

**Report on**  
  
**2017 Inspection of Anton & Chia, LLP**  
**(Headquartered in Newport Beach, California)**

**Issued by the**  
  
**Public Company Accounting Oversight Board**  
  
**November 19, 2018**

**THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT**

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

## **2017 INSPECTION OF ANTON & CHIA, LLP**

### Preface

In 2017, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") conducted an inspection of the registered public accounting firm Anton & Chia, LLP ("the Firm") pursuant to the Sarbanes-Oxley Act of 2002 ("the Act").

Inspections are designed and performed to provide a basis for assessing the degree of compliance by a firm with applicable requirements related to auditing issuers. For a description of the procedures the Board's inspectors may perform to fulfill this responsibility, see Part I.C of this report (which also contains additional information concerning PCAOB inspections generally). The inspection included reviews of portions of selected issuer audits. These reviews were intended to identify whether deficiencies existed in the reviewed audit work, and whether such deficiencies indicated defects or potential defects in the Firm's system of quality control over audits. In addition, the inspection included a review of policies and procedures related to certain quality control processes of the Firm that could be expected to affect audit quality.

The Board is issuing this report in accordance with the requirements of the Act. The Board is releasing to the public Part I of the report and portions of Part IV of the report. Part IV of the report consists of the Firm's comments, if any, on a draft of the report. If the nonpublic portions of the report discuss criticisms of or potential defects in the Firm's system of quality control, those discussions also could eventually be made public, but only to the extent the Firm fails to address the criticisms to the Board's satisfaction within 12 months of the issuance of the report. Appendix A presents the text of the paragraphs of the auditing standards that are referenced in Part I.A in relation to the description of auditing deficiencies there.

*Note on this report's citations to auditing standards:* On March 31, 2015, the PCAOB adopted a reorganization of its auditing standards using a topical structure and a single, integrated numbering system. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015). The reorganization became effective December 31, 2016. Citations in this report reference the reorganized PCAOB auditing standards.

**PROFILE OF THE FIRM<sup>1</sup>**

Offices	2 (Newport Beach and Westlake Village, California)
Ownership structure	Limited liability partnership
Partners / professional staff <sup>2</sup>	2 / 10
Issuer audit clients	81
Lead partners on issuer audit work <sup>3</sup>	6

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<sup>1</sup> The information presented here is as understood by the inspection team, generally as of the outset of the inspection, based on the Firm's self-reporting and the inspection team's review of certain information. Additional information, including additional detail on audit reports issued by the Firm, is available in the Firm's filings with the Board, available at [http://pcaobus.org/Registration/rasr/Pages/RASR\\_Search.aspx](http://pcaobus.org/Registration/rasr/Pages/RASR_Search.aspx).

<sup>2</sup> The number of partners and professional staff is provided here as an indication of the size of the Firm, and does not necessarily represent the number of the Firm's professionals who participate in audits of issuers. The number of partners cited above represents the number of individuals with an ownership interest in the Firm.

<sup>3</sup> The number of lead partners on issuer audit work represents the total number of Firm personnel (not necessarily limited to personnel with an ownership interest) who had primary responsibility for an issuer audit (as defined in AS 1201, *Supervision of the Audit Engagement*) during the twelve-month period preceding the outset of the inspection.

## **PART I**

### **INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS**

Members of the Board's inspection staff ("the inspection team") conducted primary procedures for the inspection from November 27, 2017 to December 7, 2017.<sup>4</sup>

#### **A. Review of Audit Engagements**

The inspection procedures included reviews of portions of eight issuer audits performed by the Firm. The inspection team identified matters that it considered to be deficiencies in the performance of the work it reviewed. One of the deficiencies in Part I.A relates to auditing an aspect of an issuer's financial statements that the issuer restated after the primary inspection procedures.<sup>5</sup>

The descriptions of the deficiencies in Part I.A of this report include, at the end of the description of each deficiency, references to specific paragraphs of the auditing standards that relate to those deficiencies. The text of those paragraphs is set forth in Appendix A to this report. The references in this sub-Part include only the standards that most directly relate to the deficiencies and do not include all standards that apply to the deficiencies. Further, certain broadly applicable aspects of the auditing standards that may be relevant to a deficiency, such as provisions requiring due professional care, including the exercise of professional skepticism; the accumulation of sufficient appropriate audit evidence; and the performance of procedures that address risks, are not included in any references to the auditing standards in this sub-Part, unless the lack of compliance with these standards is the primary reason for the deficiency. These broadly applicable provisions are described in Part I.B of this report.

Certain deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion that the financial statements

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<sup>4</sup> For this purpose, "primary procedures" include field work, other review of audit work papers, and the evaluation of the Firm's quality control policies and procedures through review of documentation and interviews of Firm personnel. Primary procedures do not include (1) inspection planning, which is performed prior to primary procedures, and (2) inspection follow-up procedures, wrap-up, analysis of results, and the preparation of the inspection report, which extend beyond the primary procedures.

<sup>5</sup> The 2017 inspection did not include review of any additional audit work related to the restatement.

were presented fairly, in all material respects, in conformity with the applicable financial reporting framework. In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement.

The fact that one or more deficiencies in an audit reach this level of significance does not necessarily indicate that the financial statements are materially misstated. It is often not possible for the inspection team, based only on the information available from the auditor, to reach a conclusion on those points.

Whether or not associated with a disclosed financial reporting misstatement, an auditor's failure to obtain the reasonable assurance that the auditor is required to obtain is a serious matter. It is a failure to accomplish the essential purpose of the audit, and it means that, based on the audit work performed, the audit opinion should not have been issued.<sup>6</sup>

The audit deficiencies that reached this level of significance are described below—

A.1. Issuer A

- (1) the failure to perform sufficient procedures to test revenue, including the inadequate performance of substantive analytical procedures (AS 2301.08 and .13; AS 2305.16, 17, .20, and .21; AS 2810.30); and
- (2) the failure to perform sufficient procedures to evaluate whether goodwill was impaired (AS 2301.11; AS 2502.26, .28, and .31).

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<sup>6</sup> Inclusion in an inspection report does not mean that the deficiency remained unaddressed after the inspection team brought it to the Firm's attention. Depending upon the circumstances, compliance with PCAOB standards may require the Firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or reporting on internal control, or to take steps to prevent reliance on its previously expressed audit opinions. The Board expects that firms will comply with these standards, and an inspection may include a review of the adequacy of a firm's compliance with these requirements, either with respect to previously identified deficiencies or deficiencies identified during that inspection. Failure by a firm to take appropriate actions, or a firm's misrepresentations in responding to an inspection report, about whether it has taken such actions, could be a basis for Board disciplinary sanctions.

A.2. Issuer B

(1) the failure to perform sufficient procedures to test revenue (AS 2301.08 and .13; AS 2810.30); and

(2) the failure to perform sufficient procedures to test the valuation of inventory (AS 2301.08; AS 2501.04 and .07).

A.3. Issuer C

(1) the failure to perform sufficient procedures to test revenue, including the use of sampling with an inadequate sample size developed without consideration of relevant factors (AS 2301.08, .11, and .13; AS 2315.19, .23, and .23A); and

(2) the failure to perform sufficient procedures to test the valuation of inventory (AS 1105.27; AS 2301.08).

A.4. Issuer D

(1) the failure to perform sufficient procedures to test the existence, completeness, and valuation of accounts receivable and deferred revenue (AS 2301.08 and .13; AS 2310.34; AS 2501.11; AS 2810.30); and

(2) the failure to perform sufficient procedures to test convertible debt (AS 2301.08 and .11; AS 2810.30).

A.5. Issuer E

the failure to perform sufficient procedures to test the valuation of assets acquired in a business combination (AS 2301.11; AS 2502.03, .15, .26, .28, and .31; 2810.03).

A.6. Issuer F

the failure to perform sufficient procedures to test the allowance for doubtful accounts (AS 2301.08 and .13; 2501.12).

## B. Auditing Standards

Each deficiency described above could relate to several applicable provisions of the standards that govern the conduct of audits. The paragraphs of the standards that are cited for each deficiency are those that most directly relate to the deficiency. The deficiencies also relate, however, to other paragraphs of those standards and to other auditing standards, including those concerning due professional care, responses to risk assessments, and audit evidence.

Many audit deficiencies involve a lack of due professional care. Paragraphs .02, .05, and .06 of AS 1015, *Due Professional Care in the Performance of Work*, require the independent auditor to plan and perform his or her work with due professional care and set forth aspects of that requirement. AS 1015.07-.09 and paragraph .07 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, specify that due professional care requires the exercise of professional skepticism. These standards state that professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.

AS 2301.03, .05, and .08 require the auditor to design and implement audit responses that address the risks of material misstatement. Paragraph .04 of AS 1105, *Audit Evidence*, requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the audit opinion. Sufficiency is the measure of the quantity of audit evidence, and the quantity needed is affected by the risk of material misstatement (in the audit of financial statements) and the quality of the audit evidence obtained. The appropriateness of evidence is measured by its quality; to be appropriate, evidence must be both relevant and reliable in providing support for the related conclusions.

The paragraphs of the standards that are described immediately above are not cited in Part I.A, unless those paragraphs are the most directly related to the relevant deficiency.

### B.1. List of Specific Auditing Standards Referenced in Part I.A

The table below lists the specific auditing standards that are referenced in Part I.A of this report, cross-referenced to the issuer audits for which each standard is cited.

PCAOB Auditing Standards	Issuers
AS 1105, <i>Audit Evidence</i>	C

PCAOB Auditing Standards	Issuers
AS 2301, <i>The Auditor's Responses to the Risks of Material Misstatement</i>	A, B, C, D, E, and F
AS 2305, <i>Substantive Analytical Procedures</i>	A
AS 2310, <i>The Confirmation Process</i>	D
AS 2315, <i>Audit Sampling</i>	C
AS 2501, <i>Auditing Accounting Estimates</i>	B, D, and F
AS 2502, <i>Auditing Fair Value Measurements and Disclosures</i>	A and E
AS 2810, <i>Evaluating Audit Results</i>	A, B, D, and E

**C. Information Concerning PCAOB Inspections that is Generally Applicable to Triennially Inspected Firms**

A Board inspection includes a review of certain portions of selected audit work performed by the inspected firm and a review of certain aspects of the firm's quality control system. The inspections are designed to identify deficiencies in audit work and defects or potential defects in the firm's system of quality control related to the firm's audits. The focus on deficiencies, defects, and potential defects necessarily carries through to reports on inspections and, accordingly, Board inspection reports are not intended to serve as balanced report cards or overall rating tools. Further, the inclusion in an inspection report of certain deficiencies, defects, and potential defects should not be construed as an indication that the Board has made any determination about other aspects of the inspected firm's systems, policies, procedures, practices, or conduct not included within the report.

**C.1. Reviews of Audit Work**

Inspections include reviews of portions of selected audits of financial statements and, where applicable, audits of internal control over financial reporting ("ICFR"). For these audits, the inspection team selects certain portions of the audits for inspection, and it reviews the engagement team's work papers and interviews engagement personnel regarding those portions. If the inspection team identifies a potential issue

that it is unable to resolve through discussion with the firm and any review of additional work papers or other documentation, the inspection team ordinarily provides the firm with a written comment form on the matter and the firm is allowed the opportunity to provide a written response to the comment form. If the response does not resolve the inspection team's concerns, the matter is considered a deficiency and is evaluated for inclusion in the inspection report.

The inspection team selects the audits, and the specific portions of those audits, that it will review, and the inspected firm is not allowed an opportunity to limit or influence the selections. Audit deficiencies that the inspection team may identify include a firm's failure to identify, or to address appropriately, financial statement misstatements, including failures to comply with disclosure requirements,<sup>7</sup> as well as a firm's failure to perform, or to perform sufficiently, certain necessary audit procedures. An inspection may not involve the review of all of the firm's audits, nor is it designed to identify every deficiency in the reviewed audits. Accordingly, a Board inspection report should not be understood to provide any assurance that a firm's audit work, or the relevant issuers' financial statements or reporting on ICFR, are free of any deficiencies not specifically described in an inspection report.

In some cases, the conclusion that a firm did not perform a procedure may be based on the absence of documentation and the absence of persuasive other evidence, even if the firm claimed to have performed the procedure. AS 1215, *Audit Documentation*, provides that, in various circumstances including PCAOB inspections, a firm that has not adequately documented that it performed a procedure, obtained evidence, or reached an appropriate conclusion must demonstrate with persuasive other evidence that it did so, and that oral assertions and explanations alone do not constitute persuasive other evidence. In reaching its conclusions, an inspection team considers whether audit documentation or other evidence that a firm might provide to the inspection team supports the firm's contention that it performed a procedure, obtained evidence, or reached an appropriate conclusion. In the case of every matter

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<sup>7</sup> When it comes to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with the applicable financial reporting framework, the Board's practice is to report that information to the Securities and Exchange Commission ("SEC" or "the Commission"), which has jurisdiction to determine proper accounting in issuers' financial statements. Any description in this report of financial statement misstatements or failures to comply with SEC disclosure requirements should not be understood as an indication that the SEC has considered or made any determination regarding these issues unless otherwise expressly stated.

cited in the public portion of a final inspection report, the inspection team has carefully considered any contention by the firm that it did so but just did not document its work, and the inspection team has concluded that the available evidence does not support the contention that the firm sufficiently performed the necessary work.

Identified deficiencies in the audit work that exceed a significance threshold (which is described in Part I.A of the inspection report) are summarized in the public portion of the inspection report.<sup>8</sup>

The Board cautions against extrapolating from the results presented in the public portion of a report to broader conclusions about the frequency of deficiencies throughout the firm's practice. Individual audits and areas of inspection focus are most often selected on a risk-weighted basis and not randomly. Areas of focus vary among selected audits, but often involve audit work on the most difficult or inherently uncertain areas of financial statements. Thus, the audit work is generally selected for inspection based on factors that, in the inspection team's view, heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.

## C.2. Review of a Firm's Quality Control System

QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, provides that an auditing firm has a responsibility to ensure that its personnel comply with the applicable professional standards. This standard specifies that a firm's system of quality control should encompass the following elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of issuer audit engagements; (4) engagement performance; and (5) monitoring.

The inspection team's assessment of a firm's quality control system is derived both from the results of its procedures specifically focused on the firm's quality control policies and procedures, and also from inferences that can be drawn from deficiencies in the performance of individual audits. Audit deficiencies, whether alone or when aggregated, may indicate areas where a firm's system has failed to provide reasonable

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<sup>8</sup> The discussion in this report of any deficiency observed in a particular audit reflects information reported to the Board by the inspection team and does not reflect any determination by the Board as to whether the Firm has engaged in any conduct for which it could be sanctioned through the Board's disciplinary process. In addition, any references in this report to violations or potential violations of law, rules, or professional standards are not a result of an adversarial adjudicative process and do not constitute conclusive findings for purposes of imposing legal liability.

assurance of quality in the performance of audits. Even deficiencies that do not result in an insufficiently supported audit opinion may indicate a defect or potential defect in a firm's quality control system.<sup>9</sup> If identified deficiencies, when accumulated and evaluated, indicate defects or potential defects in the firm's system of quality control, the nonpublic portion of this report would include a discussion of those issues. When evaluating whether identified deficiencies in individual audits indicate a defect or potential defect in a firm's system of quality control, the inspection team considers the nature, significance, and frequency of deficiencies;<sup>10</sup> related firm methodology, guidance, and practices; and possible root causes.

Inspections also include a review of certain of the firm's practices, policies, and processes related to audit quality, which constitute a part of the firm's quality control system. This review addresses practices, policies, and procedures concerning audit performance, training, compliance with independence standards, client acceptance and retention, and the establishment of policies and procedures.

#### END OF PART I

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<sup>9</sup> Not every audit deficiency suggests a defect or potential defect in a firm's quality control system, and this report may not discuss every audit deficiency the inspection team identified.

<sup>10</sup> An evaluation of the frequency of a type of deficiency may include consideration of how often the inspection team reviewed audit work that presented the opportunity for similar deficiencies to occur. In some cases, even a type of deficiency that is observed infrequently in a particular inspection may, because of some combination of its nature, its significance, and the frequency with which it has been observed in previous inspections of the firm, be cause for concern about a quality control defect or potential defect.

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

## PART II

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### B. Issues Related to Quality Controls

A firm's system of quality control should provide reasonable assurance of compliance with applicable professional standards and regulatory requirements with respect to its audit practice. (QC 20.04 and .17) On the basis of the information reported by the inspection team, including the audit performance deficiencies described in Part II.A (and summarized in Part I.A) and any other deficiencies identified below, the Board has concerns that the Firm's system of quality control fails to provide such reasonable assurance in at least the following respects<sup>11</sup> –

#### B.1. Firm Management's Approach to Quality Control

The Firm has a responsibility to ensure that its personnel comply with PCAOB standards in the Firm's issuer audit practice. The Firm's organizational structure, adopted policies, and established procedures should combine to provide the Firm with reasonable assurance of compliance with those standards.

In a significant portion of the Firm's audit work reviewed in this inspection, the inspection team identified what it considered to be deficiencies in the performance of the work. The high incidence of such inspection observations is consistent with the incidence of such observations in previous inspections of the Firm. Moreover, the substance of certain of the observations in this inspection is essentially identical to the substance of observations in the 2016 inspection, including the observations of deficiencies in testing goodwill impairment [Issuer A], revenue [Issuer B], inventory [Issuers B and C], and convertible debt [Issuer D] (also identified in the 2016 inspection of the Firm). These results indicate that the Firm's management lacks the necessary commitment to an approach to quality control that includes sufficient attention to –

- undertaking only those engagements that are reasonably within the professional competence of the Firm's personnel;

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<sup>11</sup> This report's description of quality control issues is based on the inspection team's observations during the primary inspection procedures. Any changes or improvements that the Firm may have made in its system of quality control since that time may not be reflected in this report, but will be taken into account by the Board during its assessment of whether the Firm has satisfactorily addressed the quality control criticisms or defects within the twelve months after the issuance of this report.

- assigning work on those engagements to persons who have the technical training and proficiency required in the circumstances;
- causing personnel to refer to authoritative literature or other sources and to consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues);
- providing proper supervision, including review, of the work of engagement team members, and appropriate performance of engagement quality reviews; and
- implementing policies and procedures such that firm personnel perform all professional responsibilities with integrity and maintain objectivity in discharging professional responsibilities, and perform audit work with due professional care, including with professional skepticism.

An appropriate approach to those fundamental quality control points should result in far fewer and less significant deficiencies than the inspection teams have regularly observed in reviewing the Firm's work. The Firm should enhance its understanding of each of those points, assess its commitment to them, and, if it intends to continue auditing issuers, implement changes in its policies and procedures necessary to provide reasonable assurance that its practices conform to those points.

## B.2. Independence Procedures

The Firm's system of quality control appears not to include policies and procedures that provide sufficient assurance that personnel maintain independence, in fact and appearance, in all required circumstances. In one of the audits reviewed, the Firm used professional staff from another firm, but failed to take appropriate steps to provide the Firm with reasonable assurance that those individuals were independent of the issuer. Specifically, although the Firm obtained independence representations from the professional staff of that other firm, those representations included indications that the professional staff had violated independence rules and regulations and did not understand the Firm's independence policies and procedures. The audit documentation did not demonstrate, and there was no persuasive other evidence, that the Firm had identified and evaluated the potential effect of those indicated matters on its independence with respect to its issuer audit client. [Issuer B]

### B.3. Audit Documentation

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will comply with the audit documentation and retention rules set forth in AS 1215. In two of the audits reviewed, the Firm failed to assemble for retention, within 45 days of the report release date, a complete and final set of audit documentation. [Issuers C and D]

### B.4. Due Professional Care

As discussed above, the inspection team reported identifying deficiencies that are included in Part I.A of this report related to the Firm's testing of revenue [Issuers A and C], goodwill impairment [Issuer A], the valuation of inventory [Issuer C], the valuation of assets acquired in a business combination [Issuer E], and the allowance for doubtful accounts [Issuer F]. Similar deficiencies related to the Firm's failure to perform sufficient procedures to test goodwill impairment in the Firm's audit of Issuer A and to test the valuation of inventory in the Firm's audit of Issuer C were also identified in the previous inspection of the Firm (in 2016). With respect to each of the deficiencies identified during the 2017 inspection, based on review of the work papers and discussions with the engagement personnel, it appeared to the inspection team that the deficiency was attributable, at least in part, to the engagement personnel having approached that aspect of the audit without due professional care. This information provides cause for concern about whether the Firm's engagement personnel will perform all aspects of their work on issuer audits with due professional care.

### B.5. Technical Training and Proficiency

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will assign personnel with the technical training and proficiency required to perform audit work in accordance with PCAOB standards. With respect to the audit deficiencies described in Part II.A related to the Firm's testing of commission revenue [Issuer A], revenue [Issuer B], and the valuation of inventory [Issuer B], it appeared to the inspection team that the engagement personnel who performed and supervised the work did not possess sufficient technical knowledge, experience, or training necessary to enable them to fulfill the responsibilities of the work assigned. Specifically, with respect to these deficiencies, it appeared to the inspection team that the engagement personnel assigned to the audit did not have an appropriate understanding of the relevant accounting and PCAOB standards, and therefore had failed to develop appropriate audit responses. Similar deficiencies related to the Firm's failure to perform sufficient procedures to test revenue and the valuation of inventory were also identified

in the Firm's audit of Issuer B that was reviewed in the previous inspection of the Firm (in 2016).

#### B.6. Supervision of an Audit Engagement

As discussed above, in one of the audits reviewed, the inspection team identified deficiencies that are included in Part I.A of this report related to the Firm's testing of accounts receivable, deferred revenue, and convertible debt. A similar deficiency related to the Firm's failure to perform sufficient procedures to test convertible debt was also identified in the Firm's audit of Issuer D that was reviewed in the previous inspection of the Firm (in 2016). With respect to each of the deficiencies identified during the 2017 inspection, based on review of the work papers and discussions with the engagement personnel, it appeared to the inspection team that the engagement partner had not exercised due professional care in reviewing the work of the engagement team members to evaluate whether the results of the work supported the conclusions reached. This information provides cause for concern regarding whether the Firm's engagement team members performing supervisory activities perform the required reviews with due professional care. [Issuer D]

#### B.7. Communications with Audit Committees

##### B.7.a. Communications Related to the Conduct of the Audit

The Firm's system of quality control appears not to provide sufficient assurance that all of the required auditor communications to the audit committee, or equivalent, occur and are appropriately documented in accordance with AS 1301, *Communications with Audit Committees*. Specifically, in six of the audits reviewed, the Firm failed to communicate to the audit committee or equivalent: (1) an overview of the overall audit strategy, including the timing of the audit and a discussion of significant risks identified during the Firm's risk assessment procedures [Issuers A, B, C, D, and G]; (2) uncorrected and corrected misstatements [Issuers A, C, and H]; (3) matters relating to the Firm's evaluation of the issuer's ability to continue as a going concern [Issuers B and D]; (4) the Firm's responsibility, procedures, and results of such procedures performed related to other information in documents containing audited financial statements [Issuers D and G]; and (5) any of the required communications related to critical accounting estimates [Issuer H]. In addition, in three of the audits reviewed, the Firm failed to determine whether the issuer's audit committee, or equivalent, had acknowledged and agreed to the terms of the audit engagements. [Issuers C, E, and H]

In addition, the Firm's system of quality control appears not to provide sufficient assurance that the Firm will provide to the audit committee, or equivalent, appropriate

communications in accordance with AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*. Specifically, in one of the audits reviewed, the Firm failed to communicate in writing all material weaknesses in internal controls identified during the audit. [Issuer H]

With respect to each of the deficiencies discussed above regarding compliance with AS 1301 or AS 1305, it appeared to the inspection team that the deficiency was attributable, at least in part, to the engagement personnel having approached this aspect of the audit without due professional care. This information provides cause for concern regarding the Firm's application of due professional care with respect to having and documenting the required communications with audit committees.

B.7.b. Communications with Audit Committees Concerning Pre-approval of Certain Tax Services

The Firm's system of quality control appears not to provide sufficient assurance that the Firm will comply with PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*. In one instance, in seeking pre-approval from the audit committee equivalent of an issuer audit client to perform certain tax services, the Firm failed to make the required written communications and failed to discuss the potential effects of the tax services on the independence of the Firm and document the substance of its discussions. Based on review of the work papers and discussions with the engagement personnel, it appeared to the inspection team that the engagement personnel may not have had an adequate understanding of what Rule 3524 required. This information provides cause for concern regarding the Firm's understanding and application of PCAOB requirements concerning audit committee pre-approval of tax services. [Issuer G]

B.8. Engagement Quality Review

Questions exist about the effectiveness of the Firm's system of quality control with respect to the execution of engagement quality reviews in compliance with AS 1220, *Engagement Quality Review*. An engagement quality review performed with due professional care in compliance with AS 1220 should have detected, and resulted in the Firm addressing, the deficiencies described in Part II.A related to the (1) testing of revenue for Issuers B and C; (2) testing of accounts receivable and deferred revenue for Issuer D; (3) testing of convertible debt for Issuer D; (4) testing of assets acquired in a business combination for Issuer E; and (5) testing of accounts receivable for Issuer F, each of which was in an area in which the engagement team had identified a significant risk.

In addition, in one of the audits reviewed, the Firm failed to obtain the required engagement quality review. [Issuer A]

In addition, in one engagement performed by the Firm, the assigned engagement quality reviewer appeared to have assumed responsibilities of the engagement team. Specifically, based on review of the work papers and discussions with the engagement personnel, it appeared to the inspection team that the engagement quality reviewer, but not the lead engagement partner, had (1) reviewed certain procedures that were designated by the engagement team as responsive to a fraud risk or other significant risk and (2) provided the signoff for the issuance of the audit report. AS 1220.07 provides that the engagement quality reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team. [Issuer D]

#### B.9. Independence

A firm should have policies and procedures that provide the firm with reasonable assurance that the firm and its personnel will maintain independence from issuer audit clients. (QC 20.09-.10) The inspection results indicate that the Firm's system of quality control may not provide the necessary assurance with respect to maintaining independence. The inspection team reported that, in two engagements reviewed, the Firm appeared not to have satisfied certain applicable independence criteria. [Issuers E and H]

#### B.10. Reporting of Audit Participants

The Firm's system of quality control appears not to provide reasonable assurance that the Firm will comply with PCAOB Rule 3211, *Auditor Reporting of Certain Audit Participants*. Rule 3211 requires that with respect to each audit report that a registered public accounting firm issues for an issuer and that is included in a document filed with the Commission, the firm that issued the audit report must file a PCAOB Form AP to report certain information by the relevant deadline prescribed in Rule 3211(b). At the time of the primary procedures, the deadline for filing Form AP had passed with respect to three of the issuer audits reviewed, and the Firm had not filed Form AP as to any of those audit reports. [Issuers D, F, and H] With respect to four of the issuer audits reviewed, the Firm failed to file the Form APs until after the relevant deadlines. [Issuers A, B, C, and G] With respect to one of the issuer audits reviewed, the Firm incorrectly identified the engagement partner. [Issuer B]

#### B.11. PCAOB Standards and Rules

The table below lists the specific PCAOB standards and rules that are primarily related to the descriptions of defects in, or criticisms of, the Firm's system of quality control included in this Part of the report.<sup>12</sup>

PCAOB Standards / Rules	Part II Sections
<i>AS 1010, Training and Proficiency of the Independent Auditor</i>	B.5 and B.7.b
<i>AS 1015, Due Professional Care in the Performance of Work</i>	B.4, B.7.a, and B.8
<i>AS 1201, Supervision of the Audit Engagement</i>	B.6
<i>AS 1215, Audit Documentation</i>	B.3
<i>AS 1220, Engagement Quality Review</i>	B.8
<i>AS 1301, Communications with Audit Committees</i>	B.7.a
<i>AS 1305, Communications About Control Deficiencies in an Audit of Financial Statements</i>	B.7.a
<i>QC Section 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>	B
<i>Rule 3211, Auditor Reporting of Certain Audit Participants</i>	B.10
<i>Rule 3520, Auditor Independence</i>	B.9

<sup>12</sup> This table does not necessarily include reference to every standard or rule that may have been related to the criticisms or potential defects that are included in Part II.

PCAOB Standards / Rules	Part II Sections
Rule 3524, <i>Audit Committee Pre-approval of Certain Tax Services</i>	B.7.b

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#### **PART IV**

#### **RESPONSE OF THE FIRM TO DRAFT INSPECTION REPORT**

Pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided the Firm an opportunity to review and comment on a draft of this report. The Firm did not provide a written response.

## APPENDIX A

### AUDITING STANDARDS REFERENCED IN PART I

This appendix provides the text of the auditing standard paragraphs that are referenced in Part I.A of this report. Footnotes that are included in this appendix, and any other Notes, are from the original auditing standards that are referenced. While this appendix contains the specific portions of the relevant standards cited with respect to the deficiencies in Part I.A of this report, other portions of the standards (including those described in Part I.B of this report) may provide additional context, descriptions, related requirements, or explanations; the complete standards are available on the PCAOB's website at <http://pcaobus.org/STANDARDS/Pages/default.aspx>.<sup>13</sup>

<b>AS 1105, <i>Audit Evidence</i></b>		
<b>SELECTING ITEMS FOR TESTING TO OBTAIN AUDIT EVIDENCE</b>		
<b>Selecting Specific Items</b>		
AS 1105.27	The application of audit procedures to items that are selected as described in paragraphs .25-.26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population. <sup>12</sup>	Issuer C
Footnote to AS 1105.27		
<sup>12</sup> If misstatements are identified in the selected items, see AS 2810.12 - .13 and AS 2810.17 - .19.		

<b>AS 2301, <i>The Auditor's Responses to the Risks of Material Misstatement</i></b>		
<b>RESPONSES INVOLVING THE NATURE, TIMING, AND EXTENT OF AUDIT PROCEDURES</b>		
AS 2301.08	The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.	Issuers A, B, C, D, and F

<sup>13</sup> The text presented in this appendix represents the standards as in effect during the applicable audit period.

**AS 2301, The Auditor's Responses to the Risks of Material Misstatement**

<b>Responses to Significant Risks</b>		
AS 2301.11	<p>For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.</p> <p>Note: AS 2110 discusses identification of significant risks<sup>10</sup> and states that fraud risks are significant risks.</p>	Issuers A, C, D, and E
<p><u>Footnote to AS 2301.11</u></p> <p><sup>10</sup> See AS 2110.71 for factors that the auditor should evaluate in determining which risks are significant risks.</p>		
<b>Responses to Fraud Risks</b>		
AS 2301.13	<p><i>Addressing Fraud Risks in the Audit of Financial Statements.</i> 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. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs .16-.17 of this standard, the auditor should perform tests of those controls.</p>	Issuers A, B, C, D, and F

**AS 2305, Substantive Analytical Procedures**

<b>ANALYTICAL PROCEDURES USED AS SUBSTANTIVE TESTS</b>		
<b>Availability and Reliability of Data</b>		
AS 2305.16	<p>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. The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the</p>	Issuer A

<b>AS 2305, Substantive Analytical Procedures</b>		
	<p>analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives:</p> <ul style="list-style-type: none"> <li>▪ Whether the data was obtained from independent sources outside the entity or from sources within the entity</li> <li>▪ Whether sources within the entity were independent of those who are responsible for the amount being audited</li> <li>▪ Whether the data was developed under a reliable system with adequate controls</li> <li>▪ Whether the data was subjected to audit testing in the current or prior year</li> <li>▪ Whether the expectations were developed using data from a variety of sources</li> </ul>	
<b>Precision of the Expectation</b>		
AS 2305.17	<p>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 (see paragraph .20). As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation.</p>	Issuer A
<b>Investigation and Evaluation of Significant Differences</b>		
AS 2305.20	<p>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</p>	Issuer A

<b>AS 2305, Substantive Analytical Procedures</b>		
	materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.	
AS 2305.21	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. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See AS 2810.)	Issuer A

<b>AS 2310, The Confirmation Process</b>		
<b>CONFIRMATION OF ACCOUNTS RECEIVABLE</b>		
AS 2310.34	<p>For the purpose of this section, <i>accounts receivable</i> means—</p> <ul style="list-style-type: none"> <li>a. The entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and</li> <li>b. A financial institution's loans.</li> </ul> <p>Confirmation of accounts receivable is a generally accepted auditing procedure. As discussed in paragraph .06, it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity. Thus, there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:</p> <ul style="list-style-type: none"> <li>▪ Accounts receivable are immaterial to the financial statements.</li> </ul>	Issuer D

### AS 2310, *The Confirmation Process*

	<ul style="list-style-type: none"> <li>▪ The use of confirmations would be ineffective.<sup>4</sup></li> <li>▪ The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.</li> </ul>	
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#### Footnote to AS 2310.34

<sup>4</sup> For example, if, based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective.

### AS 2315, *Audit Sampling*

<b>SAMPLING IN SUBSTANTIVE TESTS OF DETAILS</b>		
<b>Planning Samples</b>		
AS 2315.19	<p>After assessing and considering the levels of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive tests of details increases and, thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risks are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details.<sup>3</sup> Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.</p>	Issuer C

## **AS 2315, Audit Sampling**

### Footnote to AS 2315.19

<sup>3</sup> Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.

AS 2315.23	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.	Issuer C
AS 2315.23A	Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.	Issuer C

## **AS 2501, Auditing Accounting Estimates**

AS 2501.04	The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. 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.	Issuer B
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<b>AS 2501, Auditing Accounting Estimates</b>		
<b>EVALUATING ACCOUNTING ESTIMATES</b>		
AS 2501.07	<p>The auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate evidential matter to provide reasonable assurance that—</p> <ul style="list-style-type: none"> <li>a. All accounting estimates that could be material to the financial statements have been developed.</li> <li>b. Those accounting estimates are reasonable in the circumstances.</li> <li>c. The accounting estimates are presented in conformity with applicable accounting principles<sup>2</sup> and are properly disclosed.<sup>3</sup></li> </ul>	Issuer B
<p><u>Footnotes to AS 2501.07</u></p> <p><sup>2</sup> AS 2815, <i>The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles,"</i> discusses the auditor's responsibility for evaluating conformity with generally accepted accounting principles.</p> <p><sup>3</sup> See paragraph .31 of AS 2810, <i>Evaluating Audit Results</i>.</p>		
<b>Evaluating Reasonableness</b>		
AS 2501.11	<p>Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach:</p> <ul style="list-style-type: none"> <li>a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.</li> <li>b. 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.</li> <li>c. Consider whether there are additional key factors or alternative assumptions about the factors.</li> <li>d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.</li> </ul>	Issuer D

**AS 2501, Auditing Accounting Estimates**

	<ul style="list-style-type: none"> <li>e. 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.</li> <li>f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.</li> <li>g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions.</li> <li>h. Consider using the work of a specialist regarding certain assumptions (AS 1210, <i>Using the Work of a Specialist</i>).</li> <li>i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.</li> </ul>	
AS 2501.12	<p><i>Develop an expectation.</i> 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.</p>	Issuer F

**AS 2502, Auditing Fair Value Measurements and Disclosures**

<b>INTRODUCTION</b>		
AS 2502.03	<p>The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, <i>Using Cash Flow Information and Present Value in Accounting Measurements</i>, defines the fair value of an asset (liability) as "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."<sup>1</sup> Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.</p>	Issuer E

## AS 2502, Auditing Fair Value Measurements and Disclosures

### Footnote to AS 2502.03

<sup>1</sup> Generally accepted accounting principles (GAAP) contain various definitions of fair value. However, all of the definitions reflect the concepts in the definition that appears in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. For example, Governmental Accounting Standards Board Statement of Governmental Accounting Standards No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, defines fair value as "the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale."

<b>EVALUATING CONFORMITY OF FAIR VALUE MEASUREMENTS AND DISCLOSURES WITH GAAP</b>		
AS 2502.15	The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP. The auditor's understanding of the requirements of GAAP and knowledge of the business and industry, together with the results of other audit procedures, are used to evaluate the accounting for assets or liabilities requiring fair value measurements, and the disclosures about the basis for the fair value measurements and significant uncertainties related thereto.	Issuer E
<b>TESTING THE ENTITY'S FAIR VALUE MEASUREMENTS AND DISCLOSURES</b>		
<b>Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data</b>		
AS 2502.26	<p>The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:</p> <ul style="list-style-type: none"> <li>a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06).</li> <li>b. The fair value measurement was determined using an appropriate model, if applicable.</li> </ul>	Issuers A and E

<b>AS 2502, Auditing Fair Value Measurements and Disclosures</b>		
	c. Management used relevant information that was reasonably available at the time.	
AS 2502.28	Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.	Issuers A and E
AS 2502.31	Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor evaluates the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information.	Issuers A and E

<b>AS 2810, Evaluating Audit Results</b>		
<b>EVALUATING THE RESULTS OF THE AUDIT OF FINANCIAL STATEMENTS</b>		
AS 2810.03	In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.	Issuer E
<b>Evaluating the Presentation of the Financial Statements, Including the Disclosures</b>		
AS 2810.30	<p>The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.</p> <p>Note: AS 2815, <i>The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles,"</i> establishes requirements for evaluating the presentation of the financial statements. AS 2820, <i>Evaluating Consistency of Financial Statements,</i> establishes requirements regarding evaluating the</p>	Issuers A, B, and D

**AS 2810, *Evaluating Audit Results***

	<p>consistency of the accounting principles used in financial statements.</p> <p>Note: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.</p>	
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