Georgia Society of CPAs - Atlanta Chapter

Recent SEC and PCAOB Accounting, Auditing and Reporting Developments
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Public Company Accounting Oversight Board (PCAOB)
Members of the PCAOB Board

The SEC appoints the Chair and members of the PCAOB. The current members are:

- Chairman – James R. Doty, former SEC general counsel and partner of law firm Baker Botts
- Lewis H. Ferguson, former general counsel of PCAOB and partner at Gibson Dunn
- Jeannette M. Franzel, CPA, CMA, CIA, former director in the GAO and former small firm auditor
- Jay D. Hanson, CPA, former National Director of Accounting at McGladrey & Pullen, and EITF member
- Steven B. Harris, former Staff Director and Chief Counsel of the United States Senate Banking, Housing and Urban Affairs Committee under Chairman Paul S. Sarbanes
Members of the PCAOB Board

James R. Doty
Lewis H. Ferguson
Jeannette M. Franzel
Jay D. Hanson
Steven B. Harris
Questions

- What should be the objective of a financial statement audit?
- How should the role of the auditor be expanded?
- Are the costs of an expanded audit justified by the benefits to investors?
- Where are we going?
Auditing Standards and Guidance
Standards Adopted to Date by the PCAOB

These standards have been adopted by the PCAOB and approved by the Securities and Exchange Commission.

- AS No. 1: References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board
- AS No. 3: Audit Documentation
- AS No. 4: Reporting on Whether a Previously Reported Material Weakness Continues to Exist
- AS No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements
- AS No. 6: Evaluating Consistency of Financial Statements
- AS No. 7: Engagement Quality Review
- AS No. 8: Audit Risk
- AS No. 9: Audit Planning
- AS No. 10: Supervision of the Audit Engagement
Standards Adopted to Date by the PCAOB

- AS No. 11: Consideration of Materiality in Planning and Performing an Audit
- AS No. 12: Identifying and Assessing Risks of Material Misstatement
- AS No. 13: The Auditor's Responses to the Risks of Material Misstatement
- AS No. 14: Evaluating Audit Results
- AS No. 15: Audit Evidence
- AS No. 16: Communications with Audit Committees
- AS No. 17: Auditing Supplemental Information Accompanying Audited Financial Statements
- AS No. 18: Related Parties
On August 13, 2013, the PCAOB issued two proposals:

- The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion
- The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

The proposed auditor reporting standard is intended to increase the informational value of the auditor's report.

The proposed other information standard is intended to improve the auditor's procedures and to enhance the auditor's responsibilities with respect to other information.
Auditor's Reporting Model

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

- Critical audit matters are those matters addressed during the audit that:
  - Involved the most difficult, subjective, or complex auditor judgments;
  - Posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
  - Posed the most difficulty to the auditor in forming the opinion on the financial statements.

- Critical audit matters ordinarily are matters of such importance that they are required to be:
  - Documented in the engagement completion document, which summarizes the significant issues and findings from the audit;
  - Reviewed by the engagement quality reviewer;
  - Communicated to the audit committee; or
  - Any combination of the three.
The description of critical audit matters in the auditor's report would:
- Identify the critical audit matter;
- Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

If the auditor determines that there are no critical audit matters, the auditor would state in the auditor's report that the auditor determined that there are no such matters to communicate.
Critical Audit Matters (cont'd)

Factors that the auditor should take into account in determining critical audit matters:

- The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures
- The nature and extent of audit effort required to address the matter
- The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence
- The severity of control deficiencies identified relevant to the matter, if any
Critical Audit Matters (cont'd)

- The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any.
- The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any.
- The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
- The nature of consultations outside the engagement team regarding the matter, if any.
Some examples of possible CAMs:
- Revenue recognition in complex transactions
- Allowance for sales returns
- Valuation of deferred tax assets
- Fair value of securities
- Impairments
The proposed other information standard would:

- Apply the auditor's responsibility for other information specifically to annual reports filed with the SEC that contain the audited financial statements and related auditor's report;
- Add procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit;
- Require the auditor to evaluate the other information for
  - material misstatements of fact
  - a material inconsistency with information in the audited financial statements; and
- Require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.
Comment Letters on Proposed Rules

- PCAOB has received 240 comment letters.
- The Staff is reviewing the comments and is expected to issue a revised rule proposal by early 2015.
- Some themes in the comments:
  - The benefits of disclosing critical audit matters do not justify the costs.
  - The definition of critical audit matters is too vague.
  - Proposal may lead to meaningless boilerplate disclosure.
  - Concerns about additional liability.
  - Some call for expanded disclosure regarding quality of financial reporting.
On June 10, 2014, the Board adopted AS No. 18, Related Parties, amendments regarding significant unusual transactions, and other amendments to PCAOB auditing standards.

Requires the auditor to perform specific procedures:
- To obtain an understanding of the company's relationships and transactions with its related parties;
- For each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk;
- If the auditor determines that a related party, or relationship or transaction with a related party, previously undisclosed to the auditor exists;

Evaluate whether the company has properly identified its related parties or relationships or transactions with related parties; and

Communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.
AS No. 18 Related Parties (cont'd)

- Amends AU Sec. 316, Consideration of Fraud in a Financial Statement Audit (and other PCAOB auditing standards) to strengthen the auditor's identification and evaluation of a company's significant unusual transactions.

- Requires the auditor to:
  - perform specific procedures to identify significant unusual transactions;
  - perform specific procedures to obtain an understanding of the business purpose (or the lack thereof) of identified significant unusual transactions;
  - evaluate whether significant unusual transactions have been properly accounted for and disclosed in the financial statements.

- Intended to enhance the auditor's evaluation of the business purpose (or the lack thereof) of significant unusual transactions.
AS No. 18 Related Parties (cont'd)

- Requires the auditor to obtain an understanding of a company's financial relationships and transactions with its executive officers.
- Heighten the auditor's attention to incentives or pressures for the company to achieve a particular financial position or operating result.
- The amendments do not require the auditor make an assessment of the appropriateness or reasonableness of executive compensation arrangements.
On September 9, 2014, the PCAOB staff issued Staff Audit Practice Alert No. 2, Matters Related to Auditing Revenue in an Audit of Financial Statements.

Highlights requirements for auditing revenue, in light of significant audit deficiencies frequently observed during inspections in this area.
Significant audit deficiencies in auditing revenue include:

- The failure to perform sufficient procedures to test whether revenue was recognized properly and in the correct period;
- The failure to evaluate disclosure regarding revenue recognition;
- The failure to address fraud risks regarding revenue;
- Unsupported reliance on controls over revenue because either controls were not tested sufficiently or identified control deficiencies were not evaluated sufficiently;
- Unsupported reliance on company-generated data and reports used to audit revenue because the data and reports were not tested or not tested sufficiently;
- Insufficient testing of revenue transactions, including failure to appropriately apply audit sampling;
- The failure to perform sufficient substantive analytical procedures; and
- The failure to sufficiently test revenue in companies with multiple locations or business units.
The alert discusses the following topics related to auditing revenue:

- Testing the recognition of revenue from contractual arrangements
- Evaluating the presentation of revenue—gross versus net revenue
- Testing whether revenue was recognized in the correct period
- Evaluating whether the financial statements include the required disclosures regarding revenue
- Responding to risks of material misstatement due to fraud associated with revenue
- Testing and evaluating controls over revenue
- Applying audit sampling procedures to test revenue
- Performing substantive analytical procedures to test revenue
- Testing revenue in companies with multiple locations
On September 24, 2014, the PCAOB staff issued Staff Audit Practice Alert No. 13, Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern.

Issued in light of recent changes to U.S. GAAP about disclosure of uncertainties about a company's ability to continue as a going concern.


Auditors should look to the applicable financial reporting framework—U.S. GAAP or IFRS—to assess management's going concern evaluation and the related financial statement disclosures.

Auditors should continue to look to existing requirements of AU Sec. 341 when evaluating whether the auditor's report requires an explanatory paragraph disclosing the auditor's substantial doubt about a company's ability to continue as a going concern.
In December 2013, the Board reproposed amendments that would require disclosure in the auditor's report of:

- the name of the engagement partner who led the audit for the most recent period, and
- the names, locations, and extent of participation (as a percentage of the total audit hours) of other public accounting firms that took part in the audit, and the locations and extent of participation of other persons (whether an individual or a company) not employed by the auditor who performed procedures on the audit.
Disclosure About Certain Other Participants in the Audit

The new proposal would require information about certain other participants in the audit.

The information to be disclosed would be:

- With respect to another independent public accounting firm(s), the name of the other firm(s); with respect to other persons not employed by the auditor, the phrase "persons not employed by our firm," instead of identifying the persons by name.
- The location of other participants in the audit (the country of the firm's headquarters' office location and the country of residence or headquarters' office location for other persons).
- The percentage of the total hours attributable to the audits or audit procedures performed by the other participants in the most recent period's audit.
Disclosure About Certain Other Participants in the Audit (cont'd)

Revisions to the reproposed amendments include:

- Raising the disclosure threshold for other participants in the audit from 3% of the total audit hours in the originally proposed amendments to 5% of the total audit hours.
- Allowing for the disclosure to be stated within a range of percentages or as a single number.
- No longer requiring disclosure in the auditor's report of the names of other persons that are not employed by the auditor; instead, such persons are to be disclosed as "persons not employed by our firm"
Proposed Reorganization of PCAOB Auditing Standards

- 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.
Proposed Reorganization of PCAOB Auditing Standards

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
Inspections
Approximately 44% of the audit firms inspected between 2007 and 2010 had at least one significant audit performance deficiency compared to the 2007 report where approximately 61% of the audit firms inspected between 2004 and 2006 were reported as having at least one significant audit performance deficiency.
Audit areas with frequent findings in the 2007-2010 period related to:

- auditing revenue recognition;
- auditing share-based payments and equity financing instruments;
- auditing convertible debt instruments;
- auditing fair value measurements;
- auditing business combinations and impairment of intangible and long-lived assets;
- auditing accounting estimates;
- auditing related party transactions;
- use of analytical procedures as substantive tests; and
- audit procedures to respond to the risk of material misstatement due to fraud.
PCAOB Publishes List of Firms That Failed to Address Quality Control Criticisms

Firms include:

- KPMG
- Deloitte Touche
- Ernst & Young
- PwC
- Grant Thornton
PCAOB Publishes List of Firms That Failed to Address Quality Control Criticisms

Issues include:

- Failure to address contrary evidence
- Inadequate review and supervision
- Inadequate testing of fair value
- Inadequate testing of IT controls
Things to Consider When Your Firm is Inspected

- Get organized
- Do not alter documents!
- Cooperation and transparency
- Communication with client
- Be mindful of potential enforcement actions
- Proactively respond to PCAOB staff comments
PCAOB ENFORCEMENT

Claudius Modesti
PCAOB Director of Enforcement and Investigations
Overview of Enforcement Division

- Staff includes 27 attorneys and 17 forensic accountants
- May investigate violations of
  - Sarbanes-Oxley
  - PCAOB Rules
  - Securities laws related to auditing
  - Professional standards
Sanctions for Violations

- Penalties
  - Up to $15 million for firm
  - Up to $750,000 for individual
- Temporary or permanent suspension of registration
- Person's disassociation from firm
- Limitations on firm's activities
- Require an independent monitor to observe and report
- Censure
- Additional education
Enforcement Actions

- PCAOB has taken 97 disciplinary actions against 72 firms
- Revoked the registration of 42 firms
- Barred 61 CPAs from association with a registered firm
- Over 90 pending investigations
Randall A. Stone (7/7/14)

- Stone, a former PwC partner, was in the partner in charge of the 2007 audit of ArthroCare Corporation.
- The PCAOB determined that:
  - Stone failed to properly address indicators that ArthroCare was improperly recognizing revenue on sales to one of its largest distributors.
  - He failed to properly audit ArthroCare's accounting for that distributor's acquisition.
  - Stone improperly consented to the incorporation of PwC's 2007 audit opinion in ArthroCare's Form S-8 Registration Statement, without a sufficient subsequent events investigation.
- Stone was censured and ordered to pay a $50,000 penalty and barred from public company practice (may reapply after 3 years).
Trivia Quiz

What is the largest fine ever levied by the PCAOB on a CPA firm?

- $2 million **
- $500,000
- $3 million
- $750,000
What if Your Firm Receives a PCAOB Enforcement Inquiry?

- Consult counsel
- Preserve documents
- Do not mislead the investigator
- Answer questions carefully (see first bullet above)
- Realistic self-evaluation – what went wrong
Recent Issues Raised in the Securities and Exchange Commission (SEC)

Mary Jo White
The Financial Reporting and Audit Task Force

In July 2013, the SEC announced a new task force initiative to concentrate on expanding and strengthening the Division's efforts to identify securities-law violations relating to the preparation of financial statements, issuer reporting and disclosure, and audit failures.

- The principal goal will be fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures.
- The Task Force will focus on identifying and exploring areas susceptible to fraudulent financial reporting, including:
  - on-going review of financial statement restatements and revisions,
  - analysis of performance trends by industry, and
  - use of technology-based tools such as the Accounting Quality Model.
- It will include Enforcement attorneys and accountants from across the country, working in close consultation with the Division's Office of the Chief Accountant, the SEC's Office of the Chief Accountant, the Division of Corporation Finance, and the Division of Economic and Risk Analysis.
Accounting Quality Model aka "RoboCop"

- Objective is to detect inappropriate earnings management.
- Use regression analysis to analyze financial statements.
- Compare financial measures across industry groups.
- Some focus factors:
  - Discretionary accruals;
  - Differences in tax vs. accrual;
  - Net income versus cash flow from operations;
  - Off-balance sheet arrangements;
  - Certain phrases used in MD&A;
  - Changes in auditor status.
SEC Sanctions Florida-Based Auditor for Circumventing Rules

- SEC determined that Elliot Berman attempted to circumvent the auditor rotation requirement.
- For the audit of a company that he conducted for the previous five years, Berman installed as lead audit partner an employee at his firm who was not a CPA nor otherwise qualified to lead such an audit.
- Berman improperly continued to perform many of the lead audit partner functions for that audit.
- Berman must pay a $15,000 penalty and is suspended for at least one year from public company practice.
Frequent CF Staff Comment Areas

- Segment Reporting
- Revenue Recognition
- Loss Contingencies
- Audit Reports
- Income Taxes
- Business Combinations
- Reverse Mergers
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AGG's Securities and Corporate Governance Practice

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We regularly counsel companies and underwriters in a variety of complex securities transactions, including initial and follow-on public offerings, "going private" and "roll-up" transactions, mergers, PIPES offerings, and private offerings.
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