Forum on Auditing in the Small Business Environment

October 6, 2015

Pittsburgh, PA

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.

Opening Remarks and PCAOB Highlights

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

Jeanette Franzel, Board Member

Panel Discussion: Accounting Estimates Including Fair Value Measurements Plus Case Study No. 1

Moderator: Mary M. Sjoquist
Todd Tosti, Associate Director, Inspections
Greg Scates, Deputy Chief Auditor
John Abell, Associate Director, Accountant, Enforcement

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 based on information gathered in other audit tests.
- 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

AU 342, paragraph .12 states:

Develop an expectation. Based on the auditor's understanding of the facts and circumstances, he may independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors.

AU 342, paragraph .13 states:

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

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 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

Case Study No. 1 – On Your Way, Inc.

Case Study No. 1 – On Your Way, Inc. Background

- The Company designs, manufactures, and sells GPS navigational devices for both consumers and commercial distributors.
- During late 2014, the Company expanded its market beyond portable and handheld devices.
- This expansion was prompted by declines in sales of portable GPS devices beginning during the 1st quarter of 2014, which continued throughout 2014 and into 2015.
- Management attributes the decline in sales to the wider availability of GPS systems built into smart phones and automobiles, decreasing the demand for separate GPS devices.
- The Company's inventory write-offs also increased significantly in the second half of 2014.

Case Study No. 1 – On Your Way, Inc. Background

- The Company's inventory obsolescence reserve consists of the following two components:
  - **Specific reserve** – Company management uses its judgment to specifically identify certain inventories that it believes are obsolete and establishes a 100% obsolescence reserve for them.
  - **General reserve** – For the remainder of inventory, the Company records a general inventory obsolescence reserve of 10% of that total inventory, which Company management asserts is based on its familiarity with the Company's inventory on hand, sales history, and projected sales, as well as the fact that this product type is subject to rapidly changing technology. Management has not prepared a formal calculation or analysis to support this 10 percent reserve; however, management asserts that, historically, the reserve has proven adequate in relation to actual inventory write-offs.

Case Study No. 1 – On Your Way, Inc. Background

- The engagement team assessed inherent risk as moderate, control risk as high, and the risk of material misstatement as moderate for inventory valuation.
- The engagement team identified a significant risk related to inventory valuation.
- The Company’s system can provide various inventory and sales reports.
- Management has provided several such reports to your engagement team related to the year ended December 31, 2014.

Case Study No. 1 – On Your Way, Inc. Scenario 1

- *As the audit partner on the engagement, you are meeting with the engagement team to discuss the planning of the audit of inventory, in particular the audit of the inventory obsolescence reserve*
- *You ask the engagement team to consider using an approach of testing management's process for estimating the inventory obsolescence reserve, keeping in mind that it's one of the three prescribed approaches under AU 342, paragraph .10*

Case Study No. 1 – On Your Way, Inc.
Scenario 1

- What should the engagement team consider in developing its planned audit procedures related to the inventory obsolescence reserve?

- Are there any indicators of risk that the engagement team should consider that may impact its risk assessment and planned audit procedures related to this estimate?

- Will testing the process used by management to develop the estimate be an effective approach for auditing the inventory obsolescence reserve? Why or why not.

Case Study No. 1 – On Your Way, Inc. Scenario 1

- Auditor considerations:
  - Consideration of the 3 approaches under AU 342, par .10
  - Testing completeness and accuracy of information in reports used
  - Evaluating indications of possible management bias
  - Performing retrospective review
- Risk indicators:
  - Changes in industry / environment
  - Declining sales
  - Increased write-offs
- Testing management's process: Effective approach? - No
  - Management hasn't established a process that can be tested, but rather based the reserve on its general knowledge

Case Study No. 1 – On Your Way, Inc. Scenario 2

- *Your team considers developing an independent expectation of the estimate to corroborate the reasonableness of management's estimate.*

? What information provided by the Company would be useful in helping the engagement team develop its own independent estimate for the inventory obsolescence reserve? Are there any additional reports or other information that might be helpful?

? What procedures could the engagement team perform to develop its own estimate?

? Will developing an independent expectation be an effective approach for auditing the inventory obsolescence reserve? Why or why not.

Case Study No. 1 – On Your Way, Inc. Scenario 2

- Useful reports / data:
  - Reports listed in the background information for the case
  - Query data of slow-moving inventory
- Procedures to develop auditor's independent estimate:
  - Assess period for deeming inventory is slow moving / obsolete
  - Identify inventory that has not been purchased, utilized, or sold for that amount of time
  - Consider any obsolete inventory set aside during physical inventory count
  - Analytical procedures
- Effective approach? - Yes
  - Test completeness and accuracy of data
  - Consider qualitative factors
  - Document

Case Study No. 1 – On Your Way, Inc. Scenario 3

- *Your team considers reviewing subsequent events and transactions as an approach for auditing the estimate.*

? What procedures could the engagement team perform to audit the reserve through an evaluation of subsequent events information?

? What information or data would be useful to the engagement team in performing its procedures?

? Will reviewing subsequent events be an effective approach for auditing the inventory obsolescence reserve? Why or why not?

Case Study No. 1 – On Your Way, Inc. Scenario 3

- Procedures to evaluate subsequent events information:
  - Obtain data that correlates inventory on hand at year end to data of subsequent sales, production, and write-offs
  - Determine inventory that was either subsequently written off or subsequently had no sales or production
  - Compare total to Company's recorded obsolescence reserve
- Useful data:
  - For each inventory item on hand at December 31, 2014, information on sales, production, and write-offs in 2015 through the date of the auditor's report
  - Any subsequent events information of known or expected changes in demand for the Company's products
- Effective approach? - No
  - Subsequent period of a few months is unlikely to be long enough to have sufficient data regarding the estimate

Questions

Break

(15 minutes)

Keeping Current with PCAOB Standards

Greg Scates

Deputy Chief Auditor

October 6, 2015

Pittsburgh, PA

PCAOB

Public Company Accounting Oversight Board

Topics for Discussion

- Auditing Standard No. 18, *Related Parties*
- Reorganization of PCAOB Auditing Standards
- Audit Transparency Project
- Staff Consultation Paper, *The Auditor's Use of the Work of Specialists*
- Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*
- Going Concern
- Other Active PCAOB Standard-Setting Projects

AS 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)

- Auditing Standard No. 18 and the amendments are effective 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

Reorganization of PCAOB Auditing Standards

- The PCAOB approved the reorganization of its auditing standards on March 31, 2015
- The new organizational structure:
  - Renumbers and reorders existing standards without redrafting or making substantive changes
  - Presents standards in a logical order that generally follows the flow of the audit process
  - Help users navigate the standards more easily
  - Provides structure for future standard-setting

Reorganization of PCAOB Auditing Standards (cont'd)

"Interim" Standards

- AU 110
- AU 161
- AU 210
- Etc.

Reorganized Standards

(AS Sections)

Board-Issued Standards

- AS No. 1
- AS No. 3
- AS No. 4
- Etc.

Reorganization of PCAOB Auditing Standards (cont'd)

- Categories in the reorganized framework:
  - 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
- The reorganized auditing standards are effective as of December 31, 2016

Audit Transparency Project

Disclosure of the Name of the Engagement Partner and Certain Other Participants in the Audit

- On June 30, 2015, the Board issued a supplemental request for comment on an alternative method – a new PCAOB form - for disclosing the name of the engagement partner and information about certain other participants in the audit.
- Compared to disclosure in the auditor's report, which the Board proposed in 2013, this new form could be a new middle ground approach to balancing the potential benefits of such disclosure with the potential impact on auditors' private liability and litigation risk.
- The disclosure requirements would include –
  - Name of engagement partner
  - Names, locations, and extent of participation of other independent public accounting firms
- The supplemental request also seeks comment on disclosures of nonaccounting firm participants and engaged specialists.

Audit Transparency Project (cont'd)

Disclosure of the Name of the Engagement Partner and Certain Other Participants in the Audit

- Form AP (Auditor Reporting of Certain Audit Participants) would be –
  - Filed no later than 30 days after the date the auditor's report is first included in a document filed with the SEC, with a shorter deadline of 10 days for initial public offerings
  - Submitted similar to other PCAOB forms, through the PCAOB's existing web-based Registration, Annual, and Special Reporting system
  - Available on the Board's website in a searchable database
- In addition to filing Form AP, auditors could decide to voluntarily provide the same disclosures in the auditor's report.

Audit Transparency Project (cont'd)

Disclosure of the Name of the Engagement Partner and Certain Other Participants in the Audit

- The supplemental request for comment seeks comment on all aspects of the Form AP alternative, including how Form AP compares with the disclosure in the auditor's report proposed in the 2013 Release, its economic implications, and whether there are any special considerations relevant to audits of EGCs, brokers and dealers, and other entities.
  - The comment period closed on August 31, 2015.
- On July 1, 2015, the SEC published a concept release seeking public comment on current audit committee disclosure requirements, focusing on the committee's oversight of independent auditors. The Commission is interested in receiving information about the audit committee and auditor relationship and whether improvements can be made to enhance the information provided to investors about the audit committee's responsibilities and activities.
  - The comment period closed on September 8, 2015.

Staff Consultation Paper: *The Auditor's Use of the Work of Specialists*

PCAOB Standards That Govern the Use of the Work of Specialists

	#	Nature of Specialist's Involvement	Current Audit Requirements
Auditor's Specialist	1	Specialist employed by the auditor	*Supervision*: Auditor supervises the specialist under Auditing Standard No. 10. Specialist must be independent.
	2	Specialist engaged by the auditor	*Specified procedures*: Auditor performs the procedures required by AU sec. 336 and evaluates objectivity of the specialist
Company's Specialist	3	Specialist engaged by the company	*Specified procedures*: Auditor performs the procedures required by AU sec. 336 and evaluates objectivity of the specialist
	4	Specialist employed by the company	*Specified procedures*: Auditor performs the procedures required by AU sec. 336 and evaluates objectivity of the specialist

Staff Consultation Paper: *The Auditor's Use of the Work of Specialists* (cont'd)

Company's Specialist – Standard-Setting Alternatives

1. Amend AU sec. 336
   - Remove the provisions that may be considered to limit the auditor's responsibilities and make certain other improvements
     - For example, clarify "obtain an understanding" and consider requiring auditors to evaluate the reasonableness of assumptions and appropriateness of methods used by a company's specialist
2. Rescind AU sec. 336
   - Require the auditor to evaluate evidence provided by a company's specialist like evidence provided by others in the company

Staff Consultation Paper: *The Auditor's Use of the Work of Specialists* (cont'd)

Auditor's Specialist – Standard-Setting Alternatives: *Oversight*

1. Develop a separate standard that would apply to the work of both employed and engaged specialists
2. Extend supervision requirements in AS No. 10 to the work of engaged specialists

Potential new requirements, intended to improve the auditor's oversight, would apply under either alternative

Staff Consultation Paper: *The Auditor's Use of the Work of Specialists* (cont'd)

Auditor's Specialist – Standard-Setting Alternatives: *Independence and Objectivity*

1. Independence – Auditor would apply requirements similar to those in the SEC independence rules
   - Applies to the auditor's employed specialist
2. "Enhanced objectivity approach" – Auditor would evaluate whether the specialist's objectivity is impaired
   - Potential new requirements, based on SEC independence rules, are intended to improve the auditor's determination of whether the objectivity of the engaged specialist is impaired

Staff Consultation Paper: *The Auditor's Use of the Work of Specialists* (cont'd)

Project Timeline

Date	Action
May 28, 2015	Issued Staff Consultation Paper ("SCP"), *The Auditor's Use of the Work of Specialists*
June 18, 2015	SAG meeting discussion
July 31, 2015	Comment period closed
Next Steps	Consider SAG discussion and comments on SCP for potential rule making

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

- Staff consultation paper issued on August 19, 2014
- The staff consultation paper discusses or seeks comment 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
  - 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 PCAOB held a Standing Advisory Group meeting on October 2, 2014. The comment period closed November 3, 2014

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

- 41 comment letters were received
- High level themes from commenters
  - General support for a standard which is further integrated with the risk assessment standards and which retains the three existing approaches to testing estimates and fair value measurements
  - Mixed views on requirements related to the use of a third parties (e.g., pricing services and specialists) by management or the auditor
  - Measurement uncertainty

Going Concern

- Considering whether changes to PCAOB auditing standards are necessary in view of:
  - Changes to U.S. GAAP, which now require management to evaluate a company’s ability to continue as a going concern
- Issued Staff Audit Practice Alert No. 13, *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern* (September 22, 2014)
- Developing a staff consultation paper to solicit public comment

Going Concern – Staff Audit Practice Alert No. 13

- In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, including whether they contain the required disclosures, auditors should assess management's going concern evaluation
  - In making this assessment, the auditor should look to the requirements of the applicable financial reporting framework
- The Alert reminds auditors that AU sec. 341 requirements for the auditor's evaluation, and the auditor's reporting when substantial doubt exists, have not changed and continue to be in effect
- Auditors should continue to look to the existing requirements in AU sec. 341 when evaluating whether substantial doubt exists for purposes of determining whether the auditor's report should be modified

Other Active PCAOB Standard-Setting Projects

- Auditor's Reporting Model
- Auditor's Responsibility Regarding Other Information
- Supervision of Other Auditors and Multi-location Audit Engagements

Keeping Current with Standards-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

Securities and Exchange Commission
Division of Corporation Finance

FY 2015 Update

Disclaimer

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Agenda

- Regulatory Update
- Financial Reporting Issues
- Resources for Smaller Reporting Companies
- Questions

Regulatory Update

Regulatory Update

- Disclosure Effectiveness
- New Revenue Standard

Disclosure Effectiveness

- Comprehensive review of Regulations S-K and S-X
- Update, modernize and streamline disclosure requirements

Disclosure Effectiveness

- Striking the right balance between:
  - Providing investors information to make informed investment and voting decisions,
  - Bearing in mind compliance costs for companies, and
  - Considering efficiency, competition and capital formation

Disclosure Effectiveness

- Comprehensive review includes:
  - Evaluation of external stakeholder comments
  - Interaction with FASB projects
  - Internal analysis of disclosure requirements (i.e. Rule 3-05)

Disclosure Effectiveness Comments:
https://www.sec.gov/cgi-bin/ruling-comments

Disclosure Effectiveness

- Companies can make changes now:
  - Reduce duplication
  - Eliminate immaterial information
  - Come talk to us

SEC filings are more than compliance documents; they are communication documents to investors.

Disclosure Effectiveness

- Myth #1 – Each section of the 10-K must standalone
- Myth #2 – Additional disclosures are required to address SEC comments
- Myth #3 – Any changes to previous year's disclosures triggers SEC comments

New Revenue Standard

- Revenue from Contracts with Customers (ASU 2014-09)
- Substantially converged with International Financial Reporting Standards
- Effective for reporting periods beginning after Dec. 15, 2017

New Revenue Standard

- Existing guidance complex, detailed, and disparate
- Standard establishes principles for reporting nature, timing and uncertainty of revenue
- Financial reporting transition issues (e.g. selected financial data)

Financial Reporting Issues

Financial Reporting Issues

- Statement of Cash Flows
- Internal Control over Financial Reporting
- Fair Value
- Liability/Equity Determination
- Auditor Matters
- Income Taxes
- Goodwill

Financial Reporting Issues

- Statement of Cash Flows
- Internal Control over Financial Reporting
- Fair Value
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Statement of Cash Flows

- Restatements due to errors continue to increase
- Majority of errors related to less complex applications of GAAP
- Consider adequacy of internal controls in this area

Statement of Cash Flows

- How is your client collecting the financial data necessary to prepare the statement?
- What processes are in place to ensure information is complete and accurate, especially new/nonrecurring transactions?
- Are there manual processes that could be standardized or automated?
- Do individuals preparing and reviewing the statement understand the principles in Topic 230?

Financial Reporting Issues

- Statement of Cash Flows
- Internal Control over Financial Reporting
- Fair Value
- Liability/Equity Determination
- Auditor Matters
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- Goodwill

Internal Control over Financial Reporting

- Identification of the deficiency
- Evaluation of the severity of the deficiency
  - "…the <u>potential</u> misstatement resulting from the deficiency…"
  - Actual error is only starting point
  - Must evaluate "the could factor"

SEC Release No. 33-8810
Management's Report on ICFR

Financial Reporting Issues

- Statement of Cash Flows
- Internal Control over Financial Reporting
- Fair Value
- Liability/Equity Determination
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Fair Value

- Measurement Issues
- Disclosure Issues
- Management’s Responsibility

What is Fair Value?

Fair value is the price to sell an asset or amount paid to transfer a liability (ASC 820-10-30).

Assumes:

1. Exit price
2. Principal market
3. Orderly transaction
4. Between market participants

Measurement Issues

- Equity transactions
- Stock issued as compensation
- Business combinations
- Impairment testing

Equity Transactions

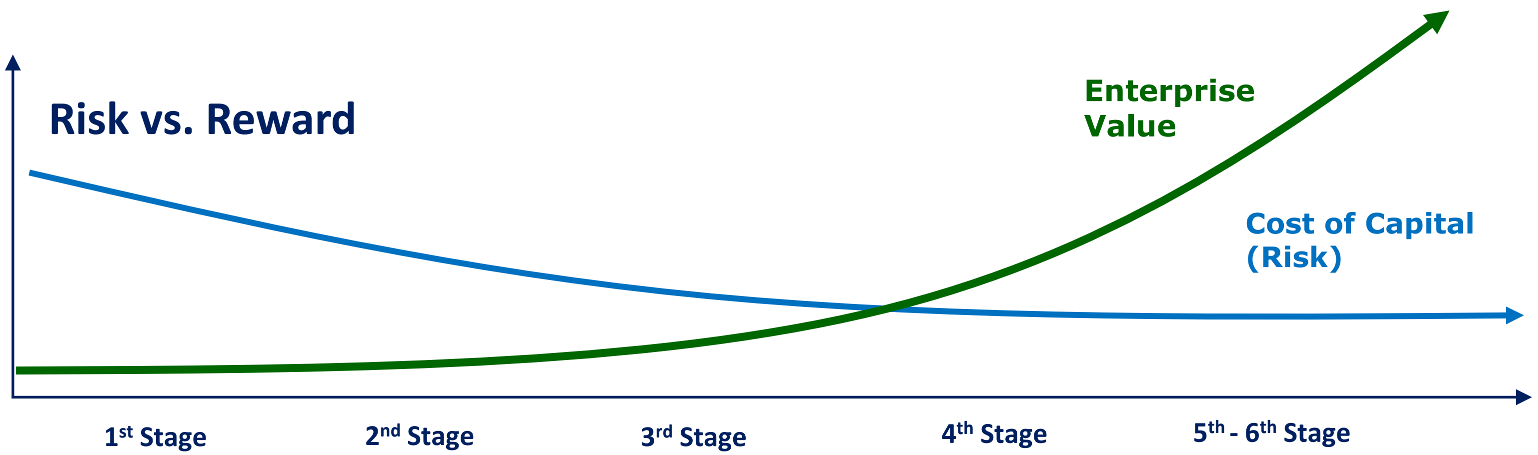
- Fair value will equal P x Q
- Active Market considerations
  - Sufficient frequency and volume to provide pricing information on an ongoing basis
  - Includes most Over-the-Counter (OTC) markets
- Use of Discounts
  - Limited and caveated in guidance
  - Results in lower level of fair value hierarchy

Stock Issued as Compensation

- Methodology
  - Option Pricing Model
  - PWERM
  - Current Value Method
- Stage of Development

Stock Issued as Compensation

- Discount Rates



Business Combinations

- Measurement of consideration
  - Contingent Consideration
  - Assumed Liabilities
- Disproportionate amount of goodwill
  - Identification and measurement of intangible assets
  - Defensive Assets

Impairment Testing

- More likely than not
- Overly Optimistic Assumptions
  - Long term growth rates
  - Return on Assets vs. Industry Returns
  - Deviations from peers
- Control Premiums

Disclosures

- Classification drives disclosure requirements
- Required disclosures for both recurring and nonrecurring fair value measurements
- Valuation technique and significant inputs

Management Responsibilities

- Understand methodologies and inputs used to measure fair value
- Implement internal controls over the valuation process
- Assess valuation expert's qualifications

Use of valuation expert does not absolve management's responsibilities

Financial Reporting Issues

- Statement of Cash Flows
- Internal Control over Financial Reporting
- Fair Value
- Liability/Equity Determination
- Auditor Matters
- Income Taxes
- Goodwill

Liability/Equity Determination

- Does it meet the definition of a freestanding financial instrument?
  - Entered into separately and apart from other instruments/transactions, or
  - Legally detachable and separately exercisable
- If freestanding, initially evaluate under topic 480
- If embedded, evaluate under topic 815, including subtopic 815-40

Liability/Equity Determination

- Determine host contract
- Evaluate whether embedded feature requires bifurcation from host:

Clearly and Closely related to host contract?
Hybrid = Marked to market under other GAAP?
If feature is freestanding, is it a derivative?

Liability/Equity Determination

- Determine host contract
- Evaluate whether embedded feature requires bifurcation from host:

Clearly and Closely related to host contract?
Hybrid = Marked to market under other GAAP?
If feature is freestanding, is it a derivative?

Underlying? Notional and/or Payment Provision?
Small initial net investment?
Net settleable?
Qualify for Scope Exception?

Liability/Equity Determination

- Determine host contract
- Evaluate whether embedded feature requires bifurcation from host:

Clearly and Closely related to host contract?

Hybrid = Marked to market under other GAAP?

If feature is freestanding, is it a derivative?

Underlying? Notional and/or Payment Provision?

Small initial net investment?

Net settleable?

Qualify for Scope Exception?

Indexed to Entity's Own Stock?

Classified in Equity?

Financial Reporting Issues

- Statement of Cash Flows
- Internal Control over Financial Reporting
- Fair Value
- Liability/Equity Determination
- Auditor Matters
- Income Taxes
- Goodwill

Auditor Matters

- Audit Reports (S-X Rule 2-02)
- Independence Considerations (S-X Rule 2-01)
  - IPO (AICPA vs. PCAOB Standards)
  - Accounting Assistance
  - Non-Audit Services

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

Auditor Matters:

Enforcement and Other Actions

- Eight Audit Firms that Audited Broker-Dealers (December 2014)

http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543608588

- EY - Lobbying (July 2014)

http://www.sec.gov/litigation/admin/2014/34-72602.pdf

- KPMG (January 2014)

http://www.sec.gov/litigation/admin/2014/34-71389.pdf

http://www.sec.gov/litigation/investreport/34-71390.pdf

Financial Reporting Issues

- Statement of Cash Flows
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Income Taxes:

Rate Reconciliation Issues

- Unclear or incomplete labeling
- Inappropriate aggregation (5% rule)
- Inconsistency of disclosures
- Corrections of errors labeled as changes in estimates

Rate Reconciliation	%
Statutory Tax Rate	34.0%
Inventory Rebalancing	8.9%
Miscellaneous Other	-18.0%
Valuation Allowance	-3.4%
Prior year change in estimate	-7.0%
Effective Tax Rate	14.5%

Income Taxes:
Valuation Allowance

- Changes in valuation allowance require significant judgment
- Continually evaluate all of the positive and negative evidence
- Weight evidence based on how objectively verifiable

Consider consistency of assumptions with other disclosures (e.g. goodwill, MD&A)

Financial Reporting Issues

- Statement of Cash Flows
- Internal Control over Financial Reporting
- Fair Value
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Goodwill

- Identify reporting units as either:
  - Operating segment, or
  - Component of operating segment (FASB ASC 350-20-35-34)

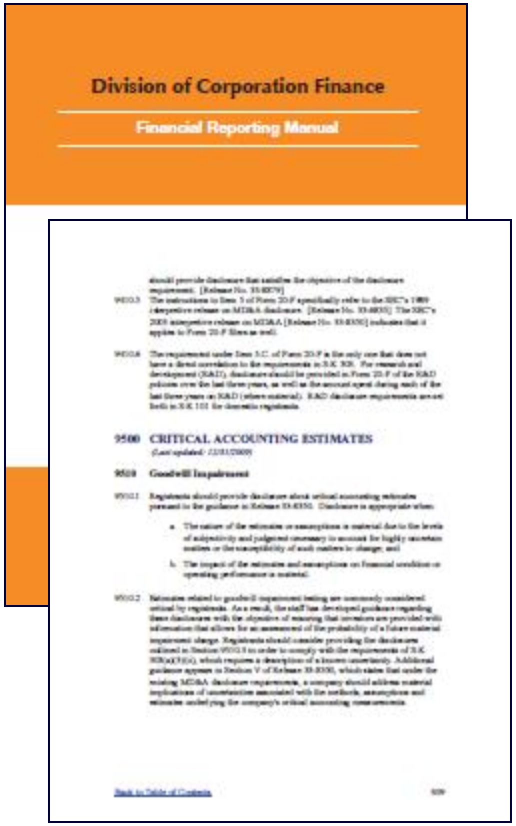
Goodwill

- MD&A Requirements
  - Disclose known trends and uncertainties
  - Consider “at-risk” reporting units

Goodwill

- Multiple ways to comply with MD&A requirements
- One way – FRM section 9510
  - How much goodwill is "at risk"
  - Percentage by which fair value exceeded carrying value
  - Methods and key assumptions utilized and how they were determined
  - Degree of uncertainty associated with key assumptions
  - Events that are reasonably likely to negatively affect key assumptions

Financial Reporting Manual Section 9510



Resources for
Smaller Reporting Companies

Reverse Mergers

Form 8-K

Shell Company

"ShellCo"

- Public Co.
- No / Limited operations
- Legal Acquirer/ Accounting Acquiree
- Issues shares to effect the transaction

Operating Co. becomes public

Pro Forma FS

- Equity Structure of Shell Co.
- Historical and continuing operations of Operating Co.

Operating Company

"OpCo"

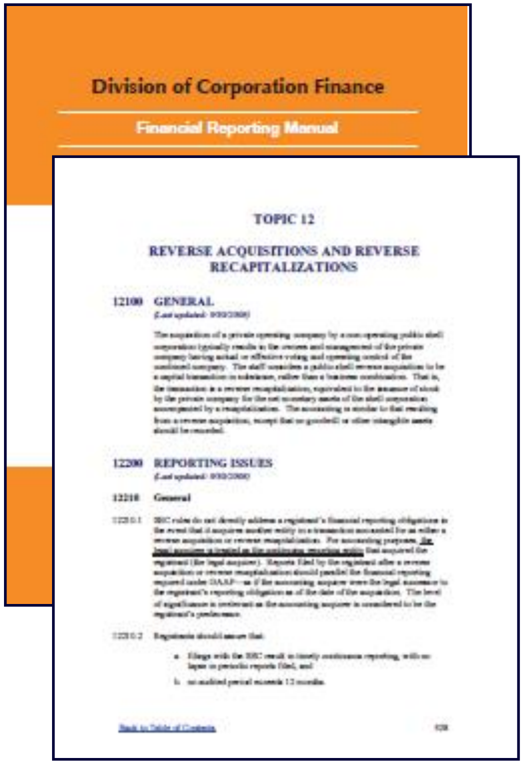
- Private Co.
- Historical operations
- Legal Acquiree/ Accounting Acquirer

Reverse Mergers:

Form 8-K Considerations

- Form 10-type information as required by Item 5.01(a)(8) of Form 8-K
  - Historical financial statements of OpCo
  - Due 4 business days from transaction date
  - Financial Statements often require updating

FRM Topic 12


Division of Corporation Finance

Financial Reporting Manual

TOPIC 12

REVERSE ACQUISITIONS AND REVERSE RECAPITALIZATIONS

12100 GENERAL

12200 REPORTING ISSUES

12210 General

Financial Statements of OpCo must be audited by PCAOB registered firm.

Reverse Mergers:

Post Transaction Equity Accounting

- Maintain equity structure of ShellCo
  - *Par value & common stock of ShellCo remain*
- Maintain historical and continuing operations of OpCo
  - *R/E of ShellCo eliminated; R/E of OpCo carried forward*

Reverse Mergers:

Post Transaction Equity Accounting

- Retroactively restate OpCo historical equity activity to account for exchange ratio
  - *Shares Issued by ShellCo / OpCo Shares Outstanding (e.g. 4 to 1 ratio)*
- Ensure EPS is retroactively restated

Financial Reporting Resources

Resource	Link
Division of Corporation Finance Website	http://www.sec.gov/corpfin
SEC Small Business Website	http://www.sec.gov/info/smallbus.shtml
Division of Corporation Finance Filing Review Process	http://www.sec.gov/divisions/corpfin/cffilingreview.htm
SRC Transition Guidance	http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf#topic5
1933 Act	http://www.sec.gov/about/laws/sa33.pdf
1934 Act	http://www.sec.gov/about/laws/sea34.pdf
Financial Reporting Manual (FRM)	http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml
Compliance and Disclosure Interpretations (C&DI)	http://www.sec.gov/divisions/corpfin/cfguidance.shtml

Financial Reporting Resources

Resource	Link
Disclosure Guidance Topic 1 Reverse Mergers	http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic1.htm
Disclosure Guidance Topic 5 Smaller Financial Institutions	http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic5.htm
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

Valuation Resources

Resource
FASB ASC Topic 820 *Fair Value Measurement*
AICPA Accounting & Valuation Guide: Testing Goodwill for Impairment
AICPA Accounting & Valuation Guide: Valuation of Privately-Held Company Equity Securities Issued as Compensation
AICPA Practice Aid: Auditing Fair Value Measurements and Disclosures

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
  - U.S. GAAP: SEC Office of the Chief Accountant at 202-551-5300 or OCA@sec.gov
  - Small Business Policy: CF Office of Small Business Policy (202) 551-3460
  - Interpretive legal questions: CF Office of Chief Counsel at 202-551-3500
  - EDGAR questions: EDGAR Filer Support at 202-551-8900

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 GAAP should be sent to - OCA@sec.gov www.sec.gov/info/accountants/ocasubguidance.htm

Questions

Lunch

(70 minutes)

Inspection Findings and Case Studies

Presenters

Todd Tosti, Associate Director, Division of Registration and Inspections

Greg Scates, Deputy Chief Auditor, Office of the Chief Auditor

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

Agenda

- Top Inspection Findings and Potential Root Causes
- Inspection Findings and Related Case Studies

Top Inspection Findings and Potential Root Causes

- 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”)

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 –

- Due professional care, including professional skepticism
- Technical competence
- Audit methodology
- Supervision and review
- Partner and professional staff work load
- Client acceptance and retention

Inspection Findings and Related Case Studies

- Auditing Accounting Estimates *(covered earlier)*
- Auditing Revenue
- Auditing Related Party Transactions
- Auditing Equity Transactions

Auditing Revenue

Auditing Revenue Inspection Findings

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

Auditing Revenue
Relevant Auditing Standards

AS 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.

Auditing 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.

Auditing 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.

Auditing 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.**

Auditing Revenue
Relevant Auditing Standards

AU 329, paragraphs .17 and .19 state, in part:

The expectation **should be precise enough** to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate.

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.**

Auditing Revenue
Relevant Auditing Standards

AU 350, *Audit Sampling* ("AU 350"), paragraph .24 states:

Sample items should be selected in such a way that the sample can be expected to be **representative of the population**. Therefore, all items in the population should have an opportunity to be selected. For example, haphazard and random-based selection of items represents two means of obtaining such samples.

Case Study No. 2 – Revenue Cycles, Inc.

Case Study No. 2 – Revenue Cycles, Inc. Background

- The Company owns and operates a chain of bicycle shops that sell new bicycles and bicycle parts and provide bicycle maintenance services.
- Included with each bicycle sold, the Company provides all scheduled maintenance services at no additional charge for a three year period from the date of sale.
- The Company also sells maintenance services separately to customers who either did not purchase their bicycles from the Company or purchased their bicycles from the Company and desire to continue receiving scheduled maintenance services beyond the initial three-year contract period.

Case Study No. 2 – Revenue Cycles, Inc. Background

- The Company accounts for its revenue as multiple element arrangements. Revenue is recognized upon delivery of the product or services. The amount allocated to any unclaimed annual maintenance is recognized as revenue upon expiration of the customer's right to such service.
- The Company records revenue weekly based on invoices generated for bicycle sales, which reflect batches of customer transaction activity over that period of time.
- Approximately 60 percent, 15 percent, and 25 percent of the Company's revenue is earned from new bicycle sales, sales of parts, and maintenance services, respectively.

Case Study No. 2 – Revenue Cycles, Inc. Scenario 1

- *You are the engagement partner on the audit and are meeting with your engagement team to discuss the audit plan related to revenue.*
- *You are aware of the Company's multiple-element arrangements related to its new bicycle sales.*
- *The engagement team has assessed revenue to be both a significant risk and a fraud risk.*

? **What key points should be addressed in the planned audit work related to the engagement team's testing of the Company's multiple-element arrangements?**

Case Study No. 2 – Revenue Cycles, Inc. Scenario 1

ASC 605-25-25-5 states, in part:

In an arrangement with multiple deliverables, the delivered item or items shall be considered a separate unit of accounting if both of the following criteria are met:

- The delivered item or items **have value to the customer on a standalone basis**. The item or items have value on a standalone basis if they are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), this criterion does not require the existence of an observable market for the deliverable(s).
- If the arrangement includes a general **right of return** relative to the delivered item, delivery or performance of the undelivered item or items is considered probable and substantially in the control of the vendor.

Case Study No. 2 – Revenue Cycles, Inc. Scenario 1

<u>Identify</u> Multiple Deliverables Considered to be Separate Units of Accounting

(i.e. do the bicycles and maintenance each represent separate units of accounting)

- The first condition of separation is met for the bicycle (delivered item) because it is considered to have standalone value, as the customer could resell the bicycle on a standalone basis.
- The second condition for separation is also met, as there are no refund or return rights in the arrangement.
- Therefore, both the bicycle and the maintenance should be considered separate units of accounting.

Case Study No. 2 – Revenue Cycles, Inc.
Scenario 1

Value Multiple Deliverables Considered to be Separate Units of Accounting

ASC 605-25-30-2 states, in part:

Arrangement consideration shall be allocated at the inception of the arrangement to all deliverables on the basis of their **relative selling price** (the relative selling price method)... When applying the relative selling price method, the selling price for each deliverable shall be determined using **vendor-specific objective evidence** of selling price, if it exists; otherwise, **third-party evidence** of selling price... If neither vendor-specific objective evidence nor third-party evidence of selling price exists for a deliverable, the vendor shall use **its best estimate** of the selling price for that deliverable.

Case Study No. 2 – Revenue Cycles, Inc. Scenario 1

PCAOB Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements* notes the following example deficiencies observed by Inspections staff :

- *Evaluate each of the deliverables to determine whether they represented separate units of accounting; and*
- *Test the value assigned to the undelivered elements (for example, allocation of relative selling price based on vendor-specific objective evidence, third party evidence or best estimate of selling price).*

Case Study No. 2 – Revenue Cycles, Inc. Scenario 2

- *You and your engagement team had decided to test controls related to revenue and, as a result, to reduce the amount of substantive testing to be performed.*
- *As the engagement partner, you are particularly interested in the test(s) of controls related to the Company's multiple-element revenue arrangements.*
- *The following was documented in the audit work papers –*

Case Study No. 2 – Revenue Cycles, Inc. Scenario 2

Revenue Cycle Control

The Company's revenue sub-ledger software system captures all new bicycle and parts sales, recognizes maintenance services as they are performed, and also allocates any multiple-element maintenance service revenue earned based on valuation model parameters input by Company management following review of the Company's standard contract language.

The revenue sub-ledger system then downloads its reported activity into the Company's general ledger system.

The Controller runs a weekly exception report, which identifies any differences between the revenue sub-ledger system and the revenue reported in the general ledger system to ensure that all revenue is captured and recognized appropriately. Any fluctuations of ten percent or more must be explained.

Case Study No. 2 – Revenue Cycles, Inc. Scenario 2

- *To test this control, the engagement team reviewed a selection of exception reports, noting no significant differences and noting the Controller's signature as indication that the review had been performed. The engagement team concluded that this control was operating effectively.*

? **What questions or concerns would you have in determining whether the procedures performed by the engagement team related to controls testing described in the work papers were sufficient?**

Case Study No. 2 – Revenue Cycles, Inc. Scenario 2

- Consider that the engagement team reviewed a selection of exception reports noting no significant differences and the Controller’s signature indicating the review had been performed.

  - Is just an indication that a review had been performed sufficient, given the Company’s revenue recognition and the risks assessed by the Firm?

  - The engagement team is relying on system-generated reports. Have information technology general controls (ITGCs) been tested in relation to the revenue sub-ledger system and the GL system?

- Would this control, if operating as it was designed, effectively prevent or detect material errors or fraud?

Case Study No. 2 – Revenue Cycles, Inc. Scenario 2

PCAOB Staff Audit Practice Alert No. 12 notes instances in which auditors appeared to place unsupported reliance on controls due, in part, to the following:

- The results of the testing identified control deficiencies indicating that the controls were ineffective; or
- The auditor failed to perform sufficient procedures to test the design and operating effectiveness of the company's controls over a significant category of revenue because it failed to evaluate whether the control addressed the relevant assertions for revenue.

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

- *The engagement team identified a material weakness in the Company's internal controls related to its revenue recognition.*
- *You have scheduled a meeting with your audit manager to discuss a revised testing approach for the current year audit of the Company's revenue.*
- *Because the engagement team is unable to rely on controls, the manager has presented an audit plan for a completely substantive approach.*

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

Substantive Procedures to be Performed:	
Tests of details	Select the five largest new bicycle sales contracts, all of which include maintenance agreements, and test the valuation of revenue for the bicycle sales and maintenance elements.
	Haphazardly select 40 transactions (each of which includes new bicycle revenue and maintenance revenue) near the year end from the revenue sub-ledger, in order to gain assurance on not only the valuation but also the completeness of revenue.
Substantive analytical procedures	Perform substantive analytical procedures by comparing gross margin by month for the current year under audit to the prior year, providing explanations for any fluctuations of ten percent or more.

? **What questions or concerns would you have in determining whether the substantive procedures performed by the engagement team as described above would be sufficient?**

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

Test of Details – Sales Contract Selection

The engagement team should have selected these contracts in an effort to meet the objective of the intended audit procedure – i.e. address the risk of material misstatement, specifically related to those high risk assertions related to occurrence, valuation, and completeness.

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

Test of Details – Sales Transaction Selection

Haphazard selection might not have been responsive to the risks identified. Consider the following:

- The selection made by the engagement team was near the year-end under audit, which could have helped the Firm address the completeness assertion (cut-off), but skews the selection towards a certain time of the year and doesn't allow for all revenue transactions throughout the year to have an opportunity to be selected for testing. As a result, it wouldn't be a representative sample, thereby leaving possible gaps in the engagement team's audit of the relevant assertions.

- The haphazard selection included new bicycle sale and maintenance sale transactions, but neglected to include any parts sale transactions, leaving approximately 15% of the Company's revenue not being subjected to substantive tests of details.

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

PCAOB Staff Audit Practice Alert No. 12 states the following related to applying audit sampling procedures to test revenue:

Designing substantive tests of details includes determining the means of selecting items for testing from among the items included in an account. The auditor is required to determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is ***sufficient to meet the objective of the audit procedure****. The alternative means of selecting items for testing are:*

- *Selecting all items;*
- *Selecting specific items; and*
- *Audit sampling*

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

Inspections staff observed instances in which auditors did not appropriately design and perform sampling procedures to test revenue transactions. Instances of such deficiencies included:

- *Using samples that were too small to provide sufficient audit evidence;*
- *Failing to select a representative sample of items for testing, which is necessary to be able to extend the auditor's conclusions to the entire population (for example, limiting the sample selection to certain types of revenue transactions or contracts within the population); and*
- *Failing to apply audit procedures to all of the sample items selected and inappropriately evaluating the sample results as if the untested sample items were tested without exception.*

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

Substantive Analytical Procedures

- Are they sufficient, in accordance with AU 329, *Substantive Analytical Procedures?*
- What procedures were performed on the data and reports used in connection with the analytical procedures?

AU 329, par. 16 states, in part:

Before using the results obtained from substantive analytical procedures, the auditor should **either test the design and operating effectiveness of controls** over financial information used in the substantive analytical procedures **or perform other procedures to support the completeness and accuracy of the underlying information**… The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data.

Case Study No. 2 – Revenue Cycles, Inc.
Scenario 3

Substantive Analytical Procedures

- Is the level of precision in the expectations sufficient? It would seem that the expectation is that revenue would be consistent with the prior year. Is that appropriate? Is that sufficient?

- Is it appropriate to use 10% as the threshold for investigating differences?

> **AU 329, par. 20** states, in part:
>
> …the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures.

- Have the analytical procedures been disaggregated by revenue stream?

Case Study No. 2 – Revenue Cycles, Inc. Scenario 3

PCAOB Staff Audit Practice Alert No. 12 states the following related to substantive analytical procedures:

To achieve the necessary level of assurance from a substantive analytical procedure, the auditor should design and perform analytical procedures that appropriately take into account, among other things, the following:

1. *The nature of the assertion;*
2. *The plausibility and predictability of the relationship;*
3. *The availability and reliability of the data used to develop the expectation;*
4. *The precision of the expectation; and*
5. *The threshold for investigation of differences.*

Question A

The auditor should accumulate uncorrected misstatements in an audit. When evaluating the effect of uncorrected misstatements, the evaluation should take into account:

A. Both qualitative and quantitative factors
B. Whether the misstatements are material, either individually or in combination with other misstatements
C. The impact of the misstatements in relation to specific accounts and disclosures
D. The impact of the misstatements in relation to the financial statements as a whole
E. The effects of uncorrected misstatements detected in prior years
F. All of the above

Question A

AS 14, par. 17 and **18** state, in part:

The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.

The auditor's evaluation of uncorrected misstatements… should include evaluation of the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

Question B

Assume you are auditing a financial institution, and the financial institution engages a real estate appraiser to determine the fair value of real estate (collateral) for a collateral-dependent impaired loan. Which of the following audit standards would apply when using work of that specialist (the real estate appraiser):

A. AU 336, *Using the Work of a Specialist*

B. AU 328, *Auditing Fair Value Measurements and Disclosures*

C. Both AU 336 and AU 328

D. Neither AU 336 nor AU 328

Question B

Au 328, paragraph .26 states, in part:

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.

Footnote 2 of AU 328 states:

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**.

Auditing Related Party Transactions

Auditing Related Party Transactions Inspection Findings

- Failure to obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflect their economic substance

- Failure to test for undisclosed related parties or undisclosed related party transactions

- Failure to identify and address the omission or inadequacy of disclosure of related party transactions in the financial statements

Auditing Related Party Transactions Relevant Auditing Standards

AS 18, *Related Parties*, ("AS 18"), was issued on June 10, 2014

- Replaces AU 334, *Related Parties*
- Amends auditing standards regarding significant unusual transactions

AS 18 is effective 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

Auditing Related Party Transactions
Relevant Auditing Standards

AS 18, paragraph 3 states, in part:

The auditor should perform procedures to **obtain an understanding** of the company's relationships and transactions with its related parties that might reasonably be expected to affect the **risks of material misstatement** of the financial statements in conjunction with performing risk assessment procedures in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

a. Obtaining an understanding of the company's process (paragraph 4);
b. Performing inquiries (paragraphs 5–7); and
c. Communicating with the audit engagement team and other auditors (paragraphs 8–9).

Auditing Related Party Transactions
Relevant Auditing Standards

AS 18, paragraphs 10 and 11 state, in part:

The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. This includes **identifying and assessing the risks of material misstatement** associated with related parties and relationships and transactions with related parties, including whether the company has properly identified, accounted for, and disclosed its related parties and relationships and transactions with related parties.

The auditor must **design and implement audit responses** that address the identified and assessed risks of material misstatement. This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.

Auditing Related Party Transactions Relevant Auditing Standards

AS 18, paragraph 12 states, in part:

For each related party transaction that is either **required to be disclosed in the financial statements or determined to be a significant risk**, the auditor should:

a. Read the underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
b. Determine whether the transaction has been authorized and approved;
c. Determine whether any exceptions to the company's established policies or procedures were granted;
d. Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Auditing Related Party Transactions
Relevant Auditing Standards

Regarding **identification** of related parties and transactions, AS 18, paragraphs 14 and 15 state, in part:

Evaluating whether a company has properly identified its related parties and relationships and transactions with related parties involves more than assessing the process used by the company. This evaluation requires the auditor to perform procedures to **test the accuracy and completeness** of the related parties and relationships and transactions with related parties identified by the company.

If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties, in fact, exist. **These procedures should extend beyond inquiry of management**.

Auditing Related Party Transactions Relevant Auditing Standards

AS 18, paragraph 16 states, in part:

If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

a. **Inquire** of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;
b. Evaluate **why** the related party or relationship or transaction with a related party was previously undisclosed to the auditor;
c. Promptly **communicate** to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;
d. Assess the need to perform **additional procedures** to identify other relationships or transactions with the related party previously undisclosed to the auditor;
e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is **required to be disclosed in the financial statements or determined to be a significant risk**; and
f. …**Reassess the risk of material misstatement** and perform additional procedures as necessary if such reassessment results in a higher risk

Case Study No. 3 – Sturdy Piping, Inc.

Case Study No. 3 – Sturdy Piping, Inc. Background

- Your firm is auditing the financial statements of Sturdy Piping, Inc. (the "Company") for the year ended December 31, 2015.
- Your firm is the principal auditor, with another auditor auditing a small subsidiary in Canada.
- You are aware of the following related party transactions with Big Town Metals, Inc., which is an entity that is partially owned by the CEO of the Company:
  - The Company purchases approximately 25% of its raw materials from Big Town Metals; and
  - The Company has a number of notes receivable due from Big Town Metals, which in the aggregate account for approximately 10% of the Company's total assets.
- All of the notes receivable are long-term, and one of them was issued in 2015. None of the notes have matured yet, and there have been no payments on the notes to date.

Case Study No. 3 – Sturdy Piping, Inc. Scenario 1

- *You are the engagement quality reviewer (EQR) and arrive at the Company's facilities to meet with the engagement team, who has already completed the majority of the audit procedures.*
- *The engagement partner and manager are aware that AS 18 is now effective and believe they have modified their procedures accordingly.*
- *The engagement team has determined that there is a significant risk associated with the accuracy and completeness of amounts reported as related party transactions.*
- *The engagement team has performed procedures to test the accuracy and completeness of the amounts reported as purchases and notes receivable from Big Town Metals.*

Case Study No. 3 – Sturdy Piping, Inc.
Scenario 1

- *The engagement team has also performed the following:*
  - *Made inquiries with the CFO regarding the existence or related parties and related party transactions*
  - *Obtained an understanding of the Company's process for identifying related parties and related party transactions, which includes the approval of related party transactions and review of disclosures for the financial statements*
  - *Reviewed Board minutes*
  - *Reviewed legal invoices and the letter from the Company's lawyers to the Firm*
- *No new related parties or related party transactions were identified as a result of performing the above procedures. The engagement team also plans to obtain a management representation letter that will include statements that all related party transactions have been identified and disclosed and are at arm's length.*

? **What questions will you ask the engagement team?**

Case Study No. 3 – Sturdy Piping, Inc. Scenario 1

Potential questions the EQR could ask the engagement team:

- What did you cover in the inquiries with the CFO? Did you cover everything in par. 5 of AS 18?

AS 18, par. 5 states:

The auditor should inquire of management regarding:

a. The names of the company's related parties during the period under audit, including changes from the prior period;

b. Background information concerning the related parties (for example, physical location, industry, size, and extent of operations);

c. The nature of any relationships, including ownership structure, between the company and its related parties;

d. The transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;

e. The business purpose for entering into a transaction with a related party versus an unrelated party;

f. Any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and

g. Any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

Case Study No. 3 – Sturdy Piping, Inc.
Scenario 1

Potential questions the EQR could ask the engagement team:

- Did you make inquiries with anyone other than the CFO?

AS 18, par. 6 and **7** state:

6. The auditor should inquire of **others** within the company regarding their knowledge of the matters in paragraph 5 of this standard. The auditor should identify others within the company to whom inquiries should be directed, and determine the extent of such inquires, by considering whether such **individuals are likely to have knowledge regarding**:

a. The company's related parties or relationships or transactions with related parties;

b. The company's controls over relationships or transactions with related parties; and

c. The existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

7. The auditor should inquire of the **audit committee**, or its chair, regarding:

a. The audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and

b. Whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

Case Study No. 3 – Sturdy Piping, Inc. Scenario 1

Potential questions the EQR could ask the engagement team:

- Did you communicate the related party transaction information to the rest of the engagement team, as well as the other auditors that are auditing the subsidiary in Canada?

AS 18, par. 8 and **9** state:

8. The auditor should **communicate to engagement team members** relevant information about related parties, including the names of the related parties and the nature of the company's relationships and transactions with those related parties.

9. If the auditor is using the work of another auditor, the auditor should **communicate to the other auditor** relevant information about related parties, including the names of the company's related parties and the nature of the company's relationships and transactions with those related parties. The auditor also should inquire of the other auditor regarding the other auditor's knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor's communications.

Case Study No. 3 – Sturdy Piping, Inc. Scenario 1

Potential questions the EQR could ask the engagement team:

- For the identified related party transactions with Big Town Metals, did you perform all the procedures specified by par. 12 of AS 18, such as determining that amounts were authorized or approved (e.g. the new note issued), and evaluating the financial capability of Big Town Metals to pay back the notes?

AS 18, par. 12 states, in part:

For each related party transaction that is either **required to be disclosed in the financial statements or determined to be a significant risk**, the auditor should:

a. Read the underlying documentation and evaluate the terms and other information;
b. Determine whether the transaction has been authorized and approved;
c. Determine whether any exceptions to the company's policies were granted;
d. Evaluate the financial capability of the related parties; and
e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Case Study No. 3 – Sturdy Piping, Inc. Scenario 1

Potential questions the EQR could ask the engagement team:

- Did you evaluate whether the Company has properly identified its related parties and related party transactions?

Appendix A of AS 18 provides examples of where indications of other possible related parties could be found:

- Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
- Disclosures contained on the company's website;
- Confirmation responses and responses to inquiries of the company's lawyers;
- Tax filings and related correspondence;
- Invoices and correspondence received from the company's professional advisors, for example, attorneys and consulting firms;
- Relevant internal auditors' reports;
- Conflicts-of-interest statements from management and others;
- Life insurance policies purchased by the company;
- Shareholder registers that identify the company's principal shareholders;
- Records of the company's investments, pension plans, and other trusts established for the benefit of employees, including the names of the officers and trustees of such investments, plans, & trusts;
- Contracts or other agreements with management;
- Significant contracts renegotiated by the company during the period under audit;
- Records from a management, audit committee, or board of directors' whistleblower program;
- Expense reimbursement documentation for executive officers;
- The company's organizational charts

Case Study No. 3 – Sturdy Piping, Inc. Scenario 2

- *Same facts as in Scenario 1.*
- *In addition, although performed late in the audit process, the engagement team has now made inquiries with the internal auditor and the VP of sales regarding related parties and related party transactions.*
- *As a result, the engagement team has now discovered that in February 2015, the Company's CEO invested in The Plumbing King and now has an 18% ownership in that entity.*
- *The Plumbing King is the Company's largest customer, and accounted for approximately 40% of the Company's revenues in 2015 and approximately 20% in 2014.*

Case Study No. 3 – Sturdy Piping, Inc. Scenario 2

- *In light of this new discovery, the audit team discussed the matter with the CFO.*
- *The CFO informed the audit team that she didn't think to mention it earlier because she didn't believe that the CEO's investment in The Plumbing King had any impact on the Company's operations, as it was already the Company's largest client prior to and after February and since she believed the sales arrangements between the two companies had not changed since February.*
- *The CFO did agree that it should now be disclosed in the financial statements as a related party transaction.*
- *The audit team has now tested the completeness and accuracy of the amount reported as sales to The Plumbing King.*

? **What additional procedures should the engagement team perform as a result of this discovery?**

Case Study No. 3 – Sturdy Piping, Inc.
Scenario 2

Perform the procedures called for in par. 16 of AS 18.

AS 18, par. 16 states, in part:

If the auditor determines that a related party or relationship or transaction with a related party previously undisclosed to the auditor exists, the auditor should:

a. **Inquire** of management regarding the existence of the related party or relationship or transaction with a related party previously undisclosed to the auditor and the possible existence of other transactions with the related party previously undisclosed to the auditor;

b. Evaluate **why** the related party or relationship or transaction with a related party was previously undisclosed to the auditor;

c. Promptly **communicate** to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information about the related party or relationship or transaction with the related party;

d. Assess the need to perform **additional procedures** to identify other relationships or transactions with the related party previously undisclosed to the auditor;

e. Perform the procedures required by paragraph 12 of this standard for each related party transaction previously undisclosed to the auditor that is **required to be disclosed in the financial statements or determined to be a significant risk**; and

f. …**Reassess the risk of material misstatement** and perform additional procedures as necessary if such reassessment results in a higher risk

Question C

Auditing Standard No. 7, *Engagement Quality Review* ("AS 7"), provides that an engagement quality reviewer should:

A. Evaluate significant judgments made by the engagement team and the related conclusions reached
B. Evaluate the engagement team's assessment of significant risks and fraud risks
C. Evaluate the engagement team's audit responses to not only significant risks and fraud risks, but also to those accounts and assertions that are not determined to be significant risks or fraud risks
D. Provide concurring approval of issuance of the audit report only if the engagement partner assures the engagement quality reviewer that any significant engagement deficiencies identified by the engagement quality reviewer will be resolved prior to issuance of the report
E. Review not only the firm's year-end audit work in connection with the Form 10-K filing, but also the firm's review work performed on interim financial information in connection with Form 10-Q filings

Question C

AS 7, par. 10 states, in part:

In an audit, the engagement quality reviewer should:

b. Evaluate the engagement team's assessment of, and audit responses to –

- **Significant risks** identified by the engagement team, including **fraud risks**, and
- **Other significant risks identified by the engagement quality reviewer** through performance of the procedures required by this standard.

AS 7, par. 12 states:

In an audit, the engagement quality reviewer may provide concurring approval of issuance **only if**, after performing with due professional care the review required by this standard, **he or she is not aware of a significant engagement deficiency**.

Question D

Which of the following statements are true about auditor communications with audit committees in accordance with AS 16, *Communications with Audit Committees*:

A. The auditor should communicate its audit strategy, including its planned use of the work of other auditors and the company's internal auditors.
B. The auditor should communicate conclusions reached regarding critical accounting estimates and the auditor's basis for determining that they are reasonable.
C. All of the audit committee communications required by AS 16 should occur prior to the issuance of the auditor's report.
D. All of the audit committee communications required by AS 16 must be communicated in the form of written communication. The communications cannot be oral.

Question D

AS 16, par. 25 states, in part:

The auditor should communicate to the audit committee the matters in this standard, either orally or in writing, unless otherwise specified in this standard. The auditor must document the communications in the work papers, whether such communications took place orally or in writing.[42/]

[42/] Consistent with the requirements of Auditing Standard No. 3, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the provisions of this standard.

Auditing Equity Transactions

Auditing Equity Transactions Inspection Findings

- Failure to obtain an understanding of the key terms of agreements related to the issuance of equity securities
- Failure to test the estimates of fair value for equity instruments, including the inputs, assumptions, and methodologies used in determining the fair value measurements
- Failure to confirm or reconcile the number of shares outstanding with the stock transfer agent

Auditing Equity Transactions
Relevant Auditing Standards

AU 328, *Auditing Fair Value Measurements and Disclosures* ("AU 328"), paragraphs .03 and .23 state, in part:

The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. . . . Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a **preference for the use of observable market prices** to make that determination.

Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures . . . . 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.

Case Study No. 4 – Stark Innovations, Inc.

Case Study No. 4 – Stark Innovations, Inc. Background

- Your firm was engaged to audit the December 31, 2014 financial statements of the Company.
- On January 1, 2013, the Company exited its primary line of business to pursue a new endeavor and as a result re-entered the development stage.
- The Company's common stock is quoted on OTCBB with very low daily market activity.

Case Study No. 4 – Stark Innovations, Inc. Scenario 1

- *Your firm is conducting its review of the Company's financial statements for the quarter ended June 30, 2014.*
- *During the review, your firm is performing auditing procedures with respect to any significant transactions as part of the year-end audit.*
- *You are the engagement partner and have just arrived at the client's site for a meeting with the engagement team to discuss the audit procedures related to significant equity transactions.*
- *In your discussions with the engagement team, you learned about the following equity transaction –*

Case Study No. 4 – Stark Innovations, Inc.
Scenario 1

- *On June 1, 2014, the Company issued stock options for 1,000,000 shares of common stock at an exercise price of $0.50, as supplemental compensation to the CEO, CFO, and COO in conjunction with new employment contracts.*
- *The Company's controller told the Firm that these awards were granted for transitioning the Company into the development stage in 2013.*
- *As such, the Company fully recognized the related compensation expense in the quarter ended June 30, 2014.*
- *The Company valued the shares of common stock issued using the Black-Scholes option-pricing model in order to estimate the fair value of the options at approximately $350,000.*

Case Study No. 4 – Stark Innovations, Inc.
Scenario 1

Options were valued using the following inputs and assumptions:

- *Exercise price: **$0.50*** *[based on quoted stock price]*
- *Stock price: **$0.50*** *[based on quoted stock price]*
- *Risk-free rate: **1.55%*** *[based on US government treasury bills with a 5-year maturity]*
- *Expected term: **5 years*** *[based on 5-year contractual term of new employment contracts]*
- *Volatility: **90%*** *[based on historical volatility over a 5-year period, using weekly prices for the first 3 years and daily prices for the latter 2 years]*

Case Study No. 4 – Stark Innovations, Inc. Scenario 1

- *The audit procedures performed by the engagement team related to this equity transaction entailed –*
  - *Recalculating the share-based payment expense as calculated by the Company;*
  - *Recalculating the historical volatility as determined by the Company for all options granted during the quarter; and*
  - *Agreeing the risk-free rate used to calculate the fair value of all options granted during the quarter to rates published on the Federal Reserve website.*

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

? Are the audit procedures described above sufficient and in accordance with AU 328?

Case Study No. 4 – Stark Innovations, Inc. Scenario 1

- Has the engagement team assessed the reasonableness of the assumptions and inputs used in the valuation model for the stock options granted?
  - Exercise price
  - Risk-free rate
  - Expected volatility
  - Stock price
  - Expected term

Case Study No. 4 – Stark Innovations, Inc. Scenario 1

Is the 5-year expected term reasonable?

ASC 718-10-55-30 and **31** state, in part:

The expected term of an employee share option or similar instrument is the period of time for which the instrument is **expected to be outstanding** (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement). The expected term is an assumption in a closed-form model.

Other factors that may affect expectations about employees' exercise and post-vesting employment termination behavior include the following:

- Employees' historical exercise and post-vesting employment termination behavior for similar grants.
- Employees' ages, lengths of service, and home jurisdictions (that is, domestic or foreign).
- …

Case Study No. 4 – Stark Innovations, Inc. Scenario 1

Is the 90% expected volatility reasonable?

ASC 718-10-55-37 states, in part:

Factors to consider in estimating expected volatility include the following:

- Volatility of the share price, including changes in that volatility and possible mean reversion of that volatility. Mean reversion refers to the tendency of a financial variable, such as volatility, to revert to some long-run average level... In computing historical volatility, for example, **an entity might disregard an identifiable period of time in which its share price was extraordinarily volatile** because of a failed takeover bid if a similar event is not expected to recur during the expected or contractual term.
- **Appropriate and regular intervals for price observations.** If an entity considers historical volatility in estimating expected volatility, it shall use intervals that are appropriate based on the facts and circumstances and that provide the basis for a reasonable fair value estimate. For example, a publicly traded entity would likely use daily price observations, while a nonpublic entity with shares that occasionally change hands at negotiated prices might use monthly price observations.

Case Study No. 4 – Stark Innovations, Inc. Scenario 1

Has the Company recognized the expense in the appropriate period?

ASC 718-10-35-2 states, in part:

The compensation cost for an award of share-based employee compensation classified as equity shall be **recognized over the requisite service period**, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is **the period during which an employee is required to provide service** in exchange for an award, which **often is the vesting period**.

ASC 718-10-55-69 states, in part:

An **explicit service period** is one that is stated in the terms of the share-based payment award. For example, an award that vests after three years of continuous employee service has an explicit service period of three years, which also would be the requisite service period.

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

- *Your firm is conducting the year-end audit of the Company's 2014 financial statements.*
- *You are the engagement partner on the engagement and have just arrived at the client's site for a meeting with the engagement team to discuss the audit procedures related to significant equity transactions.*
- *In your discussions with the engagement team, you learned about the following two equity transactions –*

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

- *On October 1, 2014, the Company issued in total 500,000 shares of common stock to two consultants for two-thousand hours of product development services to be provided ratably over the twelve-months ending September 30, 2015.*
- *The shares cliff vest on September 30, 2015 if all services have been provided.*
- *Forfeiture of shares is the only consequence of non-performance for the consultants.*
- *The Company is recognizing the expense ratably over the twelve month period.*
- *The Company valued the shares at the $1.00 per share quoted price on the issuance date.*
- *The market rate for the services to be provided by the consultants is $175 per hour.*

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

- *On December 1, 2014, the Company issued a total of 3,000,000 shares of the Company's common stock for cash to a group of investors.*
- *The Company valued the shares of common stock at $1.00 per share, which was the quoted price of the Company's common stock on the issuance date.*

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

- *The audit procedures performed by the engagement team related to the equity transactions entailed –*
  - *Obtaining a copy of the Board meeting minutes in which the issuance of common stock to the two consultants at a fair value of $1.00 per share was approved;*
  - *Recalculating total compensation of $500,000 (500,000 shares at $1.00 per share) to be recognized as $125,000 of compensation expense each quarter during the twelve months ending September 30, 2015;*
  - *Verifying that $125,000 of compensation expense related to stock issued to consultants was recognized in the 2014 financial statements;*
  - *Obtaining management's representation that the issuance of common stock to the two consultants was recorded at the fair value on the issuance date in accordance with GAAP;*
  - *Agreeing shares issued for cash to Board minutes and bank statements; and*
  - *Vouching the $1.00 stock price to historical stock quote websites.*

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

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

- Are the described audit procedures sufficient?

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

Relevant accounting guidance: ASC 505-50, *Equity-Based Payments to Non-Employees*

ASC 505-50-30-11 states:

An entity (the issuer, grantor, or purchaser) may enter into transactions with nonemployees in which equity instruments are issued in exchange for the receipt of goods or services or to provide a sales incentive. The issuer shall measure the fair value of the equity instruments in these transactions using the stock price and other measurement assumptions **as of the earlier of the following dates**, referred to as the measurement date:

a. The date at which a **commitment for performance** by the counterparty to earn the equity instruments is reached (a performance commitment)
b. The date at which the counterparty's **performance is complete**.

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

Is there a performance commitment?

ASC 505-50-30-12 states, in part:

A performance commitment is a commitment under which performance by the counterparty to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance. The disincentives must result from the relationship between the issuer and the counterparty. **Forfeiture of the equity instruments as the sole remedy in the event of the counterparty's nonperformance is not considered a sufficiently large disincentive for purposes of applying this guidance**.

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

Determining the expense prior to the measurement date

ASC 505-50-30-13 states, in part:

The counterparty's **performance is complete when the counterparty has delivered** or, in the case of sales incentives, purchased the goods or services . . .

ASC 505-50-30-21 states, in part:

The quantity and terms of the equity instruments may be known up front. If this is the case and if it is appropriate under GAAP for the issuer to recognize any cost of the transaction during financial reporting periods **before the measurement date**, for purposes of recognition of costs during those periods **the equity instruments shall be measured at their then-current fair values at each of those interim financial reporting dates**.

Case Study No. 4 – Stark Innovations, Inc. Scenario 2

Is the $1.00 stock price appropriate for valuing the transaction?

ASC 505-50-30-2 states, in part:

share-based payment transactions with nonemployees shall be measured at the **fair value** of the consideration received or the fair value of the equity instruments issued, **whichever is more reliably measurable**.

ASC 820-10-35-54D states, in part:

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

Case Study No. 4 – Stark Innovations, Inc. Scenario 3

- *Your firm is conducting the year-end audit of the Company's 2014 financial statements.*
- *You are the engagement partner on the engagement and are reviewing the Company's draft of its Statement of Cash Flows and the corresponding audit work papers.*
- *New fact discovered:*
  - *500,000 of the 3,000,000 shares of its common stock issued on December 1, 2014 represented a non-cash transaction to settle prior liabilities in the amount of $500,000.*

Case Study No. 4 – Stark Innovations, Inc. Scenario 3

? Take a look at the Statement of Cash Flows. Based on the transactions in Scenarios 1, 2, and 3, has the Company complied with ASC 230, *Statement of Cash Flows*, in recording the various equity transactions?

? Are there any other errors in the Statement of Cash Flows?

Case Study No. 4 – Stark Innovations, Inc. Scenario 3

Auditor's responsibility related to the Statement of Cash Flows

AS 14, par. 30 and **31** state, in part:

30. The auditor **must evaluate whether the financial statements are presented fairly, in all material respects**, in conformity with the applicable financial reporting framework.

31. As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a **fair presentation of the financial statements** in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

Case Study No. 4 – Stark Innovations, Inc. Scenario 3

Stark Innovations, Inc.		
Statement of Cash Flows		
Year ended December 31, 2014		
CASH FLOWS USED IN OPERATING ACTIVITIES		
Net loss	$	(3,640,000)
Adjustments to reconcile net loss to net cash		
used in operating activities:		
Amortization and depreciation		210,000
Loss on sale of equipment		15,000
Expense for stock issued in exchange for services		125,000
Change in operating assets and liabilities:		
(Increase) decrease in:		
Prepaid expenses and other assets		(100,000)
Investments		(80,000)
Other assets		10,000
Increase (decrease) in:		
Accounts payable		(235,000)
Accrued expenses		145,000
Net cash used in operating activities		(3,550,000)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment		(20,000)
Proceeds from issuance of common stock		3,000,000
Proceeds from sale of equipment		5,000
Net cash provided by investing activities		2,985,000
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from revolver		480,000
Amortization of deferred financing costs		1,500
Payments on long-term debt		(120,000)
Net cash provided by financing activities		361,500
Net decrease in cash and cash equivalents		(203,500)
Cash and cash equivaletns, beginning of the period		4,120,000
Cash and cash equivalents, end of period	$	3,916,500
SUPPLEMENTAL CASH FLOW INFORMATION AND NON-CASH FINANCING AND INVESTING ACTIVITIES:		
Cash paid for interest	$	70,000
Cash paid for income taxes	$	-

Question E

According to paragraph 6 of AS 3, which of the following statements are true about Audit Documentation:

A. The auditor **must** document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions

B. Audit documentation must **clearly** demonstrate that the work was in fact performed

C. The documentation requirement applies to the work of **all** who participate in the engagement as well as to the work of **specialists** the auditor uses as evidential matter in evaluating relevant financial statement assertions

D. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to determine **who performed** the work and the **date** such work was completed as well as the person **who reviewed** the work and **date** of such review

E. A, B, and D only

F. All of the above

Question E

AS 3, par. 6 states:

The auditor **must** document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. Audit documentation must **clearly** demonstrate that the work was in fact performed. This documentation requirement applies to the work of **all** those who participate in the engagement as well as to the work of **specialists** the auditor uses as evidential matter in evaluating relevant financial statement assertions. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:

a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and
b. To determine **who performed** the work and the **date** such work was completed as well as the person **who reviewed** the work and the **date** of such review. Note: An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

Question F

QC 30, paragraph .02 indicates that monitoring of a firm's accounting and auditing practice involves an ongoing consideration and evaluation of:

A. Relevance and adequacy of the firm's policies and procedures
B. Profitability of the firm relative to its financial plan or target
C. Appropriateness of the firm's guidance materials and any practice aids
D. Effectiveness of professional development activities
E. Compliance with the firm's policies and procedures

Question F

QC 30, paragraph .02 states, in part:

Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, describes *Monitoring* as one of the five elements of quality control... Monitoring involves an ongoing consideration and evaluation of the —

a. Relevance and adequacy of the firm's policies and procedures.

b. Appropriateness of the firm's guidance materials and any practice aids.

c. Effectiveness of professional development activities.

d. Compliance with the firm's policies and procedures.

Questions

Break

(15 minutes)

Remediation Success

Characteristics of satisfactory and non-satisfactory remediation submissions

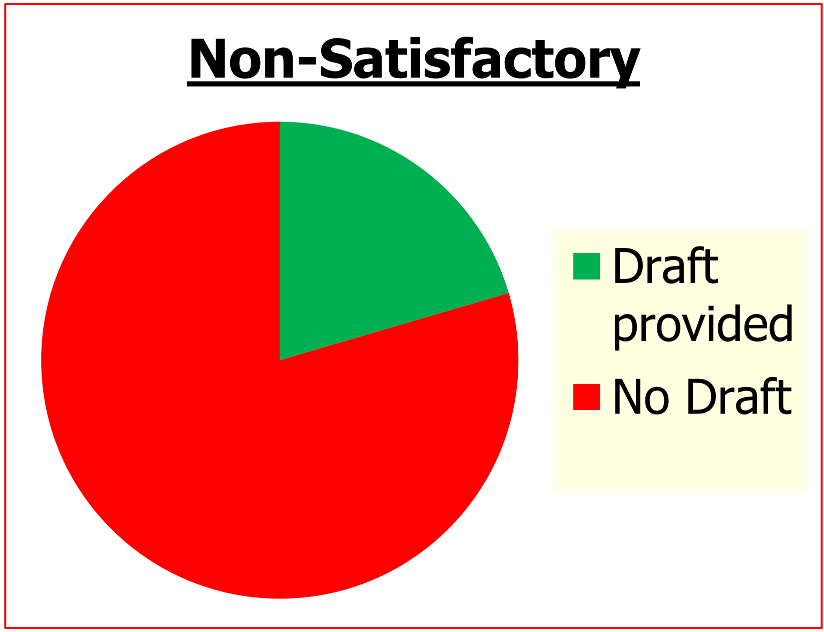
Remediation Success

Ellen Graper
Associate Director
Division of Registration and Inspections

Characteristics of Non-satisfactory Submissions

What not to do…

- Fail to provide a written submission by the deadline
- Wait until just prior to the deadline to respond
- Fail to provide a draft submission for staff review
- Fail to initiate a dialogue with the staff early in the remediation period
- Continue to argue the merits of the original comment form



Characteristics of Satisfactory Submissions

What to do…

- Initiate dialogue with the staff **early** in remediation period
- Provide a draft response **early** in the process
- Perform a root cause analysis
- Present organized and thorough responses
- Support response with documentary evidence
- Review PCAOB staff guidance on website

Example A – Tree House CPAs

<u>IIB. – Testing appropriate to the audit - revenue</u>

- Failure to sufficiently test multiple element revenue transactions

<u>Other specifics</u>

- Report was issued January 31, 2014.
- Firm sent remediation submission on January 28, 2015.
- Firm has 12 partners and 16 managers in three offices.
- There are eight issuer audits performed by the firm at two of their office locations.

Example A – Tree House CPAs

Asserted actions

- An Engagement Partner and the EQR partner attended a training session covering updates to SEC rules and regulations and PCAOB standards.
- The firm began to use a supplemental revenue audit program.
- One of the firm’s offices held a staff meeting on January 14, 2015 to discuss the inspection results.

Evidence provided

- CPE certificates from the training session
- Supplemental revenue audit program
- Engagement Partner’s CPE log for the last two years supported by CPE certificates all of the courses on the log
- Selected work papers from a subsequent issuer audit where multiple element revenue transactions were evaluated

Example A – Tree House CPAs

Remedial actions relationship to evidence provided

Asserted actions	Evidence provided
Engagement partner and EQR attended training session on updates to SEC rules and regulations and PCAOB standards.	CPE certificates
Firm began to use a supplemental revenue audit program.	The supplemental revenue audit program
One of the firm's offices held a staff meeting on January 14, 2015 to discuss the inspection results.	
	The Engagement Partner's CPE log for the last two years
	Selected work papers from a subsequent issuer audit

Example A – Tree House CPAs

Reasons for a non-satisfactory determination

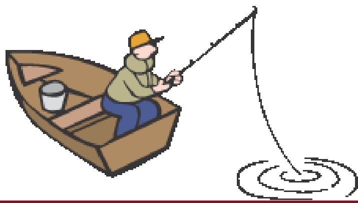
Action/ Evidence	Reason for non-satisfactory determination
Standards update training	Training materials were not provided. Course was most likely not sufficiently correlated to the report criticism. Attendance was limited to two individuals.
Supplemental revenue audit program	The supplemental audit program was available at time of the audit subject to the inspection and firm failed to use it. The program itself does not represent a change to the firm's system of quality control.

Example A – Tree House CPAs

Reasons for a non-satisfactory determination, continued

Action/ Evidence	Reason for non-satisfactory determination
Office meeting	The meeting was limited to only one of the firm's two offices. No evidence of the meeting was provided to allow the staff to determine if the discussion was sufficiently correlated to the criticism.
Engagement Partner CPE log	The firm did not provide sufficient details of the training course to allow the staff to determine the correlation of the course content to the report criticism.
Subsequent audit work papers	The firm did not indicate which remedial action the work papers were meant to support. The firm failed to indicate how the changes made to these work papers apply to all of the firm's issuer engagements.

Example B – We R Fishing CPAs



II B. – Testing appropriate to the audit - inventory

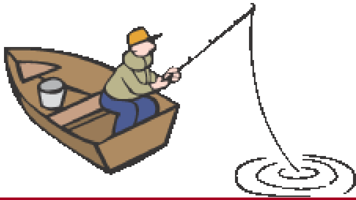
- Failure to sufficiently test the inventory obsolescence reserve

Other specifics

- Report was issued February 27, 2014.
- Firm provided a draft remediation submission on July 31, 2014.
- Firm has 20 partners and 10 managers in two offices.
- The firm audits one issuer.

Asserted actions	Evidence provided
The firm intends to conduct a training session on professional skepticism.	
The issuer audit engagement team discussed documentation during an audit planning meeting.	The firm provided the memo from the audit planning meeting.

Example B – We R Fishing CPAs



Update

- The draft submission was evaluated by the PCAOB staff and the staff's feedback was discussed with the firm on August 15, 2014.
- Based on this feedback, the firm revised its remedial actions and supporting evidence, as demonstrated below:

Updated remedial actions

Asserted actions	Evidence provided
The firm conducted a training session on auditing accounting estimates.	The firm provided the presentation and attendance records from the training.
The firm implemented a practice aid for testing inventory reserves.	The firm provided the practice aid.
The firm added a requirement to its inventory audit program that inventory reserves shall be audited by Senior In-charge level or higher.	The firm provided an updated (and previous) inventory audit program with the new requirement.

Resources

Resources:

- http://pcaobus.org/Inspections/Pages/Remediation_Process.aspx
- The firm's remediation contact from the report transmittal letter.

Questions

Division of Enforcement and Investigations Update

John Abell
Associate Director
October 6, 2015
Pittsburgh, PA

Agenda

- Today we would like to discuss:
  - Select Recent Disciplinary Proceedings
  - Adjudicated Matter
  - Rules Regarding Association

Recent Settled Disciplinary Proceedings

Select Recent Settled Disciplinary Proceedings

- Randall A. Stone, CPA
- Akiyo Yoshida, CPA
- Morrill & Associates, LLC, Douglas W. Morrill, CPA, and Grant L. Hardy, CPA
- Madsen & Associates, CPAs, Inc. and Ted A. Madsen, CPA
- Broker-Dealer Auditor Independence Matters – December 2014

**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.*

Randall A. Stone, CPA - July 7, 2014

- Stone, a former partner of PricewaterhouseCoopers LLP ("PwC"), was in charge of the 2007 audit of ArthroCare Corporation
  - Stone failed to properly address numerous indicators that ArthroCare was improperly recognizing revenue on sales to one of its largest distributors ("DiscoCare")
  - Arthrocare recorded sales to DiscoCare on the sell-in method and paid DiscoCare an upfront consulting fee
  - Stone failed to address the red flags despite identifying specific fraud risks relating to revenue recognition

Randall A. Stone, CPA - July 7, 2014

- Stone was aware that:
  - DiscoCare was given unique and advantageous payment terms of up to 360 days, while it received its consulting fee upfront
  - DiscoCare receivables represented a large and growing portion of accounts receivable and sales (slightly less than 10% FYE 2007 sales & 29% A/R at 12/31/07)
  - Short sellers had alleged potential wrongdoing related to the DiscoCare relationship and eventually communicated directly with PwC
  - The CMO resigned a day before audit report release due to concerns about DiscoCare relationship
- In response to the short seller allegations, Stone's response was to obtain management and audit committee representations

Randall A. Stone, CPA - July 7, 2014

- On December 31, 2007 ArthroCare acquired DiscoCare for $25M
- Stone failed to adequately assess the fair value of the receivables recorded in the acquisition
- Stone also 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
- In November 2009 ArthroCare restated several years of financial statements
- In August 2014 the CEO and CFO were sentenced to prison terms for orchestrating the fraud
- The Board barred Stone with the right to reapply after 3 years, and imposed a $50,000 penalty and a censure

Akiyo Yoshida, CPA – Dec. 17, 2014

- Baldwin-Japan Ltd ("BJL") was a material subsidiary of US issuer Baldwin representing 26% net sales for 2010
- Grant Thornton was auditor of Baldwin's 2010 financial statements and used the work of GT-Japan and other GT affiliates for purposes of issuing the 2010 audit report on Baldwin
- Akiyo Yoshida was responsible for auditing BJL's financial reporting
- In May 2011, Baldwin filed a Form 10-K/A reducing net income 23% due to improperly accelerated revenue at BJL
- The Audit Committee investigation indicated the internal controls of BJL were intentionally circumvented to achieve sales and earnings forecasts
- In FYE 2010, the company had changed its revenue recognition policy to recognize revenue on equipment sales and installation of equipment separately

Akiyo Yoshida, CPA – Dec. 17, 2014

- Yoshida was aware that the policy change increased the potential that revenue could be materially misstated
- Yoshida and the engagement team also recognized the presumed risk of fraud related to revenue recognition
- Yoshida had also identified a fraud risk related to a strong President coupled with a new Controller that increased the likelihood that the President could influence the accounting conclusions improperly
- Yoshida also became aware of numerous red flags in the results of audit testing
  - All material sales transactions for final month were recorded on last day of the year
  - High error rate in cutoff testing of revenue

Akiyo Yoshida, CPA – Dec. 17, 2014

- Despite these red flags the engagement team failed to adjust the nature, timing and extent of audit procedures to obtain sufficient evidence
- Yoshida also failed to properly supervise his assistants by adequately reviewing the results of their work to ensure the procedures were properly performed
- He also failed to ensure he was technically proficient in his understanding of US GAAP on multiple element arrangements
- The Board censured Yoshida and suspended him from associating for one year, placed a one-year limitation on activities, and required completion of CPE

Morrill & Associates, LLC, Douglas W. Morrill, CPA, and Grant L. Hardy, CPA – Jan. 12, 2015

- Deficiencies on two audits relate to re-audits of audits previously performed by a PCAOB-sanctioned firm whose registration was revoked
- In three separate audits, the firm and the partner failed to gather sufficient audit evidence for assets representing over 70% of the total assets of the audited entity
- Failure to perform adequate audit procedures over significant risk areas, including revenue
- Failure to perform engagement quality reviews in compliance with AS No. 7
- Violation of the SEC’s auditor rotation requirements
- Quality control standard violations

Broker-Dealer Auditor Independence Matters – December 8, 2014

- The PCAOB Board settled disciplinary orders against seven firms for violating the independence rules
- Each of the seven firms prepared at least portions of the financial statements for its broker-dealer clients that the firms were filed with the Securities and Exchange Commission
- The financial statements were then audited by the sanctioned firms
- The auditor's preparation of portions of the financial statements was a prohibited non-audit service deemed to impair independence
- Each firm settled to a censure, $2,500 penalty and significant remedial measures
- The SEC simultaneously settled cases against eight audit firms for similar independence violations

Recently Adjudicated Matter

Ron Freund, CPA – January 25, 2015

- The Board affirmed the finding of a violation by Ron Freund in the hearing officer's initial decision
- Freund, a partner with an EY affiliate firm in Israel, served as the principal auditor of the FYE 2004 audit of Taro Pharmaceuticals
- Freund used the work of EY-US auditors in forming his opinion on the Taro financial statements
- The Board affirmed findings that Freund violated AU 543 by failing to obtain, review and retain certain documentation regarding results of fraud risk procedures
- Specifically, Freund did not obtain sufficient documentation that a retrospective review of the sales allowance was performed for the 2004 audit as required by AU 316.64
- The hearing officer imposed a sanction of a censure against Freund for a single act of negligent conduct
- Freund had initially petitioned the Board for review of the hearing officer's decision, but subsequently filed a brief indicating he was willing to accept that decision

Effect of Suspensions and Bars From Being An Associated Person

- It is unlawful for any person that is suspended or barred to become or remain associated with any registered firm or with any issuer, broker, or dealer in an accountancy or a financial management capacity. See Section 105(c)(7) of the Sarbanes-Oxley Act of 2002, as amended; PCAOB Rule 5301
- It is unlawful for any registered firm, issuer, broker, or dealer that knew, or, in the exercise of reasonable care should have known, that a person is suspended or barred from association to permit such association. See Section 105(c)(7) of the Sarbanes-Oxley Act of 2002, as amended; PCAOB Rule 5301

Association with a Registered Firm

- An individual associates with a registered firm if he or she, in connection with the preparation or issuance of any audit report:
  - Shares in the profits of, or receives compensation in any other form from, that firm; or
  - Participates as agent or otherwise on behalf of such accounting firm in any activity of that firm.
- See Section 2(a)(9) of the Sarbanes-Oxley Act of 2002, as amended; PCAOB Rule 5301; Rules on Investigations and Adjudications, PCAOB Release No. 2003-015 (Sept. 29 2003), at A2-80-81.
  - Deloitte & Touche LLP, PCAOB Rel. No. 105-2013-008 (Oct. 22, 2013)
  - Cordovano & Honeck LLP, PCAOB File No. 105-2010-004 (Aug. 29, 2011)
  - SEC vs. Subaye, Inc. and James. T. Crane, Civil Action No. 13 CIV 3114 (S.D.N.Y.)

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

Closing Remarks

Jeanette Franzel