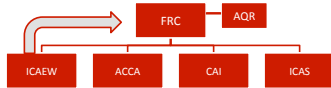


UK Audit Regulation

The **Financial Reporting Council (FRC)** is the UK's independent regulator



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UK Audit Regulation

- The Audit Quality Review (AQR) team (a department of the FRC), monitors the quality of audit work carried out by the major audit firms in the UK
- Risk based approach in selecting audits for review
- Review covers Auditing Standards, Ethical Standards and Quality Control Standards

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Summary of Results

- FRC published latest report in May 2013
- Provided overview of activities in the year to 31 March 2013

Reason for monitoring Visits (ICAEW)

Reason	Number of Firms
Monitored following a request by the registration/ licensing committee	8
With public interest without AQR involvement	48
Specifically selected due to heightened risk	39
Randomly selected	596
Total	691

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Summary of Results

Institute of Chartered Accountants in England & Wales (ICAEW)

ICAEW		2012	2013
A & B Outcomes	No	385	422
	%	54	61
C Outcomes	No	149	137
	%	21	20
D Outcomes	No	71	62
	%	10	9
N Outcomes	No	111	70
	%	15	10

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Feedback from FRC – May 2013

- Within the audits reviewed there were found to be common weaknesses in the following areas:
 - Audit Evidence
 - Documentation
 - Risk Assessment
 - Cold File Reviews
 - Other Areas

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Feedback from FRC

Audit Evidence

Common areas where Audit Evidence is lacking:

Turnover/Revenue



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Feedback from FRC

Turnover/Revenue Top tips:

- What risks/assertions do you need to cover?
- Does your completeness test start from outside the accounting system?
- Have you audited all significant income streams?

Feedback from FRC

Audit Evidence (Cont.)

Stock/Inventory



Feedback from FRC

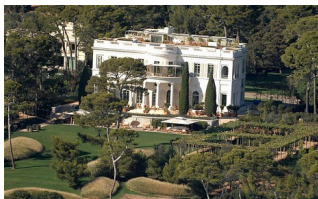
Top tips: Stock

- Have you planned to attend the stock count?
- If the count wasn't at the year end have you tested the intervening period?
- Have you carried out separate tests on cost and NRV?
- Is the basis of provisioning still appropriate?

Feedback from FRC

Audit Evidence (Cont.)

Asset Valuations/Impairment



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Feedback from FRC

Top tips : Asset valuations /impairment

- Have you obtained some independent evidence to assess directors valuations?
- If your relying on an expert's valuation, have you taken steps to check this is appropriate?
- Is the business loss-making or are there other changes in the market that may indicate if assets, including goodwill, are impaired?

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Feedback from FRC

Audit Evidence (Cont.)

Going Concern



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Feedback from FRC

Top tips: Going concern

- Have you discussed this area with management?
- Does your approach match the risk?
- If management has prepared detailed forecasts, have you tested/ challenged the assumptions?

Feedback from FRC

Documentation



Feedback from FRC

Top tips: documentation

- Have you documented all important knowledge in the audit permanent file?
- Have you documented discussion of key issues with the client
- Have you documented reasons for reaching your audit judgements?
- Firms using electronic systems, have you implemented a backup procedures?

Feedback from FRC

Risk Assessment



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Feedback from FRC

Top tips: Risk assessment

- Have you planned appropriate tests (e.g. Checks on journals) to address the risk of management override?
- Have you thought about fraud arising from manipulation of the financial statements as well as misappropriation of assets?
- Have you talked to your client about fraud and how they guard against it?
- Does the audit file show that you have done these things?

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Feedback from FRC

Cold File Review



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Feedback from FRC

Top tips: Cold File reviews

- Are your cold file reviews carried out by someone independent of the audit? If not you may need to arrange an external review. This is a new regulation that audit firms need to be complying with.
- Do you have cold reviews every year?
- Have you taken sufficient action to address the matters raised by your cold file review?

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Feedback from FRC

Other Issues:

- Professional Scepticism
- Group Audit Consideration
- Auditor Independence and Ethical Issues



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Forum on Auditing in the Small Business Environment

TAG Alliances
May 5-7, 2014
Miami, Florida

Caveat

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

Opening Remarks and Board Member Interview

Lewis H. Ferguson, Board Member

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

The Board's Near-Term Priorities for 2013

- Improving the timeliness, content and readability of inspection reports;
- Improving the timeliness of remediation determinations and providing additional information about the PCAOB's remediation process;
- Initiating a project to identify audit quality measures, tracking such measures, reporting collective measures over time;
- Enhancing the PCAOB's processes and systems to improve analysis and usefulness of PCAOB inspections findings, including comparative analysis across firms and over time, in order to better understand audit quality in firms and better inform the PCAOB's standard-setting and other regulatory activities;
- Enhancing the framework for the PCAOB's standard-setting process in order to improve the effectiveness of the process as well as the standard-setting project tracking information provided to investors and the public; and
- Enhancing PCAOB's outreach to and interaction with audit committees to constructively engage in areas of mutual interest, including auditor independence and audit quality.

Panel: Fraud and Professional Skepticism

Moderator: Mary Sjoquist, Director of Outreach
Greg Scates, Office of Chief Auditor
George Botic, Division of Inspections
Rebecca Rhodes, Division of Enforcement

Staff Audit Practice Alert No. 10 – *Maintaining and Applying Professional Skepticism in Audits*

- ❑ Practice Alert No. 10 was issued on December 4, 2012.
- ❑ PCAOB oversight activities continue to raise concerns about whether some auditors consistently and diligently apply professional skepticism.
- ❑ Reminds auditors of the critical importance of professional skepticism to effective audits.
- ❑ Describes potential impediments to professional skepticism.
- ❑ Describes steps that audit firms, engagement partners and auditors can take to enhance professional skepticism in audits.

Staff Audit Practice Alert No. 10 (continued)

- ❑ When developing conclusions on the root causes of audit failures, consideration should be given to various behavioral issues described in the Alert:
 - Unconscious human biases and other circumstances can cause auditors to gather, evaluate, rationalize and recall information in a way that is consistent with client preferences rather than the interests of external users.
 - Incentives and pressures to build or maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer's filing deadline, achieve high client satisfaction ratings, keep audit costs low, or cross-sell other services can all serve to inhibit professional skepticism.
 - Scheduling and workload demands can put pressure on partners and other engagement team members to complete their assignments too quickly, impeding professional skepticism.

Promoting Professional Skepticism

What steps could your firm take to promote and support professional skepticism?

- ❑ Establish an appropriate “Tone at the Top”
 - Provide incentives to be skeptical
 - Message importance to staff
- ❑ Provide training
- ❑ Robust “brainstorming” session – don’t just “check the box”
- ❑ QC procedures that monitor compliance

Assessing Fraud Risks

Information you should consider in assessing the risk of fraud include, but are not limited to:

- ❑ Company's industry
- ❑ Nature of the company (i.e., size and complexity, organizational structure)
- ❑ Effectiveness of internal controls
- ❑ Compensation agreements
- ❑ Earnings pressure or debt covenant compliance
- ❑ Results from analytical procedures

See AS No. 12 ¶ 5 for other examples of information that should be considered in assessing the risk of fraud.

Risk Assessment Standards-Changes in Your Audits

- ❑ Assessing and responding to the risk of fraud are an ongoing, integral part of the audit process rather than a separate, parallel process
 - Any changes in planning?
 - Any changes in documentation?
 - Any changes in review and supervision?
- ❑ Consideration of management bias in selection of accounting principles and in adequacy of disclosures
 - Any changes in assessing significant accounts or processes?
 - Any changes in documentation or in review and supervision?
- ❑ Evaluating Audit Results
 - Any changes in documentation or in review and supervision?

Responding to Identified Fraud Risks

After you identify a fraud risk, what procedures might you perform to address the risk?

- A. Perform procedures at locations on a surprise or unannounced basis
- B. Make inquiries of major customers and suppliers in addition to sending confirmations
- C. Perform substantive analytical procedures using disaggregated data (for example, gross profit or operating margin by location)
- D. All of the above

See AU § 316.53 for other examples of procedures that could be performed to address identified fraud risks.

Questions



SEC CF Staff Review of Common Financial Reporting Issues Facing Smaller Issuers



Disclaimer

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

Agenda

- ❖ **Overview of the Division of Corporation Finance**
- ❖ **Recent Developments**
- ❖ **The CF Staff Review Process**
- ❖ **Frequent CF Staff Comment Areas for SRC's**
- ❖ **Resources**



Overview of the Division of Corporation Finance

Overview of the Division of Corporation Finance

What we do

- ❖ **Selectively review the disclosure documents filed by public companies (including initial registrations)**
- ❖ **Provide interpretive assistance on SEC rules and forms**
- ❖ **Recommend new and revised rules to the Commission**

Organization

- ❖ **Disclosure Operations (12 industry groups)**
- ❖ **Legal and Regulatory Policy**
 - **Office of Chief Accountant**
- ❖ **Policy and Capital Markets**



Recent Developments

Key SEC Developments

Commission Actions

- ❖ ***Dodd-Frank Act Rulemaking and Studies***
- ❖ ***JOBS Act Rulemaking and Studies***

The JOBS Act

Title I – Reopening American Capital Markets to Emerging Growth Companies (“EGC”)

Title II – Access to Capital for Job Creators – General Solicitation

Title III – Crowdfunding

Title IV – Small Company Capital Formation - Regulation A+

Title V – Private Company Flexibility and Growth - 12(g)

Title VI – Capital Expansion - 15(d)

Title VII – Outreach on Changes to the Law

Question

Do you audit a company that qualifies as an emerging growth company?

A. Yes

B. No

C. Not sure

D. What is an emerging growth company?

EGC Eligibility Criteria

- ❖ ***Less than \$1 billion in total annual gross revenue during its most recently completed fiscal year***
- ❖ ***First sale of common equity pursuant to an effective registration statement under the 1933 Act has either (1) not yet occurred or (2) occurred after December 8, 2011***
- ❖ ***Not yet disqualified***
 - **Test EGC status continuously**
 - **Once lost, “generally” cannot get back**

EGC Eligibility Criteria

❖ Disqualification provisions:

- 1. Last day of the first fiscal year in which revenue is \$1 billion or more**
- 2. Last day of the fiscal year following the fifth anniversary of the first registered sale of common equity securities**
- 3. Date on which the company has issued more than \$1 billion in non-convertible debt securities in the preceding rolling 3-years**
- 4. Date on which the company becomes a large accelerated filer**

Accommodations Available to EGCs

❖ *Confidential submission*

- '33 Act registration statements; and
- Has never done an IPO of common equity securities

❖ *Financial reporting accommodations*

- Number of years of financial statements presented
- MD&A
- Selected financial data
- Ratio of earnings to fixed charges (if a debt offering)
[FAQ 27]

❖ *Delay in adoption of new or revised accounting standards*

❖ *Exemption from auditor attestation on internal controls over financial reporting (SOX 404(b))*

❖ *Other*

Resources – JOBS Act

- ❖ **Frequently Asked Questions of General Applicability on Title I of the JOBS Act**
 - [September 28, 2012](#) (Questions 42-54)
 - [May 3, 2012](#) (Questions 18-41)
 - [April 16, 2012](#) (Questions 1-17)

- ❖ [Link to JOBS Act page on CF website](#)



The CF Staff Review Process

Filings Subject to CF Staff Review

- ❖ **Selected by the CF staff using screening criteria not publically disclosed and Sarbanes-Oxley Section 408 requirements**
- ❖ **IPOs**
- ❖ **Other registration statements**
- ❖ **Proxy statements**
- ❖ **Form 8-K**
- ❖ **Other**

Types of Comments

- ❖ **Request for additional supplemental information**
- ❖ **Provide additional or different disclosure in a future filing**
- ❖ **Amend filing to revise financial statements or disclosure**
- ❖ **Completion of review letter**

Best Practices

- ✓ **Submit all correspondence with the Staff on EDGAR**
- ✓ **Document accounting decisions contemporaneously with the transaction**
- ✓ **Respond promptly**
- ✓ **Make responses comprehensive**
- ✓ **Pick up the phone and give us a call**

***CF Staff Focus Areas For Smaller
Reporting Companies (“SRCs”)***

Question

Has your client received a comment letter from the SEC in the past 12 months?

A. Yes

B. No

C. Not sure

D. What's a comment letter?

CF Staff Focus Areas For SRCs

- ❖ **Reverse Mergers**
- ❖ **Equity Transactions**
- ❖ **Stock Compensation**
- ❖ **Liability or Equity**
- ❖ **Deferred Tax Asset Valuation Allowance**
- ❖ **Disclosure Controls and Procedures**
- ❖ **Internal Control over Financial Reporting**
- ❖ **Form 8-K**
- ❖ **Audit Reports**
- ❖ **Smaller Reporting Company Status**

Reverse Mergers

Frequent Areas of Comment:

- ❖ **Form 10-type information in Form 8-K**
 - **Financial Statements due within 4 business days (no 71-day extension)**
- ❖ **Financial Statement updates on Form 8-K**
 - **Staff Interpretation of Exchange Act Rule 13a-1**
- ❖ **Required Form 8-K items not filed**
 - **Including Item 4.01 Form 8-K (Change in Accountants)**
- ❖ **Internal Control over Financial Reporting**
 - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

Illustration of CF Staff Interpretation of Rule 13a-1

- ❖ **Reverse merger occurs on February 1, 2013**
- ❖ **Non-accelerated shell (accounting acquiree) and private operating company (accounting acquirer) have calendar year-ends**
- ❖ **Audited f/s of the private op co for the y/e 12/31/11 and the unaudited f/s for the interim period ended 9/30/12 and comparable prior periods would be filed on Form 8-K (within 4 business days of the transaction - no 71-day extension)**
- ❖ **Registrant would file its annual report on Form 10-K for the y/e 12/31/12 within 90 days after 12/31/12**
- ❖ **Registrant would file the same info required in a Form 10-K of the private op co in an amended Form 8-K by the same Form 10-K due date – 90 days after 12/31/12.**
- ❖ **See FRM Section 12220.1**

Reverse Mergers & “Back Door” Registrations

Accounting acquirer’s audited F/S presented for all historical periods in subsequent reports

- ❖ Earnings per share recast to reflect exchange ratio
- ❖ Eliminate retained earnings of shell or legal acquirer
- ❖ Common stock of shell or legal acquirer continues

Audit Issues

- ❖ PCAOB registered audit firm
- ❖ PCAOB Standards

Reverse Mergers & “Back Door” Registrations

Recapitalization Example:

- ❖ The transaction was consummated 2/1/13
- ❖ Shell has 100,000 shares o/s @ 12/31/12 (\$1 par)
- ❖ Shell has stockholders equity of \$125,000 @ 12/31/12
- ❖ OpCo has 100,000 shares o/s @ 12/31/12 (\$2 par)
- ❖ Shell issues 400,000 shares for 100% of OpCo
- ❖ Post-recap entity has no other equity transactions from 2/1/13 – 3/31/13
- ❖ Post-recap entity has net income of \$300,000 for the period from 2/1/13 – 3/31/13

Reverse Mergers & “Back Door” Registrations

**OpCo SSE 1/1/11 -
12/31/12**

	Number of Shares	Shares at Par (\$2)	APIC	Retained Earnings (Deficit)	Total
1/1/11	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/11	20,000	40,000	110,000		150,000
Net Income				250,000	250,000
12/31/11	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/12	20,000	40,000	190,000		230,000
Net Income				200,000	200,000
12/31/12	<u>100,000</u>	<u>200,000</u>	<u>900,000</u>	<u>750,000</u>	<u>1,850,000</u>

Reverse Mergers & “Back Door” Registrations

Post-Recapitalization Continuing Entity SSE 1/1/11 – 3/31/13

	Number of Shares	Shares at Par (\$1)	APIC	Retained Earnings (Deficit)	Total
1/1/11	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/11	80,000	80,000	70,000		150,000
Net Income				250,000	250,000
12/31/11	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/12	80,000	80,000	150,000		230,000
Net Income				200,000	200,000
12/31/12	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 02/01/13	100,000	100,000	25,000		125,000
Net Income				300,000	300,000
03/31/13	500,000	500,000	725,000	1,050,000	2,275,000

Equity Transactions

Fair Value Determination – ASU 2011-04

- ❖ If publicly traded in an active market, use quoted market price
 - If discounts are appropriate under the circumstances, they should be supported by objective evidence
- ❖ If stock not publicly traded in active market
 - a) Use quoted price in an active market for the identical item held by another party
 - b) Use observable inputs, such as quoted market price in a market that is not active
 - c) If (a) and (b) not available, valuation technique (e.g. income approach or market approach)

Disclosure

- ❖ A description of the significant factors, methods and assumptions used to value stock options, warrants and other equity instruments
 - Footnotes
 - MD&A (critical accounting estimates)

Stock-Based Compensation

- ❖ **Disclosure requirements under ASC 718-10-50-1 and 2**
- ❖ **Valuation prior to IPO (“cheap stock”)**
 - **AICPA Practice Aid – valuation and disclosure guidance**
 - **FRM Section 9520 – provides guidance on critical accounting estimates and MD&A disclosure**
 - **FRM Section 7520.1 – disclosures when estimated fair value of stock is less than IPO price**

Liability or Equity?

Instruments Where Guidance Often Misapplied

- ❖ Freestanding warrants on an Issuer's shares
- ❖ Conversion options embedded in debt

Two Questions Where Mistakes Are Often Made

- ❖ *Indexed to company's own equity? (ASC 815-40-15)*
- ❖ *If indexed, qualify for classification in equity? (ASC 815-40-25)*

Common Pitfalls (that may cause fair value accounting)

- ❖ Indexed > Certain clauses that adjust the exercise or conversion price ("Ratchet" / "Down Round")
- ❖ Classification > Insufficient authorized shares or no limit on the number of shares to be delivered

Liability or Equity?

Valuation Issues

- ❖ Inappropriate model being used to value certain derivatives
 - Black-Scholes may not be appropriate in many situations given complex features and terms of conversion option (e.g., combined embedded derivatives)

Evaluate the provisions of your agreements carefully (anti-dilution provisions, warrant, registration rights, etc.)

Deferred Tax Asset Valuation Allowance

- ❖ **Decision to establish or reverse a valuation allowance – an area of significant judgment**
- ❖ **Cumulative losses in recent years – negative evidence that is difficult to overcome**
- ❖ **Continual evaluation of all positive and negative evidence**
 - **How much and how long?**
 - **Significant drivers?**
 - **Impact of economic uncertainty?**
 - **Ability to forecast?**
- ❖ **Disclosures**
- ❖ **Consistency of assumptions and disclosures**

Disclosure Controls & Procedures (DC&P)

Conclusions

- ❖ **Disclosure should state DC&P conclusion in clear and unqualified language – effective or not effective**
- ❖ **“Adequate” or “Effective except for...” are inappropriate**
- ❖ **“Effective” DC&P conclusion when ICFR conclusion is “ineffective”**
- ❖ **Consider reassessing conclusions upon the filing of any amendments**

Incomplete definition of DC&P

- ❖ **If definition is included, should conform exactly to Exchange Act Rule 13a-15 (note definition is not required)**

Internal Control over Financial Reporting (ICFR)

Management Reports under Item 308(a) of S-K

- ❖ **Separate evaluation and assessment from evaluation of disclosure controls and procedures**
- ❖ **Item 308 (a) disclosures**
 - **Large accelerated and accelerated filers that are not EGCs—comply with all 4 elements**
 - **Non-accelerated filers and EGCs – comply with first 3 elements unless voluntarily include auditor report under Item 308(b) of S-K, in which case comply with all four elements.**

Auditors Reports under Item 308(b) of S-K

- ❖ **Only required for non- EGCs that are accelerated or large accelerated filers**

SOX Section 302 Certifications should not deviate from specific form and content in Item 601(b)(31)(i) of Regulation S-K

- ❖ **Include all paragraphs (including paragraph 4(b))**

Internal Control over Financial Reporting (ICFR)

Disclosures that companies should consider when material weakness exists (see SEC Release No. 33-8810)

- ❖ **Nature of the material weakness (i.e., identification of the deficiency)**
- ❖ **Impact of material weakness on the company's financial reporting and its ICFR**
- ❖ **Disclosures should be detailed and specific for each material weakness identified**

Material changes in ICFR

- ❖ **Changes in circumstances without disclosures of changes in internal controls**
- ❖ **Change in conclusion on effectiveness**
- ❖ **Avoid boilerplate disclosure**

ICFR For Registrants With Substantially All Their Operations Outside U.S.

Background and training of CFO or other person(s) responsible for maintaining books and records and preparing financial statements

Seek information:

- **U.S. GAAP education and ongoing training**
- **Professional qualifications**
- **Specific nature of U.S. GAAP experience**
- **Specific roles / duties of person with U.S. GAAP experience**
- **Services performed by a third party CPA or consultants – specific nature, extent, and qualifications**

Form 8-K – Item 4.01 (S-K 304)

❖ Item 4.01 8-K required:

- **Change in auditor**
- **Reverse merger**
- **Accounting firm mergers**

❖ Frequent compliance issues:

- **Exhibit 16 letter**
- **Disagreements and reportable events through the termination date**
- **Subsequent interim period**
- **Failure to specify whether former accountant resigned, declined to stand for re-election, or was dismissed**

Form 8-K – 4.02

Frequent Compliance Issues:

- ❖ **Triggering event other than non-reliance conclusion (e.g., completion of restatement)**
- ❖ **Unclear statement regarding non-reliance**
- ❖ **Brief description of facts lacking or unclear**
- ❖ **“Stealth Restatements”**
 - ✓ **See Exchange Act Form 8-K Compliance and Disclosure Interpretation 215.01**

Audit Reports

- ❖ ***Audit report signatures***
- ❖ ***PCAOB “auditing standards” vs. “standards”***
- ❖ ***Development stage***
 - Cumulative amounts
 - Waiver process
- ❖ ***Revoked registration with PCAOB***

Smaller Reporting Company Status

Transition from Other Reporting Company Status to SRC Status

- ❖ **Public float < \$50 million on last business day of Q2**
- ❖ **If public float = \$0, < \$40 million annual revenues**
- ❖ **Considered an accelerated filer through the end of the fiscal year**
 - **May elect SRC reporting immediately for disclosure purposes, but subject to accelerated filer deadlines**
 - **Attestation report on ICFR is not required in 10-K**

Smaller Reporting Company Status

Transition from SRC to Other Reporting Company Status

- ❖ **Public float \geq \$75 million on last business day of Q2**
- ❖ **If public float = \$0, \geq \$50 million annual revenues**
- ❖ **Remain an SRC through fiscal year end; larger filer disclosure required starting with Q1 10-Q**
- ❖ **May elect SRC disclosure for 10-K and proxy statement relating to exit year BUT**
- ❖ **Accelerated filer for purposes of 10-K, including inclusion of attestation report on ICFR**

Key CF Staff Resources for Registrants

- ❖ **Division of Corporation Finance Financial Reporting Manual Updates (FRM)**
- ❖ **Corporation Finance Compliance and Disclosure Interpretations (CDI)**
- ❖ **CF Disclosure Guidance Topics**
 - ❖ **Staff Observations in the Review of Forms 8-K Filed to Report Reverse Mergers and Similar Transactions**
 - ❖ **Staff Observations Regarding Disclosures of Smaller Financial Institutions**
- ❖ **SEC CF Staff Review of Common Financial Reporting Issues Facing Smaller Issuers (Dec. 2012) slides**

Resources

Resources

www.sec.gov/divisions/corpfin.shtml

- ❖ Staff Guidance and Interpretations
 - ❖ Filing Review Process
 - ❖ Compliance & Disclosure Interpretations
- ❖ Disclosure Program Updates
- ❖ Division Announcements
- ❖ Statutes, Rules, and Forms

- ❖ Information for Small Businesses
 - www.sec.gov/info/smallbus.shtml

Resources

Information for Accountants

www.sec.gov/divisions/corpfin/cfreportingguidance.shtml

- **Division of Corporation Finance Financial Reporting Manual**
- **Division of Corporation Finance Compliance & Disclosure Interpretations**
- **Staff Accounting Bulletins**
- **Corporation Finance Comment Letters**
- **Corporation Finance Filing Review Process**
- **Other Frequently Requested Material**
 - **Presentation from last year's Forums**
 - **Dear CFO Letters and Other Disclosure Guidance**
 - **[CF Disclosure Guidance Topics](#)**

Resources

Whom do I contact for assistance and how?

- ❖ **Comment process - Disclosure Operations CF Staff**
 - Names and number will be on 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

Resources

Formal Requests related to financial reporting

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

Formal consultations on the application of GAAP should be sent to - OCA@sec.gov

- ❖ www.sec.gov/info/accountants/ocasubguidance.htm

Questions

Key Telephone Numbers:

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

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

Corporation Finance Office of Small Business Policy (202) 551-3460

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

Update on PCAOB Standard-Setting Activities

Greg Scates

Deputy Chief Auditor

July 18, 2013

New York, NY

Topics for Discussion

- ❑ AS No. 16 – *Communications with Audit Committees*
- ❑ Related Parties Reproposal
- ❑ Audits of Broker-Dealers
- ❑ Reorganization of PCAOB Auditing Standards
- ❑ Auditor's Reporting Model
- ❑ Auditor Independence and Audit Firm Rotation
- ❑ The JOBS Act and Standard-Setting

AS No. 16 - *Communications with Audit Committees*

- ❑ On August 15, 2012, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*, and related amendments.
 - AS No. 16 is effective for audits of fiscal years beginning on or after December 15, 2012.
- ❑ AS No. 16 requires communications with the audit committee to be made in a timely manner and prior to the issuance of the audit report.
- ❑ Auditing Standard No. 16:
 - Provides a definition of audit committee;
 - Retains or enhances existing communication requirements;
 - Incorporates certain SEC auditor communication requirements to audit committees; and
 - Adds new communication requirements that are generally linked to performance requirements in other PCAOB standards.

Related Parties Reproposal

- ❑ On May 7, 2013, the Board repropose for comment an auditing standard on related parties and related amendments, including amendments regarding significant unusual transactions.
 - An original proposal was issued for public comment on February 28, 2012. The Board received 37 comment letters and discussed the proposal at the May 17, 2012 SAG meeting.
- ❑ The repropose standard and amendments address:
 - Evaluating a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.
 - Identifying and evaluating a company's significant unusual transactions.
 - Obtaining an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment process.
- ❑ The repropose standard and amendments are designed to improve audit quality in areas that pose significant risks of material misstatement, including misstatement arising from fraud.
- ❑ The comment period closed on July 8, 2013.

Reproposed Auditing Standard – Related Parties

- The reproposed standard would strengthen existing audit procedures for identifying, assessing, and responding to risks of material misstatement associated with related party transactions.
- The reproposed standard would require the auditor to:
 - Perform specific procedures to obtain an understanding of the company's relationships and transactions with its related parties.
 - Perform specific procedures for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk.
 - Perform specific procedures if the auditor determines that a related party, or relationship or transaction with a related party, previously undisclosed to the auditor exists.
 - Evaluate whether the company has properly identified its related parties or relationships or transactions with related parties.
 - Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

Reproposed Amendments Regarding Significant Unusual Transactions

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

Other Reproposed Amendments to PCAOB Auditing Standards

- ❑ The other repropose amendments include new requirements that would complement the repropose standard on related parties and significant unusual transactions.
- ❑ Among other things, the other repropose amendments would:
 - Require the auditor to perform specific procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers as part of the auditor's risk assessment process.
 - Require the auditor to obtain representations from management that there are no side agreements or other arrangements (either written or oral) undisclosed to the auditor.
 - Emphasize the auditor's existing responsibilities to communicate possible fraud to management, the audit committee, and under certain conditions, the SEC and others.

Audits of Broker-Dealers

- ❑ Audits of brokers and dealers continue to be conducted pursuant to the auditing standards of the AICPA.
- ❑ Audits will transition to and be conducted pursuant to PCAOB standards upon the SEC's adoption of the amendments to their Rule 17a-5.
- ❑ OCA is working to develop "Day-One" guidance which may include topics such as transitioning to PCAOB standards from AICPA standards and key considerations about applying PCAOB standards on first-year engagements.

Audits of Broker-Dealers (continued)

- ❑ Working with Office of Chief Accountant/Division of Trading and Markets to develop standards supporting objectives of SEC's amendments to Rule 17a-5 for broker-dealers.
 - Includes PCAOB standards for (1) examination engagements, and (2) review engagements, as required by SEC rulemaking.
- ❑ Standards will be designed:
 - To be scalable based on size and complexity of the individual broker-dealer.
 - To coordinate with financial statement audit so evidence from both engagements is properly considered and duplication of work is avoided.

Reorganization of PCAOB Auditing Standards

“Interim” Standards

AU 110

AU 161

AU 210

Etc.

**Reorganized
Standards
(AS Sections)**

Board-Issued Standards

AS No.
1

AS No.
3

AS No.
4

Etc.

Reorganization of PCAOB Auditing Standards (continued)

□ **Categories in the proposed framework for the reorganization:**

- AS 1000 General Auditing Standards
- AS 2000 Audit Procedures
- AS 3000 Auditor Reporting
- AS 4000 Matters Relating to Filings under Federal Securities Laws
- AS 6000 Other Matters Associated with Audits

Reorganization of PCAOB Auditing Standards (continued)

- Intended to:
 - Renumber and reorder existing standards without redrafting or making substantive changes.
 - Present standards in a logical order that generally follows the flow of the audit process.
 - Enhance usability through improved navigation.
 - Provide structure for future standard-setting.
- Next steps include:
 - Consideration of comments received on the proposing release.
 - Release for public comment all amendments necessary to implement the reorganization of the auditing standards.
 - Release an online version of the proposed reorganized auditing standards.
 - Undertake reorganization of other PCAOB professional practice standards.

Auditor's Reporting Model

- ❑ On June 21, 2011, the Board issued a concept release on possible changes to the auditor's reporting model which discusses four alternatives for changing the auditor's reporting model. The Board received 155 comment letters.
- ❑ The Board hosted a roundtable to discuss the alternatives in the concept release and has discussed the auditor's reporting model with the SAG on several occasions.
- ❑ SAG members indicated that they were most interested in hearing about the audit from the auditor, including the auditor's significant judgments in forming the audit opinion.
- ❑ The IAASB has a similar project regarding changes to the auditor's report. The IAASB is considering communicating matters that were of most significance to the audit.
- ❑ Both the PCAOB and IAASB are scheduled to propose standards in the summer of 2013.

Auditor Independence and Audit Firm Rotation

- ❑ In August 2011, the Board issued a concept release to solicit public comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced, including through audit firm rotation.
- ❑ The concept release invited comment on specific questions, including, for example, whether the Board should consider a rotation requirement only for audit tenures of more than 10 years or only for the largest issuer audits.
- ❑ The Board also sought comment on whether there are other measures that could meaningfully enhance auditor independence.
- ❑ The Board hosted three public meetings in 2012 that engaged prominent and thoughtful commenters with various, often conflicting, viewpoints:
 - Panelists included investors, senior executives and audit committee chairs of major corporations, CEOs of audit firms, academics and former regulators.
- ❑ Next steps under consideration:
 - Analyzing more than 680 comment letters and the discussion at public meetings.
 - Monitoring activities of other regulators, standard setters, and legislative bodies.

Audit Reform: European Developments

□ Europe:

- November 2011: European Commission adopted proposals intended to strengthen the independence of auditors and introduce greater diversity into the audit market.
- April 2013: the European Parliament's Legal Affairs Committee voted to send a revised text for negotiation with the European Council and Commission.
- Next Steps: "Trialogue" among the European Commission, European Parliament and European Council.

□ United Kingdom:

- September 2012: FRC announced changes to UK Corporate Governance Code:
 - FTSE 350 companies to put the external audit contract out to tender at least every ten years.
 - Audit Committees to provide shareholders with information on how they carried out their responsibilities.
 - Applies on a "comply or explain" basis.
- February 2013: UK Competition Commission publishes preliminary findings on supply of audit services to large companies in the UK.

The JOBS Act and Standard-Setting

- ❑ Jumpstart Our Business Start-ups Act (enacted April 2012).
 - Defined a new category of companies – emerging growth companies (“EGCs”).
 - Requires SEC to make an additional finding that application of a new PCAOB auditing standard to audits of EGCs is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation (“ECCF”).
 - As a result of this new SEC requirement, PCAOB is providing information to the SEC to help inform its approval of new PCAOB standards:
 - Includes discussion of ECCF factors as applied to audits of EGCs.
 - Working with ORA to develop data, understanding of EGC population.

Keeping Current with Standard-Related Activities

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

Questions



Lunch

(70 minutes)

Inspection Findings, Relevant Standards, and Case Studies

Presenters

George Botic, Deputy Director, Division of Enforcement and Investigations

Rebecca Rhodes, Assistant Director, Division of Enforcement and Investigations

Greg Scates, Deputy Chief Auditor, Office of Chief Auditor

Ellen Graper, Associate Director, Division of Registration and Inspections

Agenda

- ❑ Summary of Domestic Small Firm Program
- ❑ Division of Enforcement and Investigations – Recent Disciplinary Proceedings
- ❑ Inspection Findings, Relevant Standards, and Case Studies

Summary of Domestic Small Firm Program

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

Top Inspection Findings

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

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

Potential Root Causes

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

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

Division of Enforcement and Investigations - Recent Settled Disciplinary Proceedings

- ❑ P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA and Sundeeep P S G Nair, CA
- ❑ Dale Arnold Hotz, CPA, Jyothi Nuthulaganti, CPA, and Michael Jared Fadner, CPA
- ❑ Jewett, Schwartz, Wolfe & Associates, P.L.
- ❑ Lawrence H. Wolfe, CPA
- ❑ Uma D. Basso, CPA
- ❑ Michael T. Studer, CPA, P.C. and Michael T. Studer, CPA
- ❑ Brock, Schechter & Polakoff, LLP
- ❑ James R. Waggoner, CPA

Division of Enforcement and Investigations - Settled Disciplinary Proceedings

P. Parikh & Associates, Ashok B. Rajagiri, CA, Sandeep P. Parikh, CA and Sundeeep P S G Nair, CA

- ❑ Mumbai, India small firm and two partners and a manager
- ❑ Engagement team had no training in PCAOB standards or U.S. GAAP
- ❑ Firm's policies and procedures did not ensure that staff performed procedures necessary to comply with PCAOB standards and regulatory requirements
- ❑ Lack of independence by providing internal audit outsourcing services
- ❑ Failed to comply with securities laws, PCAOB rules, quality control standards, and auditing standards
- ❑ Sanctions:
 - Firm: Censure, registration revoked with right to reapply two year after date of Order and \$10,000 civil money penalty
 - Partner (Rajagiri): permanent bar
 - Partner (Parikh): 3 year bar
 - Manager (Nair): 2 year restriction on activities and completion of 40 hours of CPE

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Dale Arnold Hotz, CPA, Jyothi Nuthulaganti, CPA, and Michael Jared Fadner, CPA

Partner, Director, and Manager at McGladrey & Pullen, LLP

- ❑ Failed to comply with AS3 and violated their duty to cooperate with Inspections
- ❑ Improperly created and/or added documents to the audit documentation and backdated a document in advance of an inspection
- ❑ Provided false and misleading information to PCAOB
- ❑ Sanctions:
 - Partner: Censure and 2 year bar
 - Director: Censure and 1 year bar
 - Manager: Censure

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Jewett, Schwartz, Wolfe & Associates, P.L.

Lawrence H. Wolfe, CPA

Uma D. Basso, CPA

- ❑ Wolfe was engagement partner and Basso served as audit manager.
- ❑ Failed to comply with PCAOB rules, quality control standards, and auditing standards in connection with multiple audits of multiple issuers
- ❑ Failure to complete or supervise others in the completion of necessary audit work, including in critical audit areas
- ❑ In several audits, one or more staff members with limited audit experience conducted virtually all of the audit procedures with minimal to no review by Wolfe or other firm staff
- ❑ Sanctions:
 - Firm: Censure and registration revoked for 5 years
 - Wolfe: Censure and permanently barred
 - Basso: Censure, 2 year restriction on activities, complete 40 hours of CPE

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Michael T. Studer, CPA, P.C. and Michael T. Studer, CPA

- ❑ Violations of PCAOB rules, auditing standards related to two China-based issuers
- ❑ Violations of quality control standards
- ❑ Failure to identify and test internal controls in an integrated audit of a French company
- ❑ Failure to direct efforts of assistants who performed field work in China or review their work and audit documentation not prepared in accordance with AS No. 3
- ❑ Sanctions:
 - Firm: Censure, retain independent monitor, temporary restriction on activities
 - Cannot issue report for issuer subject to Section 404(b) of Sarbanes-Oxley Act (ICFR) for 3 years
 - Until monitor issues certificate of compliance, Firm is restricted from acceptance of new SEC issuer audit clients, issuance of issuer audit reports for clients with substantially all operations in China, Hong Kong or Taiwan, broker-dealer financial statement certification and substantial role participation
 - Provide copy of PCAOB Order to issuer audit clients
 - Studer: Censure, complete 60 hours CPE, including 30 hours related to AS No. 5, restriction on activities
 - Until monitor issues certificate of compliance, Studer is restricted from serving as an assistant, engagement partner or EQR

Division of Enforcement and Investigations - Settled Disciplinary Proceedings (continued)

Brock, Schechter & Polakoff, LLP **James R. Waggoner, CPA**

- ❑ Waggoner was firm's Director of Accounting and Auditing
- ❑ Three issuers; audits performed by foreign-based audit firms
- ❑ Waggoner had final responsibility for the audits
- ❑ Waggoner and the firm failed to comply with standards relating to planning, performance, and supervision of audits
- ❑ The firm had inadequate quality control policies and procedures in place to reasonably assure issuer audits, including of ICFR, were conducted properly
- ❑ Non-cooperation with the inspection process - Improper creation, addition, and backdating of audit documentation prior to Board inspection
- ❑ Sanctions:
 - Firm: Censure, registration revoked for 2 years, \$20,000 civil money
 - Waggoner: Censure, 3 year bar

Inspection Findings, Relevant Standards, and Case Studies

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

Restrictions on Use

- ❑ *Information not necessarily compiled from inspection observations*
- ❑ *Information intended to provide considerations and does not necessarily represent requirements of the PCAOB*
- ❑ *Specific procedures that may be performed in a given situation are determined on facts and circumstances*

Auditing Convertible Debt

Auditing Convertible Debt

Inspection Findings

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

Auditing Convertible Debt

Relevant Auditing Standard

AU Section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, 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.

Auditing Convertible Debt

Case Study No. 1- Going Places, Inc.

Case Study No.1 – Going Places, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2012 financial statements of Going Places, Inc. (“Company”).
- ❑ The Company’s common stock is quoted on the OTCBB with normal daily market activity of around 100,000 shares in 2011 and 2012.
- ❑ On October 1, 2012, the Company issued convertible debt with detachable warrant to investor for \$1 million cash.
- ❑ The convertible debt . . .
 - Provides for cash repayment of \$1 million or conversion into 100,000 shares of common stock at any time at holder’s option prior to September 30, 2017.
 - Accrues six 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
- ❑ The common stock contains no repurchase features

Case Study No.1 – Going Places, Inc.

Background

- ❑ The warrant . . .
 - Provides for purchase of 100,000 shares of common stock at \$10 per share at any time at holder's option
 - Expires September 30, 2017
 - 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
- ❑ The convertible debt and warrant are legally detachable and separately exercisable
- ❑ Closing price of Company's common stock was \$10 per share on October 1, 2012
- ❑ As of September 30, 2012, the Company had 10 million shares of common stock authorized with 2 million shares issued and outstanding and no other instruments that could be settled in shares of common stock

Case Study No.1 – Going Places, Inc.

Scenario

- ❑ *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 detachable warrant and the procedures performed by your engagement team.*

Case Study No.1 – Going Places, Inc.

Scenario

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

Case Study No.1 – Going Places, Inc.

Classification of Warrant

The ASC Master Glossary defines a freestanding financial instrument as:

A financial instrument that meets either of the following conditions:

- ❑ It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.
- ❑ It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Case Study No.1 – Going Places, Inc.

Classification of Warrant

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,
- Certain obligations to issue a variable number of shares

Case Study No.1 – Going Places, Inc.

Definition of Derivative

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 contract, or
 - delivery of an asset.

Case Study No.1 – Going Places, Inc.

Derivative 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
 - Classified in stockholders' equity in its statement of financial position.

Case Study No.1 – Going Places, Inc. Indexed to its Own Stock

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.1 – Going Places, Inc.

Equity Classification

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.1 – Going Places, Inc. Reassessment of Equity Classification

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.1 – Going Places, Inc.

Embedded Conversion Options

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.1 – Going Places, Inc.

Allocation of Proceeds

ASC Paragraph 470-20-25-2 provides: 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.1 – Going Places, Inc.

Allocation of 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

Case Study No.1 – Going Places, Inc.

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 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. Paragraph 470-20-30-4 provides guidance on measuring intrinsic value that applies to both the determination of whether an embedded conversion feature is beneficial and the allocation of proceeds.

Case Study No.1 – Going Places, Inc.

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.

Case Study No.1 – Going Places, Inc. 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.1 – Going Places, Inc.

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.1 – Going Places, Inc. Beneficial Conversion Feature

	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

Question A

PCAOB Rule 3521 provides that a registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for:

- A. a contingent fee (received directly or indirectly)
- B. a fixed fee
- C. a commission (received directly or indirectly)
- D. reimbursement of expenses

Question B

PCAOB Rule 3524 provides that in connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall –

- A. describe, in writing, to the audit committee of the issuer certain terms of the services (as provided in the Rule)
- B. call the audit committee chairman to verify that he received the written communication
- C. discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm
- D. document the substance of its discussion with the audit committee of the issuer

Questions



Inspection Findings, Relevant Standards, and Case Studies – Part II

Auditing Business Combinations

Auditing Business Combinations

Inspection Findings

- ❑ Failed to address whether all assets acquired and liabilities assumed, including identifiable intangible assets, had been recorded
- ❑ Failed to evaluate whether purchase price was appropriately allocated to the acquired net assets based on appropriate valuations
- ❑ Failed to identify and address incorrect accounting for a reverse-merger transaction

Auditing Business Combinations

Relevant Auditing Standards

AU Section 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .03 states, in part, that the auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, defines the fair value of an asset (liability) as “the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.” Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination.

Auditing Business Combinations

Relevant Auditing Standards

AU Section 336, *Using the Work of a Specialist*, paragraph 12 provides that 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.

Auditing Business Combinations

Case Study No. 2 – Good Lighting, Inc.

Case Study No. 2 – Good Lighting, Inc.

Background

- ❑ Your Firm was engaged to audit the December 31, 2012 financial statements of Good Lighting, Inc. (“Company”)
- ❑ The Company manufactures and sells lighting equipment.
- ❑ The Company’s common stock is quoted on the OTCBB and normal weekly trading activity is around 10,000 shares, which was consistent throughout 2012.
- ❑ On March 1, 2012, the Company signed an agreement to acquire Little Lighting, Inc. (“Little”) for 10 million shares of the Company’s common stock in a business combination, which closed on June 30, 2012.
- ❑ The Company’s management believed that Little’s valuable patents, customer relationships, and assembled workforce would have a valuable impact on operations.

Case Study No. 2 – Good Lighting, Inc.

Background

- ❑ On March 1, 2012, the agreement date, the Company granted options to its employees to purchase, in aggregate, one million shares of the Company's common stock at \$3 per share – the quoted price on the OTCBB on the grant date.
- ❑ On May 1, 2012, the Company issued one million shares of its common stock for cash of \$4 per share to investors.
- ❑ Subsequent to this stock issuance and through the June 30, 2012 closing date of the acquisition, the Company's common stock was quoted on the OTCBB at or around \$4 per share.
- ❑ The fair value of the purchase price consideration was based on the \$3 share price as that represented the valuation on which the agreement was based.
- ❑ The Company's controller said the May 1st stock issuance was unusual and should be ignored in valuing the business combination.

Case Study No. 2 – Good Lighting, Inc.

Background

- ❑ The Company engaged a recognized and reputable valuation firm to assist management in determining the acquisition date fair values of the patents and assembled workforce, which were recorded as intangible assets.
- ❑ The Company provided the specialist with prospective financial data that the specialist used to prepare discounted cash flows to determine the values of the patents and assembled workforce.

Case Study No. 2 – Good Lighting, Inc.

Scenario

- ❑ *Your Firm is conducting its audit of the Company's 2012 financial statements. You are the engagement partner and have just arrived at the client site to discuss the audit of the business combination.*
- ❑ *The engagement team obtained, reviewed, and relied on the valuation specialist's report as audit evidence supporting the fair value of the patents and assembled workforce.*
- ❑ *Audit documentation stated, "The specialist is an expert in valuation of intangible assets within the lighting distribution industry. Methods and assumptions used by the specialist to value the patents and assembled workforce appear reasonable. No further test work deemed necessary."*
- ❑ *The engagement team obtained management's written representation that the value assigned to the assets acquired and liabilities assumed in the purchase were appropriate as of the acquisition date.*

Case Study No. 2 – Good Lighting, Inc. Measurement Date for Valuing Consideration

ASC Paragraph 805-30-30-7 states that 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 – Good Lighting, Inc. Fair Value Measurement

ASC Paragraph 820-10-35-20 states:

The definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. However, the definition of fair value also shall be applied to instruments measured at fair value that are classified in stockholders' equity.

Case Study No. 2 – Good Lighting, Inc. Fair Value Measurement

ASC Paragraph 820-10-35-44 states, in part:

The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

Case Study No. 2 – Good Lighting, Inc. Fair Value Measurement

ASC Paragraph 820-10-35-51B 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 in accordance with this Subtopic.

Case Study No. 2 – Good Lighting, Inc. Identifying Intangible Assets

ASC Section 805-10-20 states that an asset is *identifiable* if it either:

- Is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or
- Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Case Study No. 2 – Good Lighting, Inc. Identifying Intangible Assets

ASC Paragraph 805-20-55-23 states that if an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights.

ASC Paragraph 805-20-55-27 states that a customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable.

Case Study No. 2 – Good Lighting, Inc. Identifying Intangible Assets

ASC 805-20-55-6 states that . . . an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed into goodwill.

Question C

QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* ("QC 20"), paragraph .23 provides that a firm should communicate its quality control policies and procedures to its personnel in a manner that provides reasonable assurance that those policies and procedures are:

- A. understood
- B. memorized
- C. complied with
- D. recited periodically

Question D

QC 20, paragraph .22 provides that responsibility for the *design* and *maintenance* of the various quality control policies and procedures should be assigned to an appropriate individual or individuals in the firm. In making that assignment, consideration should be given to:

- A. the proficiency of the individuals
- B. the age of the individuals
- C. the authority to be delegated to them
- D. the colleges the individuals attended
- E. the extent of supervision to be provided

Break

(15 minutes)

Auditing Revenue

Auditing Revenue

Inspection Findings

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

Auditing Revenue

Relevant Auditing Standards

AS No. 12, *Identifying and Assessing Risks of Material Misstatement* ("AS 12"), paragraph .68, states, in part:

Presumption of Fraud Risk Involving Improper Revenue Recognition. 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.

AS 12, paragraph .71, states, in part:

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

- Whether the risk is a fraud risk;
- Note: A fraud risk is a significant risk.

Auditing Revenue

Relevant Auditing Standards

AU Section 316, *Consideration of Fraud in a Financial Statement Audit* (“AU 316”), paragraph .07 states:

Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them. The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.

Auditing Revenue

Relevant Auditing Standards

AU Section 334, *Related Parties* (“AU 334”), paragraph .08, states, in part:

The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

- Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.
- Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

Auditing Revenue

Relevant Auditing Standards

AU 316, paragraph .53, states, in part:

The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- Performing substantive analytical procedures using disaggregated data
- Making oral inquiries of major customers and suppliers in addition to sending written confirmation, or sending confirmation requests to a specific party within an organization

Auditing Revenue

Relevant Auditing Standards

AU 334, paragraph .10.e, states, in part:

When necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered.

With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns

Auditing Revenue

Relevant Auditing Standards

AS No. 13, *The Auditor's Responses to the Risks of Material Misstatements*, paragraph 11 states:

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

Auditing Revenue

Relevant Auditing Standards

AS No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, paragraphs 44 and 45 state, in part:

The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Case Study No. 3 – Strong Boxes, Inc.

Case Study No. 3 – Strong Boxes, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2012 financial statements of Strong Boxes, Inc. (the “Company”) and the effectiveness of its ICFR
- ❑ This will be your firm’s first audit of the Company
- ❑ The Company manufactures and sells perforated and labeled cardboard boxes to moving companies
- ❑ The Company is experiencing increasing competition and declining revenue, margins, and cash flows
- ❑ The CEO owns 42 percent of the Company and is Chairman of the Board and reportedly dominates the Board and the management team

Case Study No. 3 – Strong Boxes, Inc.

Background

- ❑ The Company needs to expand its line of credit with its bank or reduce operating activities
- ❑ The bank is concerned about the Company's financial situation and may not agree to expand the line
- ❑ The CEO is known to have stated, "We will do whatever it takes to get the financing this Company needs. Laying off employees is not an option."
- ❑ Despite the recent history of poor results, the Company reported increases in revenue for the third and fourth quarter of 2012

Case Study No. 3 – Strong Boxes, Inc.

Scenario 1

- ❑ You, the engagement partner, have arrived at the client site to review work performed by the engagement team in the area of revenue.
- ❑ You learned the following information from the engagement team in your discussions:
 - The list of related parties includes a company, High Speed Movers, Inc. (“HSM”), that is a privately-held residential moving company of which the Company’s CEO owns 65 percent.
 - The related party listing indicated an accounts receivable balance resulting from occasional box sales to HSM.

Case Study No. 3 – Strong Boxes, Inc.

Scenario 1

- ❑ Engagement team confirmed the HSM receivable
 - The Company's CEO signed the confirmation as HSM Board Chairman
 - HSM receivable balance had doubled since prior year end
- ❑ To address fraud risk, the engagement team conducted a brainstorming session, made inquiries of relevant Company personnel, and tested nonstandard journal entries throughout year
- ❑ Substantive audit procedures over revenue consisted primarily of analytical and cut-off procedures due to reliance on control testing
- ❑ Exhibit A is work paper of analytical procedures

Case Study No. 3 – Strong Boxes, Inc.

Scenario 2

- ❑ As part of the Company's integrated audit for 2012, the Firm tested all controls identified as important in the revenue process.
- ❑ These control tests were selected from
 - Throughout the year for financial statement audit purposes, and
 - At or near year end for ICFR audit purposes
- ❑ The Board's quarterly review of revenue performance was tested with documentation as follows:

Control 101: The Company's management prepares an analysis of quarterly revenue performance and provides this analysis to the Board for their review. Any fluctuations of ten percent or more must be explained. The Board members initial the analysis noting their review of the information.

Case Study No. 3 – Strong Boxes, Inc. Scenario 2

- To test this control, engagement team
 - Reviewed Board minutes noting indication of reviews
 - Reviewed all quarterly revenue analyses noting the initials of all seven Board members
- Engagement team concluded that Board members' initials were evidence that the quarterly analysis control was operating effectively

Case Study No. 3 – Strong Boxes, Inc.

Scenario 3

- ❑ Your Firm has received the PCAOB's 2013 inspection report, which includes a Part IIA deficiency related to the Firm's failure to perform sufficient procedures to test the issuer's revenue for the year ended December 31, 2012.
- ❑ The inspection report also includes a corresponding Part IIB deficiency regarding the Firm's quality control policies and procedures related to testing revenue.
- ❑ The following are excerpts from Part II of the Firm's 2013 inspection report.

Case Study No. 3 – Strong Boxes, Inc.

Scenario 3

A. Insufficiently Supported Audit Opinions

The Firm performed analytical procedures as its primary substantive procedure to test revenue. In performing these procedures, the Firm failed to satisfy the requirements of AU 329, *Analytical Procedures*. Specifically, the Firm failed to develop expectations that were sufficiently precise to provide the necessary level of assurance that potential material misstatements would be identified and failed to obtain corroboration of management's explanations for the fluctuations in revenue.

Case Study No. 3 – Strong Boxes, Inc.

Scenario 3

B. Issues Related to Quality Controls

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 one of the audits reviewed, the inspection team identified a significant deficiency related to the Firm's testing of revenue. This information provides cause for concern regarding the Firm's quality control policies and procedures related to testing of revenue.

Question E

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

Question F

QC Section 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*, paragraph .12 provides that a peer review does not substitute for monitoring procedures. However, since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for some or all of its inspection procedures for the period covered by the peer review.

- A. True
- B. False

Starting a First Year Audit

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
- Failure to evaluate the impact of the 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

Relevant Quality Control Standards

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.

Starting a First Year Audit

Relevant Quality Control Standards

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.

Starting a First Year Audit

Relevant Auditing Standards

AU Section 315, *Communications Between Predecessor and Successor Auditors* ("AU 315"), paragraph .03 states:

An auditor should not accept an engagement until the communications described in paragraphs .07 through .10 have been evaluated. However, an auditor may make a proposal for an audit engagement before communicating with the predecessor auditor. The auditor may wish to advise the prospective client (for example, in a proposal) that acceptance cannot be final until the communications have been evaluated.

Starting a First Year Audit

Relevant Auditing Standards

AU 315, paragraph .09 states, in part:

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.

Starting a First Year Audit

Relevant Auditing Standards

AS No. 16, *Communications with Audit Committees*, paragraph 7:

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.

Starting a First Year Audit

Relevant Auditing Standards

Auditing Standard No. 7, *Engagement Quality Review* ("AS 7"), paragraph 3 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 7, paragraph 5 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.

Starting a First Year Audit

Relevant Quality Control Standards

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.

Starting a First Year Audit

Relevant Quality Control Standards

QC 40, paragraph .08 states:

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.

Starting a First Year Audit

Case Study No. 4 – Sound Deposits Bank

Case Study No. 4 – Sound Deposits Bank Background

- ❑ In August 2012, your Firm won a proposal contest to audit the financial statements of Sound Deposits Bank (the "Bank") for the year ended December 31, 2012.
- ❑ 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, 2013.

Case Study No. 4 – Sound Deposits Bank

Scenario 1

- ❑ 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 the one 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 of you.
- ❑ 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.
- ❑ As you begin to focus on this client acceptance task, the following thoughts begin to run through your mind:

Case Study No. 4 – Sound Deposits Bank

Scenario 1

- ❑ 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.
- ❑ 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 – Sound Deposits Bank

Scenario 1

- ❑ 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 professional 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.

Case Study No. 4 – Sound Deposits Bank

Scenario 1

- ❑ 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.
- ❑ 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 their 8-K.

Case Study No. 4 – Sound Deposits Bank

Scenario 1

- ❑ You have presented the Bank CFO with an engagement letter outlining an understanding of the terms of the audit engagement;
- ❑ however, the CFO immediately indicated that the Bank would have a problem with the alternative dispute resolution language contained in the letter.
- ❑ While the partners of your Firm are fairly adamant that this is something the Firm will not budge on, your managing partner has agreed that the Bank can have some time to familiarize itself with alternative dispute resolution provisions before signing the engagement letter.
- ❑ He 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 – Sound Deposits Bank

Scenario 2

- ❑ Your Firm is in the beginning stage of planning its audit of the Bank's financial statements for the year ended December 31, 2012.
- ❑ You are the engagement partner on the Bank audit and have over 25 years of experience auditing publicly-held regional banks.
- ❑ You have just arrived in your managing partner's office to discuss the assignment of an engagement quality reviewer to the Bank engagement.
- ❑ Your managing partner has done some homework on the subject and presents you with the following options for the engagement quality reviewer.
- ❑ However, he wants to use one of the options within the Firm to enhance realization on the engagement

Case Study No. 4 – Sound Deposits Bank

Scenario 2

- ❑ A manager of the Firm with 10 years experience auditing publicly-held regional banks – high level of competence in accounting, auditing, financial reporting, and SEC rules and regulations
- ❑ A partner of the Firm with 25 years experience providing tax services to publicly-held regional banks – expert on tax issues of regional banks and is liked by the Bank's CEO and CFO
- ❑ A partner of the Firm with 30 years experience auditing publicly-held manufacturing companies – no bank experience but is the Firm's Director of Accounting and Auditing
- ❑ An accounting professor at state university with 30 years experience auditing publicly-held banks at large accounting firm from which he retired five years ago – wrote a highly regarded book entitled, How to Audit a Publicly-Held Regional Bank

Questions



Wrap-Up and Closing Remarks

Lewis H. Ferguson, Board Member
and all Speakers

Forum on Auditing Smaller Broker-Dealers

TAG Alliances
May 5-7, 2014
Miami, Florida

Opening Remarks

Jay D. Hanson
Board Member, PCAOB
October 31, 2013
Jersey City, NJ

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.

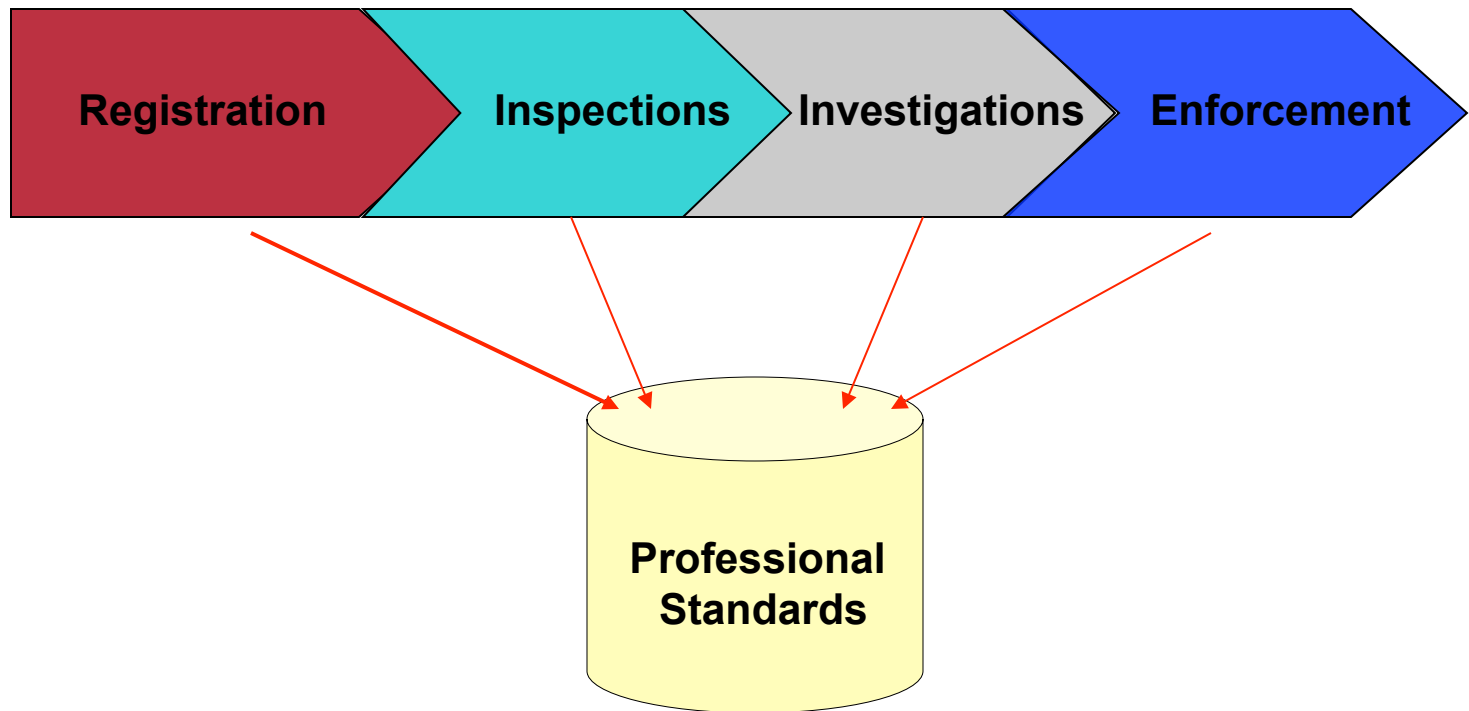
PCAOB Overview

Mary M. Sjoquist, Director,
Office of Outreach and
Small Business Liaison
October 31, 2013
Jersey City, NJ

Mission Statement

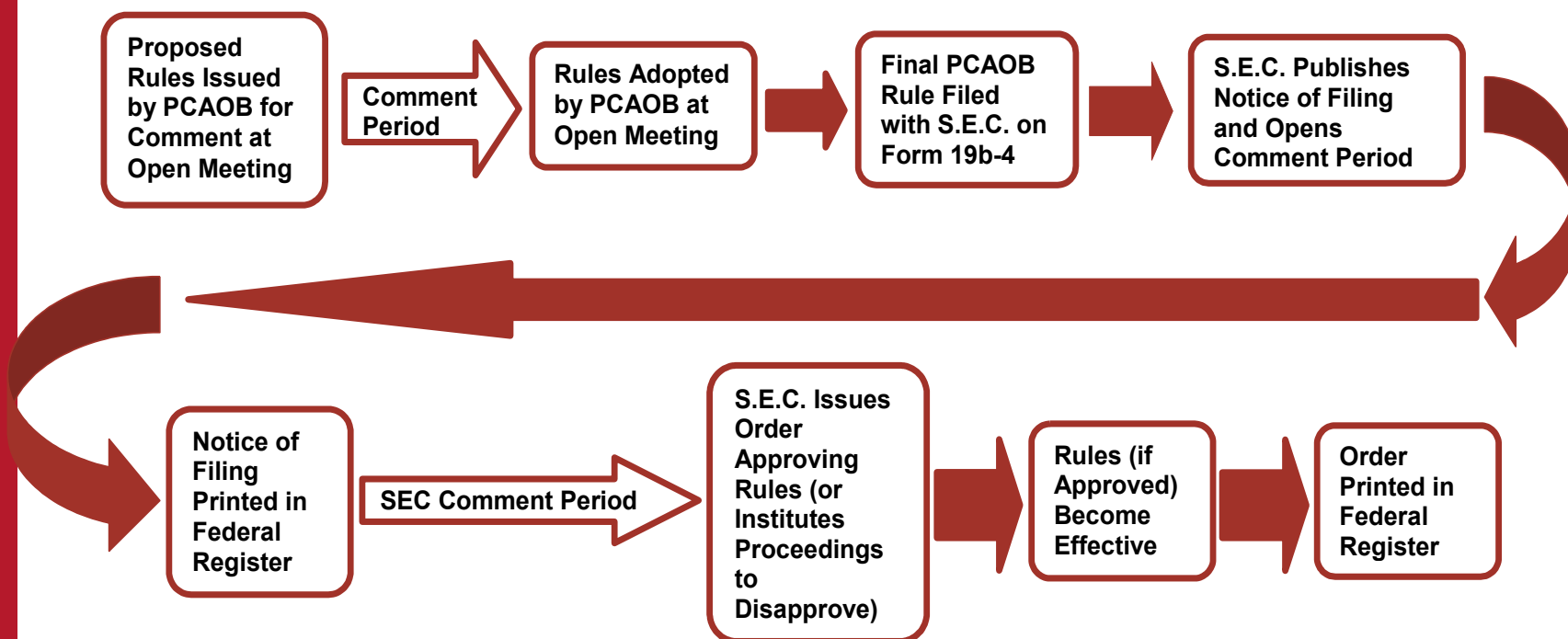
- ❑ The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

The PCAOB in a Nutshell



PCAOB's Standard-Setting Process

PCAOB Typical Rulemaking Process



Other Steps in Standard-Setting

- ❑ Standing Advisory Group input
- ❑ Investor Advisory Group input
- ❑ Roundtables
- ❑ Outreach to individuals and entities with interest in the subject matter
- ❑ Concept releases
- ❑ Reproposals

Key Proposed Amendments to Conform PCAOB Rules and Forms to the Dodd-Frank Act

- Definition of audit committee (Rule 3501)
- Overall framework (Rules 3502 and 3520)
- Contingent fees (Rule 3521)
- Tax transactions (Rule 3522)
- Tax services for persons in a financial reporting oversight role (Rule 3523)
- Communications with audit committees concerning independence (Rule 3526)
- PCAOB independence rules applicable to auditors of issuers but not to auditors of brokers and dealers (Rules 3524 and 3525)
- Deferred compliance date for Rules 3521-3526

Dodd-Frank--Funding

- ❑ The Act provides that the Board must allocate the accounting support fee equitably among not only issuers but also brokers and dealers (see section 109(d))
- ❑ The Board may establish different classes of issuers and of brokers and dealers for funding purposes (sections 109(g) and 109(h)(2))
- ❑ The amount due from a broker or dealer must be in proportion to the net capital of the broker or dealer (before or after any adjustments), compared to the total net capital of all brokers and dealers (before or after any adjustments), in accordance with the rules of the Board (see section 109(h)(3))

Funding Rule

- ❑ As adopted, fee is based on “tentative net capital,” which under the SEC’s Rules is net capital before deducting certain securities haircuts and charges for certain commodities transactions (see SEC Rule 15c3-1(c)(15)).*
- ❑ A class of brokers and dealers, each with average quarterly tentative net capital \$5 million or less or that have a basis not to file audited financial statements, will be allocated a portion of the BD ASF of zero.
 - Represents 85.2% of brokers and dealers registered with the SEC or 1.6% of the industry’s total net capital*
 - 687 of the approximately 4,600 BDs registered with the SEC were assessed portions of the 2012 BD ASF fee**

*Adopted by PCAOB on June 14, 2011 and approved by SEC on August 18, 2011

**Fee assessed as of October 19, 2012.

Funding Rule (cont'd)

- ❑ Firm may not sign an audit report; consent to the inclusion of a report; or sign a document, report, notice, or other record concerning procedures or controls of any issuer, broker, or dealer required under the securities laws for a BD with an outstanding ASF
- ❑ Limited exception where broker, or dealer needs the audit report or consent in order to submit a report to, or make a filing with, the Commission
- ❑ Under those circumstances, the auditor must provide a notice to the Board the day after the filing is made; only good for 15 days; and is a one time exception

Fee Summary

- ❑ Registration Application Fees Paid by Firms
 - 0-49 issuer audit clients--\$500
 - 50-100 issuer audit clients--\$3000
 - 101-1000 issuer audit clients--\$29,000
 - 1001 issuer audit clients and up--\$390,000
- ❑ Annual Fees Paid by Firms
 - More than 500 issuer clients and more than 10,000 personnel--\$100,000
 - More than 200 issuer clients and more than 1000 personnel--\$25,000
 - All other firms \$500
- ❑ Accounting Support Fee (ASF)
 - Paid by issuers—approximately 92% of 2012 total ASF
 - Paid by broker-dealers—approximately 8% of total ASF

Rules on Periodic Reporting by Registered Public Accounting Firms--Annual Reporting

Form 2 includes –

- ❑ General information concerning the firm
- ❑ Audit clients and audit reports*
- ❑ Offices and affiliations
- ❑ Personnel
- ❑ Certain relationships
- ❑ Acquisitions
- ❑ Affirmation of consent

Proposed amendments to Form 2

*Currently only applicable to issuer reports

Rules on Periodic Reporting by Registered Public Accounting Firms--Special Reporting

Form 3 triggering events and disclosures include –

- ❑ Name change
- ❑ Audit reports (withdrawn report or consent*, or crossed 100 issuer threshold)
- ❑ Certain legal proceedings
- ❑ Bankruptcy
- ❑ Certain relationships
- ❑ Licenses and certifications
- ❑ Changes in the firm's Board contact person

Proposed amendments to Form 3

*Currently only applicable to issuer reports

Reporting Rules on Succeeding to a Predecessor Firm's Registration Status

- ❑ The rules provide for:
 - A Form 4 must be filed within 14 days after the event
 - With certain representations
- ❑ Allows firms whose structure has changed to retain registration status under two scenarios:
 - A registered firm changes its legal form of organization or jurisdiction in which it operates
 - A registered firm is acquired by an unregistered firm or merges with another firm to create a new legal entity
- ❑ If deadline for filing Form 4 not met, registration process using Form 1 may be required along with Board action.

Confidential Treatment Requests

- ❑ Confidential Treatment Requests are more limited on these forms than on the registration application form
 - Board has determined that certain information will never qualify
 - In practice, this means no check box is available to request confidential treatment for U.S. firms
- ❑ To request confidential treatment:
 - Firm must represent that information is not public AND
 - Firm must provide a detailed explanation of how the information is proprietary OR
 - Firm must provide a detailed explanation of how the information is protected from public disclosure by applicable law, and must provide a publicly available citation to or a copy of the law

Office of Outreach and Small Business Liaison

- ❑ Established on December 15, 2010
- ❑ Formalized and centralized currently existing small business initiatives
 - Small business forums
 - Outreach to smaller firms and issuers
- ❑ New functions
 - Outreach to the broker-dealer community including forums for auditors of broker-dealers
 - Central point of contact for:
 - questions about the Board's activities
 - identifying areas where information related to the Board's work is not well understood
 - suggesting actions to address these areas

Office of Outreach Contact Information

- ❑ Outreach@PCAOBUS.ORG
- ❑ 202-591-4135

Questions?



Research & Analysis

Broker-Dealers: Landscape, Trends and Risks

October 31, 2013

“(T)he criteria that were considered in making selections for the interim inspection program are not necessarily representative of any decision that the Board will make on whether and how to differentiate among categories of registered accounting firms and classes of brokers and dealers”

PCAOB Release No. 2013-006

August 19, 2013

“The Board has not finalized any determinations on the attributes that provide for differentiation of classes of brokers and dealers or whether the risk of loss can be differentiated.”

PCAOB Release No. 2013-006

August 19, 2013

1% of Audit Firms Audit 95% of Net Capital in 2012

Firm Category	# of Firms	# of B-Ds	Sum of Net Capital (2012 in \$m)	% of Total Net Capital
<i>Firms that audit more than 100 B-Ds</i>	6	899	161,468	95%
<i>Firms that audit 1 to 100 B-Ds</i>				
51 to 100 B-Ds	8	542	1,092	1%
21 to 50 B-Ds	23	665	4,049	2%
11 to 20 B-Ds	30	433	623	-
6 to 10 B-Ds	60	464	826	-
5 B-Ds	30	150	165	-
4 B-Ds	57	228	222	-
3 B-Ds	71	213	273	-
2 B-Ds	135	270	189	-
1 B-D	363	363	212	-
<i>Subtotal – Firms that audit 1 to 100 B-Ds</i>	777	3,328	7,651	5%
Grand Total	783	4,227	169,120	100%

Demographics of Firms that Audited B-D's in 2012

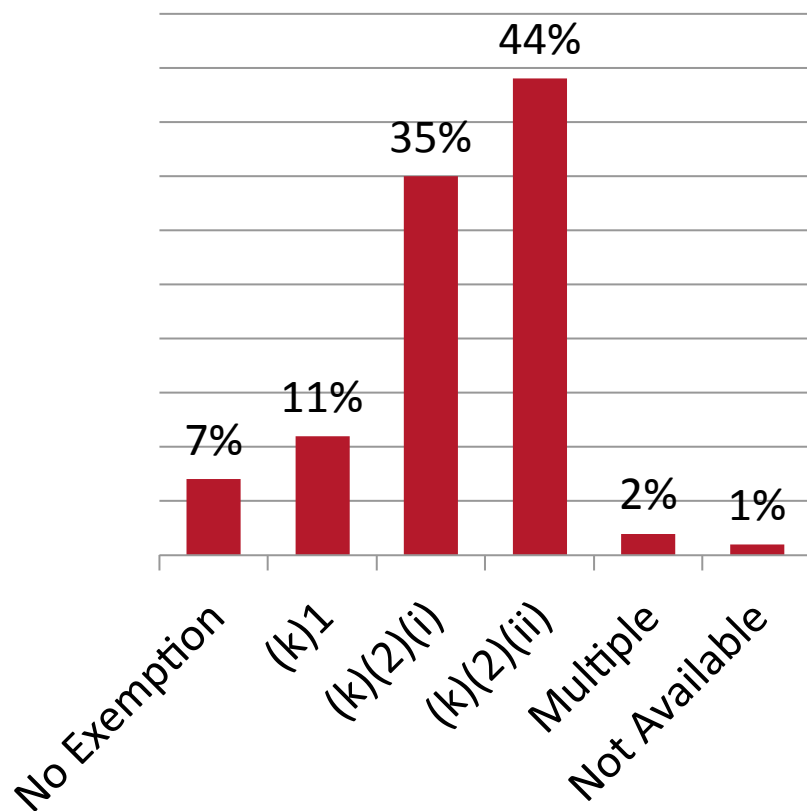
Firm Category	# of Firms	% Audit Carrying B-Ds	% Audit Issuers	% of B-Ds Outside NY, NJ, IL and CA	Average Number of CPAs	Median Number of CPAs
<i>Firms that audit more than 100 B-Ds</i>	6	100%	100%	40%	6,929	8,065
<i>Firms that audit 1 to 100 B-Ds</i>						
51 to 100 B-Ds	8	63%	50%	43%	73	8
21 to 50 B-Ds	23	43%	43%	42%	314	5
11 to 20 B-Ds	30	37%	70%	56%	200	67
6 to 10 B-Ds	60	23%	55%	52%	159	19
5 B-Ds	30	13%	47%	57%	102	17
4 B-Ds	57	7%	39%	63%	43	12
3 B-Ds	71	10%	34%	54%	23	9
2 B-Ds	135	7%	30%	63%	31	10
1 B-D	363	3%	36%	60%	23	6
<i>Subtotal – Firms that audit 1 to 100 B-Ds</i>	777					
Grand Total	783					

Demographics of Firms Inspected in 2012

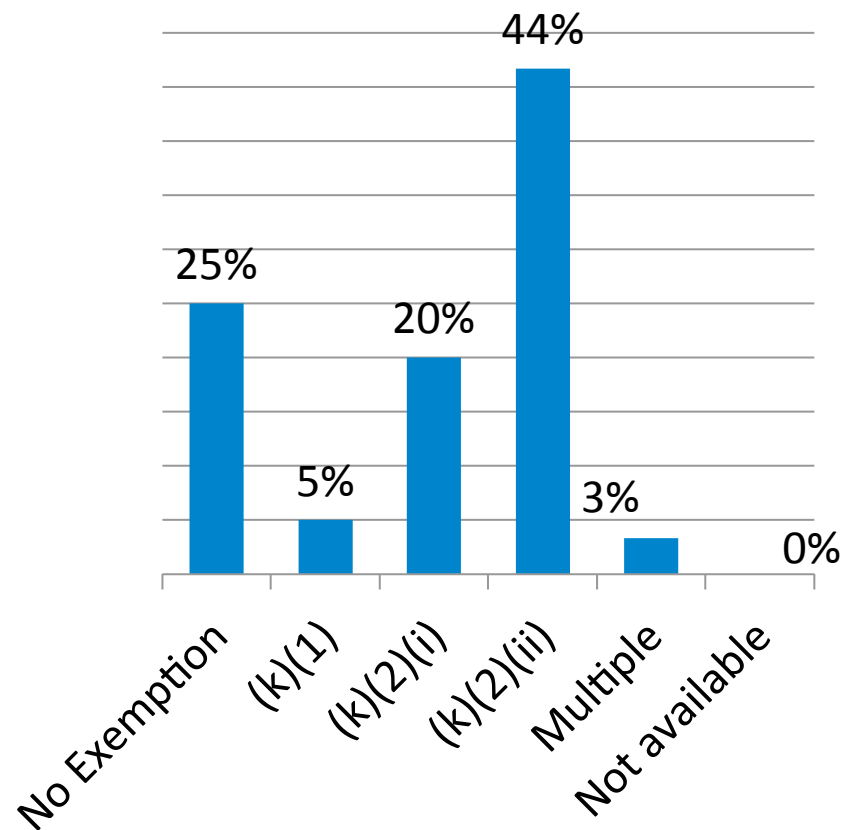
Firm Category	# of Firms		% Audit Issuers	Average Number of CPAs	Median Number of CPAs
<i>Firms that audit more than 100 B-Ds</i>	5		100%	8,022	8,654
<i>Firms that audit 1 to 100 B-Ds</i>					
51 to 100 B-Ds	3		33%	129	3
21 to 50 B-Ds	12		25%	343	2
11 to 20 B-Ds	5		100%	595	650
6 to 10 B-Ds	4		50%	53	29
5 B-Ds	1		0%	7	7
4 B-Ds	2		0%	11	11
3 B-Ds	1		0%	5	5
2 B-Ds	2		0%	23	23
1 B-D	8		25%	11	2
Subtotal – Firms that audit 1 to 100 B-Ds	38				
Grand Total	43				

Customer Protection Rules

All B-Ds

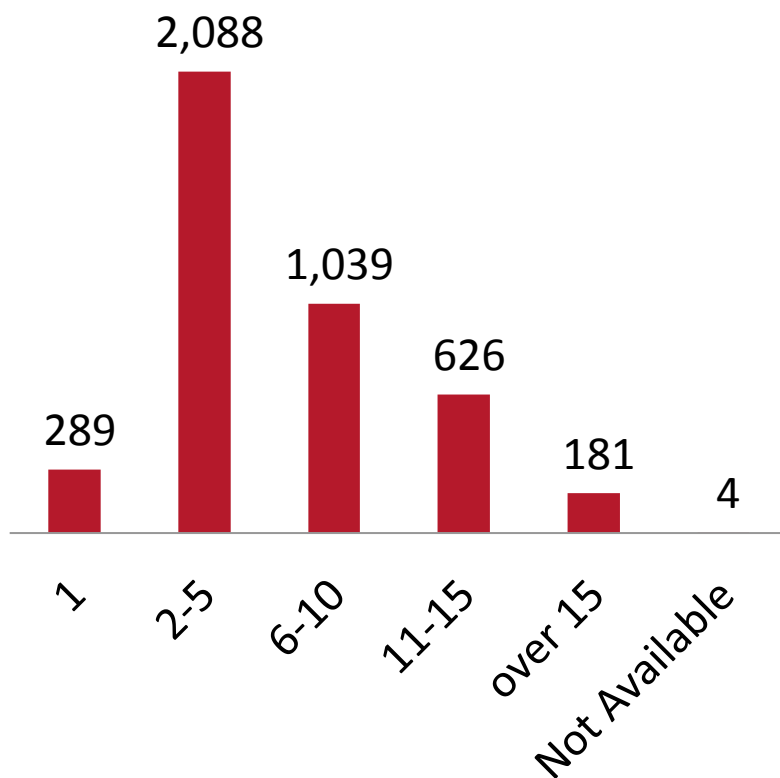


2012 Inspections

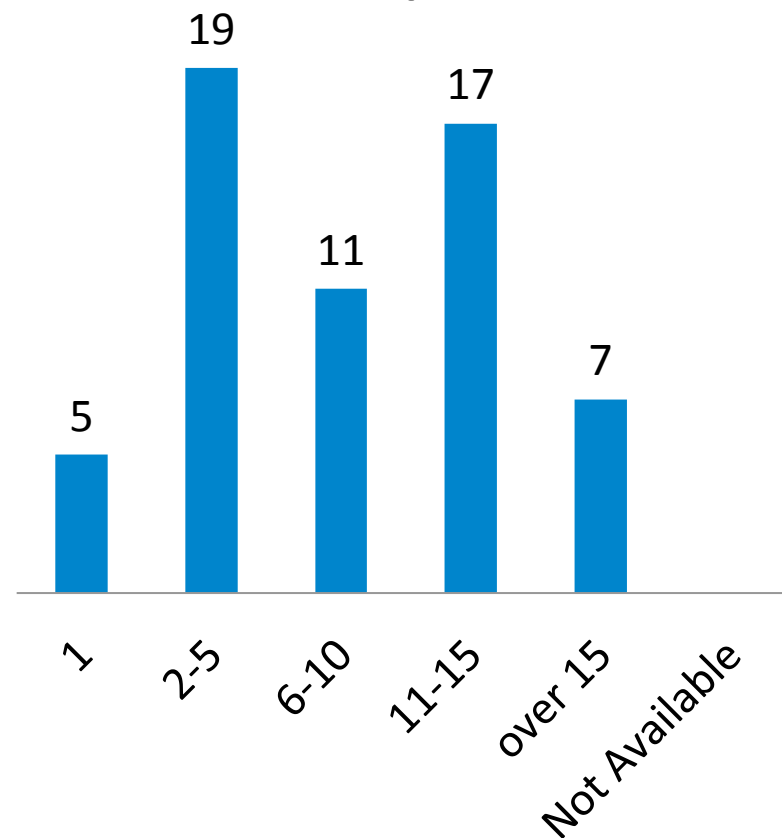


Lines of Business

All B-Ds

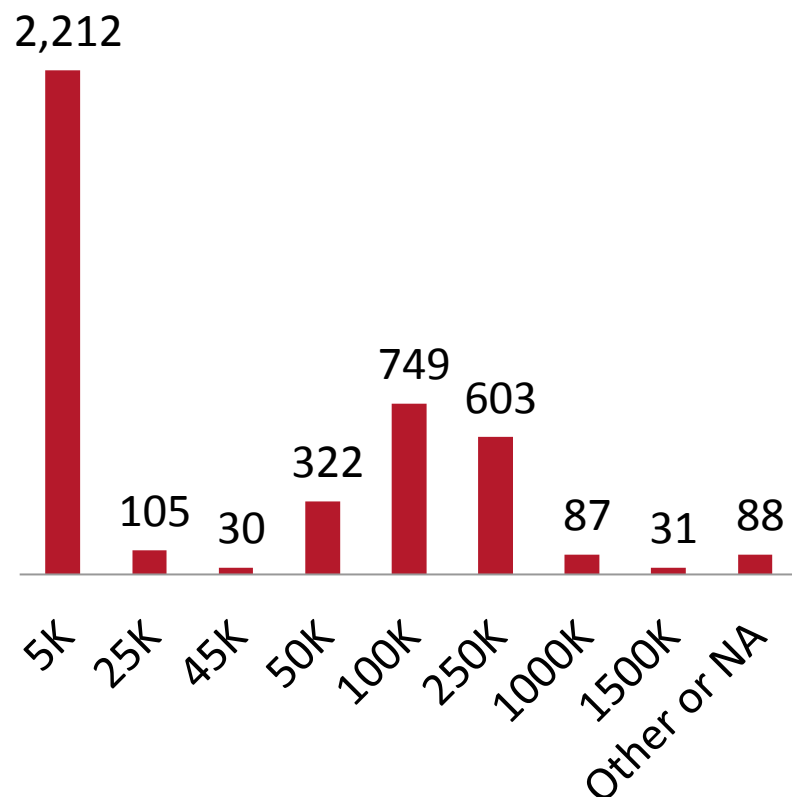


2012 Inspections

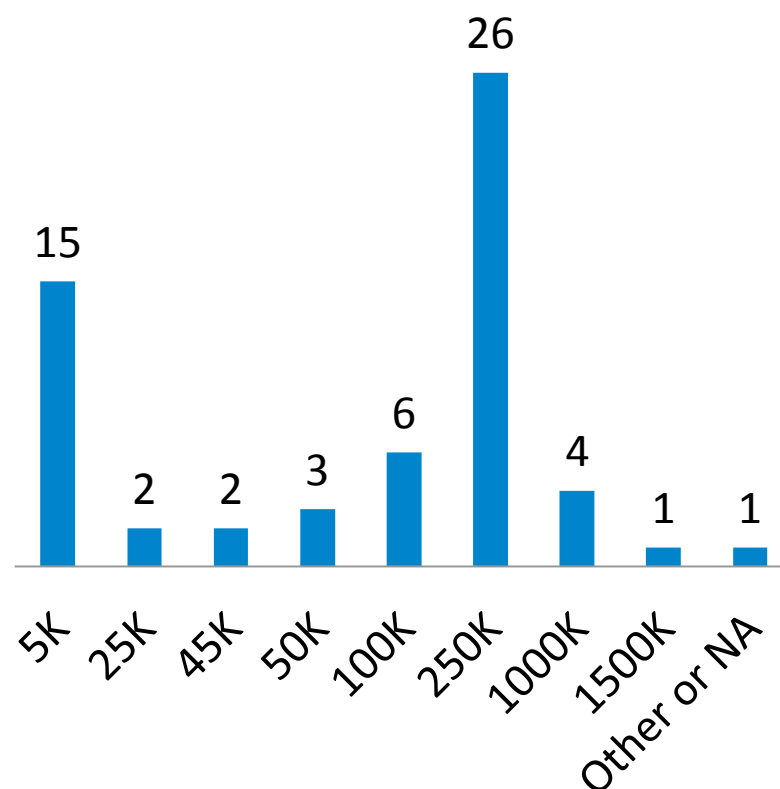


Minimum Fixed-Dollar Net Capital Requirement Reported

All B-Ds

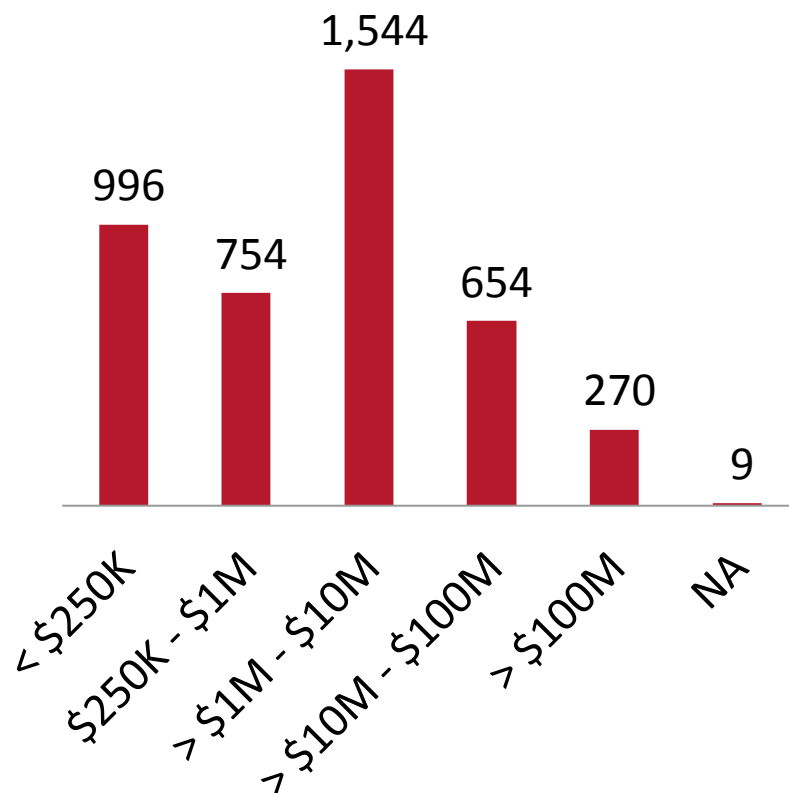


2012 Inspections

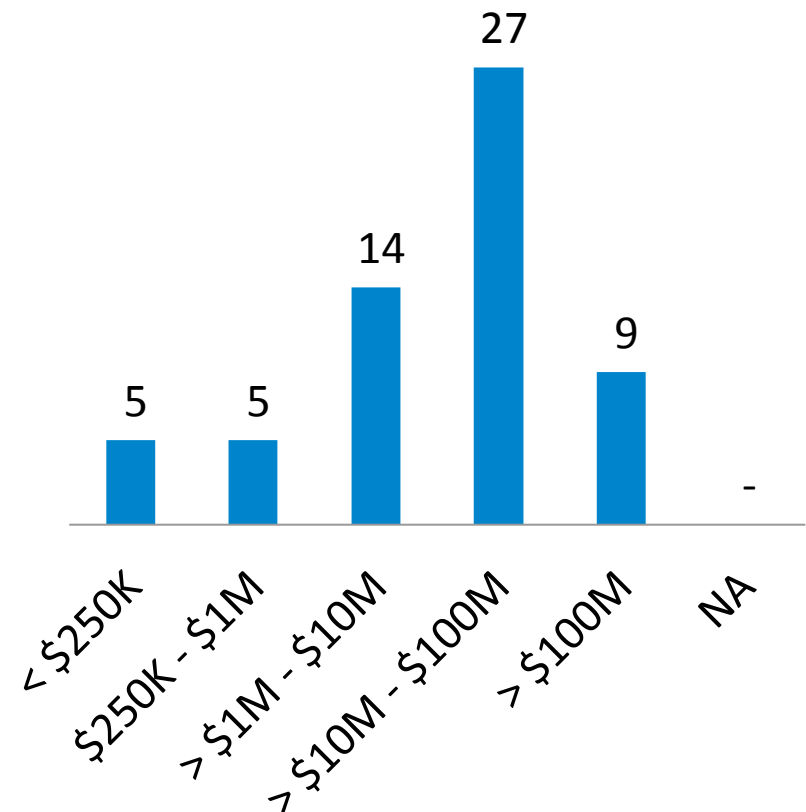


Revenue

All B-Ds

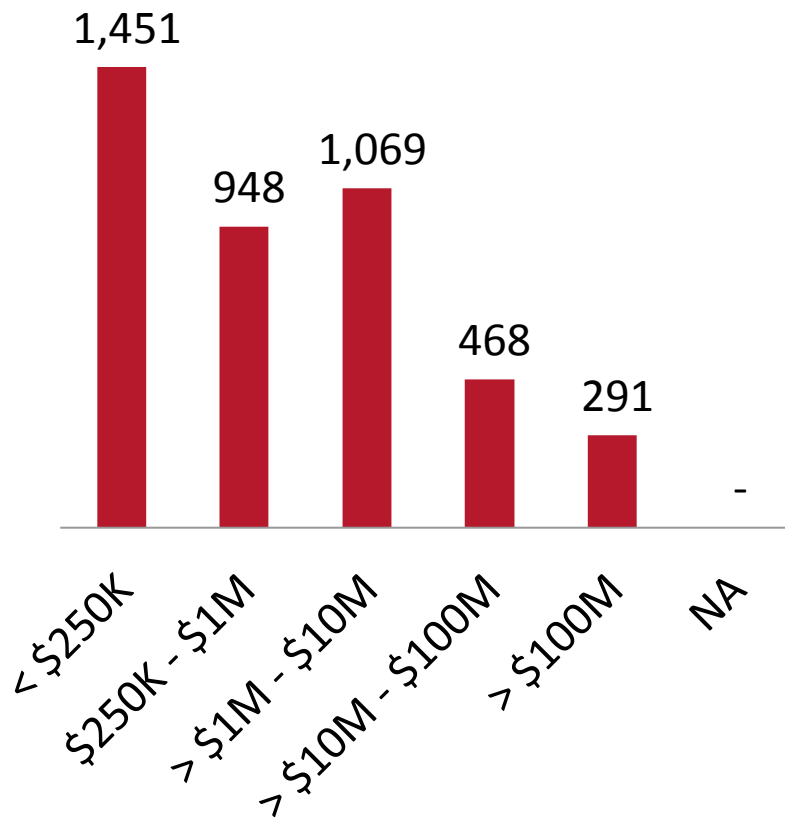


2012 Inspections

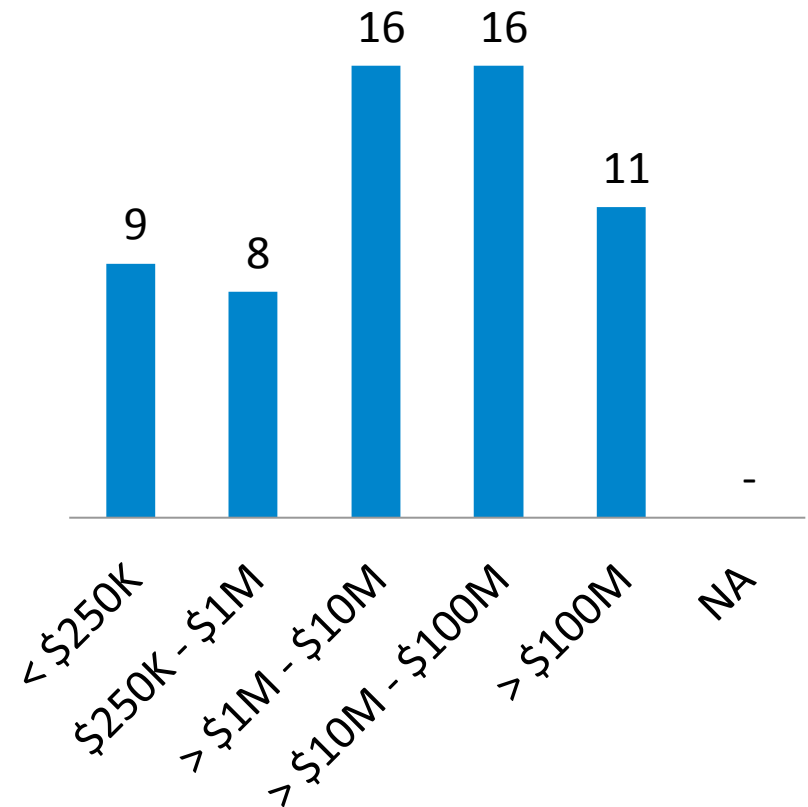


Assets

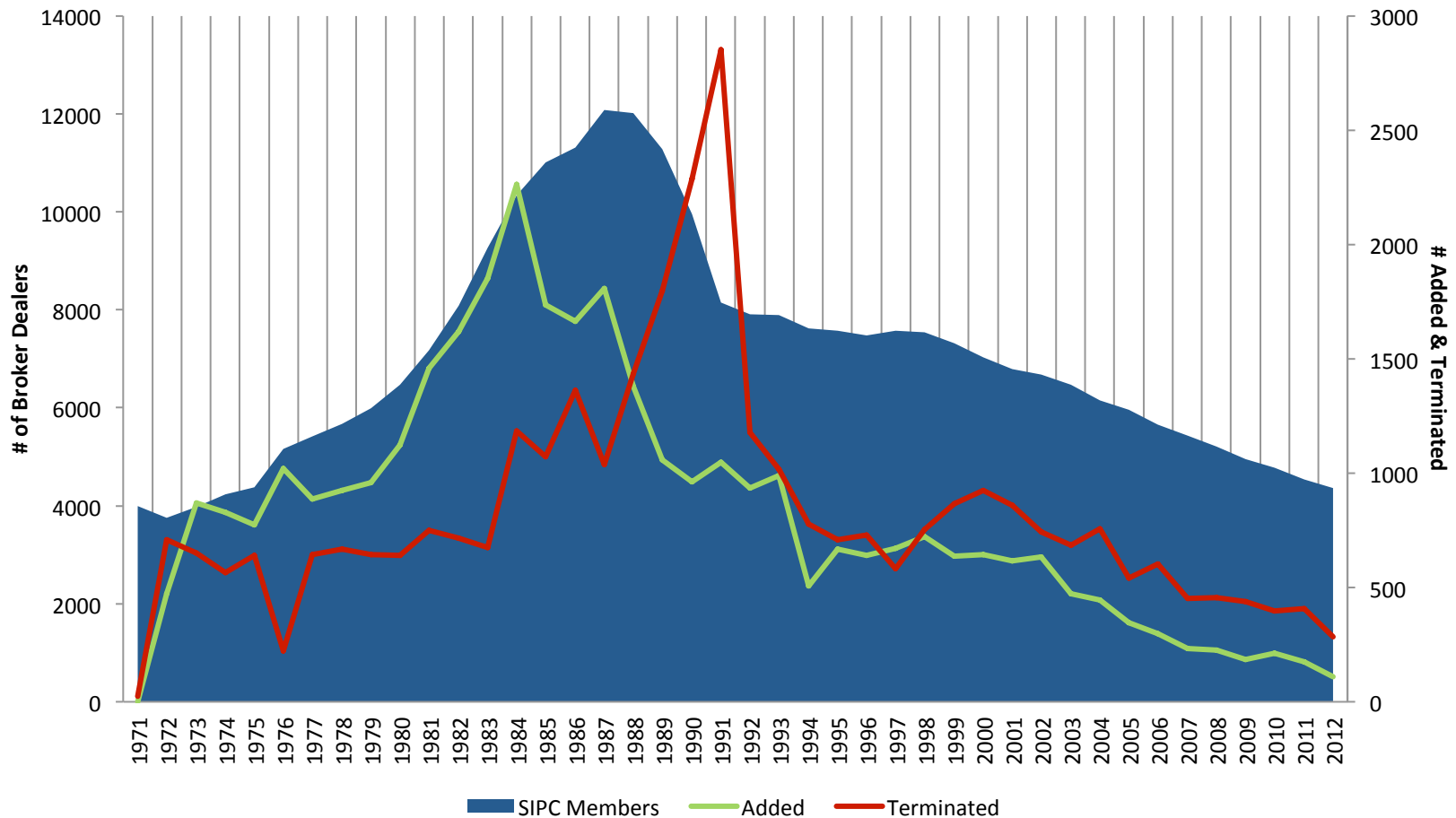
All B-Ds



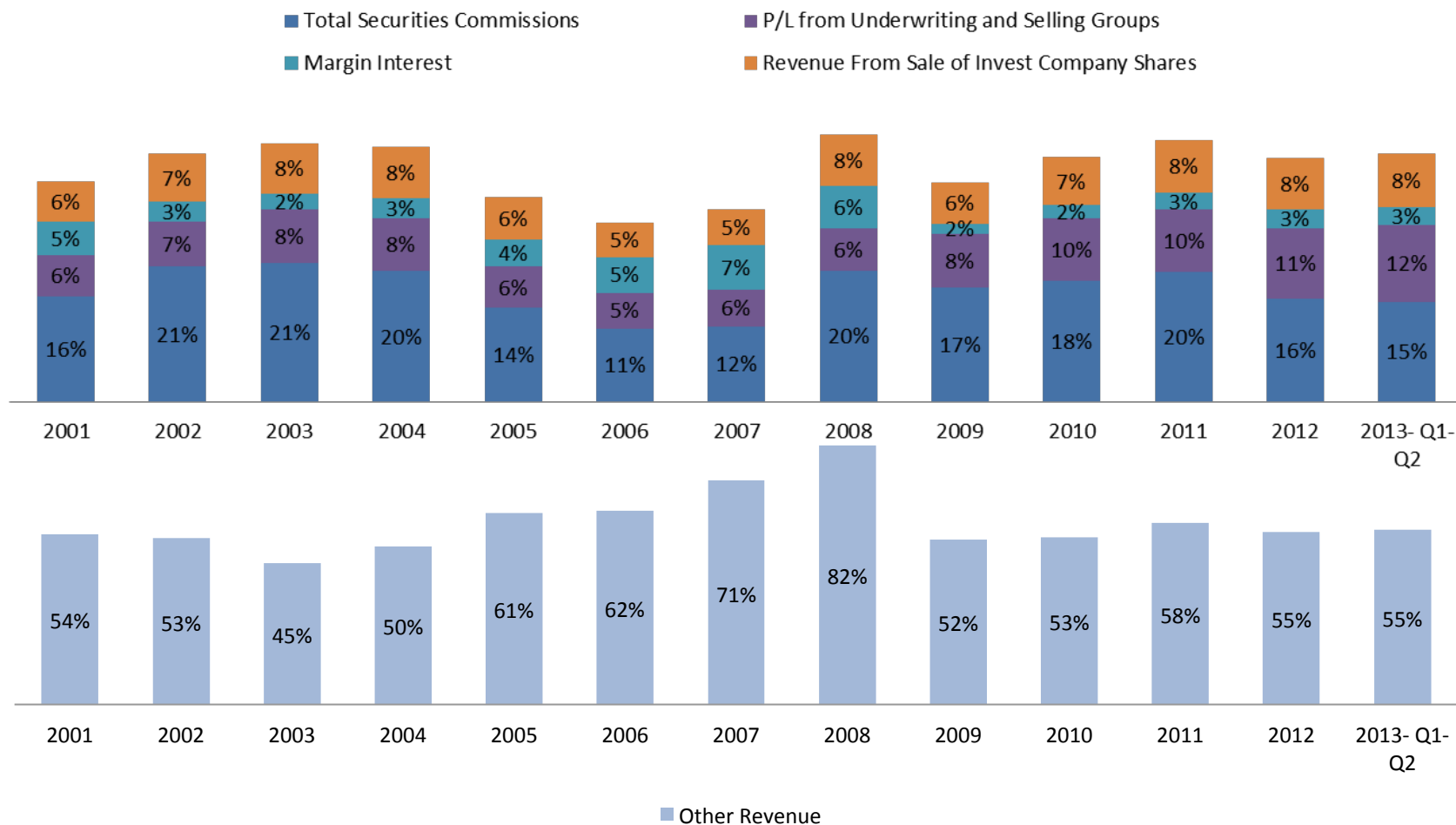
2012 Inspections



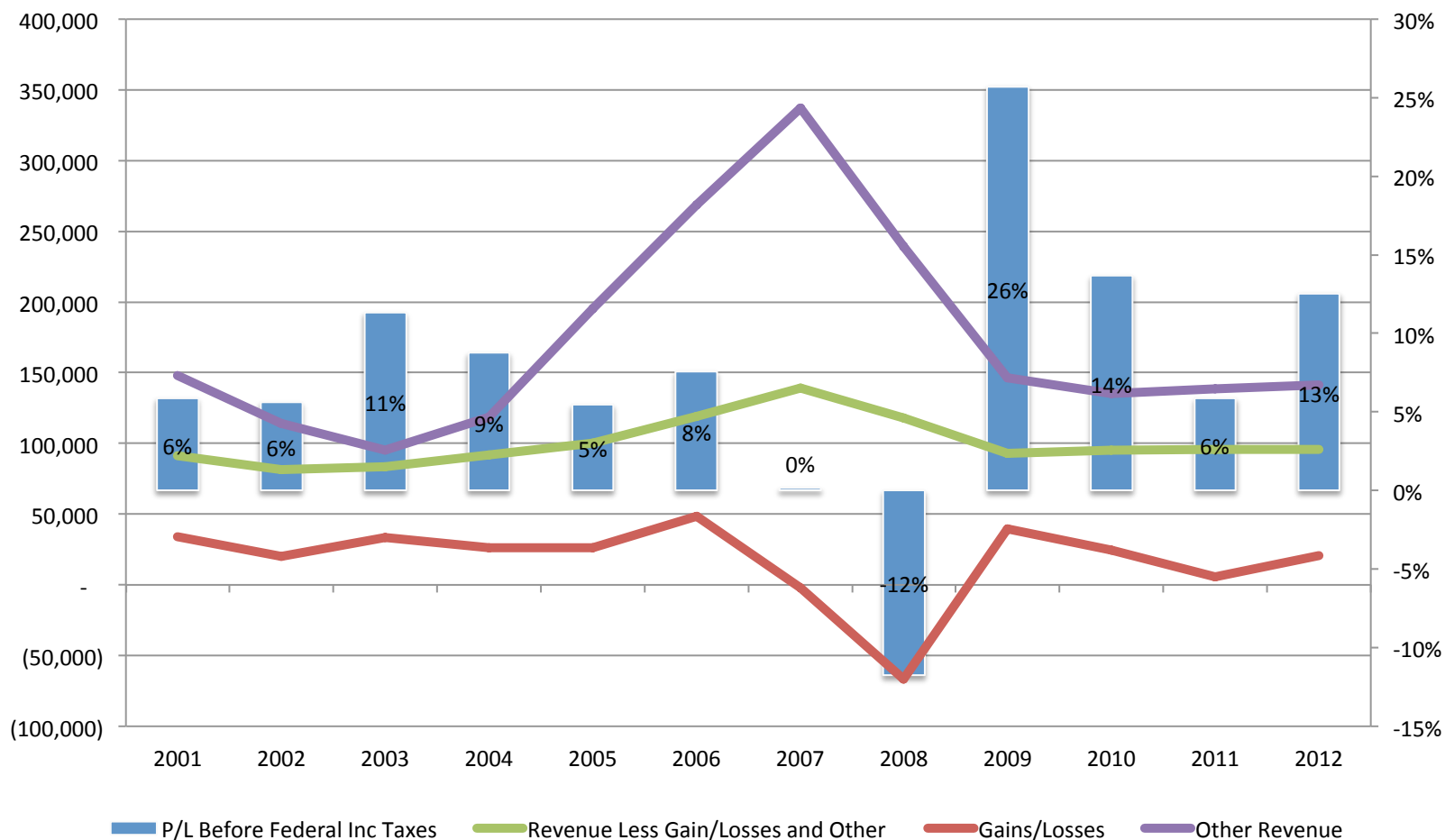
Population of Broker Dealers in Steady Decline Since Late 80's



Revenue Trends



Revenue vs. Pre-Tax Net Income Trends



Questions?



Break

(15 minutes)

Financial Surveillance – Current Issues and Observations

**PCAOB Forum on Auditing Smaller Broker-Dealers
Jersey City, New Jersey - October 31, 2013**

Susan DeMando Scott

Office of Risk Oversight and Operational Regulation
Financial Operations Policy Group



“Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers”

PCAOB inspected portions of 60 audits by 43 firms, 24 of which audit broker-dealers only. Deficiencies were identified in 57 of the 60 audits.

PCAOB Observations:

- Auditor Independence.
 - In 22 of 60, it appeared that auditors performed bookkeeping or other services related to the accounting records, financial statements or supporting schedules required to be included in the audit per SEA Rule 17a-5.
 - Independence required by Rule 2-01 of Regulation S-X, *Qualification of Accountants*
- Procedures Regarding Broker-Dealer Compliance with the Net Capital Rule
 - In 23 of the 60 audits, issues were noted in the following areas:

- Minimum Net Capital Requirements:	10 of 23
- Allowable Assets	17 of 23
- Haircuts	9 of 23
- Operational changes	3 of 23
- Auditing Financial Statement Disclosures
 - In 19 of the 60, auditors failed to identify incomplete disclosures or respond to evidence that was inconsistent with the disclosures included in the financial statements.

PCAOB Release No. 2013-006 (August 19, 2013)

Audit Quality Issues

PCAOB Observations, for the second time, align with FINRA experience.

Audit Quality Issues may be the result of multiple factors.

One possible reason - auditor may lack a breadth of knowledge about the industry and regulatory requirements.

Statistics:

- Approximately 4,200 broker/dealer audits were submitted with a FYE date in 2012.
- 363 FINRA members utilized the services of an auditor who had no other broker-dealer clients.
- 483 FINRA members utilized the services of an auditor who had only one or two other broker-dealer audit clients
 - In the case of more than one broker-dealer audit client, the broker-dealers may have been affiliated with each other.

Audit Quality/FOCUS Report Issues

Neither the auditor nor the broker/dealer may fully understand:

(1) The Net Capital Rule

- Rule is self-operative
- Net Capital Requirement is, conceptually, ever-changing
- Not established by Firm's Membership Agreement with FINRA

(2) The Customer Protection Rule

- The meaning of the exemption claimed by the broker-dealer
- Claim must be supported by the scope of the firm's activity with respect to its customers

SEA Rule 15c3-3 - Member Statistics (2012)

Recent Amendments to SEA Rule 17a-5

- **Approximately 300 Firms Are Required to Comply with the Customer Protection Rule.**
 - Amended Rule 17a-5 will require such firms to submit a Compliance Report as part of their Annual Audit.
 - Auditors will have to perform an examination of the Compliance Report.
- **Approximately 3,900 Firms Claimed an Exemption from the Customer Protection Rule.**
 - Amended Rule 17a-5 will require such firms to submit an Exemption Report as part of their Annual Audit.
 - Auditors will have to perform a review of the Exemption Report.

The Exemption Report – SEA Rule 17a-5(d)(4)

The Exemption Report must contain the following statements made to the best knowledge and belief of the broker-dealer:

- (1) A statement that identifies the provisions in paragraph (k) of Rule 15c3-3 under which the broker-dealer claimed an exemption;
- (2) a statement the broker-dealer *met the identified exemption provisions* in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year except as described in the exemption report; (emphasis added) and
- (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) and that briefly describes the nature of each exception and the appropriate date(s) on which the exception existed.

The Exemption Report – SEA Rule 17a-5(d)(4)

Re: The Exemption Report...

“There may be circumstances in which a broker-dealer has not held customer securities or funds during the fiscal year, but does not fit into one of the exemptive provisions... these broker-dealers should file an exemption report and related accountant’s report.”

See *Federal Register* 78 FR 51910 dated 2013-08-21 re: Broker-Dealer Reports or SEC Final Rule Release 34-70073, Footnote 74

Integrity of Firms' Books and Records

- **Inappropriate offsetting of assets and liabilities, or offsetting without adequate documentation**
 - Offsetting or netting related transactions, but with differing counter-parties; or with the same party but lacking documentation regarding right of offset
- **Failing to record liabilities**
 - Constructive obligations – cost relates to the activities of, and is paid by, the broker-dealer
- **Inappropriate revenue recognition**
 - Recognizing service-based revenue before it has been earned
- **Not accurately comprehending the financial implications of related party transactions**
 - Expense Sharing Agreements
 - Management Services Agreements

Importance of Firms' Books and Records

Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

A broker/dealer is insolvent if it is unable to make such computations as may be necessary to establish compliance with this section [i.e. the entirety of the net capital rule] or with the Customer Protection Rule.

SEA Rule 15c3-1(c)(16)(iv)

Rule Change Effective October 21, 2013

Expense Sharing Agreements (ESAs)

- Where warranted the 2003 letter imposes “charges” in the Broker-Dealer’s (B/D) Net Capital Computation.
- A written ESA is required anytime a parent or an affiliate *assumes responsibility for*:
 - 1) costs incurred by the B/D (i.e., B/D is obligor to 3rd party service provider) OR
 - 2) parent or affiliate incurs costs which will benefit the B/D (i.e., parent or affiliate contracts for services that will be used by the B/D (in whole or in part)).
- The agreement between the B/D and parent/affiliate must:
 - 1) be with a parent/affiliate which has independent financial resources from B/D,
 - 2) make clear the nature of the responsibility of each party,
 - 3) identify the costs covered by the agreement and how they arise, and
 - 4) allocate costs on a reasonable basis and in a consistent manner.

Expense Sharing Agreements (ESAs) - continued

Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

In calculating net capital, deduct from net worth

“... any *liability or expense relating to the business of the broker or dealer* for which a third party has assumed the responsibility, unless the broker or dealer can demonstrate that the third party has adequate resources independent of the broker or dealer to pay the liability or expense.” (emphasis added)

SEA Rule 15c3-1(c)(2)(i)(F)

Rule Change Effective October 21, 2013

Expense Sharing Agreements (ESAs) - continued

When agreements are required:

Scenario 1

Parent is liable to 3rd party.

B/D expected to pay parent something.

ESA establishes BD liability to parent, and allocates cost to BD.

Scenario 2

Parent is liable to 3rd party.

B/D is expected to pay nothing to parent.

ESA establishes BD has no liability to parent, but parent informs the broker-dealer of the cost so the broker-dealer can satisfy its recordkeeping obligation. Points 2 and 6 of the SEC's letter. See NTM 03-63.

Scenario 3

B/D is liable to 3rd party.

Parent will pay 3rd party.

ESA establishes that parent will make payment to 3rd party, and allocates some/all of the costs back to BD.

Note: B/D has obligation under GAAP to record payable to vendor until parent has made payment. B/D's ultimate cost may be adjusted downward due to allocation.

Management Services Agreements (MSAs)

■ What is an MSA?

- An MSA describes services whereby a party (usually the B/D's parent or affiliate) provides administrative or management services to the B/D.
 - Different from an ESA. In an MSA, the parent or affiliate is providing the services. In an ESA, there is a contract with a 3rd party that provides a good or service.
- In an MSA, we look for the following:
 - The parent or affiliate has the capacity to offer the service.
 - The BD needs the service to support its operations.
 - There is evidence that the services were provided to the B/D.
 - The costs of the services are reasonable. What would an independent 3rd party charge?
- An MSA should not include the following:
 - Costs based upon the B/D's revenue/profits.
 - A clause providing for the automatic forgiveness of payments by the B/D if net capital issues arise.



Possible undeclared withdrawal of capital.

Possible Undeclared Withdrawals of Capital

■ Evidenced by:

- Increase in MSA agreements that appear to have no economic substance
- Decline in Withdrawals of Equity Capital Notifications
 - Notifications declined by over 40% between 2008 and 2012
- Questionable Profit Margins

Capital Withdrawals

Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

“The Commission may by order restrict, for a period up to twenty business days, any withdrawal by the broker or dealer of equity capital or unsecured loan or advance to a stockholder, partner, sole proprietor, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors.”

SEA Rule 15c3-1(e)(3)(i)

Rule Change Effective October 21, 2013

Examination Findings

- Misuse of accounts
 - Inappropriate use of firm error accounts, or other accounts
 - For the Benefit of the Firm
 - For the Benefit of a Customer(s)
- Failing to recognize charges to net worth
 - Unsecured Debts
 - Open Contractual Commitment Changes
- Inappropriate role of affiliates,
 - Activity may require the affiliate to register as a broker-dealer
 - Activity which if conducted in the broker-dealer would result in a higher net capital requirement
- “Borrowing” Capital

Borrowing Capital

■ Potential Obligations when Guarantees Exist

- Capital Contributions from Parent, Using Borrowed Funds
 - Interpretation to SEA Rule 15c3-1(c)(2)/08
 - The parent of a broker-dealer **may** borrow funds and infuse those funds as additional paid-in capital into the firm without adverse net capital consequences provided the broker-dealer:
 - 1) Is not, in any way, *a party to* the lending arrangement;
 - 2) Has no *assets*, directly or indirectly, *pledged to secure* the loan; and
 - 3) Is not subject to any *recourse* of any kind to the lender *for collection* of the loan against the parent. (*emphasis added*)

Capital Contributions – Sources of Capital

- Source of Capital Contributions
 - Acceptable contributions for regulatory purposes may be made by existing owners or parties which receive newly issued ownership interests in exchange for their contributions
 - Capital contributions from any other party will be considered a “loan” and excluded from regulatory capital
- Basis for the Limitation on Contributors
 - Ownership and capital structures are deliberately designed
 - Capital contributions should be made in a manner consistent with the capitalization structure of the firm
 - By-passing ownership structure creates potential risk to the broker/dealer
 - Contributions from non-owners could be claimed in a lawsuit
 - Potential claims due to the insolvency of the contributing party

Capital Contributions – Permanency of

Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

In calculating net capital, deduct from net worth

“... any contribution of capital to the broker or dealer: (1) Under an agreement that provides the investor with the option to withdraw the capital; or (2) That is intended to be withdrawn within a period of one year of contribution. Any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer.”

SEA Rule 15c3-1(c)(2)(i)(G)

Rule Change Effective October 21, 2013

Financial and Operational Interpretations

- Interpretations to SEC's Financial and Operational Rules can be found on finra.org
- <http://www.finra.org/Industry/Regulation/Guidance/FOR/>

Financial and Operational Considerations

Questions?

Results of Inspections of Audits of Brokers and Dealers and Related Standards

Bob Maday and Kate Ostasiewski
Division of Registration and Inspections

October 31, 2013
Jersey City, NJ

Agenda

- ❑ Introduction and Background
- ❑ Overview of the Second Annual Progress Report
- ❑ Inspection Observations
- ❑ Summary

Interim Inspection Program – Objective

- ❑ Assess compliance with applicable Board and Commission rules and professional standards
- ❑ Help inform the Board's eventual determinations about the scope and elements of a permanent inspection program, including
 - Whether and how to differentiate among classes of brokers and dealers
 - Whether to exempt any category of registered public accounting firm
 - Establishment of minimum inspection frequency schedules

Interim Inspection Program - Status

- ❑ Inspections - First Progress Report
 - ❑ Inspected 10 Firms and portions of 23 audits
- ❑ Inspections during 2012 – Second Progress Report
 - ❑ Inspected 43 Firms and portions of 60 audits
- ❑ Inspections during 2013
 - ❑ In process of inspecting approximately 60 firms and portions of 90 audits
- ❑ Looking forward: Plans for 2014

Inspection Process

- ❑ Communication and scheduling with the registered public accounting firm
- ❑ Inspection of audit work
- ❑ Information gathering
- ❑ Communication of findings/observations
- ❑ Firm response to findings and responsibilities under AU-C 585
- ❑ Reporting

Consideration of Omitted Procedures

AU-C 585 Consideration of Omitted Procedures After the Report Release Date

.06 “If subsequent to the report release date, the auditor becomes aware of an omitted procedure, the auditor should assess the effect of the omitted procedure on the auditor’s present ability to support the previously expressed opinion on the financial statements.”

Consideration of Omitted Procedures

AU-C 585 Consideration of Omitted Procedures After the Report Release Date

.07 “If the auditor concludes that an omitted procedure of which the auditor has become aware impairs the auditor’s present ability to support a previously expressed opinion on the financial statements and the auditor believes that there are users currently relying, or likely to rely, on the previously released report, the auditor should promptly perform the omitted procedures, or alternative procedures, to determine whether there is a satisfactory basis for the auditor’s previously expressed opinion.”

Recent Developments

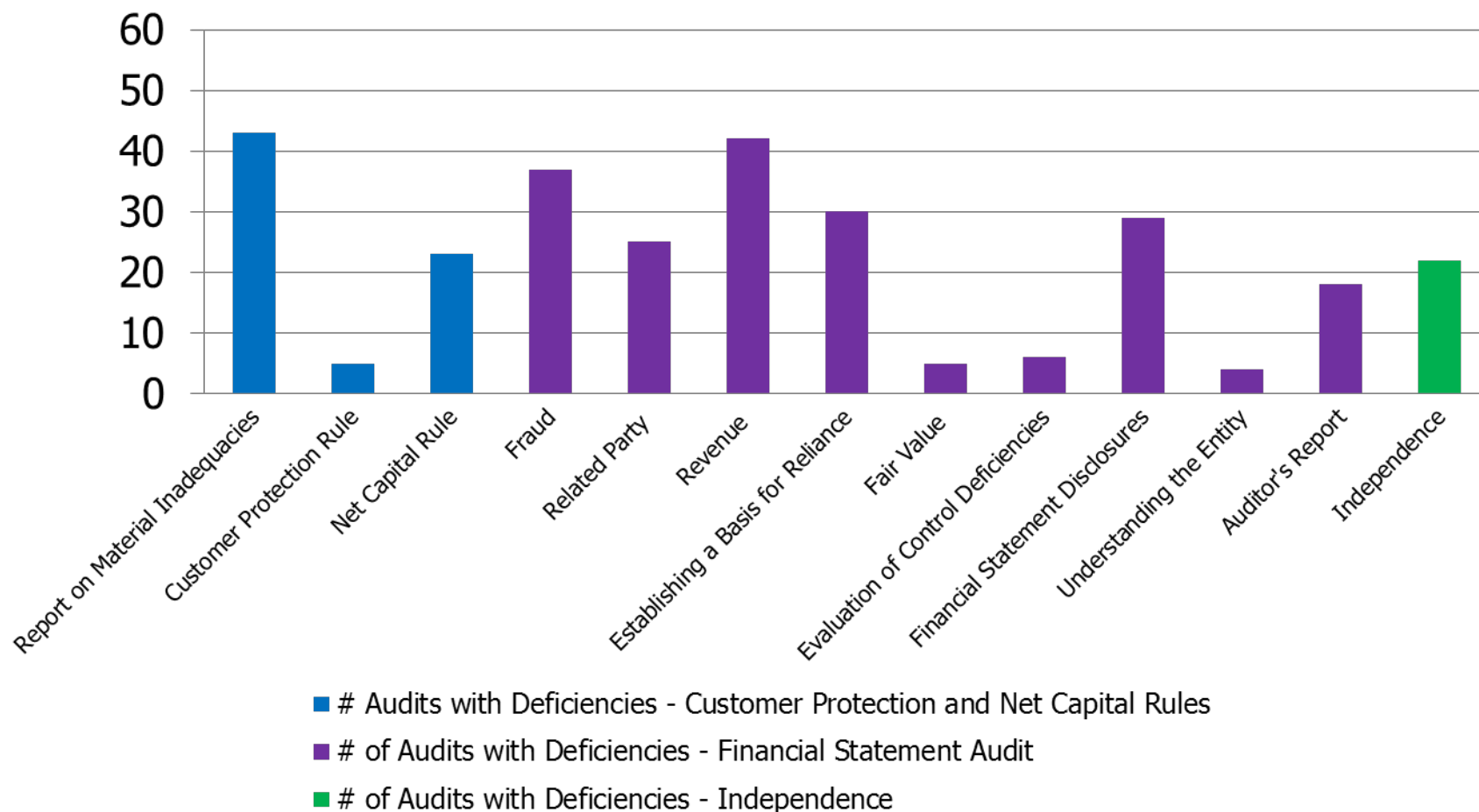
- ❑ Amendments to Rule 17a-5
- ❑ PCAOB standards
 - ❑ Transition
 - ❑ New or Amended
- ❑ Conforming changes to PCAOB Rules
- ❑ AICPA clarified standards

2013 Annual Progress Report

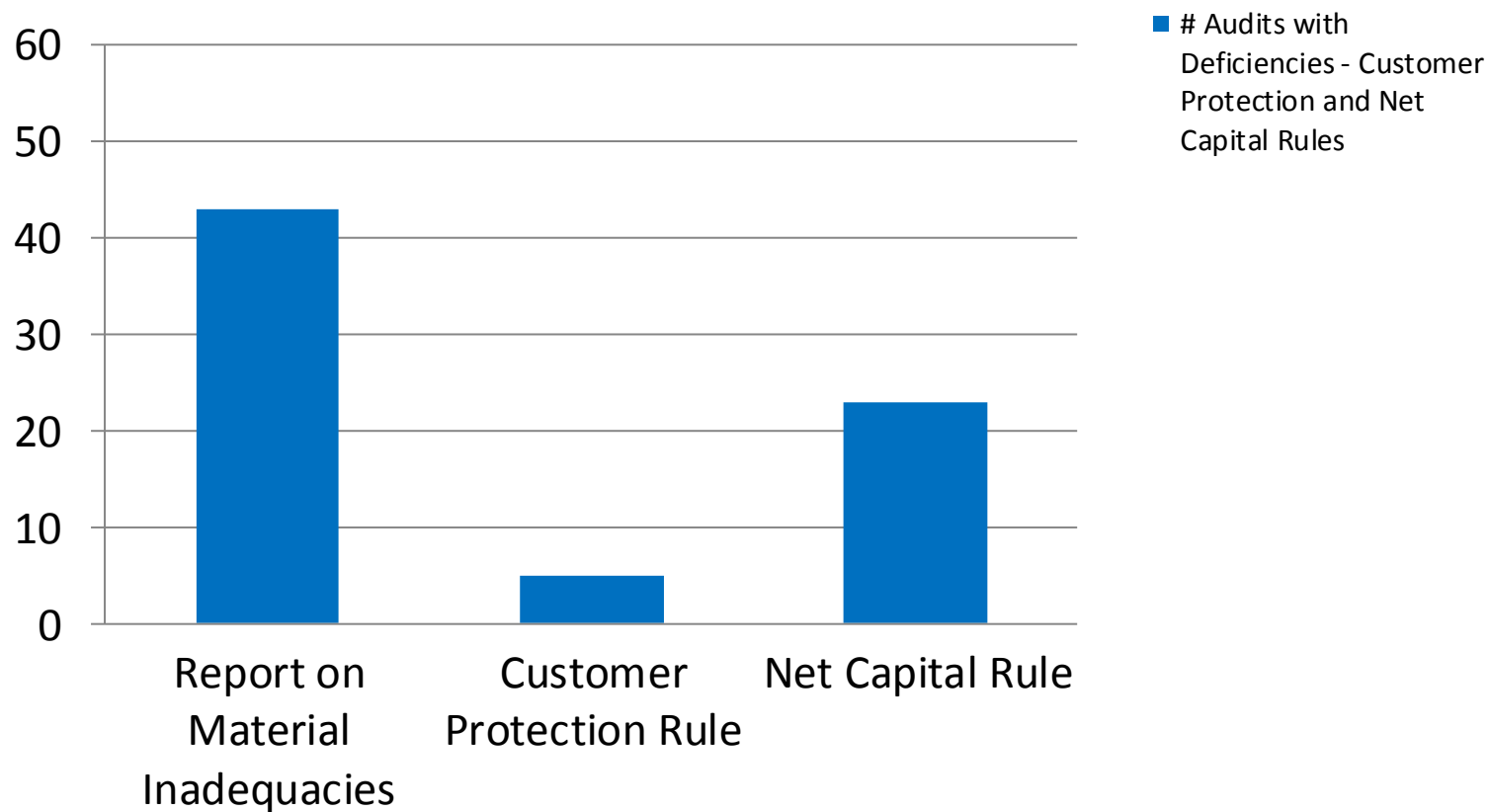
- ❑ Issued on August 19, 2013
 - ❑ Part I – Inspections of Registered Public Accounting Firms
 - ❑ Part II – Determining the Scope and Elements of a Permanent Inspection Program
 - ❑ Part III – Recent Developments and Next Steps of the Interim Inspection Program

Inspections Observations by Audit Area

of Audits with Deficiencies – All Areas



Inspections Observations: Customer Protection and Net Capital Rules

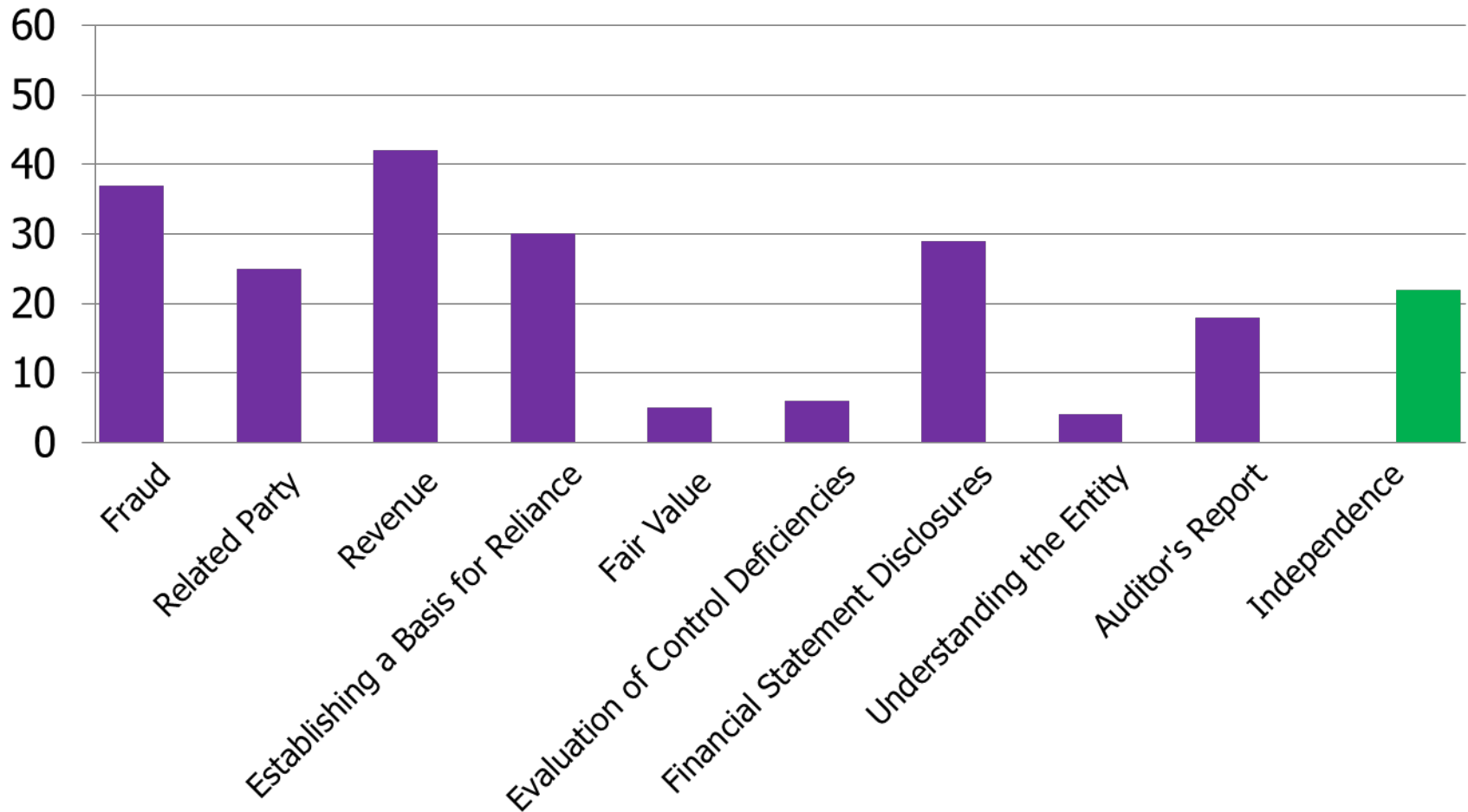


Inspections Observations:

Customer Protection and Net Capital Rules

Audit Deficiencies	Number of Audits with Deficiencies	Number of Applicable Audits	Percentage of Audits with Deficiencies
Report on Material Inadequacies	43	60	72%
Customer Protection Rule	5	13	38%
Net Capital Rule	23	60	38%

Inspections Observations: Financial Statement Audit and Independence



■ # of Audits with Deficiencies - Financial Statement Audit ■ # of Audits with Deficiencies - Independence

Inspections Observations: Financial Statement Audit

Audit Deficiencies	Number of Audits with Deficiencies	Number of Applicable Audits	Percentage of Audits with Deficiencies
Risk of Material Misstatement Due to Fraud	37	60	62%
Related Party Transactions	25	60	42%
Revenue Recognition	42	60	70%
Reliance on Records and Reports	30	60	50%
Fair Value Measurements	5	19	26%
Evaluation of Internal Control Deficiencies	6	60	10%
Financial Statement Disclosures	29	60	48%
Understanding the Entity	4	60	7%
Auditor's Report	18	60	30%

Inspections Observations: Independence

Independence Findings	Number of Audits with Findings	Number of Applicable Audits	Percentage of Audits with Findings
Failure to Satisfy Independence Requirements	22	60	37%

2013 Inspections Observations

- ❑ Observations continuing
- ❑ Many similar to prior inspections
- ❑ Independence
- ❑ Other observations

Deficiencies Related to the Net Capital Rule and the Customer Protection Rule

Rule 17a-5 Annual Reporting Requirements

Generally, brokers and dealers are required to file with the SEC, audited financial statements along with:

- ❑ Audited supporting schedules relating to:
 - The computation of net capital,
 - The computation of the customer reserve requirements, and
 - Information relating to the possession or control requirements under Rule 15c3-3

Compliance with Net Capital Requirements

PCAOB Observation

Deficiencies noted related to:

- ❑ Minimum net capital requirements
- ❑ Allowable assets
- ❑ Haircuts
- ❑ Operational charges

Compliance with Customer Protection Rule

PCAOB Observation

Deficiencies noted related to:

- ❑ Customer credits or debits
- ❑ Special Reserve Bank Account

Auditing Supporting Schedules

AU-C 725 Supplementary Information in Relation to the Financial Statements as a Whole

.07 “In addition to the procedures performed during the audit of the financial statements, in order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform the following procedures using the same materiality level used in the audit of the financial statements...”

Auditing Supporting Schedules

Example #1

Broker A has material amounts of receivables from clearing organization, payables to clearing organization, and other assets as part of its net capital computation. Auditor obtained a copy of the clearing agreement for the files and reviewed the interim and year-end FOCUS reports to verify that net capital met or exceeded the minimum requirement.

Given the required scope of the auditor's work, what additional procedures, if any, would the auditor perform and why?

Auditing Supporting Schedules

Example #2

Broker B relies on its clearing firm to calculate haircuts. The clearing firm uses a risk-based haircut methodology. The auditor obtained an understanding of the methodology used by the clearing firm and agreed the haircuts to the clearing broker report.

Given the required scope of the auditor's work, what additional procedures, if any, would the auditor perform and why?

Audit Deficiencies Related to the Accountant's Supplemental Report on Material Inadequacies

Accountant's Supplemental Report on Material Inadequacies

Generally, brokers and dealers are required to file with the SEC, audited financial statements along with (cont.):

- ❑ An accountant's report on material inadequacies describing any material inadequacies found to exist or found to have existed since the date of the previous audit

Accountant's Supplemental Report on Material Inadequacies

PCAOB Observation

Deficiencies noted related to:

- ❑ Reasonable assurance to support whether material inadequacies were disclosed
- ❑ Exemption claimed under Rule 15c3-3
- ❑ Evaluation of reported net capital deficiencies as indicators of a material inadequacy
- ❑ Timely notification of material inadequacy to SEC/FINRA

Accountant's Supplemental Report on Material Inadequacies

Rule 17a-5 states that:

The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide **reasonable assurance** that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities; and (d) the practices and procedures whose review is specifies in (i), (ii), (iii) and (iv) of this paragraph would be disclosed.

Accountant's Supplemental Report on Material Inadequacies

Example #1

Auditor completed questionnaires documenting an understanding of internal controls for significant transaction cycles and obtained narratives prepared by management describing regulatory processes. Auditor performs independent tests of the net capital and reserve calculations and finds no errors.

Did the auditor perform sufficient procedures to obtain reasonable assurance? If not, what other procedures could be considered to enable the auditor to obtain reasonable assurance?

Accountant's Supplemental Report on Material Inadequacies

Example #2

Auditor tested accounting controls and the accounting systems and concludes there are 2 deficiencies: 1) a lack of segregation of duties over journal entries and 2) no ability to prevent or detect changes made to the general ledger system. The auditor also tested that focus reports are reviewed for accuracy and approved by the CEO by obtaining draft reports from the CEO and noting that they had hand-written notes.

What additional procedures, if any, did the auditor need to perform to issue the MI report?

Internal Control Considerations

- ❑ Understand business process and identify “what could go wrongs”
- ❑ Identify controls to address “what could go wrongs”
- ❑ Testing design of control
 - ❑ Controls address relevant assertions
 - ❑ Controls address risk of material misstatements if operating properly
- ❑ Testing operating effectiveness of controls
 - ❑ Relevant, consistent, by whom and by what means
 - ❑ Inquiry, observation, examination of evidence, reperformance
- ❑ Evaluating control deficiencies
 - ❑ Assess severity of control deficiencies individually and in combination
 - ❑ Identify and assess mitigating controls

Deficiencies Related to the Financial Statement Audit

Consideration of Material Misstatement Due to Fraud

PCAOB Observation

Deficiencies noted related to:

- ❑ Audit response to identified fraud risk
- ❑ Presumption that revenue recognition is a fraud risk
- ❑ Journal entry testing

Consideration of Material Misstatement Due to Fraud

AU-C 240 Consideration of Fraud in a Financial Statement Audit

.32 "... Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to

a. Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts...."

Consideration of Material Misstatement Due to Fraud

Example #1

Auditor identified a fraud risk related to cash, commissions and compensation. Auditor tested cash disbursement journal entries greater than \$20,000 including verifying that associated wire transfers and checks were authorized.

Has the auditor performed sufficient procedures to examine journal entries to address the risk of management override? To address the presumptive fraud risk associated with revenue recognition?

Consideration of Material Misstatement Due to Fraud

Example #2

Auditor identified trading and fee revenue as having a greater risk of management override. Auditor obtained a listing of journal entries and tested for completeness. Auditor identified a population of 100 journal entries related to these accounts and selected a sample of 20 and verified that each entry had a valid business purpose.

Has the auditor performed sufficient procedures to examine journal entries to address the risk of management override?

Related Party Transactions

PCAOB Observation

Deficiencies noted related to:

- ☐ No procedures performed
- ☐ Existence and identification of related parties and related party transactions
- ☐ Examining identified related party transactions
- ☐ Other

Related Party Transactions

AU-C 550 *Related Parties*

.12 "As part of the risk assessment procedures and related activities that section 240 and section 315 require the auditor to perform during the audit, the auditor should perform the audit procedures and related activities set out in paragraph .13-.18 to obtain information relevant to identifying the risks of material misstatements associated with related party relationships and transactions."

Related Party Transactions

Example

Broker A disclosed in the footnotes that two shareholders generate substantially all of its commission revenues. The auditor obtained management's representation that there were no other related parties or related party transactions.

What additional procedures, if any, should the auditor perform to determine the existence of related parties and identify related party transactions?

Lunch

(70 minutes)

Revenue Recognition

PCAOB Observation

Deficiencies noted related to:

- ❑ Extent of testing
- ❑ Substantive analytical procedures
- ❑ Other procedures to test revenue recognition

Revenue Recognition

AU-C 330 Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

.18 “Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.”

.22 “If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedure, those procedures should include tests of details.”

Revenue Recognition

Example #1

Auditor tests commissions and fee revenue by obtaining clearing statements from the BD for all 12 months and tracing revenue reported to the general ledger. Auditor obtained a confirmation of commissions revenue for December 2012 from the clearing firm. Auditor observed that the amount confirmed agreed to the December clearing statement and the general ledger.

What else, if anything, does the auditor need to do to test the revenue balance?

Revenue Recognition

Example #2

Auditor tests commission income by selecting a sample of 30 transactions that occurred during June, September or December as recorded in the BD's general ledger and agreed the amount and date recorded to reports received by the BD from insurance carriers and to bank deposits.

What else, if anything, does the auditor need to do to test the revenue balance?

Revenue Recognition

Example #3

Auditor performed analytical procedures to test underwriting revenue and trading gains. Auditor established prior year recorded balance as the expectation for each revenue component and performed a comparison of prior year revenues by component to current year recorded balances. Auditor investigated differences that exceeded the lesser of 80% of planning materiality or 30% of the expectation.

What else, if anything, does the auditor need to do to test the revenue balance?

Establishing a Basis for Reliance on Records and Reports

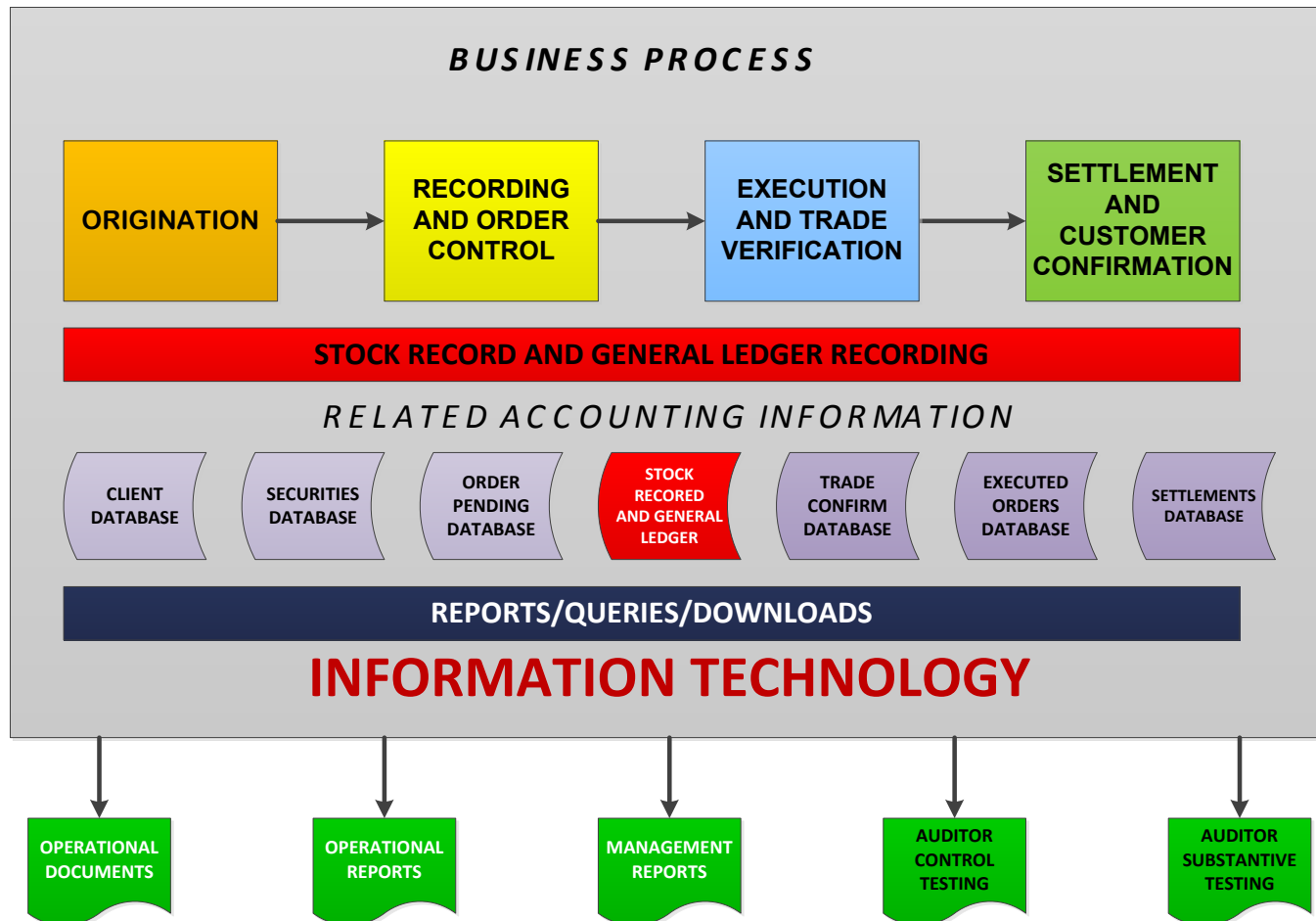
PCAOB Observation

Deficiencies noted related to:

- ❑ Completeness and accuracy of records and reports from service organizations
- ❑ Completeness and accuracy of records and reports produced by brokers and dealers

Establishing a Basis for Reliance on Records and Reports

BROKER/DEALER INFORMATION SYSTEM



Establishing a Basis for Reliance on Records and Reports

AU-C 402 Audit Considerations Relating to an Entity Using a Service Organization

.09 “When obtaining an understanding of the user entity in accordance with section 315, the user auditor should obtain an understanding of how the user entity uses the service organization in the user entity’s operations...”

.15 “In responding to assessed risks in accordance with section 330, the user auditor should

- a. determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertion is available from records held at the user entity and, if not,

- b. perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organization on the user auditor’s behalf.”

Establishing a Basis for Reliance on Records and Reports

AU-C 500 *Audit Evidence*

.09 “When using information produced by the entity, the auditor should evaluate whether the information is sufficiently reliable for the auditor’s purposes, including, as necessary, in the following circumstances:

- a. Obtaining audit evidence about the accuracy and completeness of the information...”

Establishing a Basis for Reliance on Records and Reports

Example #1

Auditor performed analytical procedures to test advisory fees. Auditor expected advisory fees to be approximately 65 basis points (based on a historical average) of assets under management (AUM). Auditor obtained system based reports of AUM to calculate the historical average. Auditor calculated expected revenue and compared it to actual advisory fees recorded.

What else does the auditor need to do to establish a reasonable basis for reliance on AUM used in these procedures?

Establishing a Basis for Reliance on Records and Reports

Example #2

Auditor selected a sample of accounts receivables from private placements from an accounts receivable schedule provided by the BD. Auditor selected a sample of receivable balances from this schedule and traced the balances to cash receipts subsequent to year-end.

What else does the auditor need to do to establish a reasonable basis for reliance on the accounts receivable schedule obtained from the BD?

Evaluation of Internal Control Deficiencies

PCAOB Observation

Deficiencies noted related to:

- ❑ Assessment of the severity of a control deficiency
- ❑ Evaluation of errors performed as part of substantive testing

Evaluation of Internal Control Deficiencies

AU-C 265 Communicating Internal Control Related Matters Identified in an Audit

.09 “If the auditor has identified one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses.”

Evaluation of Internal Control Deficiencies

Example

Auditor documents in its understanding of the BD's control environment that given the size of the BD and its operations the checks and balances included in a system of internal accounting control and division of duties are difficult to achieve. Auditor indicates that reliance therefore is placed on owner oversight.

What factors does the auditor need to consider to determine whether an internal control deficiency exists?

Financial Statement Disclosures

PCAOB Observation

Deficiencies noted related to:

- ❑ Omitted disclosures
- ❑ Inaccurate or incomplete disclosures
- ❑ Fair value disclosures

Financial Statement Disclosures

AU-C 705

.07a “The auditor should modify the opinion in the auditor’s report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated....”

.A7a “With regard to the appropriateness of the financial statement presentation or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when the financial statements do not include all of the disclosures required by the applicable financial reporting framework...”

Financial Statement Disclosures

Example

Auditor determined that BD earned 53% of its commission income from Company 1 and 39% of its commission income from Company 2. The BD has disclosed the following in the financial statements: "BD earned a substantial portion of its income from commission earned on the sale of variable universal life insurance policies. Income earned on commissions from these products represented 96% of income for the year ended."

What should the auditor consider when evaluating the adequacy of this disclosure?

Auditor's Report

PCAOB Observation

Deficiencies noted related to:

- ❑ Auditor's report on supporting schedules
- ❑ Accountant's supplemental report on material inadequacies

Understanding the Entity

PCAOB Observation

Deficiencies noted related to:

- ❑ Understanding of the entity and its environment

Determining the Scope of a Permanent Program

- ❑ Part II of the 2013 Progress Report
- ❑ Promote investor protection
- ❑ Auditor's role in the protection of the assets of customers
- ❑ Differentiation of the risk of loss to customers
- ❑ Consideration of attributes that characterize brokers and dealers

Summary

- ❑ Interim inspection program continues through 2013 and 2014
- ❑ Third progress report to be issued in 2014
- ❑ Transition to PCAOB Standards
- ❑ Determination of the scope and elements of a permanent inspection program under consideration
- ❑ Rule proposal for a permanent inspection program

Next Steps for Firms that Audit Brokers and Dealers

- ❑ Review and enhance as necessary:
 - ❑ arrangements with brokers and dealers and quality control procedures to help ensure that SEC independence rules are not violated
 - ❑ guidance and training to determine whether topics observed as audit deficiencies are given appropriate attention
 - ❑ policies for supervision and review to help ensure partners and supervisory personnel place appropriate attention to these areas
- ❑ Prepare now for transition to PCAOB Standards and amended Rule 17a-5 requirements

Questions?





PCAOB Forum on Auditing Smaller Broker-Dealers

Kevin M. Stout

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**Office of the Chief Accountant
U.S. Securities and Exchange Commission**

October 31, 2013

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Agenda

- ❖ **Broker-Dealer Rulemaking**
 - Background/Rulemaking Timeline
 - Existing SEC Annual Reporting Requirements
 - Final Amendments to SEC Annual Reporting Requirements
 - Compliance Report (Examination)
 - Exemption Report (Review)
 - Other Requirements
- ❖ **Applicability of Auditor Independence Rules to Broker-Dealer Audits**

Broker-Dealer Rulemaking

Background/Rulemaking Timeline

- ❖ **July 21, 2010 – Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act granted the PCAOB oversight over audits of brokers and dealers registered with the Commission**
- ❖ **Sept. 24, 2010 – Commission published interpretive guidance to clarify the application of certain rules, regulations, releases, and staff bulletins in light of the PCAOB's oversight**
- ❖ **Nov. 18, 2010 – Letter issued by SEC Director of Trading and Markets and SEC Chief Accountant concerning requirements for broker-dealer annual audits pursuant to Rule 17a-5**

Background/Rulemaking Timeline

- ❖ **June 14, 2011 – PCAOB adopted final rules for allocation of the Board's accounting support fee among issuers, brokers, and dealers, and other amendments to the Board's funding Rules**
- ❖ **June 14, 2011 – PCAOB adopted temporary rule for an interim program of inspection related to audits of brokers and dealers**
- ❖ **August 18, 2011 - Commission order approving the rules noted above**
- ❖ **October 10, 2013 - PCAOB adopted new attestation standards and a new auditing standard, subject to Commission approval**

Rulemaking Timeline

- ❖ **June 15, 2011 – Commission proposed amendments to broker-dealer financial reporting rules to:**
 - Update existing requirements of Rule 17a-5
 - Facilitate the ability of the PCAOB to implement oversight of independent public accountants of broker-dealers
 - Eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually registered as, investment advisors
 - Other amendments included:
 - Access to audit documentation
 - New Form Custody

Rulemaking Timeline

- ❖ **Comment period closed on August 26, 2011**
 - 27 comment letters received
- ❖ **Areas of public comment included:**
 - Material non-compliance and material weakness
 - Reporting of remediation of material weaknesses
 - Relationship between internal control over compliance with Financial Responsibility Rules and internal control over financial reporting
 - Internal control considerations related to broker-dealer's books and records

Rulemaking Timeline

❖ **Areas of public comment included (cont'd):**

- **Period or “as of date” exemption from Rule 15c3-3**
- **Notification requirements to the Commission**
- **Effective date and transition period**
- **Access to audit documentation**
- **Interaction with other regulatory rules and requirements**

Rulemaking Timeline

- ❖ **On July 30, 2013, the SEC finalized amendments to broker-dealer financial responsibility rules and financial reporting rules**
 - **The amendments to the reporting rules are expected to improve compliance with the SEC's financial responsibility rules**

Final Amendments to SEC Financial Responsibility Rules

❖ **Amendments made to:**

- **Customer Protection Rule (15c3-3)**
- **Net Capital Rule (15c3-1)**
- **Books and Records Rules (17a-3 and 17a-4)**
- **Notification Rule (17a-11)**

❖ **The amendments to the financial responsibility rules are expected to better protect customers and enhance the SEC's ability to monitor and prevent unsound practices.**

Existing SEC Annual Reporting Requirements

- ❖ **Broker-dealers are required to file an annual report with the SEC and the broker-dealer's designated examining authority pursuant to Rule 17a-5**
 - Annual report must contain audited financial statements and certain supporting schedules and supplemental reports, as applicable
 - The audit is conducted in accordance with GAAS (i.e., not PCAOB standards)
- ❖ **The new annual reporting requirements become effective for all broker-dealers with fiscal years ending on or after June 1, 2014.**

Existing SEC Annual Reporting Requirements

❖ **Report on internal controls**

- The auditor is required to obtain reasonable assurance that any *material inadequacies* existing at the audit report date in the following areas are disclosed:
 - Accounting system
 - Internal control
 - Procedures for safeguarding securities, and
 - Practices and procedures specified by Rule 17a-5
- Study of practices and procedures followed, including consideration of control activities for safeguarding securities
- Broker-dealers that are exempt from Rule 15c3-3

Final Amendments to SEC Annual Reporting Requirements

- ❖ **In addition to existing requirements to file audited financial statements and certain supporting schedules (“Financial Report”), the revised Rule 17a-5 also requires the following new reports:**
 - **Carrying broker-dealer that has custody of customer assets to file a new Compliance Report, that will be examined by its independent public accountant**
 - **Non-carrying broker-dealer that does not have custody of customer assets to file a new Exemption Report, that will be reviewed by its independent public accountant**

Final Amendments to SEC Annual Reporting Requirements

- ❖ **Audits of the Financial Report, the examination of the Compliance Report and the review of the Exemption Report are to be conducted in accordance with PCAOB standards, instead of GAAS**
- **The PCAOB has developed new attestation standards (AT Nos. 1 & 2) specifically tailored to the examination of the Compliance Report and the review of the Exemption Report, as well as a new auditing standard for supplemental information included with the financial statements**

Final Amendments to SEC Annual Reporting Requirements

- ❖ **Carrying broker-dealers are required to file a Compliance Report which would include statements as to whether:**
 - The broker-dealer has established and maintained Internal Control over Compliance;
 - Internal Control over Compliance was effective during the most recent fiscal year;
 - Internal Control over Compliance was effective as of the end of the most recent fiscal year;
 - The broker-dealer was in compliance with Rule 15c3-1 and Rule 15c3-3(e) as of its fiscal year-end;
 - The information used to state whether it was in compliance was derived from the books and records of the broker-dealer.

Final Amendments to SEC Annual Reporting Requirements

- ❖ **If applicable, a carrying broker-dealer would be required to include:**
 - A description of each material weakness in Internal Control Over Compliance during the most recent fiscal year
 - A description of each instance of non-compliance with Rules 15c3-1 or 15c3-3(e) as of the end of the most recent fiscal year

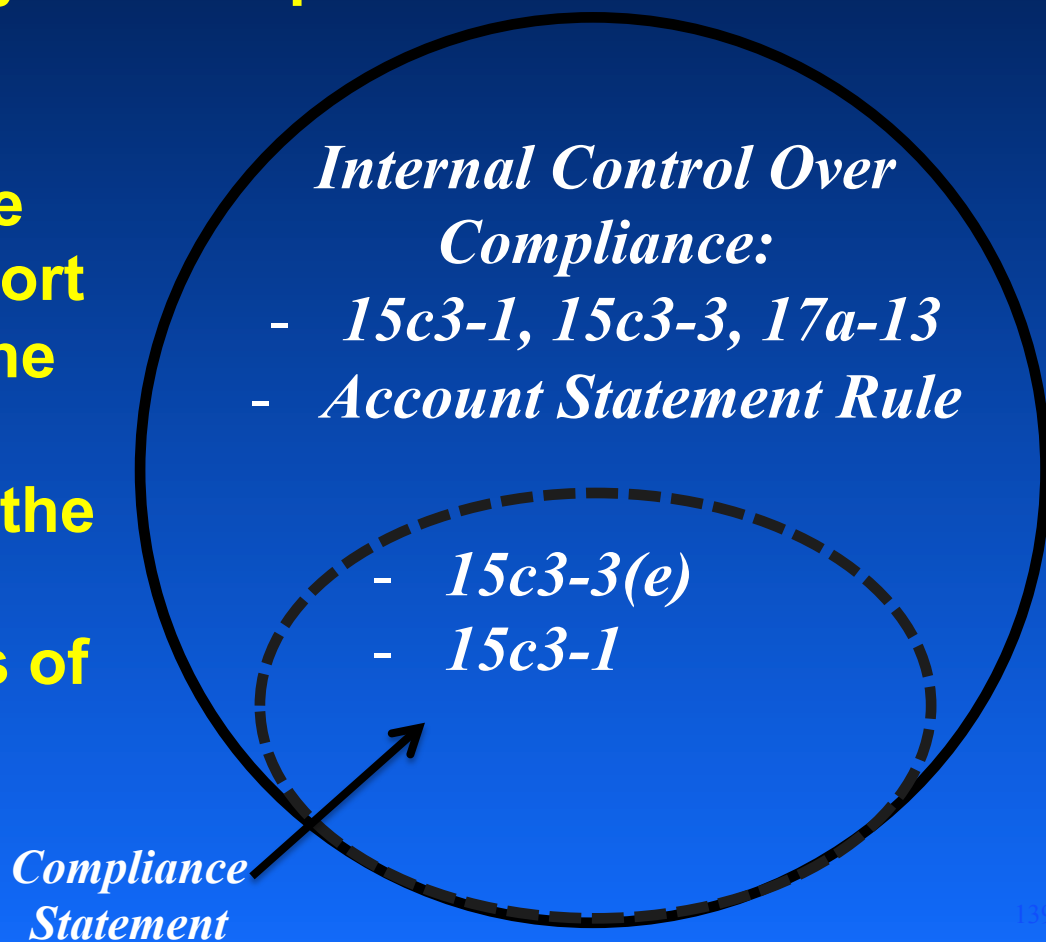
Final Amendments to SEC Annual Reporting Requirements

❖ **Internal Control Over Compliance**

- Internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with Rules 15c3-1, 15c3-3, 17a-13, or any rule of the designated examining authority of the broker or dealer that requires account statements (an “Account Statement Rule”) to be sent to the customers of the broker or dealer will be prevented or detected on a timely basis

Final Amendments to SEC Annual Reporting Requirements

- ❖ The rules covered by the term Internal Control Over Compliance (“ICOC”) are broader than those covered by the compliance statement
- ❖ Additionally, the statements in the Compliance Report on ICOC cover the entire year and year end, where the statement on compliance is as of year end only



Final Amendments to SEC Annual Reporting Requirements

- ❖ **Internal Control Over Compliance (ICOC) is intended to focus on a broker-dealer's net capital requirements, oversight of custody arrangements and protection of customer assets.**
- **ICOC differs from Internal Control over Financial Reporting, which focuses on the reliability of financial reporting and the preparation of financial statements.**
- **The Final Rule does not require that the effectiveness of internal control over financial reporting be included as one of the statements made by the broker-dealer in the compliance report, or opined on by the auditor**

Final Amendments to SEC Annual Reporting Requirements

❖ **Material Weakness**

- A deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with Rule 15c3-1 or Rule 15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with Rule 15c3-3, except for paragraph (e), Rule 17a-13, or any Account Statement Rule will not be prevented or detected on a timely basis

❖ **Existing term “material inadequacy” no longer relevant**

Final Amendments to SEC Annual Reporting Requirements

- ❖ **Carrying broker-dealer is not permitted to conclude that its Internal Control Over Compliance was effective**
 - during the fiscal year if there were one or more material weaknesses in ICOC during the fiscal year
 - as of the end of the fiscal year if there were one or more material weaknesses in ICOC as of the end the fiscal year
- ❖ **Carrying broker-dealer required to engage an independent public accountant to:**
 - Prepare a report based on an examination of certain of the broker-dealer's statements contained in the Compliance Report

Final Amendments to SEC Annual Reporting Requirements

❖ **Non-carrying broker-dealer required to state the following in its Exemption Report:**

- The provisions in Rule 15c3-3(k) under which the broker-dealer claimed an exemption from Rule 15c3-3
- Either:
 - The broker-dealer met the identified exemption provisions in Rule 15c3-3(k) throughout the most recent fiscal year without exception, or
 - The broker-dealer met the identified exemption provisions except as described in the Exemption Report
- If applicable, an identification of each exception, a description of the nature of each exception, and the approximate date(s) on which the exception existed

Final Amendments to SEC Annual Reporting Requirements

- ❖ **Non-carrying broker-dealer required to engage an independent public accountant to:**
 - Prepare a report based on a review of the broker-dealer's statements contained in the Exemption Report
- ❖ **Note that a broker-dealer must file an exemption report if it claimed that it was exempt from Rule 15c3-3 throughout the most recent fiscal year, even in situations in which the broker-dealer had exceptions to meeting the exemption provisions in 15c3-3(k).**

Final Amendments to SEC Annual Reporting Requirements

❖ **Notification requirements**

- An auditor must immediately notify the CFO of the broker-dealer if
 - the auditor determines, in the course of preparing its reports, that the broker-dealer was not in compliance with any of the financial responsibility rules, or
 - In the performance of an examination of the Compliance Report, the accountant determines that any material weakness existed in the broker-dealer's ICOC

Final Amendments to SEC Annual Reporting Requirements

❖ **Notification requirements (cont'd)**

- The broker-dealer must file a notification with the Commission and its DEA if the auditor's notice relates to an instance of non-compliance that would trigger notification, and provide a copy of the notification to the auditor
- If the auditor does not receive a copy of the notification within 1 business day, or if the auditor does not agree with the statements in the notification, the auditor must notify the SEC and DEA within one business day

Final Amendments to SEC Annual Reporting Requirements

❖ **Form Custody**

- New form to be filed by broker-dealers quarterly
- Filed with DEA concurrent with FOCUS Reports
- Comprised of 9 items designed to elicit information about a broker-dealer's custodial activities.
- The Commission believes that the information required by Form Custody will provide the Commission with an enhanced understanding of the scope of broker-dealer introducing/carrying relationships and activities, and the custodial practices of broker-dealers involved in such relationships.

Final Amendments to SEC Annual Reporting Requirements

❖ **Access to audit documentation**

- **Clearing and Carrying broker-dealers to consent to permitting their independent public accountants to:**
 - **Make available to the Commission and Designated Examining Authority (“DEA”) examiners the audit documentation associated with its annual reports required under Rule 17a-5**
 - **Discuss findings relating to the audit reports with the Commission and DEA examiners**

Final Amendments to SEC Annual Reporting Requirements

❖ **Effective dates:**

- **New Form Custody requirement effective on December 31, 2013.**
- **Broker-dealer annual reports must be filed with SIPC for fiscal years ending on or after December 31, 2013**
- **The filing of compliance reports and exemption reports and the related auditor reports effective for fiscal years ending on or after June 1, 2014**
- **Amendments to the notification requirements effective for fiscal years ending on or after June 1, 2014**

Final Amendments to SEC Annual Reporting Requirements

- ❖ **Interaction with the Investment Advisors Custody Rule:**
 - **Broker-dealers that must also comply with the Custody Rule are required to obtain annually an auditor's written internal control report**
 - **The Commission has determined that the independent public accountant's report based on an examination of the compliance report will satisfy this requirement**

Applicability of Auditor Independence Rules to Broker- Dealer Audits

Applicability of Auditor Independence Rules to Broker-Dealer Audits

- ❖ **Auditors of both issuer and non-issuer broker-dealers are required to be qualified and independent in accordance with the Commission's auditor independence requirements in Rule 2-01 of Regulation S-X, *Qualifications of Accountants***
 - **No currently proposed changes to current requirements**

Applicability of Auditor Independence Rules to Broker-Dealer Audits

❖ **Examples of applicable independence requirements:**

- **Non-Audit Services – An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides, among others, the following non-audit services to an audit client:**
 - **Bookkeeping or Other Services Related to the Accounting Records or Financial Statements of the Audit Client.**
 - **Management Functions**
- **Other Financial Interests in Audit Client**

Applicability of Auditor Independence Rules to Broker-Dealer Audits

- ❖ **Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions**
 - Auditors of non-issuer brokers-dealers are not subject to SEC rules related to:
 - Partner rotation requirements
 - Certain partner compensation arrangements
- ❖ **Auditors of non-issuer broker-dealers are also not subject to rules related to:**
 - Audit committee administration requirements
 - “Cooling off” period requirements

Contact Information

- ❖ **Office of the Chief Accountant Involvement in Auditor Independence Matters**
 - Professional Practice Group – Independence
 - Phone: (202) 551-5300
 - E-mail : OCA@sec.gov

- ❖ **Subscribe to receive SEC updates by e-mail:**
 - http://sec.gov/news/press/subscribe_updates.htm

Questions?

Break

(15 minutes)

PCAOB Standards

Keith Wilson

Deputy Chief Auditor, Office of the Chief Auditor

Agenda

- ❑ Existing PCAOB Standards
- ❑ Recently Adopted Standards, Subject to SEC Approval
 - Attestation Standard Nos. 1 and 2
 - Auditing Standard No. 17

Standards of the PCAOB

- Auditing
- Attestation
- Quality control
- Ethics and independence standards
- Standards-related rules
 - Example: Rule 3101

Recently Adopted Standards Related to Audits of Brokers and Dealers

Recently Adopted Standards, Subject to SEC Approval

- ❑ Attestation Standard No. 1 – *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*
- ❑ Attestation Standard No. 2 – *Review Engagements Regarding Exemption Reports of Brokers and Dealers*
- ❑ Auditing Standard No. 17 – *Auditing Supplemental Information Accompanying Audited Financial Statements*

Attestation Standard No. 1 – *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

Examination Engagements Regarding Compliance Reports of Brokers and Dealers

- ❑ Applies when auditor examines certain statements in the broker's or dealer's compliance report
- ❑ Covers four assertions:
 - Internal control over compliance during the year
 - Internal control over compliance as of year end
 - Compliance with net capital rule and reserve requirements rule
 - Whether the information for asserting compliance with the net capital rule and reserve requirements rule was derived from the broker's or dealer's books and records

Examination Engagements Regarding Compliance Reports of Brokers and Dealers

- Sets forth an approach consisting of:
 - General and planning procedures, including consideration of risk
 - Selecting and testing controls over compliance
 - Testing compliance with the net capital rule and reserve requirements rule, including obtaining evidence about the existence of customer assets
 - Performing procedures, in connection with compliance tests, to determine whether the information used to assert compliance is derived from the books and records

Examination Engagements Regarding Compliance Reports of Brokers and Dealers

- ❑ Requires coordination with the financial statement audit and audit procedures on supporting schedules
- ❑ Includes communication requirements to the audit committee and/or management
- ❑ Provides requirements for the auditor's report which address both unqualified and adverse opinions

Attestation Standard No. 2 – *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

Review Engagements Regarding Exemption Reports of Brokers and Dealers

- Applies when auditors review the statements in a broker's or dealer's exemption reports
- Focuses on conditions that might cause the assertions not to be fairly stated, in all material respects, e.g.:
 - Incorrect exemption provision
 - Incorrectly asserting that exemption provisions met without exception
 - Incorrect or incomplete list of exceptions

Review Engagements Regarding Exemption Reports of Brokers and Dealers

- ❑ Sets forth an approach that covers:
 - General and planning procedures, including consideration of risk factors
 - Review procedures to obtain moderate assurance
 - Additional procedures, in certain instances
 - Communication to the audit committee and/or management
- ❑ Requires coordination with the financial statement audit and audit procedures on the supporting schedules
- ❑ Establishes reporting requirements

Auditing Standard No. 17 – *Auditing Supplemental Information Accompanying Audited Financial Statements*

Auditing Supplemental Information Accompanying Audited Financial Statements

- ❑ Applies when the auditor of the financial statements is engaged to perform audit procedures and report on supplemental information that accompanies financial statements audited under PCAOB standards
 - Example: Supporting schedules required by SEC Rule 17a-5 for broker-dealers
- ❑ Retains “in relation to approach” – generally use the same materiality considerations as for the financial statement audit
- ❑ Requires procedures to test supplemental information, including evaluating compliance with regulatory requirements
- ❑ Changes the standard language in the auditor’s report on supplemental information

Keeping Current with Standards

- Our Web site - www.pcaobus.org/Standards/index.aspx
 - PCAOB standards and related rules, including interim standards
 - PCAOB proposed standards
 - Staff questions and answers
 - Staff audit practice alerts
 - Standing Advisory Group
- Contact us at info@pcaobus.org
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our Web site:
<http://pcaobus.org/About/Pages/Subscribe.aspx>

Questions?



Division of Enforcement and Investigations: An Overview

C. Ian Anderson

Regional Associate Director, New York

Division of Enforcement and Investigations

Disclaimer

The views expressed are the views of the speaker and do not necessarily reflect the views of the Board, individual Board members, or other members of the Board's staff.

Division of Enforcement and Investigations Overview

- ❑ Staff consists of 29 attorneys, 17 accountants, and support staff, totaling over fifty staff based in DC and NY offices
- ❑ Enforcement's role:
 - Identify appropriate matters for investigation
 - Conduct investigations and make recommendations to the Board
 - Litigate disciplinary proceedings before Board's Hearing Officer and, on appeal, to the Board

Enforcement's Jurisdiction

- Registered Public Accounting Firms
 - Audits of “Issuers” (*i.e.*, public companies) and Broker/Dealers
- “Associated Persons”

Investigative Authority

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

Sources of Investigations

- ❑ Other PCAOB divisions and offices
 - Division of Registration and Inspections
 - Office of Research and Analysis
- ❑ Enforcement public source analysis
 - Issuer disclosures of restatements and auditor changes
 - Media reports, blogs, and analyst reports
 - Tips
- ❑ Referrals from other regulators, *e.g.*, SEC and FINRA

Common Types of Investigations

- ❑ Violations of professional standards
 - Audit failures: *e.g.*, failure to obtain sufficient audit evidence, exercise due care and professional skepticism (ignored red flags)
 - Failure of firm quality control procedure to operate effectively
- ❑ Independence violations
- ❑ Failure to cooperate with an inspection or investigation

Investigations Process Overview

- ❑ The Act requires confidentiality of investigative information
- ❑ Most matters start as informal inquiries—reliance on voluntary productions based on Division requests
- ❑ If matter warrants significant use of resources, or parties are not complying with requests, Staff requests an Order of Formal Investigation from the Board
 - “Accounting Board Demands” compel firms/associated persons to
 - Produce documents
 - Testify
 - Provide other information
 - Refusal to comply may amount to sanctionable non-cooperation
- ❑ DEI frequently coordinates its investigations with the enforcement efforts of other regulators, such as the SEC

Investigations Process Overview

- If evidence of serious violations exists
 - Staff communicates to the firm or associated persons and gives them an opportunity to respond to staff's position in writing
 - Staff reviews the responses and determines whether to recommend charges against firm(s) and/or associated person(s), or closure of the formal investigation
 - Staff communicates recommendations to the Board

Investigations Process Overview

- ❑ Enforcement recommendations to the Board for disciplinary proceedings
 - Enforcement submits a memorandum to the Board outlining facts and law and parties to be charged with violations
 - If Board approves litigated proceeding, order is nonpublic
 - If parties wish to settle, the recommendation will include whether acceptance of the settlement is recommended by the Division
 - If Board approves settlement, order becomes public

Disciplinary Proceedings and Hearings

- ❑ Hearings (trials) are conducted by the Board Hearing Officer to determine whether firms or associated persons committed violations and should be disciplined
- ❑ Hearings are nonpublic, as required by Act
- ❑ Initial decision by Board's Hearing Officer
- ❑ Any sanctions imposed can be appealed to the Board, then to the SEC, and then to the United States Circuit Court

Sanctions

- ❑ In a disciplinary proceeding, the Board may
 - Impose a censure
 - Suspend or permanently bar an individual from association with a registered public accounting firm
 - Temporarily or permanently revoke a firm's registration
 - Temporarily or permanently limit the activities, functions, or operations of a firm or person
 - Impose a civil money penalty
 - Appoint an independent monitor
 - Require additional professional education or training, and/or impose any other sanction allowed by the Board rules

Effect of Suspension or Bar

- ❑ A person suspended or barred from associating with a registered public accounting firm by the Board is prohibited from associating with a registered public accounting firm
- ❑ Dodd-Frank also makes it unlawful for the person to associate with any issuer, broker, or dealer in an accountancy or a financial management capacity

Settled and Adjudicated Disciplinary Proceedings

- ❑ To date the Board has settled or completed adjudication on over 40 disciplinary orders
- ❑ These orders have resulted in the following sanctions:
 - Bars (Firms and auditors)
 - Suspensions
 - Censures
 - Civil money penalties

Settled Disciplinary Proceeding

- ❑ Ernst & Young, Jeffrey Anderson, CPA, Ronald Butler, CPA, Thomas Christie, CPA, and Robert Thibault, CPA (Feb. 8, 2012)
 - Ernst & Young and four partners
 - Found to have violated PCAOB auditing standards in connection with three audits and a National Office consultation stemming from an internal audit quality review related to the company's non-GAAP methodology for its sales returns reserve estimate
 - \$2 million civil money penalty and censure imposed on firm penalty (largest PCAOB penalty to-date)
 - 2 year bar and \$50,000 penalty imposed on partner responsible for two audits
 - 1 year bar and \$25,000 penalty imposed against national office partner who also served as concurring partner on two audits; \$25,000 penalty and censure imposed against partner who served as second partner on one audit and signing partner on another audit; and a censure imposed against the second partner on one audit

Settled Disciplinary Proceeding

- ❑ Price Waterhouse, Bangalore, Lovelock & Lewes, Price Waterhouse & Co., Bangalore, Price Waterhouse, Calcutta, and Price Waterhouse & Co. (April 5, 2011)
 - Two PwC International firms found to have violated PCAOB rules and auditing standards in connection with the audit of India IT service provider, Satyam Computer Services
 - \$1.5 million fine imposed on these two firms (in addition to \$6 million penalty imposed by SEC)
 - Five PwC International firms based in India (including the above two) were censured based on violations of the PCAOB's quality control standards, prohibited from accepting new U.S. issuer work for six months, independent monitor appointed, and remedial steps required
 - Matter was part of coordinated investigation with the SEC

Settled Disciplinary Proceeding

- ❑ In the Matters of Peter C. O'Toole, CPA; Darrin G. Estella, CPA; and Jacqueline A. Higgins, CPA (Aug. 1, 2011)
 - Partner, Sr. Manager and Manager at Ernst & Young
 - Failed to comply with AS3 (*Audit Documentation*) and failed to cooperate with Inspections
 - Improperly removed, added and backdated working papers in advance of an inspection
 - Partner received bar (can petition for Board consent to associate with a registered public accounting firm after 3 years) and \$50,000 civil money penalty
 - Sr. Manager barred (can petition for Board consent to associate with a registered public accounting firm after 2 years)
 - Manager censured

Adjudicated Disciplinary Proceeding

- ❑ In the Matter of Davis Accounting Group, P.C. and Edwin R. Davis, Jr., CPA
 - Audit firm and its sole owner failed to cooperate with a PCAOB investigation
 - While the firm and its sole owner continued to issue more than 30 audit opinions, they claimed they were unable to respond to an Accounting Board Demand
 - Firm's registration was permanently revoked and its sole owner was permanently barred from association, with monetary sanctions of \$75,000

PCAOB Center for Enforcement Tips, Complaints and Other Information

Website: <http://pcaobus.org/Enforcement/Tips>

Letter: PCAOB Tip Center
1666 K Street, NW
Washington, DC 20006

FAX: 202-862-0757

Telephone: 800-741-3158

Questions?



PCAOB/SEC/FINRA Panel

Moderator: Jay Hanson

Closing Remarks and Wrap-Up

Jay Hanson
Board Member, PCAOB
October 31, 2013
Jersey City, NJ