): 3 year bar
  - Manager (Nair): 2 year restriction on activities and completion of 40 hours of CPE

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Dale Arnold Hotz, CPA, Jyothi Nuthulaganti, CPA, and Michael Jared Fadner, CPA

Partner, Director, and Manager at McGladrey & Pullen, LLP

- Failed to comply with AS3 and violated their duty to cooperate with Inspections
- Improperly created and/or added documents to the audit documentation and backdated a document in advance of an inspection
- Provided false and misleading information to PCAOB
- Sanctions:
  - Partner: Censure and 2 year bar
  - Director: Censure and 1 year bar
  - Manager: Censure

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Jewett, Schwartz, Wolfe & Associates, P.L.

Lawrence H. Wolfe, CPA

Uma D. Basso, CPA

- Wolfe was engagement partner and Basso served as audit manager.
- Failed to comply with PCAOB rules, quality control standards, and auditing standards in connection with multiple audits of multiple issuers
- Failure to complete or supervise others in the completion of necessary audit work, including in critical audit areas
- In several audits, one or more staff members with limited audit experience conducted virtually all of the audit procedures with minimal to no review by Wolfe or other firm staff
- Sanctions:
  - Firm: Censure and registration revoked for 5 years
  - Wolfe: Censure and permanently barred
  - Basso: Censure, 2 year restriction on activities, complete 40 hours of CPE

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Michael T. Studer, CPA, P.C. and Michael T. Studer, CPA

- Violations of PCAOB rules, auditing standards related to two China-based issuers
- Violations of quality control standards
- Failure to identify and test internal controls in an integrated audit of a French company
- Failure to direct efforts of assistants who performed field work in China or review their work and audit documentation not prepared in accordance with AS No. 3
- Sanctions:
  - Firm: Censure, retain independent monitor, temporary restriction on activities
    - Cannot issue report for issuer subject to Section 404(b) of Sarbanes-Oxley Act (ICFR) for 3 years
    - Until monitor issues certificate of compliance, Firm is restricted from acceptance of new SEC issuer audit clients, issuance of issuer audit reports for clients with substantially all operations in China, Hong Kong or Taiwan, broker-dealer financial statement certification and substantial role participation
    - Provide copy of PCAOB Order to issuer audit clients
  - Studer: Censure, complete 60 hours CPE, including 30 hours related to AS No. 5, restriction on activities
    - Until monitor issues certificate of compliance, Studer is restricted from serving as an assistant, engagement partner or EQR

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Brock, Schechter & Polakoff, LLP
James R. Waggoner, CPA

- Waggoner was firm's Director of Accounting and Auditing
- Three issuers; audits performed by foreign-based audit firms
- Waggoner had final responsibility for the audits
- Waggoner and the firm failed to comply with standards relating to planning, performance, and supervision of audits
- The firm had inadequate quality control policies and procedures in place to reasonably assure issuer audits, including of ICFR, were conducted properly
- Non-cooperation with the inspection process - Improper creation, addition, and backdating of audit documentation prior to Board inspection
- Sanctions:
  - Firm: Censure, registration revoked for 2 years, $20,000 civil money
  - Waggoner: Censure, 3 year bar

Inspection Findings, Relevant Standards, and Case Studies

- Auditing Convertible Debt
- Auditing Business Combinations
- Auditing Revenue
- Starting a First Year Audit

Restrictions on Use

- *Information not necessarily compiled from inspection observations*
- *Information intended to provide considerations and <u>does not</u> necessarily represent requirements of the PCAOB*
- *Specific procedures that may be performed in a given situation are determined on facts and circumstances*

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Auditing Convertible Debt

Auditing Convertible Debt Inspection Findings

- Failed to evaluate allocation of proceeds received between debt and warrants
- Failed to evaluate balance sheet classification of warrants
- Failed to evaluate whether embedded conversion option and warrants should be accounted for as derivatives
- Failed to address whether beneficial conversion features exist

Auditing Convertible Debt
Relevant Auditing Standard

AU Section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* paragraph .19, states, in part:

> The auditor should use the assessed levels of inherent risk and control risk for assertions about derivatives and securities to determine the nature, timing, and extent of the substantive procedures to be performed to detect material misstatements of the financial statement assertions. Some substantive procedures address more than one assertion about a derivative or security. Whether one or a combination of substantive procedures should be used to address an assertion depends on the auditor's assessment of the inherent and control risk associated with it as well as the auditor's judgment about a procedure's effectiveness. Paragraphs .21 through .58 provide examples of substantive procedures that address assertions about derivatives and securities.

Case Study No. 1- Going Places, Inc.

Case Study No.1 – Going Places, Inc. Background

- Your Firm has been engaged to audit the December 31, 2012 financial statements of Going Places, Inc. ("Company").
- The Company's common stock is quoted on the OTCBB with normal daily market activity of around 100,000 shares in 2011 and 2012.
- On October 1, 2012, the Company issued convertible debt with detachable warrant to investor for $1 million cash.
- The convertible debt . . .
  - Provides for cash repayment of $1 million or conversion into 100,000 shares of common stock at any time at holder's option prior to September 30, 2017.
  - Accrues six percent interest payable annually in cash only
  - Allows net share settlement but not net cash settlement
  - Allows for delivery of unregistered shares
  - Contains no anti-dilution or down-round provisions and no put or call features
- The common stock contains no repurchase features

Case Study No.1 – Going Places, Inc. Background

- The warrant . . .
  - Provides for purchase of 100,000 shares of common stock at $10 per share at any time at holder's option
  - Expires September 30, 2017
  - Allows for net share settlement but not net cash settlement
  - Allows for delivery of unregistered shares
  - Contains no anti-dilution provisions and no repurchase or redemption features
- The convertible debt and warrant are legally detachable and separately exercisable
- Closing price of Company's common stock was $10 per share on October 1, 2012
- As of September 30, 2012, the Company had 10 million shares of common stock authorized with 2 million shares issued and outstanding an no other instruments that could be settled in shares of common stock

Case Study No.1 – Going Places, Inc. Scenario

- *Your Firm is conducting its audit of the Company's financial statements.*
- *You are the engagement partner and have just arrived at the client site for a meeting with the engagement team to discuss the audit.*
- *In your discussions with the engagement team, you learned about the convertible debt with detachable warrant and the procedures performed by your engagement team.*

Case Study No.1 – Going Places, Inc. Scenario

- *The audit procedures performed by the engagement team related to this transaction included –*
  - *Obtained a copy of the Board meeting minutes in which the issuance of convertible debt and detachable warrant for $1 million in cash was approved;*
  - *Vouched $1 million cash receipt;*
  - *Obtained copies of debt and warrant agreements;*
  - *Verified $1 million of convertible debt recorded on balance sheet;*
  - *Verified disclosure of key terms of the debt and warrant; and*
  - *Obtained management's representation that the issuance of convertible debt and detachable warrant were recorded in accordance with GAAP.*

Case Study No.1 – Going Places, Inc. Classification of Warrant

The ASC Master Glossary defines a freestanding financial instrument as:

A financial instrument that meets either of the following conditions:

- It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.
- It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Case Study No.1 – Going Places, Inc. Classification of Warrant

ASC Section 480-10-25 requires liability classification for the following freestanding financial instruments:

- Mandatorily redeemable financial instruments,
- Obligations to repurchase issuer's equity shares by transferring assets,
- Certain obligations to issue a variable number of shares

Case Study No.1 – Going Places, Inc. Definition of Derivative

ASC Paragraph 815-10-15-83 states, in part: A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- One or more underlyings and one or more notional amounts or payment provisions or both.
- No initial net investment or an initial net investment that is smaller than would be required . . .
- Provisions that allow for net settlement through:
  - implicit or explicit terms,
  - means outside contract, or
  - delivery of an asset.

Case Study No.1 – Going Places, Inc. Derivative Scope Exception

ASC Paragraph 815-10-15-74 states, in part, that the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- Contracts issued or held by that reporting entity that are both:
  - Indexed to its own stock
  - Classified in stockholders' equity in its statement of financial position.

Case Study No.1 – Going Places, Inc. Indexed to its Own Stock

ASC Paragraph 815-40-15-7 states, in part: An entity shall evaluate whether an equity-linked financial instrument (or embedded feature) . . . is considered indexed to its own stock within the meaning of this Subtopic and paragraph 815-10-15-74(a) using the following two-step approach:

- Evaluate the instrument's contingent exercise provisions, if any.
- Evaluate the instrument's settlement provisions.

Case Study No.1 – Going Places, Inc. Equity Classification

ASC Paragraph 815-40-25-10 states, in part: Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity . . . all of the following conditions must be met for a contract to be classified as equity:

- Settlement permitted in unregistered shares.
- Entity has sufficient authorized and unissued shares.
- Contract contains an explicit share limit.
- No required cash payment if entity fails to timely file with SEC.
- No cash-settled top-off or make-whole provisions.
- No counterparty rights rank higher than shareholder rights.
- No collateral required.

Case Study No.1 – Going Places, Inc. Reassessment of Equity Classification

ASC Paragraph 815-40-35-8 states: The classification of a contract shall be reassessed at each balance sheet date. If the classification required under this Subtopic changes as a result of events during the period (if, for example, as a result of voluntary issuances of stock the number of authorized but unissued shares is insufficient to satisfy the maximum number of shares that could be required to net share settle the contract [see discussion in paragraph 815-40-25-20]), the contract shall be reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

Case Study No.1 – Going Places, Inc. Embedded Conversion Options

ASC Paragraph 815-15-25-1 states, in part, that: An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- The economic characteristics and risks of the embedded derivative are not clearly and closely related to the host contract
- The hybrid instrument is not remeasured at fair value
- A separate instrument with the same terms as the embedded derivative would . . . be a derivative instrument

Case Study No.1 – Going Places, Inc. Allocation of Proceeds

ASC Paragraph 470-20-25-2 provides: Proceeds from the sale of a debt instrument with stock purchase warrants shall be allocated to the two elements based on the relative fair values of the debt instrument without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants shall be accounted for as paid-in capital. The remainder of the proceeds shall be allocated to the debt instrument portion of the transaction. This usually results in a discount (or, occasionally, a reduced premium), which shall be accounted for under Topic 835.

Case Study No.1 – Going Places, Inc.
Allocation of Proceeds

	Fair Value	Relative Fair Value as Percentage	Allocated Proceeds and Initial Carrying Value
Convertible debt	$ 1,000,000	80%	$ 800,000
Warrant	250,000	20%	200,000
Total proceeds	$1,250,000	100%	$1,000,000

Case Study No.1 – Going Places, Inc. Beneficial Conversion Feature

- ASC Section 470-20-20 defines a beneficial conversion feature as a nondetachable conversion feature that is in the money at the commitment date.

- ASC Paragraph 470-20-25-5 provides that an embedded beneficial conversion feature present in a convertible instrument shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. Paragraph 470-20-30-4 provides guidance on measuring intrinsic value that applies to both the determination of whether an embedded conversion feature is beneficial and the allocation of proceeds.

Case Study No.1 – Going Places, Inc. Beneficial Conversion Feature

ASC Paragraph 470-20-30-5 provides, in part, that the effective conversion price based on the proceeds received for or allocated to the convertible instrument shall be used to compute the intrinsic value, if any, of the embedded conversion option. Specifically, an issuer shall do all of the following:

- First, allocate the proceeds received to the convertible instrument and any other detachable instruments included in the exchange on a relative fair value basis.
- Second, apply the guidance beginning in paragraph 470-20-25-4 to the amount allocated to the convertible instrument.
- Third, calculate an effective conversion price and use that effective conversion price to measure the intrinsic value, if any, of the embedded conversion option.

Case Study No.1 – Going Places, Inc. Beneficial Conversion Feature

ASC Paragraph 470-20-30-6 provides that intrinsic value shall be calculated at the commitment date (see paragraphs 470-20-30-9 through 30-12) as the difference between the conversion price (see paragraph 470-20-30-5) and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible.

Case Study No.1 – Going Places, Inc. Beneficial Conversion Feature

Proceeds allocated to convertible debt	$800,000
Divided by number of shares to obtain upon conversion	100,000
Effective conversion price per share	$8.00
Fair value of a common share at issuance date	$10.00
Less effective conversion price per share	8.00
Intrinsic value per share	$2.00
Multiplied by number of shares to obtain upon conversion	100,000
Total intrinsic value	$200,000

Case Study No.1 – Going Places, Inc. Beneficial Conversion Feature

	Allocated Proceeds and Initial Carrying Value from Above	Adjusted Carrying Value for Beneficial Conversion Feature
Convertible debt	$ 800,000	$ 600,000
Beneficial conversion feature	-	200,000
Warrant	200,000	200,000
Total	$1,000,000	$1,000,000

Question A

PCAOB Rule 3521 provides that a registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for:

A. a contingent fee (received directly or indirectly)
B. a fixed fee
C. a commission (received directly or indirectly)
D. reimbursement of expenses

Question B

PCAOB Rule 3524 provides that in connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall –

A. describe, in writing, to the audit committee of the issuer certain terms of the services (as provided in the Rule)

B. call the audit committee chairman to verify that he received the written communication

C. discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm

D. document the substance of its discussion with the audit committee of the issuer

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Questions

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Inspection Findings, Relevant Standards, and Case Studies – Part II

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Auditing Business Combinations

Auditing Business Combinations Inspection Findings

- Failed to address whether all assets acquired and liabilities assumed, including identifiable intangible assets, had been recorded
- Failed to evaluate whether purchase price was appropriately allocated to the acquired net assets based on appropriate valuations
- Failed to identify and address incorrect accounting for a reverse-merger transaction

Auditing Business Combinations
Relevant Auditing Standards

AU Section 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .03 states, in part, that the auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, defines the fair value of an asset (liability) as "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination.

Auditing Business Combinations
Relevant Auditing Standards

AU Section 336, *Using the Work of a Specialist*, paragraph 12 provides that the auditor should (a) obtain an understanding of the methods and assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements.

Case Study No. 2 – Good Lighting, Inc.

Case Study No. 2 – Good Lighting, Inc. Background

- Your Firm was engaged to audit the December 31, 2012 financial statements of Good Lighting, Inc. ("Company")
- The Company manufactures and sells lighting equipment.
- The Company's common stock is quoted on the OTCBB and normal weekly trading activity is around 10,000 shares, which was consistent throughout 2012.
- On March 1, 2012, the Company signed an agreement to acquire Little Lighting, Inc. ("Little") for 10 million shares of the Company's common stock in a business combination, which closed on June 30, 2012.
- The Company's management believed that Little's valuable patents, customer relationships, and assembled workforce would have a valuable impact on operations.

Case Study No. 2 – Good Lighting, Inc. Background

- On March 1, 2012, the agreement date, the Company granted options to its employees to purchase, in aggregate, one million shares of the Company's common stock at $3 per share – the quoted price on the OTCBB on the grant date.
- On May 1, 2012, the Company issued one million shares of its common stock for cash of $4 per share to investors.
- Subsequent to this stock issuance and through the June 30, 2012 closing date of the acquisition, the Company's common stock was quoted on the OTCBB at or around $4 per share.
- The fair value of the purchase price consideration was based on the $3 share price as that represented the valuation on which the agreement was based.
- The Company's controller said the May 1st stock issuance was unusual and should be ignored in valuing the business combination.

Case Study No. 2 – Good Lighting, Inc. Background

- The Company engaged a recognized and reputable valuation firm to assist management in determining the acquisition date fair values of the patents and assembled workforce, which were recorded as intangible assets.
- The Company provided the specialist with prospective financial data that the specialist used to prepare discounted cash flows to determine the values of the patents and assembled workforce.

Case Study No. 2 – Good Lighting, Inc. Scenario

- *Your Firm is conducting its audit of the Company's 2012 financial statements. You are the engagement partner and have just arrived at the client site to discuss the audit of the business combination.*
- *The engagement team obtained, reviewed, and relied on the valuation specialist's report as audit evidence supporting the fair value of the patents and assembled workforce.*
- *Audit documentation stated, "The specialist is an expert in valuation of intangible assets within the lighting distribution industry. Methods and assumptions used by the specialist to value the patents and assembled workforce appear reasonable. No further test work deemed necessary."*
- *The engagement team obtained management's written representation that the value assigned to the assets acquired and liabilities assumed in the purchase were appropriate as of the acquisition date.*

Case Study No. 2 – Good Lighting, Inc. Measurement Date for Valuing Consideration

ASC Paragraph 805-30-30-7 states that the consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer.

Case Study No. 2 – Good Lighting, Inc.
Fair Value Measurement

ASC Paragraph 820-10-35-20 states:

The definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. However, the definition of fair value also shall be applied to instruments measured at fair value that are classified in stockholders' equity.

Case Study No. 2 – Good Lighting, Inc.
Fair Value Measurement

ASC Paragraph 820-10-35-44 states, in part:

The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

Case Study No. 2 – Good Lighting, Inc.
Fair Value Measurement

ASC Paragraph 820-10-35-51B states, in part:

If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly). Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with this Subtopic.

Case Study No. 2 – Good Lighting, Inc. Identifying Intangible Assets

ASC Section 805-10-20 states that an asset is *identifiable* if it either:

- Is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or
- Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Case Study No. 2 – Good Lighting, Inc. Identifying Intangible Assets

ASC Paragraph 805-20-55-23 states that if an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights.

ASC Paragraph 805-20-55-27 states that a customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable.

Case Study No. 2 – Good Lighting, Inc. Identifying Intangible Assets

ASC 805-20-55-6 states that . . . an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed into goodwill.

Question C

QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* ("QC 20"), paragraph .23 provides that a firm should communicate its quality control policies and procedures to its personnel in a manner that provides reasonable assurance that those policies and procedures are:

A. understood
B. memorized
C. complied with
D. recited periodically

Question D

QC 20, paragraph .22 provides that responsibility for the *design* and *maintenance* of the various quality control policies and procedures should be assigned to an appropriate individual or individuals in the firm. In making that assignment, consideration should be given to:

A. the proficiency of the individuals
B. the age of the individuals
C. the authority to be delegated to them
D. the colleges the individuals attended
E. the extent of supervision to be provided

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Break

(15 minutes)

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Auditing Revenue

Auditing Revenue Inspection Findings

- Failure to sufficiently test the occurrence, accuracy, and completeness of revenue
- Failure to read and evaluate contract terms
- Failure to test whether revenue was recognized in appropriate period
- Failure to assess whether revenue recognition policies are consistent with GAAP
- Failure to appropriately determine sample sizes and select revenue transactions to test
- Failure to perform sufficient tests to support the level of reliance placed on controls
- Failure to perform adequate substantive analytical procedures

Auditing Revenue
Relevant Auditing Standards

AS No. 12, *Identifying and Assessing Risks of Material Misstatement* ("AS 12"), paragraph .68, states, in part:

Presumption of Fraud Risk Involving Improper Revenue Recognition. The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

AS 12, paragraph .71, states, in part:

Factors that should be evaluated in determining which risks are significant risks include:

- Whether the risk is a fraud risk;

- Note: A fraud risk is a significant risk.

Auditing Revenue
Relevant Auditing Standards

AU Section 316, *Consideration of Fraud in a Financial Statement Audit* ("AU 316"), paragraph .07 states:

Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them. The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.

Auditing Revenue
Relevant Auditing Standards

AU Section 334, *Related Parties* ("AU 334"), paragraph .08, states, in part:

The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

- Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.
- Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

Auditing Revenue
Relevant Auditing Standards

AU 316, paragraph .53, states, in part:
The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- Performing substantive analytical procedures using disaggregated data

- Making oral inquiries of major customers and suppliers in addition to sending written confirmation, or sending confirmation requests to a specific party within an organization

Auditing Revenue
Relevant Auditing Standards

AU 334, paragraph .10.e, states, in part:
When necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered.

With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns . . .

Auditing Revenue
Relevant Auditing Standards

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatements*, paragraph 11 states:

For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

Auditing Revenue
Relevant Auditing Standards

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraphs 44 and 45 state, in part:

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.

Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Case Study No. 3 – Strong Boxes, Inc.

Case Study No. 3 – Strong Boxes, Inc. Background

- Your Firm has been engaged to audit the December 31, 2012 financial statements of Strong Boxes, Inc. (the "Company") and the effectiveness of its ICFR
- This will be your firm's first audit of the Company
- The Company manufactures and sells perforated and labeled cardboard boxes to moving companies
- The Company is experiencing increasing competition and declining revenue, margins, and cash flows
- The CEO owns 42 percent of the Company and is Chairman of the Board and reportedly dominates the Board and the management team

Case Study No. 3 – Strong Boxes, Inc. Background

- The Company needs to expand its line of credit with its bank or reduce operating activities
- The bank is concerned about the Company's financial situation and may not agree to expand the line
- The CEO is known to have stated, "We will do whatever it takes to get the financing this Company needs. Laying off employees is not an option."
- Despite the recent history of poor results, the Company reported increases in revenue for the third and fourth quarter of 2012

Case Study No. 3 – Strong Boxes, Inc. Scenario 1

- You, the engagement partner, have arrived at the client site to review work performed by the engagement team in the area of revenue.

- You learned the following information from the engagement team in your discussions:

  - The list of related parties includes a company, High Speed Movers, Inc. ("HSM"), that is a privately-held residential moving company of which the Company's CEO owns 65 percent.

  - The related party listing indicated an accounts receivable balance resulting from occasional box sales to HSM.

Case Study No. 3 – Strong Boxes, Inc. Scenario 1

- Engagement team confirmed the HSM receivable
  - The Company's CEO signed the confirmation as HSM Board Chairman
  - HSM receivable balance had doubled since prior year end
- To address fraud risk, the engagement team conducted a brainstorming session, made inquiries of relevant Company personnel, and tested nonstandard journal entries throughout year
- Substantive audit procedures over revenue consisted primarily of analytical and cut-off procedures due to reliance on control testing
- Exhibit A is work paper of analytical procedures

Case Study No. 3 – Strong Boxes, Inc. Scenario 2

- As part of the Company's integrated audit for 2012, the Firm tested all controls identified as important in the revenue process.

- These control tests were selected from
  - Throughout the year for financial statement audit purposes, and
  - At or near year end for ICFR audit purposes

- The Board's quarterly review of revenue performance was tested with documentation as follows:

Control 101: The Company's management prepares an analysis of quarterly revenue performance and provides this analysis to the Board for their review. Any fluctuations of ten percent or more must be explained. The Board members initial the analysis noting their review of the information.

Case Study No. 3 – Strong Boxes, Inc. Scenario 2

- To test this control, engagement team
  - Reviewed Board minutes noting indication of reviews
  - Reviewed all quarterly revenue analyses noting the initials of all seven Board members

- Engagement team concluded that Board members' initials were evidence that the quarterly analysis control was operating effectively

Case Study No. 3 – Strong Boxes, Inc.
Scenario 3

- Your Firm has received the PCAOB's 2013 inspection report, which includes a Part IIA deficiency related to the Firm's failure to perform sufficient procedures to test the issuer's revenue for the year ended December 31, 2012.

- The inspection report also includes a corresponding Part IIB deficiency regarding the Firm's quality control policies and procedures related to testing revenue.

- The following are excerpts from Part II of the Firm's 2013 inspection report.

Case Study No. 3 – Strong Boxes, Inc. Scenario 3

A. Insufficiently Supported Audit Opinions

The Firm performed analytical procedures as its primary substantive procedure to test revenue. In performing these procedures, the Firm failed to satisfy the requirements of AU 329, *Analytical Procedures.* Specifically, the Firm failed to develop expectations that were sufficiently precise to provide the necessary level of assurance that potential material misstatements would be identified and failed to obtain corroboration of management's explanations for the fluctuations in revenue.

Case Study No. 3 – Strong Boxes, Inc.
Scenario 3

B. Issues Related to Quality Controls

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will conduct all testing appropriate to a particular audit. As discussed above, in one of the audits reviewed, the inspection team identified a significant deficiency related to the Firm's testing of revenue. This information provides cause for concern regarding the Firm's quality control policies and procedures related to testing of revenue.

Question E

QC 20, paragraph .09 states that policies and procedures should be established to provide the firm with reasonable assurance that personnel:

A. maintain independence (in fact and in appearance) in all required circumstances
B. pass the CPA exam
C. perform all professional responsibilities with integrity
D. are satisfied with their compensation
E. maintain objectivity in discharging professional responsibilities

Question F

QC Section 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*, paragraph .12 provides that a peer review does not substitute for monitoring procedures. However, since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for some or all of its inspection procedures for the period covered by the peer review.

A. True
B. False

PCAOB
Public Company Accounting Oversight Board

Starting a First Year Audit

Starting a First Year Audit Inspection Findings

- Policies and procedures fail to provide reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized
- Policies and procedures fail to provide reasonable assurance that a firm undertakes only those engagements that it can reasonably expect to be completed with professional competence
- Failure to evaluate the impact of the opening balances on the current-year financial statements and the consistency of accounting principles
- Engagement Quality Reviewer was not qualified

Starting a First Year Audit
Relevant Quality Control Standards

QC 20, paragraph .14 states:

Policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized. Establishing such policies and procedures does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to any person or entity but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its client relationships and the professional services it will provide.

Starting a First Year Audit
Relevant Quality Control Standards

QC 20, paragraph .15 states:

Such policies and procedures should also provide reasonable assurance that the firm—

- Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.

- Appropriately considers the risks associated with providing professional services in the particular circumstances.

Starting a First Year Audit
Relevant Auditing Standards

AU Section 315, *Communications Between Predecessor and Successor Auditors* ("AU 315"), paragraph .03 states:

An auditor should not accept an engagement until the communications described in paragraphs .07 through .10 have been evaluated. However, an auditor may make a proposal for an audit engagement before communicating with the predecessor auditor. The auditor may wish to advise the prospective client (for example, in a proposal) that acceptance cannot be final until the communications have been evaluated.

Starting a First Year Audit
Relevant Auditing Standards

AU 315, paragraph .09 states, in part:

The successor auditor should make specific and reasonable inquiries of the predecessor auditor regarding matters that will assist the successor auditor in determining whether to accept the engagement. Matters subject to inquiry should include—

- Information that might bear on the integrity of management.
- Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters.
- Communications to audit committees or others with equivalent authority and responsibility regarding fraud, illegal acts by clients, and internal-control-related matters.
- The predecessor auditor's understanding as to the reasons for the change of auditors.

Starting a First Year Audit
Relevant Auditing Standards

AS No. 16, *Communications with Audit Committees*, paragraph 7:

If the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee, the auditor should decline to accept, continue, or perform the engagement.

Starting a First Year Audit
Relevant Auditing Standards

Auditing Standard No. 7, *Engagement Quality Review* ("AS 7"), paragraph 3 states, in part:

An engagement quality reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) must be a partner or another individual in an equivalent position. The engagement quality reviewer may also be an individual from outside the firm.

AS 7, paragraph 5 states:

The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.

Starting a First Year Audit
Relevant Quality Control Standards

QC Section 40, *The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-in-Charge of an Attest Engagement* ("QC 40"), paragraph .07 states, in part:

The practitioner-in-charge of an engagement to audit the financial statements of a public company would be expected to have certain technical proficiency in SEC reporting requirements . . . This would include, for example, experience in the industry and appropriate knowledge of SEC and ISB rules and regulations, including accounting and independence standards.

Starting a First Year Audit
Relevant Quality Control Standards

QC 40, paragraph .08 states:

Technical Proficiency—Practitioners-in-charge of an engagement should possess an understanding of the applicable accounting, auditing, and attest professional standards including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages.

Case Study No. 4 – Sound Deposits Bank

Case Study No. 4 – Sound Deposits Bank Background

- In August 2012, your Firm won a proposal contest to audit the financial statements of Sound Deposits Bank (the "Bank") for the year ended December 31, 2012.
- The Bank is a regional provider of commercial banking services.
- The Bank's Form 10-K is due to be filed with the SEC by March 31, 2013.

Case Study No. 4 – Sound Deposits Bank Scenario 1

- Your Firm is celebrating from the good news that it won the audit of the Bank's financial statements.
- However, as the partner that led the proposal effort and the one that will serve as the engagement partner on the audit, the reality is beginning to set in that you and your firm have a big job ahead of you.
- The first and most pressing task is that of completing your firm's client acceptance process so that the Bank can file an 8-K communicating dismissal of the predecessor auditor and the engagement of your firm as the new auditor.
- As you begin to focus on this client acceptance task, the following thoughts begin to run through your mind:

Case Study No. 4 – Sound Deposits Bank Scenario 1

- Your firm's process requires that the Firm's managing partner and its Director of Accounting and Auditing must both approve acceptance of any new audit client of the Firm.
- While they have not formally signed off yet, you figure that since these two partners are the ones leading the celebration of the proposal victory that their approval is fairly certain.
- You do have concerns over your lack of familiarity with the management team of the Bank since its headquarters office is about 200 miles from your one-office Firm.
- One of your partners suggests that since the Bank is in a regulated industry and you are not aware of any negative press on the Bank or its leadership that the likelihood of management having any integrity issues is minimal.

Case Study No. 4 – Sound Deposits Bank Scenario 1

- You are concerned about your Firm's ability to properly staff the audit of the Bank, particularly during busy season, given your current staff resource issues.
- Your firm has 10 partners and 45 professional staff that focus on audit work; however, you are the Firm's only bank audit partner and there are only five professional staff with bank audit experience.
- You and your five staff are already fully scheduled on another public regional bank with a March 31st filing deadline as well as several privately-held banks with calendar year ends.
- You recall that you and your managing partner thought your chances of winning the Bank audit were not very good so you didn't really worry about the staffing issue until now.

Case Study No. 4 – Sound Deposits Bank Scenario 1

- Your managing partner thinks that if you can hire one or two more audit staff before the end of the year and begin to train one or two of your non-banking staff on bank audits that you should be able to get the Bank audit done on time.
- You realize that you ought to talk to the predecessor auditor at some point but can't imagine when you will have time to do that with all that has to be done to accept this new client.
- The Bank's CFO agrees that it is important to have a conversation with the predecessor auditor but said it will have to wait until later in the year – maybe while your engagement team is planning the audit.
- Right now, you have to do whatever is necessary to give the Bank approval to file their 8-K.

Case Study No. 4 – Sound Deposits Bank Scenario 1

- You have presented the Bank CFO with an engagement letter outlining an understanding of the terms of the audit engagement;
- however, the CFO immediately indicated that the Bank would have a problem with the alternative dispute resolution language contained in the letter.
- While the partners of your Firm are fairly adamant that this is something the Firm will not budge on, your managing partner has agreed that the Bank can have some time to familiarize itself with alternative dispute resolution provisions before signing the engagement letter.
- He has also made it clear that you will not be able to issue the Firm's audit opinion without a signed engagement letter.

Case Study No. 4 – Sound Deposits Bank Scenario 2

- Your Firm is in the beginning stage of planning its audit of the Bank's financial statements for the year ended December 31, 2012.
- You are the engagement partner on the Bank audit and have over 25 years of experience auditing publicly-held regional banks.
- You have just arrived in your managing partner's office to discuss the assignment of an engagement quality reviewer to the Bank engagement.
- Your managing partner has done some homework on the subject and presents you with the following options for the engagement quality reviewer.
- However, he wants to use one of the options within the Firm to enhance realization on the engagement

Case Study No. 4 – Sound Deposits Bank Scenario 2

- A manager of the Firm with 10 years experience auditing publicly-held regional banks – high level of competence in accounting, auditing, financial reporting, and SEC rules and regulations

- A partner of the Firm with 25 years experience providing tax services to publicly-held regional banks – expert on tax issues of regional banks and is liked by the Bank's CEO and CFO

- A partner of the Firm with 30 years experience auditing publicly-held manufacturing companies – no bank experience but is the Firm's Director of Accounting and Auditing

- An accounting professor at state university with 30 years experience auditing publicly-held banks at large accounting firm from which he retired five years ago – wrote a highly regarded book entitled, How to Audit a Publicly-Held Regional Bank

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Questions

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Wrap-Up and Closing Remarks

Lewis H. Ferguson, Board Member
and all Speakers