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Report on

2010 Inspection of John Kinross-Kennedy CPA

(Headquartered in Irvine, California)

Issued by the

Public Company Accounting Oversight Board

February 2, 2012

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

PORTIONS OF THE COMPLETE REPORT ARE OMITTED FROM THIS DOCUMENT IN ORDER TO COMPLY WITH SECTIONS 104(g)(2) AND 105(b)(5)(A) OF THE SARBANES-OXLEY ACT OF 2002

PCAOB RELEASE NO. 104-2012-080A
(Includes portions of Parts II and IV of the full report that were not included in PCAOB Release No. 104-2012-080)

PCAOB
Public Company Accounting Oversight Board

Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.

2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the supervisory context in which this report was prepared. Any such references are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.

3. Board inspections encompass, among other things, whether the firm has failed to identify departures from U.S. Generally Accepted Accounting Principles ("GAAP") or Securities and Exchange Commission ("SEC" or "Commission") disclosure requirements in its audits of financial statements. This report's descriptions of any such auditing failures necessarily involve descriptions of the related GAAP or disclosure departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP or Commission disclosure requirements, rests with the Commission. Any description, in this report, of perceived departures from GAAP or Commission disclosure requirements should not be understood as an indication that the Commission has considered or made any determination regarding these issues unless otherwise expressly stated.

PCAOB Release No. 104-2012-080A

2010 INSPECTION OF JOHN KINROSS-KENNEDY CPA

In 2010, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm John Kinross-Kennedy CPA[1/] ("the Firm"). The Board is issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report and portions of Part IV of the report. Part IV of the report consists of the Firm's comments, if any, on a draft of the report.[2/]

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.[3/] A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

1/ The Firm has issued audit reports under the name of John Kinross-Kennedy Certified Public Accountant.

2/ The Board does not make public any of a firm's comments that address a nonpublic portion of the report unless a firm specifically requests otherwise. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board routinely grants confidential treatment, if requested, for any portion of a firm's response that addresses any point in the draft that the Board omits from, or any inaccurate statement in the draft that the Board corrects in, the final report.

3/ See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from November 29, 2010 to December 3, 2010. These procedures were tailored to the nature of the Firm, certain aspects of which the inspection team understood at the outset of the inspection to be as follows:

Number of offices	1 (Irvine, California)
Ownership structure	Sole proprietorship
Number of partners	1
Number of professional staff[4/]	None
Number of issuer audit clients[5/]	13

Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits.[6/] To achieve that goal, Board

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4/ "Professional staff" includes all personnel of the Firm, except partners or shareholders and administrative support personnel.

5/ The number of issuer audit clients shown here is based on the Firm's self-reporting and the inspection team's review of certain information for inspection planning purposes. It does not reflect any Board determination concerning which, or how many, of the Firm's audit clients are "issuers" as defined in the Act. In some circumstances, a Board inspection may include a review of a firm's audit of financial statements and internal control over financial reporting ("ICFR") of an issuer that ceased to be an audit client before the inspection, and any such former clients are not included in the number shown here.

6/ This focus on weaknesses and deficiencies necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools.

inspections include reviews of certain aspects of selected audits performed by the firm and reviews of other matters related to the firm's quality control system.

In the course of reviewing aspects of selected audits, an inspection may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, respects in which an issuer's financial statements do not present fairly the financial position, results of operations, or cash flows of the issuer in conformity with GAAP.[7/] It is not the purpose of an inspection, however, to review all of a firm's audits or to identify every respect in which a reviewed audit is deficient. Accordingly, a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements or reporting on internal control, are free of any deficiencies not specifically described in an inspection report.

In addition, inclusion of a deficiency in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the firm's attention. Under PCAOB standards, when audit deficiencies are discovered after the date of the audit report, a firm must take appropriate action to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions.[8/] Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on previously expressed audit opinions. A Board inspection does not typically include review of a firm's actions to address deficiencies identified in that

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[7/] When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in issuers' financial statements.

[8/] See AU 390, *Consideration of Omitted Procedures After the Report Date,* and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (both included among the PCAOB's interim auditing standards, pursuant to PCAOB Rule 3200T), and PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* ("AS No. 5"), ¶ 98.

inspection, but the Board expects that firms are attempting to take appropriate action, and firms frequently represent that they have taken, are taking, or will take, action. If, through subsequent inspections or other processes, the Board determines that the firm failed to take appropriate action, that failure may be grounds for a Board disciplinary sanction.

A. Review of Audit Engagements

The inspection procedures included a review of aspects of the Firm's auditing of financial statements of two issuers. The scope of this review was determined according to the Board's criteria, and the Firm was not allowed an opportunity to limit or influence the scope.

The inspection team identified what it considered to be audit deficiencies. Those deficiencies included failures by the Firm to identify or appropriately address errors in the issuer's application of GAAP, including, in some cases, errors that appeared likely to be material to the issuer's financial statements. In addition, the deficiencies included failures by the Firm to perform, or to perform sufficiently, certain necessary audit procedures.

In some cases, an inspection team's observation that a firm failed to perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if a firm claims to have performed the procedure. PCAOB Auditing Standard No. 3, *Audit Documentation* ("AS No. 3"), provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. See AS No. 3, paragraph 9 and Appendix A to AS No. 3, paragraph A28. For purposes of the inspection, an observation that the Firm did not perform a procedure, obtain evidence, or reach an appropriate conclusion may be based on the absence of such documentation and the absence of persuasive other evidence.

The deficiencies identified in both of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. Those deficiencies were –

(1) the Firm's failure to identify, or to address appropriately, a departure from GAAP that related to a potentially material misstatement in the audited financial statements concerning the accounting for a prior period error;

(2) the Firm's failure to identify, or to address appropriately, a departure from GAAP that related to a potentially material misstatement in the audited financial statements concerning the issuer's failure to disclose segment information;

(3) the failure to perform sufficient audit procedures to test revenues;

(4) the failure to perform audit procedures to test accounts receivable and the allowance for doubtful accounts;

(5) the failure to perform audit procedures to test notes receivable;

(6) the failure to perform sufficient audit procedures related to foreign currency translation;

(7) the failure to perform audit procedures to evaluate goodwill for impairment; and

(8) the failure to perform an audit, instead issuing an audit report on the basis of procedures performed by another accounting firm, without the Firm having planned, performed, supervised, or reviewed the work.

One of the deficiencies described above related to auditing an aspect of an issuer’s financial statements that the issuer revised in a restatement subsequent to the primary inspection procedures.[9/]

B. Review of Quality Control System

In addition to evaluating the quality of the audit work performed on specific audits, the inspection included review of certain of the Firm's practices, policies, and

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[9/] The Board inspection process did not include review of any additional audit work related to the restatement.

procedures related to audit quality. This review addressed practices, policies, and procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures. Any defects in, or criticisms of, the Firm's quality control system are discussed in the nonpublic portion of this report and will remain nonpublic unless the Firm fails to address them to the Board's satisfaction within 12 months of the date of this report.

END OF PART I

PORTIONS OF THE REST OF THIS REPORT ARE NONPUBLIC AND ARE OMITTED FROM THIS PUBLIC DOCUMENT

PART II

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B. Issues Related to Quality Controls

The inspection of the Firm included consideration of aspects of the Firm's system of quality control. Assessment of a firm's quality control system rests both on review of a firm's stated quality control policies and procedures and on inferences that can be drawn from respects in which a firm's system has failed to assure quality in the actual performance of engagements.[10/] On the basis of the information reported by the inspection team, the Board has the following concerns about aspects of the Firm's system of quality control.

Design of Quality Control System

Practice Monitoring

The Firm's policies and procedures appear not to provide sufficient assurance that the Firm is effectively monitoring its accounting and auditing practice. Specifically, the Firm has not adopted quality control policies and procedures for monitoring as required by QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

Audit Performance

A firm's system of quality control should provide reasonable assurance that the work performed on an audit engagement will meet applicable professional standards and regulatory requirements. On the basis of the information reported by the inspection team, including the audit performance deficiencies described in Part II.A (and summarized in Part I.A) and any other deficiencies identified below, the Board has

[10/] A firm's failure to comply with the requirements of PCAOB standards when performing an audit may be an indication of a potentially significant defect in a firm's quality control system even if that failure did not result in an insufficiently supported audit opinion.

concerns that the Firm's system of quality control fails to provide such reasonable assurance in at least the following respects[****] –

Testing Appropriate to the Audit

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, specifically with respect to the following issues:

Accounting for a Prior Period Error

As discussed above, in one of the audits reviewed, the inspection team identified a significant deficiency related to the Firm's failure to identify, or to address appropriately, a departure from GAAP that related to potentially material misstatements in the audited financial statements concerning an issuer's accounting for an error recorded in its current period financial statements for a prior period. This information provides cause for concern regarding the Firm's quality control policies and procedures related to the Firm's auditing of the accounting for a prior period error. [Issuer A]

Segment Reporting

As discussed above, in one of the audits reviewed, the inspection team identified a significant deficiency related to the Firm's failure to identify, or to address appropriately, a departure from GAAP that related to potentially material misstatements in the audited financial statements concerning an issuer's disclosures related to segment reporting. This information provides cause for concern regarding the Firm's quality control policies and procedures related to the Firm's auditing of segment reporting. [Issuer B]

Revenues and Accounts Receivable

As discussed above, in one of the audits reviewed, the inspection team identified significant deficiencies related to the testing of revenues and accounts receivable. This information provides cause for concern regarding the Firm's quality control policies and procedures related to the Firm's auditing of revenues and accounts receivable. [Issuer A]

Notes Receivable

As discussed above, in one of the audits reviewed, the inspection team identified a significant deficiency related to the testing of notes receivable. This information provides cause for concern regarding the Firm's quality control policies and procedures related to the Firm's auditing of notes receivable. [Issuer A]

Foreign Currency Translation

As discussed above, in one of the audits reviewed, the inspection team identified a significant deficiency related to foreign currency translation. This information provides cause for concern regarding the Firm's quality control policies and procedures related to the Firm's testing of the use and application of foreign exchange rates in the issuer's financial statements. [Issuer A]

Planning, Performance, Supervision, and Review

As discussed above, in one of the audits reviewed, the inspection team identified an instance in which the Firm inappropriately issued an audit report stating that the Firm had performed an audit and that the Firm's audit provided it with a reasonable basis for an opinion even though the Firm and its personnel did not plan, did not perform, did not supervise, and did not review the audit work performed in the engagement. This information provides cause for concern regarding the Firm's quality control policies and procedures related to the Firm's planning, performance, supervision, and review of issuer audit engagements. [Issuer B]

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Technical Competence

The audit performance deficiencies discussed in Part II.A suggest that the Firm's system of quality control may not provide sufficient assurance that the audit partner has the level of knowledge and the degree of technical training and proficiency required in the circumstances and that he refers to authoritative literature or other sources and consults with knowledgeable individuals when appropriate.

Auditor Communications

The Firm's system of quality control appears not to provide sufficient assurance that the required auditor communications to the audit committee, or equivalent, occur and are appropriately documented, including required independence confirmations. Specifically, the Firm failed to make the required auditor communications to the audit committee in accordance with AU 380, *Communication with Audit Committees*. [Issuer A] In addition, the Firm failed to provide to the audit committee, or equivalent, independence confirmations required by PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. [Issuers A and B]

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Monitoring and Addressing Identified Weaknesses

The Firm's system of quality control appears to lack a monitoring element sufficient to provide the Firm with reasonable assurance that the Firm's policies and procedures concerning compliance with independence requirements are suitably designed and effectively applied. In a report dated December 18, 2007, which related to an inspection of the Firm conducted in 2007, the Board noted that the Firm's procedures appear not to provide sufficient assurance that the Firm is independent of its issuer clients. An appropriate approach to monitoring would have resulted in the Firm avoiding further failures to comply with the independence requirements, yet such failures were identified in one audit reviewed in this inspection.

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PART IV

RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Firm provided a written response to a draft of this report. Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the Firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report.[11/]

[11/] In any version of an inspection report that the Board makes publicly available, any portions of a firm's response that address nonpublic portions of the report are omitted. In some cases, the result may be that none of a firm's response is made publicly available.

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January 31, 2012

Helen A. Hunter
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006

Re: Draft Report of Inspection – Public Portion

Dear Ms. Hunter:

Thank you for the opportunity to respond to the draft report of inspection. The attached are my responses to the public portion of the report. The responses are in the same order as the draft deficiencies.

The attached working papers need not be published with the public portion of the report.

Sincerely,

John Kinross-Kennedy, C.P.A.

RESPONSES TO REPORT OF INSPECTION: JOHN KINROSS-KENNEDY, C.P.A.

Deficiency: The firm's failure to identify, or address appropriately, a departure from GAAP that related to a potentially material misstatement in the audited financial statements concerning the accounting for a prior period error.

This relates to Issuer A, accounting for a prior period error. An error in a capital asset contribution became evident in the wake of a major reorganization of the Company's operations. The subsequent revaluation of assets after the initial estimate was not considered significant to company operations since it did not affect net equity or net profit, and a restatement was not made. The operative word in the Deficiency is *"potentially material misstatement"*. It was potential, but the adjustment actually had no effect on the company's financial condition or results of its operations. None-the-less as was pointed out it had significance and a restatement was subsequently made.

Deficiency: The Firm's failure to identify, or address appropriately, a departure from GAAP that related to a potentially material misstatement in the audited financial statements concerning the issuer's failure to disclose segment information.

This relates to issuer B. Segment reporting. Conceded that segment reporting should have been addressed. This was a one-year event, in a year when the parent was transitioning out of one business and into another. There was only one business the following year. Segment reporting was not going to be a permanent feature in this company's accounting and an internal case was made for its omission. However the management approach dictates that this one year should have been accounted for as such. Failure to do so did not result in a "*material misstatement*" of the company's overall financial position or results of operations, but of presentation.

Deficiency. The failure to perform sufficient audit procedures to test revenues.

This relates to issuer A. Revenue and Accounts Receivable. My "Quality Review" analysis in the 2009 audit file is:

> **"Auditing Standard No. 7 is effective after March 31, 2010. An engagement quality review was not performed by a partner other than the engagement partner. However there were two main decisions resulting from an inherent weakness identified in the ICQ. The ICQ identified the accounting system as a medium risk.**
>
> **Decision 1: Focus on the balance sheet as a means to nail down the change in net equity, as opposed to the income statement.**
>
> **Decision 2: Truncate income statement tests, since it is a foregone conclusion that significant errors may have occurred. Spend time on the balance sheet.**
>
> **Balance sheet audit procedures provided reasonable assurance that the change in net equity was without material error."**

In 20'07 the AICPA had issued a series of new auditing standards on risk assessment, (SAS) Nos. 104-111, and SAS 112. These required auditors to obtain a deeper understanding of the client's organization, environment, and internal control systems. They also required an assessment of the presence of risk. A 2004 lecture on risk-based auditing was published by the AICPA, in which it was opined that documentation was required of inherent, control and combined risk, and that the Audit program should be modified in response to these identified risks[1]. The PCAOB in Release No. 2008-006 on October 21, 2008, issued Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk. Two features were "making a comprehensive evaluation of the evidence" and "tailoring the audit to respond appropriately to the risks of material misstatement".

The audit file reflected a comprehensive assessment of the three types of risk mentioned. The audit program related to revenue testing was therefore modified accordingly, as indicated. It made little sense to continue testing a line item that was known to have high risk of misstatement. One could have increased the audit procedures infinitely to determine how much of a misstatement had occurred, or alternatively adopt a strategic approach, as risk based auditing advocates. The audit program was modified to concentrate on the balance sheet to determine the accuracy of "results of operations".

Deficiency: The failure to perform audit procedures to test accounts receivable and the allowance for doubtful accounts.

It is inconceivable that accounts receivable were not tested, especially in view of the conclusions about the audit program in the previous paragraph. There is evidence elsewhere in the file specifically Section 23, on the allowance for doubtful accounts. As a result of the audit, the client was informed that an allowance of $1,300.80 should be registered against A/R for one receivable, which the client dutifully booked. The inspection team may have missed this, but in the absence of other documentation they had no alternative but to report as they did. The relevant audit program, attached, includes a notation for Section 14 *"Few accounts –(etc)"*, but the A/R trial balance is missing from the file. The entire section 15 on the Sales system, also referenced in the audit program, is also missing from the file. The file was passed back and forth during the inspection, and items pulled and re-attached, so it may have been misplaced.

Deficiency: Failure to perform audit procedures to test notes receivable.

The note was from the host company for Issuer A. Issuer A co-located its headquarters with the debtor in 2008. The debtor is a retailer having brand recognition of its own products. A visit to the premises and discussion with the retailer's management in June 2009 as a precursor to the audit indicated acceptance of the liability and ability to repay. The loan had been made in contemplation of a union of the two companies to expand marketing and gain synergy. The economic downturn put plans on hold, and the principals agreed informally to waive interest and to amortize the loan by charging Issuer No. 1 rent. Management considered the rent collectable, doubly so since it was being amortized by rent. This arrangement was reflected in the financial statements. The loan was originated in April 2008 and documentation recorded with the review of the 2nd and 3rd quarter filings. I was satisfied that sufficient audit procedures had been performed, however I agree documentation could have been much better.

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[1] [1] Lecture by David A. Allan at the AICPA National Construction Conference, New Orleans, December 4, 2004.

Deficiency: The failure to perform sufficient audit procedures related to foreign currency translation.

This relates to Issuer A: Foreign Currency Translation. The inspection team found audit procedures in place, which identified an error and caused an adjustment to cash. The report indicates a failure to evaluate the effect on non-cash balance sheet accounts. This was done in aggregate on the Audit Difference Evaluation Form", attached, where the effect on the financial statements of Over/Under amounts is shown.

Deficiency: The failure to perform audit procedures to evaluate goodwill for impairment.

This relates to Issuer B: Goodwill. The inspection team found no documentation, and were not persuaded by other evidence that goodwill had been evaluated. The "other evidence" was discussions with myself and the audit manager as to why it was so. Goodwill per ASC 350-20 can be calculated as the excess of the value of the reporting entity over its carrying value. In this case, with a net profit before currency translation of $201,080, a sight estimate of the company's value was in the low millions, far in excess of a requirement for the goodwill of $451,311. In other words, it was self evident. In the same vein as risk based auditing, the utter lack of risk of misstatement resulted in a modification of the audit program to limit formal testing. This could be carrying it too far, but it was thought that testing something that did not need testing did not make sense. Nonetheless, it should follow the letter of the ASC, and documentation of formal testing will be performed in future.

Deficiency: the failure to perform an audit, instead issuing an audit report on the basis of procedures performed by a separate accounting firm, without the firm having planned, performed, supervised or reviewed the work.

This aptly describes the reliance of an auditor upon another auditor's work, in opining on comparative financial statements. The principle is already in place, and the audit of Issuer B was similar. Issuer B is located in the same city as the audit firm engaged to assist me. That firm is the company's auditor for local purposes. Firstly, as to planning. This was documented in a memo in my audit file for the engagement, attached. It describes the competence of the audit firm. My first formal exchange with that firm is attached. The memo describes the planning meeting I had in their city with the auditor, reviewing their audit procedures and special emphases. I held a conference with the client. This was the third audit under this arrangement, and I had every confidence that the firm was competent to perform the audit. They were skilled in preparing financial statements for S.E.C clients. I planned the audit. As to "performed" the audit, I "performed" it as much as an audit partner in a large firm does: overall management. As the audit progressed, I monitored it by e-mail and phone, especially the key items, in this case WIP. The daily supervision of the fieldwork is in the hands of the audit manager, but he was "supervised" by me. As to reviewing the work, this was also done electronically, and the completion procedures checked, e.g., 'work papers been signed off with conclusions'; 'management representation letters received', 'confirmations received and analyzed satisfactorily'; etc. Time constraints eliminated the possibility of a visual review.

In the previous PCAOB audit, I asked the opinion of the senior examiner whether this type of audit arrangement would be suitable. He responded that it would be, if I were the principal auditor. The PCAOB Standing Advisory Group Meeting on April 7-8, 2010 issued "Responsibilities of a Principal Auditor" including, "Part of Audit Performed by Other Independent Auditors ("AU sec 543). They acknowledged that:

Currently, many registered firms routinely enter into arrangements of varying size and complexity with other firms to perform audit procedures ("multiform audits") generally to provide services to audit clients that operate in more than one city, and:

"*AU sec. 543 requires the auditor to determine if his or her participation is sufficient to serve as the principal auditor when significant parts of the audit are performed by other auditors.13/ The standard does not describe when participation is "sufficient.""*"

The discussion outlines the matters an auditor "should consider" in deciding participation, which includes the materiality of the portion audited by other auditors in comparison to the whole. AU sec. 543.12 includes four safe harbor items including: "*The component audited by the other auditor is not material to the financial statements covered by the principal auditor's opinion*". My audit satisfied three of the four, but it is obvious from the fourth item that my situation is not in the safe harbor. Does this eliminate my being the principal auditor?
Even though I completed the additional considerations mentioned:

Further, according to AU sec. 543.12, the principal auditor "should consider performing" one or more of the procedures listed in that paragraph, e.g., visiting the other auditor, reviewing the other auditor's audit programs, reviewing additional audit documentation.

The Standing Committee goes on to say that:

In practice, the level of participation of the principal auditor in audit engagements for which part of the work is performed by another auditor varies. A new standard on responsibilities of the principal auditor could establish more specific criteria (qualitative and/or quantitative) for serving as principal auditor.

The discussion that follows asks questions:

1. What criteria should be included in a new standard to describe when an auditor is qualified to serve as principal auditor? Should there be any quantitative criteria, i.e., should a new standard require that the principal auditor obtain audit evidence for a certain minimum percentage of the issuer's revenue or assets? Should the qualitative criteria currently included in AU sec. 543.02 be retained or modified?

My point is that the rules for principal auditor are in flux. The current set of rules are guidelines, but not definitive, and I cannot be held to a set of rules that are not definitive and liable to change. However I believe that under the general guidelines of AU sec 543.02 that the criteria I applied in this audit permitted me to issue an opinion.

**RESPONSES TO REPORT OF INSPECTION: JOHN KINROSS-KENNEDY, C.P.A.
NON PUBLIC PORTION**

1. Design of Quality Control System: Practice Monitoring.

Monitoring a sole practitioner's practice is self monitoring, an ongoing procedure that is less formal than in a multi-partner practice. The examiners may have been looking for a checklist, but it is already there in QC 20. The evidence of the execution is, per items in QC 20.20:

a. *Relevance and adequacy of the firm's policies & procedures.* It is obviously a concern of any sole proprietor to stay current, but it is hard to measure whether this is effective or not, since there reliance on QC 20 for guidance but no documentation.
b. *Appropriateness of the firm's guidance materials and any practice aids.* The firm is involved primarily in "desk audits" of startup companies. The audit program is a printed version of a small business program developed by Grant Thornton. It is not on computer. It is augmented by GAAP and SEC disclosure checklists. I have reviewed several computerized audit programs but have not found one that suits this practice. However I am resigned to going on computer and will be so before the inspection period is over. I am looking at the PPC public company audit program, which is expensive. As to guidance materials, not being a training firm, and having only one part time assistant, there is little need in this regard.
c. *Effectiveness of professional development activities.* Again this requirement is styled toward a multi-partner firm. There are no professional development activities in this sole practitioner practice. The activities are external, e.g. financial assistance to the part-timer for study towards her CPA designation. For myself, membership in the AICPA audit section, PCAOB forums, 12 e-mail newsletters of the AICPA, a newsletter on S.E.C regulations, webinars and the usual continuing education.
d. *Compliance with the firm's policies and procedures.* There is no documentation or formal policies and procedures manual. This would be an advantage to this small practice and will be implemented. The PPC Guide to Quality Controls will be used to develop a suitable program.

2. Audit Performance. "The Board has concerns that the Firm's system of quality control fails to provide such reasonable assurance in at least the following respects"
   a. Testing Appropriate to the Audit:
      (i) "Accounting for a prior period error". This was addressed in the public portion and was more of a reclassification than a prior period adjustment, since it had no effect on net income or net equity and did not potentially or actually result in a material misstatement. It was non-representative of the firm's approach to prior period error, and perhaps a further inspection of prior period adjustments in other audits should have been made before drawing a conclusion.
      (ii) "Segment Reporting". In the public portion, it was acknowledged that segment reporting should have been a part of the audit. It was also noted that it was a "one off" situation. It did not rise to the level of the risk of

material misstatement to the issuer's financial statements in the overall sense.

(iii) "Revenues and Account Receivable". The significant deficiencies related to the testing of revenues, as indicated in the public portion, was a difference of opinion regarding the audit program. The audit program was changed as a result of strategic planning based on risk-based auditing. The inspection team had been well trained – brilliantly – in classical audit theory and practise. Hence the emphasis on testing revenue streams. But they were indifferent to risk based auditing and the attendant requirement for modification of audit procedures. I can only suggest that inspection teams be cognizant of this development in audit theory.

As to the accounts receivable, as indicated in my response to the audit of accounts receivable, please note that my audit file was missing two sections when that inspection finished. Those sections were specifically referred to in my audit papers, and there was other evidence in the file that I had examined accounts receivable. It is not known to what extent the team examined records, and it is possible they made the conclusion based on missing sections. I am unable to respond properly.

(iv) "Notes Receivable". Testing of Notes Receivable was found deficient. My response in the public portion indicated that audit procedures indeed were performed, but that the documentation could have been much better. This was again a strategic approach to audit procedures based on identified risk, or lack thereof, that replaced classical testing. I can see that there is a great dichotomy in this area, and that documentation is absolutely essential when one strays from testing. That is the great lesson here, and will be adhered to.

(v) "Foreign Currency Translation". The paragraph says that the inspection team indentified a significant deficiency here, but in the non public portion they acknowledged that the audit procedures had identified it and adjustment was made to cash. I don't know why this is an observation. In the public portion they went on to say that the effect on non-cash elements had not been addressed, but I submitted to you the audit difference form where differences had been addressed. I leave it in your hands as to whether this was sufficient.

(vi) "Planning, Performance, Supervision and Review". I refer to my response in the public portion where I flatly rejected the notion that I did not plan, perform, supervise and review the audit work. I will not repeat it here. The inspection team as I mentioned earlier were superbly trained in classical audit theory and practice. But they were not comfortable with the notion of a far off audit team working for me. The auditing workplace is becoming more virtual, and this was representative of another shift in audit practice. Hence the Standing Committee's concern over work performed by audit teams in another city. To illustrate, I had until recently (not now reporting) a truly virtual audit client: the HQ was in Florida, the external accountant in Seattle, the securities attorney in Vancouver, the investor, (with whom I had much communication), was in Switzerland,

and the operation in two parts of Argentina (which I examined). The internet makes it all possible. In conclusion, I can see that the arrangement with a distant audit team may not make the PCAOB comfortable that I am the principal auditor- yet. I have reluctantly informed the client that I am withdrawing from future engagements.

REDACTED. Comments on Non-public Aspects of Report

b. "Technical Competence". The audit deficiencies indicated that I do not have the level of knowledge, degree of technical training and proficiency nor knowledge of authoritative literature to perform an audit. My rebuttal of many of their conclusions would I hope, attenuate this conclusion. The conclusions were generated from opinions of an audit team I found were superbly trained in classical audit theory, but unable to address nor even consider new developments in auditing related to risk based auditing, and the virtual office place.
In my previous PCAOB audit, all 12 of my audits were examined, and only one observation resulted. It is hard to believe that my technical competence has deteriorated to such an extent.

c. "Auditor Communications". The situation here is acknowledged. I originally explained in my response to the team's draft report that I deal with startup companies on the internet, usually with a single CEO, and always in other cities. Independence is not a large concern. Independence rules are made from experience with large audits in the same city, and the notion of an audit committee, for example, is very foreign to these clients. However I acknowledge that it is a vital prerequisite for the audit and communication regarding independence will be a part of future audits.

REDACTED. Comments on Non-public Aspects of Report

4. "Monitoring and Addressing Identified Weaknesses". The sentence links an earlier report of lack of independence to deficiencies in the monitoring function. If there was no lapse in independence recently, then the monitoring aspect would not be mentioned.

REDACTED. Comments on Non-public Aspects of Report