

Forum on Auditing in The Small Business Environment

January 23, 2006

Santa Monica, California

Opening Keynote Address

January 23, 2006

Santa Monica, California

Overview of the PCAOB and "Hot Topics"

January 23, 2006

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Caveat

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

- ❑ Overview of the PCAOB
- ❑ Interplay between Inspections, Enforcement and Standards
- ❑ Most frequently encountered inspection observations - "hot topics"

Unique Structure

- ❑ Operates as a private, non-profit corporation
NOT a government organization
- ❑ But, the SEC has oversight authority over the Board in specific areas:
 - Appointment/removal of Board members
 - Approval of budget and all rules (including professional standards)
 - Forum for appeal of certain Board decisions
 - May inspect any portion of the Board's operations

PCAOB Offices

□ Washington, D.C. - Headquarters

- Board members
- Registration
- Inspections
- Standards
- Research and Analysis
- Enforcement
- Internal Oversight
- Operations

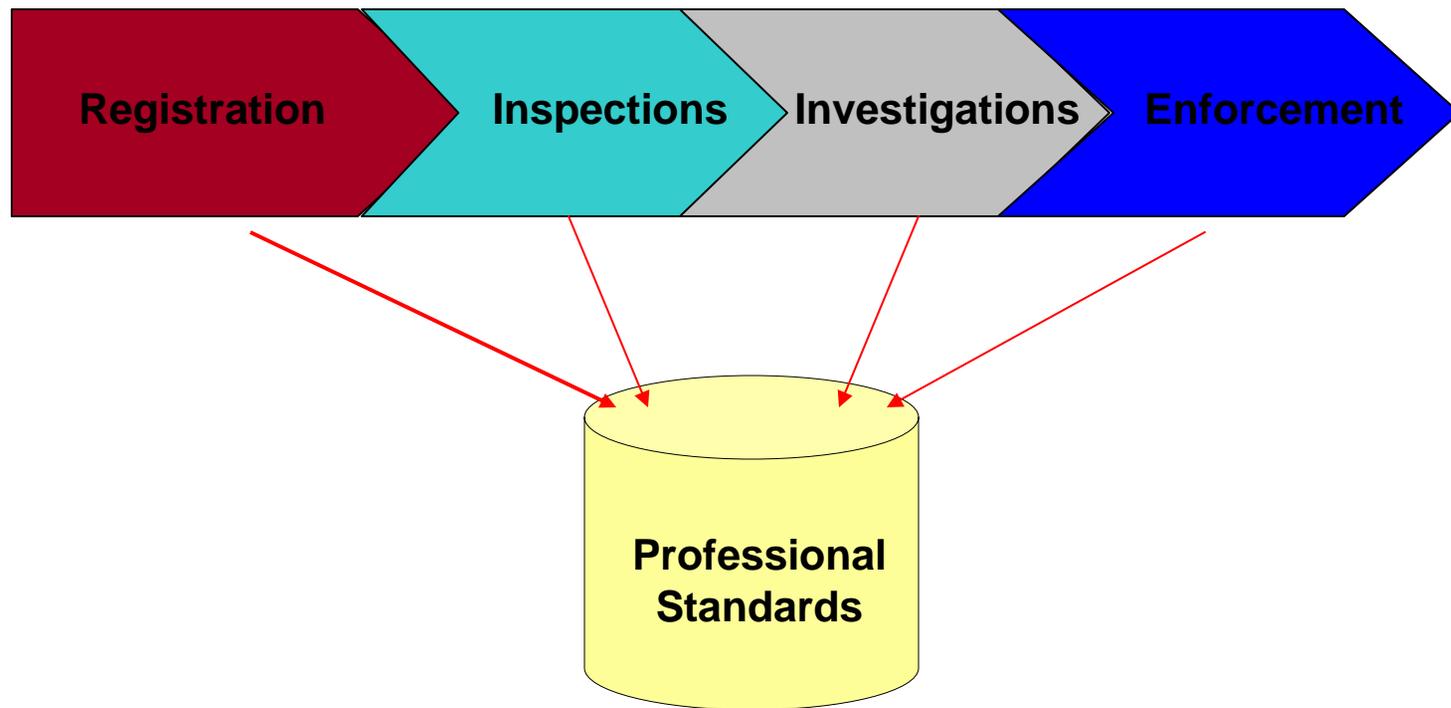
□ Regional Inspections Offices

- New York
- Atlanta
- Dallas
- San Mateo
- Orange County
- Denver
- Chicago

PCAOB's Mission

The Board's mission is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports of public companies.

The PCAOB in a Nutshell



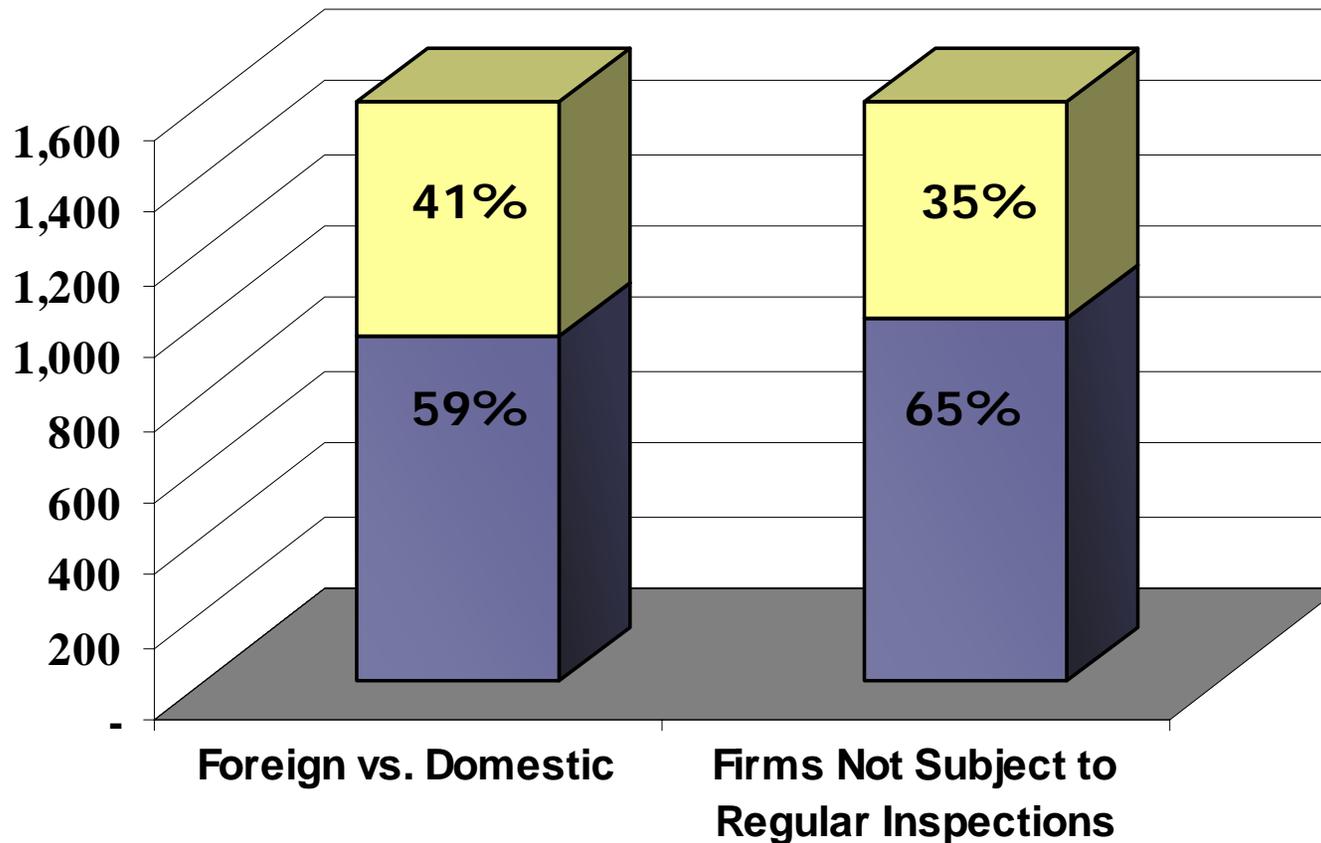
Registration

□ Registration System

- Foundation for the Board's jurisdiction
 - No accounting firm may participate in the audit of any US-traded company without being registered with the PCAOB

Registered Firms

Over 1,600 Registered Firms



Inspections Overview

- Inspections assess a firm's compliance with the Act and other securities laws, the Board's and the SEC's rules, and with professional standards
 - Our approach: look both at quality control systems and the planning and performance of audit engagements
- All inspections result in a report, part of which must be kept confidential for at least 12 months, and part of which must be public
 - The public portions of the inspections reports issued to date are available on the Board's Web site at www.pcaobus.org

Inspections Progress

- Of the almost 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 165 reports
 - Looked at portions of the audits of over 1,800 public companies

Inspection Reports - Drafts

- 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
- Part II.C discusses other audit performance issues and is nonpublic

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

□ Part III - nonpublic

- Firm is responsible for addressing the criticisms and potential defects described in Part II of the report
- Portions of Part II may be made public if these criticisms and defects are not addressed within 12 months from the date of the final inspection report
- 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 regulators
 - The public portions of inspection reports are posted on the PCAOB's website (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

The Sarbanes-Oxley Act directs the Board to establish

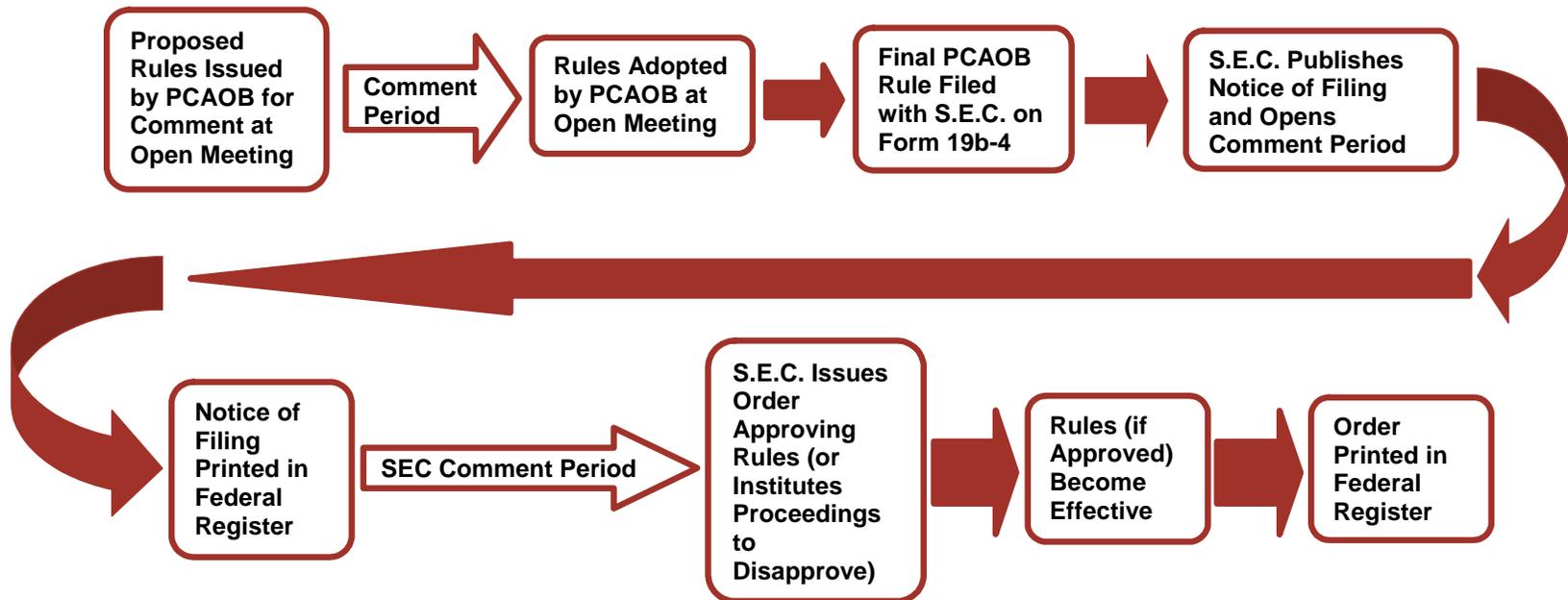
- Auditing standards
- Attestation standards
- Quality control standards
- Ethics standards
- Independence standards

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

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

Division of Enforcement and Investigations

- ❑ DEI consists of attorneys, accountants and support staff.
- ❑ Currently 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
 - Research & Analysis
 - Inspections

Inspections Referred to DEI

- Firms may be referred for further 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

Case Study #1

- ❑ 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

Case Study #2

- Inspected all of the firm's issuer audit clients
 - Principal auditor finding on several audits inspected
 - Other firm audited all of the assets, liabilities, revenues and substantially all of the expenses of the private company that merged with public shell company.
 - Numerous observations on remaining audits inspected
 - No work performed in significant audit areas, such as lack of inventory observation, valuation of accounts receivable (confirmation procedures) or income tax valuation.

Case Study #3

- ❑ Firm has several issuer audit clients and approximately half were inspected
- ❑ Bookkeeping services provided on all audits inspected
 - Firm was unaware that the provision of these services was an independence violation
- ❑ Insufficient audit procedures on significant areas of all audits inspected
 - No testing of significant transactions
- ❑ Firm cooperative and indicated desire to respond to comment forms but did not
- ❑ Certain members of the engagement team lacked industry-specific experience and CPE

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)

- ❑ 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.

Enforcement Cases

- ❑ Summaries of recent disciplinary proceedings included in Appendix A
- ❑ Disciplinary orders are available on the Board's web site

PCAOB Center for Enforcement Tips, Complaints and other Information

- ❑ Web site: www.pcaobus.org/Enforcement/
- ❑ E-mail: 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"

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

1. 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

2. Revenues

- ❑ 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

3. Expenses

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

4. Estimates

- ❑ 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

4. Estimates (cont'd)

□ 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

5. Contractual Arrangements

- 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

5. 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

6. Equity Transactions

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

7. Inventory

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

8. Going Concern

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

9. 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

10. Principal Auditor

- 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

Keeping Current with PCAOB

- Our Web site - www.pcaobus.org
 - List of registered firms
 - Inspection reports
 - PCAOB standards, including interim standards
 - Enforcement disciplinary proceedings
- Contact us at info@pcaobus.org

Questions?

PCAOB Inspections Process: What Can Be Expected

January 23, 2006

Santa Monica, California

Mission of Orange County and San Mateo Inspection Offices

- ❑ Integrate into national PCAOB mission of inspecting the large Firms (> 100 Issuer clients)
- ❑ Inspect the small firms in the Orange County and San Mateo regions
- ❑ Support Small Firm Inspection Process in other PCAOB offices
- ❑ Support other PCAOB initiatives

Orange County and San Mateo Offices - Number of Registered Firms by State

| | |
|----------------|------------|
| Oregon | 4 |
| Washington | 14 |
| Nevada | 16 |
| Utah | 21 |
| California* | <u>120</u> |
| Total | 175 |
| | |
| *San Francisco | 14 |
| *Los Angeles | 10 |
| *San Diego | 10 |

Inspection Approach

- ❑ Regional small firm inspection approach
- ❑ Size of inspection team based on number of issuer audit clients
- ❑ 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
- ❑ Inspection focuses on audit performance

Lifecycle of an Inspection

- ❑ Initial contact with firm
- ❑ Inspection commencement date determined
- ❑ Formal letter issued with document request
- ❑ Engagements 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 regulators
- ❑ Firm has 12 months to cure the quality control criticisms

Initial Contact with Firm – Document Request

- Purpose is to obtain information about the firm, it's 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)

- ❑ 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
- ❑ Quality control (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

- 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

Part I (Public)

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted fieldwork for the inspection from January XX, 2006 to January XX 2006. The fieldwork included procedures tailored to the nature of the Firm, certain aspects of which the inspection team understood at the outset of the inspection to be as follows:

| | |
|--------------------------------|--------------------------|
| Number of offices | 1 (Denver, Colorado) |
| Ownership structure | Professional corporation |
| Number of partners | 2 |
| Number of professional staff | 6 |
| Number of issuer audit clients | 4 |

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

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

Example Inspection Report Part I (Public) (cont'd)

A. Review of Audit Engagements

The scope of the inspection procedures performed included reviews of aspects of the performance of two of the Firm's audits of the financial statements of issuers. Those audits and aspects were selected according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the selection process.

The inspection team identified matters that it considered to be audit deficiencies. The deficiencies identified in one of the audits reviewed included a deficiency of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements. That deficiency was the failure to perform and document adequate procedures related to revenue.

B. Review of Quality Control System

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

END OF PART I

Example Inspection Report Part II (Nonpublic)

DETAILED DISCUSSION OF INSPECTION RESULTS

This Part II contains a description of the inspection results. Part II.A describes an audit performance issue that, in the inspection team's view, resulted in the Firm issuing an insufficiently supported audit opinion. Part II.B describes the Board's concerns about potential defects in the Firm's quality control system. Part II.C describes information on the basis of which it appears that the Firm may not have been independent of its issuer clients within the meaning of the Commission's independence requirements.

A. Insufficiently Supported Audit Opinion

The inspection of the Firm included reviews of portions of the Firm's audits of the financial statements of two of its issuer audit clients. In one of the engagements reviewed, the inspection team found what it considered to be an audit deficiency of such significance that it appeared that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements. The inspection team's observations concerning that deficiency are described below.

Issuer A

Revenue

The Firm identified revenue recognition as an area where there was a risk of fraud. The work papers do not evidence that the Firm performed adequate procedures to ensure that revenue was recognized appropriately. Specifically, the work papers did not evidence that the Firm examined significant sales contracts, which included rights-of-return provisions, to determine if revenue was recognized in accordance with Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*. The Firm also did not perform sales cut-off procedures even though significant sales were recorded at year end. In light of the significance of the issuer's revenue and the risks surrounding revenue recognition, the Firm should have performed and documented such procedures.

Example Inspection Report Part II (Nonpublic) (cont'd)

B. Issues Related to Quality Controls

The inspection of the Firm included consideration of aspects of the Firm's system of quality control. Assessment of a firm's quality control system rests both on a review of a firm's stated quality control policies and procedures and on inferences that can be drawn from respects in which a firm's system has failed to assure quality in the actual performance of engagements. On the basis of the information reported by the inspection team, the Board has the following concerns about aspects of the Firm's system of quality control.

1. Audit Performance

A firm's system of quality control should provide reasonable assurance that the work performed on an audit engagement will meet applicable professional standards and regulatory requirements. On the basis of the information reported by the inspection team, including the audit performance deficiency described in Part II.A and any other deficiencies identified below, the Board has concerns that the Firm's system of quality control fails to provide such reasonable assurance in at least the following respects –

- a. Technical Competence, Due Care, and Professional Skepticism
- b. Auditor Communications
- c. Concurring Partner Review

2. Independence

C. Other Audit Performance Issues

SAMPLE ONLY

Example Inspection Report

Part III (Nonpublic)

POST-INSPECTION PROCEDURES

A. Addressing Quality Control Criticisms

The Act and PCAOB Rules provide that no portions of an inspection report that deal with criticisms of or potential defects in the quality control systems of the Firm shall be made public if those criticisms or defects are addressed by the Firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report. Part II.B of this report deals with criticisms of or potential defects in the quality control systems of the Firm. Accordingly, to the extent that the Firm fails to address those criticisms or potential defects to the Board's satisfaction within 12 months, the Board will make the relevant portions of Part II.B publicly available.

The process for addressing criticisms and defects and the process through which the Board may make portions of Part II.B publicly available are governed by PCAOB Rule 4009, which provides as follows:

- Rule 4009. Firm Response to Quality Control Defects (Inspection Reports Contain the Rule 4009)

Consistent with PCAOB Rule 4009, no later than the date 12 months from the date of this report, the Firm should submit evidence or otherwise demonstrate to the Director of the Division of Registration and Inspections the ways in which the Firm has addressed the criticisms and potential defects described in Part II.B of this report. If the Firm fails to make any such submission or demonstration, the Board will, pursuant to PCAOB Rule 4009(d)(1), make Part II.B of this report publicly available. The Board encourages the Firm to initiate a dialogue with the Director of the Division of Registration and Inspections, as early as practicable in the 12-month period, about the ways in which the Firm intends to try to address the criticisms and potential defects.

Example Inspection Report

Part III (Nonpublic) (cont'd)

B. Additional Assessment of Audits

In light of the nature of the deficiency reported by the inspection team, the Board makes two general points. First, the Board reminds the Firm of the Firm's obligation under PCAOB standards to take appropriate actions. To the extent that these actions identify facts that would have affected the Firm's reports on those financial statements, the Board reminds the Firm of the Firm's obligation to take the appropriate actions specified in AU 561.05-09 to prevent unwarranted reliance on its previously expressed opinions. Failure to comply with these (or any other) PCAOB standards can be grounds for Board disciplinary actions against the Firm, potentially including suspension or revocation of the Firm's registration with the Board.

Second, because the inspection team identified serious deficiencies in one of the audits it reviewed, the Board suggests that it would be prudent for the Firm to obtain a reputable and qualified independent reviewer to review the most recent audits of the Firm's other issuer audit clients that were not included in the inspection. The Board is not requiring the Firm to obtain such reviews, but suggests the Firm consider doing so voluntarily. The Firm's willingness to obtain such reviews and to report the results to the Board will be taken into account by the Board in determining whether to conduct another Board inspection of the Firm sooner than three years from the date of the inspection addressed in this report or in determining whether other action is warranted.

Example Inspection Report

Part III (Nonpublic) (cont'd)

C. Imminent Disciplinary Proceedings

Overall, on the basis of the information derived from the inspection, the Board has serious concerns about the Firm's commitment to conducting audits with sufficient care, or its ability to conduct audits with sufficient competence, to protect the interests of investors and to further the public interest in the preparation of informative, fair, and independent audit reports. The information derived from the inspection includes indications that the Firm may have violated a provision of one or more of the following: the 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. In light of the nature of this information, the Board is at this time considering commencement of an investigation or a disciplinary proceeding to determine whether the Firm has committed any such violation. In the event that such a proceeding is commenced and a violation is established, the Board may impose appropriate sanctions, up to and potentially including revocation of the Firm's registration with the Board. If the Board eventually determines to commence a disciplinary proceeding against the Firm, the Firm will receive additional notice and an opportunity to defend itself before the Board determines whether to impose any sanction.

END OF PART III

SAMPLE ONLY

Example Inspection Report Part IV (Public and/or Nonpublic)

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

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

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

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

OR

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm chose not to provide a written response.

SAMPLE ONLY

12-Month Remediation Process

- 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?

Technical Discussion – Issues Identified through PCAOB Inspections

January 23, 2006

Santa Monica, California

Objectives

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

Audit Documentation

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

Auditing Standard No. 3 – *Audit Documentation*

- 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

- 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

- 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

- ❑ 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

- 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

- 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

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

- ❑ 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/

□ SEC

- Independence Rules – 17 CFR Section 210.2-02
www.sec.gov/info/accountants/independref.shtml
- Frequently Asked Questions (12/13/04)
www.sec.gov/info/accountants/independref.shtml
- Interpretations Relating to Independence – SEC Codification of Financial Reporting – Section 602.02

Questions?

Appendix A - Enforcement Cases

- ❑ In the Matter of Goldstein and Morris, CPAs, P.C. and Edward B. Morris, CPA
- ❑ In the Matter of Alan J. Goldberger, CPA and William A. Postelnik, CPA
- ❑ In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA
- ❑ In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA

In the Matter of Goldstein and Morris, CPAs, P.C. and Edward B. Morris, CPA

Facts

- ❑ Inspections requested certain information from the firm in connection with a scheduled inspection.
- ❑ Morris and two subordinates formulated and carried out a plan to conceal from the Board information about some of the services provided to its clients.
- ❑ Morris and two subordinates also intentionally created and back-dated certain documents to conceal from the Board its failure to comply with certain PCAOB standards.

In the Matter of Goldstein and Morris, CPAs, P.C. and Edward B. Morris, CPA

Violation of PCAOB Rule 4006

Every registered public accounting firm, and every associated person of a registered public accounting firm, *shall cooperate* with the Board in the performance of any Board inspection.

In the Matter of Goldstein and Morris, CPAs, P.C. and Edward B. Morris, CPA

Sanctions imposed

- ❑ Revoked registration of the firm
- ❑ Barred principal from being an associated person

In the Matter of Alan J. Goldberger, CPA and William A. Postelnik, CPA

- ❑ Relates to *In the Matter of Goldstein & Morris, CPAs, P.C. et al.*
- ❑ PCAOB censured two associated persons of Goldstein & Morris.
- ❑ Goldberger and Postelnik participated in the firm's efforts to conceal information from the Board and to submit false information to the Board in connection with a Board inspection.

In the Matter of Alan J. Goldberger, CPA and William A. Postelnik, CPA

Sanctions imposed

- Limited to censures because the two individuals
 - promptly and voluntarily brought the matter to the Board's attention
 - disclosed their own misconduct and the misconduct of others, and
 - made affirmative efforts to provide the Board with relevant information.

In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA

Facts

- ❑ In connection with its audits of the 2003 financial statements of four issuer clients, the firm and its principal failed to
 - exercise due professional care
 - exercise professional skepticism, and/or
 - obtain sufficient competent evidential matter.

In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA

Specific Violations included

- ❑ Failure to assess values assigned to reported assets
- ❑ Failure to evaluate appropriateness of revenue recognition
- ❑ Failure to evaluate existence of material related party transactions
- ❑ Undue reliance on the work of other auditors

In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA

Sanctions imposed

- ❑ Revoked registration of the firm
- ❑ Barred principal from being an associated person

In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA

Facts

- ❑ The firm and its principal violated PCAOB auditing standards in performing audits of the consolidated financial statements of two issuers during 2004.
- ❑ With respect to one of those issuers, the firm and its principal violated independence standards when the firm was its auditor and while its principal served on the issuer's board of directors.

In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA

Specific Violations Included

- ❑ Failure to ensure existence and appropriate valuation of reported assets
- ❑ Failure to assess whether reported assets were impaired
- ❑ Failure to audit a restatement
- ❑ Failure to maintain independence by becoming a member of its client's Board of Directors

In the Matter of Kenny H. Lee CPA Group, Inc., and Kwang Ho Lee, CPA

Sanctions imposed

- ❑ Revoked registration of the firm
- ❑ Barred principal from being an associated person