

Illustrative Examples for Auditors of Issuers

Glenn Temprow
Division of Registration and Inspections
October 19, 2020

DISCLAIMER

Any views expressed are my own and do not necessarily reflect the views of the Board as a whole, any individual Board Members, or other staff.

OVERVIEW OF TOPICS COVERED

- Evaluation of goodwill impairment
- Critical audit matters
- The auditor's report
- Communications with audit committees
- Communications with audit committees concerning independence

Evaluation of Goodwill Impairment



EVALUATION OF GOODWILL IMPAIRMENT

Background Information

- Your firm is auditing the December 31, 2020 financial statements of Diversified Travel, Inc. (the “Company”), a provider of travel arrangements, corporate retreats, conventions, and cruises
- Back in 2018, the Company acquired Cruises R Fun, Inc. (“Cruises”), a provider of short-term cruises
- The Company presents Cruises as a separate operating segment in its financial statements because discrete financial information is produced for Cruises that is regularly reviewed by the Company’s CEO to make decisions about resources to be allocated to the segment and to assess its performance

EVALUATION OF GOODWILL IMPAIRMENT

Background Information

- A material amount of goodwill resulted from the Company's purchase of Cruises in 2018
- The goodwill was allocated to the Cruises' operating segment as of the acquisition date
- The Company's net income (loss) for the past three years was as follows (in millions):

Year	Travel- Retreats- Conventions	Cruises	Consolidated
2018	\$20	\$12	\$32
2019	21	16	37
2020	9	(4)	5

EVALUATION OF GOODWILL IMPAIRMENT

Background Information

- There has been a decline in Cruises' revenue in 2020 as a result of COVID-19 concerns and government-imposed restrictions
- During the 2nd quarter of 2020, management suspended the use of three of Cruises' five cruise ships
- On September 1, 2020, the Company's Board of Directors approved management's plan to dry-dock the three cruise ships until March 15, 2021

EVALUATION OF GOODWILL IMPAIRMENT

Background Information

- Cruises' quarterly revenues during 2020 were as follows (in millions):

2020 Quarter End	Cruises' Revenue
March 31 st	\$30
June 30 th	8
September 30 th	4
December 31 st	3

EVALUATION OF GOODWILL IMPAIRMENT

Background Information

- For its goodwill impairment testing, the Company's management views Cruises as a separate reporting unit
- The Company established its annual goodwill impairment test date to be December 31
 - In addition, for 2020, the Company also performed a goodwill impairment analysis at June 30, 2020
- For its goodwill impairment analysis, the Company's management applied a qualitative assessment of goodwill and concluded that it is more likely than not that the goodwill is impaired

EVALUATION OF GOODWILL IMPAIRMENT

Background Information

- The Company utilized a discounted cash flow model to estimate the fair value of the Cruises reporting unit in order to assess any impairment
- The Company developed significant assumptions related to Cruises' revenue, operating expenses, and cash flows for the next five years. The projected cash flows are as follows (in millions):
- After completing its quantitative assessment, management concluded that goodwill was not impaired

Year	Cruises' Cash Flows Projected
2021	\$25
2022	35
2023	40
2024	55
2025	60

EVALUATION OF GOODWILL IMPAIRMENT

The audit

- You are the engagement partner on the audit and you are discussing the goodwill impairment evaluation with the engagement team
- The relevant audit procedures performed by the engagement team included the following:
 1. Assessed a significant risk related to goodwill impairment;
 2. Obtained management and the Board's approved plans for ceasing the use and dry-docking of three cruise ships;
 3. Obtained management's representation that the impairment test was in accordance with GAAP;

continued on next slide 11

EVALUATION OF GOODWILL IMPAIRMENT

The audit

- The relevant audit procedures performed by the engagement team included the following (*continued*):
 4. Discussed the goodwill impairment analysis with the Company's controller, who indicated that:
 - he believed that the three dry-docked cruise ships would be reinstated to the Company's fleet in 2021;
 - assumptions related to future bookings were based on 2019 actual bookings;
 - the company expects the cruise business to grow well beyond pre-pandemic levels in the next five years; and
 - no impairment of goodwill is needed;

continued on next slide

EVALUATION OF GOODWILL IMPAIRMENT

The audit

- The relevant audit procedures performed by the engagement team included the following (*continued*):
 5. Reviewed the Company's goodwill impairment calculation for Cruises, and concurred with management's conclusion that goodwill was not impaired; and
 6. Documented in the work papers that goodwill appeared reasonable and that no further test work was deemed needed

EVALUATION OF GOODWILL IMPAIRMENT

Questions

- What are some of the good steps the engagement team has taken to evaluate the goodwill impairment assessment?
- What else, if anything, should the engagement team take into consideration when evaluating the goodwill impairment assessment? What might the lead engagement partner want to better understand?

Obtain a further understanding of:

- The impact of the COVID-19 pandemic
- The engagement team's testing of management's estimates for its future cash flows

EVALUATION OF GOODWILL IMPAIRMENT

AS 2501, Auditing Accounting Estimates, Including Fair Value Measurements, provides the following approaches for testing accounting estimates:

- a. Test the company's process used to develop the accounting estimate
- b. Develop an independent expectation for comparison to the company's estimate
- c. Evaluate audit evidence from events or transactions occurring after the measurement date related to the accounting estimate for comparison to the company's estimate

EVALUATION OF GOODWILL IMPAIRMENT

- AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, provides that testing a company's process used to develop an estimate involves the auditor testing and evaluating the:
 - methods,
 - data, *and*
 - significant assumptionsthat were used by the company in developing the estimate.

EVALUATION OF GOODWILL IMPAIRMENT

Using the Work of a Specialist

- Companies and auditors may also choose to use the work of specialists in connection with goodwill impairment testing, such as in performing or evaluating a discounted cash flow analysis
- AS 1210, *Using the Work of an Auditor-Engaged Specialist*, is effective for audits of financial statements for fiscal years ending on or after December 15, 2020

Critical Audit Matters



CRITICAL AUDIT MATTERS

- The provisions in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, related to **Critical Audit Matters** (or “CAMs”) are effective for:
 - audits of fiscal years ending on or after June 30, 2019, for large accelerated filers, and
 - audits of fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply

CRITICAL AUDIT MATTERS

A Critical Audit Matter is any matter arising from the audit of the financial statements that:

1. was communicated or required to be communicated to the audit committee;
2. relates to accounts or disclosures that are material to the financial statements; and
3. involved especially challenging, subjective, or complex auditor judgment

CRITICAL AUDIT MATTERS

Through our inspections, we've identified instances in which auditors have performed appropriate procedures to:

1. Determine and document whether certain matters are or are not CAMs
2. Communicate CAMs in the auditor's report

The Auditor's Report

THE AUDITOR'S REPORT

- The following is an example auditor's report:

Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of Diversified Travel, Inc.

Opinion on the Financial Statements

We have audited the accompanying balance sheets of Diversified Travel, Inc. (the "Company") as of December 31, 2020 and 2019, the related statements of statements of operations, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 2020, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2020, in conformity with U.S. generally accepted accounting principles.

continued on next slide

THE AUDITOR'S REPORT

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

continued on next slide

THE AUDITOR'S REPORT

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[Include critical audit matters]

/s/ Better CPA's LLC

Better CPAs, LLC

We have served as the Company's auditor since 2017.

Chicago, Illinois

February 26, 2021

Communications with Audit Committees

COMMUNICATIONS WITH AUDIT COMMITTEES

The auditor should communicate to the audit committee:

- The terms of the audit (objective, responsibilities of each of the auditor and management)
- The overall strategy, timing of the audit, and significant risks
- The results of the audit, including:
 - The auditor's evaluation of the quality of the company's financial reporting
 - The auditor's responsibility under PCAOB rules and standards for other information in documents containing the audited financial statements
 - Difficult or contentious matters for which the auditor consulted

continued on next slide

COMMUNICATIONS WITH AUDIT COMMITTEES

- The results of the audit, including (*continued*):
 - Management's consultation with other accountants
 - Uncorrected and corrected misstatements
 - Material written communications between the auditor and management
 - Any disagreements with management
 - Any difficulties encountered during the audit
 - The auditor's going concern evaluation (where applicable)

The auditor should also:

- Inquire of the audit committee about matters relevant to the audit
- Provide a draft of the auditor's report to the audit committee

COMMUNICATIONS WITH AUDIT COMMITTEES

Scenario

- During the firm's risk assessment procedures, the firm identified the following significant risks, including fraud risks: (1) management override of controls; (2) improper revenue recognition due to fraud; and (3) lack of proper segregation of duties for payroll
- The firm held a planning meeting with the audit committee on November 19, 2020 in which it discussed prior year findings and recommendations, significant risks identified, and an overview of the audit strategy and timing of the audit

continued on next slide

COMMUNICATIONS WITH AUDIT COMMITTEES

Scenario (*continued*)

- The firm conducted interviews related to fraud risks with certain management and non-management employees
- The firm issued its audit report on February 26, 2021, and discussed the results of the audit in a meeting with the audit committee and management on March 12, 2021

Question

- Has the firm satisfied its obligations with respect to communications with the audit committee?

COMMUNICATIONS WITH AUDIT COMMITTEES CONCERNING INDEPENDENCE

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*:

A registered public accounting firm must –

- a) prior to accepting an initial engagement
 - 1) describe, in writing, to the audit committee, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

continued on next slide

COMMUNICATIONS WITH AUDIT COMMITTEES CONCERNING INDEPENDENCE

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence (continued)*:

A registered public accounting firm must –

- 2) discuss with the audit committee of the potential audit client the potential effects of any such relationships on the independence of the registered public accounting firm; and
- 3) document the substance of its discussion with the audit committee of the potential audit client.

continued on next slide

COMMUNICATIONS WITH AUDIT COMMITTEES CONCERNING INDEPENDENCE

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence (continued)*:

- b) at least annually with respect to each of its audit clients –
 - 1) describe, in writing, to the audit committee of the audit client, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence;
 - 2) discuss with the audit committee of the audit client the potential effects of any such relationships on the independence of the registered public accounting firm;

continued on next slide

COMMUNICATIONS WITH AUDIT COMMITTEES CONCERNING INDEPENDENCE

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence (continued)*:

- 3) affirm to the audit committee of the audit client, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and
- 4) document the substance of its discussion with the audit committee of the audit client.

COMMUNICATIONS WITH AUDIT COMMITTEES CONCERNING INDEPENDENCE

Scenario

- The independence letter provided by the firm to the issuer's audit committee included the following:

PCAOB Rule 3526, Communications with Audit Committees Concerning Independence, requires that we disclose to you in writing, at least annually all relationships between our firm and any affiliates and your company and its related entities or persons in financial reporting oversight roles at your Company that may reasonably be thought to bear on independence.

We are not aware of any relationships between our Firm and the Company that are relevant to our audit of the Company's financial statements for the year ending November 30, 2019.

We confirm that we are independent of the Company in compliance with Rule 3520 and within the meaning of the federal securities laws administered by the Securities and Exchange Commission.

As further required by PCAOB Rule 3526, we will be pleased to discuss the potential effects of such relationships on our independence with respect to the Company with you at a mutually agreed upon date.

QUESTIONS

Please submit any questions or feedback you might have on this presentation to forum@pcaobus.org.

