Forum on Auditing in the Small Business Environment

September 11, 2014

Vancouver, B.C.

Caveat

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

Welcome

Mary M. Sjoquist, Director

Office of Outreach and Small Business Liaison

PCAOB and CPAB: Perspectives in a Global Environment

Lewis Ferguson, Board Member, PCAOB

Brian Hunt, CEO, CPAB

Keeping Current with PCAOB Standards

Greg Scates
Deputy Chief Auditor

September 11, 2014
Vancouver, British Columbia

Topics for Discussion

- Auditing Standard No. 18, *Related Parties*
- Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*
- Audits of Brokers and Dealers
- Proposal of Auditor's Reporting Model and Auditor's Responsibilities Regarding Other Information
- Audit Transparency Project
- Proposed Reorganization of PCAOB Auditing Standards

Auditing Standard No. 18, *Related Parties*

- On June 10, 2014, the Board adopted Auditing Standard No. 18, *Related Parties*, amendments regarding significant unusual transactions, and other amendments to PCAOB auditing standards.
- The standard and amendments address:
  - Evaluating a company's identification of, accounting for, and disclosure of, relationships and transactions between the company and its related parties.
  - Identifying and evaluating a company's significant unusual transactions.
  - Obtaining an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment process.

AS No. 18, *Related Parties* (cont'd)

- The standard and amendments are designed to improve audit quality in areas that could pose increased risks of material misstatement, including misstatements arising from fraud.
- The standard strengthens requirements for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with related parties.
- The standard requires the auditor to:
  - Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties;
  - Perform specific procedures for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk;

AS No. 18, *Related Parties* (cont'd)

- The standard requires the auditor to (cont'd):
  - Perform specific procedures if the auditor determines that a related party, or relationship or transaction with a related party, previously undisclosed to the auditor exists;
  - Evaluate whether the company has properly identified its related parties or relationships or transactions with related parties; and
  - Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

AS No. 18, *Related Parties* (cont'd)

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

AS No. 18, *Related Parties* (cont'd)

- The other amendments to PCAOB auditing standards require, among other things, that the auditor obtain an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment process.
  - A company's executive officers are in a unique position to influence a company's accounting and disclosures.
  - A company's financial relationships and transactions with its executive officers can create incentives and pressures for executive officers to meet financial targets, which can result in risks of material misstatement to a company's financial statements.
  - The amendments do not require the auditor make an assessment of the appropriateness or reasonableness of executive compensation arrangements.

AS No. 18, *Related Parties* (cont'd)

- Auditing Standard No. 18 and the amendments will be effective, subject to SEC approval, for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within those fiscal years.

Staff Consultation Paper: *Auditing Accounting Estimates and Fair Value Measurements*

- On August 19, 2014, the PCAOB issued a staff consultation paper on auditing accounting estimates and fair value measurements.
- The staff consultation paper, prepared by the Office of the Chief Auditor, discusses and solicits comment on certain issues related to auditing accounting estimates and fair value measurements. It describes the staff's preliminary views concerning the potential need for change and presents potential revisions to PCAOB standards in response to that potential need for change.
- The staff has on its agenda a project to consider replacement or amendment of the Board's existing related standards. In connection with this project, the staff has issued guidance, performed research, and conducted outreach to inform the project, particularly with respect to the use of third parties in determining fair value measurements.

Staff Consultation Paper: *Auditing Accounting Estimates and Fair Value Measurements* (cont'd)

- The Office of the Chief Auditor staff is conducting additional outreach by issuing the consultation paper to obtain information and views, beyond what it has learned from the Board's oversight activities. Specifically, the staff is seeking information on:
  - The potential need for changes to the Board's existing auditing standards to better address changes in the financial reporting frameworks related to accounting estimates and fair value measurements
  - Current audit practices that have evolved to address issues relating to auditing accounting estimates and fair value measurements
- The PCAOB will hold a Standing Advisory Group meeting to further discuss matters related to auditing accounting estimates and fair value measurements on October 2, 2014.
- Comments on the staff consultation paper are requested by November 3, 2014.

Audits of Brokers and Dealers

- On October 10, 2013, the PCAOB issued Standards for Attestations Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission (Attestation Standards No. 1 and No. 2) and Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*.
- On February 12, 2014, the SEC approved the attestation standards and AS no. 17, which are effective for audits of fiscal years ending on or after June 1, 2014.
- On June 26, 2014, the PCAOB released Staff Guidance for Auditors of SEC-Registered Brokers and Dealers.
- 2014 Forums on Auditing Smaller Brokers and Dealers.

Auditor's Reporting Model and Auditor's Responsibilities Regarding Other Information

- On August 13, 2013, the PCAOB issued two proposals:
  - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* which would supersede portions of AU sec. 508, *Reports on Audited Financial Statements*
  - *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report,* which would supersede AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*
- The proposed auditor reporting standard is intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report.
- The proposed other information standard is intended to improve the auditor's procedures and to enhance the auditor's responsibilities with respect to other information, further protecting the interests of investors.

Auditor's Reporting Model

- The Board's proposed auditor reporting standard would retain the pass/fail model and the basic elements of the current auditor's report, but would require the auditor to communicate a wider range of information specific to the particular audit.
- The proposed standard would require:
  - Communication of <u>critical audit matters</u> that would be specific to each audit
  - Addition of <u>new elements</u> to the auditor's report related to –
    - Auditor independence
    - Auditor tenure
    - Auditor's responsibility regarding other information that is included in documents containing the audited financial statements and the related auditor's report
  - <u>Enhancements</u> to existing language in the auditor's report related to the auditor's responsibility for fraud and notes to the financial statements
- The proposed auditor's reporting standard would retain the requirements relating to explanatory language or paragraphs in the auditor's report (e.g. going concern). Also would retain the auditor's ability to emphasize a matter regarding the financial statements.

Critical Audit Matters

- Critical audit matters are those matters addressed during the audit that:
  - Involved the most difficult, subjective, or complex auditor judgments;
  - Posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
  - Posed the most difficulty to the auditor in forming the opinion on the financial statements.
- Critical audit matters ordinarily are matters of such importance that they are required to be:
  - Documented in the engagement completion document, which summarizes the significant issues and findings from the audit;
  - Reviewed by the engagement quality reviewer;
  - Communicated to the audit committee; or
  - Any combination of the three.
- The proposed standard provides a list of factors the auditor should take into account to determine critical audit matters.

Critical Audit Matters (cont'd)

- The description of critical audit matters in the auditor's report would:
  - Identify the critical audit matter;
  - Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
  - Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.
- If the auditor determines that there are no critical audit matters, the auditor would state in the auditor's report that the auditor determined that there are no such matters to communicate.

Auditor’s Responsibilities Regarding Other Information

- The proposed other information standard, among other things, would:
  - Apply the auditor’s responsibility for other information specifically to annual reports filed with the SEC under the Securities Exchange Act of 1934 that contain the audited financial statements and related auditor’s report;
  - Enhance the auditor’s responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit;
  - Require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements; and
  - Require communication in the auditor’s report regarding the auditor’s responsibilities for, and the results of, the auditor’s evaluation of the other information.

Auditor’s Reporting Model/Auditor’s Responsibilities Regarding Other Information

- Comments
  - The Board sought comments on all aspects of the proposed standards and related amendments to other PCAOB standards and among other things, sought comments on economic considerations relating to the proposed standards and amendments, including potential costs.
  - The Board also requested that commenters prepare, and forward to the Board for its consideration, examples of critical audit matters that could be communicated in the auditor’s report under the proposed auditor reporting standard.
  - The Board has received over 240 comment letters.
- Roundtable Discussion
  - The Board held a public roundtable on April 2-3, 2014, to discuss the proposed standards and comments received.
  - The Staff is currently analyzing the comments and the feedback received from the public roundtable.

Audit Transparency Project

Identification of the Engagement Partner and Other Public Accounting Firms or Persons That Are Not Employed by the Auditor but Participate in the Audit

- On December 4, 2013, the Board reproposed the amendments that would require disclosure in the auditor's report of:
  - The name of the engagement partner who led the audit for the most recent period; and
  - The names, locations, and extent of participation (as a percentage of the total audit hours) of other public accounting firms that took part in the audit, and the locations and extent of participation of other persons (whether an individual or a company) not employed by the auditor who performed procedures on the audit.
- The Board comment period closed on March 17, 2014.

Audit Transparency Project (cont'd)

Identification of the Engagement Partner and Other Public Accounting Firms or Persons That Are Not Employed by the Auditor but Participate in the Audit

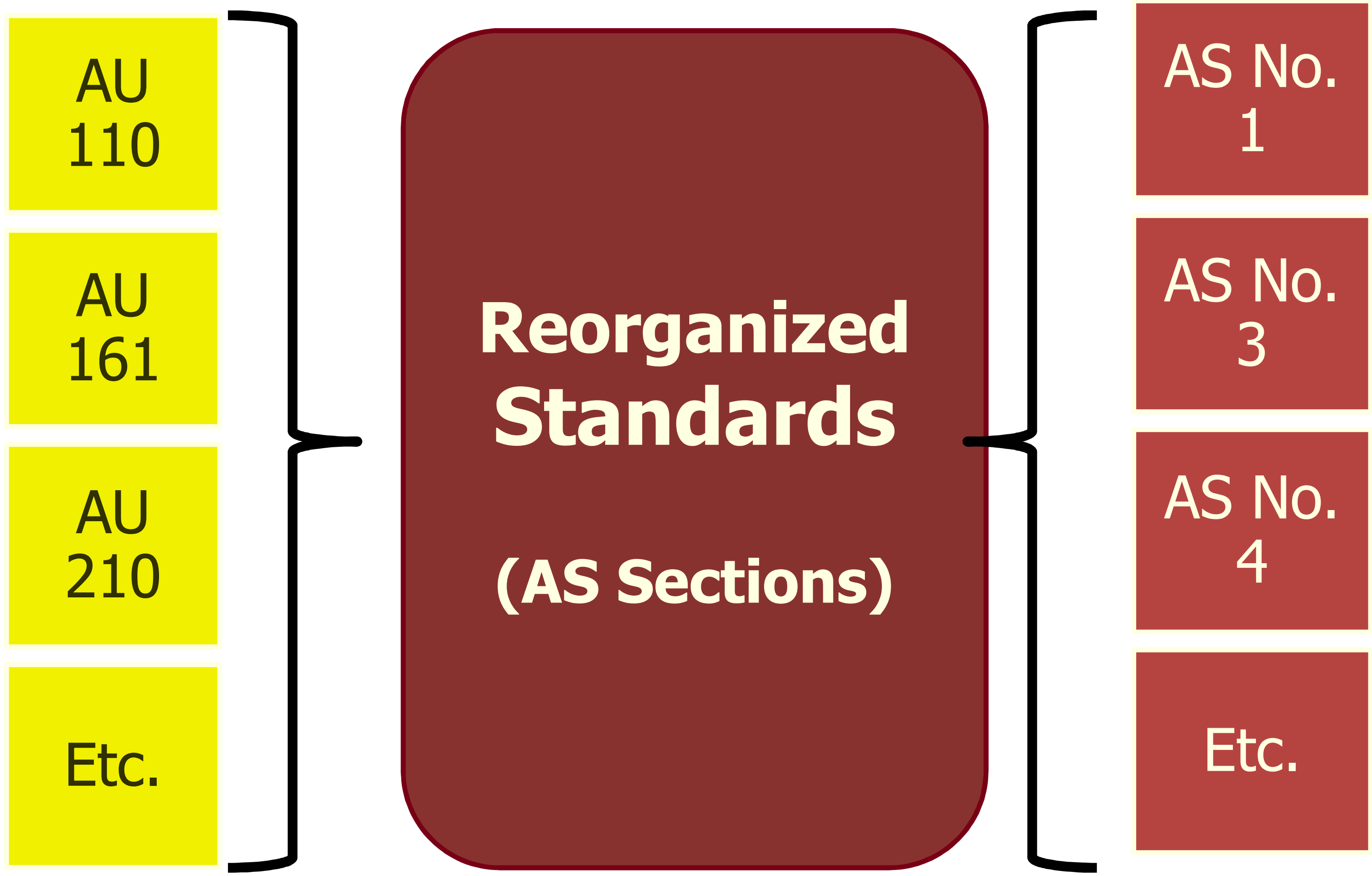
- The Board requested comments on matters such as the usefulness of the information that would be required to be disclosed, the potential costs the reproposed amendments might impose, whether the reproposed amendments would affect competition, and any other aspects of the reproposal.
- The Board also made technical changes to the originally proposed requirement that the auditor disclose information about other participants in the audit, such as changing the threshold for disclosure, and requested commenters' views on those revisions and whether the reproposed amendments should apply to audits of emerging growth companies.

Proposed Reorganization of PCAOB Auditing Standards

- Issued the proposed reorganization of PCAOB auditing standards in March 2013 with the intent to:
  - Renumber and reorder existing standards without redrafting or making substantive changes.
  - Present standards in a logical order that generally follows the flow of the audit process.
  - Help users navigate the standards more easily.
  - Provide structure for future standard-setting.

Proposed Reorganization of PCAOB Auditing Standards (cont'd)

"Interim" Standards **Board-Issued Standards**



Proposed Reorganization of PCAOB Auditing Standards (cont'd)

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

Proposed Reorganization of PCAOB Auditing Standards (cont'd)

- In May 2014:
  - Released for public comment all amendments necessary to implement the reorganization of the auditing standards.
  - Released an online demonstration version of the proposed reorganized auditing standards to facilitate comment on the reorganization.

Keeping Current with Standard-Related Activities

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

Questions

Break

(15 minutes)

Panel Discussion: Risk Assessment and Response, plus Case Study

Moderator: Mary M. Sjoquist
Greg Scates, Deputy Chief Auditor
Alan Skinner, Deputy Director, Inspections
John Abell, Associate Director, Enforcement

Risk Assessment Standards Overview

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*
- Auditing Standard No. 15, *Audit Evidence*

- http://pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx

Substantive Testing of Revenue

Substantive Testing of Revenue Inspection Findings

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

Substantive Testing of Revenue
Relevant Auditing Standards

AS 12, *Identifying and Assessing Risks of Material Misstatement*, ("AS 12"), paragraphs 63 and 68 state:

The components of a potential significant account or disclosure might be subject to significantly differing risks.

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

Substantive Testing of Revenue
Relevant Auditing Standards

AS 12, paragraph 70 states:

To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.

> Note: The determination of whether a risk of material misstatement is a significant risk is based on inherent risk, without regard to the effect of controls.

Substantive Testing of Revenue
Relevant Auditing Standards

AS 12, paragraph 71 states, in part:

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

b. Whether the risk is a fraud risk;

Note: A fraud risk is a significant risk.

Substantive Testing of Revenue
Relevant Auditing Standards

AS 13, *The Auditor's Responses to the Risks of Material Misstatement* ("AS 13"), paragraphs 11 and 12 state, in part:

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

The audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

Substantive Testing of Revenue
Relevant Auditing Standards

AS 13, paragraph 14, states, in part:

The following are examples of ways in which planned audit procedures may be modified to address assessed fraud risks:

- Changing the *nature* of audit procedures;
- Changing the *timing* of audit procedures; and
- Changing the *extent* of the procedures applied to obtain more evidence.

  Note: AU secs. 316.54-.67 provide additional examples of responses to assessed fraud risks.

Substantive Testing of Revenue Relevant Auditing Standards

AS 15, *Audit Evidence* ("AS 15"), paragraph 5, provides, in part:

As the risk increases, the amount of evidence that the auditor should obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.

Substantive Testing of Revenue
Relevant Auditing Standards

AU 329, paragraph .09, states, in part:

The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures. **For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.**

Substantive Testing of Revenue
Relevant Auditing Standards

AU 329, paragraph .19, states, in part:

Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. . . Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. **Disaggregation helps reduce this risk.**

Substantive Testing of Revenue
Relevant Auditing Standards

AU 350, *Audit Sampling* ("AU 350"), paragraph .23 states:

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

Substantive Testing of Revenue
Relevant Auditing Standards

AU 350, paragraph .23A states:

Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, **when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.**

Substantive Testing of Revenue

Case Study No. 1 – Improve Your Soil, Inc.

Case Study No. 1 – Improve Your Soil, Inc. Background

- Your Firm is auditing the 2014 financial statements of Improve Your Soil, Inc. (the "Company")
- The Company manufactures and sells fertilizer through the Farm Segment and the Home and Garden Segment ("H&G")
- The Farm Segment represents 55 percent of the Company's revenue.
- The Farm Segment customers are large distributors that sell to large farm operators
- In 2013, the Farm Segment had 400 sales with average sale of $350,000

Case Study No. 1 – Improve Your Soil, Inc. Background

- Farm Segment sales arrangements are not standard, are negotiated, and may include right of return or customer acceptance clauses.
- Home and Garden Segment (H&G) represents 45 percent of the Company's revenue.
- H&G customers are retail home and garden businesses that sell to end users
- In 2013, H&G had 11,000 sales with average sale of $10,000
- H&G has standard sales documents and shipping terms: FOB shipping point, no right of return, and warranty

Case Study No. 1 – Improve Your Soil, Inc. Background

- Sales for each segment occur with predictable seasonality in spring and summer months
- Sales executives in both segments can earn bonuses if annual sales growth targets are attained
- Predecessor auditor tested and relied on internal controls in 2013 audit and based on preliminary review, controls over revenue appear effective.

Case Study No. 1 – Improve Your Soil, Inc. Scenario

- *Your Firm is planning its audit of the Company's 2014 financial statements*
- *You are the lead partner on the audit*
- *The engagement team's risk assessment for revenue is as follows:*

	Farm Segment	Home and Garden Segment
Inherent risk of occurrence	High	Low
Inherent risk of valuation	High	Low
Inherent risk of completeness	Low	Low
Fraud risk	Fraud risk related to cut-off	Fraud risk related to cut-off
Significant risk	Yes, due to: (1) risk that revenue recognition may not reflect contract terms, and (2) fraud risk related to revenue cut-off.	Yes, due to fraud risk related to cut-off.

Case Study No. 1 – Improve Your Soil, Inc. Scenario

- *Due to concerns you have about your firm's application of the PCAOB's risk based standards, you asked the two managers on the audit engagement to each independently develop an approach for testing the Company's revenue.*
- *You then also asked the two managers to collaborate with each other and jointly develop an approach to testing the Company's revenue.*
- *You are now in the process of considering each of the three proposed approaches to testing the Company's revenue, as follows:*

Case Study No. 1 – Improve Your Soil, Inc. Scenario

First Option

Type of Procedures to be Performed:	Farm Segment	Home and Garden Segment
Tests of internal controls	No	No
Tests of details	Test revenue recognition criteria for a random sample of segment sales transactions from throughout the year with estimated sample size of 25 sales transactions based on Firm's controls testing sampling guidance.	Test revenue recognition criteria for a random sample of segment sales transactions from throughout the year with estimated sample size of 25 sales transactions based on Firm's controls testing sampling guidance.
Analytical procedures	**Annual Revenue Fluctuation Review:** Comparison of current year and prior year annual revenue for the segment with inquiry regarding significant fluctuations.	**Annual Revenue Fluctuation Review:** Comparison of current year and prior year annual revenue for the segment with inquiry regarding significant fluctuations.
Other substantive procedures	1. Test cut-off by selecting the last five shipments prior to and the first five shipments subsequent to year end and determine whether related sales were recognized in proper period. 2. Confirmation of random sample of year-end accounts receivable with projected sample size of 53 customer accounts representing $15 million or 30 percent of total accounts receivable and six percent of total revenue.	

Case Study No. 1 – Improve Your Soil, Inc. Scenario

Second Option

Type of Procedures to be Performed:	Farm Segment	Home and Garden Segment
Tests of internal controls	Yes, with control risk expected to be low	No
Tests of details	Test revenue recognition criteria for a random sample of segment sales transactions from throughout the year with estimated sample size of 215 sales transactions based on Firm's substantive sampling methodology.	Test revenue recognition criteria for the 60 largest sales transactions in the segment from throughout the year with projected coverage representing $0.9 million or 0.4 percent of total revenue and 0.8 percent of segment revenue.
Analytical procedures	**Annual Revenue Fluctuation Review:** Comparison of current year and prior year annual revenue for the segment with inquiry regarding significant fluctuations.	**Annual Revenue Fluctuation Review:** Comparison of current year and prior year annual revenue for the segment with inquiry regarding significant fluctuations.
Other substantive procedures	1. Test cut-off by selecting the last five shipments prior to and the first five shipments subsequent to year end and determine whether related sales were recognized in proper period. 2. Confirmation of accounts receivable as described in First Option above.	

Case Study No. 1 – Improve Your Soil, Inc. Scenario

Third Option

Type of Procedures to be Performed:	Farm Segment	Home and Garden Segment
Tests of internal controls	Yes, with control risk expected to be low	Yes, with control risk expected to be low
Tests of details	Test revenue recognition criteria for (1) the 25 largest sales transactions in the segment from throughout the year with projected coverage representing $25 million or ten percent of total revenue and 18 percent of segment revenue, and (2) a random sample of segment sales transactions from throughout the year with estimated sample size of 92 sales transactions based on Firm's substantive sampling methodology.	See cut-off test in other substantive procedures below.

Case Study No. 1 – Improve Your Soil, Inc. Scenario

Third Option (continued)

Type of Procedures to be Performed:	Farm Segment	Home and Garden Segment
Analytical procedures	**Disaggregated Monthly Revenue Analysis**: Comparison of monthly revenue by salesperson and customer for the segment for current year, prior year, and budget with investigation into fluctuations that exceed expectations by a specified amount. For unusual sales transactions identified through investigation, examine related sales transaction documents and request confirmation of contract terms with the customer.	**Disaggregated Monthly Revenue Analysis**: Comparison of monthly revenue by salesperson and customer for the segment for current year, prior year, and budget with investigation into fluctuations that exceed expectations by a specified amount. For unusual sales transactions identified through investigation, examine related sales transaction documents and request confirmation of contract terms with the customer.

Case Study No. 1 – Improve Your Soil, Inc. Scenario

Third Option (continued)

Type of Procedures to be Performed:	**Farm Segment**	**Home and Garden Segment**
Other substantive procedures	1. Test cut-off by selecting last five shipments prior to and first five shipments subsequent to year end, as well as, <u>the five largest shipments in each of the months of December and January</u> and determine whether related revenue was recognized in proper period. 2. Compare monthly sales returns and credit memos for the last two months of the year to the first two months of the subsequent year. 3. Confirmation of accounts receivable as described in First Option above.	1. Test cut-off by selecting last five shipments prior to and first five shipments subsequent to year end and determine whether related revenue was recognized in proper period. 2. Compare monthly sales returns and credit memos for the last two months of the year to the first two months of the subsequent year. 3. Confirmation of accounts receivable as described above.

Case Study No. 1 – Improve Your Soil, Inc. Scenario

What are your thoughts on the three options provided to audit revenue?

Questions

Lunch

(75 minutes)

While you are gathering…

Think of one word that describes "remediation"

Remediation: Satisfactory or Not?

Karen Kubis
Associate Director
Division of Registration and Inspections

Remediation Process

- The remediation process begins during the inspection
- Importance of communication with inspection team
- Importance of root cause evaluation

Information Concerning the Quality Control Remediation Process under PCAOB Rule 4009

- General Guidance
  - Each firm is best suited to determine how to address particular quality control weakness
  - Differences between firms of different sizes
  - Initiate a dialogue early

Criteria to Assess Remedial Actions

Additional Information on the Application of the Criteria

- Repeated criticisms require a **<u>new</u>** or **<u>enhanced</u>** response
- A firm should monitor the effectiveness of its remedial actions
- Training and intra-firm communications should be tailored and responsive
- The inspections staff considers evidence of the effectiveness of implemented remedial actions

Case Study No. 2 – Remediation: Satisfactory or Not?

- Testing Appropriate to the Audit - Revenue
- Fraud Procedures
- Testing Appropriate to the Audit – Loan from Related Parties

Question 1

- Apple & Apple, LLP has been inspected three times. The firm's third inspection report contains a quality control criticism in Part IIB for "testing appropriate to the audit" for intangible assets. Specifically, the firm failed to perform procedures to test the appropriateness of the valuation methods and reasonableness of the significant assumptions used by a specialist.

- A similar "testing appropriate to the audit" criticism was previously in the Apple & Apple, LLP second inspection report which the firm had satisfactorily remediated by including a session on auditing the impairment of intangible assets during its annual training. This training was provided to the firm's personnel before the performance of the audits that were reviewed in the third inspection.

Question 1, cont.

Which of the following remedial actions best meets the criteria for this repeat criticism in the third inspection report?

A. Conducted the same segment on auditing impairment of intangible assets again in the next annual training
B. Updated its intangible asset audit program to include specific steps on how to test assumptions included in a specialist report
C. Updated the employee handbook on the firm’s vacation policy
D. All of the above

Question 2

- The remediation staff is currently reviewing the Rule 4009 submission for Orange & Orange, LLP's second inspection report conducted in 2011. What types of information would the staff consider in making a determination on whether the firm's remedial actions were satisfactory?

  A. Results of the firm's monitoring procedures
  B. Results of the firm's PCAOB inspection conducted in 2014
  C. Evidence to support remedial actions taken during the 12 month remediation period
  D. All of the above

Resources

Resources:

http://pcaobus.org/Inspections/Pages/Remediation_Process.aspx

PCAOB
Public Company Accounting Oversight Board

Questions

PCAOB
Public Company Accounting Oversight Board

Division of Enforcement and Investigations Update

John Abell
Associate Director, Accountant, Enforcement
September 11, 2014
Vancouver, B.C.

Enforcement and Investigations

- The Board may investigate possible violations by registered public accounting firms or their associated persons of
  - any relevant provision of Sarbanes-Oxley Act
  - the rules of the Board
  - the provisions of the securities laws relating to the preparation and issuance of audit reports
  - professional standards

SEC Coordination

- Weekly conference calls with SEC's Financial Reporting and Audit Task Force
- Quarterly meetings with Enforcement's Chief Accountant's Office and OCA
- Day-to-day coordination on tips, referrals, and parallel investigations
- Coordinate with other regulators as permitted by Act

Recent Settled Disciplinary Proceedings

Recent Settled Disciplinary Proceedings

- Randall A. Stone, CPA
- Patrick Rodgers, CPA, PA and Patrick E. Rodgers, CPA
- Labrozzi & Co., P.A., and Douglas A. Labrozzi, CPA
- Harris F. Rattray CPA, PL and Harris F. Rattray, CPA
- Hood & Associates CPAs, P.C. and Rick C. Freeman, CPA
- Acquavella, Chiarelli, Shuster, Berkower & Co., LLP
- Deloitte & Touche LLP
- Nathan M. Suddeth, CPA
- Lake & Associates, CPA's LLC and Jay Charles Lake, CPA
- Gruber & Co., LLC, and E. Randall Gruber, CPA
- Rehan Saeed, CPA
- Michael F. Cronin, CPA and Michael F. Cronin, CPA

**In all of the settled disciplinary proceedings, the firms and the associated persons neither admitted nor denied the Board's findings, except as to the Board's jurisdiction over them and the subject matter of the proceedings.*

Recent Settled Disciplinary Proceedings

Randall A. Stone, CPA (July 7, 2014)

- Stone, a former partner of PricewaterhouseCoopers LLP, was in charge of the 2007 audit of ArthroCare Corporation.
  - Stone ignored or failed to properly address numerous indicators that ArthroCare was improperly recognizing revenue on sales to one of its largest distributors
  - He failed to properly audit ArthroCare's accounting for that distributor's acquisition after ArthroCare acquired the distributor at the end of 2007.
  - Stone improperly consented to the incorporation of PwC's 2007 audit opinion in ArthroCare's June 2008 Form S-8 Registration Statement, after receiving new allegations regarding ArthroCare's relationship to that distributor, without a sufficient subsequent events investigation.
- The Board barred Stone with the right to reapply after 3 years, and imposed a $50,000 penalty and a censure.

Recent Settled Disciplinary Proceedings

Patrick Rodgers, CPA, PA and Patrick E. Rodgers, CPA (Mar. 6, 2014)

- Matter concerns four audits of one issuer.
- In each of the four audit years, Rodgers became aware of information suggesting that payments and stock issuances were being made to, or on behalf of, officers of the issuer that were not disclosed in the financial statements.
- Rodgers erroneously relied on management representations in lieu of performing other audit procedures to determine the purpose, nature and extent of these transactions.
- In doing so, Rodgers failed to exercise due care and professional skepticism and to gather sufficient evidence to properly assess whether these transactions were with related parties and required disclosure.
- Firm was censured and its registration was revoked with a right to reapply in two years.
- Mr. Rodgers was censured and barred from being associated with a registered firm for two years.

Recent Settled Disciplinary Proceedings

Labrozzi & Co., P.A., and Douglas A. Labrozzi, CPA (Feb. 13, 2014)

- Respondent failed to cooperate with a Board investigation as evidenced by:
  - Failing to produce documents demanded under an Accounting Board Demand
  - Failing to appear for sworn testimony until after the institution of disciplinary proceedings.
  - Adding, altering and backdating audit documentation for three audits prior to providing it to the Enforcement division without informing the division and contemporaneously documenting when documents were changed or added, by whom and why, as required by AS 3.
- The firm was censured and its registration revoked.
- Mr. Labrozzi was permanently barred from associating with a registered firm.

Recent Settled Disciplinary Proceedings

Harris F. Rattray CPA, PL (November 21, 2013)

- Mr. Rattray’s conduct involves four audit clients, in two cases for multiple years.
- Mr. Rattray and his firm were charged with fraud for falsely stating that audits of three issuers had been conducted in accordance with PCAOB standards.
- At the time Mr. Rattray began auditing US issuer clients he had no experience auditing under PCAOB Standards nor familiarity with U.S. GAAP.
- He also failed to plan and perform sufficient audit work in critical areas of the audits.
- Violated 10A(a) of the Exchange Act by failing to design procedures around possible illegal acts with a direct and material effect on the financial statements.
- The Board permanently revoked firm's registration; permanently barred Mr. Rattray.

Recent Settled Disciplinary Proceedings

Hood & Associates CPAs, P.C. (November 21, 2013)

- Rick Freeman was the sole audit partner at Hood & Associates CPAs.
- Matter involves the audits of three issuers over multiple years.
- Mr. Freeman violated Section 10A(j) of the Exchange Act related to independence because on two clients he served as engagement partner for more than 5 years.
- Mr. Freeman and the firm falsely stated that audits of three issuers had been conducted in accordance with PCAOB standards thereby violating Rule 10b-5.
- There were multiple audit failures including failure to properly perform fraud procedures, to properly select samples for testing, to gather sufficient audit evidence and to have an EQR performed on the audits as required by AS No. 7.
- Mr. Freeman caused the firm to violate the quality control standards.
- The Board revoked firm's registration with a right to reapply after three years and imposed a $10,000 penalty; permanently barred individual.

Recent Settled Disciplinary Proceedings

Acquavella, Chiarelli, Shuster, Berkower & Co., LLP (November 21, 2013)

- Violations relate to the firm and partner David Svoboda.
- Matter involves audit failures in audits of two issuers based in PRC and one based in Hong Kong.
- Mr. Svoboda did not speak or read Chinese and relied on lower level personnel, including those from the Chinese firms, to identify audit issues and analyze audit evidence.
- Mr. Svoboda and the firm failed to adequately assess the competency of those assigned to the audits, including in US GAAP and PCAOB Standards.
- To make matters worse, Mr. Svoboda reviewed hardly any of their audit work.
- Mr. Svoboda also violated the SEC's independence rules related to prohibited services by preparing financial statements for two clients that he then audited.
- Mr. Svoboda also caused the firm to violate the quality control standards.
- The Board revoked firm's registration with a right to reapply after two years and imposed a $10,000 penalty; barred individual with a right to petition the Board to terminate the bar after three years.

Recent Settled Disciplinary Proceedings

Deloitte & Touche LLP (Oct. 22, 2013)

- Proceeding brought as a contested, non-public matter (March 2013).
- Firm permitted a former partner to perform or continue to perform activities as an "associated person" that were prohibited while he was subject to a PCAOB suspension order.
- While subject to suspension order, former partner consulted with audit teams for three issuers and participated in the development, drafting, and presenting of training materials, firm guidance, and forms relating to a variety of audit-related topics.
- $2 million penalty – equal to the Board's largest penalty. Board also censured the firm and ordered the firm to undertake certain remedial actions.

Recent Settled Disciplinary Proceedings

Nathan M. Suddeth, CPA (Sept. 10, 2013)

- Former Partner in Charge of Deloitte's audit practice in the firm's Pittsburgh office.
- Failed to cooperate in Board inspection and violated audit documentation standards by improperly backdating work papers for an audit selected for inspection.
- Among other things, Suddeth added backdated documents on the morning the Board inspection began.
- Deloitte voluntarily reported to PCAOB and removed Suddeth from role as Partner in Charge and from direct audit responsibilities.
- Suddeth was censured and barred with the right to file a petition for Board consent to associate after two years.

Recent Settled Disciplinary Proceedings

Lake & Associates, CPA's LLC and Jay Charles Lake, CPA (Aug. 13, 2013)

- Audit failures in audits of four issuers (three China-based).
- Mr. Lake failed to adequately plan the audit or conduct the most basic substantive audit procedures of confirming accounts receivable or observing inventory.
- Lake also failed to reconcile and properly test accounting records that showed material differences with the general ledger and suggested accounts receivable and revenue were materially overstated.
- He failed to put quality control policies and procedures in place to provide reasonable assurance that audits were performed in compliance with applicable standards including PCAOB Standards.
- Firm received censure and revocation of registration, with right to reapply for registration after three years.
- Mr. Lake received censure and bar from association, with right to file petition for Board consent to associate after three years.

Recent Settled Disciplinary Proceedings

Gruber & Co., LLC, and E. Randall Gruber, CPA (June 27, 2013)

- Gruber falsely claimed to inspectors to have done audit work when none was performed.
- Failure to cooperate with PCAOB inspectors and violation of AS 3 (audit documentation).
- Firm's registration permanently revoked; individual permanently barred.
- Non-public proceeding commenced in March 2012 – firm issued 11 audit opinions during proceeding.

Recent Settled Disciplinary Proceedings

Rehan Saeed, CPA (May 21, 2013)

- Mr. Saeed was an employee or independent contractor of Kabani & Company
- Mr. Saeed failed to perform concurring review procedures until after the firm had released audit reports for two issuers and the issuers had filed their financial statements with the SEC.
- He also backdated documents to make it appear that he had performed procedures before release of audit reports in violation of AS3.
- Respondent was censured and barred, with right to file a petition for Board consent to associate after 18 months.

Recent Settled Disciplinary Proceedings

Michael F. Cronin, CPA and Michael F. Cronin, CPA (May 14, 2013)

- Cronin became aware of likely payments to the issuer's officers, but failed to consider whether these were related party transactions requiring disclosure by the company and additional testing and scrutiny by Cronin.
- Cronin violated auditor independence rules related to auditor rotation on four issuer audits.
- PCAOB inspectors warned of independence rules, yet partner rotation violations continued.
- The firm also failed to have an EQR performed for one audit.
- Firm was censured and its registration was revoked, with right to reapply for registration after three years. $10,000 penalty imposed.
- Cronin was censured and barred, with right to petition for Board consent to associate after three years.

Recent Adjudicated Disciplinary Proceedings

Recent Adjudicated Disciplinary Proceedings

Stan Jeong-Ha Lee and Stan J.H. Lee, CPA (July 30, 2013)

- Respondents were alleged to have improperly created, altered, and backdated audit documentation in connection with a Board inspection.
- Respondents defaulted by failing to attend a pre-hearing conference.
- Firm’s registration revoked; individual barred and ordered to pay a $50,000 penalty.
- The matter was non-public for over fifteen months.

Recent Adjudicated Disciplinary Proceedings

S.W. Hatfield, CPA and Scott W. Hatfield, CPA (July 3, 2013)

- First Commission ruling in PCAOB audit case.
- Upholds permanent bar and revocation.
- Whether financial statements were materially misleading or investors misled not the issue.
- Whether companies lied or withheld documents not the issue
- Issue is whether auditor acted "diligently and with a reasonable degree of competence."
- Auditor deferred to untested management reps and relied on experience with other companies without adequate audit evidence, despite red flags.
- Matter was non-public for over four years.

Extraordinary Cooperation

- April 2013: Board's first formal statement on the benefits of extraordinary cooperation in enforcement matters.
- Extraordinary cooperation is voluntary and timely action beyond compliance with legal or regulatory obligations.
- Includes self-reporting violations before the conduct comes to the attention of the Board or another regulator, taking remedial or corrective action to reduce the risk of similar violations recurring, and providing substantial assistance in the PCAOB's investigative processes.
- May result in reduced charges or sanctions.

Whistleblower Protection and Auditors

- Section 806 of the Sarbanes-Oxley Act entitles employees of public companies to protection from retaliation for whistleblowing on their employer.

- In March 2014 the United States Supreme Court held in *Lawson v. FMR LLC* that the whistleblower protections in Section 806 of the Act apply to independent contractors and subcontractors of public companies (such as consultants and auditors).

- These protections under Section 806 attach even when the whistleblower does not alert law enforcement authorities, but instead provides information to his or her supervisor.

PCAOB Center for Enforcement Tips, Complaints and Other Information

- Website:
  http://pcaobus.org/Enforcement/Tips/Pages/default.aspx
- E-mail: TIPS@pcaobus.org
- Letter PCAOB Complaint Center
  1666 K Street, NW
  Washington, DC 20006
- FAX: 202-862-0757
- Telephone: 800-741-3158

Questions

SEC
Division of Corporation Finance
FY 2014 Update
Vancouver, BC

Disclaimer

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. Therefore, the views expressed today are my own, and do not necessarily reflect the views of the Commission or the other members of the staff of the Commission.

FY 2014 Update

- Financial Reporting Issues Relevant to Smaller Companies reporting under IFRS
- Resources for Smaller Companies reporting under IFRS

Disclosure Effectiveness

- Assessing materiality of disclosure
- Call us if unclear about a comment
- Not more disclosure but effective disclosure
- Updating Regulation S-K and S-X

Financial Reporting Issues Relevant to Smaller Companies reporting using IFRS

Foreign Private Issuers

Which country has the most number of SEC registrants reporting under IFRS?

A. *Australia*

B. *Brazil*

C. *Canada*

D. *United Kingdom*

Financial Reporting Issues

1. Financial Statement Presentation
2.
3.
4.
5.
6.
7.
8.
9.
10.

Financial Statement Presentation

- **Operating profit measure excludes some operating items**

Statement of Profit/(Loss)	2013		2012
Revenue	$750		$680
Cost of Sales	450		420
Operating profit	300		260
Selling expense	50		40
Impairment	100		80
Other expense	50		50
Profit before taxes	$100		$90

Financial Reporting Issues

1. **Financial Statement Presentation**
2. **Revenue Recognition**
3.
4.
5.
6.
7.
8.
9.
10.

Revenue Recognition

- Disclose when revenue recognition criteria are met specific to the <u>entity</u>
- Example of generic revenue policy:

> **Revenue Recognition:**
> **Revenue from the sale of products is recognized when persuasive evidence of a sale arrangement exists, the risks and rewards of ownership pass to the purchaser, including title risk, the selling price is measurable, and collectability is probable.**

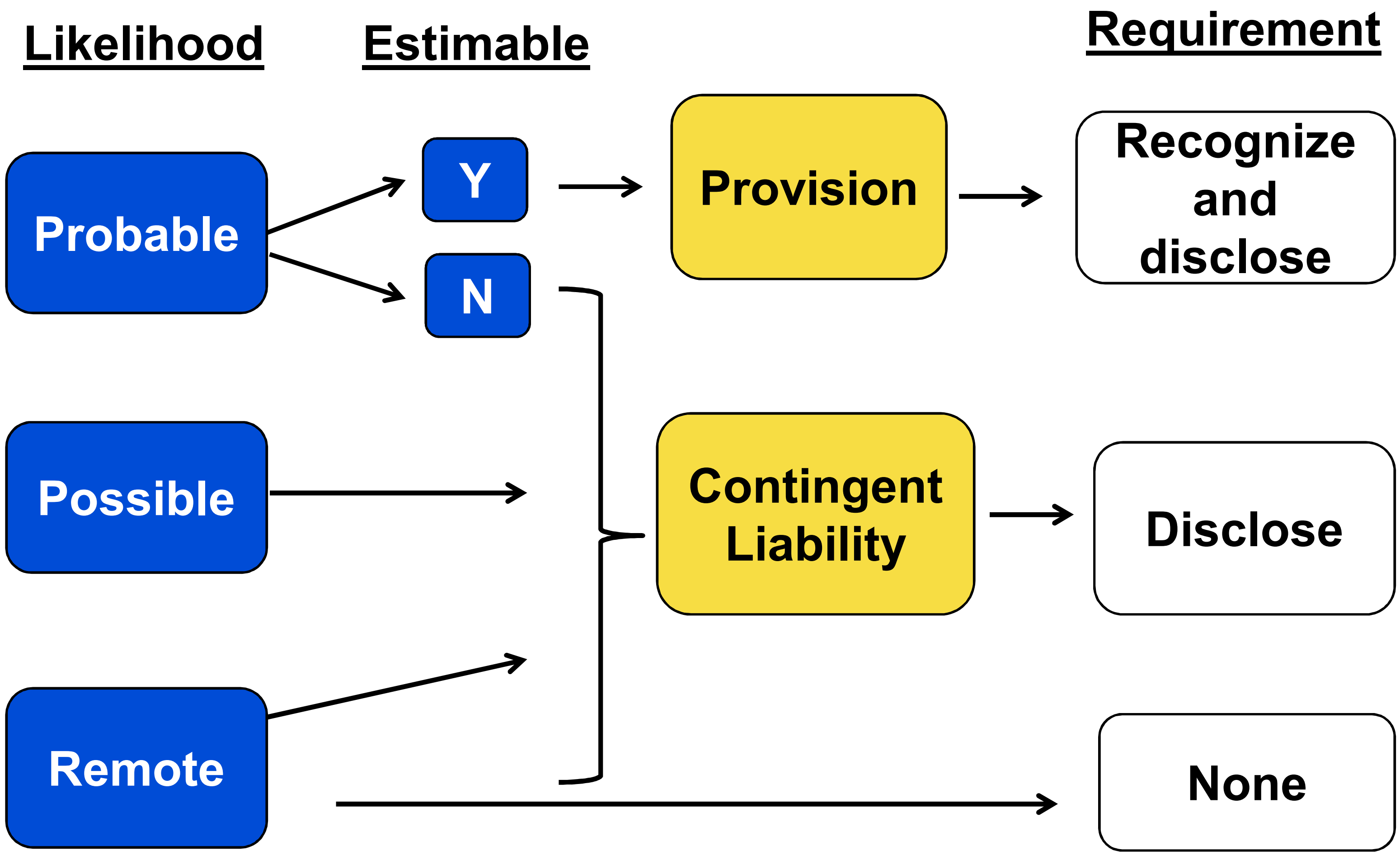
Revenue Recognition Issues

- **Material revenue-generating activities not discussed**
- **Multiple element arrangements**
- **Clarity on the terms and details of revenue streams**

Financial Reporting Issues

1. **Financial Statement Presentation**
2. **Revenue Recognition**
3. **Provisions and Contingent Liabilities**
4.
5.
6.
7.
8.
9.
10.

Provisions and Contingent Liabilities



Provisions and Contingent Liabilities

- Disclosing nature of the matter
- Aggregating to form a class
- Estimating financial effects
- Identifying uncertainties on timing of outflow
- Evaluating matters continually
- Applying prejudicial exemption

Financial Reporting Issues

1. Financial Statement Presentation
2. Revenue Recognition
3. Provisions, Contingent Liabilities
4. Segment Reporting
5.
6.
7.
8.
9.
10.

Segment Reporting

- Identification of operating segments
- Evaluate segments for changes in organization
- Aggregation of operating segments
- Entity-wide disclosures

Financial Reporting Issues

1. Financial Statement Presentation
2. Revenue Recognition
3. Provisions and Contingent Liabilities
4. Segment Reporting
5. Impairment of Assets
6.
7.
8.
9.
10.

Impairment of Assets

- Identify cash generating units (CGUs)
- Reassess CGUs for changes in organization

Impairment of Assets

- Evaluate Indicators of Impairment
- Example: consider long-term price and cash flows over life of mine

Impairment of Assets

Disclosures:

- **Policies were not entity-specific**
- **Critical Judgements**
- **Sources of Estimation Uncertainty**
- **Unclear or incomplete information on Impairment loss**

Financial Reporting Issues

1. **Financial Statement Presentation**
2. **Revenue Recognition**
3. **Provisions and Contingent Liabilities**
4. **Segment Reporting**
5. **Impairment of Assets**
6. **Property, Plant and Equipment**

Property, Plant and Equipment

- Capitalization of costs
- Estimating the useful life
- Units of production method

$$\frac{\textit{depreciable amount}}{\textit{total expected units}} \times \textit{units produced}$$

- Use of reliable estimates
- Disclose critical judgements

Financial Reporting Issues

1. Financial Statement Presentation
2. Revenue Recognition
3. Provisions and Contingent Liabilities
4. Segment Reporting
5. Impairment of Assets
6. Property, Plant and Equipment
7. Income Taxes

Income Taxes

- Tax rate reconciliation issues
- Deferred tax asset recoverability

Tax Rate Reconciliation Issues

- **Unclear or incomplete labeling**
- **Inappropriate aggregation**
- **Corrections of errors labeled as changes in estimates**
- **Inconsistency of disclosures**

Rate Reconciliation	%
Statutory Tax Rate	30.0%
Nontaxable gain/(loss)	8.9%
Miscellaneous Other	-18.0%
Impairment of goodwill	-3.4%
Prior year change in estimate	-7.0%
Effective Tax Rate	10.5%

Deferred Tax Assets

- **Recognize if probable that taxable profit will be available:**
  - **Nature and timing of reversal of taxable temporary differences**
  - **Future taxable income**
  - **Tax planning strategies**

Deferred Tax Assets (Cont.)

- **Recognition requires significant judgment**
  - **Weight evidence on how objectively verifiable**
  - **Consistency of assumptions**
- **Disclosures**

Financial Reporting Issues

1. Financial Statement Presentation
2. Revenue Recognition
3. Provisions and Contingent Liabilities
4. Segment Reporting
5. Impairment of Assets
6. Property, Plant and Equipment
7. Income Taxes
8. Investments and Consolidation
9.
10.

Investments and Consolidation

- New investments and consolidation standards:
  - IFRS 10
  - IFRS 11
  - IFRS 12
- Missing opening balance sheet when new standard is adopted
- S-X Rule 3-09 financial statements

Investments and Consolidation

- **Rule 3-09 information see FRM 2400**

Financial Reporting Manual

FRM

Topic 6

TOPIC 6: FOREIGN PRIVATE ISSUERS & FOREIGN BUSINESSES

Financial Reporting Issues

1. Financial Statement Presentation
2. Revenue Recognition
3. Provisions and Contingent Liabilities
4. Operating Segments
5. Impairment of Assets
6. Property, Plant and Equipment
7. Income Taxes
8. Investments and Consolidation
9. Auditor Matters
10.

Auditor Matters

- **Compliance with “IFRS as issued by IASB” (FRM 6300)**
- **Going concern language “Substantial doubt” (FRM 4230)**
- **Audit Reports (FRM 4210)**
- **Independence considerations (FRM 6800)**

Auditor Matters

- Independence Considerations (S-X Rule 2-01)
  - Accounting Assistance
  - Non-Audit Services

Auditor Independence FAQs:
http://www.sec.gov/info/accountants/ocafaqaudind080607.htm

Financial Reporting Issues

1. Financial Statement Presentation
2. Revenue Recognition
3. Provisions and Contingent Liabilities
4. Operating Segments
5. Impairment of Assets
6. Property, Plant and Equipment
7. Income Taxes
8. Investments and Consolidation
9. Auditor Matters
10. Management's Discussion and Analysis

Management's Discussion & Analysis

- Results of Operations
- Liquidity and Capital Resources
- Trends and Uncertainties
- Critical Accounting Estimates

SEC Interpretive Releases:

http://www.sec.gov/rules/interp/33-8350.htm

https://www.sec.gov/rules/interp/33-6835.htm

Results of Operations

- Separately quantify each material, underlying factor
- Example disclosure:

> **<u>Results of Operations</u>**
>
> **Revenue increased $1,111 or 1% from $107,346 in the fiscal year ended December 31, 2012 to $108,457 in the fiscal year ended December 31, 2013.**

Liquidity & Capital Resources

Analyze material, underlying reasons for changes in cash flows

Historical financing arrangements

Is it clear how the Company will meet their cash requirements?

Material cash requirements

Available future financing arrangements

Trends & Uncertainties

- **Identify known trends, demands, commitments, events and uncertainties**

- **Disclose, if material, impact on liquidity, capital resources or results of operations**

Critical Accounting Estimates

- Address quality and variability of the estimate
  - Why estimate bears risk of change
  - Accuracy of estimate historically
  - Whether it is reasonably likely estimate will change

Appendix: Resources for Smaller Companies Reporting under IFRS

Key Resources

Resource	Link
Division of Corporation Finance (DCF) website	http://www.sec.gov/corpfin
DCF Foreign Issuer Information	http://www.sec.gov/divisions/corpfin/cfforeignissuers.shtml
DCF International Business Rules, Regulations and Forms	http://www.sec.gov/divisions/corpfin/forms/international.shtml
DCF Filing Review Process	http://www.sec.gov/divisions/corpfin/cffilingreview.htm
1933 Act	http://www.sec.gov/about/laws/sa33.pdf
1934 Act	http://www.sec.gov/about/laws/sea34.pdf

Key Resources

Resource	Link
Financial Reporting Manual (FRM) Topic 6: Foreign Private Issuers, Topic 16: MJDS	http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml
Compliance and Disclosure Interpretations (C&DI)	http://www.sec.gov/divisions/corpfin/cfguidance.shtml
SEC Work Plan for global accounting standards	http://www.sec.gov/spotlight/globalaccountingstandards.shtml
SEC Staff Paper, An Analysis of IFRS in Practice (2011)	http://www.sec.gov/spotlight/globalaccountingstandards.shtml
Staff Accounting Bulletins	http://www.sec.gov/interps/account.shtml
SEC Interpretation: MD&A (2003)	http://www.sec.gov/rules/interp/33-8350.htm#
SEC Interpretation: MD&A (1989)	https://www.sec.gov/rules/interp/33-6835.htm
SEC Interpretation: Liquidity and Capital Resources (2010)	https://www.sec.gov/rules/interp/2010/33-9144.pdf
SEC Interpretation: Management's Report on ICFR (2007)	http://www.sec.gov/rules/interp/2007/33-8810.pdf

Auditor Independence Resources

Resource	Link
Rule 2-01 of Regulation S-X	http://www.sec.gov/about/forms/forms-x.pdf
SEC Release - Strengthening the Commission's Requirements Regarding Auditor Independence	http://www.sec.gov/rules/final/33-8183.htm
SEC Release - Revision of the Commission's Auditor Independence Requirements	https://www.sec.gov/rules/final/33-7919.htm
SEC – Auditor Independence FAQ's	http://www.sec.gov/info/accountants/ocafaqaudind080607.htm
Audit Committees and Auditor Independence	http://www.sec.gov/info/accountants/audit042707.htm
SEC Speech – Auditor Independence	http://www.sec.gov/news/speech/2007/spch121007vk.htm

Contact Information

- **Comment Letter Process : contact information will be at the end of the comment letter**
- **Informal staff interpretation or informal question**
  - **Financial Reporting: CF Office of Chief Accountant at 202-551-3400 or submit request through online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive**
  - **IFRS/U.S. GAAP: SEC Office of the Chief Accountant at 202-551-5300 or OCA@sec.gov**
  - **Foreign Issuer matters: CF Office of International Corporate Finance at 202- 551-3450**
  - **Interpretive legal questions: CF Office of Chief Counsel at 202-551-3500**
  - **EDGAR questions: EDGAR Filer Support at 202-551-8900**

Contact Information

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

- Formal consultations on the application of IFRS/US GAAP should be sent to - OCA@sec.gov
  www.sec.gov/info/accountants/ocasubguidance.htm

Questions

Key Telephone Numbers:

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

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

Corporation Finance Office of International Corporate Finance (202) 551-3450

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

Break

(15 minutes)

Inspection Findings and Case Studies

Presenters

Alan Skinner, Deputy Director, Division of Inspections

John Abell, Associate Director, Accountant, Division of Enforcement and Investigations

Greg Scates, Deputy Chief Auditor, Office of Chief Auditor

Agenda

- Summary of Domestic Small Firm Program
- Inspection Findings and Case Studies

Summary of Domestic Small Firm Program

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

Top Inspection Findings

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

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

Potential Root Causes

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

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

Inspection Findings and Case Studies

- Auditing Fair Value Measurements
- Auditing Accounting Estimates
- Evaluation of Goodwill for Impairment

Auditing Fair Value Measurements

Auditing Fair Value Estimates Inspection Findings

- Failure to obtain an understanding of the methods and evaluate the reasonableness of the significant assumptions used by the issuer's pricing sources (specialist)
- Failure to evaluate the appropriateness of the methods and the reasonableness of the significant assumptions used with respect to fair value estimates not involving specialists
- Failure to obtain fair values from an independent external source when developing independent fair value estimates

Auditing Fair Value Measurements Relevant Auditing Standards

AU 328, *Auditing Fair Value Measurements and Disclosures* ("AU 328"), paragraph .23, states, in part:

Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures. Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent.

Auditing Fair Value Measurements
Relevant Auditing Standards

AU 328, paragraph .09, states:

The auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.

AU 328, paragraph .23, states, in part:

For example, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) reviewing subsequent events and transactions.

Auditing Fair Value Measurements Relevant Auditing Standards

AU 328, paragraph .26, states, in part:

The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:

- Management's assumptions are reasonable and reflect, or are not inconsistent with, market information.
- The fair value measurement was determined using an appropriate model, if applicable.
- Management used relevant information that was reasonably available at the time.

Auditing Fair Value Measurements Relevant Auditing Standards

AU 328, paragraph .20, states, in part:

If the use of such a specialist is planned, the auditor should consider the guidance in section 336, *Using the Work of a Specialist*.

Auditing Fair Value Measurements
Relevant Auditing Standards

AU 336, *Using the Work of a Specialist* ("AU 336"), paragraph .12, states:

The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (*a*) **obtain an understanding of the methods and assumptions used by the specialist**, (*b*) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements. Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.

Auditing Fair Value Measurements
Relevant Auditing Standards

AU 328, paragraph .05, footnote 2, states, in part:

For purposes of this section, management's assumptions include assumptions developed by management under the guidance of the board of directors and assumptions developed by a specialist engaged or employed by management.

Case Study No. 3 – Safe and Reliable Bancorp

Case Study No. 3 – Safe and Reliable Bancorp Background

- Your firm was engaged to audit the December 31, 2013 financial statements of Safe and Reliable Bancorp (the "Bank"), a regional commercial bank
- At December 31, 2013, the Bank had available-for-sale investment securities that represented 30 percent of total assets, as follows:
  - Common stock of a large, actively traded, US public company (the “Big Stock”) represented half, and
  - Residential mortgage-backed securities of a government-sponsored enterprise (the “RMBS”) represented half

Case Study No. 3 – Safe and Reliable Bancorp Background

- The Bank engaged a reputable service organization to serve as custodian and record-keeper (the "Service Organization") of its investment securities
- The Service Organization uses quoted prices in an active market to value Big Stock
- Due to the complexity of valuing the RMBS, the Service Organization engages a pricing service to establish the fair value of the RMBS
- The pricing service uses a model with significant observable inputs, including quoted prices for similar securities, interest rates, default rates, and prepayment rates

Case Study No. 3 – Safe and Reliable Bancorp Scenario 1

- *Your Firm is conducting its audit of the Bank's 2013 financial statements*
- *You are the lead engagement partner and you are in a meeting with the engagement team to discuss the audit of investment securities*
- *The engagement team assessed inherent risk of the existence assertions for the investment securities to be low*
- *The engagement team assessed inherent risk of the valuation assertion for the investment in Big Stock to be low and for the RMBS to be high*

Case Study No. 3 – Safe and Reliable Bancorp Scenario 1

The audit procedures on investment securities included –

- *Obtained a copy of the Service Organization's 2013 statement of the Bank's investment securities directly from the Service Organization;*
- *Agreed the balances of investment securities reported in the Bank's financial statements to amounts in the Service Organization's statement without exception; and*
- *Obtained management's representation that investment securities were recorded in accordance with GAAP.*

Case Study No. 3 – Safe and Reliable Bancorp Scenario 1

- *Because the Service Organization was a large reputable company and its 2013 statement was provided directly to the engagement team and agreed to the bank's financial statements without exception, the audit manager believed that the engagement team fully supported the existence and the valuation assertions related to the Bank's investment securities.*

- What questions will you ask the engagement team during your review?

Case Study No. 3 – Safe and Reliable Bancorp Scenario 2

- *Scenario 2 is the same as Scenario 1 except that the following additional audit procedure*
- *Obtained a service auditor's report on controls placed in operation and tests of operating effectiveness over activities at the Service Organization (the "Service Auditor's Report").*
- *Considered whether the Service Auditor's Report was satisfactory for the engagement team's purposes, as follows:*
  - *concluded based on the results of inquiries of professional organizations and other professionals that the service auditor had a solid professional reputation;*

Case Study No. 3 – Safe and Reliable Bancorp Scenario 2

- *determined that the specific controls described in the Service Auditor's Report were relevant to the assertions that were significant to the Bank's investment securities, with the exception that there was no discussion regarding controls over the valuation assertion of the RMBS as the Service Organization outsourced the pricing of the RMBS to a pricing service; and*
- *determined, for those controls that are relevant, that the nature, timing, and extent of such tests of controls and results provide appropriate evidence about the effectiveness of the controls to support the engagement team's assessed level of control risk.*

Case Study No. 3 – Safe and Reliable Bancorp Scenario 2

- *Because the engagement team thoroughly considered whether the Service Auditor's Report was satisfactory for the engagement team's purposes, the audit manager believed that the engagement team fully supported the valuation assertion related to the Bank's investment securities.*

- What questions will you ask the engagement team during your review?

Case Study No. 3 – Safe and Reliable Bancorp Scenario 3

- *Scenario 3 is the same as Scenario 2 except that the following additional audit procedures were performed*
- *Engagement team performed substantive audit procedures on the valuation assertion of the RMBS as follows:*
  - *Assessed credentials of the pricing service*
  - *Evaluated pricing service's work for the intended purpose*
  - *Obtained an understanding of the model used to value RMBS and that it is generally an accepted model for valuing RMBS*

Case Study No. 3 – Safe and Reliable Bancorp Scenario 3

  - *Identified key assumptions used in the valuation model and assessed whether the assumptions (1) were consistent with those used in prior periods or (2) contradicted other information gathered by the auditor*

- What questions will you ask the engagement team during your review?

Question A

Auditing Standard No. 3, *Audit Documentation* ("AS 3"), paragraph 16, provides that audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate:

A. the date the information was added
B. the time incurred to prepare the added information
C. the name of the person who prepared the additional documentation
D. the additional fees billed for the added documentation
E. the reason the information was added

Question A

<u>Related guidance for Question A:</u>

- AS 3, paragraph 14, provides that the *report release date* is the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements.

- AS 3, paragraph 15, provides that the *documentation completion date* is a date on which a complete and final set of audit documentation is assembled for retention and which should not be more than 45 days after the report release date.

Question B

Auditing Standard No. 7, *Engagement Quality Review*, paragraph 5, provides that the engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as:

A. the chief accountant of the SEC
B. the engagement manager on the engagement under review
C. the firm's partner responsible for accounting and auditing consultations
D. the engagement partner on the engagement under review
E. the chief financial officer of the client

Auditing Accounting Estimates

Auditing Accounting Estimates Inspection Findings

- Failure to sufficiently perform one or a combination of the following procedures:
  - Test the process used by management to develop the estimate, or
  - Develop an independent expectation of the estimate to obtain corroboration of the reasonableness of the estimate, or
  - Review subsequent events or transactions occurring prior to the date of the auditor's report that would be relevant to evaluating the adequacy of the estimate
- When testing the process used by management, firms failed to:
  - Sufficiently evaluate the reasonableness of significant assumptions used, and
  - Sufficiently test the data underlying calculation of the estimate

Auditing Accounting Estimates
Relevant Auditing Standards

AU 342, *Auditing Accounting Estimates* ("AU 342"), paragraph .10 states, in part:

In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- Review and test the process used by management to develop the estimate.
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- Review subsequent events or transactions occurring prior to the date of the auditor's report.

Auditing Accounting Estimates
Relevant Auditing Standards

AU 342, paragraph .11 states, in part:

Review and test management's process. The following are procedures the auditor may consider performing when using this approach:

- Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose.
- Consider whether there are additional key factors or alternative assumptions about the factors.
- Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.

Auditing Accounting Estimates Relevant Auditing Standards

AS 14, *Evaluating Audit Results*, paragraph 27, states, in part:

If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates. Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using swings in estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

Auditing Accounting Estimates
Relevant Auditing Standards

AU 342, paragraph .04 states, in part:

Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.

Auditing Accounting Estimates
Relevant Auditing Standards

AU 316, *Consideration of Fraud in a Financial Statement Audit* ("AU 316"), paragraph .64 states:

The auditor also should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management. The significant accounting estimates selected for testing should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates. This review, however, is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

Auditing Accounting Estimates
Relevant Auditing Standards

AU 316, paragraph .65 states:

If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor should evaluate whether circumstances producing such a bias represent a risk of a material misstatement due to fraud. For example, information coming to the auditor's attention may indicate a risk that adjustments to the current-year estimates might be recorded at the instruction of management to arbitrarily achieve a specified earnings target.

Case Study No. 4 – Good Wood, Inc.

Case Study No. 4 – Good Wood, Inc. Background

- Your firm has been engaged to audit the year ended December 31, 2013 financial statements of Good Wood, Inc. (the "Company")
- The Company manufactures and sells wood products directly to the large builder supply companies and through distributors to smaller builder supply companies
- Began selling internationally in late 2012
- Experienced stronger growth in 2013 resulting in significant increases in revenue and net income
- Reported net income for 2013 of approximately $10 million on pretax income of approximately $15 million

Case Study No. 4 – Good Wood, Inc. Background

- The Company's most significant accounting estimate is its allowance for doubtful accounts
- Its allowance for doubtful accounts is based on
  - a specific reserve for known exposures and
  - a general reserve based on a historically determined percentage of each aging category
- Historically, the allowance has proven adequate in relation to bad debt write-offs

Case Study No. 4 – Good Wood, Inc. Background

- At December 31, 2013, the specific reserve was lower than in the prior year, as management indicated there were fewer problem accounts than in previous years
- The historical percentages applied to the aging categories in recent periods were maintained in estimating the general reserve at December 31, 2013
- As a result, the year-end allowance was consistent with prior year, despite a significant increase in accounts receivable
- The year-end allowance was $2.5 million less than it would have been if the allowance, as a percentage of accounts receivable, had remained consistent

Case Study No. 4 – Good Wood, Inc.
Scenario 1

- *The audit manager has prepared a plan for auditing the allowance that includes the following procedures:*
  - *Obtain an understanding of the process used by management to develop its allowance for doubtful accounts through inquiries and walkthroughs;*
  - *Obtain the issuer prepared allowance for doubtful accounts calculation, test the calculation for clerical accuracy, and agree the recorded allowance to the general ledger; and*

Case Study No. 4 – Good Wood, Inc.
Scenario 1

- *Obtain an issuer prepared comparative analysis for the year under audit to the prior year of:*
  - *gross accounts receivable balances,*
  - *days sales outstanding,*
  - *sales turnover, and*
  - *accounts receivable as a percentage of current assets.*

- What are the potential deficiencies in the above plan?

Case Study No. 4 – Good Wood, Inc. Scenario 2

- *The manager has presented a revised plan that includes the following procedures, in addition to those described in Scenario 1:*
- *Develop an independent estimate of the allowance by:*
  - *Using accounts receivable balances per the Company's aging reports*
  - *Obtain and analyze management's listing of problem accounts to determine necessary specific reserves*
  - *Recalculate the general reserve by applying the historical loss percentages utilized by management*
  - *Compare this independent calculation to the Company's allowance*

Case Study No. 4 – Good Wood, Inc.
Scenario 2

- *Compare the following data by aging category for the current and prior year-ends:*
  - *accounts receivable,*
  - *write downs,*
  - *specific reserves, and*
  - *historical loss percentages.*
- Do you see any problems with this revised plan?

Case Study No. 4 – Good Wood, Inc.
Scenario 3

- *The manager has prepared another plan that includes the following procedures, in addition to those described in Scenario 1:*
  - *Test the accuracy and completeness of the system-generated accounts receivable aging reports*
  - *Test the reasonableness of the historical loss percentages used the allowance calculation*
  - *Obtain management's listing of accounts with specific reserves and evaluate those reserves through review of the aging reports and other supporting documentation*

Case Study No. 4 – Good Wood, Inc.
Scenario 3

- *Select a sample of receivables from the aging reports based on risk criteria (e.g., days past due, times past due, dollar amount), and evaluate for appropriate identification as receivables evaluated for specific reserves; and*
- *Compare the following data by aging category at each quarter end for the current and prior years and evaluate variances over established thresholds: accounts receivable, write downs, specific reserves, and historical loss percentages*

- Do you see any problems with this revised plan?

Case Study No. 4 – Good Wood, Inc.
Scenario 4

- *During an August 2013 meeting with the Company's management, you learn that the Company is in the process of securing a larger operating line of credit with a new lender that will help support the Company's growth plans.*
- *Securing this line of credit is dependent upon the Company achieving pretax income level of $14 million for 2013.*

- Does this information affect the procedures performed by the engagement team to evaluate the reasonableness of the allowance for doubtful accounts?

Question C

Auditing Standard No. 14, *Evaluating Audit Results* ("AS 14"), paragraph 13, provides that if a range of reasonable estimates is supported by sufficient appropriate audit evidence and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat as a misstatement, the difference between the recorded accounting estimate and –

A. the midpoint of the range of reasonable estimates
B. the smallest amount in the range of reasonable estimates
C. the closest reasonable estimate
D. the square root of the average of all reasonable estimates

Question D

AS 14, paragraphs 20 and 21, provide that the auditor should evaluate whether identified misstatements might be indicative of fraud. If the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statements could be material or cannot be readily determined, the auditor should:

A. discuss the matter with the audit committee chair
B. determine whether other similar misstatements were identified that might reveal a pattern that should be investigated
C. call local law enforcement
D. perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred

Question D

<u>Related guidance for Question D:</u>

AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraph 79, provides that:

- Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee in a timely manner and prior to the issuance of the auditor's report.
- In addition, the auditor should reach an understanding with the audit committee regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower-level employees.

Evaluation of Goodwill for Impairment

Evaluation of Goodwill for Impairment Inspection Findings

- Failure to sufficiently test the significant assumptions, underlying data, and methodology used in the estimation of the fair value of a reporting unit
- Failure to evaluate whether other relevant information was inconsistent with management's determination that goodwill was not impaired based on certain qualitative factors
- Failure to sufficiently evaluate the identification of operating segments and reporting units

Evaluation of Goodwill for Impairment Relevant Auditing Standards

AU 342, paragraph .04, states:

The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.

Case Study No. 5 – Information is Good, Inc.

Case Study No. 5 – Information is Good, Inc. Background

- Your firm is auditing the 2013 financial statements of Information Is Good, Inc.'s (the "Company"), a provider of social media
- In September 2010, the Company acquired Paperweight Phones, Inc. ("Paperweight"), a manufacturer of cellular phones
- The Company presents Paperweight as a separate operating segment in its financial statements because Paperweight produces discrete financial information that is regularly reviewed by the Company's CEO to make decisions about resources to be allocated to the segment and to assess its performance

Case Study No. 5 – Information is Good, Inc. Background

- A material amount of goodwill resulted from the Company's purchase of Paperweight
- The goodwill was allocated to the Paperweight operating segment as of the acquisition date as the Company's social media operating segment was not expected to benefit from the combination
- Net income (loss) for the past three years was as follows (in millions):

Year	Social Media	Paperweight	Consolidated
2011	$ 20	$ 7	$27
2012	22	3	25
2013	25	(1)	24

Case Study No. 5 – Information is Good, Inc. Background

- The Company's quarterly filings in 2012 and 2013 have revealed a steady decline in Paperweight's revenue due to the first quarter 2012 release of a competitor's new cellular phone
- This new phone has dominated the cellular market since its release.
- Quarterly revenue for the Paperweight segment in 2013 was as follows (in millions):

Quarter Ended	Paperweight Revenue
March 31	$100
June 30	92
September 30	80

Case Study No. 5 – Information is Good, Inc. Background

- There has also been a reduction in the number of software applications available for Paperweight's cellular phones contributing to the decline in its use.
- On September 1, 2013, the Company's Board of Directors approved management's plan to introduce a more technologically relevant cellular phone product in an attempt to reclaim Paperweight's share of the market.
- The release of the new product is anticipated to occur in the second quarter of 2014.

Case Study No. 5 – Information is Good, Inc. Background

- For annual goodwill impairment test purposes, the Company's management views Paperweight as a separate reporting unit.
- The Company established its annual goodwill impairment test date to be October 1.
- In 2012, the new option became available to assess qualitative factors in determining whether it is necessary to perform the two-step goodwill impairment test.
- As a cost reduction measure starting in 2012, management employed the qualitative assessment relative to goodwill in the Paperweight reporting unit.

Case Study No. 5 – Information is Good, Inc. Background

- Based on the assessment, management concluded that it was more likely than not that the goodwill was not impaired at both October 1, 2012 and 2013.
- The Company last performed the first step of the two step goodwill impairment test as of October 1, 2011.
- That step one test utilized a discounted cash flow model to measure the reporting unit's fair value, which exceeded its carrying value by ten percent.
- The assumptions that were most significant to the discounted cash flow model were revenue and the projected growth rate for the reporting unit.

Case Study No. 5 – Information is Good, Inc. Scenario

- *You are the engagement partner on the audit and you are discussing the goodwill impairment evaluation with the engagement team.*
- *The relevant audit procedures performed by the engagement team included the following:*
- *Obtained management's Board approved plans for a new cellular phone and inquired about the progress of these plans; and*
- *Obtained management's representation that the impairment test was in accordance with GAAP.*

Case Study No. 5 – Information is Good, Inc. Scenario

- *Additional audit documentation stated: "It appears reasonable that it is more likely than not that the goodwill is not impaired. No further test work is deemed necessary."*
- *The Company's controller mentioned that his decision to utilize the qualitative assessment option in 2012 and 2013 was affected by his desire to not lose the option. Your manager agreed he should maintain the option.*

- What questions will you ask the engagement team during your review?

Case Study No. 5 – Information is Good, Inc. Evaluation of Goodwill for Impairment

FASB ASC paragraph 350-20-35-3 states:

An entity may first assess qualitative factors, as described in paragraphs 350-20-35-3A through 35-3G, to determine whether it is necessary to perform the two-step goodwill impairment test discussed in paragraphs 350-20-35-4 through 35-19. If determined to be necessary, the two-step impairment test shall be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any).

Case Study No. 5 – Information is Good, Inc. Evaluation of Goodwill for Impairment

FASB ASC paragraphs 350-20-35-3A and 3B state:

An entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount, including goodwill.

An entity has an unconditional option to bypass the qualitative assessment described in the preceding paragraph for any reporting unit in any period and proceed directly to performing the first step of the goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

Case Study No. 5 – Information is Good, Inc. Evaluation of Goodwill for Impairment

FASB ASC paragraph 350-20-35-3C states, in part:

In evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, an entity shall assess relevant events and circumstances. Examples of such events and circumstances include the following:

- an increased competitive environment
- a change in the market for an entity's products
- overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with prior periods

Case Study No. 5 – Information is Good, Inc. Evaluation of Goodwill for Impairment

FASB ASC paragraph 350-20-35-3F states, in part:

The examples included in paragraph 350-20-35-3C(a) through (g) : are not all-inclusive, and an entity shall consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit in determining whether to perform the first step of the goodwill impairment test. . . . **If an entity has a recent fair value calculation for a reporting unit, it also should include as a factor in its consideration the difference between the fair value and the carrying amount** in reaching its conclusion about whether to perform the first step of the goodwill impairment test.

Question E

Auditing Standard No. 16, *Communications with Audit Committees* (“AS 16”), paragraph 6, provides that the auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should:

A. report the matter to the Board of Directors
B. be glad that someone signed the letter
C. determine that the audit committee has acknowledged and agreed to the terms of the engagement
D. resign from the engagement

Question E

Related guidance for Question E:

- AS 16, paragraph 6, provides that the auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee annually.

- AS 16, paragraph 6, footnote 4, provides that absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

Question F

Staff Accounting Bulletin No. 108 provides that registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying and evaluating misstatements under both of the following approaches:

A. Rollunder
B. Parallel straddle
C. Rollover
D. Fosbury flop
E. Iron curtain

Question F

Related guidance for Question E from SAB 108:

- The rollover approach quantifies a misstatement based on the amount of the error originating in the current year income statement. Thus, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years (i.e., it ignores the “carryover effects” of prior year misstatements).

- The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement’s year(s) of origination.

Questions

Closing Remarks

Lew Ferguson and Brian Hunt