# Forum on Auditing in the Small Business Environment

June 21, 2016

Philadelphia, PA

# Welcome

# 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.

# Learning Objectives

To discuss important information concerning PCAOB activities with registered accounting firms that audit public companies operating in the small business community. The forum also provides an opportunity for Board members and PCAOB staff to hear comments, concerns and questions from auditors. More specifically, the forum features a panel discussion on effective approaches for firms to monitor audit quality. Case studies will be presented and facilitated by PCAOB staff from the Division of Registration and Inspections, the Division of Enforcement and Investigations, and the Office of the Chief Auditor, and will focus on revenue, business combinations, convertible debt, and first year audits. Other discussion topics will include key inspection findings, an update on standard setting including transparency and reorganization of PCAOB standards and other matters, and an enforcement update. Inspections remediation staff will provide an update and examples of audit firm quality control remediation. In addition, staff from the Securities and Exchange Commission's (SEC) Division of Corporation Finance will join us to provide an update on recent SEC activities and observations of common financial reporting issues facing smaller public companies.

# PCAOB Highlights

Jeanette Franzel
Board Member

# Panel Discussion: Monitoring Audit Quality

Moderator: Jeanette Franzel

Todd Tosti

Associate Director, Division of Registration and Inspections

Stephen D'Angelo

Assistant Director-Accountant, Division of Enforcement and Investigations

Dima Andriyenko

Associate Chief Auditor, Office of Chief Auditor

# Inspections Overview

Todd Tosti
Associate Director
Division of Registration and Inspections

# Agenda

- The Inspection Process
- Top Inspection Findings
- Potential Root Causes

# The Inspection Process

- Planning and preparation
- Inspection fieldwork
- Issuance of comment forms, if any
- Evaluating responses to comment forms and drafting inspection report
- Review of inspection report and inspection files
- Issuance of draft inspection report
- Evaluating response to draft inspection report
- Board approval of inspection report
- Remediation submission

# Reports Issued Related to The Inspection Process and Top Inspection Findings

- Issued “Staff Inspection Briefs” in April 2016 and in October 2015
- 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 –

- 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

Likely 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 Revenue
- Auditing Business Combinations
- Auditing Convertible Debt
- Starting a First Year Audit

# Auditing Revenue

## Inspection Findings and Case Study

Todd Tosti
Associate Director
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Dima Andriyenko
Associate Chief Auditor
Office of the Chief Auditor

# Auditing Revenue Inspection Findings

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

## Case Study No. 1 – Roll Forward Tires, Inc.

# Case Study No. 1 – Roll Forward Tires, Inc. Background

- Your Firm has been engaged to audit the December 31, 2016 financial statements of Roll Forward Tires, Inc. (the “Company”).
- This is the first year your firm has been engaged by the Company to perform an audit of its financial statements. An audit of the effectiveness of the Company’s internal control over financial reporting (“ICFR”) is not required.

# Case Study No. 1 – Roll Forward Tires, Inc. Background

- The Company manufactures and sells tires through two operating segments – the Wholesale Segment and the Retail Segment.
- The Company's total revenues in 2016 are $105 million.
- The Wholesale Segment accounts for approximately $68 million, or 65 percent, of the Company's total revenue.
- The Retail Segment accounts for approximately $37 million, or 35 percent, of the Company's total revenue.
- Sales executives in both segments can earn bonuses if annual sales growth targets are attained.

# Case Study No. 1 – Roll Forward Tires, Inc. Background

- Wholesale Segment customers are large distributors that sell to large tire and car care operations.
- In 2016, the Wholesale Segment had 150 sales transactions, with the average sale amount being approximately $450,000.
- Wholesale Segment sales arrangements are not standard, but rather are negotiated, and may include right of return or customer acceptance clauses.
- During 2016, the Company successfully negotiated an arrangement with its first overseas customer, which resulted in approximately $6 million of revenue in Q2 of 2016.
- The overseas arrangement was completed under the direction of the CEO and offered larger than usual discounts and extended rights of return and extended payment terms.

# Case Study No. 1 – Roll Forward Tires, Inc. Background

- Retail Segment customers are end users that have purchased the Company's tires on-line with credit card payment.
- In 2016, the Retail Segment had 90,000 sales transactions, with the average sale amount being approximately $400. Revenues have been steady throughout 2015 and 2016.
- Retail sales arrangements are standard and have standard shipping terms: FOB shipping point, no right of return, and a limited warranty.
- The Firm's review of the Retail Segment's revenue recognition process indicates a simple but well designed process.

# Case Study No. 1 – Roll Forward Tires, Inc. Scenario *Background*

- *Your Firm is planning its audit of the Company's 2016 financial statements. You are the engagement partner on the audit.*
- *The engagement team's risk assessment for revenue is as follows:*

| | **Wholesale Segment** | **Retail Segment** |
|---|---|---|
| **Inherent risk of occurrence** | High | Low |
| **Inherent risk of valuation and allocation** | High | Low |
| **Inherent risk of completeness** | Low | Low |
| **Fraud risk** | Fraud risk related to cut-off | Fraud risk related to cut-off |
| **Significant risk** | Yes, due to: (1) risk that revenue recognition may not reflect contract terms, including foreign contracts and arrangements, and (2) the fraud risks related to revenue cut-off. | Yes, due to the fraud risk related to revenue cut-off. |

## Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Background*

- *As the lead engagement partner, you asked the two managers on the engagement team to each independently develop and propose to you an approach for testing the Company's revenue.*

- *You are now in the process of considering each of the two proposed approaches to testing the Company's revenue, which are as follows:*

# Case Study No. 1 – Roll Forward Tires, Inc.

## Scenario *Background*

| | *Manager A's Proposal* | *Manager B's Proposal* |
|---|---|---|
| **WHOLESALE SEGMENT:** | | |
| **Tests of controls:** | Yes, with control risk expected to be low and proposed dual-purpose testing | None |
| **Tests of details:** | Test <u>revenue recognition criteria</u> for a random sample of segment sales transactions from throughout the year with an estimated sample size of 40 sales transactions based on the Firm's control testing sampling methodology. | Based on an assumed effective substantive analytical procedure, test <u>revenue recognition criteria</u> for a random sample of segment sales transactions from throughout the year, with a projected sample size of 72 sales transactions based on the Firm's substantive sampling methodology. |
| **Analytical procedures:** | <u>Analytical Procedures:</u> Comparison of current year and prior year <u>quarterly and annual revenue</u> for the segment <u>with inquiry regarding significant fluctuations</u>. | <u>Substantive Analytical Procedures:</u> Comparison of <u>monthly revenue</u>, <u>disaggregated</u> by customer for the segment for current year and prior year, with inquiry and investigation into any fluctuations in <u>disaggregated</u> revenue amounts that exceed the investigative threshold, which is based on a factor of tolerable misstatement. For unusual sales transactions identified through investigation, examine related sales transaction documents and request confirmation of contract terms with the customer. |

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Background*

| | *Manager A's Proposal* | *Manager B's Proposal* |
|---|---|---|
| **RETAIL SEGMENT:** | | |
| **Tests of controls:** | Yes, with control risk expected to be low and proposed dual-purpose testing | None |
| **Tests of details:** | Test revenue recognition criteria for the 15 largest sales transactions in the segment from throughout the year. | See cut-off testing in the "Other Substantive Procedures" section on the next slide. |
| **Analytical procedures:** | Analytical Procedures:<br>Comparison of current year and prior year quarterly and annual revenue for the segment with inquiry regarding significant fluctuations. | Substantive Analytical Procedures:<br>Comparison of monthly revenue for the segment for current year and prior year with inquiry and investigation into any fluctuations in revenue that exceed expectations by a specified amount, which is based on a factor of tolerable misstatement. For unusual sales transactions identified through investigation, examine related sales transaction documents. |

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Background*

| | *Manager A's Proposal* | *Manager B's Proposal* |
|---|---|---|
| **OTHER SUBSTANTIVE PROCEDURES:** | | |
| **Other substantive procedures:** | 1. Confirmation of a random sample of year-end accounts receivable with a projected sample size of 45 customer accounts representing $7 million or 30 percent of total accounts receivable and seven percent of total revenue.<br><br>2. Test cut-off <u>at the consolidated level</u> by selecting the last five shipments prior to and the first five shipments subsequent to year end and determine whether related sales were recognized in the proper period. | 1. Confirmation of a random sample of year-end accounts receivable with a projected sample size of 45 customer accounts representing $7 million or 30 percent of total accounts receivable and seven percent of total revenue.<br><br>2. Test cut-off <u>for each segment</u> by selecting the last five shipments prior to and the first five shipments subsequent to year end, as well as the five largest shipment in each of the months of December and January, and determine whether related sales were recognized in the proper period.<br><br>3. Compare monthly sales returns and credit memos for the last two months of the year to the first two months of the subsequent year. |

*Question:*

? **What are your thoughts on the two proposed approaches to audit revenue?**

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Debrief*

Considerations

- Risk assessment – significant risks / fraud risks
- Procedures to be performed to address those risks
- Any concerns with the proposed procedures to be performed

# Case Study No. 1 – Roll Forward Tires, Inc. Scenario *Debrief*

Relevant auditing standards

- AS 2110, *Identifying and Assessing Risks of Material Misstatement* (currently AS 12)
- AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* (currently AS13)
- AS 1105, *Audit Evidence* (currently AS 15)
- AS 2305, *Substantive Analytical Procedures* (currently AU 329)
- AS 2315, *Audit Sampling* (currently AU 350)

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Debrief*

Relevant auditing standards *Risk Assessment*

AS 2110 (currently AS 12), paragraphs .68 and .69 state, in part:

> 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.
>
> The auditor's identification of fraud risks should include the risk of management override of controls.
>
> > Note: Controls over management override are important to effective internal control over financial reporting for all companies, and **may be particularly important at smaller companies** because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

# Case Study No. 1 – Roll Forward Tires, Inc. Scenario *Debrief*

## Relevant auditing standards *Risk Assessment*

AS 2110 (currently AS 12), paragraph .71 states:

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

- The effect of the quantitative and qualitative risk factors discussed in paragraph .60 on the likelihood and potential magnitude of misstatements;
- Whether the risk is a fraud risk;

  Note: **A fraud risk is a significant risk**.
- Whether the risk is related to recent significant economic, accounting, or other developments;
- The **complexity of transactions**;
- Whether the risk involves significant transactions with related parties;
- The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- Whether the risk involves **significant unusual transactions**.

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Debrief*

Relevant auditing standards *Risk Assessment*

AS 2110 (currently AS 12), paragraph .73A states:

> The auditor should obtain an understanding of the **controls** that management has established to identify, authorize and approve, and account for and disclose **significant unusual transactions** in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs .18-.40 and .72-.73 of this standard.

Relevant auditing standards *Responding to Risk*

AS 2301 (currently AS 13), paragraph .11 states, in part:

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

AS 1105 (currently AS 15), paragraph .05 states, 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**.

# Case Study No. 1 – Roll Forward Tires, Inc. Scenario *Debrief*

<u>Relevant auditing standards</u> *Responding to Risk*

AS 2301 (currently AS 13), paragraph .11A states:

> *Responding to Risks Associated with Significant Unusual Transactions.* AS 2110.71g indicates that one of the factors to be evaluated in determining significant risks is whether the risk involves **significant unusual transactions**. Also, AS 2401.66-67A establish requirements for performing procedures to respond to fraud risks regarding significant unusual transactions. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, the auditor should take into account the types of potential misstatements that could result from significant unusual transactions in designing and performing further audit procedures, including procedures performed pursuant to AS 2401.66-.67A.

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Debrief*

Relevant auditing standards

*Substantive Analytical Procedures*

AS 2305 (currently AU 329), paragraph .19 states:

> 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**.

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Debrief*

Relevant auditing standards *Dual-Purpose Tests*

AS 2301 (currently AS 13), paragraph .47 states, in part:

> In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "dual-purpose test"). In those situations, the auditor should **design** the dual-purpose test to achieve the objectives of **both** the test of the control and the substantive test.

AS 2315 (currently AU 350), paragraph .44 states, in part:

> The size of a sample designed for dual purposes should be the **larger** of the samples that would otherwise have been designed for the two separate purposes.

# Case Study No. 1 – Roll Forward Tires, Inc.
## Scenario *Debrief*

<u>Additional Revenue Guidance</u>

PCAOB Staff Practice Alert No. 12: Matters Related to Auditing Revenue in an Audit of Financial Statements

- Issued in September 2014
- Highlights requirements from other auditing standards that are relevant when auditing revenue
- Discusses frequent audit deficiencies identified through inspections related to auditing revenue

## Question A

If a firm is located and licensed in one state and performs an audit of an issuer that is headquartered in a different state, does the firm need to be licensed in that other state as well?

A. Yes
B. No
C. It depends

## Question A

Laws of certain states provide that an auditor must meet the requirements of that state (e.g., licensure, registration) in order to perform audits of entities located in that state.

## Question B

According to AS 2410 (currently AS 18), paragraph .18, if the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should:

A. determine whether the evidence obtained supports or contradicts management's assertion
B. request the client to change its disclosure
C. inform the audit committee of the disclosure
D. resign from the engagement

# Questions

# Break

(15 minutes)

U.S. Securities and Exchange Commission

# UPDATES FROM THE DIVISION OF CORPORATION FINANCE

JUNE 21, 2016

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# Agenda

- Regulatory Update
- Financial Reporting Issues
- Questions
- Appendix: Resources for Auditors and Smaller Reporting Companies

# Regulatory Update

# Regulatory Update

- SEC Updates:
  - Disclosure Effectiveness
  - Regulation A+
  - Crowdfunding
  - FAST Act
  - Financial Reporting Manual Updates
- GAAP Updates:
  - Consolidations ASU
  - New Revenue Standard
  - New Leases Standard

# Disclosure Effectiveness

- Disclosure Effectiveness initiative
  - Regulation S-X – financial disclosures about entities other than the registrant (e.g. significant acquired business)
  - Regulation S-K
  - Elimination of duplicative, overlapping, outdated or unnecessary requirements
  - Technology

# Disclosure Effectiveness

- Changes can be made in context of current rules
- Focus areas
  - Streamline disclosures
  - Eliminate outdated information
  - Tailor disclosures, focusing on factors unique to registrant
  - Trends in staff comment letters can be helpful
    - BUT, comment letters tailored to specific company circumstances

**Remember: SEC filings are more than compliance documents; they are communication documents to investors**

# Regulation A+

- New provisions were effective June 19, 2015
- Exemption from registration of offerings under the Securities Act of 1933
- Regulation A consists of two tiers:
  - Tier 1: securities offerings of up to $20 million in a 12-month period
  - Tier 2: securities offerings of up to $50 million in a 12-month period

# Regulation A+ – Financial Statement Requirements

| Required? | Tier 1 | Tier 2 |
|---|---|---|
| Audited financial statements | If available | Yes |
| Auditor independence and audit report | AICPA/U.S. GAAS or Article 2 of Reg S-X | Article 2 of Reg S-X |
| Auditor registered w/ PCAOB | No | |
| Audit standards | U.S. GAAS or PCAOB | |
| Article 8 of Reg. S-X | No | Yes |
| Rule 4-10 of Reg. S-X | Yes, if issuer is engaged in oil and gas producing activities | |

# Regulation A+ – Other Reporting

- Tier 2: Periodic and Current Reports
  - Form 1-K (annual report)
  - Form 1-SA (semiannual report)
  - Form 1-U (current event updates)
  - Special Financial Report

- Tier 2 may use a Form 8-A short form registration statement concurrently with the qualification of a Regulation A offering statement to register a class of securities under Sections 12(g) or 12(b) of the Exchange Act

# Crowdfunding

- New rules take effect 5/16/16 allowing companies to offer securities through crowdfunding
- To utilize, required to file a Form C in EDGAR
- File annual report
- Financial statement requirements
  - 2 years annual financials (no interims required)
- Resources:
  - Office of Investor Education and Advocacy bulletin: http://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html
  - Fact sheet: https://www.sec.gov/news/pressrelease/2015-249.html

# Crowdfunding – Financial Statement Requirements

| Required? | Offerings up to $100k | Offerings from $100k-$500k | Offerings > $500k |
|---|---|---|---|
| Financial statements | Info from tax returns and officer certified US GAAP f/s[1] | US GAAP w/ Review Report[1] | 1st time: US GAAP w/ Review Report[1]<br>Others: US GAAP w/ Audit Report |
| Auditor independence | N/A | Article 2 of Reg S-X or AICPA independence standards | |
| Auditor registered w/ PCAOB | No | | |
| Audit/review standards | N/A | AICPA SSARS | Auditing standards issued by AICPA or PCAOB |

[1] If f/s of issuer are available that have been reviewed or audited by independent public accountant, provide those f/s instead

# FAST Act

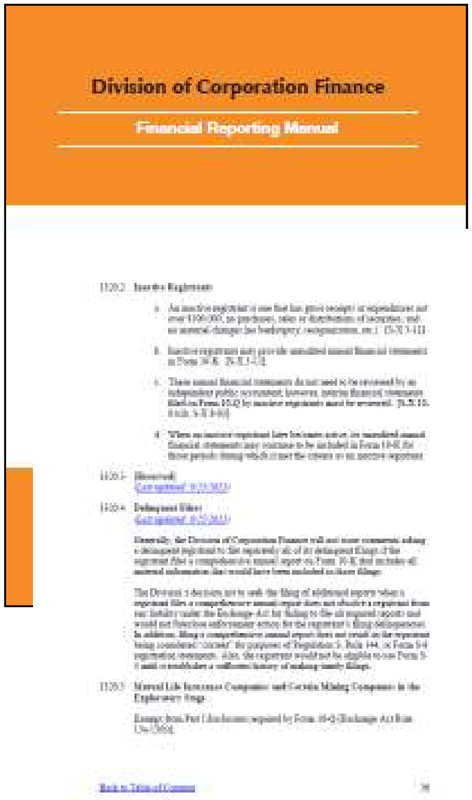
- Fixing America's Surface Transportation Act signed into law 12/4/15
- Includes amendments to federal securities laws
  - Public filing period for EGC's submitting confidential draft registration statements shortened to 15 days (previously 21 days)
  - One-year grace period for EGC's that lose EGC status prior to consummation of IPO
  - Simplified disclosure requirements for EGC's

# FAST Act – Simplified Disclosures for EGC's

- Omit financial information that relates to historical periods otherwise required by Regulation S-X if reasonably believe omitted information will not be required prior to distributing preliminary prospectus (Forms S-1 and F-1 only)
- Example
  - 6/30/16 year-end company (EGC) plans to file a confidential draft registration statement on 6/15/16.
  - IPO process expected to take 4 months (consummate October 2016)
  - Prior to prelim prospectus, S-1 will be updated with 6/30/16 audited f/s
  - Initial filing may include only 6/30/15 audited f/s (plus interims for 9 months ended 3/31/15 and 3/31/16)
- Refer to Compliance and Disclosure Interpretations at http://www.sec.gov/divisions/corpfin/guidance/fast-act-interps.htm and Section 10 of the Financial Reporting Manual (http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml)

# Financial Reporting Manual Updates

- August 2015 – updated guidance for delinquent filers (FRM 1320.4)
  - No longer write in to CF-OCA
  - Comprehensive annual report should generally include:
    - All audited f/s that would have been available had registrant filed timely
    - Unaudited quarterly f/s for at least periods required by Item 302 of Regulation S-K (8 quarters)
    - Discussion of results, trends and liquidity for each interim and annual period
  - Filing comprehensive annual report DOES NOT result in filer being considered "current"



# Regulatory Update

- SEC Updates:
  - Disclosure Effectiveness
  - Regulation A+
  - Crowdfunding
  - FAST Act
  - Financial Reporting Manual Updates
- GAAP Updates:
  - Consolidations ASU
  - New Revenue Standard
  - New Leases Standard

# ASU 2015-02 – Consolidations – Amendment to the Consolidation Analysis

- Effective for public business entities for fiscal years beginning after 12/15/15
- Rescinds indefinite deferral of FAS 167 for certain investment funds
- Revision to requirements for limited partnerships to qualify as voting interest entities
- Elimination of presumption that general partner should consolidate LP
- Changes analysis of decision maker fee arrangements and related party relationships
- Effect on disclosure requirements
- FASB project to address implementation questions

# New Revenue Standard

- FASB / IASB Converged Standard
  - Unit of account is performance obligation
  - Account for performance obligations separately if distinct
  - Transaction price allocated to each distinct performance obligation
- Effective for periods beginning after 12/15/17 (1/1/18 for calendar year-end public companies)
  - Early adoption
  - Emerging growth companies
- Transition Issues
  - Financial Reporting Manual Topic 11 (http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml)
  - Transition Resource Group (TRG)
- SAB 74 (SAB Topic 11M)
- Internal control considerations

# New Leases Standard

- Effective for fiscal years beginning after 12/15/18
- Impact on lessees:
  - Most leases will be reported on the balance sheets
  - Expense recognition similar to today
  - Real estate-specific provisions eliminated for all entities
- Impact on lessors
  - Changes to classification criteria and accounting for sales-type and direct financing leases
- Not fully converged with new IFRS lease standard

# Financial Reporting Issues

# Financial Reporting Issues

- Derecognition of Liabilities
- Cash Flows
- Segments
- Liability/Equity Determination
- Controls (ICFR and DCP)

# Derecognition of Liabilities

- Derecognize a liability if and only if it has been extinguished[1]
- Criteria to consider extinguished:
  - Debtor **pays** the creditor and is relieved of its obligation,

  OR

  - Debtor is **legally released** from being the primary obligor under the liability, **either judicially or by the creditor**

[1] ASC 405-20-40-1

# Derecognition of Liabilities - Example

- Company A (California company) issued $15,000 in promissory notes to Company B (an Illinois company) on 5/1/09
- In 2009 and early 2010, Company A paid $5,000 of outstanding liability
- Due to financial difficulties, Company A stopped making payments
- In 2016, Company A proposes writing off $10,000 liability, citing expiration of statute of limitations (which is 6 years in California)

# Derecognition of Liabilities - Example

- To support expiration assertion, company obtains a legal opinion
- Legal opinion states:
  - "I have reviewed the notes provided to me. Based on my review, the debt is unenforceable."
  - "My review assumes that the jurisdiction for the debt is California."
  - "In connection with the application of the statute of limitations, certain situations could result in tolling the statute of limitations. The advice in this letter assumes that no such situations have occurred."

# Derecognition of Liabilities

**Does expiration of the statute of limitations result in debtor being "legally released" under ASC 405?**

- Conclusion that courts would grant a declaratory judgment – high hurdle
- Legal opinions can serve as a basis for conclusion…
- But legal opinions must be robust and detailed
  - Jurisdiction considerations
  - "Would" level opinion – no caveats or limitations
    - "Assumptions" raise concern

# Derecognition of Liabilities - Example

- "I have reviewed the notes provided to me. Based on my review, the debt is unenforceable."
  - Statement not sufficiently robust or certain.
- "My review assumes that the jurisdiction for the debt is California."
  - Assumption of jurisdiction rather than detailed analysis
- "In connection with the application of the statute of limitations, certain situations could result in tolling the statute of limitations. The advice in this letter assumes that no such situations have occurred."
  - Does not appropriately analyze tolling and instead is built off of assumptions
- No statement that includes "would"

# Derecognition of Liabilities - Example

## Has the liability been extinguished?

- Criteria to consider extinguished:
  - Debtor pays the creditor and is relieved of its obligation,

  OR

  - Debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor

**Answer: NO. Legal opinions provided were not sufficient to support a conclusion that the debtor has been legally released. Liability must continue to be reflected as outstanding.**

# Financial Reporting Issues

- Derecognition of Liabilities
- Cash Flows
- Segments
- Liability/Equity Determination
- Controls (ICFR and DCP)

# Statement of Cash Flows

- Frequent area of restatement
- Majority of errors related to less complex applications of GAAP
- Consider adequacy of internal controls

# 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 ASC Topic 230?

# Statement of Cash Flows

- Proposed ASU related to EITF-15F provides guidance on 8 specific cash flow issues:
  - Debt prepayment or debt extinguishment costs
  - Settlement of zero-coupon bonds
  - Contingent consideration payments made after a business combination
  - Proceeds from settlement of insurance claims
  - Proceeds from settlement of corporate-owned life insurance policies (including bank-owned)
  - Distributions received from equity method investees
  - Beneficial interests in securitization transactions
  - Separately identifiable cash flows and application of the predominance principle

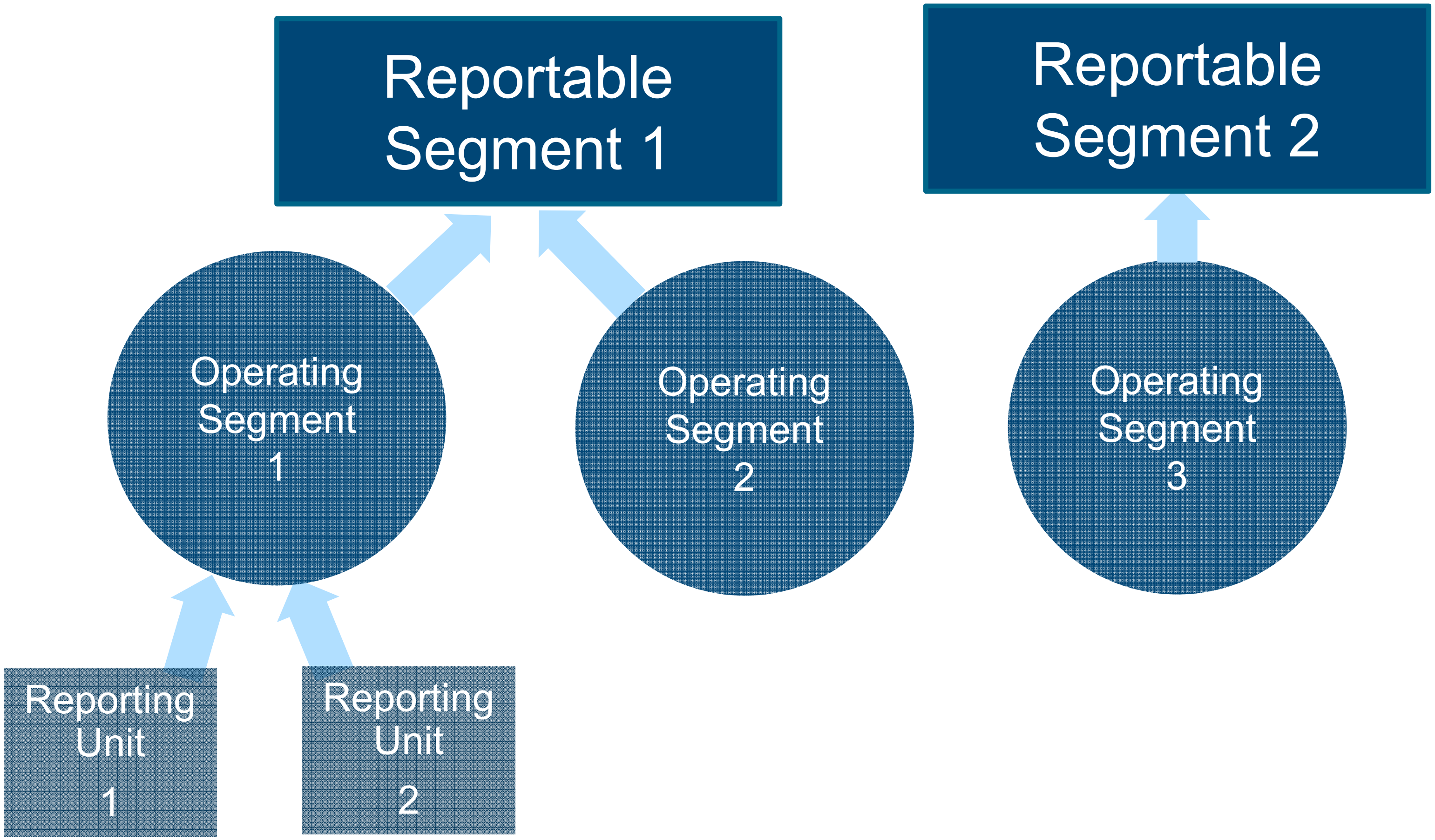
# Financial Reporting Issues

- Derecognition of Liabilities
- Cash Flows
- Segments
- Liability/Equity Determination
- Controls (ICFR and DCP)

# Segments

- Focus area for CF and PCAOB staff
  - Information important to investors/analysts
  - Internal control considerations
- Frequent areas of confusion:
  - Terminology and interplay with goodwill testing
  - Identification of operating segments
    - Discrete financial information
    - CODM report
  - Aggregation criteria

# Segments - Terminology



# Identifying the Operating Segment – Definition of Operating Segment[1]

- Engages in business activities
- Discrete financial information available
  - Full cost allocation not required
- CODM:
  - Regularly reviews
  - Operating results
  - Allocate resources and assess performance
    - More than “receives” and “uses”
  - Consider management structure, CODM report, budgets, compensation & other factors
  - Management assertions need to be tested

[1]ASC 280-10-50-5

# Aggregation[2]

- Consistent with objectives and principles in standard
- Similar economic characteristics
- Similar in each of the following areas:
  - Products and services
  - Production processes
  - Type or class of customer
  - Distribution methods
  - Regulatory environment

**Must meet ALL of the above.**
**Evaluation is relative to the range of the entity's operations.**

[2]ASC 280-10-50-11

# Financial Reporting Issues

- Derecognition of Liabilities
- Cash Flows
- Segments
- Liability/Equity Determination
- Controls (ICFR and DCP)

# Liability / Equity Determination

- Does instrument 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 ASC Topic 480

- If embedded, evaluate under ASC 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

- Derecognition of Liabilities
- Cash Flows
- Segments
- Liability/Equity Determination
- Controls (ICFR and DCP)

# Controls (ICFR and DCP)

- Recurring theme in CF reviews
- Internal control over Financial Reporting (ICFR) – disclosures of deficiencies
  - Identification of deficiency
  - Evaluation of the severity of the deficiency
    - "…the potential misstatement resulting from the deficiency…"
    - Actual error is only starting point
    - Must evaluate "the could factor"
  - Disclosure of material weakness
- ICFR – Framework
  - COSO's Internal Control – Integrated Framework revised in 2013
  - 1992 framework superseded

# Controls (ICFR and DCP)

- ICFR – Changes in controls
  - Item 308(c) of Regulation S-K
  - Quarterly disclosure
- Disclosure controls and procedures

Questions?

# Appendix: Resources for Auditors and Smaller Reporting Companies

# Financial Reporting Manual

- Provides informal staff interpretations on a number of financial reporting issues
  - Registrant & other financial statements
  - Pro forma financial information
  - Independent accountants
  - Smaller reporting companies & EGCs
  - Foreign private issuers
  - Non-GAAP
  - MD&A
  - Reverse mergers
  - MORE!
- Updated periodically

# Financial Reporting Resources

| Resource | Link |
|---|---|
| Division of Corporation Finance website | http://www.sec.gov/corpfin |
| Financial Reporting Manual (FRM) | http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml |
| Compliance and Disclosure Interpretations (CDI) | http://www.sec.gov/divisions/corpfin/cfguidance.shtml |
| 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 |
| Securities Act of 1933 | http://www.sec.gov/about/laws/sa33.pdf |
| Exchange Act of 1934 | http://www.sec.gov/about/laws/sea34.pdf |

# 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 Staff Speech – Auditor Independence | http://www.sec.gov/news/speech/2007/spch121007vk.htm |

# Contact Information

- Comment Letter Process: contact information will be at the end of the comment letter
- Informal staff interpretation or informal question
  - Financial Reporting: CF Office of Chief Accountant at (202) 551-3400 or submit request through online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive
  - 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.
  – Refer to guidance on the information to include www.sec.gov/info/accountants/ocasubguidance.htm

# Business Combinations

## Inspection Findings and Case Study

Stephen D'Angelo
Assistant Director, Accountant
Division of Enforcement and Investigations

Dima Andriyenko
Associate Chief Auditor
Office of the Chief Auditor

# Business Combinations
# Inspection Findings

- Failure to address whether all assets acquired and liabilities assumed, including identifiable intangible assets, had been recorded

- Failure to sufficiently test the valuation of the purchase price or consideration given in the business combination

- Failure to evaluate whether the purchase price was appropriately allocated to the acquired net assets based on appropriate valuations

- Failure to identify and address incorrect accounting for a reverse-merger transaction

## Case Study No. 2 – Mediocre Distributors, Inc.

# Case Study No. 2 – Mediocre Distributors, Inc. Background

- Your Firm has been engaged to audit the December 31, 2015 financial statements of Mediocre Distributors, Inc. (the “Company”).
- This is the fourth year your firm has been engaged by the Company to perform an audit of its financial statements.  An audit of the effectiveness of the Company’s internal control over financial reporting (“ICFR”) is not required.
- The Company is a distributor of glass products.
- The Company’s common stock is quoted on the over-the-counter bulletin board (“OTCBB”).

# Case Study No. 2 – Mediocre Distributors, Inc. Background

- On April 1, 2015, the Company acquired Fragile Glass, Inc. ("Fragile"), a manufacturer of windows.
- The acquisition resulted in a material amount of goodwill recorded by the Company.
- The Company issued 10 million shares of its common stock, which was quoted at $3 per share on the over-the-counter bulletin board ("OTCBB") on April 1, 2015.
- The $3 stock price was relatively close to the recent trading range of the Company's common stock around that time.
- However, around that time, the Company had also consummated multiple stock transactions, in exchange for services, at $4 per share.

# Case Study No. 2 – Mediocre Distributors, Inc. Background

- The Company engaged an external valuation specialist to assist the Company's management in determining the acquisition-date fair values of the assets and liabilities of Fragile.
- The valuation specialist is a recognized and reputable firm.
- The Company provided the valuation specialist with data related to Fragile's operations, including Fragile's prospective financial data (e.g., revenue, costs, and cash flows), which the specialist used to prepare discounted cash flows and other calculations to determine the fair values of Fragile's assets and liabilities.
- The specialist's report indicated that the specialist did not perform any procedures to test the accuracy or completeness of the information provided by the Company.

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 1 *Background*

- *Your Firm is conducting its audit of the Company's financial statements.*
- *You are the engagement partner and have just arrived at the client site for a meeting with the engagement team to discuss the audit.*
- *In your discussions with the engagement team, you learned about the procedures performed by your engagement team with respect to the business combination.*

# Case Study No. 2 – Mediocre Distributors, Inc. Scenario 1 *Background*

- *The valuation assertion related to business combinations has been assessed as a significant risk. The engagement team obtained and read the valuation specialist's report and is using the work of the specialist as audit evidence for the valuation of the acquired assets and liabilities.*

- *Audit documentation stated the following: "The specialist is an expert in valuation within the window manufacturing industry. Methods and assumptions used by the specialist to value the assets and liabilities appear reasonable. No further test work deemed necessary."*

- *The engagement team obtained management's written representation that the values assigned to the assets acquired and liabilities assumed in the purchase were appropriate as of the acquisition date.*

*Questions:*

- ? **What questions will you ask the engagement team regarding the valuation of the consideration paid by the Company (i.e. the 10 million shares issued)?**

- ? **What questions will you ask the engagement team regarding the valuation of the net assets acquired (i.e. the assets and liabilities of Fragile)?**

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 1 *Debrief*

Valuation of the consideration *Consideration of GAAP*

What accounting standards should be considered:

- ASC Topic 805, *Business Combinations*
- ASC Topic 820, *Fair Value Measurement*

ASC Paragraph 805-30-30-7 states, in part:

> The consideration transferred in a business combination shall be measured **at fair value**, which shall be calculated as the sum of the **acquisition-date fair values** of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and **the equity interests issued by the acquirer**.

# Case Study No. 2 – Mediocre Distributors, Inc. Scenario 1 *Debrief*

Valuation of the consideration *Consideration of GAAP*

ASC Paragraph 820-10-05-1D states:

> The definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. In addition, this Topic **shall be applied to instruments measured at fair value that are classified in shareholders' equity**.

ASC Paragraph 820-10-35-41 states, in part:

> A **quoted price in an active market** provides the most reliable evidence of fair value and shall be used **without adjustment** to measure fair value whenever available.

# Case Study No. 2 – Mediocre Distributors, Inc.
# Scenario 1 *Debrief*

Valuation of the consideration *Consideration of GAAP*

ASC Paragraph 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. 2 – Mediocre Distributors, Inc.
## Scenario 1 *Debrief*

Valuation of the consideration

**Conclusion:** Thus, in our case, the $3 acquisition-date fair value of the Company's common stock should be used to value the consideration, which would result in consideration of $30 million.

Note: The $4 stock price used to value the purchase of professional services around the same time as the business combination would not alter the conclusion that the correct GAAP valuation for the common stock is $3.

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 1 *Debrief*

Valuation of the net assets acquired

- Evaluate the qualifications and relationship of the specialist (AS 1210.08 – 1210.11)
- Test the data that the Company provided to the specialist (AS 1210.12 and AS 2502.39)
- Test the assumptions and evaluate the valuation methods used for the valuation
  - Evaluate whether the assumptions are reasonable and not inconsistent with market information (AS 2502.26)
  - Evaluate the data used to develop the assumptions (AS 2502.31)

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 1 *Debrief*

Valuation of the net assets acquired

*Consideration of GAAP*

- ASC Paragraph 805-20-25-1 states, in part, that as of the acquisition date, the acquirer shall **recognize**, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.
- ASC Paragraph 805-30-20-1 states that the acquirer shall **measure** the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree **at their acquisition-date fair values**.
- ASC Paragraph 805-20-25-10 states, in part, that the acquirer shall recognize separately from goodwill **the identifiable intangible assets** acquired in a business combination.

# Case Study No. 2 – Mediocre Distributors, Inc. Scenario 1 *Debrief*

<u>Relevant auditing standards</u>

AS 2502, *Auditing Fair Value Measurements and Disclosures* (currently AU 328), paragraph .23 states, in part:

> Based on the auditor’s assessment of the risk of material misstatement, the auditor should **test the entity’s fair value measurements and disclosures**. Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent. For example, substantive tests of the fair value measurements may involve (*a*) **testing management's significant assumptions, the valuation model, and the underlying data**, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) reviewing subsequent events and transactions.

# Case Study No. 2 – Mediocre Distributors, Inc. Scenario 1 *Debrief*

## Relevant auditing standards

AS 2502 (currently AU 328), paragraph .26 states, in part:

> The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:
>
> - **Management's assumptions are reasonable** and reflect, or are not inconsistent with, market information.
> - The fair value measurement was determined using an **appropriate model**, if applicable.
> - Management used **relevant information** that was reasonably available at the time.

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 1 *Debrief*

Relevant auditing standards

AS 2502 (currently AU 328), paragraph .39 states, in part:

> The auditor should test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. Specifically, **the auditor evaluates whether the data on which the fair value measurements are based, including the data used in the work of a specialist, is accurate, complete, and relevant**; and whether fair value measurements have been properly determined using such data and management's assumptions. The auditor's tests also may include, for example, procedures such as verifying the source of the data, mathematical recomputation of inputs, and reviewing of information for internal consistency, including whether such information is consistent with management's intent and ability to carry out specific courses of action.

# Case Study No. 2 – Mediocre Distributors, Inc.
# Scenario 1 *Debrief*

<u>Relevant auditing standards</u>

AS 2502 (currently AU 328), footnote 2 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**.

AS 2502 (currently AU 328), paragraph .20 states, in part:

> The auditor should consider whether to **engage a specialist** and use the work of that specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions… If the use of such a specialist is planned, the auditor should consider the guidance in AS 1210, *Using the Work of a Specialist*.

# Case Study No. 2 – Mediocre Distributors, Inc.
# Scenario 1 *Debrief*

<u>Relevant auditing standards</u>

AS 1210, *Using the Work of a Specialist* (currently AU 336), paragraph .12 states, in part:

> The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (*a*) **obtain an understanding of the methods and assumptions used by the specialist**, (*b*) **make appropriate tests of data provided to the specialist**, taking into account the auditor's assessment of control risk, and (*c*) **evaluate whether the specialist's findings support the related assertions** in the financial statements.

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 2 *Background*

- *The following year, your firm has been engaged to audit the Company's financial statements for the year ended December 31, 2016.*
- *The Company's quarterly filings in 2015 and 2016 show a steady decline in Fragile's revenue due, in part, to a downturn in the housing construction market which has reduced demand for the manufacture of new windows.*
- *Quarterly revenues for Fragile for 2015 and the first three quarters of 2016 were as follows:*

| Quarter Ended | Windows Manufacturing Segment Revenue ($ in millions) |
|---|---|
| Q1 2015 | $22 |
| Q2 2015 | $18 |
| Q3 2015 | $16 |
| Q4 2015 | $15 |
| Q1 2016 | $14 |
| Q2 2016 | $14 |
| Q3 2016 | $12 |

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 2 *Background*

- *The Company performs its evaluation of goodwill for potential impairment on October 31st of each year.*
- *The continuing quarterly decline in the Windows Manufacturing Segment Revenue (i.e. Fragile's business) resulted in management concluding that it was more likely than not that the goodwill in the reporting segment had been impaired.*
- *The Company engaged the same external valuation specialist to assist the Company in determining the fair value of the reporting unit and of its individual assets and liabilities, as part of the Company's evaluation of whether goodwill was impaired (step 1 analysis). Upon completion of its evaluation, the Company concluded that goodwill has not been impaired.*
- *The Firm used its internal valuation specialist to review the Company's external valuation specialist's valuation of reporting unit.*

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 2 *Questions*

*Questions:*

? **What questions will you ask your engagement team about using the work of the Company's engaged valuation specialist?**

? **What are the relevant considerations when the audit firm is using its own valuation specialist to review the measurement of the reporting unit's fair value used in step 1 of the goodwill impairment analysis?**

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 2 *Debrief*

Evaluating goodwill impairment *Consideration of GAAP*

ASC Paragraph 350-20-35-3 states, in part:

> An entity may **first assess qualitative factors**… to determine whether it is necessary to perform the two-step goodwill impairment test

ASC Paragraph 350-20-35-4 states:

> Step 1
>
> The first step of the goodwill impairment test, used to identify potential impairment, compares the **fair value of a reporting unit** with its carrying amount, including goodwill.

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 2 *Debrief*

Evaluating goodwill impairment

- Go through similar steps as before:
  - Evaluate the qualifications and relationship of the specialist, as they may have changed (AS 1210.08 – 1210.11)
  - Test data that the Company provided to the specialist (AS 1210.12 and AS 2502.39)
  - Test the assumptions and valuation models used in the valuation (AS 2502.26 and .31)
- Consider changes in the company, industry, and market
  - Declining quarterly revenue trend
- Evaluate the original assumptions in relation to actual results (AS 2502.36)

# Case Study No. 2 – Mediocre Distributors, Inc. Scenario 2 *Debrief*

<u>Relevant auditing standards</u>

AS 2502 (currently AU 328), paragraph .36 states, in part:

> To be reasonable, the assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows), individually and taken as a whole, need to be realistic and consistent with:
>
> - The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances;
> - Existing market information;
> - **Assumptions made in prior periods**, if appropriate;
> - **Past experience of, or previous conditions experienced by, the entity** to the extent currently applicable;
> - …

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 2 *Debrief*

Relevant auditing standards

- When using an internal valuation specialist:

  AS 1201, *Supervision of the Audit Engagement* (currently AS 10), applies

  AS 1201 (currently AS 10), paragraph .03 states:

  > The engagement partner is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for **proper supervision of the work of engagement team members** and for compliance with PCAOB standards, **including standards regarding using the work of specialists**, other auditors, internal auditors, and others who are involved in testing controls. Paragraphs .05-.06 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.

# Case Study No. 2 – Mediocre Distributors, Inc.
## Scenario 2 *Debrief*

<u>Relevant auditing standards</u>

- When using an internal valuation specialist:

  AS 1201 (currently AS 10), paragraph .06 states, in part:

  > To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:
  >
  > - …
  > - The **risks of material misstatement**; and
  > - The **knowledge, skill, and ability** of each engagement team member.
  >
  >   Note: In accordance with the requirements of AS 2301.05, the extent of supervision of engagement team members **should be commensurate with the risks of material misstatement**.

# Case Study No. 2 – Mediocre Distributors, Inc.
# Scenario 2 *Debrief*

## Relevant auditing standards

- However, when using an engaged external specialist:

  AS 1210, *Using the Work of a Specialist* (currently AU 336), applies

- Regardless of whether the auditor uses an internal specialist or engages an external specialist:

  AS 2502, *Auditing Fair Value Measurements and Disclosures* (currently AU 328), applies, including with regard to the Company's use of a specialist

## Question C

When should the auditor provide the required communications to the audit committee?

A. before issuance of the audit report
B. within one month after completion of the audit
C. before starting the next year's audit
D. when the audit committee asks for it

# Question C

AS 1301, *Communications with Audit Committees* (currently AS 16), paragraph .26 states, in part:

> All audit committee communications required by this standard should be made **in a timely manner** and **prior to the issuance of the auditor's report**. The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

# Question D

After a person serves as the engagement partner on an entity's audit, how many audits of that entity must that person not serve as the engagement partner before serving as the engagement quality reviewer on the entity's audit? *(Note: This assumes the person is otherwise in compliance with partner rotation requirements.)*

A. none, if less than five years on audit

B. two

C. five

D. nine

## Question D

AS 1220, *Engagement Quality Review* (currently AS 7), paragraph .08 states:

> The person who served as the engagement partner during **either** of the **two** audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer. Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(6)(ii), are exempt from the requirement in this paragraph.

# Questions

# Lunch

(75 minutes)

# Standard-Setting Update

Robert Ravas
Assistant Chief Auditor

Dima Andriyenko
Associate Chief Auditor

PCAOB
Public Company Accounting Oversight Board

# Agenda

- Reorganization of PCAOB Auditing Standards
- Audit Transparency Project
- Supervision of Audits Involving Other Auditors
- Auditor’s Reporting Model
- Other Active PCAOB Standard-Setting Projects

# Reorganization of PCAOB Auditing Standards

| Action | Date |
|---|---|
| PCAOB adopted amendments to reorganize auditing standards | March 31, 2015 |
| Securities and Exchange Commission approved the amendments | September 17, 2015 |
| **Effective date** | **December 31, 2016** |

Auditors may begin to use and reference the reorganized PCAOB auditing standards prior to December 31, 2016

# Reorganization of PCAOB Auditing Standards – What is Changing?

- The new organizational structure:
  - Renumbers and reorders existing "interim" and Board-issued standards without redrafting, imposing new requirements, or making substantive changes to existing requirements
  - Presents standards in a logical order that generally follows the flow of the audit process
  - Helps users navigate the standards more easily
  - Provides structure for future standard setting

# Reorganization of PCAOB Auditing Standards – What is Changing?

In addition, the PCAOB's amendments to reorganize auditing standards:

- Rescinds certain interim standards no longer necessary
- Retains almost all of the AICPA auditing interpretations
- Replaces references to GAAS throughout with references to PCAOB auditing standards
- Updates titles, cross-references, etc.

# Reorganization of PCAOB Auditing Standards – How Will It Be Reorganized?

- 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

# Reorganization of PCAOB Auditing Standards – Tools and Other Changes

- Tools available map:
  - Pre-organized standards to reorganized standards and vice versa
  - PCAOB auditing standards with the analogous standards of the ASB and IAASB
- Links to applicable guidance within each standard
- Expands table of contents within each standard for easier navigation
- Enhances the "Guidance" page to include all auditing interpretations

# Reorganization of PCAOB Auditing Standards – How to Access the Reorganized Standards?

PCAOB
Public Company Accounting Oversight Board

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Standards | Registration & Reporting | Inspections | Enforcement | International | Economic & Risk Analysis | Careers

Home > Standards > Auditing

## Auditing Standards

On March 31, 2015, the Public Company Accounting Oversight Board ("PCAOB") adopted amendments that reorganize its auditing standards. (*See* **PCAOB Release No. 2015-002**.) The amendments were approved by the Securities and Exchange Commission ("SEC") on September 17, 2015 and are effective as of December 31, 2016. (*See* SEC Release No. 34-75935, File No. PCAOB-2015-01.) Auditors may begin to use and reference the reorganized PCAOB auditing standards prior to December 31, 2016.

- Auditing standards - before the reorganization
- Auditing standards - as reorganized

# Reorganization of PCAOB Auditing Standards – Revised Layout

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Home > Standards > Auditing

## Auditing Standards

The standards presented below reflect the reorganization of PCAOB auditing standards, which is effective as of December 31, 2016. These reorganized standards can be used and referenced by auditors before the effective date; the auditing standards before the reorganization can be found **here**. (*See* **PCAOB Release No. 2015-002**.)

Reference Tools ▼

### General Auditing Standards

**1000 General Principles and Responsibilities**

- AS 1001: Responsibilities and Functions of the Independent Auditor
- AS 1005: Independence
- AS 1010: Training and Proficiency of the Independent Auditor
- AS 1015: Due Professional Care in the Performance of Work

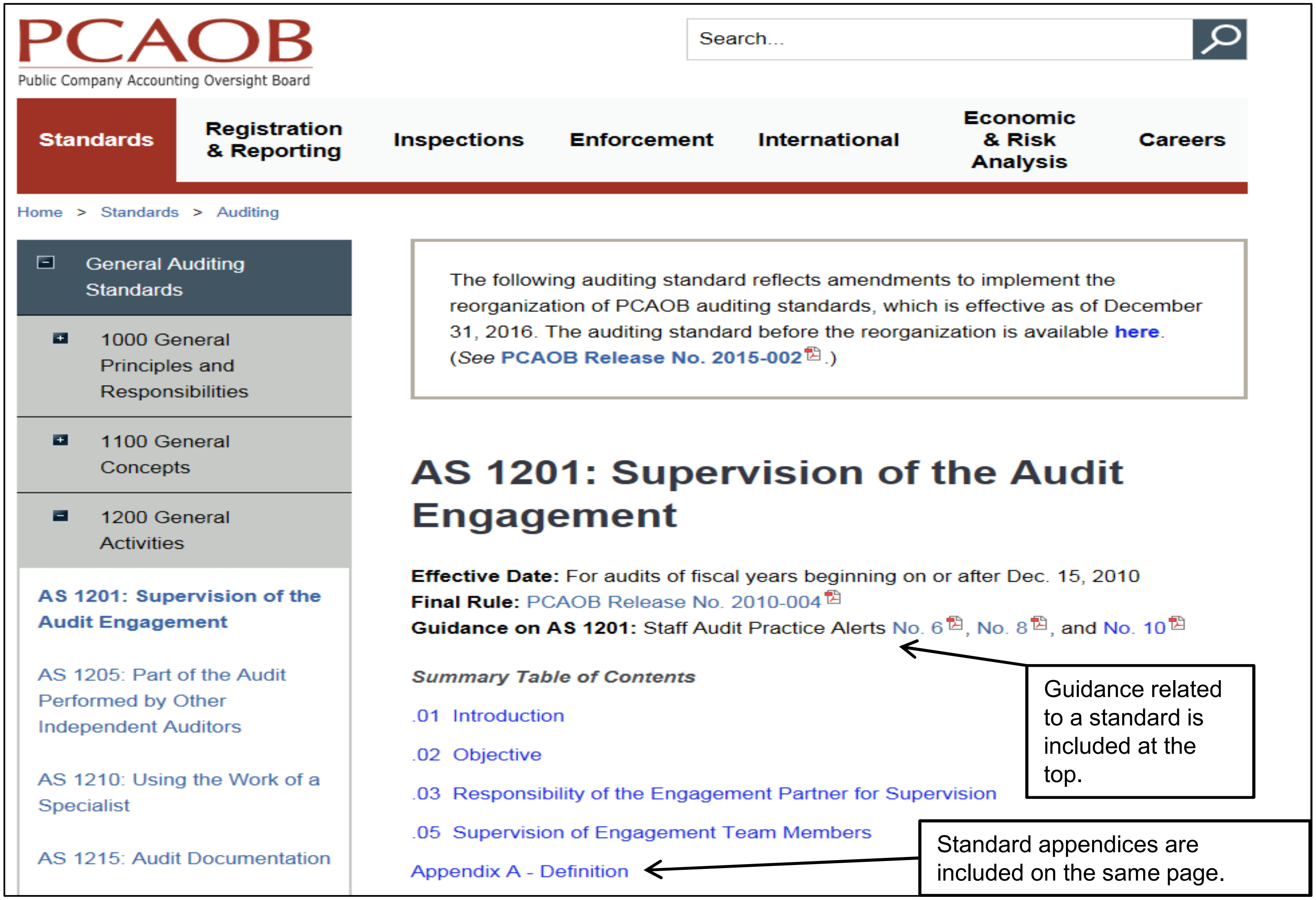
**1100 General Concepts**

- AS 1101: Audit Risk
- AS 1105: Audit Evidence
- AS 1110: Relationship of Auditing Standards to Quality Control Standards

**1200 General Activities**

- AS 1201: Supervision of the Audit Engagement
- AS 1205: Part of the Audit Performed by Other Independent Auditors
- AS 1210: Using the Work of a Specialist
- AS 1215: Audit Documentation

# Reorganization of PCAOB Auditing Standards – Revised Layout (continued)



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Home > Standards > Auditing

General Auditing Standards
1000 General Principles and Responsibilities
1100 General Concepts
1200 General Activities
**AS 1201: Supervision of the Audit Engagement**
AS 1205: Part of the Audit Performed by Other Independent Auditors
AS 1210: Using the Work of a Specialist
AS 1215: Audit Documentation

The following auditing standard reflects amendments to implement the reorganization of PCAOB auditing standards, which is effective as of December 31, 2016. The auditing standard before the reorganization is available **here**. (*See* **PCAOB Release No. 2015-002**.)

**AS 1201: Supervision of the Audit Engagement**

**Effective Date:** For audits of fiscal years beginning on or after Dec. 15, 2010
**Final Rule:** PCAOB Release No. 2010-004
**Guidance on AS 1201:** Staff Audit Practice Alerts No. 6, No. 8, and No. 10

***Summary Table of Contents***

.01 Introduction
.02 Objective
.03 Responsibility of the Engagement Partner for Supervision
.05 Supervision of Engagement Team Members
Appendix A - Definition

Guidance related to a standard is included at the top.

Standard appendices are included on the same page.

# Reorganization of PCAOB Auditing Standards – Reference Tools

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Public Company Accounting Oversight Board

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Home > Standards > Auditing

## Auditing Standards

The standards presented below reflect the reorganization of PCAOB auditing standards, which is effective as of December 31, 2016. These reorganized standards can be used and referenced by auditors before the effective date; the auditing standards before the reorganization can be found **here**. (*See* **PCAOB Release No. 2015-002**.)

### General Auditing Standards

**1000 General Principles and Responsibilities**

- AS 1001: Responsibilities and Functions of the Independent Auditor
- AS 1005: Independence
- AS 1010: Training and Proficiency of the Independent Auditor
- AS 1015: Due Professional Care in the Performance of Work

**1100 General Concepts**

- AS 1101: Audit Risk
- AS 1105: Audit Evidence
- AS 1110: Relationship of Auditing Standards to Quality Control Standards

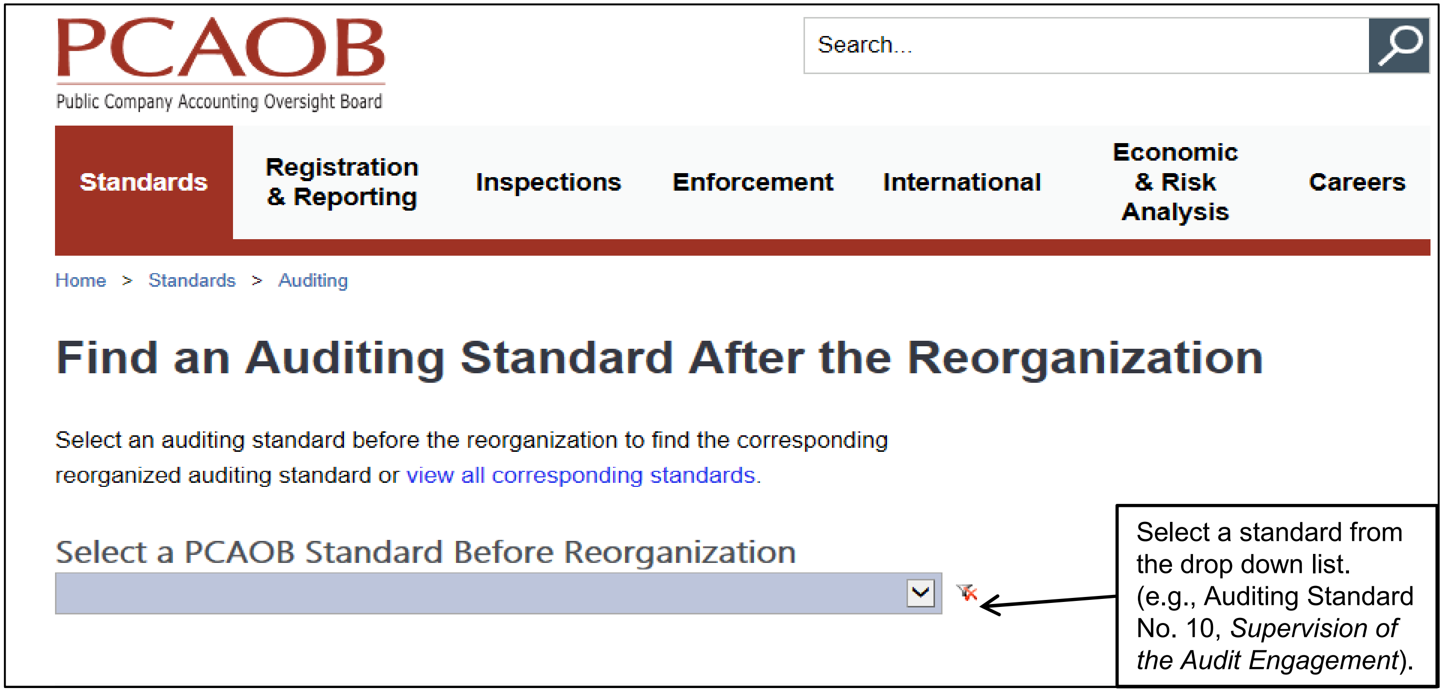
**1200 General Activities**

- AS 1201: Supervision of the Audit Engagement
- AS 1205: Part of the Audit Performed by Other Independent Auditors
- AS 1210: Using the Work of a Specialist
- AS 1215: Audit Documentation

Reference Tools ▼

- Reorganized to Pre-reorganized
- Pre-reorganized to Reorganized
- PCAOB to ASB and IAASB
- Printable Reference Table

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)



# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

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## Find an Auditing Standard After the Reorganization

Select an auditing standard before the reorganization to find the corresponding reorganized auditing standard or view all corresponding standards.

### Select a PCAOB Standard Before Reorganization

AS No. 10: Supervision of the Audit Engagement

### Corresponding Standards

| BEFORE REORGANIZATION | AFTER REORGANIZATION |
|---|---|
| AS No. 10: Supervision of the Audit Engagement | AS 1201: Supervision of the Audit Engagement |

The reorganized standard that appears is an active link to open the respective standard.

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

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## Find an Auditing Standard After the Reorganization

### Corresponding Standards

| BEFORE REORGANIZATION | AFTER REORGANIZATION |
| --- | --- |
| AS No. 3: Audit Documentation | AS 1215: Audit Documentation |
| AS No. 4: Reporting on Whether a Previously Reported Material Weakness Continues to Exist | AS 6115: Reporting on Whether a Previously Reported Material Weakness Continues to Exist |
| AS No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements | AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements |
| AS No. 6: Evaluating Consistency of Financial Statements | AS 2820: Evaluating Consistency of Financial Statements |
| AS No. 7: Engagement Quality Review | AS 1220: Engagement Quality Review |
| AS No. 8: Audit Risk | AS 1101: Audit Risk |

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

PCAOB
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Home > Standards > Auditing

## Auditing Standards

The standards presented below reflect the reorganization of PCAOB auditing standards, which is effective as of December 31, 2016. These reorganized standards can be used and referenced by auditors before the effective date; the auditing standards before the reorganization can be found **here**. (*See* **PCAOB Release No. 2015-002**.)

### General Auditing Standards

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- AS 1205: Part of the Audit Performed by Other Independent Auditors
- AS 1210: Using the Work of a Specialist
- AS 1215: Audit Documentation

Reference Tools ▼
- Reorganized to Pre-reorganized
- Pre-reorganized to Reorganized
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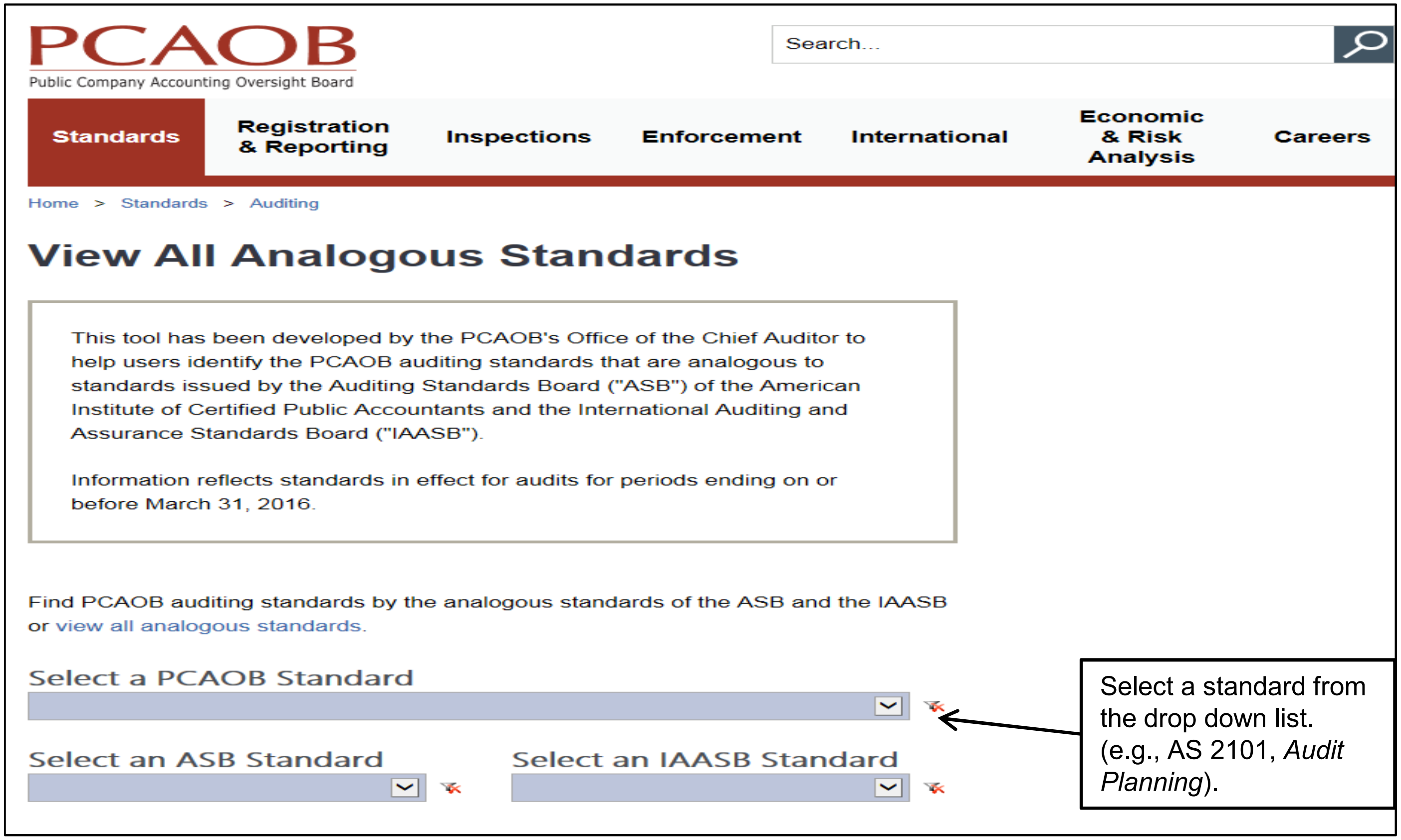
- Printable Reference Table

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)



# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

Find PCAOB auditing standards by the analogous standards of the ASB and the IAASB or view all analogous standards.

### Select a PCAOB Standard

AS 2101: Audit Planning

### Select an ASB Standard

### Select an IAASB Standard

### Analogous Standards

| PCAOB STANDARD | ASB STANDARD | IAASB STANDARD |
| --- | --- | --- |
| AS 2101: Audit Planning | AU-C 300: Planning an Audit | ISA 300: Planning an Audit of Financial Statements |

As in the previous example, the reorganized standard is an active link to open the respective standard.

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

Find PCAOB auditing standards by the analogous standards of the ASB and the IAASB or view all analogous standards.

Also as in the previous example, you can view a table that includes a comparison to all auditing standards.

Select a PCAOB Standard

AS 2101: Audit Planning

Select an ASB Standard

Select an IAASB Standard

Analogous Standards

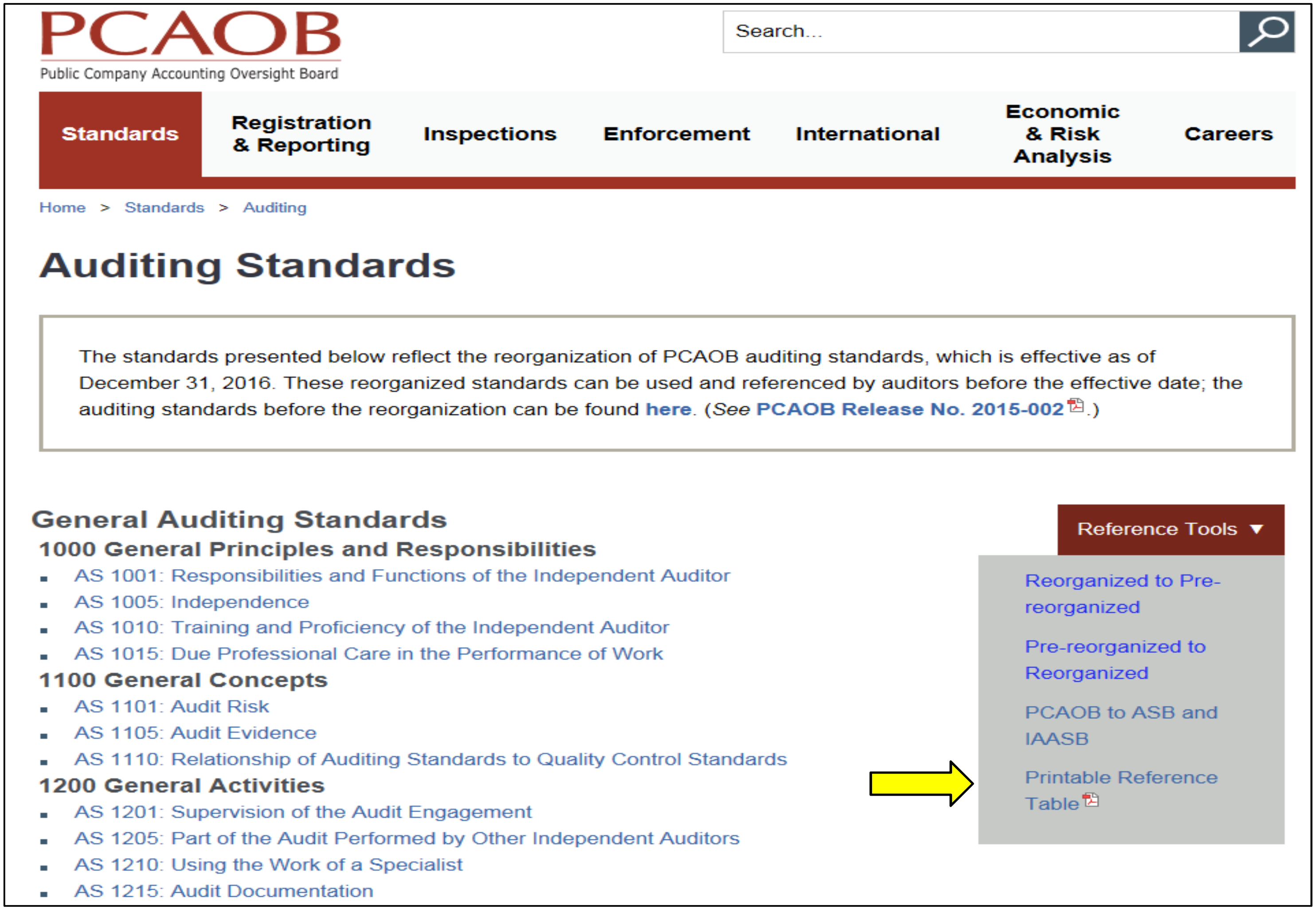
| PCAOB STANDARD | ASB STANDARD | IAASB STANDARD |
|---|---|---|
| AS 2101: Audit Planning | AU-C 300: Planning an Audit | ISA 300: Planning an Audit of Financial Statements |

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

**Analogous Standards**

| PCAOB STANDARD | ASB STANDARD | IAASB STANDARD |
|---|---|---|
| AS 1001: Responsibilities and Functions of the Independent Auditor | AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards | ISA 200: Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing |
| AS 1005: Independence | AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards | ISA 200: Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing |
| AS 1010: Training and Proficiency of the Independent Auditor | AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards | ISA 200: Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing |

# Reorganization of PCAOB Auditing Standards – Reference Tools (continued)



# Reorganization of PCAOB Auditing Standards – Location of Auditing Interpretations:

At the bottom of "Guidance Related to Standards" page

## Auditing Interpretations

The auditing interpretations presented below have been renumbered in conjunction with the reorganization of the auditing standards, which is effective as of December 31, 2016. The auditing interpretations before the reorganization can be found here. (*See* PCAOB Release No. 2015-002.)

The following are auditing interpretations issued by the American Institute of Certified Public Accountant's Auditing Standards Board as in existence on April 16, 2003, to the extent not superseded or amended by the PCAOB. The auditor should be aware of and consider auditing interpretations applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable auditing interpretation, the auditor should be prepared to explain how he or she complied with the provisions of the auditing standard addressed by such auditing guidance.

- AI 10 - Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205
- AI 11 - Using the Work of a Specialist: Auditing Interpretations of AS 1210
- AI 12 - Communications About Control Deficiencies in an Audit of Financial Statements: Auditing Interpretations of AS 1305
- AI 13 - Illegal Acts by Clients: Auditing Interpretations of AS 2405

# Audit Transparency Project – Disclosure of Engagement Partner and Accounting Firms

- On Dec. 15, 2015, the Board adopted new rules and amendments to provide investors with information about engagement partners and accounting firms that participate in the audits of issuers.
  - On May 9, 2016, the SEC approved these rules and amendments.
- The final rules require accounting firms to file a new PCAOB form—Form AP, *Auditor Reporting of Certain Audit Participants* — for each issuer audit, disclosing:
  - The name of the engagement partner;
  - The name, location, and extent of participation of each other accounting firm participating in the audit whose work constituted at least 5 percent of total audit hours; and
  - The number and aggregate extent of participation of all other accounting firms participating in the audit whose individual participation was less than 5 percent of total audit hours.

# Audit Transparency Project – Disclosure of Engagement Partner and Accounting Firms

- Form AP, *Auditor Reporting of Certain Audit Participants*, is required to be –
  - Filed no later than 35 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
- Form AP information will be available in a searchable database on the Board's website
- In addition to filing Form AP, auditors can decide to voluntarily provide the same disclosures in the auditor's report.

# Audit Transparency Project – Phased Effective Date

- The new rules of the Board and amendments to auditing standards take effect as set forth below:
  - Engagement partner: auditors' reports issued on or after January 31, 2017
  - Other accounting firms: auditors' reports issued on or after June 30, 2017

# Supervision of Audits Involving Other Auditors

- On April 12, 2016, the Board proposed
  - Amendments to certain existing standards to strengthen the requirements and impose a more uniform approach to the lead auditor's supervision of other auditors; and
  - A new auditing standard for situations in which the lead auditor divides responsibility for the audit with another accounting firm
- Comment period is open through July 29, 2016

# Supervision of Audits Involving Other Auditors – What is Being Proposed?

- Amend AS 1201, *Supervision of the Audit Engagement* to provide additional direction to the lead auditor on procedures to be performed in supervising the other auditor's work

- Amend AS 2101, *Audit Planning* to incorporate and update requirements from AS 1205 to specify that they be performed by the lead auditor. For example, the proposal would incorporate and revise requirements for determining the firm's eligibility to serve as lead auditor in an audit that involves other auditors

# Supervision of Audits Involving Other Auditors – What is Being Proposed?

- Amend <u>AS 1215, *Audit Documentation*</u> to require that the lead auditor document which specific work papers of the other auditor it has reviewed, though not retained
- Amend <u>AS 1220, *Engagement Quality Review*</u> to explicitly require that the engagement quality reviewer evaluate the engagement partner's determination of his or her own firm's eligibility to serve as lead auditor

# Proposed New Standard on Dividing Responsibility for the Audit with Another Accounting Firm (AS 1206) – What is Being Proposed?

The proposed new standard:

- Would retain, with modifications, many existing requirements of AS 1205, including the requirement that the lead auditor disclose in its report which portion of the financial statements was audited by another auditor

- New requirements proposed in AS 1206 would include:
  - Obtaining a representation from the other auditor that it is duly licensed to practice under the applicable laws of the country or jurisdiction
  - Determining whether the other auditor is required to be registered or is in fact registered with the PCAOB

## Proposed New Standard on Dividing Responsibility for the Audit with Another Accounting Firm (AS 1206) – What is Being Proposed?

- New requirements proposed in AS 1206 include (cont'd):
  - Disclosing the name of the other auditor in the lead auditor's report

- AS 1205, *Part of the Audit Performed by Other Independent Auditors*, would be superseded by the proposed amendments and proposed new standard

# The Auditor’s Reporting Model

- On May 11, 2016 the Board reproposed for public comment the auditor reporting standard to make the auditor’s report more relevant and informative to investors and other financial statement users.
- Comment period is open through August 15, 2016.

# The Auditor’s Reporting Model

- The reproposal would:
  - Retain the pass/fail model in the existing auditor's report;
  - Require communication of critical audit matters;
  - Clarify existing auditor responsibilities;
  - Require new elements related to auditor tenure and independence; and
  - Require the opinion to be the first section, and require section titles to guide the reader.

# The Auditor's Reporting Model

- The concept of critical audit matters was carried forward from the 2013 proposal but refined in a number of respects, including by:
  - Limiting the source of potential critical audit matters to matters communicated or required to be communicated to the audit committee;
  - Adding a materiality component to the definition;
  - Narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgment;
  - Expanding the communication requirement to require the auditor to describe how the critical audit matter was addressed in the audit; and
  - Revising the related documentation requirement.

# Other Active PCAOB Standard-Setting Projects

- Going Concern
- Auditing Accounting Estimates, including Fair Value Measurements
- Auditor's Use of the Work of Specialists
- Quality Control Standards, including Assignment and Documentation of Firm Supervisory Responsibilities

# 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 the Standards-Inquiry Line via the web form or at (202) 591-4395
- 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

# Auditing Convertible Debt
## Inspection Findings and Case Study

Todd Tosti
Associate Director
Division of Registration and Inspections

Dima Andriyenko
Associate Chief Auditor
Office of the Chief Auditor

# Convertible Debt Inspection Findings

- Failure to evaluate allocation of proceeds received between debt and warrants
- Failure to evaluate balance sheet classification of warrants
- Failure to address whether beneficial conversion features exist
- Failure to evaluate whether embedded conversion option and warrants should be accounted for as derivatives
- Failure to sufficiently test the valuation of warrants and conversion option derivatives

# Case Study No. 3 – Steady Manufacturing, Inc.

# Case Study No. 3 – Steady Manufacturing, Inc. Background

- Your Firm has been engaged to audit the December 31, 2015 financial statements of Steady Manufacturing, Inc. (the “Company”).
- This is the third year your firm has been engaged by the Company to perform an audit of its financial statements. An audit of the effectiveness of the Company’s internal control over financial reporting (“ICFR”) is not required.
- The Company’s common stock is quoted on the OTCBB with normal daily market activity of around 200,000 shares in 2014 and 2015.
- On August 1, 2015, the Company issued convertible debt with a detachable warrant to an investor for cash of $1 million.

# Case Study No. 3 – Steady Manufacturing, Inc. Background

- The convertible debt . . .
  - Provides for cash repayment of $1 million or conversion into 100,000 shares of common stock at any time at the holder's option prior to July 31, 2020
  - Accrues eight percent interest, payable annually in cash only
  - Allows net share settlement but not net cash settlement
  - Allows for delivery of unregistered shares
  - Contains no anti-dilution or down-round provisions and no put or call features

# Case Study No. 3 – Steady Manufacturing, Inc. Background

- The warrant . . .
  - Provides for purchase of 100,000 shares of common stock at $10 per share at any time at the holder's option
  - Expires July 31, 2020
  - Allows for net share settlement but not net cash settlement
  - Allows for delivery of unregistered shares
  - Contains no anti-dilution provisions and no repurchase or redemption features

# Case Study No. 3 – Steady Manufacturing, Inc. Background

- The convertible debt and warrant are legally detachable and separately exercisable.
- Closing price of the Company's common stock was $10 per share on August 1, 2015.
- The common stock contains no repurchase features.
- As of July 31, 2015, the Company had 20 million shares of common stock authorized with 4 million shares issued and outstanding and had no other instruments that could be settled in shares of common stock.

# Case Study No. 3 – Steady Manufacturing, Inc.

## Scenario *Background*

- *Your Firm is conducting its audit of the Company's financial statements.*
- *You are the engagement partner and have just arrived at the client site for a meeting with the engagement team to discuss the audit.*
- *In your discussions with the engagement team, you learned about the convertible debt with the detachable warrant and the procedures performed by your engagement team.*

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Background*

- *The audit procedures performed by the engagement team related to this transaction included –*
  - *Obtaining a copy of the Board meeting minutes in which the issuance of convertible debt and detachable warrant for $1 million in cash was approved;*
  - *Vouching the $1 million cash receipt;*
  - *Obtaining copies of the debt and warrant agreements;*
  - *Verifying that the Company recorded $1 million of convertible debt on its balance sheet at year end;*
  - *Verifying disclosure in the financial statements of key terms of the debt and warrant; and*
  - *Obtaining management's representation that the issuance of convertible debt and detachable warrant were recorded in accordance with GAAP.*

*Questions:*

? **Do you believe the engagement team has performed sufficient procedures related to the issuer's accounting for the convertible debt and warrant?**

? **What are the accounting principles that apply to recording the issuance of the convertible debt?**

## Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

What accounting standards should be considered?

- ASC Subtopic 470 – 20, *Debt – Debt with Conversion and Other Options*
  - *Allocation of proceeds*
  - *Beneficial conversion feature*
- ASC Topic 480, *Distinguishing Liabilities from Equity*
  - *Warrant classification (liability or equity) on the balance sheet*
- ASC Topic 815, *Derivatives and Hedging*
  - *Derivatives accounting*

# Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

| | | |
|---|---|---|
| 1. | Evaluate Warrant for Classification (*Liability vs Equity*) | *ASC 480* |
| 2. | Evaluate Warrant for Derivative Accounting | *ASC 815* |
| 3. | Evaluate Conversion Feature of Convertible Debt for Derivative Accounting | *ASC 815* |
| 4. | Allocate Proceeds to Instruments | *ASC 470-20 & ASC 820* |
| 5. | Identify and Calculate any Beneficial Conversion Feature | *ASC 470-20* |

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

1. <u>Classification of the warrant</u>

ASC Section 480-10-25 requires liability classification for the following freestanding financial instruments:

- Mandatorily redeemable financial instruments,
- Obligations to repurchase issuer's equity shares by transferring assets, and
- Certain obligations to issue a variable number of shares

In our case, the warrant is outside the scope of ASC 480

# Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

2. Evaluating the warrant for derivative accounting

Does the warrant meet the definition of a derivative, and if so, should the warrant be accounted for as a derivative liability?

A. **Yes** – the warrant does meet the definition of a derivative; and **No** – the warrant should not be accounted for as a derivative liability because it met the scope exception.

B. **Yes** – the warrant does meet the definition of a derivative; and **Yes** – the warrant should be accounted for as a derivative liability.

C. **No** – the warrant does not meet the definition of a derivative; and **No** – the warrant should not be accounted for as a derivative liability.

# Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

2. Evaluating the warrant for derivative accounting

Correct answer is A

A. **Yes** – the warrant does meet the definition of a derivative; and **No** – the warrant should not be accounted for as a derivative liability because it met the scope exception.

B. **Yes** – the warrant does meet the definition of a derivative; and **Yes** – the warrant should be accounted for as a derivative liability.

C. **No** – the warrant does not meet the definition of a derivative; and **No** – the warrant should not be accounted for as a derivative liability.

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

2. <u>Evaluating the warrant for derivative accounting</u>

ASC Paragraph 815-10-15-83 states, in part: A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- **One or more underlyings** and **one or more notional amounts** or payment provisions or both.
- No initial net investment or **an initial net investment that is smaller than would be required** . . .
- Provisions that allow for **net settlement** through:
  - implicit or **explicit terms**,
  - means outside the contract, or
  - delivery of an asset.

# Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

2. Evaluating the warrant for derivative accounting

Does it meet the definition of derivative in our case?

- Underlying? – Yes, market price of the shares of the Company's common stock issuable upon exercise of the warrant
- Notional amount? – Yes, the number of shares of common stock to be received upon exercise
- Initial net investment (none or small)? – Yes, no initial net investment to directly purchase the warrant
- Net settlement provisions? – Yes, explicit terms indicate net settlement is permissible

2. Evaluating the warrant for derivative accounting



***The scope exception –***

ASC Paragraph 815-10-15-74 states, in part, that the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- Contracts issued or held by that reporting entity that are both:
  - Indexed to its own stock, and
  - Classified in stockholders' equity in its statement of financial position

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

2. <u>Evaluating the warrant for derivative accounting</u> *The scope exception*

ASC Paragraph 815-40-15-7 states, in part: An entity shall evaluate whether an equity-linked financial instrument (or embedded feature) . . . is considered indexed to its own stock within the meaning of this Subtopic and paragraph 815-10-15-74(a) using the following two-step approach:

- Evaluate the instrument's contingent exercise provisions, if any
- Evaluate the instrument's settlement provisions

# Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

2. Evaluating the warrant for derivative accounting

*The scope exception*

Is the scope exception met in our case?

- Indexed to own stock? – Yes, as the warrant:
  - has no contingencies associated with its exercise, and
  - is exercisable into a fixed number of shares at a fixed exercise price
- Classified in equity?

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

2. Evaluating the warrant for derivative accounting *The scope exception*

ASC Paragraph 815-40-25-10 states, in part: Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity... **all** of the following conditions must be met for a contract to be classified as equity:

- Settlement permitted in unregistered shares
- Entity has sufficient authorized and unissued shares
- Contract contains an explicit share limit
- No required cash payment if entity fails to timely file with SEC
- No cash-settled top-off or make-whole provisions
- No counterparty rights rank higher than shareholder rights
- No collateral required

# Case Study No. 3 – Steady Manufacturing, Inc.

## Scenario *Debrief*

2. Evaluating the warrant for derivative accounting

*The scope exception*

Is the scope exception met in our case?

- Indexed to own stock? – Yes, as the warrant:
  - has no contingencies associated with its exercise, and
  - is exercisable into a fixed number of shares at a fixed exercise price
- Classified in equity? – Yes, as it meets the requirements of ASC 815-40-25-10

Thus, it does meet the scope exception, and therefore is not to be accounted for as a derivative.

2. Evaluating the warrant for derivative accounting *The scope exception*

ASC Paragraph 815-40-35-8 states:

**The classification of a contract shall be reassessed at each balance sheet date**. If the classification required under this Subtopic changes as a result of events during the period (if, for example, as a result of voluntary issuances of stock the number of authorized but unissued shares is insufficient to satisfy the maximum number of shares that could be required to net share settle the contract [see discussion in paragraph 815-40-25-20]), the contract shall be reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

3. Evaluating the debt for derivative accounting

- Determine nature of host contract
- Identify all embedded features
- Evaluate embedded features for derivative accounting

## Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

3. <u>Evaluating the debt for derivative accounting</u>

ASC Paragraph 815-15-25-1 states, in part, that: An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- The economic characteristics and risks of the embedded derivative **are not** clearly and closely related to the host contract
- The hybrid instrument **is not** remeasured at fair value
- A separate instrument with the same terms as the embedded derivative **would**… be a derivative instrument

# Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

4. Allocating the proceeds

ASC Paragraph 470-20-25-2 states:

Proceeds from the sale of a debt instrument with stock purchase warrants shall be **allocated to the two elements based on the relative fair values** of the debt instrument without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants shall be accounted for as paid-in capital. The remainder of the proceeds shall be allocated to the debt instrument portion of the transaction. This usually results in a discount (or, occasionally, a reduced premium), which shall be accounted for under Topic 835.

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

4. Allocating the proceeds

| | Fair Value | Relative Fair Value as Percentage | Allocated Proceeds and Initial Carrying Value |
|---|---|---|---|
| **Convertible debt** | $ 1,000,000 | 80% | $ 800,000 |
| **Warrant** | 250,000 | 20% | 200,000 |
| **Total proceeds** | $ 1,250,000 | 100% | $ 1,000,000 |

Note: The $250,000 fair value amount for the warrant is provided here for illustrative purposes only and is not meant to represent an accurate fair value measurement.

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

5. <u>Beneficial conversion feature</u>

We'll look to:

- ASC 470-20-20 for the definition of a beneficial conversion feature
- ASC 470-20-25-5 for recognition of the beneficial conversion feature
- ASC 470-20-30-5 and ASC 470-20-30-6 for measurement of the beneficial conversion feature

5. Beneficial conversion feature

- ASC Section 470-20-20 defines a beneficial conversion feature as a nondetachable conversion feature that is in the money at the commitment date.

- ASC Paragraph 470-20-25-5 provides, in part, that an embedded beneficial conversion feature present in a convertible instrument shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital.

## 5. Beneficial conversion feature

ASC Paragraph 470-20-30-5 provides, in part, that the effective conversion price based on the proceeds received for or allocated to the convertible instrument shall be used to compute the intrinsic value, if any, of the embedded conversion option. Specifically, an issuer shall do all of the following.

- First, allocate the proceeds received to the convertible instrument and any other detachable instruments included in the exchange on a relative fair value basis.
- Second, apply the guidance beginning in paragraph 470-20-25-4 to the amount allocated to the convertible instrument.
- Third, calculate an effective conversion price and use that effective conversion price to measure the intrinsic value, if any, of the embedded conversion option.

5. Beneficial conversion feature

ASC Paragraph 470-20-30-6 provides that **intrinsic value** shall be calculated at the commitment date (see paragraphs 470-20-30-9 through 30-12) as the difference between the conversion price (see paragraph 470-20-30-5) and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible.

# Case Study No. 3 – Steady Manufacturing, Inc.
## Scenario *Debrief*

5. Beneficial conversion feature

| | |
|---|---|
| **Proceeds allocated to convertible debt** | $800,000 |
| **Divided by number of shares to obtain upon conversion** | 100,000 |
| **Effective conversion price per share** | $8.00 |
| **Fair value of a common share at issuance date** | $10.00 |
| **Less effective conversion price per share** | $8.00 |
| **Intrinsic value per share** | $2.00 |
| **Multiplied by number of shares to obtain upon conversion** | 100,000 |
| **Total intrinsic value** | $200,000 |

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

5. Allocating the proceeds

| | Allocated Proceeds and Initial Carrying Value from Above | Adjusted Carrying Value for Beneficial Conversion Feature |
|---|---|---|
| **Convertible debt** | $ 800,000 | $ 600,000 |
| **Beneficial conversion feature** | - | 200,000 |
| **Warrant** | 200,000 | 200,000 |
| **Total** | $ 1,000,000 | $ 1,000,000 |

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

Relevant auditing standards

- AS 2110, *Identifying and Assessing Risks of Material Misstatement* (currently AS 12)
- AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* (currently AS13)
- AS 2502, *Auditing Fair Value Measurements and Disclosures* (currently AU 328)
- AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (currently AU 332)

# Case Study No. 3 – Steady Manufacturing, Inc. Scenario *Debrief*

Relevant auditing standards

AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (currently AU 332), paragraph .19 states, in part:

> The auditor should use the **assessed levels of inherent risk and control risk for assertions about derivatives and securities** to determine the nature, timing, and extent of the substantive procedures to be performed to detect material misstatements of the financial statement assertions. Some substantive procedures address more than one assertion about a derivative or security. Whether one or a combination of substantive procedures should be used to address an assertion depends on the auditor's assessment of the inherent and control risk associated with it as well as the auditor's judgment about a procedure's effectiveness. **Paragraphs .21 through .58 provide examples of substantive procedures that address assertions about derivatives and securities.**

# Question E

According to AS 2315 (currently AU 350), paragraph .16, when planning a particular sample for a substantive test of details, the auditor should consider:

A. the relationship of the sample to the relevant audit objective
B. tolerable misstatement
C. the auditor’s allowable risk of incorrect acceptance
D. characteristics of the population
E. all of the above

## Question F

For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the ___________ associated with the control.

A. dollars
B. number of accounts
C. risk
D. people

# Question F

AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (currently AS 5), paragraph .46 states:

> For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the **risk** associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

# Questions

# Break

(15 minutes)

# Remediation and Root Cause

# Remediation and Root Cause

Ellen Graper
Associate Director
Division of Registration and Inspections

# Remediation Refresher

## What to do…

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

# Why a Root Cause Analysis?

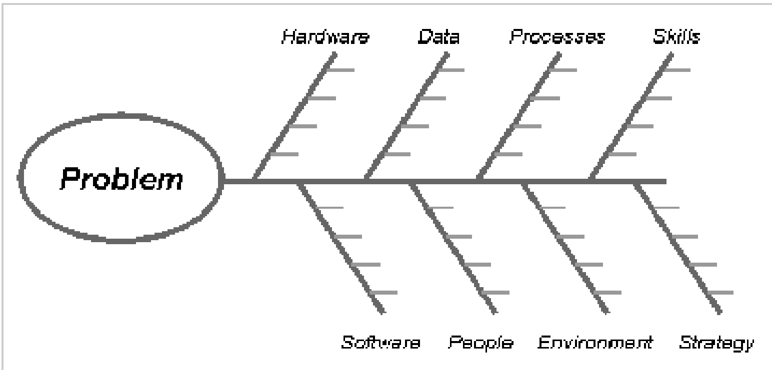
- Quality control standards
- Larger firms
- Smaller firms

# What is a Root Cause Analysis?

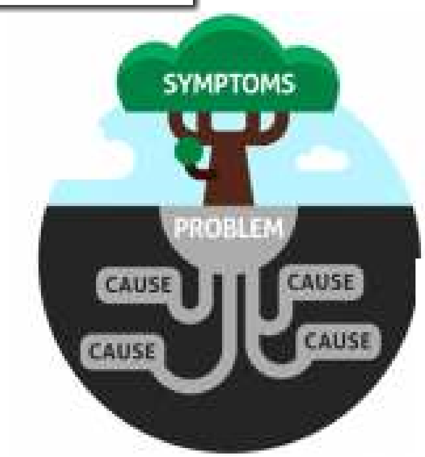
- Systematic process for identifying the reasons for a problem or event and an approach for responding to them.

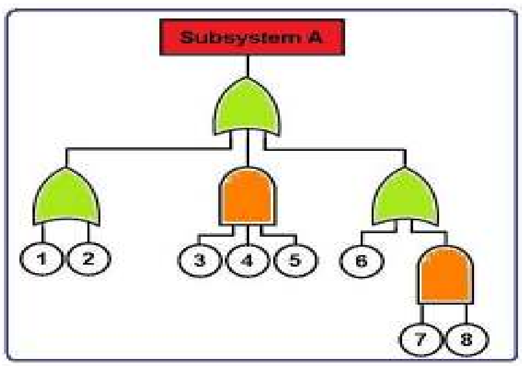
- Based on the basic idea that effective management requires more than merely “putting out fires” for problems that develop, but requires finding a way to prevent them.

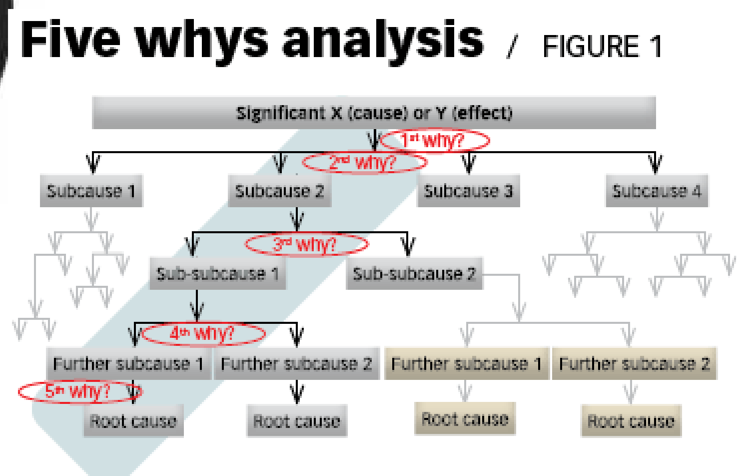
# Types of Root Cause Analyses



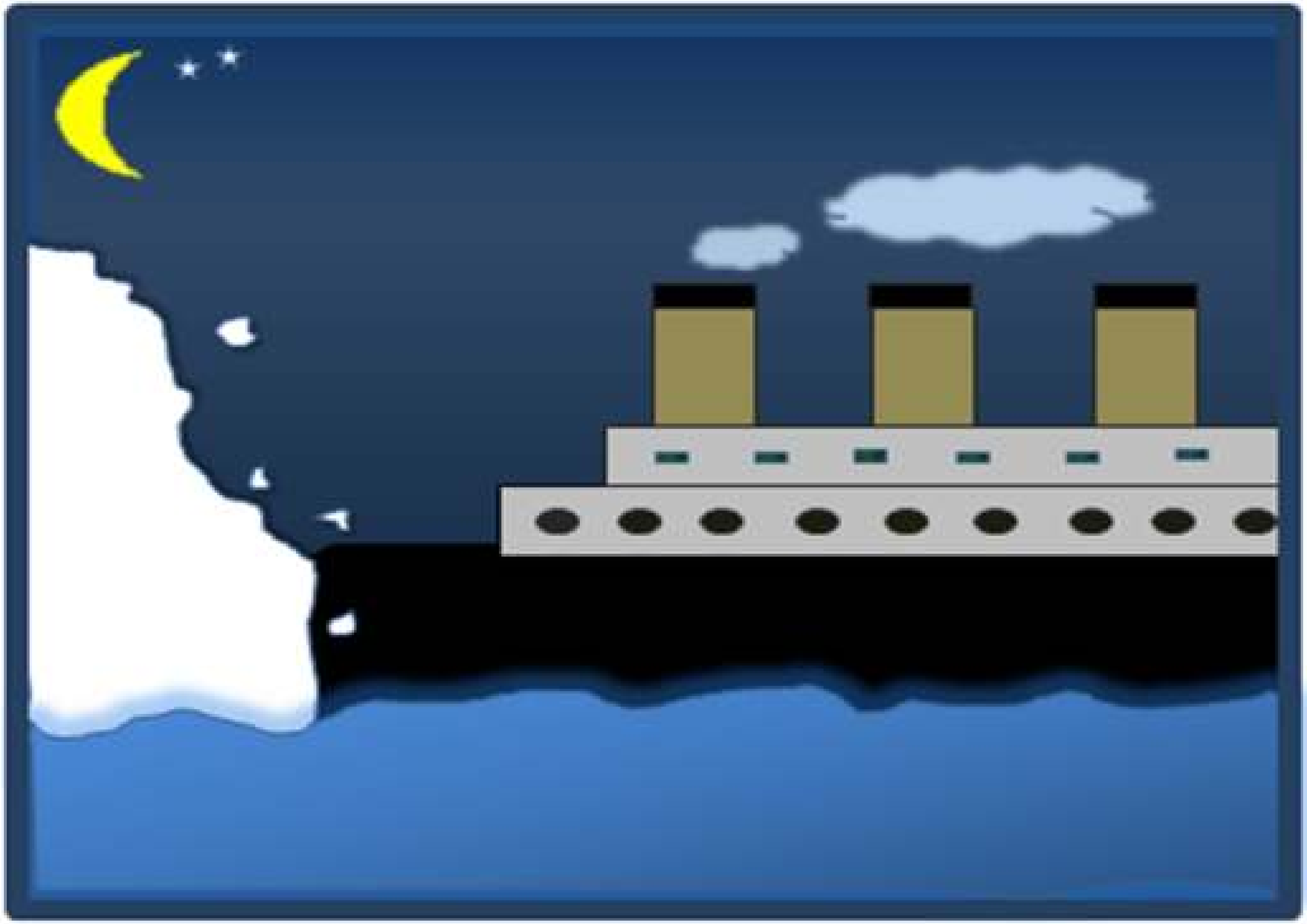


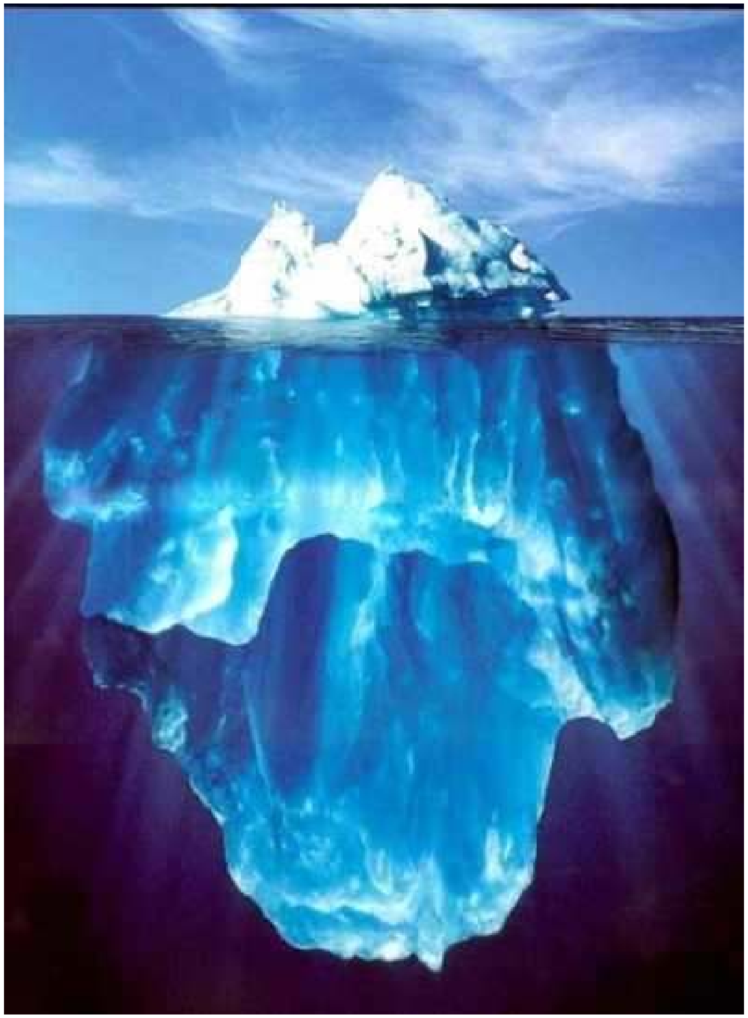


# Why did the Titanic Sink??





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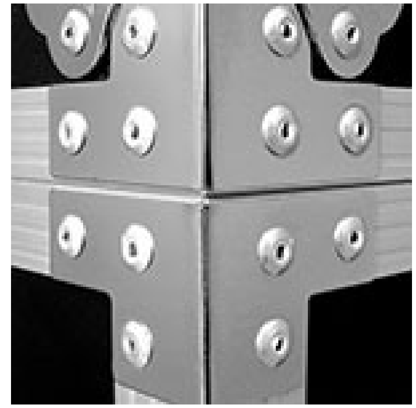
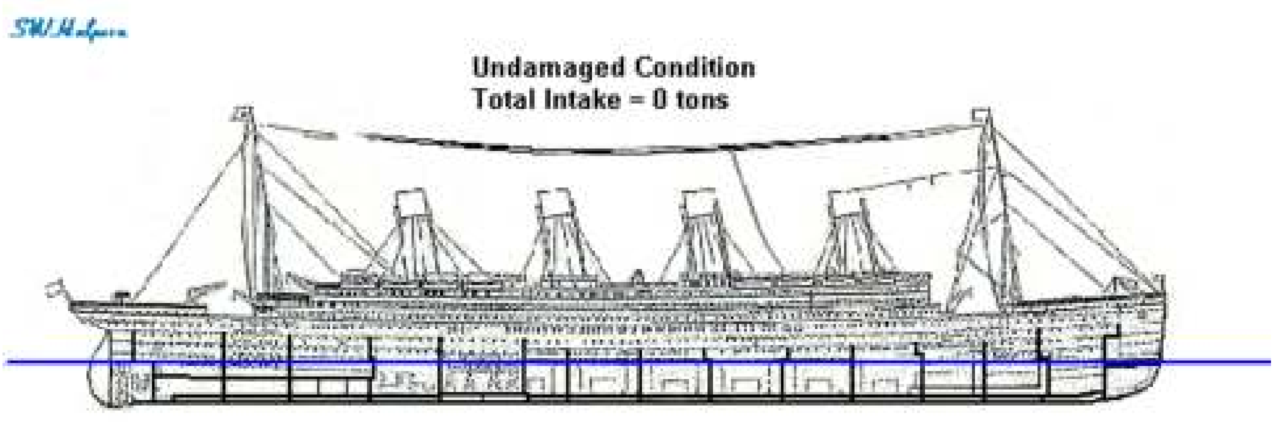
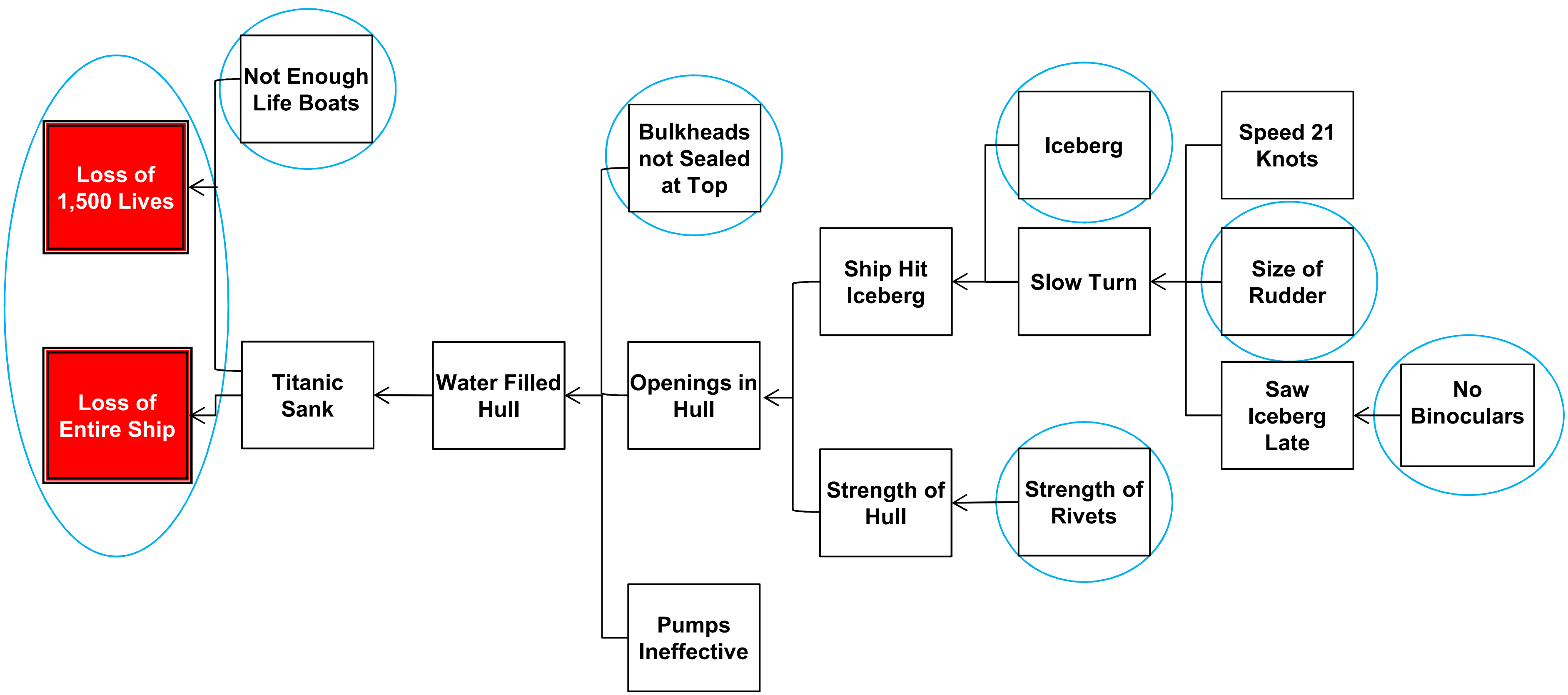



SW Halpern
Undamaged Condition
Total Intake = 0 tons

# Titanic - Cause Map



# Titanic – 5 Whys

**Loss of 1,500 Lives**

↑

**Titanic sank**

↑

**Water filled hull**

↑

**Openings in hull**

↑

**Ship hit iceberg**

↑

**Lookouts saw iceberg late**

# Remediation and Root Cause Example

**Testing Appropriate to the Audit - Revenue**

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will conduct all testing appropriate to a particular audit. As discussed above, in the audit reviewed, the inspection team identified a significant deficiency related to the Firm's **testing of the occurrence and valuation of revenue, including inadequate substantive analytical review procedures**. **The inspection team attempted to identify apparent or likely causes of this deficiency**. Based on review of the work papers and discussions with the engagement personnel, it **appeared to the inspection team that the deficiency was attributable, at least in part, to the engagement personnel having approached this aspect of the audit without due care, including without professional skepticism.** This information provides cause for concern regarding the Firm's **application of due care, including professional skepticism, with respect to auditing revenue.**

# Revenue Report Criticism– 5 Whys

**Revenue Recognition/Substantive Analytical Procedures**

**Lack of Due Care, Skepticism**

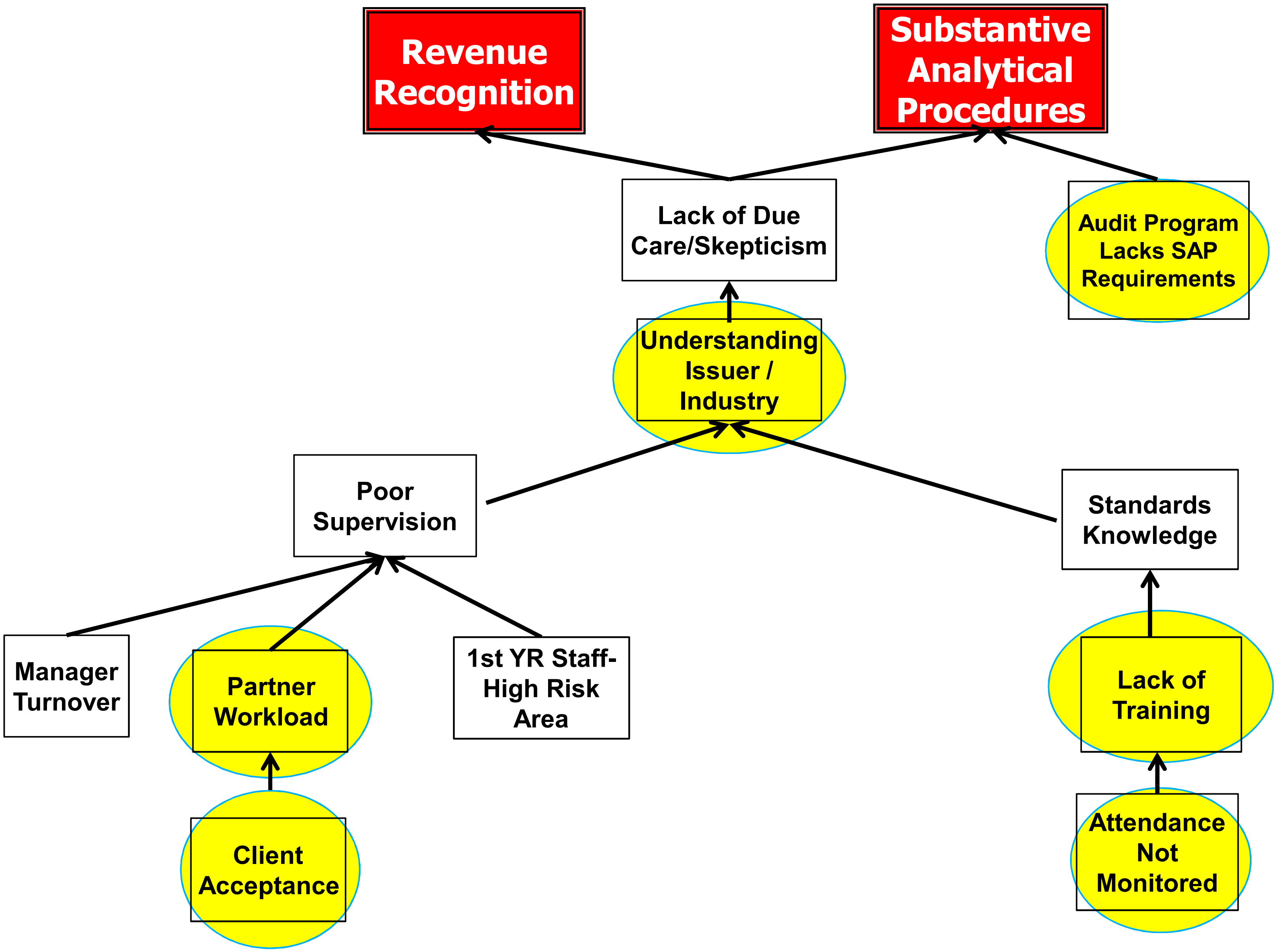
**Incomplete understanding of issuer/industry**

**Inexperienced staff; inadequate supervision**

**Staff turnover; partner workload**

**Client acceptance**

# Revenue Report Criticism - Cause Map



# Remediation and Root Cause

Possible remedial actions

- Template on performing substantive analytical procedures
- Training on revenue recognition and the execution of substantive analytical procedures
- Monitor attendance at training and follow up on non-participation
- Flowcharts on client processes
- Ensure a detail review of revenue work papers (and all high risk areas)

# Remediation and Root Cause

Inappropriate remedial actions

- New policy to use substantive audit sampling worksheet
- Email to staff to increase documentation for revenue on issuer audits
- The two staff on the engagement take revenue training

# Common Root Causes

- Ineffective supervision and review
- Lack of / insufficient depth of supervision and review
- Lack of professional skepticism
- Insufficient understanding of PCAOB Standards
- Lack of experience
- Inadequate skillset
- Improper scoping of control testing
- Improper scoping of audit approach
- Failure to understand audit risks
- Partner workload
- Engagement team workload
- Engagement team turnover
- Overreliance of specialists work
- Client acceptance issues
- Lack of challenging prior knowledge and audit strategy
- Lack of understanding the issuer's business processes
- Improper resolution of inspection findings
- Improper execution of National Office consultation
- Improper use of Firm guidance
- Lack of adequate training
- Timing of procedures
- Inappropriate budget / audit fees
- Effect of significant issuer transactions
- Ineffective project management
- Firm culture
- Time constraints

# Resources

Resources:

- http://pcaobus.org/Inspections/Pages/Remediation_Process.aspx
- Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards (No. 8 through No. 15) dated October 15, 2015
- The firm's remediation contact from the report transmittal letter.

# Questions

# Starting a First Year Audit

## Inspection Findings and Case Study


Stephen D'Angelo
Assistant Director
Division of Enforcement and Investigations

Dima Andriyenko
Associate Chief Auditor
Office of the Chief Auditor

# Starting a First Year Audit Inspection Findings

- Policies and procedures fail to provide reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized
- Policies and procedures fail to provide reasonable assurance that a firm:
  - undertakes only those engagements that it can reasonably expect to be completed with professional competence; and
  - appropriately considers the risk associated with providing professional services in the particular circumstances
- Failure to evaluate the impact of opening balances on the current-year financial statements and the consistency of accounting principles
- Engagement quality reviewer was not qualified

# Starting a First Year Audit

## Case Study No. 4 – Neighborly Bank

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Background*

- In August 2016, your Firm won a proposal contest to audit the financial statements of Neighborly Bank (the "Bank") for the year ended December 31, 2016. The Bank is a regional provider of commercial banking services.
- The Bank's Form 10-K is due to be filed with the SEC by March 31, 2017.
- Your Firm is celebrating from the good news that it won the audit of the Bank's financial statements.
- However, as the partner that led the proposal effort and that will serve as the engagement partner on the audit, the reality is beginning to set in that you and your firm have a big job ahead.
- The first and most pressing task is that of completing your firm's client acceptance process so that the Bank can file an 8-K communicating dismissal of the predecessor auditor and the engagement of your firm as the new auditor.

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Background*

As you begin to focus on this client acceptance task, the following thoughts begin to run through your mind:

i. Your firm's process requires that the Firm's managing partner and its Director of Accounting and Auditing must both approve acceptance of any new audit client of the Firm. While they have not formally signed off yet, you figure that since these two partners are the ones leading the celebration of the proposal victory that their approval is fairly certain.

ii. You do have concerns over your lack of familiarity with the management team of the Bank since its headquarters office is about 200 miles from your one-office Firm. One of your partners suggests that since the Bank is in a regulated industry and you are not aware of any negative press on the Bank or its leadership that the likelihood of management having any integrity issues is minimal.

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Background*

iii. You are concerned about your Firm's ability to properly staff the audit of the Bank, particularly during busy season, given your current staff resource issues.

Your firm has 10 partners and 45 professional staff that focus on audit work; however, you are the Firm's only bank audit partner, and there are only five other staff with bank audit experience.

You and your five staff are already fully scheduled on another public regional bank with a March 31st filing deadline as well as several privately-held banks with calendar year ends.

You recall that you and your managing partner thought your chances of winning the Bank audit were not very good, so you didn't really worry about the staffing issue until now.

Your managing partner thinks that if you can hire one or two more audit staff before the end of the year and begin to train one or two of your non-banking staff on bank audits that you should be able to get the Bank audit done on time.

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Background*

iv. You realize that you ought to talk to the predecessor auditor at some point but can't imagine when you will have time to do that with all that has to be done to accept this new client.

The Bank's CFO agrees that it is important to have a conversation with the predecessor auditor but said it will have to wait until later in the year – maybe while your engagement team is planning the audit.

Right now, you have to do whatever is necessary to give the Bank approval to file its 8-K.

## Case Study No. 4 – Neighborly Bank
## Scenario 1 *Background*

v. You have presented the Bank CFO with an engagement letter outlining an understanding of the terms of the audit engagement.

The CFO, however, immediately indicated that the Bank would need more time to sign the engagement letter, as a result of the audit fee payment schedule contained in the letter that specified the payment of the majority of the fees prior to completion of the audit.

While the partners of your Firm are fairly adamant that this payment schedule is standard and is something the Firm will not budge on, your managing partner has agreed that the Bank can have some time before signing the engagement letter.

Your Firm's managing partner has also made it clear that you will not be able to issue the Firm's audit opinion without a signed engagement letter.

# Case Study No. 4 – Neighborly Bank
## Scenario 1

*Questions*

*Questions:*

? **What are your thoughts on accepting the Bank as an audit client of the Firm?**

? **Can the Bank go ahead and file the 8-K?**

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Debrief*

Matters to consider in connection with the Firm's client acceptance process:

- Management's integrity and capability
- Staffing considerations – Firm's ability to complete the audit with professional competence
- Communication with predecessor auditor
- Communication with audit committee, including audit committees approval of audit services

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Debrief*

Relevant QC standards

QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* ("QC 20"), paragraph .14 states:

> Policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. **Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized**. Establishing such policies and procedures does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to any person or entity but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its client relationships and the professional services it will provide.

# Case Study No. 4 – Neighborly Bank
# Scenario 1 *Debrief*

<u>Relevant QC standards</u>

QC 20, paragraph .15 states:

> Such policies and procedures should also provide reasonable assurance that the firm—
>
> - **Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence**.
> - Appropriately considers the risks associated with providing professional services in the particular circumstances.

# Case Study No. 4 – Neighborly Bank
# Scenario 1 *Debrief*

<u>Relevant QC standards</u>

QC Section 40, *The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-in-Charge of an Attest Engagement* ("QC 40"), paragraph .07 states, in part:

> The practitioner-in-charge of an engagement to audit the financial statements of a public company would be expected to have certain technical proficiency in SEC reporting requirements . . . This would include, for example, experience in the industry and appropriate knowledge of SEC and ISB rules and regulations, including accounting and independence standards.

QC 40, paragraph .08 states, in part:

> *Technical Proficiency* — Practitioners-in-charge of an engagement should possess an understanding of the applicable accounting, auditing, and attest professional standards including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages.

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Debrief*

Relevant auditing standards

AS 1220, *Engagement Quality Review* (currently AS 7), paragraph .03 states, in part:

> An engagement quality reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) must be a partner or another individual in an equivalent position. The engagement quality reviewer may also be an individual from outside the firm.

AS 1220 (currently AS 7), paragraph .05 states:

> The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Debrief*

Relevant auditing standards

AS 2101, *Audit Planning* (currently AS 9), paragraphs .18 and .19 state:

The auditor should undertake the following activities before starting an initial audit:

a) Perform procedures regarding the **acceptance** of the client relationship and the specific audit engagement; and

b) Communicate with **the predecessor auditor** in situations in which there has been a change of auditors in accordance with AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors.*

The purpose and objective of planning the audit are the same for an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding **the opening balances**.

# Case Study No. 4 – Neighborly Bank
# Scenario 1 *Debrief*

## Relevant auditing standards

AS 2610 (currently AU 315), paragraph .09 states:

> The successor auditor should make specific and reasonable inquiries of the predecessor auditor regarding matters that will assist the successor auditor in determining whether to accept the engagement. Matters subject to inquiry should include—
>
> - Information that might bear on the integrity of management.
> - Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters.
> - Communications to audit committees or others with equivalent authority and responsibility regarding fraud, illegal acts by clients, and internal-control-related matters.
> - The predecessor auditor's understanding as to the reasons for the change of auditors.
> - The predecessor auditor's understanding of the nature of the company’s relationships and transactions with related parties and significant unusual transactions.

# Case Study No. 4 – Neighborly Bank
## Scenario 1 *Debrief*

Relevant auditing standards

AS 1301, *Communications with Audit Committees* (currently AS 16), paragraph .07 states:

> If the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee, the auditor should decline to accept, continue, or perform the engagement.

# Case Study No. 4 – Neighborly Bank Scenario 1 *Debrief*

## Relevant independence rule

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, states, in part:

A registered public accounting firm must –

(a) prior to accepting an initial engagement pursuant to the standards of the PCAOB -

(1) describe, in writing, to the audit committee of the potential audit client, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the potential audit client the potential effects of the relationships described in subsection (a)(1) on the independence of the registered public accounting firm, should it be appointed the potential audit client's auditor; and

(3) document the substance of its discussion with the audit committee of the potential audit client.

# Case Study No. 4 – Neighborly Bank
## Scenario 2 *Background*

- Your Firm was able to work through its client acceptance issues and did accept the Bank as an audit client.
- Your Firm has now begun to perform interim audit procedures for the 2016 audit.
- In connection with your Firm's audit procedures, you become aware of a matter that suggests a material error in the prior year's financial statements that were audited by the predecessor auditor.

# Case Study No. 4 – Neighborly Bank
## Scenario 2



*Questions:*

? **What are your Firm's responsibilities with regard to the potential error in the prior year financial statements?**

? **What are the predecessor auditor's responsibilities?**

? **If it's determined that the prior year financial statements need to be restated, should it be the predecessor auditor or the successor auditor that audits the adjustments related to restating the prior year financial statements?**

# Case Study No. 4 – Neighborly Bank
## Scenario 2 *Debrief*

AS 2610, *Initial Audits–Communications Between Predecessor and Successor Auditors* (currently AU 315), paragraph .21 states:

If during the audit or reaudit, the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, **the successor auditor should request that the client inform the predecessor auditor of the situation and arrange for the three parties to discuss this information and attempt to resolve the matter**. The successor auditor should communicate to the predecessor auditor any information that **the predecessor auditor may need to consider in accordance with AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report***, which sets out the procedures that an auditor should follow when the auditor subsequently discovers facts that may have affected the audited financial statements previously reported on.

# Case Study No. 4 – Neighborly Bank
## Scenario 2 *Debrief*

In accordance with AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (currently AU 561), the **predecessor auditor should**:

- Investigate the matter, including discussing the matter with the company management / board of directors.
- Determine if:
  a. The predecessor auditor's report would have been affected if the information had been known at the date of its report and had not been reflected in the financial statements; and
  b. The predecessor auditor believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information.
- If yes to (a) and (b) above, then advise the company to make disclosures of the matter, such as through restated financial statements and potentially notification of non-reliance of previously issued financial statements prior to issuance of the restated financial statements.

# Case Study No. 4 – Neighborly Bank
## Scenario 2 *Debrief*

AS 3101, *Reports on Audited Financial Statements* (currently AU 508), paragraphs .71 and .73 state, in part:

Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period,… **a predecessor auditor should**

- read the financial statements of the current period,
- compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and
- obtain representation letters from management of the former client and from the successor auditor

…when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. **If the predecessor auditor revises the report or if the financial statements are adjusted, he or she should dual-date the report**.

# Case Study No. 4 – Neighborly Bank
## Scenario 2 *Debrief*

PCAOB issued a Staff Questions and Answers (Q&A) in June 2006 on *Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor*.

Per that Q&A:

- Either the successor auditor or the predecessor auditor may audit the adjustments made to prior-period financial statements, so long as the auditor is independent and registered with the PCAOB.

- The exception is that if the successor auditor has not yet completed its initial audit of the company's current-period financial statements, then the successor auditor cannot audit and report on the adjustments made to the prior-period financial statements, as it does not yet have sufficient knowledge of the company and its financial reporting to adequately plan and perform an audit of the adjustments to conclude on whether they are appropriate and have been properly applied.

# Case Study No. 4 – Neighborly Bank
## Scenario 2 *Debrief*

Also per that Q&A:

If the predecessor auditor is the one who audits the adjustments related to the prior year, the successor auditor still has responsibilities, including:

- Obtaining an understanding of the adjustments made to the prior-period financial statements and their effects, if any, on the current-period financial statements; and
- Evaluating the consistency of the application of accounting principles from period to period.

## Question G

According to AS 1215 (currently AS 3), paragraph .04, audit documentation should be prepared in sufficient detail to provide a clear understanding of ____________.

A. its purpose
B. its source
C. the conclusions reached
D. all of the above

# Question H

QC 20, paragraph .09 states that policies and procedures should be established to provide the firm with reasonable assurance that personnel:

A. maintain independence (in fact and in appearance) in all required circumstances
B. pass the CPA exam
C. perform all professional responsibilities with integrity
D. are satisfied with their compensation
E. maintain objectivity in discharging professional responsibilities

# Questions

# Division of Enforcement and Investigations Update

Stephen D'Angelo
Assistant Director, Accountant,
Division of Enforcement and Investigations

# Agenda

- Today we would like to discuss:
  - Overview of Division of Enforcement and Investigations (DEI) program statistics for 2015
  - Coordination with the SEC
  - Selected Recent Disciplinary Proceedings
    - Admissions in Settlements
  - Other Settled Independence Matters
  - Other Settled Engagement Quality Review Matters

Unless otherwise noted, in 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.

# DEI Program Statistics for 2015

- During 2015
  - The Board imposed sanctions on auditors ranging from censures to monetary penalties to bars against their association with registered accounting firms
    - The Board issued 44 settled disciplinary orders
    - Two adjudicated disciplinary orders were issued
  - In all, the Board disciplined 38 registered accounting firms and 27 associated persons in those proceedings, and imposed a total of $257,000 in penalties
- DEI continues to prioritize large firm cases involving significant potential audit failures and risk to investors, as well as matters involving non-cooperation with Board processes

# Coordination with the SEC

- PCAOB may share information with the SEC, DOJ, and other agencies enumerated in the Act
- Coordination with SEC Enforcement is standard practice
  - Parallel investigations:  PCAOB investigates auditor conduct; SEC investigates public company, its management, and others
- PCAOB may defer its investigation of auditor to the SEC

# Staff Practice Alert No. 14, *Improper Alteration of Audit Documentation*

- Improper alteration of audit documentation in connection with an inspection or investigation can result in disciplinary actions with severe consequences (violation of duty to cooperate)
- Issues in recent oversight activities have heightened concerns about this at a range of firms including global network affiliates
- Consequences of improper alteration, in many cases, is more severe than from the underlying perceived audit deficiency

# The Hall Group, CPAs and David S. Hall, CPA – April 26, 2016

- Matter involves
  - Audit failures for three audits
    - In two audits, failed to obtain sufficient audit evidence in connection with related party revenue transactions
    - In a third audit, failed to evaluate GAAP compliance in connection with an asset retirement obligation
  - Violations of AS 7
    - In two audits, failed to have an EQR performed by someone meeting the required level of knowledge and competence
    - In the third audit, the engagement partner also served in the EQR role
  - Failure to cooperate with investigation
    - After receiving notification of an inspection, the engagement partner and staff altered, added, and backdated work papers without making the disclosures required by AS3 or otherwise advising the inspectors of these alterations.
- As a result, the firm's registration was revoked and the engagement partner was barred with a right to reapply after three years. The firm also received a $10,000 penalty.

# Mark Shelley CPA, Mark A. Shelley, CPA, & Allan J. Ricks – May 28, 2015

- Matter involves two audits of an issuer
- The firm and Shelley were in violation of rule 10(b)5 when the firm issued audit reports, because of repeated failures to
  - Exercise due professional care and skepticism
  - Obtain sufficient and appropriate audit evidence
- The firm and Shelley violated AS 7 by failing to have an EQR performed by someone meeting the required level of knowledge and competence (Ricks)
- Ricks violated AS 7 by providing EQR concurrence without due professional care
- As a result, the firm's registration was revoked and its sole-proprietor was barred.  Ricks was barred with a right to reapply after one year.  All were censured

# L.L. Bradford & Co. LLC, et al. – Various 2015

- Matters involve the firm and five associated persons
- The firm had pervasive independence and quality control violations in its issuer practice
  - Not independent of six issuer audit clients due to partner rotation violations
  - An audit principal of the firm provided bookkeeping and financial statement preparation for one audit client, and failed to communicate that to the audit committee
  - Violated "cooling-off" period for engagement quality reviewers
- The firm also violated rules and auditing standards in an audit and a review of an issuer
- As a result
  - The firm's registration was revoked with a right to reapply after 5 years, censured, and penalized $12,500
  - The five associated persons all received censures and
    - one person received a one-year suspension with an additional year's limitation on activities and additional CPE
    - The other persons received bars with rights to reapply after one or two years and penalties up to $25,000

# David A. Aronson, CPA, P.A. & David A. Aronson, CPA – October 2, 2015

- Repeated violations of the auditor independence rules
- Repeated violations of the engagement quality review requirements
  - Failed to obtain an EQR in 10, separate audits
  - Failed to obtain EQRs, even after being put on notice in two, separate PCAOB inspections
  - Failed to obtain an EQR during the timeframe of the Board's investigation
- As a result
  - Firm's registration was revoked
  - Aronson was barred
- Aronson admitted to the disciplinary order's facts, findings, and violations
  - **First settlement in which the Board obtained admissions**

# Admissions in Settled Orders

- Going forward, in its settlement recommendations to the Board, DEI will consider requiring admissions in certain circumstances
- In considering whether to require admissions, DEI will reflect on whether a matter involves
  - Egregious and intentional conduct
  - Obstruction of Board processes
  - Significant harm to investors or securities markets
  - Situations where an admission can send a particularly important message to audit firms, auditors, or the public
  - Situations where a wrongdoer poses a particular future threat to investors
- DEI still anticipates most settlement recommendations will continue to include language stating that respondent(s) “neither admit nor deny” the Board’s findings

# Clay Thomas, P.C., and Clay Thomas, CPA – February 18, 2016

- Matter involves
  - Failure to cooperate with investigation
    - Firm failed to produce documents
    - Thomas failed to appear for testimony
  - Audit failures for two audits
    - Failed to obtain EQRs
    - Failed to retain audit documentation
- As a result, the registration of the firm was revoked, Thomas was barred, and both were censured

# AWC (CPA) Limited, et al. – May 18, 2016

- Matter involves a Hong Kong firm's audit of an issuer
  - Violation of Section 10A by failing to consider whether:
    - Cash balances held by the issuer's chairman were prohibited loans constituting illegal acts
    - Last-minute adjustments were made to avoid related party disclosures
  - Violation of AS 7 due to EQR also performing audit procedures
  - Independence violation due to the EQR representing the issuer before a regulatory agency
- As a result, the registration of the firm was revoked with a right to reapply after two years; an affiliated firm also received a one-year suspension
- The individuals involved received a range of sanctions including limitations on serving as engagement partner, bars with a right to reapply after one to two years, and penalties between $5,000 and $10,000

# Auditor Independence Matters – Recent Broker-Dealer Settlements

- Since December 2014, the Board has entered into settled orders with 22 firms and certain associated persons for violations of independence associated with maintaining the financial records or preparing financial statements of a **broker-dealer** audit client of the firm
  - Ordinary Offenders
    - Maintained and prepared accounting records, or prepared client financial statements, but had not received specific inspection comments on this conduct
  - Repeat Offenders
    - Received inspection comments noting that preparation of financial statements impaired independence
    - Did things differently thereafter, but still engaged in financial statement preparation activities
  - Aggravated Repeat Offenders
    - Continued to prepare audit client's financial statements after receiving inspection comments noting that preparation impaired independence

# Auditor Independence Matters – Broker-Dealer Audit Firm Sanctions

- Ordinary Offenders
  - All 18 firms were sanctioned with a censure, a $2,500 monetary penalty, and were required to take remedial measures for independence
- Repeat Offenders
  - The 2 firms were sanctioned with a censure, a $7,500 penalty, and remedial measures for independence
- Aggravated Repeat Offenders
  - The 2 firms were sanctioned with a censure, a $20,000 penalty, a 1-year prohibition on new broker-dealer clients, and remedial measures for independence
  - Each associated person sanctioned with a censure and a bar from association, with a right to reapply after one year
  - One associated person also sanctioned with a $10,000 penalty; the other associated person was the sole-proprietor of the firm

# Auditor Independence Matters – Sanctionable Conduct

- For one or more of its Broker-Dealer audit clients members of the audit firm
  - Prepared all or a portion of the financial statements, including notes
  - Prepared draft statements with placeholders for dollar amounts
  - Obtained drafts, but made extensive changes
  - Directed or supervised professionals from another firm to prepare all or a portion of the financial statements that were the subject of the firm's audit opinion
  - Maintained and prepared accounting records

# Auditor Independence Matters – Non-sanctioned Auditors

- The Board has also announced that two unnamed broker-dealer audit firms had prepared financial statements, but would not be sanctioned
- The Board awarded credit for extraordinary cooperation based on the firms':
  - Timely and voluntary self-reporting to the PCAOB Tip Line
  - Timely, voluntary, and meaningful remedial actions, including, in one case, communicating the violation to the client and discussing the conduct and violation at an annual firm training session

# Auditor Independence Matters – Other Recent Settlements

- The Board has also recently entered into settled orders with firms and certain associated persons for violations of independence of an **issuer audit client** of the firm
  - *Samyn & Martin* (Jul. 23, 2015) – Staff of the firm provided bookkeeping, financial statement preparation and valuation services for audit clients. Censures and bars with a right to reapply after one year for firm and individual, $10,000 penalty to firm
  - *Scott & Co., et al. and Nelson* (Feb. 18, 2016) – Hired audit staff prepared tax provision and footnote tables for audit client. Firm and engagement partner were censured, $10,000 penalty and re-registration requirements on firm. Hired audit staff (Nelson) was censured
  - *Moss, Krusick & Associates and Joseph M. Krusick* (April 12, 2016) – Arranged for the engagement of an outside accountant to prepare financial statements who was directed and paid by the firm. Censures and bars with a right to reapply after two years for firm and engagement partner; $10,000 penalty on firm and $5,000 penalty for engagement partner.

# Engagement Quality Review Matters – July 23, 2015 Settlements

- The Board settled disciplinary orders against seven firms and seven associated persons for conduct including violations of EQR requirements (AS No. 7)
  - EQRs are required for issuer audits and interim reviews, broker-dealer audits, **and** examinations/reviews of broker-dealer compliance/exemption reports
- Each of the firms violated one of two requirements
  - <u>5 firms</u> – No concurring approval of an EQR was obtained prior to granting permission to the client to use the firm's audit report
    - "An engagement quality review and concurring approval of issuance are required…." (AS 7 ¶ 1)
    - "In an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance." (AS 7 ¶ 13)
  - <u>2 firms</u> – Engagement quality reviewer had not satisfied the cooling-off requirement:
    - "The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer." (AS 7 ¶ 8)

# Engagement Quality Review Matters – July 23, 2015 Settlements

- With respect to sanctions, the firms fell into one of three groups
  - One or two violations of cooling-off requirement
    - **censure**
  - One or two violations of requirement to have EQR performed
    - **censure, remedial measures, penalty ($5K, $7.5K)**
  - Multiple violations of requirement to have EQR performed
    - **censure, revocation, larger penalty ($10K, $15K)**
- Each associated person sanctioned with censure and, where firm received revocation, a bar with rights to reapply after one or two years
- Two cases included other audit standard or rule violations
- Note in particular:
  - *R.R. Hawkins*: Inspectors had reminded firm of requirement
  - *Keith K. Zhen, CPA*: Firm had EQR done in earlier audits

# Engagement Quality Review Matters

- Engagement Quality Reviewers have a "Cooling-off" period requirement (AS 1220 ¶8 [Currently AS 7 ¶8])
  - Engagement quality reviewers are subject to "cooling-off" requirement, unless they qualify for the small firm exemption
  - The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer
- Small firm exemption
  - Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(6)(ii), are exempt from the "cooling-off" requirement
  - Small Firm = Firm with less than 5 issuer audit clients and less than 10 partners shall be exempt, provided the PCAOB conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence

# PCAOB Center for Enforcement Tips, Complaints and Other Information

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

# Questions

# Closing Remarks

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