PCAOB
Public Company Accounting Oversight Board

Forum on Auditing in the Small Business Environment

May 19, 2017

Los Angeles, CA

Welcome

Caveat

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

Learning Objectives

To discuss important information concerning PCAOB activities with registered accounting firms that audit public companies operating in the small business community. The forum also provides an opportunity for Board members and PCAOB staff to hear comments, concerns, and questions from auditors. More specifically, the forum features a panel discussion on exercising professional skepticism. Also, case studies will be presented and facilitated by PCAOB staff from the Division of Registration and Inspections, the Division of Enforcement and Investigations, and the Office of the Chief Auditor, and will focus on auditing accounting estimates, revenue, and related party transactions, as well as substantive analytical procedures. Other discussion topics will include an inspections overview, an update on standard setting activities, and an enforcement update. In addition, a Professional Accounting Fellow from the Office of the Chief Accountant at the Securities and Exchange Commission will join us to provide an update on the new revenue and leases standards.

Stay Connected

- Stay up-to-date on current PCAOB activities (including announcements about future forums!) by signing up for our email list.

- https://pcaobus.org/About/Pages/PCAOBUpdates.aspx

Polling Test Question

Go to https://pcaobsb.cnf.io/ and select the "Welcome Remarks" session to respond

Who is your favorite Beatle?

A. John
B. Paul
C. George
D. Ringo

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PCAOB Highlights

Greg Scates
Interim Director
Office of Outreach and Small Business Liaison

Panel Discussion: Exercising Professional Skepticism

Moderator: Greg Scates

Todd Tosti

Associate Director, Division of Registration and Inspections

R. Davis Taylor

Associate Director, Accountant, Division of Enforcement and Investigations

Lillian Ceynowa

Associate Chief Auditor, Office of Chief Auditor

Exercising Professional Skepticism

Topics for Discussion

- Professional skepticism – Why so important?
- What could undermine professional skepticism?
- Examples of where auditors went wrong
- Examples of where auditors have taken positive steps
- Other ideas and takeaways to drive better application

Why is professional skepticism so important?

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What is professional skepticism?

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What are some of the impediments that could undermine professional skepticism?

Impediments that Can Undermine Professional Skepticism

- Incentives to maintain a long-term audit engagement
  - Avoiding significant conflicts with management
  - Trying to please the client to achieve high satisfaction ratings
  - Keeping audit costs down
- Inappropriate level of trust or confidence with management
- Pressure to avoid potential negative interactions
- Workload demands

Be Aware of Unconscious Human Biases

- These types of biases can be seen in the audit environment
  - Confirmation bias
  - Anchoring bias
  - Availability bias
  - Familiarity bias
  - Halo bias

POLLING QUESTION

Which one of these biases have you experienced or witnessed at some point in your audit career (select only one)?

a. Confirmation bias

b. Anchoring bias

c. Availability bias

d. Familiarity bias

e. Halo bias

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Discussion of Real-life Examples – Where Auditors Went Wrong

Impediments

- **Incentives to maintain long-term client**
  - Avoiding conflicts with management
  - Pleasing the client
  - Keeping audit costs down
- **Pressure to avoid potential negative interactions**
- **Workload demands**

Unconscious Biases

- **Confirmation bias**
- **Anchoring bias**
- **Availability bias**
- **Familiarity bias**
- **Halo bias**

Discussion of Real-life Examples – Where Auditors Did the Right Thing

- Project management skills
- Appropriate supervision
- Level of involvement and communication by engagement partner
- Partner compensation and evaluation process
- Empowering staff to improve their own judgment under appropriate supervision

Other Considerations to Enhance Professional Skepticism

- Firm Level
- Engagement Team Level
- Individual Auditor Level

Firm Level – Considerations to Enhance Professional Skepticism

- Tone at the top
- Performance appraisal, promotion & compensation processes
- Professional competence and assignment of personnel to engagement teams
- Documentation
- Monitoring

Engagement Team Level – Considerations to Enhance Professional Skepticism

- Project management techniques
- Appropriate supervision
  - Maintaining a questioning mind throughout the audit
  - Exercising professional skepticism in gathering and evaluating audit evidence
  - Helping more junior auditors identify matters that appear to be unusual or inconsistent
  - Assisting lower level staff to be better able to challenge assertions made by senior levels of management, when necessary

Individual Level – Considerations to Enhance Professional Skepticism

- It is ultimately the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including with specific focus into the following areas
  - Identifying and assessing risks of material misstatement
  - Performing tests of controls and substantive procedures
  - Evaluating audit results to form the opinion to be expressed in the auditor's report

In Sum: Other Considerations to Enhance Professional Skepticism

- Firm Level
- Engagement Team Level
- Individual Auditor Level

PCAOB Resource on Professional Skepticism

As a great follow up for today, most of the information we covered during this morning's panel discussion can be found in:

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

Questions

Auditing Accounting Estimates

Inspection Findings and Case Study

R. Davis Taylor
Associate Director, Accountant
Division of Enforcement and Investigations

Lillian Ceynowa
Associate Chief Auditor

Auditing Accounting Estimates Inspection Findings

- Failure to sufficiently perform one or a combination of the following procedures:
  - Test the process used by management to develop the estimate, or
  - Develop an independent expectation of the estimate to obtain corroboration of the reasonableness of the estimate, or
  - Review subsequent events or transactions occurring prior to the date of the auditor’s report that would be relevant to evaluating the adequacy of the estimate

- When testing the process used by management, failure to perform sufficient procedures to:
  - Evaluate the reasonableness of significant assumptions used, and
  - Test the data underlying the calculation of the estimate

Auditing Accounting Estimates Polling Question

Polling Question:

Which of the following is **<u>not</u>** one of the three approaches to evaluate an accounting estimate in accordance with AS 2501?

A. review and test the process used by management to develop the estimate

B. rely solely on the work of a management-hired specialist

C. develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate

D. review subsequent events occurring prior to the date of the auditor's report

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Auditing Accounting Estimates Polling Question

Debrief

AS 2501, *Auditing Accounting Estimates*, paragraph .10 states:

In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

Auditing Accounting Estimates

Case Study No. 1 – The Security Company

Case Study No. 1 – The Security Company Background

- Your firm is auditing the financial statements of The Security Company (the "Company") for the year ended December 31, 2016. The Company sells in-home digital security systems and provides video monitoring services that can be viewed on a smartphone or computer.
- The Company's customer base has historically been customers located in the southeast. But starting in the second quarter of 2016, the Company expanded its market to customers in the northeast too.
- In connection with this expansion, the Company reduced its credit requirements for new customers and extended various promotions to attract new customers, including granting extended payment terms for the services and offering a free promotional period for the services.
- The Company's aged accounts receivable and accounts receivable write-offs also increased significantly in the second half of 2016.

Case Study No. 1 – The Security Company Background

- The Company's allowance for doubtful accounts is comprised of the following two components:
  - **Specific reserve** – The Company's management uses its judgment to specifically identify certain accounts receivable balances that it believes are uncollectable and establishes a 100% allowance reserve for them.
  - **General reserve** – For the remainder of accounts receivable, the Company records a general reserve of 10% of noncurrent balances. Company management asserts that the 10% rate is based on its familiarity with the Company's collection history. Although management hasn't prepared a formal calculation or analysis to support this 10 percent reserve, management contends that the reserve has historically proven to be adequate in relation to actual write-offs of accounts receivable.

Case Study No. 1 – The Security Company Background

- The engagement team has identified a significant risk related to valuation of the allowance for doubtful accounts, particularly in relation to the receivables corresponding to the Company's expansion into the northeast.

- The Company's system can provide various accounts receivable and bad debt expense reports. In particular, management has provided print-outs of the following 2016 reports to your engagement team:
  - a system-generated detailed accounts receivable aging report
  - a detailed schedule of the allowance for doubtful accounts
  - a detailed list of all accounts receivable write-offs during the year

- In addition to those print-out reports, the Company can also download them into Excel and provide those to the engagement team. The Company can also run various customized query reports.

Case Study No. 1 – The Security Company Scenario 1 *Background*

- *You're the engagement partner for the audit and are meeting with the engagement team to discuss the plan for auditing accounts receivable, in particular the allowance for doubtful accounts.*

- *In order to test the allowance for doubt accounts, you ask the engagement team to consider using an approach of **testing management's process for estimating the allowance**.*

Case Study No. 1 – The Security Company
Scenario 1 *Questions*

Discussion questions:

1. *What should the engagement team consider in developing its planned audit procedures related to the allowance for doubtful accounts?*

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

3. *Will testing the process used by management to develop the estimate be an effective approach for auditing the Company's allowance for doubtful accounts? Why or why not?*

Case Study No. 1 – The Security Company
Scenario 2 *Questions*

Instead of testing management's process for developing its allowance for doubtful accounts estimate, you ask the engagement team to consider ***developing an independent expectation*** *of the estimate.*

Discussion questions:

1. *What information provided by the Company would be useful in helping the engagement team develop an independent expectation of the estimate for the allowance for doubtful accounts? Are there any additional reports or other information that might be helpful?*

2. *What procedures could the engagement team perform to develop its own expectation of the estimate?*

3. *Will developing an independent expectation be an effective approach for auditing the Company's allowance for doubtful accounts? Why or why not?*

Case Study No. 1 – The Security Company Scenario 3 *Questions*

You now ask the engagement team to consider auditing the estimate by using an approach of reviewing ***subsequent events and transactions****.*

Discussion questions:

1. *What procedures could the engagement team perform to audit the reserve through an evaluation of subsequent events information?*
2. *What information or data would be useful to the engagement team in performing its procedures?*
3. *Will reviewing subsequent events be an effective approach for auditing the Company's allowance for doubtful accounts? Why or why not?*

Case Study No. 1 – The Security Company
Relevant Auditing Standards

Consideration of Risk

AS 2501, *Auditing Accounting Estimates*, paragraph .05 indicates, in part:

The risk of material misstatement of accounting estimates normally varies with:

- the complexity and subjectivity associated with the process,
- the availability and reliability of relevant data,
- the number and significance of assumptions that are made, and
- the degree of uncertainty associated with the assumptions.

Case Study No. 1 – The Security Company Relevant Auditing Standards

Management Bias

AS 2501, paragraph .04 states, in part:

> Even when management's estimation process involves competent personnel using relevant and reliable data, there is **potential for bias** in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of **professional skepticism**, both the subjective and objective factors.

AS 2810, *Evaluating Audit Results*, paragraph .27 states, in part:

> *Evaluating Bias in Accounting Estimates.* The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a **possible bias** on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase earnings or loss, the auditor should evaluate whether these circumstances indicate **potential management bias** in the estimates.

Case Study No. 1 – The Security Company Relevant Auditing Standards

Testing Management's Process

AS 2501, paragraph .11 states, in part:

Review and test management's process. The following are procedures the auditor may consider performing when using this approach:

- Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
- Consider whether there are additional key factors or alternative assumptions about the factors.
- Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.

Case Study No. 1 – The Security Company
Relevant Auditing Standards

Developing an Independent Expectation

AS 2501, paragraph .12 states:

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

Case Study No. 1 – The Security Company Relevant Auditing Standards

Reviewing Subsequent Events or Transactions

AS 2501, paragraph .13 states:

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

Question A

PCAOB Rule 3400T(b) requires registered firms to comply with the quality control standards described in section 1000.08(o) of the AICPA SEC Practice Section Reference Manual, which in turn requires that a firm have policies and procedures in place to comply with Appendix L, section 1000.46 of that manual. Appendix L requires registered firms to maintain a Restricted Entity List, which shall include:

A. any individuals with whom firm personnel should not associate
B. any companies that would not qualify for client acceptance
C. all audit clients of the firm that are SEC registrants
D. other entities that the firm is required to be independent of under SEC requirements
E. C and D above

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Questions

Break

(15 minutes)

Introduction to ASC 606 and ASC 842

PCAOB Forum on Auditing in the Small Business Environment
May 19, 2017

Ruth Uejio
Professional Accounting Fellow
Office of the Chief Accountant

Disclaimer

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Agenda

1. Objective of the New Revenue Standard
2. Overview of the New Revenue Standard
3. Key Takeaways of the New Leases Standard
4. Overview of the New Leases Standard
5. Appendix – Resources

Objective of New Revenue Standard

- Provide comprehensive framework for addressing revenue recognition issues
- Increase comparability among entities, industries, jurisdictions, and capital markets
- Simplify preparation by reducing complexity and volume of guidance
- Enhance disclosures about revenue-generating activities

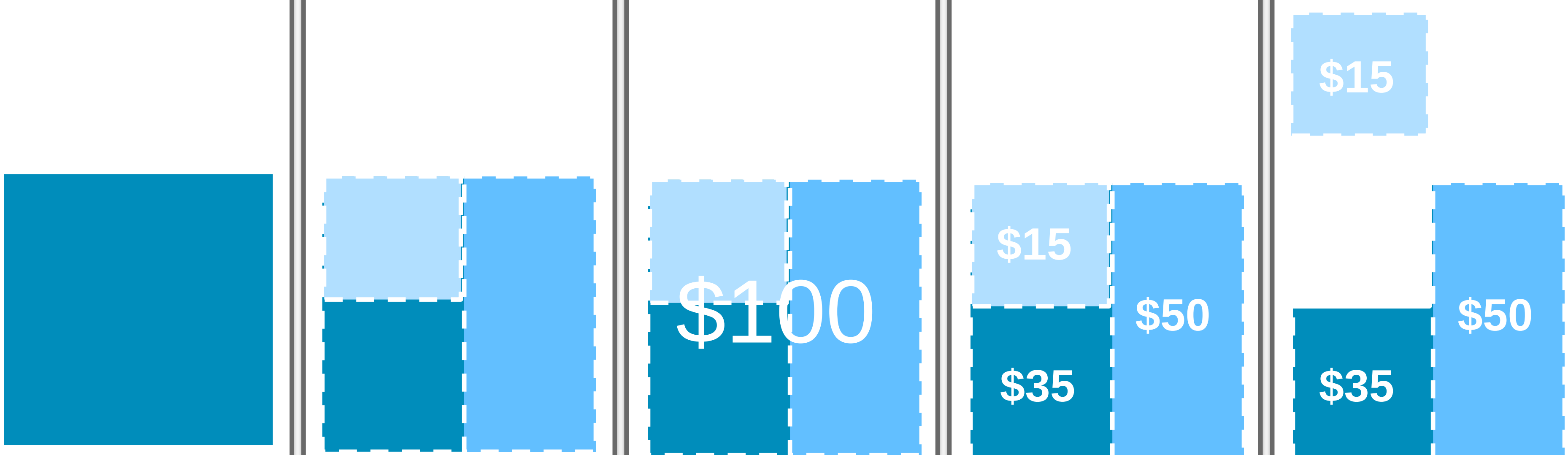
ASC 606 and IFRS 15 are largely converged but not identical; may result in different conclusions.

Training Outline

1. Objective of the Revenue Standard
2. Overview of the New Revenue Standard
3. Key Takeaways of the Leases Standard
4. Overview of the New Leases Standard
5. Appendix - Resources

Overview of Standard – 5 Steps

Step 1: Identify the contract with a customer	Step 2: Identify the performance obligations in the contract	Step 3: Determine the transaction price	Step 4: Allocate the transaction price to the performance obligations	Step 5: Recognize revenue as each performance obligation is satisfied



Overview of Standard – 5 Steps

Step 1:
Identify the contract with a customer

Step 1: Identify the contract

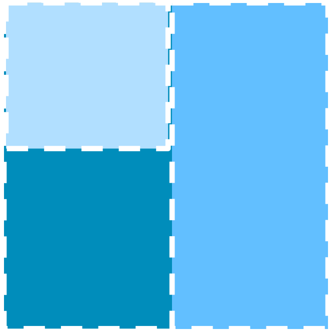
Step 1: Identify the contract with a customer

- Is it a contract with a customer within the scope of the standard?
- Certain contracts with customers outside the scope (e.g. Leases, Financial Instruments)
- Are the required criteria for a contract met?

Overview of Standard – 5 Steps

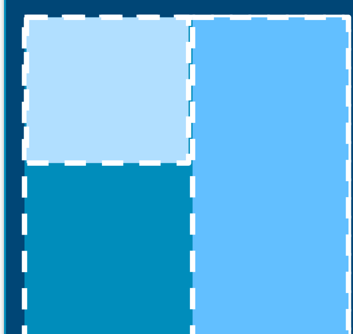
Step 1:
Identify the contract with a customer

Step 2:
Identify the performance obligations in the contract



Step 2: Identify Performance Obligations

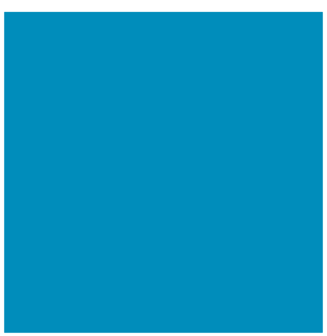
Step 2: Identify the performance obligations in the contract



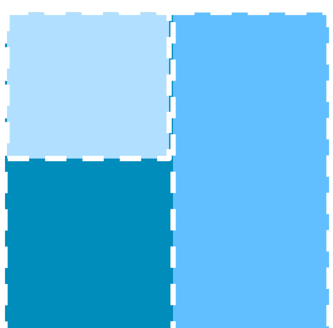
- Identify the goods or services promised to a customer
- Are goods and services distinct?

Overview of Standard – 5 Steps

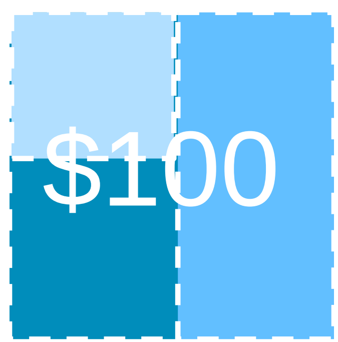
Step 1: Identify the contract with a customer



Step 2: Identify the performance obligations in the contract



Step 3: Determine the transaction price



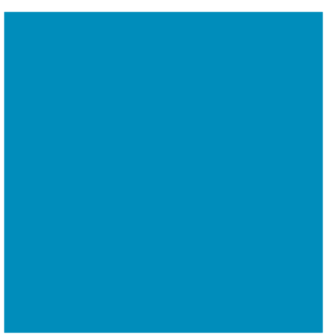
Step 3 – Determine Transaction Price

Step 3: Determine the transaction price

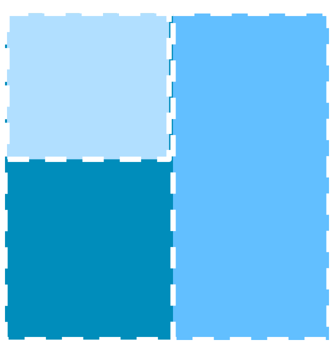
- Amount of consideration entity expects to be entitled to for goods/services
- Evaluation includes:
  - Variable consideration
  - Significant financing component
  - Noncash consideration
  - Consideration payable to the customer

Overview of Standard – 5 Steps

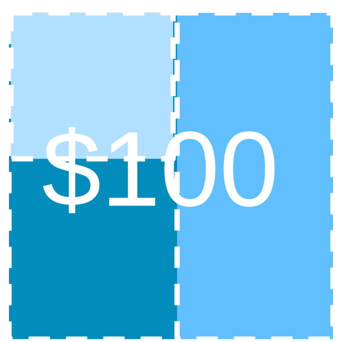
Step 1: Identify the contract with a customer



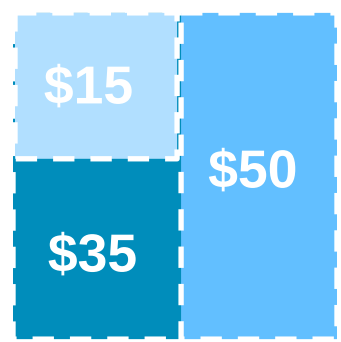
Step 2: Identify the performance obligations in the contract



Step 3: Determine the transaction price



Step 4: Allocate the transaction price to the performance obligations



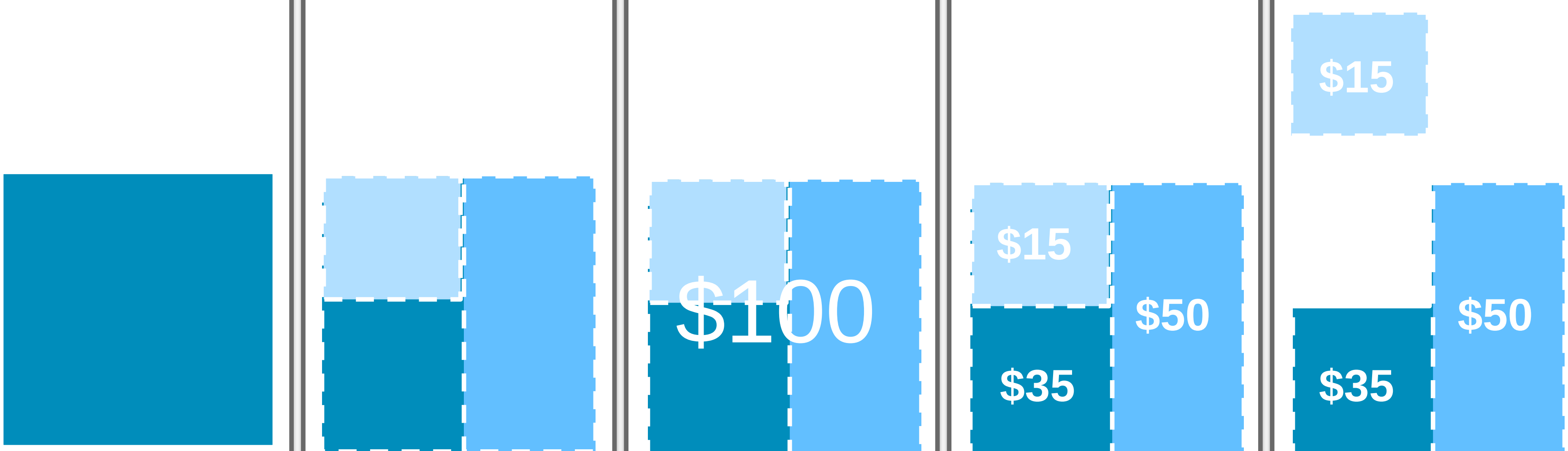
Step 4 – Allocate Transaction Price

Step 4: Allocate the transaction price to the performance obligations

- Allocation based on relative standalone selling prices
- Standalone selling price will need to be estimated if not directly observable

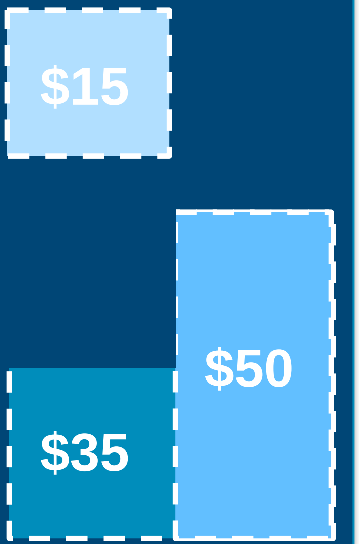
Overview of Standard – 5 Steps

Step 1: Identify the contract with a customer	Step 2: Identify the performance obligations in the contract	Step 3: Determine the transaction price	Step 4: Allocate the transaction price to the performance obligations	Step 5: Recognize revenue as each performance obligation is satisfied



Step 5 – Recognize Revenue

Step 5: Recognize revenue as each performance obligation is satisfied



- Performance obligation satisfied when customer obtains control of good or service
- Control model vs. risk and reward model

Expanded Principles-Based Disclosures

Contracts with Customers	• Disaggregation of revenue • Information about contract assets and contract liabilities • Description of performance obligations, including nature, timing of satisfaction and significant payment terms • Transaction price allocated to remaining performance obligations (and when amounts will be recognized)

Significant Judgments	• Description of significant judgments and changes in judgments about:
	  • When control is transferred
	  • Methods used to recognize revenue over time
	  • Methods, inputs and assumptions to determine and allocate the transaction price

Effective Date of the New Revenue Standard

- Public business entities – annual reporting periods beginning after December 15, 2017, and interim periods therein
- All other entities – annual reporting periods beginning after December 15, 2018 and interim periods beginning after December 15, 2019
- Early adoption is permitted for annual reporting periods beginning after December 15, 2016

Transition Methods

Transition method		PY2 (2016)	PY1 (2017)		CY (2018)	CY Footnotes
Full Retrospective*	Cumulative catch-up	Contracts under new standard				
Modified Retrospective*		Contracts under legacy standard		Cumulative catch-up	Existing and new contracts under new standard	Existing and new contracts under legacy standard for CY (2018)

* Optional practical expedients available

Slide source: FASB/IASB webcast.

Recent Consultation Topics

- Principal vs. agent
- Contract combination
- Identification of performance obligations
- Measure of progress
- Costs of performance obligation

Avenues for Consultations with OCA

- Pre-filing basis – requests from registrants
  - Guidance for resolving ‘pre-filing’ questions is posted on the SEC’s website
    - www.sec.gov/info/accountants/ocasubguidance.htm
- Post-filing basis
  - Division of Corporation Finance
  - Enforcement
  - PCAOB
  - Requests from registrants
- Informal consultations
  - Informal discussion with OCA staff members
    - Accountant-on-call: (202) 551-5300

Training Outline

1. Objective of the Revenue Standard
2. Overview of the New Revenue Standard
3. Key Takeaways of the Leases Standard
4. Overview of the New Leases Standard
5. Appendix - Resources

Key Takeaways of the New Leases Standard

- FASB's objective was to increase transparency and comparability
- Lessees
  - Most leases will be on balance sheet
  - Lease classification will drive expense profile (a difference with IFRS 16)
- Lessor model is largely unchanged
  - Changes due to alignment with Topic 606

ASC 842 and IFRS 16 are largely converged but there are some differences; will result in different conclusions.

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Overview of the Leases Standard

- Scope
- Identifying a lease
- Lessee accounting model
- Lessor accounting model
- Presentation requirements
- Effective date
- Transition

Scope of the New Leases Standard

- Topic 842 applies to leases of property, plant, or equipment
- Topic 842 does **not** apply to:
  - Leases of intangible assets
  - Leases to explore for or use nonregenerative resources
  - Leases of biological assets
  - Leases of inventory
  - Leases of assets under construction

Identifying a Lease

- Definition: A lease is a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration
  - Right to control
    - Right to obtain substantially all of the economic benefits from use of the identified asset
    - Right to direct the use of the identified asset
  - Identified asset
    - Explicit
    - Implicit

Lessee Accounting Model

- Most leases are recorded on balance sheet
- Initial measurement
  - Right of use ("ROU") asset = initial direct costs + prepaid lease payments + lease obligation – lease incentives
  - Lease liability = PV of lease payments not yet paid
- Subsequent measurement
  - ROU asset → depends on lease classification
    - Finance lease – front-loaded
    - Operating lease – generally straight line
  - Lease obligation → effective interest method

Lessor Accounting Model

- Existing lessor accounting retained with minimal changes
- Classification depends on an assessment of control of the underlying asset
  - Sales-type
  - Direct financing
  - Operating
- Interaction between Topic 606 and Topic 842
  - Alignment of new lessor guidance with the new revenue guidance

Lessor Accounting Model (con't.)

- Sales-type
  - Lessee gains control of the underlying asset
  - Underlying asset is derecognized and net investment in a lease is recognized
  - Selling profit/loss recognized at lease commencement
- Direct financing
  - Lessee does not obtain control of the underlying asset but the lessor loses control of the underlying asset
  - Underlying asset is derecognized and net investment in a lease is recognized
  - Profit is deferred and amortized into income over the lease term
- Operating
  - Lessor retains control of the underlying asset
  - Underlying asset remains on the lessor's balance sheet
  - Income is generally recognized on a straight line basis

Presentation Requirements

Lessee

	Balance Sheet	Income Statement	Cash Flow Statement
Financing Lease:	ROU asset Lease liability	Amortization Expense Interest Expense	Principal (Financing), Interest (Operating)
Operating Lease:	ROU asset Lease liability	Lease Expense (single line on SL basis)	Lease Payments (Operating)

Lessor

Balance Sheet	Income Statement	Cash Flow Statement
Presentation depends on lease classification	Profit or loss recognized in a manner consistent with business model	Cash Receipts (Operating)

Effective Date of the New Leases Standard

- Public business entities – fiscal years beginning after December 15, 2018, and interim periods therein
- All other entities – fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020
- Early adoption permitted

Transition of the New Leases Standard

- Must use modified retrospective method for all leases
- Recognize and measure leases at the beginning of the earliest period presented
- Optional practical expedients:
  - Identification & classification of leases that commenced before the effective date
  - Initial direct costs of leases that commenced before the effective date
  - Ability to use hindsight

FASB Post-Issuance Update

- Impairment
  - Prior asset group impairments on operating lease ROU asset measurement
  - Testing operating leases for impairment
- Head lease’s lease term in a sublease situation
- Sales-type leases with significant variable payments

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Appendix - Resources

Transition Resource Group (TRG) for Revenue Recognition

- Established by FASB and IASB to seek feedback on potential implementation issues
- Publishes memos discussing wide range of implementation issues
- TRG memos are not authoritative: http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176164066683
- Revenue Recognition Implementation Resources document: http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168954704

FASB Post-Issuance Update (Leases)

- November 30, 2016 – update to the FASB Board on leases inquiries received since the issuance of Topic 842:
  http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168680906

AICPA Industry Task Forces (Revenue)

- Aerospace and Defense
- Airlines
- Asset Management
- Broker-Dealers
- Construction Contractors
- Depository Institutions
- Gaming
- Health Care
- Hospitality
- Insurance
- Not-for-Profit
- Oil and Gas
- Power and Utility
- Software
- Telecommunications
- Timeshare

AICPA Task Force publications are not authoritative.

Transition Disclosures

SAB Topic 11.M (SAB 74)

- Describe the new standard and disclose date registrant plans to adopt,
- Identify the method of adoption,
- Discuss impact adoption is expected to have on financial statements (or disclose that impact is not known or not reasonably estimable), and
- Disclose impact of other significant matters that might result from adoption (i.e. debt covenant impact, changes in business practice).

Transition Disclosures (con't.)

Staff Announcement at 9/22/16 EITF Meeting

SEC Staff expect additional qualitative financial statement disclosures when impact is "unknown", including:

- Description of the effect of the accounting policies that registrant expects to apply, if determined,
- Comparison to the registrant's current accounting policies, and
- Description of status of implementation and significant matters yet to be addressed.

SEC Speeches

- Bloomberg BNA Conference; May 2017
  - https://www.sec.gov/news/speech/alicea-remarks-bloomburg-bna-conference-revenue-recognition-050817
- 13th Annual Life Sciences Accounting & Reporting Congress; March 2017
  - https://www.sec.gov/news/speech/bricker-remarks-annual-life-sciences-accounting-and-reporting-congress-032117
- 2016 AICPA Conference; December 2016
  - https://www.sec.gov/news/speech/alicea-2016-aicpa.html
- 35th Annual SEC and Financial Reporting Institute, June 2016
  - https://www.sec.gov/news/speech/bricker-remarks-35th-financial-reporting-institute-conference.html
- Baruch College Conference, May 2016
  - https://www.sec.gov/news/speech/speech-bricker-05-05-16.html
- Bloomberg BNA Conference; Sept. 2015
  - https://www.sec.gov/news/speech/wesley-bricker-remarks-bloomberg-bna-conf-revenue-recognition.html

Questions?

Inspections Overview

Todd Tosti
Associate Director
Division of Registration and Inspections

General Reports Related to the Inspection Process

- Issued “Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies” in February 2013
- Issued “Staff Inspection Brief” in July 2016 discussing scope and objectives of 2016 inspections
- Issued “Staff Inspection Brief” in April 2016 discussing the 2015 inspection findings
- Staff Q&A: Audits of Mainland China Issuers by Registered Firms Outside of Mainland China

Frequent Inspection Findings

Audit areas with frequent findings –

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

Likely Causes of Audit Deficiencies

Likely causes contributing to audit deficiencies identified –

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

Likely Cause Language

- Example report language **with** a likely cause discussion:

B.1.a. Proficiency in Auditing Convertible Debt

As discussed above, in one of the audits reviewed, the inspection team identified a significant deficiency related to the Firm's testing of convertible debt. Based on review of the work papers and discussions with the engagement personnel, it appeared to the inspection team that the deficiency was attributable, at least in part, to engagement personnel lacking an appropriate understanding of the accounting standards related to convertible debt instruments and embedded derivatives. This information provides cause for concern regarding the Firm's proficiency with respect to auditing convertible debt. [Issuer A]

Inspection Findings and Related Case Studies

- Auditing Accounting Estimates
- Auditing Revenue
- Auditing Related Party Transactions
- Substantive Analytical Procedures

PCAOB
Public Company Accounting Oversight Board

Auditing Revenue

Inspection Findings and Case Study

Todd Tosti
Associate Director
Division of Registration and Inspections

Lillian Ceynowa
Associate Chief Auditor

Auditing Revenue Inspection Findings

Failure to perform sufficient procedures to:

- assess risks related to revenue
- test whether revenue was recognized in appropriate period
- read and evaluate contract terms
- determine appropriate sample sizes and select revenue transactions to test
- support the level of reliance placed on controls
- perform adequate substantive analytical procedures

Case Study No. 2 – The Auto Parts Company

Case Study No. 2 – The Auto Parts Company Background

Your firm has recently completed its audit of the December 31, 2017 financial statements of The Auto Parts Company (the “Company”).

The Company has been a client of your firm for several years.

<u>The following relates to the Company’s operations for 2017:</u>

- The Company manufactures automobile parts and sells its products exclusively to distributors.

Case Study No. 2 – The Auto Parts Company Background

The following relates to the Company's operations for 2017:

- Although title to the product is transferred upon shipment to the distributors, the Company often provides discounts and other concessions to the distributors, based, in part, on the amount and timing of the distributors' sales of the products to end users.
- The Company has disclosed that it recognizes revenue using a "sell-through" model, whereby the Company doesn't recognize revenue upon shipment to the distributor, but rather upon the distributor's sale to an end user.
- The Company utilizes reports provided by the distributors to determine the amount of product sold by distributors to end users.

Case Study No. 2 – The Auto Parts Company Background

- Now that the 2017 audit is completed, your firm has been engaged to audit the Company's annual financial statements and review the quarterly reports for 2018 as well.
- The lead audit partner from the 2017 engagement is rotating off of the engagement, and you will now be the new lead engagement partner for the 2018 engagement. You have not previously worked on any engagements related to this client.
- The audit manager and other members of the 2017 engagement team will continue to be on the audit engagement team for 2018.
- An audit of internal controls over financial reporting ("ICFR") is not required.

Case Study No. 2 – The Auto Parts Company
Scenario 1 *Background*

- *You've asked the audit senior to provide you with her assessment of risks related to auditing revenue of the Company.*
- *The senior recommends using the same risk assessment that was used for the 2017 audit, as there haven't been any significant changes to the Company's operations over the past year, and none are expected in 2018. That risk assessment is as follows:*

	Inherent Risk	Control Risk	Risk of Material Misstatement	Significant / Fraud Risk?
Existence or Occurrence (EO)	High	Low	High	✓
Completeness (CO)	High	Low	Low	
Valuation or Allocation (VA)	High	Low	High	✓
Rights and Obligations (RO)	Low	High	Low	
Presentation & Disclosure (PD)	Low	High	Low	

Case Study No. 2 – The Auto Parts Company
Scenario 1 *Background*

- *The senior explains her risk assessment is based on the following:*
  - *The higher risks are related to the Company's dependence on reports from the distributors.*
  - *Similar to last year, controls testing can be performed for the assertions with high inherent risk.*
- *Also, the CFO has informed you that the adoption of ASC 606 to account for revenue will impact the Company as follows for 2018:*
  - *Sales to distributors will now be recorded on a "sell-in" basis, rather than a "sell-through" basis.*

Case Study No. 2 – The Auto Parts Company
Scenario 1 *Questions*

	Inherent Risk	Control Risk	Risk of Material Misstatement	Significant / Fraud Risk?
Existence or Occurrence (EO)	High	Low	High	✓
Completeness (CO)	High	Low	Low	
Valuation or Allocation (VA)	High	Low	High	✓
Rights and Obligations (RO)	Low	High	Low	
Presentation & Disclosure (PD)	Low	High	Low	

Polling question:

Do you agree with the senior's proposed risk assessment?
What assertions do you believe should likely be the significant risks?

A. *EO and VA*
B. *EO, CO, and VA*
C. *EO, CO, VA, and PD*
D. *All assertions, based on the presumed fraud risk for revenue*

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Case Study No. 2 – The Auto Parts Company
Scenario 1 *Debrief*

- Companies should be disclosing the impact of recently issued accounting standards in accordance with:
  - ASC 250-10-S99-5 (which is from SAB Topic 11M, or SAB 74)
  - ASC 250-10-S99-6 (which is from ASU 2017-03)

Case Study No. 2 – The Auto Parts Company
Scenario 2 *Background*

- *After discussing the risk assessment with the audit manager and audit senior, you've all agreed that the risk assessment for inherent risks and significant/fraud risks related to revenue should be:*

	Inherent Risk	Significant / Fraud Risk?
Existence or Occurrence (EO)	High	✓
Completeness (CO)	High	✓
Valuation or Allocation (VA)	High	✓
Rights and Obligations (RO)	Low	
Presentation & Disclosure (PD)	High	✓

- *You've now asked both the manager and senior to each provide you with a suggested set of audit procedures to audit revenue. Here's what each of them came up with…*

Case Study No. 2 – The Auto Parts Company Scenario 2 *Background*

Proposed Audit Approach #1	Proposed Audit Approach #2
Controls Testing: Test the Company's controls over obtaining and processing distributors' reports, including controls related to assessing that all distributor reports are received, are as of the balance sheet date, and have been properly reviewed and approved.	***Controls Testing:*** None.
Substantive Testing:	***Substantive Testing:***
Obtain the Company's detail report of revenue recorded and test a sample of transactions as follows: Using audit sampling, select a sample of distributors from the sales detail, and for each: (1) confirm ending inventory balances, (2) obtain a listing of all shipments from the Company to that distributor and select a sample of shipments to test, by examining P.O.s and shipping documents, (3) recalculate number of units sold as the difference between (1) and (2) above, (4) agree the unit sales price to the invoice or distribution agreement between the Company and distributor, (5) agree any discounts or other concessions to supporting documentation, (6) recalculate the revenue amount.	Obtain the Company's detail report of revenue recorded and test a sample of transactions as follows: Using audit sampling, select a sample of sales transactions, and for each: (1) vouch transaction to sales invoice and shipping documents of shipment to distributor, (2) vouch the sales price to the sales invoice, (3) evaluate collectability of the sale by examining subsequent cash collection or, if still uncollected, payment terms to assess whether the distributor is delinquent or may be negotiating a discount or other concession, and (4) test the Company's estimate of discounts or other concessions related to the transaction.
Perform testing of credit memos and debit memos issued throughout the year and subsequent to year end related to any adjustments for distributor sales.	Perform a retrospective review of actual discounts provided to distributors in connection with final cash collection vs the estimated discounts used to record revenue at the time of sale to the distributor.
	Perform sales cut-off testing for sales near year end.
Perform substantive analytical procedures.	Perform substantive analytical procedures.

Case Study No. 2 – The Auto Parts Company
Scenario 2 *Questions*

Polling question:

Which proposed set of audit procedures do you prefer?

A. *Proposal #1*

B. *Proposal #2*

C. *Either proposal, as both appear to adequately address the risks*

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Case Study No. 2 – The Auto Parts Company
Scenario 2 *Questions*

Polling question:

Which proposed set of audit procedures do you prefer?

A. *Proposal #1*

B. *Proposal #2*

C. *Either proposal, as both appear to adequately address the risks*

Discussion question:

What are your thoughts on the two proposed sets of audit procedures to audit revenue? Why did you choose the proposal that you chose?

Case Study No. 2 – The Auto Parts Company Relevant Auditing Standards

Risk Assessment

AS 2110, *Identifying and Assessing Risks of Material Misstatement*, paragraphs .68 and .70 state, in part:

> The auditor should presume that there is a **fraud risk** involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.
>
> To determine whether an identified and assessed risk is a **significant risk**, the auditor should evaluate whether the risk requires **special audit consideration** because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.
>
> Note: The determination of whether a risk of material misstatement is a significant risk is based on **inherent risk**, without regard to the effect of controls.

Case Study No. 2 – The Auto Parts Company Relevant Auditing Standards

Risk Assessment

AS 2110, paragraph .71 states:

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

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

b. Whether the risk is a fraud risk;

Note: A **fraud risk** is a **significant risk**.

c. Whether the risk is related to **recent significant economic, accounting, or other developments**;

d. The complexity of transactions;

e. Whether the risk involves significant transactions with related parties;

f. The degree of **complexity or judgment** in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

g. Whether the risk involves significant unusual transactions.

Case Study No. 2 – The Auto Parts Company Relevant Auditing Standards

Responding to Risks

AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, paragraphs .11 and .12 state, in part:

> For significant risks, the auditor should perform substantive procedures, including **tests of details**, that are **specifically responsive** to the assessed risks.
>
> The audit procedures that are necessary to address the assessed **fraud risks** depend upon the types of risks and the relevant assertions that might be affected.

Case Study No. 2 – The Auto Parts Company Relevant Auditing Standards

Responding to Risks

AS 2301, paragraph .05 states, in part:

The auditor should design and implement overall **responses** to address the assessed risks of material misstatement as follows:

...

c. Incorporating elements of **unpredictability** in the selection of audit procedures to be performed.

d. Evaluating the company's selection and **application of significant accounting principles**. The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions, are indicative of bias that could lead to material misstatement of the financial statements.

Case Study No. 2 – The Auto Parts Company Relevant Auditing Standards

Responding to Risks

AS 2301, paragraph .07 states, in part:

> Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly **fraud risks**, should involve the application of **professional skepticism** in gathering and evaluating audit evidence. Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters.

Case Study No. 2 – The Auto Parts Company
Relevant Auditing Standards

Auditing Estimates

AS 2501, *Auditing Accounting Estimates*, paragraph .09 states, in part:

In evaluating the **reasonableness of an estimate**, the auditor normally concentrates on key factors and assumptions that are —

a. Significant to the accounting estimate.
b. Sensitive to variations.
c. Deviations from historical patterns.
d. Subjective and susceptible to misstatement and bias.

The auditor normally should consider the **historical experience** of the entity in making past estimates as well as the auditor's experience in the industry. However, changes in facts, circumstances, or entity's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.

Case Study No. 2 – The Auto Parts Company Relevant Auditing Standards

Consideration of Fraud

AS 2401, *Consideration of Fraud in a Financial Statement Audit*, paragraph .64 states, in part:

> The auditor also should perform a **retrospective review** of **significant accounting estimates** reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management... With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates.

Question B

In connection with determining a sample size for a substantive test of details, paragraph .23 of AS 2315, *Audit Sampling*, indicates that the auditor should take into account the allowance risk of incorrect acceptance, the characteristics of the population, and...

A. the company's control environment
B. tolerable misstatement for the population
C. the sample size used in the prior year audit
D. all of the above

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Question B

Debrief

AS 2315, paragraph .23 states:

> To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account **tolerable misstatement for the population**; **the allowable risk of incorrect acceptance** (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and **the characteristics of the population**, including the expected size and frequency of misstatements.

Questions

Lunch

(75 minutes)

Standard-setting Update

Lillian Ceynowa

Associate Chief Auditor

Agenda

- Key Aspects of the Standard-setting Process
- Standard-setting Projects
- Research Projects & Monitoring Activities
- Form AP
- Keeping Current with PCAOB Standards

Key Aspects of the Standard-setting Process

- Key Principles:
  - Use a multi-disciplinary approach
  - Define problem to solve early and keep it front and center throughout the process
  - Obtain input on incremental decision points throughout the process
  - Seek diverse perspectives throughout the process

Key Aspects of the Standard-setting Process

- Phases:
  - Phase I – Environmental Scan
  - Phase II – Research
  - Phase III – Proposal
  - Phase IV – Adoption
- Projects:
  - Research projects
  - Standard-setting projects

Standard-setting Projects

- The table below includes the projects on the March 31, 2017 standard-setting agenda:

Project	Current Stage
Auditor's Reporting Model	Drafting final standard and adopting release
Auditing Accounting Estimates, Including Fair Value Measurements	Drafting proposal
The Auditor's Use of the Work of Specialists	Drafting proposal
Supervision of Audits Involving Other Auditors	Determining next action
Going Concern	Outreach, monitoring, and research

Research Projects and Monitoring

- The table below includes the projects on the March 31, 2017 research agenda:

Project
Quality Control Standards, Including Assignment and Documentation of Firm Supervisory Responsibilities
Changes in the Use of Data and Technology in the Conduct of Audits
The Auditor's Role Regarding Other Information and Company Performance Measures, Including Non-GAAP Measures
Auditor's Consideration of Noncompliance with Laws and Regulations

- Monitoring activities are also conducted in other areas that could impact audits or PCAOB standards (e.g., financial reporting fraud, auditor independence, and new accounting standards)

Form AP

Firms are required to file Form AP with the PCAOB for public company audit reports issued on or after January 31, 2017:

- Engagement partner names started being disclosed on January 31, 2017.
- Information about other accounting firms that participated in the audit will be disclosed for audit reports issued on or after June 30, 2017. Disclosures will include:
  - The name, location, and extent of participation of each other accounting firm participating in the audit whose work constituted at least 5 percent of total audit hours; and
  - The number and aggregate extent of participation of all other accounting firms participating in the audit whose individual participation was less than 5 percent of total audit hours.

Form AP

- Form AP is required to be filed by:
  - The 35th day after the date the audit report is first included in a document filed with the SEC; *or*
  - The 10th day after the date the audit report is first included in a registration statement under the Securities Act filed with the SEC
- In addition to filing Form AP, auditors can choose to voluntarily provide the same disclosures in the auditor's report

Form AP – Guidance and Resources

- Form APs filed with the PCAOB are publicly available and searchable through AuditorSearch
- Staff guidance for Form AP Implementation (February 16, 2017): *Auditor Reporting of Certain Audit Participants and Related Voluntary Audit Report Disclosure*
- PCAOB Web Resource Page - https://pcaobus.org/Pages/form-ap-reporting-certain-audit-participants.aspx

Keeping Current with PCAOB Standards

- PCAOB Standards website – http://www.pcaobus.org/Standards/Pages/default.aspx
  - PCAOB standards and rules
  - Guidance
  - Standard-related activities
  - Standing Advisory Group
- Contact the Standards-Inquiry Line via the web form or at (202) 591-4395
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our website at: http://pcaobus.org/About/Pages/RSSFeeds.aspx

Questions

PCAOB
Public Company Accounting Oversight Board

Auditing Related Party Transactions

Inspection Findings and Case Study

R. Davis Taylor
Associate Director, Accountant
Division of Enforcement and Investigations

Lillian Ceynowa
Associate Chief Auditor

Auditing Related Party Transactions Inspection Findings

Failure to perform sufficient procedures to:

- Assess the identified risks of material misstatement associated with related party relationships and transactions, including whether the issuer had properly identified, accounted for, and disclosed its related party relationships and transactions
- Obtain an understanding of the nature and business purpose of transactions with related parties and to evaluate whether the accounting for those transactions reflect their economic substance
- Test for undisclosed related parties or undisclosed related party transactions
- Identify and address the omission or inadequacy of disclosure of related party transactions in the financial statements

Case Study No. 3 – Sporting Goods, Inc.

Case Study No. 3 – Sporting Goods, Inc. Background

- Your firm is auditing the financial statements of Sporting Goods, Inc. (the "Company") for the year ended December 31, 2016.
- The Company is a manufacturer of sporting equipment, and sells its product directly to retailers and distributors.
- Revenue increased by 10% from $60 million in 2015 to $66 million in 2016.
- The increase in revenue was consistent with loan covenant requirements of the Company's primary debt obligation.

Case Study No. 3 – Sporting Goods, Inc. Background

Per inquiry of the Company's CFO and controller by the audit manager of your firm's engagement team:

- There have been no changes to the Company's processes and policies regarding related party transactions in 2016, other than the CEO now approving all related party transactions.

- The following related party transactions exist for 2016:
  - Two companies owned by immediate family members of the Company's CEO provided marketing and advertising services for the Company.
  - The Company entered into a sales arrangement with a new distributor, Big Bob's Bats ("BBB"), which is owned by the Company's CEO.

Case Study No. 3 – Sporting Goods, Inc. Background

Per inquiry of the Company's CFO and controller by the audit manager of your firm's engagement team:

- Key terms and information related to the sales arrangement with BBB are as follows:
  - There are rights of return for any unsold products;
  - Payment terms are net 90 days, as compared to net 30 days for all other distributor customers of the Company;
  - All products sold to BBB were sold at prices that were 20% lower than those for other distributor customers of the Company;
  - Sales to BBB are initially shipped and held in a third-party warehouse located near the Company's inventory warehouses; and
  - Sales to BBB in 2016 accounted for approximately $3.5 million, or approximately 5% of the Company's total revenue for the year, and most of the products sold were delivered in the fourth quarter.

Case Study No. 3 – Sporting Goods, Inc.
Scenario 1 *Background*

- *You're the engagement partner for the audit.*
- *You're meeting with the engagement team to discuss planning, including risk assessment procedures for related party transactions.*
- *The audit senior manager informed you of his inquiries of the CFO and the controller and the information learned from those inquiries.*

Case Study No. 3 – Sporting Goods, Inc.
Scenario 1 *Questions*

Discussion questions:

1. *What are your thoughts on the information provided by the CFO and controller? Are there any red flags or additional factors that should be considered in your team's risk assessment?*

2. *In addition to the inquiries of the CFO and controller, are there any other risk assessment procedures that the engagement team should perform to obtain an understanding of the Company's relationships and transactions with related parties?*

Case Study No. 3 – Sporting Goods, Inc. Scenario 1 *Questions*

Polling question:

Should the engagement team identify and assess a risk of material misstatement related to the Company's related party transactions? If so, should it be assessed as a fraud risk or other significant risk?

A. ***No*** *– risk should not be assessed specifically for related party transactions*

B. ***Yes*** *– risk should be assessed, but* ***No*** *– it should not be a fraud/significant risk*

C. ***Yes*** *– risk should be assessed, and* ***Yes*** *– it should be a fraud risk*

D. ***Yes*** *– risk should be assessed, and* ***Yes*** *– it should be a significant risk (other than a fraud risk)*

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Case Study No. 3 – Sporting Goods, Inc.
Scenario 2 *Background*

- *The engagement team has determined that there's a significant risk associated with the accuracy and completeness of amounts reported as related party transactions with the two advertising and marketing companies owned by the CEO's immediate family members.*

- *To address that risk, the engagement team:*
  - *read the Company's professional services agreements with those two companies;*
  - *vouched a sample of transactions to the professional services invoices from those two companies; and*
  - *traced all of the invoices to evidence of payment.*

Case Study No. 3 – Sporting Goods, Inc. Scenario 2 *Background*

- *As a result of performing those procedures, the engagement team identified several payments made directly to the CEO for invoices described as “advance payments.”*
- *Upon further inquiry, the Company’s management informed the engagement team that these advance payments were for retainer fees and that this was a standard practice for the marketing and advertising industry.*
- *The services and payments were approved in accordance with the Company’s policies.*
- *The Company recorded the advance payments as a debit in accounts payable, and the amount of the payments equaled approximately 10 percent of the Company’s net income for the year.*

Case Study No. 3 – Sporting Goods, Inc. Scenario 2

Questions

Discussion questions:

1. *What other information or sources of information might be gathered by the engagement team to evaluate whether the Company has properly identified its related parties and relationships and transactions with related parties?*

2. *Do you believe the engagement team has performed sufficient procedures to address the advance payments to the CEO that were previously undisclosed to the Firm? Why or why not?*

3. *Should the firm consider whether or not the advance payments actually were loans made directly to CEO?*

Case Study No. 3 – Sporting Goods, Inc.
Scenario 2 *Debrief*

If the advances were actually loans made directly to the CEO, the auditor should consider whether the loans might be prohibited loans under Section 13(k) of the Securities Exchange Act of 1934 (the “Exchange Act”).

- In addition to AS 2410, *Related Parties*, the auditor should also consider:
  - Section 10A(b) of the Exchange Act
  - AS 2401, *Consideration of Fraud in a Financial Statement Audit*
  - AS 2405, *Illegal Acts by Clients*

Case Study No. 3 – Sporting Goods, Inc. Relevant Auditing Standards

Risk Assessment Procedures

AS 2410, *Related Parties*, paragraph .03 states, in part:

The auditor should perform procedures to **obtain an understanding** of the company's relationships and transactions with its related parties that might reasonably be expected to affect the **risks of material misstatement** of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110, *Identifying and Assessing Risks of Material Misstatement*. The procedures performed to obtain an understanding of the company's relationships and transactions with its related parties include:

a. Obtaining an understanding of the company's process (paragraph .04);

b. Performing inquiries (paragraphs .05–.07); and

c. Communicating with the audit engagement team and other auditors (paragraphs .08–.09).

Case Study No. 3 – Sporting Goods, Inc. Relevant Auditing Standards

Performing Inquiries

Paragraphs .05 – .07 of AS 2410 require the auditor to make inquiries regarding related parties and related party transactions of:

- **management** (paragraph .05);
- **the audit committee**, or its chair (paragraph .07); and
- **others**** with the company who are likely to have knowledge of related parties or related party transactions (paragraph .06).

** footnote 5 of AS 2410 states:

Examples of "others" within the company who may have such knowledge include: **personnel in a position to initiate, process, or record transactions** with related parties and those who **supervise or monitor** such personnel; **internal auditors**; **in-house legal counsel**; **the chief compliance/ethics officer** or person in equivalent position; and **the human resources director** or person in equivalent position.

Case Study No. 3 – Sporting Goods, Inc. Relevant Auditing Standards

Assessing and Responding to Risks

AS 2410, paragraphs .10 and .11 state, in part:

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

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

Case Study No. 3 – Sporting Goods, Inc. Relevant Auditing Standards

Responding to Risks

AS 2410, paragraphs .12 states, in part:

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

a. Read the underlying documentation and evaluate the terms and other information;

b. Determine whether the transaction has been authorized and approved;

c. Determine whether any exceptions to the company's established policies or procedures were granted;

d. Evaluate the financial capability of the related parties; and

e. Perform other procedures as necessary to address the identified and assessed risks of material misstatement.

Case Study No. 3 – Sporting Goods, Inc. Relevant Auditing Standards

AS 2410, paragraphs .14 and .15 state, in part:

Evaluating Whether the Company Has Properly Identified Related Parties and Transactions

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

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

Case Study No. 3 – Sporting Goods, Inc. Relevant Auditing Standards

AS 2410, paragraph .16 states, in part:

Evaluating Whether the Company Has Properly Identified Related Parties and Transactions

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

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

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

c. Promptly **communicate** to appropriate members of the engagement team and other auditors participating in the audit engagement relevant information;

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

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

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

Case Study No. 3 – Sporting Goods, Inc.
Relevant Auditing Standards

Appendix A of AS 2410 provides examples of:

Evaluating Whether the Company Has Properly Identified Related Parties and Transactions

- **Information** that may be gathered during the audit that could indicate that previously undisclosed related parties and related party transactions might exist (paragraph .A2), including, but not limited to:
  - Buying or selling goods or services at prices that differ significantly from prevailing market prices;
  - Sales transactions with unusual terms;
  - ....
- **Sources** of such information (paragraph .A3), including, but not limited to:
  - Periodic and current reports, proxy statements, and other relevant company filings with the SEC and other regulatory agencies;
  - Disclosures contained on the company's website;
  - ....

Question C

According to paragraph .07 of AS 1220, *Engagement Quality Review*, to maintain objectivity, the engagement quality reviewer should not:

A. make decisions on behalf of the engagement team
B. evaluate significant judgments made by the engagement team
C. assume any of the responsibilities of the engagement team
D. A and C above
E. A and B above

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Question C

Debrief

AS 1220, paragraph .07 states:

> To maintain objectivity, the engagement quality reviewer and others who assist the reviewer **should not make decisions on behalf of the engagement team** or **assume any of the responsibilities of the engagement team**. The engagement partner remains responsible for the engagement and its performance, notwithstanding the involvement of the engagement quality reviewer and others who assist the reviewer.

Questions

Break

(15 minutes)

Division of Enforcement and Investigations Update

R. Davis Taylor
Associate Director, Accountant
Division of Enforcement and Investigations

Division of Enforcement & Investigations

What do we do......

Investor Protection

Agenda

- Today we would like to discuss:
  - Program Statistics for 2016 & YTD 2017
  - Matters involving Interference in Board Processes
  - Independence Matters
  - Matters involving Audit Standards Violations
  - Engagement Quality Review Matters
  - Admissions in Settlements
  - Coordination with the SEC
  - Termination of Bars

Unless otherwise noted, in settled disciplinary proceedings, the firms and the associated persons neither admitted nor denied the Board's findings, except as to the Board's jurisdiction over them and the subject matter of the proceedings.

Program Statistics for 2016 & 2017

- The Board has imposed sanctions on auditors ranging from censures to monetary penalties and bars on association with registered firms in settled or public adjudicated disciplinary orders
  - For **2016**:
    - The Board issued 54 settled disciplinary orders
    - Sanctioned 30 registered firms and 44 associated persons in those proceedings, imposing a total of $9.3 million in monetary penalties
  - In **2017** (to March 31):
    - The Board issued 22 settled disciplinary orders
    - Sanctioned 16 registered firms and 16 associated persons in those proceedings, imposing a total of $1.3 million in monetary penalties
  - Six adjudicated orders were made public during 2016 and 2017

Program Statistics for 2016 & 2017

- The DEI continues to prioritize:
  - Large firm cases involving significant potential audit failures and risk to investors
  - Investigations involving a lack of professional skepticism
  - Audit matters related to the independence and integrity of the audit
  - Matters threatening or eroding the integrity of the Board's regulatory oversight processes
  - Investigations focusing on risks associated with cross border audits

Matters involving Interference in Board Processes

- Violations of PCAOB Rules 4006 and 5110, which govern registered firms and associated person's conduct with respect to a Board inspection or investigation
  - ZERO tolerance for failing to provide information or interference with these processes
- Failures to timely file PCAOB Form 3

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

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

Deloitte Touche Tohmatsu Auditores Independentes – December 5, 2016

- *Firm is a Brazilian affiliate firm of Deloitte Touche Tohmatsu Limited*
- First admissions in a settled order obtained from a global network firm
- Matter involved:
  - 14 now former partners and other audit personnel
  - Violations of AS 3, Rule 4006 and 5110, SEC Rule 10(b)(5)
  - Failure to obtain sufficient evidence prior to issuance of the Firm's audit opinion or issuance of false audit report
- Sanctions imposed
  - Firm: censure, limitation of activities, independence monitor, adoption of certain QC policies and procedures, $8 million monetary penalty
  - Associated Persons: censures, range of $20,000 monetary penalties, bar with right to reapply after 5 years, permanent bars

Galaz,Yamazaki, Ruiz Urquiza, S.C. – December 5, 2016

- *Galaz,Yamazaki, Ruiz Urquiza is a Mexican affiliate firm of Deloitte Touche Tohmatsu Limited*
- In December 2016, three individuals were sanctioned for
  - Participating in the deletion and improper alteration of archived audit documentation in advance of an internal practice review
  - Providing improperly altered work papers to Board staff during an inspection (Rule 4006)
- The firm was sanctioned for quality control violations associated with timely archiving working papers
- There were also significant audit violations by the individuals
- Sanctions included:
  - Firm: censure and a $750,000 monetary penalty
  - Associated Persons:
    - All received a censure
    - Two of the three received a bar with a right to reapply (after 2 or 5 years) and a monetary penalty (either $50,000 or $25,000)

Paul L. Ford, Jr. CPA – March 29, 2017

- Matter involves both Issuer and B/D audits:
  - Multiple AS 3 violations
    - Made, or directed, additions and alterations to work papers in 15 broker-dealer audits and one issuer audit after document completion date, and after learning of upcoming PCAOB inspection
  - Failure to cooperate with inspectors (Rule 4006)
    - Alterations were not disclosed to inspectors
- As a result:
  - Engagement partner
    - Censured and bar, with right to reapply after five years
    - Monetary penalty of $30,000

Kabani & Co. – Released March 10, 2017

- Significant efforts were made over a several week period to alter documents in the audit files of three issuers with the intent to deceive the PCAOB about the deficiencies in the Firm's audit work papers in a noticed inspection
- The SEC noted that respondents engaged in an egregious attempt to deceive PCAOB
- Violations included PCAOB Rule 4006 and AS No. 3
- Sanctions included:
  - Firm – permanent revocation
  - Kabani – permanent bar and $100,000 monetary penalty
  - Deutchman – bar, with a right to reapply after 2 years, and $35,000 monetary penalty
  - Khan – bar, with right to reapply after 18 months, and $20,000 monetary penalty
- Litigation was non-public as required by SOX for approximately 4 years and 8 months – firm allowed to continue auditing

Failures to Timely File PCAOB Form 3

- PCAOB Rules require firms to complete and file a special report on Form 3 to report any event specified in that form within 30 days of an event’s occurrence
- Information on violations or disciplinary proceeding helps the PCAOB staff identify possible audit quality issues
- Event examples include:
  - The institution of certain criminal or disciplinary proceedings against the firm or its partners
  - The conclusions of such criminal or disciplinary proceedings
- Seven firms have been sanctioned
  - All firms received a censure, and monetary penalty of either $10,000 or $15,000
  - Three firms were required to undertake remedial measures

Independence Matters

- Since December 2014, the Board has entered into settled orders with **32 firms** and certain associated persons for violations associated with maintaining the financial records or preparing financial statements of a **broker-dealer** audit client of the firm
- The Board has also entered into settled orders with **three firms** and certain associated persons for violations associated with maintaining the financial records or preparing financial statements of an **issuer** audit client of the firm
- Sanctions included:
  - **Firms**: censures, monetary penalties of $2,500 - $20,000, remedial measures, one year prohibitions on new clients
  - **Associated Persons**: censures, monetary penalties of $5,000-$10,000, bars with a right to reapply after one year

Independence Matters – Sanctionable Conduct

- For one or more of its audit clients, members of the audit firm
  - Prepared and filed Focus reports
  - Prepared all or a portion of the financial statements, including notes
  - Prepared draft statements with placeholders for dollar amounts
  - Obtained drafts, but made extensive changes
  - Directed or supervised professionals from another firm to prepare all or a portion of the financial statements that were the subject of the firm’s audit opinion
  - Maintained and prepared accounting records, including journal entries
  - Prepared tax provision
  - Provided valuation services

Independence Matters – Factors in Severity of Sanctions

- Range of Conduct
  - Audits of multiple issuers or broker-dealers over multiple years resulted in more severe sanctions
- Context of Conduct
  - More severe sanctions resulted from:
    - Specific awareness of independence rules
    - Continued conduct after specific notice of previous violations
  - Less severe sanctions when firms or associated person made changes with the intent to comply, but efforts fell short

Extraordinary Cooperation Credit

- Extraordinary cooperation is voluntary and timely action – beyond compliance with legal or regulatory obligations – that contributes to the mission of the Board
- Three types:
  - self-reporting
  - remedial or corrective action
  - substantial assistance to the Board's investigative processes or to other law enforcement authorities
- Examples
  - Certain non-sanctioned auditors with independence violations
  - Matter of Schild & Co. Inc. and David Schild, CPA
  - Matter of KAP Purwantono, Sungkoro & Surja

Extraordinary Cooperation Credit

- The Board has announced that two unnamed broker-dealer audit firms had prepared financial statements, but would not be sanctioned
  - The Board awarded credit for extraordinary cooperation based on the firms':
    - Timely and voluntary self-reporting to the PCAOB Tip Line
    - Timely, voluntary, and meaningful remedial actions, including, in one case, communicating the violation to the client and discussing the conduct and violation at an annual firm training session
- In Schild, et al., sanctions credit was given for the substantial assistance it provided the Division through timely and voluntarily providing information on independence and EQR violations
  - Disclosure that financial statements for an issuer had been prepared by Respondents
  - Disclosure that the Firm did not obtain concurring approval of issuance of an audit report before granting permission to use it

Matters involving Audit Standards Violations

- Wander Rodrigues Teles – March 20, 2017
- KAP Purwantono, Sungkoro & Surja – February 9, 2017
- Arshak Davtyan, Inc. and Arshak Davtyan, CPA – December 20, 2016
- Scrudato & Co. – December 20, 2016
- HJ & Associates, LLC – January 24, 2017

Wander Rodrigues Teles – March 20, 2017

- *Teles was a partner of the Brazilian affiliate firm of PricewaterhouseCoopers International Ltd.*
- Matter involves:
  - Failure to obtain sufficient evidence prior to issuance of an interoffice opinion for referred audit work on a U.S. -based issuer's Brazilian subsidiaries
  - On two successive audits, the lead partner in Brazil:
    - failed to adequately follow-up on evidence that a subsidiary was re-aging its receivables; and
    - treated trade promotions as a normal risk area, despite substantial customer disputes over trade promotions
- As a result:
  - Lead partner on referred work received censure, $10,000 penalty, and a bar with right to reapply after 2 years

KAP Purwantono, Sungkoro & Surja – February 9, 2017

- *KAP Purwantono, Sungkoro & Surja is an Indonesian affiliate firm of Ernst & Young Global Limited*
- Matter involves:
  - Failure to obtain sufficient evidence prior to issuance of the Firm’s audit opinion
  - Also violations of AS 3, PCAOB Rules 4006 and 5110
- As a result
  - Firm received censure and $1 million penalty
  - Engagement Partner received censure, $20,000 penalty, bar with right to reapply after 5 years
  - Asia-Pacific Area Prof. Practice Director (a U.S. seconded partner) received censure, $10,000 monetary penalty, 1 year limitation on activities

Arshak Davtyan, Inc. and Arshak Davtyan, CPA – December 20, 2016

- Matter involves
  - Two audits on one issuer (China based)
  - Significant audit violations
    - Failed to exercise due care and professional skepticism
      - Failed to evaluate whether revenue recognition conformed with GAAP even through fraud risk was identified
      - Failed to evaluate the reasonableness of reserve percentages used in the allowance for doubtful accounts
- Firm sanctions: censure, 2 year revocation
- Engagement partner sanctions: censure, bar with right to reapply after 2 years

Scrudato & Co. – December 20, 2016

- Matter involves
  - Seven audits on five issuers
  - Significant audit violations
    - Failed to obtain sufficient appropriate audit evidence on significant accounts (*e.g.*, revenue, fixed assets, oil and gas properties)
    - Inappropriate reliance on specialist (*e.g.,* failed to understand methods/ assumptions used by specialist)
    - Failed to perform a re-audit of prior year financial statements on certain issuers
- Firm sanctions: censure, 2 year revocation, $15,000 monetary penalty
- Engagement partner sanctions: censure, bar with right to reapply after 2 years

HJ & Associates, LLC – January 24, 2017

- Matter involves
  - Significant audit failures on both financial statement and ICFR audits
    - In the financial statement audits, failed to use professional skepticism and to obtain sufficient audit evidence in connection with various significant audit areas
    - In the ICFR audit, failed to consider the financial statement audit results in its evaluation
  - Violations of AS 7
    - For all audits cited, the EQR failed to exercise due care
- Engagement partner sanctions: censure, bar with right to reapply after 3 years, and $10,000 monetary penalty
- EQR sanctions: censure and 1 year suspension

Engagement Quality Review Matters – June 14, 2016 Settlements

- In June 2016, the Board settled disciplinary orders against eight firms and eight associated persons for conduct substantially relating to violations of EQR requirements (AS No. 7)
  - EQRs are required for issuer audits and interim reviews, broker-dealer audits, **and** examinations/reviews of broker-dealer compliance/exemption reports
- Each of the firms violated one of two requirements
  - <u>3 firms</u> – No concurring approval of an EQR was obtained prior to granting permission to the client to use the firm's audit report
  - <u>1 firm</u> – Engagement quality reviewer had not satisfied the experience requirement

Engagement Quality Review Matters – June 14, 2016 Settlements

- With respect to sanctions, the firms fell into one of two groups
  - **Multiple violations** resulted in censure, revocation, $5,000 – $10,000 monetary penalty
  - **Attempting to comply** resulted in censure, $2,500 monetary penalty, remedial actions
- Each associated person was sanctioned with censure
  - Where misconduct was more severe, a bar with right to reapply after one or two years
- Three of the four cases also included other audit standard or regulation violations

Engagement Quality Review Matters – *David Lee Hillary, Jr., et al.*

- On December 13, 2016, Board sanctioned a firm and its managing partner for failing to obtain an EQR prior to issuing the audit opinion for 24 audits
  - For three of these audits, the Firm failed to obtain an EQR despite being on notice of the requirement from PCAOB inspectors
- Firm was censured and its registration was revoked
- Managing Partner was censured and was permanently barred
- One of the audits also included significant audit standard violations

Admissions in Settlements

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

Settled Cases with Admissions

- Through March 2017, the Division has 16 settled disciplinary orders that include admissions
  - Ten of the settled orders included admissions by associated persons
  - Six of the settled orders included admissions by the involved firms
- The 16 matters involved some combination of
  - Significant audit violations, on multiple audits
  - Audits of issuers and broker-dealers
  - Instances of noncooperation
  - Failures to perform an EQR

Coordination with the SEC

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

Terminations of Bars

- PCAOB Rule 5302(b) governs petitions to terminate a bar
  - Specific items outlined in the PCAOB Rules 5302(b)(2), 5302(b)(3), and 5302(b)(4) must be addressed for the Board to consider a petitioners request
- In 2016, one individual petitioned the Board

PCAOB Center for Enforcement Tips, Complaints and Other Information

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

PCAOB
Public Company Accounting Oversight Board

Questions

Substantive Analytical Procedures

Inspection Findings and Case Study

Todd Tosti
Associate Director
Division of Registration and Inspections

Lillian Ceynowa
Associate Chief Auditor

Substantive Analytical Procedures Inspection Findings

Failure to perform sufficient procedures to:

- Develop expectations at a sufficient level of precision to provide assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for investigation
- Establish a threshold for the evaluation of significant differences
- Evaluate whether there were significant, unexpected differences requiring further investigation, and investigate those differences
- Obtain corroboration of management's explanations for significant unexpected differences
- Test the accuracy and completeness of the underlying information used in the analytical procedures

Substantive Analytical Procedures

Case Study No. 4 – Premium Petrol, Inc.

Case Study No. 4 – Premium Petrol, Inc.
Background

- Your firm is auditing the financial statements of Premium Petrol, Inc. (the "Company") for the year ended December 31, 2016.
- The Company owns and operates 10 gas stations that are located in northwestern states. Two of the gas stations are new in 2016, as both of them opened in September 2016.
- The Company recognizes revenue from each gas station from:
  - The sale of gasoline
  - The sale of groceries and merchandise through convenience stores located at the stations
  - Car wash sales from the car wash machines at the stations

Case Study No. 4 – Premium Petrol, Inc. Background

- The corporate headquarters receives daily reporting from each station that breaks down the station's sales for the day by category, such as:
  - diesel, regular unleaded, etc. for the gasoline sales
  - snacks, drinks, etc. for the convenience store sales
  - basic car wash, deluxe car wash, etc. for the car was sales
- Your Firm's engagement team has identified a significant risk related to certain revenue assertions and has performed tests of details to address that risk. The engagement team is also performing substantive analytical procedures, which serve to reduce the extent of tests of details and to address those assertions that were not significant risks and were not subjected to tests of details.

Case Study No. 4 – Premium Petrol, Inc. Background

The engagement team has also documented the following in its planning section:

- There were no significant events or changes from the prior year, except for the opening of the two new gas stations (stations # 9 and # 10)
- Management explained that sales have remained relatively consistent year over year (for stations # 1 through # 8)
- Industry and economic factors remained virtually the same year over year
- The Company has provided the engagement team with data for total sales and cost of goods sold
- Materiality for the audit has been established at $150,000

Case Study No. 4 – Premium Petrol, Inc. Background

The engagement team has performed and documented the following substantive analytical procedures by comparing the gross profit margin for each of the three product lines on a year-over-year basis, using an issuer-prepared profit margin analysis report, and by inquiring of Company management regarding certain differences between the expected gross profit margin and the recorded gross profit margin.

		Current Year Sales ($)	Current Year Cost of Sales ($)	Current Year Profit Margin	Prior Year Profit Margin	% Change in Profit Margin	
Gasoline							
	Station # 1	$ 1,302,000	$ 1,172,000	9.98%	9.99%	-0.05%	
	Station # 2	$ 1,281,000	$ 1,162,000	9.29%	9.50%	-2.21%	
	Station # 3	$ 1,357,000	$ 1,268,000	6.56%	6.69%	-1.96%	
	Station # 4	$ 1,265,000	$ 1,150,000	9.09%	8.98%	1.24%	
	Station # 5	$ 1,275,000	$ 1,157,000	9.25%	9.49%	-2.48%	
	Station # 6	$ 1,300,100	$ 1,192,000	8.31%	8.21%	1.28%	
	Station # 7	$ 1,294,000	$ 1,232,000	4.79%	9.10%	-47.35%	
	Station # 8	$ 1,273,000	$ 1,162,000	8.72%	8.93%	-2.36%	
	Station # 9	$ 339,000	$ 306,000	9.73%	N/A	N/A	
	Station # 10	$ 252,000	$ 229,000	9.13%	N/A	N/A	
		$ 10,938,100	$ 10,030,000	8.30%	8.86%	-6.30%	B
Convenience Store							
	Station # 1	$ 109,000	$ 76,000	30.28%	30.14%	0.45%	
	Station # 2	$ 105,000	$ 68,500	34.76%	34.02%	2.18%	
	Station # 3	$ 100,000	$ 68,000	32.00%	31.89%	0.34%	
	Station # 4	$ 106,000	$ 71,000	33.02%	32.09%	2.89%	
	Station # 5	$ 98,000	$ 62,500	36.22%	35.50%	2.04%	
	Station # 6	$ 91,000	$ 77,000	15.38%	29.75%	-48.29%	
	Station # 7	$ 90,000	$ 63,000	30.00%	29.21%	2.70%	
	Station # 8	$ 111,000	$ 72,000	35.14%	34.15%	2.88%	
	Station # 9	$ 21,000	$ 15,000	28.57%	N/A	N/A	
	Station # 10	$ 20,000	$ 13,000	35.00%	N/A	N/A	
		$ 851,000	$ 586,000	31.14%	32.09%	-2.96%	A
Car wash							
	Station # 1	$ 27,000	$ 8,000	70.37%	70.67%	-0.42%	
	Station # 2	$ 30,000	$ 8,500	71.67%	70.98%	0.97%	
	Station # 3	$ 24,000	$ 6,900	71.25%	70.65%	0.85%	
	Station # 4	$ 32,000	$ 9,600	70.00%	70.09%	-0.13%	
	Station # 5	$ 22,000	$ 6,300	71.36%	71.56%	-0.27%	
	Station # 6	$ 20,000	$ 6,100	69.50%	69.24%	0.38%	
	Station # 7	$ 22,000	$ 6,800	69.09%	70.25%	-1.65%	
	Station # 8	$ 24,000	$ 7,000	70.83%	70.10%	1.05%	
	Station # 9	$ 8,000	$ 2,300	71.25%	N/A	N/A	
	Station # 10	$ 10,000	$ 3,000	70.00%	N/A	N/A	
		$ 219,000	$ 64,500	70.55%	70.44%	0.15%	A
		$ 12,008,100	$ 10,680,500	11.06%			

Case Study No. 4 – Premium Petrol, Inc. Background

The team also documented the following in its substantive analytical work paper:

Scope: The Firm has performed analytical procedures over gross profit margin by product line rather than sales by product line, since the Company's new service stations just started operations in September 2016, and therefore the total gross sales would not be comparable for the two years.

Expectation: Per our inquiry of the VP of Sales and Marketing, he indicated that (1) the overall profit margin was expected to be 12% – 15%, but due to competition, it would be lower; (2) over 90% of total revenue has been from gasoline sales, which management tried to maintain at a profit margin of about 10%; and (3) for convenience store sales, profit margin would be about 30% – 35%.

The engagement team expects the following:

- Gasoline: profit margin ~ 8% – 11%
- Convenience Stores: profit margin ~ 32%
- Car Wash: profit margin less than 75%

Case Study No. 4 – Premium Petrol, Inc. Background

The team also documented the following in its substantive analytical work paper:

Note: Total revenue and cost of sales amounts were agreed to the general ledger without exception. Prior year %'s were agreed to prior year work papers without exception. All other %'s were recalculated without exception, and all totals and subtotals were footed without exception.

Tickmarks:

A – Actual results met the engagement team's expectations, and the engagement team will not perform further analysis.

B – Total gross profit for fiscal 2016 decreased primarily due to a decrease in the average retail price of a gallon of gas, offset by an increase in the number of gallons sold.

Case Study No. 4 – Premium Petrol, Inc.
Scenario 1 *Questions*

You are the engagement partner for the audit and are reviewing the engagement team's procedures related to auditing revenue.

Discussion questions:

- *What are your thoughts on the substantive analytical procedures performed? Is there anything about them that would raise concern for you?*

Case Study No. 4 – Premium Petrol, Inc. Scenario 2 *Background*

After receiving your review notes related to the substantive analytical procedures, the engagement team has performed additional procedures. In particular, the engagement team revised its analytical procedures as follows –

The engagement team changed its tickmarks on the work paper as follows:

		Current Year Sales ($)	Current Year Cost of Sales ($)	Current Year Profit Margin	Prior Year Profit Margin	% Change in Profit Margin
Gasoline						
	Station # 1	$ 1,302,000	$ 1,172,000	9.98%	9.99%	-0.05%
	Station # 2	$ 1,281,000	$ 1,162,000	9.29%	9.50%	-2.21%
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	Station # 9	$ 339,000	$ 306,000	9.73%	N/A	N/A
	Station # 10	$ 252,000	$ 229,000	9.13%	N/A	N/A
		$ 10,938,100	$ 10,030,000	8.30%	8.86%	-6.30%
Convenience Store						
	Station # 1	$ 109,000	$ 76,000	30.28%	30.14%	0.45%
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	Station # 9	$ 21,000	$ 15,000	28.57%	N/A	N/A
	Station # 10	$ 20,000	$ 13,000	35.00%	N/A	N/A
		$ 851,000	$ 586,000	31.14%	32.09%	-2.96%
Car wash						
	Station # 1	$ 27,000	$ 8,000	70.37%	70.67%	-0.42%
	Station # 2	$ 30,000	$ 8,500	71.67%	70.98%	0.97%
	Station # 3	$ 24,000	$ 6,900	71.25%	70.65%	0.85%
	Station # 4	$ 32,000	$ 9,600	70.00%	70.09%	-0.13%
	Station # 5	$ 22,000	$ 6,300	71.36%	71.56%	-0.27%
	Station # 6	$ 20,000	$ 6,100	69.50%	69.24%	0.38%
	Station # 7	$ 22,000	$ 6,800	69.09%	70.25%	-1.65%
	Station # 8	$ 24,000	$ 7,000	70.83%	70.10%	1.05%
	Station # 9	$ 8,000	$ 2,300	71.25%	N/A	N/A
	Station # 10	$ 10,000	$ 3,000	70.00%	N/A	N/A
		$ 219,000	$ 64,500	70.55%	70.44%	0.15%
		$ 12,008,100	$ 10,680,500	11.06%		

Case Study No. 4 – Premium Petrol, Inc.
Scenario 2 *Background*

Revised documentation in the substantive analytical work paper included:

Expectation: The engagement team developed its expectation of gross profit margin based on prior-year audited amounts (gross profit margin), taking into consideration the engagement team's knowledge of the Company and its industry. Specifically, over the past three years, the Company has predominantly experienced gross margins on individual station and product line levels that have not fluctuated by more than 3.0% from year to year. We are also aware that fluctuations within that range are consistent for other petroleum companies in the same geographic region as the Company over the past several years. Based on that, the engagement team expects the gross margin percentage for each product line of each station to fluctuate by no more than 3.0% from the prior year's gross margin percentage, and we will investigate gross margin percentages that fluctuate by more than 3.0%.

Case Study No. 4 – Premium Petrol, Inc. Scenario 2 *Background*

Revised documentation in the substantive analytical work paper included:

Note: The engagement team will exclude stations # 9 and # 10 from the substantive analytical procedures, due to lack of comparability, and the engagement team will instead perform tests of details for those stations. Refer to tests of details at work paper [___].

Note: The amounts in the work paper were obtained from the issuer's profit margin analysis report, for which the engagement team has performed tests of the completeness and accuracy at work paper [___].

Case Study No. 4 – Premium Petrol, Inc.
Scenario 2 *Background*

Revised documentation in the substantive analytical work paper included:

Tickmarks: A – The gross margin for gasoline sales at station # 7 experienced a 47% decrease, which significantly exceeded the engagement team's expectation of a change within 3%. Per our inquiry with the accounting manager and controller, station #7 is located in a remote valley with limited highway access to the town, and there were significant mudslides throughout the autumn and winter months that caused fuel tank trucks to take detours that significantly increased the distance driven to reach the station and, in turn, significantly increased the shipping costs of incoming fuel. Station # 7 did not raise its prices to customers, in order to keep pace with competitors in the area, and as such, the gross margins for that station suffered during that time. The increased shipping costs resulted in approximately $57,000 of additional costs for that station in 2016. As corroboration for management's explanation, the engagement team examined a schedule prepared by the controller that showed shipping costs per gallon and total gallons of fuel received, in the months before and during the mudslides, and noted that the schedule supported management's $57,000 approximated amount for the impact. The engagement team also selected a sample of shipping transactions from that schedule and vouched them to corresponding shipping invoices and company disbursements. See testing done at work paper [___]. In addition, the engagement team examined several news articles that corroborated the company's explanation about mudslides in the area, road closures, and the months involved. The engagement team notes that if the $57,000 additional costs had not been incurred, the gross margin for gasoline sales for station # 7 would have changed by only 1%, which would be within our expectations. As such, the gross margin for station # 7's gasoline sales appears reasonable.

Case Study No. 4 – Premium Petrol, Inc.
Scenario 2 *Background*

Revised documentation in the substantive analytical work paper included:

Tickmarks: **B** – The gross margin for convenience store sales at station # 6 experienced a 48% decrease, which significantly exceeded the engagement team's expectation of a change within 3%. Per our inquiry with the accounting manager and controller, competition in this station's area increased significantly due to a new retail drugstore that opened in April 2016 and is located adjacent to the service station. In order to compete, the station's convenience store reduced its prices throughout the store. The price reductions resulted in approximately $18,000 of less revenue for the station's convenience store in 2016. As corroboration for management's explanation, the engagement team examined the controller's schedule that supported the $18,000 amount, which showed sales prices per unit before and after the new nearby retail drugstore opened. The engagement team vouched a sample of items from that schedule to supporting documentation. See testing done at work paper [___]. In addition, the engagement team verified that a new retail drug store did, in fact, open up adjacent to station # 6 in April 2016. The engagement team notes that if $18,000 of additional revenue had been earned, the gross margin for station # 6's convenience store would have changed by only 1%, which would be within our expectations. As such, the gross margin for station # 6's convenience store sales appears reasonable.

Case Study No. 4 – Premium Petrol, Inc.
Scenario 2 *Questions*

Discussion questions:

- *What are your thoughts on the* ***revised*** *substantive analytical procedures performed? Is there anything about them that would concern you?*

Case Study No. 4 – Premium Petrol, Inc.
Relevant Auditing Standards

Consideration of Risk

AS 2305, *Substantive Analytical Procedures*, paragraph .09 states, in part:

> For **significant risks** of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, paragraphs .11 and .13 state, in part:

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

> In the audit of financial statements, the auditor should perform substantive procedures, including **tests of details**, that are specifically responsive to the assessed **fraud risks**.

Case Study No. 4 – Premium Petrol, Inc.
Relevant Auditing Standards

Polling Question:

According to paragraph .11 of AS 2305, the expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things:

A. the nature of the assertion, and the plausibility and predictability of the relationship

B. the availability and reliability of the data used to develop the expectation, and the precision of the expectation

C. the nature and amount of misstatements recorded in previous periods

D. All of the above

E. A and B above

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Case Study No. 4 – Premium Petrol, Inc.
Relevant Auditing Standards

Reliability of Data

AS 2305, paragraph .16 states, in part:

Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the **completeness and accuracy** of the underlying information.

Case Study No. 4 – Premium Petrol, Inc. Relevant Auditing Standards

Developing Expectations

AS 2305, paragraphs .05 and .14 state, in part:

Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to **expectations developed by the auditor**. The auditor develops such expectations by identifying and using **plausible relationships** that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates.

As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation.

Case Study No. 4 – Premium Petrol, Inc.
Relevant Auditing Standards

Developing Expectations

AS 2305, paragraphs .17 and .19 state, in part:

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

Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. . . Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. **Disaggregation helps reduce this risk.**

Case Study No. 4 – Premium Petrol, Inc.
Relevant Auditing Standards

Investigating and Evaluating Significant Differences

AS 2305, paragraphs .20 and .21 state, in part:

In planning the analytical procedures as a substantive test, the auditor should **consider the amount of difference from the expectation that can be accepted without further investigation**. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures.

The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. **Management responses, however, should ordinarily be corroborated with other evidential matter.**

Question D

Paragraph .13 of AS 2810, *Evaluating Audit Results*, discusses misstatements related to accounting estimates. It indicates that if a range of reasonable estimates is supported by sufficient appropriate audit evidence and the recorded accounting estimate is outside of the range of reasonable estimates, the auditor should treat as a misstatement, the difference between the recorded accounting estimate and...

A. the closest reasonable estimate
B. the midpoint of the range of reasonable estimates
C. the smallest amount in the range of reasonable estimates
D. the largest amount in the range of reasonable estimates

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Questions

Q&A and Closing Remarks

Greg Scates