

# Forum on Auditing in The Small Business Environment

April 23, 2007

*Houston, TX*

# Opening Keynote Address

Charles Niemeier  
PCAOB Board Member  
April 23, 2007  
*Houston, TX*

# Caveat

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One of the benefits of today's session is that you will hear first-hand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff. Therefore, unless it is clear that the Board has authorized the statement, you should not attribute it to the Board or staff.

# Avoiding the Potholes During the Audit Process

April 23, 2007

*Houston, TX*

# Presenters

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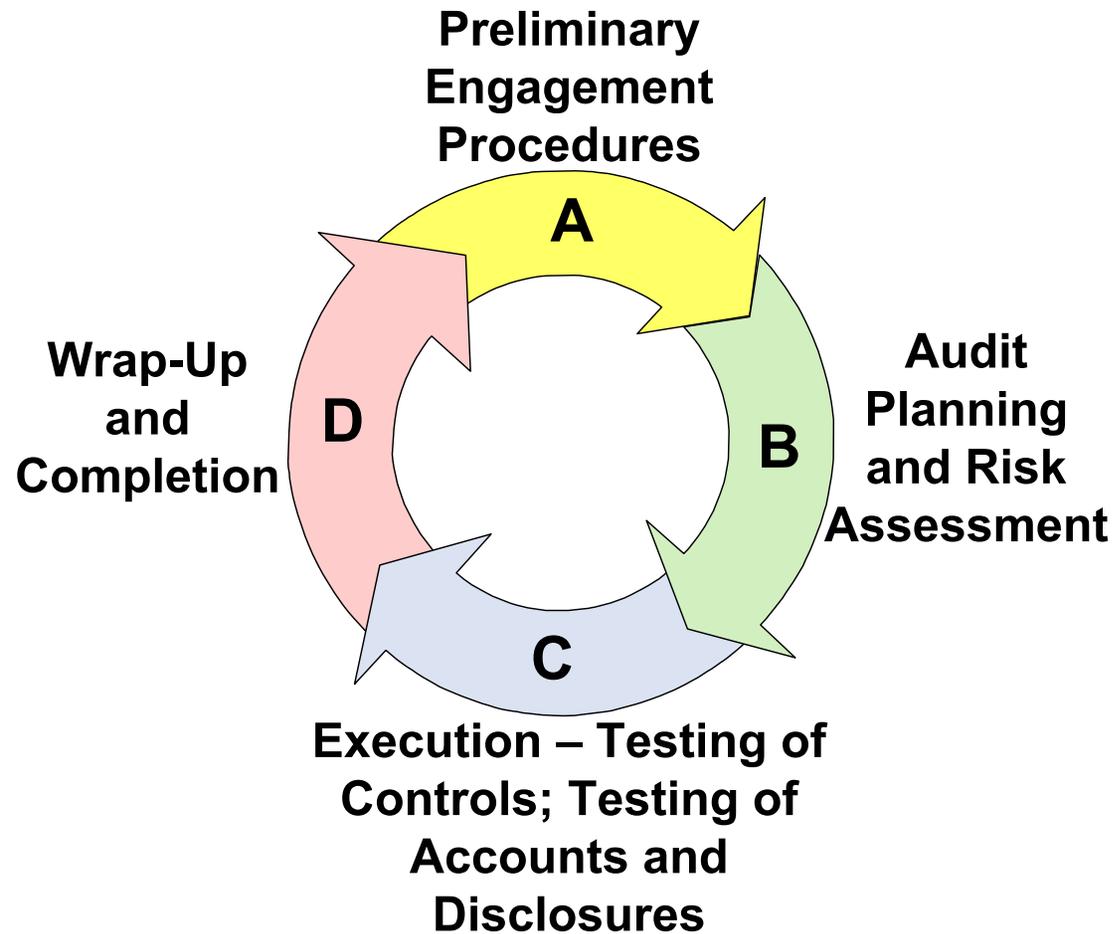
- ❑ Keith Wilson, Office of the Chief Auditor
- ❑ Betina Dufault, Division of Registration and Inspections
- ❑ Marion Koenigs, Division of Enforcement and Investigations

# What We Will Cover

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- Avoiding the potholes during the audit process
  - Overview of the audit process
  - Key aspects of audit quality
  - Recap of applicable literature

# The Audit Process



# Preliminary Engagement Procedures

# Client Acceptance and Continuance

- Perform procedures to determine if the accounting firm should
  - Continue as the auditor of a current audit client or
  - Accept an issuer as a new audit client
- Focus on
  - Company and management
  - Firm
- Engagement terms - establish an understanding with the audit client regarding services to be performed

# 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?

# Confirming Independence

- ❑ 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
  - Certain tax services (next slides)
- ❑ Other independence restrictions
- ❑ Pre-approval of permissible non-audit services

# PCAOB Rule 3523 - Tax Services to Persons in Financial Reporting Oversight Roles

- A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any tax service to a person in a financial reporting oversight role at the audit client or their immediate family member\*
  - Financial reporting oversight role ("FROR") means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them
  - Several exceptions to the rule:
    - Excludes members of the board of directors when their oversight role is solely because of their membership on the board
    - Excludes person in a FROR at an affiliate if the affiliate is not material to the audit client or if the affiliate is audited by a different accounting firm
    - Provides 180-day transition period for persons who are promoted or hired into a FROR

\* As of November 1, 2006, auditors must comply with Rule 3523 as it relates to tax services provided during the professional engagement period. The Board delayed the implementation date as it relates to tax services provided during the audit period to July 31, 2007, as long as the tax services are completed before the professional engagement period begins.

# PCAOB Rule 3522 - Tax Transactions

- A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction that is -
  - A confidential transaction; or
  - An aggressive tax position transaction that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws (for example, a listed transaction)

# PCAOB Rule 3524 - Audit Committee Pre-Approval of Certain Tax Services

- In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall –
  - Describe, in writing, to the audit committee of the issuer the scope of the service, the fee structure for the engagement, and other certain information;
  - Discuss with the audit committee of the issuer the potential effects of the services on the auditor's independence; and
  - Document the substance of the discussion with the audit committee of the issuer

# Other Independence Restrictions

- ❑ Financial interests in audit client
- ❑ Business relationships with audit client
- ❑ Employment relationships with audit client
  - Accounting role
  - Financial reporting oversight role – cooling-off period
- ❑ Contingent fee arrangements
- ❑ Partner compensation for selling non-audit services
- ❑ Partner rotation on the audit engagement
  - Lead and concurring partner – 5 years on, 5 years off
  - Other partner – 7 years on, 2 years off
  - Small firm exception – accounting firm with less than 5 audit issuer clients and less than 10 partners

# Enforcement Case - Independence

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- In the Matter of Kenny H. Lee, CPA Group, Inc. and Kwang Ho Lee, CPA (November 22, 2005)
  - Firm's engagement as auditor continued after firm principal accepted client's offer to serve on its board of directors

# 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 – Regulation S-X, Rule 210.2-01  
[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 web site.

# Engagement Letter – Indemnification Clauses

- Accountant is not independent when he or she enters into an indemnity agreement with the issuer audit client that -
  - seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, or
  - seeks to have the audit client release, indemnify or hold harmless the auditor from any liability and costs resulting from knowing misrepresentations by the audit client's management

Source: SEC Frequently Asked Questions - Question 4 (issued December 13, 2004) (<http://www.sec.gov/info/accountants/ocafaqaudind121304.htm#other>), and SEC Codification of Financial Reporting – Section 602.02.f.i., *Indemnification by Client*

# Pothole Alert - Indemnification Language



- ❑ X Company hereby agrees to release and indemnify the accounting firm and its directors and employees, and hold them harmless from all claims, liabilities, losses and costs arising in circumstances where there has been a knowing misrepresentation by a member of X Company's management, regardless of whether such person was acting in X Company's interest.

# Audit Considerations for Principal Auditor

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- ❑ Deciding whether the auditor can serve as principal auditor (AU sec. 543.02)
- ❑ Using other auditors to perform a portion of the audit for the auditor (AU secs. 230 and 311)

# Principal Auditor Case Study Example

## FACTS:

- ❑ Company X's corporate offices are located in New York but over 90% of the company's operations (Subsidiary Y) are located in Atlantis.
- ❑ Subsidiary Y engaged an accounting firm in Atlantis (the "foreign firm") to audit its financial statements.
- ❑ An unqualified audit opinion was issued by the domestic firm on the consolidated financial statements of Company X.
- ❑ The domestic firm concluded that it was the principal auditor and did not refer to the work of other auditor in its opinion. The domestic firm performed the following procedures with respect to the foreign firm:
  - Held initial discussions with the foreign firm regarding the operations of Subsidiary Y;
  - Obtained a copy of the foreign firm's professional license;
  - Reviewed the financial statements reported on by the foreign firm;
  - Determined that foreign firm conducted audit in accordance with Atlantis GAAS and Subsidiary's Y's F/S's presented in accordance with Atlantis GAAP; and
  - Converted Subsidiary Y's financial statements from Atlantis GAAP to US GAAP.

# Principal Auditor Case Study Example (cont'd)

1. Was the domestic accounting firm able to act as the principal auditor?
  - ❑ No - The domestic accounting firm's participation in the audit was insufficient to enable it to act as the principal auditor.
2. Was it appropriate for the domestic accounting firm to not make reference to the report of the foreign accounting firm?
  - ❑ No – Because the firm was not the principal auditor it should not have opined on Company X's F/S's.
  - ❑ No – The domestic accounting firm did not perform any procedures to satisfy itself as to the independence and professional reputation of the foreign accounting firm.
  - ❑ No - The domestic accounting firm did not perform any procedures to discuss or review the work performed by the foreign firm.
3. Was the domestic accounting firm independent of its public company client?
  - ❑ No – The domestic accounting firm violated the SEC independence rules by converting Subsidiary Y's financial statements from Atlantis GAAP to US GAAP.

# Principal Auditor Observations

- ❑ Back-door registrations ("reverse mergers")
  - Operating company merges with a public non-operating shell company
    - Auditor of shell company opines on the merged entity
- ❑ Registrant conducts principal operations abroad
  - Foreign accounting firm audits subsidiary
  - Domestic accounting firm assumes complete responsibility for the work of other auditing firm and does not refer to the report of the other firm
- ❑ Use of another firm's staff ("out-sourced" audit staff)

# Enforcement Case - Principal Auditor

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- In the Matter of PKF, AAER No. 2409 (April 12, 2006) (SEC cease-and-desist proceeding)
  - Firm used the work of other auditing firms to report on issuer's financial statements and did not refer to the work of the other firms in its audit report
  - Firm assumed complete responsibility for the work of the other auditing firms

# Enforcement Case - Principal Auditor

- In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA (November 22, 2005)
  - Firm consulted with other auditor and relied on the other auditor's work papers, but did not plan or perform audit procedures sufficient to issue an audit report

# Audit Planning and Risk Assessment

# Audit Planning

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- ❑ Preliminary judgments about materiality
- ❑ Preliminary audit strategy and plan

# Risk Assessment Procedures

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- ❑ Obtain an understanding of the company and its environment
  - Includes obtaining an understanding of internal control over financial reporting
- ❑ Assess company-level controls
- ❑ Perform preliminary analytical procedures
- ❑ Brainstorm about potential errors or fraud

# Risk Assessment Procedures (cont'd)

- ❑ Inquire of management, audit committee, and others about the risk of misstatement
- ❑ Consider fraud risk factors
- ❑ Consider the results of quarterly reviews
- ❑ Assess risks
  - Risk of material misstatement
  - Risk of material weakness
- ❑ Identify significant accounts and relevant assertions
- ❑ Select controls to test

# Auditor Response to Assessed Risks

- Overall responses
  - Assignment of staff
  - Level of supervision
  - Need for specialists
  - Level of professional skepticism
  - Appropriateness of planned audit strategy and scope
- Specific responses (audit plan)
  - Tests of controls
  - Tests of accounts and disclosures (substantive tests)

# Audit Considerations for Predecessor and Successor Auditor

- PCAOB Staff Questions & Answers - Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor (June 9, 2006)
  - Addresses situations in which adjustments are made to prior-period financial statements when there has been a change of auditors
  - Provides the staff's views on auditing of the adjustments by
    - Predecessor auditor
    - Successor auditor
  - Reporting considerations

# Examples of New Accounting Pronouncements

- ❑ FIN No. 48, *Accounting for Uncertainty in Income Taxes*
  - Issued 2006 and interprets SFAS No. 109, *Accounting for Income Taxes*
- ❑ SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140*
  - Effective first fiscal year beginning after 9/15/06
- ❑ SFAS No. 156, *Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140*
  - Effective first fiscal year beginning after 9/15/06
- ❑ SFAS No. 157, *Fair Value Measurements*
  - Effective for fiscal years beginning after 11/15/2007
- ❑ SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)*
  - Effective for public companies as of the end of the fiscal year ending after 12/15/2006
  - Effective for non-public companies as of the end of the fiscal year ending after 12/15/2007
- ❑ SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities— Including an amendment of FASB Statement No. 115*
  - Effective as of the beginning of first fiscal year that begins after November 15, 2007.

# **Execution – Tests of Controls; Tests of Accounts and Disclosures**

# Execution – Tests of Controls; Tests of Accounts and Financial Statement Disclosures

## Tests of Controls

- Nature
  - Inquiry, observation, document inspection, re-performance
  - Using the work of others
- Timing
  - Interim versus year-end
  - Benchmarking
- Extent
  - Number of items tested

## Tests of Accounts and Disclosures

- Nature
  - Analytical procedures and tests of details
  - Using the work of others (internal audit)
- Timing
  - Interim versus year-end
- Extent
  - Number of items tested

# Tests of Controls

- Common inspection observations
  - Sampling
  - Service auditor
  - Internal auditor
- Discuss audit considerations in these areas and common causes for these deficiencies

# Audit Sampling Considerations

- Audit sampling
  - Test of controls
  - Substantive test of details
- Audit sampling approach
  - Relationship of sample to the relevant audit objective
  - Preliminary judgments about materiality levels
  - Audit sampling risk
  - Characteristics of the population
    - Sample size
    - Representative sample
  - Evaluating sampling results

# Sampling Example

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## FACTS

- ❑ Manufacturing company employs several hundred personnel
- ❑ Firm's audit approach with respect to disbursements, including payroll, was to test and rely on controls
  - Firm tested one transaction from the last quarter of the year
  - Firm made inquiries of management regarding controls in place at year-end

# Audit Considerations Regarding Service Organizations

- Evaluation of controls of service organizations
  - If the auditor decides to use a service auditor's report, the auditor should consider the extent of the evidence provided by the report about the effectiveness of controls intended to prevent or detect material misstatements in the particular assertions. (AU sec. 324.14)
  - The auditor remains responsible for evaluating the evidence presented by the service auditor report and for determining its effect on the assessment of control risk at the audit client. (AU sec. 324.14)
  - The auditor's assessments of control risk regarding assertions about account balances or classes of transactions are based on the combined evidence provided by the service auditor's report and the auditor's own procedures. (AU sec. 324.15)

# Service Auditor Example

## FACTS

- ❑ Retirement and savings plan uses 3<sup>rd</sup> party service organization for accounting and administrative functions (e.g., process employee contributions and direct monies into investment selections)
- ❑ Firm obtains service auditor's report on controls placed in operation and tests of operating effectiveness
- ❑ Report covers only 6 months of the issuer's fiscal year
  - Firm does not consider whether the report provides sufficient evidence regarding the effectiveness of controls to support assessed level of control risk
  - Firm makes inquiries regarding possible changes in service organization controls
  - Firm does not test user controls identified by the service auditor

# Audit Considerations when Using Internal Auditors

- ❑ Obtain an understanding of the internal audit function and determine the relevance of internal audit activities on the audit of financial statements (AU sec. 322.04-.08)
- ❑ Assess the competence and objectivity of the internal auditors (AU sec. 322.09-.11)
- ❑ Consider the effect of the internal auditors' work on the audit (AU sec. 322.12-.17)
- ❑ Evaluate and test the effectiveness of internal auditors' work (AU sec. 322.24-.26)

\*PCAOB proposed auditing standard, *Considering and Using the Work of Others in an Audit*, superseding AU sec. 322 will be discussed in afternoon session.

# Internal Auditor Example

## FACTS

- ❑ Defined contribution plan uses plan sponsor's internal payroll processing department to process participant contributions
- ❑ Plan sponsor's internal audit department had performed a review of payroll processing in a prior year
  - Firm obtained the prior-year report from internal audit and determined that was sufficient as few changes were made to the payroll department's policies and procedures in the current year
  - Firm relied upon the plan sponsor's payroll department and performed no substantive testing of participants' contribution elections

# Tests of Accounts and Financial Statement Disclosures (Substantive Audit Procedures)

- ❑ Most inspection observations pertain to the "execution" phase of the audit, in particular, substantive and analytical audit procedures
- ❑ Inspection observations generally are characterized in three different ways:
  - Inappropriate application of GAAP
  - No evidence in the work papers and no persuasive other evidence that procedures were performed
  - Engagement team did not perform certain procedures

# Tests of Accounts and Financial Statement Disclosures (cont'd)

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- Common inspection observations
  - Revenue recognition
  - Business combinations
  - Stock-based compensation
  - Confirmation procedures
  - Going concern issues

# Revenue Recognition

- Possible causes for revenue recognition deficiencies:
  - Testing A/R is not a proxy for testing revenue recognition
  - Important to review revenue contracts for terms and conditions that can impact revenue recognition
  - Over-reliance on poorly designed analytical procedures
  - Cannot rely solely on management representations or examination of client-prepared analyses
  - Sample should be representative of the population of revenue transactions

# Business Combinations

- Possible causes of business combination deficiencies
  - Inadequate testing of initial valuation of equity securities issued (e.g., valuation report)
  - No testing of allocation of the purchase price to the assets acquired and liabilities assumed
  - Unaware of certain terms contained in the merger agreement (e.g., contingent considerations)
  - No evaluation of appropriateness of recording goodwill or other intangibles and subsequently writing them off
  - No testing of client's accounting for and reporting of a business combination (e.g., reverse merger, common control merger)

# Stock-based Compensation

- ❑ Possible causes of stock-based compensation deficiencies
  - No testing of valuation of equity instruments issued for goods/services
  - No testing of the accounting for transactions with non-employees (e.g., EITF 96-18)
  - No testing of assumptions used to value options (e.g., volatility factor)
  - Inadequate testing of existence and completeness of outstanding shares of common stock

# PCAOB Staff Audit Practice Alert: Matters Related to Timing and Accounting for Option Grants

- ❑ Advises auditors that some issuers' practices related to stock options grants may have audit implications
- ❑ Discusses factors that may be relevant to assessing the risks relating to those matters
  - Based on existing requirements of PCAOB standards and relevant laws
  - Includes accounting, auditing, and certain legal considerations
- ❑ Applies to
  - Current audits
  - Involvement with registration statements
  - Previously issued opinions

# PCAOB Staff Q&As: Auditing the Fair Value of Employee Share Options

- ❑ Purpose is to help auditors implement PCAOB's existing auditing standards when auditing the fair value of employee share options
- ❑ Provides factors for assessing risk, e.g., when an assumption has the effect of reducing fair value below what it would have been had the company used unadjusted historical information
- ❑ Provides guidance for evaluating reasonableness of company's process
- ❑ Focus on evaluating reasonableness of expected term and expected volatility assumptions
- ❑ Provides additional guidance about use of specialists
- ❑ Limited to auditing fair value measurements for compensation cost

# Confirmation Procedures

- ❑ Possible causes of confirmation procedure deficiencies
  - No or insufficient alternative procedures performed for confirmations not received
  - Unresolved discrepancies from confirmation responses
  - Inadequate sample size to substantively test existence of A/R or loans receivable
  - No consideration or documentation of rationale for not confirming A/R

# Enforcement Case - Confirmations

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- In the Matter of Armando C. Ibarra, P.C., Armando C. Ibarra, Sr. and Armando C. Ibarra, Jr. (December 19, 2006)
  - Repeated failure to confirm accounts receivable and failure to perform any procedures other than obtaining management representations

# Going Concern Issues

- ❑ Possible deficiencies associated with going concern analyses
  - No going concern analysis performed despite warning signs, such as recurring losses, negative working capital, stockholders' deficit, debt coming due, declining sales prospects
  - Over-reliance on management's representations that additional sources of funding will be found
  - Going concern analysis focused upon the best case scenario

# Aspects of Audit Quality – Where Are the Potholes?



- ❑ Audit documentation
- ❑ Maintaining technical competence
- ❑ Training

# Audit Documentation

- ❑ Use of standard audit programs not tailored for audits of public companies
- ❑ Firm unable to demonstrate procedures performed, evidence obtained, and conclusions reached
  - Lack of documentation is tantamount to "no performance"
  - Auditor may provide persuasive other evidence
    - Oral evidence, alone, is not sufficient and may be used only to *clarify* other written evidence

# Auditing Standard No. 3, *Audit Documentation* - General Requirements

- ❑ For relevant financial statement assertions, audit documentation must contain sufficient information to enable an *experienced auditor*, having no previous connection with the engagement to understand the
  - Procedures performed,
  - Evidence obtained, and
  - Conclusions reached (par. 6)
- ❑ Audit documentation should
  - Demonstrate that the engagement complied with PCAOB standards
  - Support the basis for the auditor's conclusions concerning every relevant financial statement assertion, and
  - Demonstrate that the underlying accounting records agreed or reconciled with the financial statements (par. 5)
- ❑ The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached (par. 12)

# Suggested Approaches

- ❑ Develop or obtain audit programs tailored to a specific audit area (e.g., business combinations)
- ❑ Consider modifying firm's internal quality control policies and procedures to stress the importance of using authorized and relevant practice aids and emphasize documentation requirements under the provisions of AS No. 3
  - Provide all professional staff training on AS No. 3
- ❑ Enhance internal inspection program or consider hiring an external consultant to perform a comprehensive internal inspection

# Maintaining Technical Competence

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- ❑ Firm's ability to consult with accounting and auditing experts
- ❑ Access to a current resource library (e.g., accounting and auditing literature)
- ❑ Access to up-to-date and sufficiently detailed audit programs and guidance materials

# Training

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- ❑ Training in SEC rules and regulations and PCAOB auditing standards
- ❑ Independence training (e.g., PCAOB standards, SEC requirements)
- ❑ Specialized industry training (e.g., oil and gas, financial institutions)
- ❑ Training related to specific accounting and auditing issues affecting public company clients

# Wrap-Up and Completion Procedures

# Evaluation of Audit Results

- Misstatements
  - Known and likely misstatements
  - Includes evaluation of –
    - Potential bias in accounting estimates
    - Appropriateness of the selection and application of accounting principles
- Control deficiencies
  - Likelihood and magnitude of misstatements
  - Control deficiencies, significant deficiencies, and material weaknesses
  - Strong indicators of material weaknesses
- Sufficiency of Audit Evidence

# Pothole Alert



- The auditor is prohibited from providing bookkeeping and other services related to the accounting records or financial statements of the audit client, such as -
  - 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

# Audit Considerations for Concurring Partner Review

- ❑ SEC Practice Section, Section 1000.08(f), Appendix E – Concurring Partner Review Requirements
  - Qualifications of concurring partner
  - Nature, timing, and extent of concurring partner reviews
  - Documentation of concurring partner review
  - Quarterly reviews

# Concurring Partner Review

- ❑ Scope of concurring partner review
  - No evidence that review was performed
- ❑ Timeliness of concurring partner review
  - Review points are not addressed by the engagement team prior to release of the audit opinion
- ❑ Qualifications of concurring partner
  - Reviewer does not have sufficient technical competence and/or experience

# Suggested Approaches

- ❑ Review and revise firm's internal quality control policies and procedures to expand on the requirements and scope of a concurring partner review
- ❑ Consider entering into a formal arrangement with a consulting CPA firm to perform concurring reviews in the future. The scope of the review should include, at a minimum, review of planning work papers and evaluating judgments regarding significant transactions, estimates, and decisions, as well as the review of the completion document and passed adjustments
- ❑ Develop (or acquire) a concurring partner review program to ensure the review is documented

# Audit Documentation

- Engagement Completion Document
  - Auditor must identify all significant findings or issues in an *engagement completion document* (par. 13)
  - Examples of *significant findings* or *issues* include:
    - Significant matters involving selection, application and consistency of GAAP, including related disclosures
    - Audit adjustments
    - Disagreements among members of the engagement team
    - Circumstances that cause significant difficulty in applying auditing procedures
    - Any matters that could result in modification of auditor's report (par. 12)

# Audit Documentation (cont'd)

## □ Record retention

- Audit documentation must be retained for 7 years from the date auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements (report release date), unless a longer period of time is required by law. (par. 14)
- Auditor should assemble a complete and final set of audit documentation not more than 45 days after the report release date (documentation completion date). (par. 15) 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

# Enforcement Case - Documentation

- In the Matter of Armando C. Ibarra, P.C., Armando C. Ibarra, Sr. and Armando C. Ibarra, Jr. (December 19, 2006)
  - Various documentation deficiencies, along with other departures from PCAOB standards

# Other Documentation Requirements

- SEC Rule 2-06 of Regulation S-X, *Retention of Records Relevant to Audits and Reviews*
  - In addition to documentation that is required by Auditing Standard No. 3, auditors must retain memoranda, correspondence, communications, other documents and records (including electronic records), that are relevant to the audit or review and that:
    - Are created, sent, or received in connection with the audit or review, and
    - Contain conclusions, opinions, analyses, or financial data related to the audit or review

# ISB No. 1 – Independence Discussions with Audit Committees

- At least annually, an auditor shall -
  - disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;
  - confirm in the letter that, in its professional judgment, it is independent of the company; and
  - discuss the auditor's independence with the audit committee.

# Pothole Alert - Auditor's Report Related Issues



- ❑ Audit client uses the auditor's name in connection with the issuance of the company's financial statements *before* auditor is complete and report is issued
- ❑ Decision about whether principal auditor can make reference in report to audit of another auditor (AU sec. 543, as amended\*)
- ❑ Evaluation of whether to include an explanatory paragraph in the auditor's report about the issuer audit client's ability to continue as a going concern

\* Amended by the Board in Conforming Amendments resulting from Auditing Standard No. 3

# Enforcement Case – Unauthorized Use of Auditor's Name

- In the Matter of Reuben E. Price & Co. Public Accountancy Corp. (April 18, 2006)
  - Issuer filed financial statements including a document it claimed was an audit report with Form 10-KSB
  - Auditor had neither issued the audit report nor completed the audit at the time of the issuer's filing
  - Auditor did not inform issuer's Board of Directors as required under Section 10A(b)(2) of the Securities Exchange Act

# Enforcement Case – Going Concern

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- In the Matter of Armando C. Ibarra, P.C., Armando C. Ibarra, Sr. and Armando C. Ibarra, Jr. (December 19, 2006)
  - Repeated failure to use required language in going concern explanatory paragraph

# 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)
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our Web site:

[www.pcaobus.org/About/Pages/RSSFeeds.aspx](http://www.pcaobus.org/About/Pages/RSSFeeds.aspx)

# Questions?

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# **Standards Update: Auditing Internal Control Over Financial Reporting**

April 23, 2007

*Houston, TX*

# What We Will Cover

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- ❑ PCAOB four-point plan to improve ICFR audit efficiency and effectiveness
- ❑ Proposed standard on an audit of internal control
- ❑ Other related proposals
- ❑ Project status

# PCAOB Four-Point Plan to Improve ICFR Audit Efficiency and Effectiveness

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- ❑ Amend Auditing Standard No. 2
- ❑ Emphasize efficiency during 2006 PCAOB inspections
- ❑ Implementation guidance and education for auditors of smaller companies
- ❑ Continuation of PCAOB Forums on Auditing in the Small Business Environment

# Amend Auditing Standard No. 2

- ❑ December 19, 2006 public meeting of the Board
- ❑ Proposed a package of ICFR-related standards, amendments, and a rule for public comment –
  - *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements ("Audit of Internal Control")*
  - Other Related Proposals

# Proposed Standard on an Audit of Internal Control - Objectives

- ❑ Focus the audit of internal control on the most important matters
- ❑ Eliminate procedures unnecessary to achieving the intended benefits
- ❑ Provide direction on scaling the audit to fit the company's size and complexity
- ❑ Simplify the text of the standard

# Significant Changes in the Proposed Standard – Scoping the Audit

- ❑ Emphasize risk assessment concepts to focus the auditor on the higher-risk areas
- ❑ Require a top-down approach to focus on the most important controls
- ❑ Establish additional emphasis on the control environment and period-end close process
- ❑ Clarify the evaluation of materiality
- ❑ Provide risk-based multi-location direction – eliminate the "large portion" provision

# Significant Changes in the Proposed Standard – Procedures to Perform

- ❑ Remove the requirement to assess management's evaluation process
- ❑ Allow special considerations for subsequent years' audits
- ❑ Recalibrate the walkthrough requirement by focusing on significant processes

# Significant Changes in the Proposed Standard - Definitions

- Revise the strong indicators of a material weakness
  - No longer a required significant deficiency
  - Emphasize the control environment
- Redefine key terms in a simpler way, particularly the definitions of material weakness and significant deficiency
  - "more than remote likelihood" would be replaced by "reasonable possibility"
  - "more than inconsequential" misstatement would be replaced by "significant" misstatement

# Significant Changes in the Proposed Standard - Scalability

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- ❑ Direct the auditor to evaluate the size and complexity of the company
- ❑ Provide examples of tailoring the audit to the size and complexity of the audit

# Significant Changes in the Proposed Standard – Scalability (cont'd)

- Six example areas where tailoring may be necessary –
  - Obtaining sufficient evidence with limited company documentation
  - Assessing company-level controls
  - Evaluating risk of management override and mitigating actions
  - Evaluating controls implemented in lieu of segregation of duties
  - Evaluating financial reporting competencies
  - Evaluating information technology ("IT") controls

# Other Related Proposals

- ❑ Auditing Standard - *Considering and Using the Work of Others in an Audit*
- ❑ Amendments to the Board's Interim Standards
- ❑ Independence Rule 3525 – *Audit Committee Pre-Approval of Services Related to Internal Control Over Financial Reporting*

## Proposed Auditing Standard - Considering and Using the Work of Others in an Audit

- ❑ Would supersede AU sec. 322 and the direction in AS No. 2
- ❑ Allow the use of others for both the financial statement audit and internal control audit
- ❑ Require auditors to evaluate the extent to which they may use the work of others
- ❑ Encourage greater use of the work of others – eliminate the principal evidence provision

## Proposed Auditing Standard - Considering and Using the Work of Others in an Audit (cont'd)

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- ❑ Require understanding of relevant activities performed by others
- ❑ Provide a single framework based on the combined competence and objectivity of others and the nature of the subject matter being tested
- ❑ Eliminate the principal evidence provision

# Proposed Amendments to the Interim Standards

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- ❑ Simplify the internal control standard
- ❑ Update references in the interim standards to the Board's standard on audit of internal control
- ❑ Change the date of the auditor's report

## Independence Rule 3525 - Audit Committee Pre-approval of Services Related to Internal Control

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- ❑ Replace direction on independence in AS No. 2
- ❑ Focus on providing the audit committee with the information necessary regarding the effect of the services on independence
- ❑ Require pre-approval, but not *specific* pre-approval

# Project Status

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- ❑ Comment period ended February 26, 2007
- ❑ Over 170 letters received, spanning over 1,200 pages of comments
- ❑ Comment letters are available on the Board's web site  
[www.pcaobus.org/Rules/Rulemaking/Pages/Docket021.aspx](http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket021.aspx)
- ❑ All of the comments received are analyzed by the staff
- ❑ Expect to finalize the proposals in early summer, subject to SEC approval

# Questions?

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# **Inspections Update: Navigating the Remediation Process**

April 23, 2007

*Houston, TX*

# Objectives of Presentation

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- ❑ Overview of remediation process
- ❑ Steps involved in the remediation process
- ❑ Examples of satisfactory and unsatisfactory remediation responses
- ❑ Communications from the PCAOB

# Overview of Remediation Process

- Section 104 of the Sarbanes-Oxley Act and PCAOB Rule 4009 govern the process for addressing quality control criticisms
  - 12-month remediation process is triggered once the Board issues the final inspection report.
  - These criticisms or potential defects are made public only if they are not satisfactorily addressed by the firm before the 12-month period deadline.
    - The criticisms or potential defects will remain nonpublic if the quality control criticisms are satisfactorily addressed.

# Step 1 - Final Inspection Report Issued

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- A transmittal letter will accompany the final inspection report
  - It describes the remediation process and provides examples of documentation to be submitted to the PCAOB as part of its response
  - Contact name and number also provided

# Step 2 - Responding to the Quality Control Observations

- Follow the guidance in the transmittal letter that accompanies the final inspection report
  - Written submission are strongly encouraged
  - Communicate with PCAOB staff if you have any questions
- Respond as early as practicable
  - PCAOB staff often requests clarification or additional information
- Firm must demonstrate that it has remediated the quality control observations before the 12-month deadline

## Step 2 - Responding to the Quality Control Observations (cont'd)

- ❑ Each quality control criticisms or potential defect should be addressed separately
  - Documentary evidence of remediation efforts
- ❑ Submission should also include documentation related to AU secs. 390 and 561 follow-up procedures on the audit deficiencies included in the report
- ❑ Firm is not required to address the quality control criticisms
  - No response will result in Board making the quality control criticisms public
- ❑ If firm intends its response to the comment form(s) or draft inspection report to serve as its only submissions, submit a copy of that response and inform the PCAOB staff of that fact in writing

## Step 3 – Evaluation of Firm Response

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- ❑ PCAOB staff currently working on a FIFO basis
- ❑ If additional documentation or clarification is needed, PCAOB staff will contact firm
- ❑ Based upon information provided, the Director of Registrations and Inspections will make a recommendation to the Board
- ❑ Board reviews recommendation and decides if firm has satisfactorily remediated

# Example - Firm in Remediation

## Facts

- ❑ Part II.A of the report contains two audit performance deficiencies
  - Testing of A/R and the related allowance for doubtful accounts on two of the four issuers inspected
  - Testing related to the initial valuation of a recently acquired entity on two of the four issuers inspected
- ❑ Part II.B of the report contains four quality control criticisms
  - Technical competence, due care, and professional skepticism
  - Concurring partner
  - Auditor communications
  - Appropriate procedures for A/R and allowance inspection observations and valuation of an acquired entity
- ❑ Part III.B of the report requests that the firm conduct a review of the engagements not inspected

# Example Response

- Firm provides the following response shortly after receiving the final report
  - Provides copies of work papers supporting subsequent audit procedures in the areas of A/R, allowance, and the valuation of the acquired net assets
  - Revises its QC practices to require a concurring partner checklist and provides a copy of the checklist
  - Provides CPE information on training provided on testing of A/R, allowance and SFAS No. 141
  - Revises its QC practices on the requirements of AU sec. 380 and ISB No. 1 and provides a copy of revised QC policy changes
  - Conducts independent review of the engagements not inspected and provides a copy of the procedures performed and conclusions reached

# Communications from the PCAOB

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- ❑ Initial transmittal letter that accompanies final report
- ❑ 6-month letter
- ❑ 60-day letter
- ❑ Final notification
- ❑ Letter from Division Director
- ❑ Letter from the Board

# Questions?

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# Open Discussion

April 23, 2007

*Houston, TX*