

# **Forum on Auditing in The Small Business Environment**

February 27, 2006

*Fort Lauderdale, Florida*

# Opening Keynote Address

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# PCAOB and Unique Challenges Facing Small Business

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- ❑ Tailoring inspection program
- ❑ Soliciting input from small business in standards-setting process
- ❑ Participating in various outside groups addressing small business concerns

# Small Business in the New Regulatory Environment

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- ❑ PCAOB/SEC comment process
- ❑ PCAOB inspection reports
- ❑ Final orders relating to disciplinary proceedings
- ❑ Lessons learned from first year of Section 404 implementation
- ❑ Visit [www.pcaobus.org](http://www.pcaobus.org)

# Overview of the PCAOB and "Hot Topics"

February 27, 2006

*Fort Lauderdale, Florida*

# Caveat

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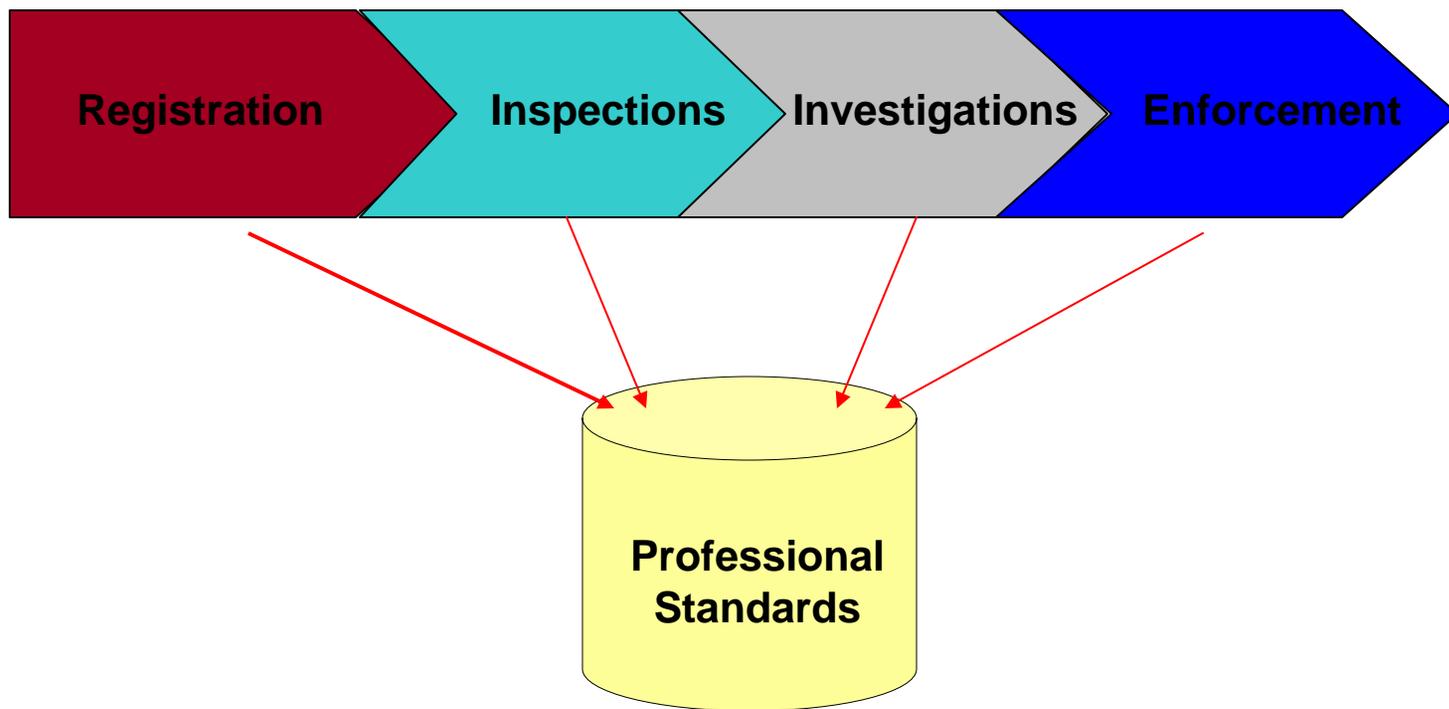
Although much of the information that will be provided to you has been made public by the Board via Releases and the like, there also will be views expressed that are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff. Therefore, unless it is clear that the Board has authorized the statement, you should not attribute it to the Board or staff.

# Objectives of this Presentation

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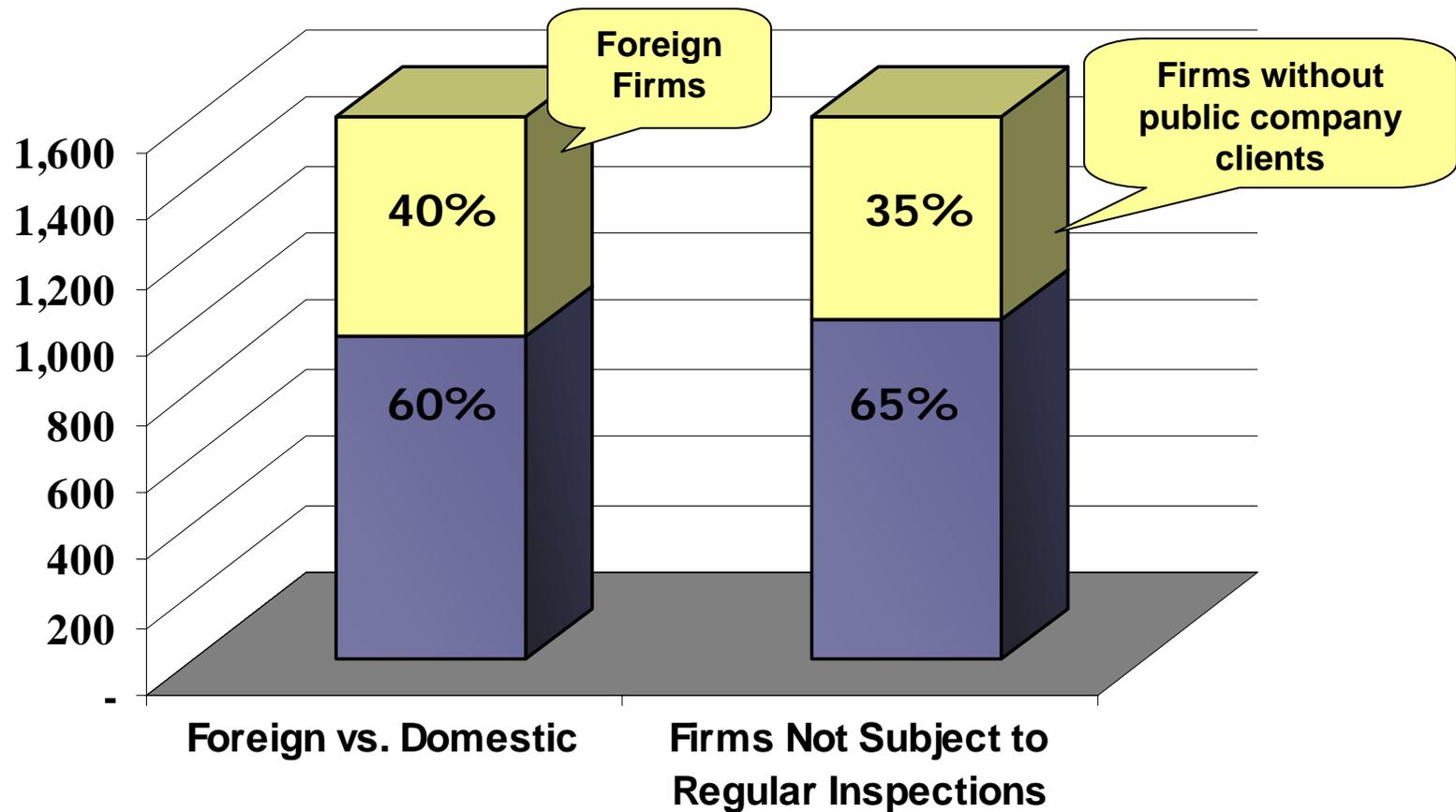
- ❑ Brief overview of the PCAOB
- ❑ Interplay between Inspections, Standards and Enforcement
- ❑ Most frequently encountered inspection observations - "hot topics"
- ❑ Update on internal control over financial reporting

# The PCAOB in a Nutshell



# Registered Firms

Approximately 1,600 Registered Firms



# Inspections Progress

- ❑ Of the approximately 1,600 registered firms, approximately 1,000 are subject to regular inspections
  - Must take place annually for firms that issue audit reports for more than 100 US-traded companies
  - Firms that issue audit reports for 100 or fewer US-traded companies must be inspected at least once every three years
- ❑ Since inception
  - Completed fieldwork on more than 350 inspections
  - Issued more than 180 reports
  - Looked at portions of the audits of over 1,800 public companies

# Inspection Reports - Drafts

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- Draft inspection reports are issued once fieldwork is complete and after the inspection team's observations and related inspection report have been reviewed
  - Comment forms provide the foundation of the inspection report
  - Firms have 30 days to respond to our draft inspection reports

# Inspection Reports – Overview of Reports for Small Firms

## □ Four sections

### ■ Part I - public

- Part I provides overview of firm size, legal structure and summary of inspection observations

### ■ Part II

- Part II.A details the inspection observations and is nonpublic
- Part II.B discusses criticisms of, and potential defects in, the firm's quality control policies and practices and may become public
- Part II.C discusses other audit performance issues and is nonpublic

# Inspection Reports - Overview of Reports for Small Firms (cont'd)

## □ Part III - nonpublic

- This section provides guidance on addressing quality control criticisms:
  - It is the Firm's responsibility to address the criticisms and potential defects described in Part II of the report
  - If the quality control criticisms are not addressed in 12 months, portions of Part II may become public
- Certain reports may recommend that the Firm review the audits not inspected
- Certain reports may include an imminent disciplinary paragraph

## □ Part IV – public

- May include portions or all of the firm's response to the draft report

# Inspection Reports - Final

- After the 30-day response period expires and the report is approved by the Board, the final inspection report will be issued
  - The entire inspection report is provided to the firm, the SEC and the appropriate state licensing board
  - The public portions of inspection reports are posted on the PCAOB's website ([www.pcaobus.org](http://www.pcaobus.org)), including the public part of firm responses

# Impact of Inspections on Standards and Enforcement

- ❑ Inspectors' observations help identify areas to be addressed by the Board for potentially new auditing standards and evaluate compliance with currently existing standards
- ❑ Nature and type of observations as well as conduct of the firm impacts whether enforcement action is taken

# Standards-setting Overview

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The Sarbanes-Oxley Act directs the Board to establish

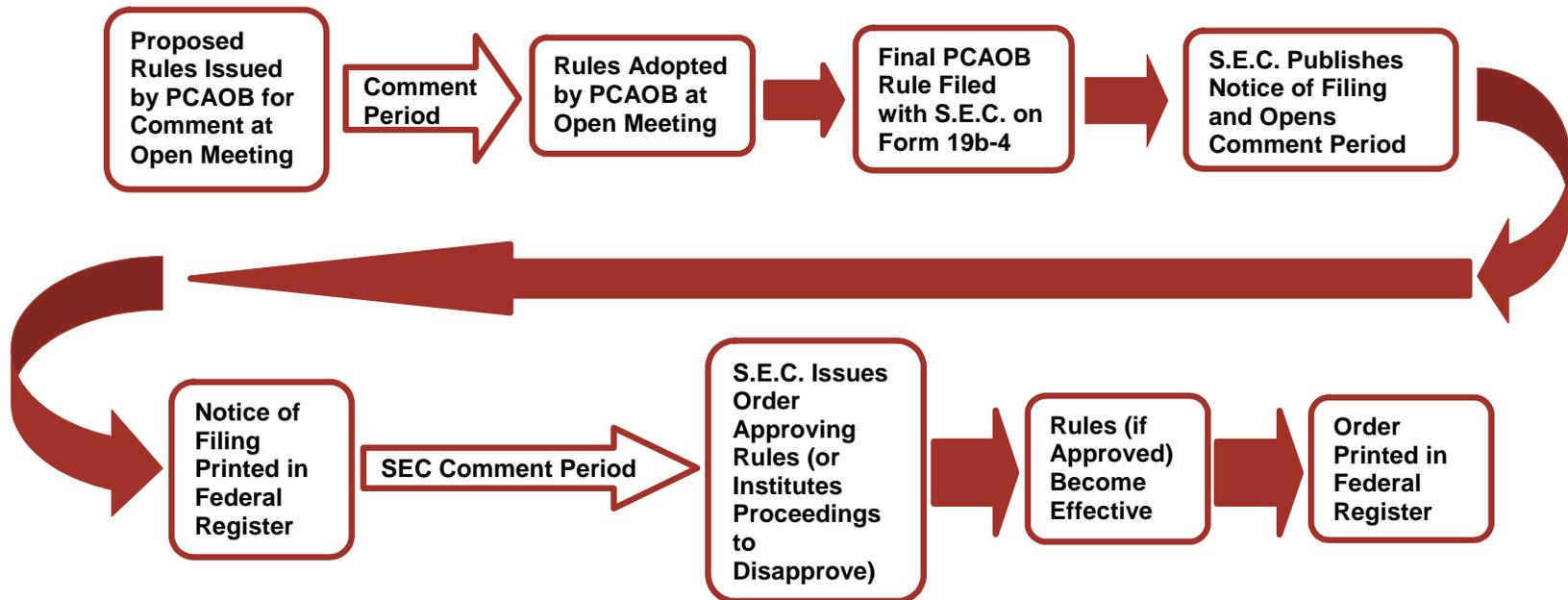
- Auditing standards
- Attestation standards
- Quality control standards
- Ethics standards
- Independence standards

# Standards-setting Information Gathering Sources

- ❑ Standing Advisory Group ("SAG")
- ❑ PCAOB inspection observations
- ❑ PCAOB enforcement cases
- ❑ Office of Research and Analysis
- ❑ Roundtables on selected issues
- ❑ Ad hoc task forces and working groups
- ❑ Academic research
- ❑ Other sources

# Standards-setting Process

## PCAOB Typical Rulemaking Process



# Auditing Standards and Selected Rules Issued to Date

- ❑ Auditing Standard No. 1 – References in Auditors' Reports to the Standards of the PCAOB
- ❑ Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements
- ❑ Auditing Standard No. 3 – Audit Documentation
- ❑ Auditing Standard No. 4 – Reporting on Whether a Previously Reported Material Weakness Continues to Exist
- ❑ Rule 3101 – Certain Terms – "Must vs. Should"
- ❑ Rules 3501 to 3524 - Independence and Ethics\*

# Standards-setting Activities\*

- ❑ Engagement quality review
- ❑ Fraud
- ❑ Communications with audit committees
- ❑ Principles of reporting
- ❑ Fair value
- ❑ Risk assessment
- ❑ Quality control
- ❑ Codification of PCAOB standards/authority of PCAOB interim standards

\*Activities subject to change based on emerging issues

# Examples of Consultations with Standards

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- ❑ Independence
- ❑ Engagement quality review
- ❑ Audit documentation requirements

# Division of Enforcement and Investigations

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- ❑ DEI consists of attorneys, accountants and support staff
- ❑ All are based in Washington, DC

# Enforcement and Investigations

- The Board may investigate possible violations by registered public accounting firms or their associated persons of
  - any provision of the Sarbanes-Oxley Act
  - the rules of the Board
  - the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or
  - professional standards
- The Board may impose appropriate sanctions if violations are found

# Sources of Investigations

- Issuer disclosures
  - Auditor changes
  - Restatements
- Public news sources
- Tips
- Other regulators
- Other PCAOB divisions and offices
  - Office of Research & Analysis
  - Division of Registration and Inspections

# Inspections Referred to DEI

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- Firms may be referred for investigation or disciplinary proceedings where there are serious concerns about
  - the firm's commitment to conducting audits with sufficient care, or
  - the firm's ability to conduct audits with sufficient competence

# What Prompts a Referral from Inspections to DEI?

- ❑ Numerous deficiencies on each issuer audit client inspected
- ❑ Firm not cooperative
  - Difficulty scheduling inspection
  - Personnel not available during course of inspection procedures
- ❑ Engagement partners assigned to dozens of audit clients in various industries
- ❑ Firm indicated in response to comment form and draft report that issuer would restate for certain of the inspection observations
  - Issuer never restates
- ❑ Firm had not corrected deficiencies noted from prior peer review

# Investigations

- ❑ The Board conducts informal inquiries and formal investigations
- ❑ With formal investigations, the Board may demand testimony or document production from audit firms and associated persons, and may request testimony or documents from any other person (e.g., public company audit clients)
- ❑ Audit firms and associated persons are required to testify and produce information
- ❑ Individuals may assert Fifth Amendment rights against self-incrimination, but the Board may draw adverse inferences if appropriate

## Investigations (cont'd)

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- ❑ PCAOB may share information with the SEC, DOJ and other agencies enumerated in the Act
- ❑ Coordination with SEC Enforcement is standard practice in PCAOB enforcement matters
- ❑ Otherwise, the Act requires confidentiality of information

# Common Types of Investigations

- Violations of professional standards
  - "Audit failure" — issuer's financial statements are not in accordance with GAAP and the auditor should have detected the misstatement
  - Not limited to matters involving GAAP departures
- Independence violations

# Common Types of Investigations (cont'd)

- ❑ Failure to cooperate with an inspection or investigation
  - May result in a separate disciplinary proceeding
  - Need not wait for conclusion of investigation relating to underlying violations
  - Sanctions available to Board are similar to those for other Board disciplinary proceedings
  - Staff usually will communicate what it views as non-cooperation

# After the Investigation

- Upon completion of investigation
  - Staff typically will communicate in writing what it views as the alleged violations, including laws and rules violated and facts supporting the violations
  - Staff typically will provide the firm or individual two weeks to respond in writing to staff's position
  - Staff typically will discuss settlement of disciplinary proceedings with proposed respondents

# Disciplinary Proceedings and Hearings

- ❑ The Board will conduct on-the-record hearings to determine whether firms or associated persons should be disciplined
- ❑ Hearings will not be public, unless otherwise ordered by the Board for good cause shown, with the consent of the parties to such hearing
- ❑ Any sanctions imposed will be public and can be appealed first to the SEC and then to the appropriate federal courts

# Sanctions

- In a disciplinary proceeding, the Board may
  - suspend or permanently bar an individual from association with a registered public accounting firm
  - temporarily or permanently limit the activities, functions, or operations of a firm or person
  - appoint an independent monitor
  - impose a civil money penalty
  - impose a censure, require additional professional education or training, or impose any other sanction per Board rules.

# PCAOB Center for Enforcement Tips, Complaints and Other Information

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- ❑ Web site: [www.pcaobus.org/Enforcement/](http://www.pcaobus.org/Enforcement/)
- ❑ E-mail: [tips@pcaobus.org](mailto:tips@pcaobus.org)
- ❑ Letter     PCAOB Complaint Center  
              1666 K Street, NW  
              Washington, DC 20006
- ❑ FAX:        202-862-0757
- ❑ Telephone: 800-741-3158

# Inspections "Hot Topics"

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1. Revenue
2. Expenses
3. Estimates
4. Contractual arrangements
5. Equity transactions
6. Inventory
7. Going concern
8. Internal control
9. Principal auditor
10. Independence

# 1. Revenues

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- ❑ No or insufficient testing of revenue recognition
- ❑ Tests of transactions but no basis for sample size selections
- ❑ No cut-off testing when transactions occurred at or near year end
- ❑ Reliance on analytics but no evidence obtained to corroborate management's representations

## 2. Expenses

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- ❑ Analytical review of income statement with no corroborating evidence to support management representations
- ❑ Agreed salary and wage expense to 941 form

## 3. Estimates

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- ❑ Allowance for doubtful accounts and loan loss reserves
  - No or insufficient testing of collectibility of A/R, Loans Receivable
- ❑ Valuation allowances
  - No valuation allowance of deferred tax asset despite evidence that asset may not be recoverable

## 3. Estimates (cont'd)

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### □ Impairment charges

- Issuer has poor financial prospects yet no testing performed to evaluate amortization period and/or impairment of asset
- Asset considered impaired shortly after it was acquired
- No evidence that annual goodwill impairment test was performed or, if performed, no testing of management assumptions

## 4. Contractual Arrangements

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- Business combinations
  - No testing whether purchase price is appropriately allocated to net assets acquired
  - No testing whether transaction accounted for properly
  - Issuer omits material disclosures of the business combination

## 4. Contractual Arrangements (cont'd)

- Joint ventures
  - No consideration whether JV should be consolidated
  - Inadequate disclosure of the JV arrangement
  - No assessment of the parties to the JV agreement
- Debt agreements
  - No testing of compliance with debt covenants or appropriateness of long-term debt classification
  - No awareness of debt covenants – agreement not obtained or not reviewed

# 5. Equity Transactions

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- Fair value
  - Stock for services and stock for assets
  - Debt issued with detachable warrants
  - Notes converted into common stock

## 6. Inventory

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- ❑ Flawed lower-of-cost-or-market testing
- ❑ Obsolescence testing
- ❑ Capitalization of costs

## 7. Going Concern

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- ❑ No evaluation of firm's ability to continue for next 12 months

## 8. Internal Control

- ❑ Reliance on system-generated reports
  - No or insufficient testing of the accuracy of the report
- ❑ Service auditor's reports
  - Accounting function of a significant area outsourced to a third party (e.g., payroll, employee retirement plan)
    - No service auditor's report obtained and no testing of controls at either the user or service organization
    - Service auditor report obtained but provides no evidence about operating effectiveness of relevant controls at the service organization
    - Service auditor report from prior year relied upon

## 9. Principal Auditor

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- Back-door registrations
  - Operating company merges with a public non-operating shell company
    - Auditor of shell company opines on the merged entity
      - Auditor did not perform procedures to accept responsibility for work performed by other auditor

# 10. Independence

- ❑ Firm provides one or more of the following services:
  - Bookkeeping services
    - Maintains general ledger
    - Posts adjustments to general ledger
    - Combines general ledgers from several subsidiaries and records elimination and other consolidating entries
    - Prepares trial balance
    - Calculates income tax provision including deferred tax valuation allowance
  - Preparation of financial statements
    - Prepares certain/all financial statements
    - Prepares footnotes to audited financial statements
  - Valuation services
- ❑ The Firm does not confirm its independence with the audit client

# Update on Internal Control over Financial Reporting

- Basics of Section 404
- SEC Reference Material
- PCAOB Sources of Information
  - Staff Questions & Answers
  - Board Policy Statement
  - Report on Initial Implementation
- SEC Advisory Committee on Smaller Public Companies
- COSO Update

# Sarbanes-Oxley Act: Section 404

- Requirements:
  - Management report on internal control over financial reporting
  - Audit of management's assessment
- Effective dates:
  - Accelerated filers (U.S.): first fiscal year after November 15, 2004
  - Non-accelerated filers: first fiscal year after July 15, 2007

# SEC Reference Material on Section 404

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- ❑ Implementing rules
- ❑ Other Commission releases
- ❑ Staff guidance
- ❑ Other information

[www.sec.gov/spotlight/soxcomp.htm](http://www.sec.gov/spotlight/soxcomp.htm)

# PCAOB Sources of Information

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- ❑ Auditing Standard No. 2
- ❑ Conforming Amendments Resulting from Auditing Standard No. 2
- ❑ Staff Questions and Answers
- ❑ Board Policy Statement
- ❑ Report on Initial Implementation

[www.pcaobus.org/Standards/Standards\\_and\\_Related\\_Rules/Auditing\\_Standard\\_No.2.aspx](http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx)

# Staff Questions & Answers

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- ❑ Top-down approach (Q&A 38)
- ❑ Role of risk assessment (Q&A 39-40)
- ❑ Integrating the audit (Q&A 50)
- ❑ Scope and extent of testing matters (Q&A 41-53)
- ❑ Using the work of others (Q&A 54)

# Board Policy Statement

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- ❑ Use of auditor judgment
- ❑ Timely communications with audit clients about accounting issues
- ❑ Approach to inspections

# Report on Initial Implementation of AS2

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- Highlights issues identified through the Board's monitoring
  - Efficiency observations
  - Effectiveness observations
- Clarification of concepts related to
  - Evaluating Deficiencies
  - Definition of Material Weakness

# Report on Initial Implementation of AS2 - Efficiency and Effectiveness

- Efficiency
  - Integrating the Audit
  - Top-Down Approach
  - Risk Based Approach
  - Using the Work of Others
  - Walkthroughs
- Effectiveness
  - Compensating Controls
  - Controls over Presentation and Disclosures

# Report on Initial Implementation of AS2

## - Discussion of Concepts

- Evaluating Control Deficiencies and Implementing the Definition of Material Weakness
  - More than Remote Likelihood
    - Means "at least reasonably possible likelihood"
  - Use of Judgment
    - Assessment of reasonable assurance requires judgment, not a mechanical application of a predetermined probability formula
  - Strong Indicators of a Material Weakness
    - Identification of a strong indicator is the beginning of the process, not the end

# SEC Advisory Committee on Smaller Public Companies

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- ❑ Composed of representatives of smaller public companies and professionals who work with smaller public companies
- ❑ Primary areas of focus
  - Accounting standards
  - Internal control over financial reporting
  - Corporate governance and disclosure
  - Capital formation

# SEC Advisory Committee Activities

- Activities to date
  - Online survey and public meetings
  - Formal recommendations to SEC
  - Other "proposed preliminary recommendations" under consideration
- Future Activities
  - Final recommendations and report to the SEC

[www.sec.gov/info/smallbus/acspc.shtml](http://www.sec.gov/info/smallbus/acspc.shtml)

# Concepts Discussed by Advisory Committee

- Small public companies redefined
  - Market capitalization in the lower 6% of U.S. public companies (approx. \$700-\$750 million) and last fiscal year revenues no greater than \$250 million
  - 71% of all public companies fall within the market cap threshold
- Microcap companies defined
  - Market capitalization in the lower 1% of U.S. public companies (approx. \$100-\$125 million) and last fiscal year revenues no greater than \$125 million
  - 57% of all public companies fall within the market cap threshold
- Various levels of Section 404 reporting being discussed

## Draft Guidance from COSO

- *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting* (draft, October 2005)
  - Focus on internal control over financial reporting
  - Essential principles for effective internal control
  - Illustrative approaches and examples for smaller public companies

[www.coso.org](http://www.coso.org)

# PCAOB Comment Letter on COSO Draft Guidance

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- ❑ Make all comments publicly available
- ❑ Re-focus guidance on management's responsibilities regarding internal control
- ❑ Make the guidance simpler and easier to use
- ❑ Make sure that attributes, approaches, and examples are appropriate for smaller public companies

# Looking forward

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- ❑ Continued focus on internal control over financial reporting by all participants
- ❑ Leveraging lessons learned
- ❑ Developments for small businesses
- ❑ Potential additional regulatory actions

# Keeping Current with PCAOB

- Our Web site - [www.pcaobus.org](http://www.pcaobus.org)
  - List of registered firms
  - Inspection reports
  - PCAOB standards, including interim standards
  - Enforcement disciplinary proceedings
- Contact us at [info@pcaobus.org](mailto:info@pcaobus.org)

# Questions?

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# **PCAOB Inspections Process: What Can Be Expected**

February 27, 2006

*Fort Lauderdale, Florida*

# Mission of Atlanta Inspection Office

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- ❑ Integrate into national PCAOB mission of inspecting the large firms (> 100 Issuer clients)
- ❑ Inspect the small firms in the Atlanta region
- ❑ Support small firm inspection process in other PCAOB offices
- ❑ Support other PCAOB initiatives

# Atlanta Office - Number of Registered Firms by State

Florida	91
Georgia	30
Tennessee	20
Alabama	14
North Carolina	12
South Carolina	9
Mississippi	<u>8</u>
Total	184

# Inspection Approach

- ❑ Regional small firm inspection approach
- ❑ Size of inspection team based on number of issuer audit clients and offices
- ❑ Certain inspections are conducted at a PCAOB office and the inspection team follows up with the firm telephonically
- ❑ Some inspections may be completed in less than a week
- ❑ Inspections focus on audit performance and quality control

# Lifecycle of an Inspection

- ❑ Contact firm
- ❑ Inspection commencement date determined
- ❑ Formal letter issued with document request
- ❑ Engagements and offices selected for review
- ❑ Quality control assessment and engagement reviews
- ❑ Comment forms prepared, reviewed by firm, and responded to
- ❑ Draft report prepared by inspection staff
- ❑ Draft report made available to firm
- ❑ Firm has 30 days to respond to draft report
- ❑ Board issues final report to firm, SEC and certain state licensing boards
- ❑ Firm has 12 months to cure the quality control criticisms

# Contact Firm – Document Request

- Purpose is to obtain information about the firm, its professional staff and issuer clients. For example:
  - Firm demographic information
  - List of individuals who manage the firm and their biographies
  - Firm's quality control policies and procedures, including current year's internal inspection and/or peer review results
  - Firm's policies covering independence, including policies regarding non-audit services, fee arrangements and business ventures, alliances, and arrangements with issuer audit clients

## Document Request (cont'd)

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- ❑ List of concurring reviewers outside of the firm
- ❑ List of issuer audit clients
- ❑ List of former issuer audit clients that "changed auditors" from your firm
- ❑ List of issuer audit clients that restated their financial statements

# Quality Control Assessment

- ❑ Tone-at-the-top
- ❑ Independence
- ❑ Partner compensation
- ❑ Practice monitoring (internal programs and peer review results)
- ❑ Concurring partner reviews
- ❑ Client acceptance and retention
- ❑ Training
- ❑ Audit methodology
- ❑ Work of other auditors
- ❑ Alternative practice structure

# Engagement Reviews

- Meet with engagement partner
- Review of audit work papers
  - Audit areas selected based on inspector's judgment
  - Engagement team personnel should be available to answer questions
- Comment forms issued at the conclusion of the inspection
  - Ensure that facts are accurately described
  - If firm chooses to respond, must do so in 10 business days

# Draft Inspection Report

- Inspection team prepares draft inspection report
  - Several layers of review
    - Factual accuracy of report scrutinized
    - Firm's response to comment forms reviewed again
  - Inspection report may not include all comment forms
    - Comment may not meet criteria for inclusion in report
    - Inspection observation reworded
    - New observation
    - Quality control deficiencies

# Draft Inspection Report – Firm Response

- ❑ Firm has 30 days to respond to draft report
  - Firm's responsibility to ensure response received within the 30-day period
  - Another opportunity to respond to the inspection observations
  - Can impact the inspection report
- ❑ Firm response treated similarly to inspection report
  - Part I is always public
  - Part II is nonpublic
  - Contact person provided in transmittal letter
  - No draft responses accepted
- ❑ Confidentiality requests
  - Factual inaccuracies in report

# Final Inspection Report

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- Report presented to the Board
  - After review completed, the report is submitted to the Board
  - The Board determines whether the report may be made final
- Final report posted on the website, provided to the SEC and any state(s) in which the firm is licensed

# Example Inspection Report with Observations

## **Part I Inspection Procedures and Certain Observations** Public

- A – Review of Audit Engagements
- B – Review of Quality Control System

## **Part II Detailed Discussion of Inspection Results**

- A – Insufficiently Supported Audit Opinions **Non Public**
- B – Issues Related to Quality Controls **Non Public \***
  - 1. Audit Performance
  - 2. Independence
  - 3. Monitoring and Addressing Identified Weaknesses
- C – Other Audit Performance Issues **Non Public**

\*Subject to 12-month remediation process

## **Part III Post Inspection Procedures** All Non Public

- A – Addressing Quality Control Criticisms
- B – Additional Assessment of Audits \*
- C – Imminent Disciplinary Proceeding \*

\*Sections B and C of Part III are only included in the report, if appropriate

## **Part IV Response of the Firm to Draft Inspection Report** **Public/Non Public \***

\* Portions of firm's response may be non public

# 12-Month Remediation Process

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- Final inspection report accompanied by a transmittal letter
  - Provides contact information
  - Instructions for communicating with PCAOB during this period
  - Quality control criticisms may become public if not adequately addressed by firm

# Questions?

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# **Technical Discussion – Issues Identified through PCAOB Inspections**

February 27, 2006

*Fort Lauderdale, Florida*

# Objectives

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- ❑ Discuss the importance of proper documentation of audit procedures and conclusions
- ❑ Discuss in more detail certain of the "hot topics"

# Audit Documentation

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- ❑ Pervasive lack of audit documentation
- ❑ Inventory
- ❑ Equity

# Auditing Standard No. 3 – *Audit Documentation*

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- For relevant financial statement assertions, auditors must document
  - Procedures performed
  - Evidence obtained
  - Conclusions reached (par. 6)

# Experienced Auditor

- Documentation must have sufficient information to enable an *experienced auditor*, having no previous connection with the engagement, must be able to understand the work performed, evidence obtained, and conclusions reached
  - An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the A&A issues relevant to the industry. (par. 6)

# Audit Documentation

- If there is insufficient documentation in the working papers, auditor must *demonstrate* procedures performed, evidence obtained, and conclusions reached (par. 9)
  - Auditor must have persuasive other evidence
  - Oral evidence, alone, is not sufficient and may be used only to *clarify* other written evidence

# Engagement Completion Document

- ❑ All significant findings or issues to be documented in an *engagement completion document* (par. 13)
- ❑ Examples of *significant findings or issues* include:
  - Significant matters involving selection, application, and consistency of GAAP
  - Audit adjustments
  - Disagreements among engagement team members
  - Significant difficulty in applying auditing procedures
  - Any matters that could result in modification of auditor's report

# Multi-Location Audits

- ❑ The office of the firm issuing the auditor's report must ensure that *all* audit documentation prepared and retained (par. 18)
- ❑ Certain documentation related to the work performed by other auditors must be obtained prior to the report release date. Such documentation includes
  - Engagement completion document
  - Schedule of audit adjustments
  - Significant deficiencies/material weaknesses
  - Matters to be communicated to the audit committee

# Definitions of Dates

- Two new dates defined in this standard
  - *Report release date* – the date the auditor grants permission to use the auditor's report in connection with the issuance of the financial statements (par. 14)
  - *Documentation completion date* – not more than 45 days after the report release date (par. 15)

# 45-day Period to Assemble Work Papers

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- During this period auditor can
  - Discard superseded drafts of memoranda, financial statements, and other documents
  - Discard duplicates of documents
  - Correct minor edits in the working papers

# Hypothetical Inspection Finding – Revenue

- Operating company earns revenues from various sources
  - Auditor obtains client summary of revenue recognition policies and procedures
  - Auditor does not perform cut-off procedures because client indicates all transactions processed the same way throughout the year
  - Auditor confirms certain accounts receivable

# Auditing Revenue

- Auditing challenges
  - Complicated area
  - Numerous technical references
- Would any of these pronouncements apply to your audit clients?
  - Staff Accounting Bulletin 104, *Revenue Recognition*
  - ARB 45, *Long-Term Construction-Type Contracts*
  - FTB 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*
  - SFAS No. 45, *Accounting for Franchise Fee Revenue*
  - SFAS No. 48, *Revenue Recognition When Right of Return Exists*
  - EITF 99-17, *Accounting for Advertising Barter Transactions*
  - EITF 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*
  - EITF 00-8, *Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services*
  - EITF 00-10, *Accounting for Shipping Handling Fees and Costs*
  - EITF 03-5, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*

# Auditing Revenue (cont'd)

- ❑ Revenue is usually a significant account, so substantive procedures must be applied (AU sec. 319, as amended\*)
- ❑ Analytical procedures (AU sec. 329, as amended\*)
  - Precision level appropriate for degree of assurance
  - Expectations and differences quantified
    - Test completeness and accuracy of underlying reports
    - Consider potential management override
  - Management explanations corroborated
- ❑ Audit sampling (AU sec. 350 and Auditing Standard No. 3)
  - Basis for sample size
  - Sample selection (must be representative)
  - Documentation
- ❑ Cutoff and revenue recognition (AU sec. 316)

\* Amended by the Board in Conforming Amendments resulting from Auditing Standard No. 2

# Auditing Revenue Recognition

- Understand client and industry, revenue composition, terms of revenue transactions, and relevant accounting principles.
- Presumption that improper revenue recognition is a fraud risk. Consider:
  - Confirming with customers the contract terms and the absence of side agreements
  - Asking sales/marketing personnel or in-house legal counsel about sales near period-end and any unusual terms or conditions
  - Visiting one or more locations at period-end to observe shipments (or returns) and performance of cutoff procedures
  - Testing controls, especially when sales are electronically initiated, processed, and recorded
  - In applying substantive analytical procedures, using disaggregated data or Computer-Assisted Audit Techniques

# Hypothetical Inspection Finding – Business Combination

- Company A acquires Company B
  - Company A prepares purchase price allocation and provides to auditor
    - Auditor accepts issuer's accounting for the transaction
    - Auditor does not challenge write-off of goodwill in the same period recorded
- Public shell Company C acquires operating private Company D
  - Auditor does not perform testing to determine if the transaction is a reverse merger

# Hypothetical Inspection Finding – Impairment

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- Company ABC invests in certain equipment in anticipation of increased demand for its products
  - Two years later competitors in market have absorbed the additional demand
  - No alternate use of capital equipment

# Hypothetical Inspection Finding – Equity

- ❑ Company XYZ acquires (via issuance of stock) certain technology developed by an employee of the company
  - Client capitalizes cost of acquired technology
    - Technology not relevant to client's ongoing business
    - Client discounts trading value of stock 90% because large issuance and stock is thinly traded

# Auditing Business Combinations, Impairment and Equity

- ❑ Auditing challenges
  - Complicated terms and conditions of agreements
  - Requires judgment and possibly third-party expertise
- ❑ Are you familiar with these pronouncements and their implications to your clients?
  - Staff Accounting Bulletin No. 107, *Share Based Payment*
  - SFAS No. 123R, *Share-Based Payment*
  - SFAS No. 141, *Business Combinations*
  - SFAS No. 142, *Goodwill and Other Intangible Assets*
  - SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
  - SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*
  - SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
  - SFAS No. 153, *Exchanges of Nonmonetary Assets an amendment of APB Opinion No. 29*
  - EITF 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*
  - EITF 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*
  - EITF 01-2, *Interpretations of APB Opinion No. 29*
  - EITF 02-17, *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*
  - EITF 03-9, *Determination of the Useful Life of Renewable Intangible Assets under FAS Statement No. 142*

# Auditing Significant Transactions

- ❑ Understanding of business and industry (AU sec. 311)
- ❑ Understand business purpose of transaction (AU sec. 316.66-.67)
  - Is the transaction overly complex in form?
  - Has management discussed the nature of the transaction and its accounting with the audit committee or board of directors?
  - Does management emphasize the need for a particular accounting treatment rather than the underlying economics of the transaction?
  - If the transaction involves unconsolidated related parties, including special purpose entities, has it been reviewed and approved by the audit committee or board of directors?
  - Does the transaction involve previously unidentified related parties or parties that lack the substance or financial strength to support the transaction without assistance from the issuer?

# Auditing Significant Transactions (cont'd)

- ❑ Consider substance over form (AU sec. 411.06)
- ❑ Evaluate bias in selection and application of accounting principles (AU sec. 316.50, AU sec. 380.11)
- ❑ Document work performed and conclusions reached (Auditing Standard No. 3)

# Hypothetical Inspection Finding – Estimates

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- ❑ Client determines allowance for doubtful accounts based on percentages applied to each aging bucket
  - Percentages developed several years ago
  - No consideration whether certain A/R should be specifically reserved
  - Account receivables aging report produced electronically

# Estimates

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- Estimates
  - Significant judgment
- Examples of Accounting Standards
  - APB No. 20, *Accounting Changes* (now superseded by SFAS No. 154)
  - SFAS No. 5, *Accounting for Contingencies*
  - SFAS No. 109, *Accounting for Income Taxes*

# Auditing Accounting Estimates

- AU secs. 342 and 328 (and other standards)
  - Three approaches
    - Test management's process
    - Develop independent estimate
    - Review subsequent events
- Consider management bias (AU secs. 312, 342, and 316)
  - Retrospective review of prior-year estimates (AU sec. 316.64)
- Using a specialist (AU sec. 336)

# Independence

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- Firm provides one or more of the following services:
  - Bookkeeping services
  - Preparation of financial statements
  - Management function

# Auditor Must be Independent in Fact and Appearance

Second general auditing standard states –

- ❑ "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." (AU sec. 220.01)
- ❑ "To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners." (AU sec. 220.03)

# Auditor Independence is Governed by –

- ❑ SEC Auditor Independence Rules (17 CFR 210.2-01)
- ❑ AICPA Code of Professional Conduct, Ethics Secs. 101, 102, and 191
- ❑ PCAOB Interim Independence and Ethics Standards
  - Adopted AICPA ET secs. 101, 102, 191, and ISB Standards No. 1, 2, and 3
  - Look to SEC auditor independence rules when SEC rules are more restrictive

# SEC Overarching Independence Principles

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Does the auditor/client relationship or the provision of services –

- Create a mutual or conflicting interest?
- Place the auditor in the position of auditing his or her own work?
- Result in the auditor acting as management or an employee of the audit client?
- Place the auditor in a position of being an advocate for the audit client?

# Prohibited Non-Audit Services

- ❑ Bookkeeping or other services related to the accounting records or financial statements of the audit client
- ❑ Financial information system design and implementation
- ❑ Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- ❑ Actuarial services
- ❑ Internal audit outsourcing services
- ❑ Management functions
- ❑ Human resources
- ❑ Broker-dealer, investment adviser, or investment banking services
- ❑ Legal services
- ❑ Expert services unrelated to the audit

# Bookkeeping Services\*

The auditor is prohibited from –

- Maintaining or preparing the audit client's accounting records
- Preparing the audit client's financial statements that are filed with the SEC or that form the basis of financial statements filed with the SEC
- Preparing or originating source data underlying the audit client's financial statements

\* includes other services related to the accounting records or financial statements of the audit client

# Management Functions

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- ❑ The auditor is prohibited from acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client

# Other Independence Restrictions

- ❑ Financial interests in audit client
- ❑ Business relationships with audit client
- ❑ Employment relationships with audit client
- ❑ Contingent fee arrangements
- ❑ Audit client hiring an audit engagement team member within a certain timeframe into a financial reporting oversight role
- ❑ Partner rotation on the audit engagement
- ❑ Partner compensation for selling non-audit services

# Recent PCAOB Ethics and Independence Rules\*

- Rules cover three distinct areas\*\* –
  - Core ethics and independence requirements (Rules 3502 and 3520)
  - Specific services that impair the auditor's independence
    - Contingent fees (Rule 3521)
    - Tax transactions (Rule 3522)
    - Tax services to persons in a financial reporting oversight role (Rule 3523)
  - Additional communication requirements with audit committees as they relate to permissible tax services (Rule 3524)

\* Not effective unless approved by the SEC

\*\* Definitions of terms used in the independence rules are located in Rule 3501

# Reference materials relating to Independence

## □ PCAOB

- Ethics and Independence Rules
- Interim Independence Standards
- Interim Quality Control Standards
  - SECPS Requirement 1000.08(o) and Appendix L – Independence Quality Controls
- [www.pcaobus.org/standards/](http://www.pcaobus.org/standards/)

## □ SEC

- Independence Rules – 17 CFR Section 210.2-02  
[www.sec.gov/info/accountants/independref.shtml](http://www.sec.gov/info/accountants/independref.shtml)
- Frequently Asked Questions (12/13/04)  
[www.sec.gov/info/accountants/independref.shtml](http://www.sec.gov/info/accountants/independref.shtml)
- Interpretations Relating to Independence – SEC Codification of Financial Reporting – Section 602.02. Not available on SEC website.

# Questions?

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# Open Discussion

February 27, 2006

*Fort Lauderdale, Florida*