

Forum on Auditing in the Small Business Environment

July 29, 2010

New York, NY

Opening Remarks

Steven Harris
PCAOB Board Member
July 29, 2010
New York, NY

Caveat

One of the benefits of today's session is that you will hear firsthand from one of the PCAOB Board members and numerous PCAOB staff. 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. Therefore, unless it is clear that the Board has authorized the statement, you should not attribute it to the Board or staff.

Office of Research and Analysis: Risk-Based Selection and the Current Environment

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Director
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Andres Vinelli
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Topics

- ❑ ORA Overview

- ❑ Triennial Practice
 - ❑ Industry breakdown of issuers
 - ❑ The Broker-Dealer universe
 - ❑ Triennial-Firm Surveillance

- ❑ Emerging Risk in the Coming Year (s)
 - ❑ The euro zone
 - ❑ The US economic outlook
 - ❑ The “GAAP Tsunami”
 - ❑ The role of discretion

Office of Research and Analysis

- Business Intelligence
 - Data for surveillance and reporting
 - Quant Model
 - Peer-reviewed research
- Surveillance
 - IRA (Internal Risk Application)
 - Quant Model
 - Monitor
- Risk Policy
 - Strategy
 - Standards
 - Quality control

NY/NJ Attendee Firm Composite

| | |
|--|----|
| Number of firms attending SBF | 99 |
| Number of firms with issuer clients | 50 |
| Number of firms with broker/dealer clients | 62 |
| Number of firms with issuer and broker/dealer clients | 31 |
| Number of firms with issuer clients only | 19 |
| Number of firms with broker/dealer clients only | 31 |
| Number of firms with no reported issuer or B/D clients | 18 |

NY/NJ Sectors of Issuer Clients

| | |
|--|-----|
| Number of firms attending Small Business Forum | 99 |
| Number of firms with issuer clients | 50 |
| Total number of issuer clients | 698 |

| Sector | Issuer Count* | Market Cap** (\$ in millions) |
|----------------------------|---------------|----------------------------------|
| Consumer Discretionary | 71 | 1,869.7 |
| Consumer Staples | 24 | 1,068.6 |
| Energy | 28 | 5,673.8 |
| Financials | 173 | 10,641.2 |
| Health Care | 90 | 3,335.2 |
| Industrials | 82 | 3,086.8 |
| Information Technology | 89 | 1,796.1 |
| Materials | 39 | 6,540.9 |
| Misc. Financial Services | 35 | 58.7 |
| Telecommunication Services | 9 | 161.2 |
| Utilities | 9 | 1,253.4 |
| Unassigned | 49 | 1,789.6 |
| Grand Total | 698 | 37,275.3 |

*Issuer count based on opinions issued in 2009

** Market cap as of June 30, 2010

Firms Auditing Broker/Dealers – NYC and NJ

- Number of firms attending 99
- Number of firms with broker/dealer clients 62
- Total number of broker/dealer clients 379
- Total assets audited of broker/dealer clients
 - \$6,015,966,572*

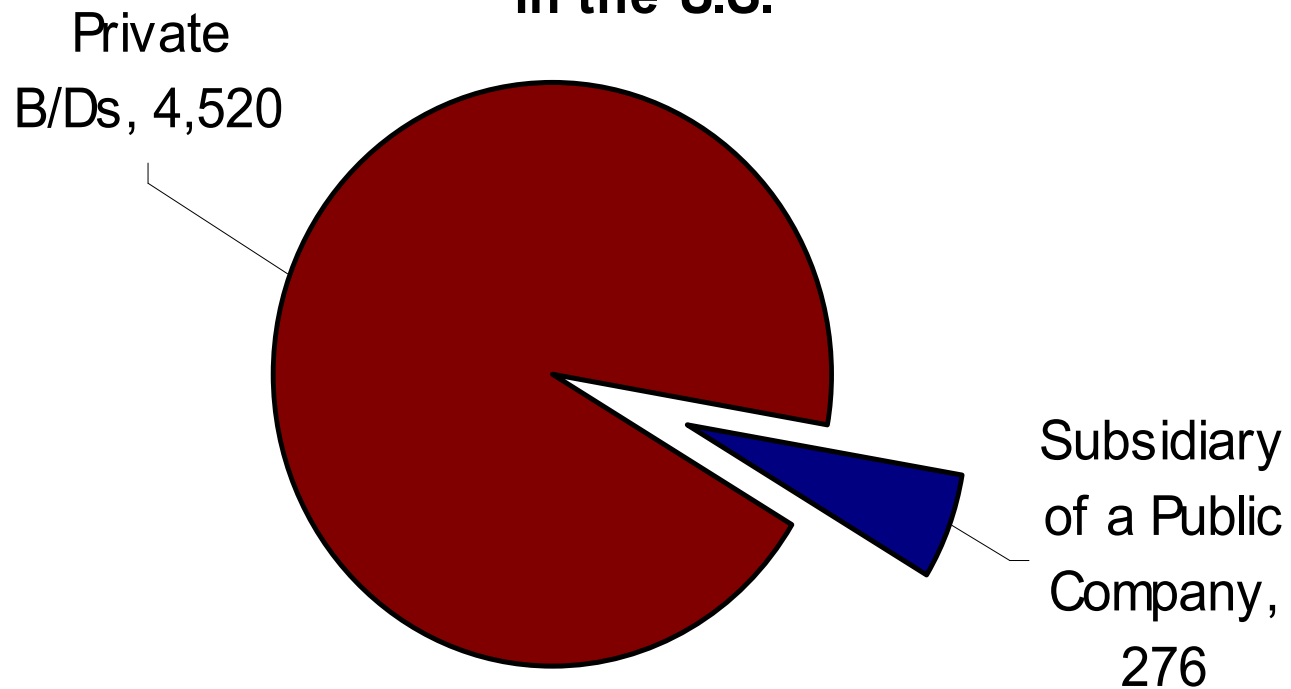
*Based on publicly available fiscal year 2009 data

Broker-Dealer Industry

| Broker/Dealer | Total Assets (\$MM) | % of Total | Firm | Subsidiary of an Issuer (Y/N) |
|--|---------------------|--------------|----------------------------|-------------------------------|
| GOLDMAN, SACHS & CO. | 476,490 | 13.1 | PricewaterhouseCoopers LLP | Y |
| J.P. MORGAN SECURITIES INC. | 399,545 | 11.0 | PricewaterhouseCoopers LLP | Y |
| CREDIT SUISSE SECURITIES (USA) LLC | 326,348 | 8.9 | KPMG LLP | Y |
| CITIGROUP GLOBAL MARKETS INC. | 286,825 | 7.9 | KPMG LLP | Y |
| UBS SECURITIES LLC | 253,420 | 6.9 | Ernst & Young LLP | Y |
| DEUTSCHE BANK SECURITIES INC. | 244,413 | 6.7 | KPMG LLP | Y |
| BARCLAYS CAPITAL INC. | 240,429 | 6.6 | PricewaterhouseCoopers LLP | Y |
| BANC OF AMERICA SECURITIES LLC | 207,678 | 5.7 | PricewaterhouseCoopers LLP | Y |
| BNP PARIBAS SECURITIES CORP. | 171,735 | 4.7 | Deloitte & Touche LLP | N |
| MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED | 138,013 | 3.8 | Deloitte & Touche LLP | Y |
| J.P. MORGAN CLEARING CORP. | 105,884 | 2.9 | PricewaterhouseCoopers LLP | Y |
| HSBC SECURITIES (USA) INC. | 61,544 | 1.7 | KPMG LLP | Y |
| ING FINANCIAL MARKETS LLC | 43,585 | 1.2 | Ernst & Young LLP | Y |
| NEWEDGE USA, LLC | 40,849 | 1.1 | Ernst & Young LLP | N |
| NATIONAL FINANCIAL SERVICES LLC | 31,036 | 0.9 | Deloitte & Touche LLP | N |
| CHARLES SCHWAB & CO., INC. | 25,139 | 0.7 | Deloitte & Touche LLP | Y |
| BNP PARIBAS PRIME BROKERAGE, INC. | 23,672 | 0.6 | Deloitte & Touche LLP | N |
| MF GLOBAL INC. | 22,915 | 0.6 | PricewaterhouseCoopers LLP | Y |
| UBS FINANCIAL SERVICES INC. | 19,163 | 0.5 | Ernst & Young LLP | Y |
| JEFFERIES & COMPANY, INC. | 17,063 | 0.5 | KPMG LLP | Y |
| Subtotal of Top Twenty Broker Dealers | 3,135,744 | 86.0 | | |
| All Other Broker Dealers | 511,185 | 14.0 | | |
| Grand Total | 3,646,929 | 100.0 | | |

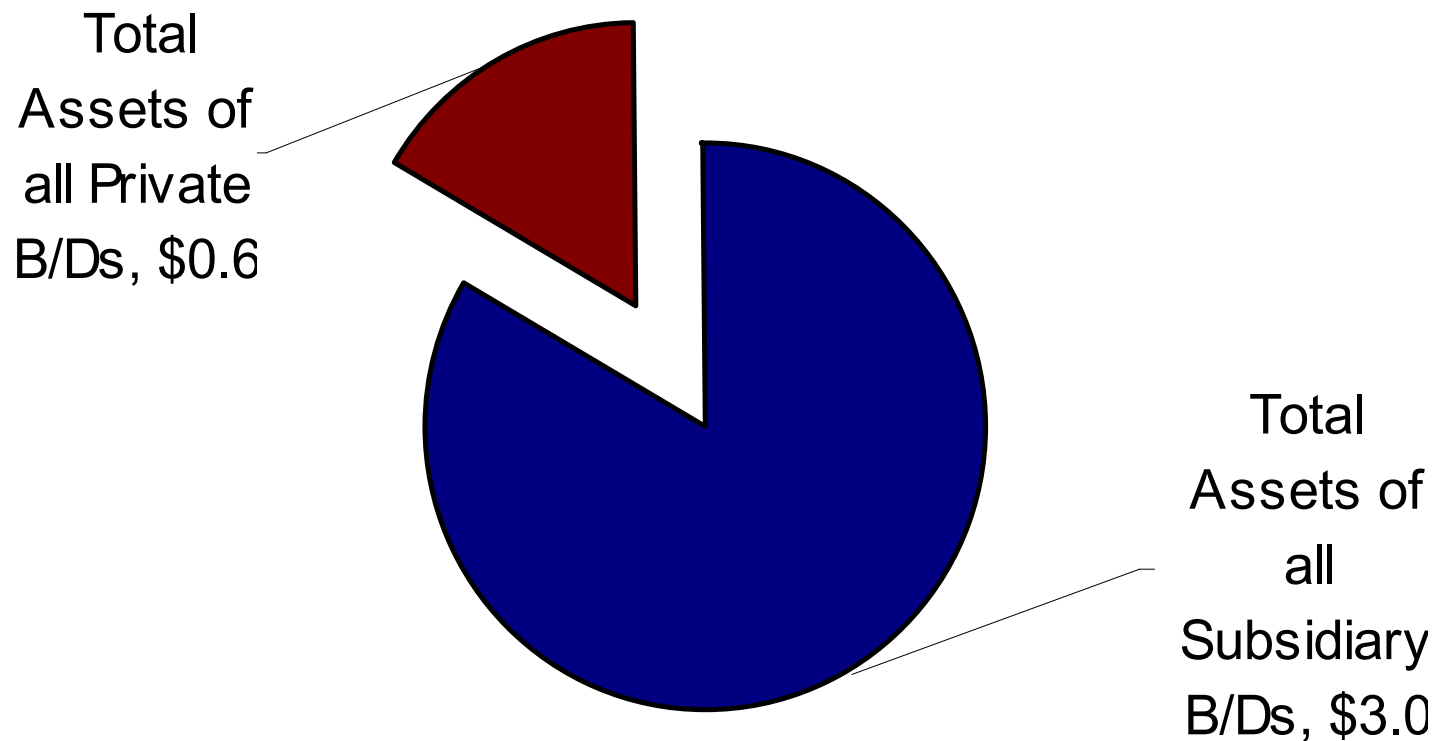
Broker-Dealer Status

Exhibit 1: Legal Status of 4,796 B/Ds Operating in the U.S.



Broker-Dealer Assets by Status

**Exhibit 2: B/D Total Assets by Type of B/D
(\$ trillion)**



Broker-Dealer Auditors

| Firm | Total B/D Opinions | % of Total | B/D Total Assets (\$MM) | % of Total | Average B/D Size (\$MM) |
|----------------------------|--------------------|--------------|-------------------------|--------------|-------------------------|
| Ernst & Young LLP | 217 | 4.5 | 505,289 | 13.9 | 2,329 |
| PricewaterhouseCoopers LLP | 205 | 4.3 | 1,522,665 | 41.8 | 7,428 |
| KPMG LLP | 199 | 4.1 | 1,041,042 | 28.5 | 5,231 |
| Deloitte & Touche LLP | 171 | 3.6 | 480,622 | 13.2 | 2,811 |
| Subtotal Big 4 | 792 | 16.5 | 3,549,618 | 97.3 | 4,482 |
| BDO Seidman LLP | 34 | 0.7 | 4,822 | 0.1 | 142 |
| Crowe Horwath LLP | 17 | 0.4 | 748 | 0.0 | 44 |
| Grant Thornton LLP | 44 | 0.9 | 2,145 | 0.1 | 49 |
| McGladrey & Pullen LLP | 122 | 2.5 | 50,973 | 1.4 | 418 |
| Subtotal Next 4 | 217 | 4.5 | 58,687 | 1.6 | 270 |
| Subtotal Large 8 | 1,009 | 21.0 | 3,608,305 | 98.9 | 3,576 |
| Triennial | 3,776 | 78.7 | 38,616 | 1.1 | 10 |
| International | 11 | 0.2 | 7 | 0.0 | 1 |
| Grand Total | 4,796 | 100.0 | 3,646,928 | 100.0 | 760 |

Triennial Firms by B/Ds Audited

| Firm | Total B/D Opinions | % of Total | B/D Total Assets (\$MM) | % of Total | Registered with PCAOB |
|--|--------------------|--------------|-------------------------|--------------|-----------------------|
| Breard & Associates Inc CPAs | 102 | 2.7 | 145 | 0.4 | Yes |
| CF & Co LLP | 79 | 2.1 | 172 | 0.4 | Yes |
| Rothstein Kass & Company PC | 75 | 2.0 | 1,423 | 3.7 | Yes |
| Fulvio & Associates LLP | 70 | 1.9 | 399 | 1.0 | Yes |
| Lerner & Sipkin CPAs LLP | 53 | 1.4 | 181 | 0.5 | Yes |
| Rubio CPA PC | 51 | 1.4 | 35 | 0.1 | Yes |
| Dunleavy & Company PC | 49 | 1.3 | 193 | 0.5 | Yes |
| Spicer Jeffries LLP | 48 | 1.3 | 74 | 0.2 | Yes |
| Ryan & Juraska | 42 | 1.1 | 8,842 | 22.9 | Yes |
| Citrin Cooperman & Company LLP | 40 | 1.1 | 987 | 2.6 | Yes |
| Eisner LLP | 37 | 1.0 | 4,833 | 12.5 | Yes |
| Weiser LLP | 36 | 1.0 | 2,540 | 6.6 | Yes |
| Phillip V George PLLC | 30 | 0.8 | 11 | 0.0 | Yes |
| Elizabeth Tractenberg CPA | 29 | 0.8 | 14 | 0.0 | Yes |
| JH Cohn LLP | 26 | 0.7 | 139 | 0.4 | Yes |
| Joseph Yafeh CPA | 26 | 0.7 | 11 | 0.0 | Yes |
| Brace & Associates PLLC | 25 | 0.7 | 38 | 0.1 | Yes |
| Brian W Anson CPA | 25 | 0.7 | 35 | 0.1 | Yes |
| Halpern & Associates LLC | 25 | 0.7 | 164 | 0.4 | Yes |
| Kempisty & Company CPAs PC | 25 | 0.7 | 1,384 | 3.6 | Yes |
| Subtotal - Firms Auditing >25 B/Ds | 893 | 23.6 | 21,619 | 56.0 | |
| 37 Firms Auditing 10-24 B/Ds | 542 | 14.4 | 7,035 | 18.2 | |
| 236 Firms Auditing 3-9 B/Ds | 1,053 | 27.9 | 5,883 | 15.2 | |
| 214 Firms Auditing 2 B/Ds | 428 | 11.3 | 2,786 | 7.2 | |
| 860 Firms Auditing 1 B/D | 860 | 22.8 | 1,293 | 3.3 | |
| Grand Total | 3,776 | 100.0 | 38,616 | 100.0 | |

PCAOB Surveillance Programs

- Context
 - X-Axis
 - Y-Axis
- IRA – “Internal Risk Application”
- Quant Model
- Both are dynamic applications
 - Continuous evolution

Triennial Firm Surveillance

- IRA-based issuer surveillance
 - Sourced from firm profiles maintained in the ORA EDW
 - Grain: sector-based
 - 100 scored X-axis screen components

Triennial Firm Surveillance, Cont'd

- 25 Y-axis screen components
 - Firm-provided information gathered through RASR
 - Inspection history
 - Other
- Scoring options allow the application to be “aimed” at specific industries or issues within sectors
- Unique to triennial firms: practice dynamics
 - Engagements/resignations/dismissals/referred work
- Quant model coverage

Performance Measurement

- “Negative Events”
 - Restatements
 - Litigation
 - SEC investigations
- PCAOB Inspection Comments

Historical Performance – All Selections

| | 2007 | 2008 | 2009 | Totals |
|--|-------------|-------------|-------------|-------------|
| Issuer-Audits Inspected | 437 | 347 | 371 | 1155 |
| Issuer-Audits Inspected w/ Negative Events - Expanded Observation Period | 105 | 58 | 42 | 205 |
| Negative Event Rate for Issuer- Audits Inspected - Expanded Observation Period | 24.0% | 16.7% | 11.3% | 17.7% |
| Large 8 Negative Event Rate | 8.3% | 5.2% | 4.5% | 6.1% |

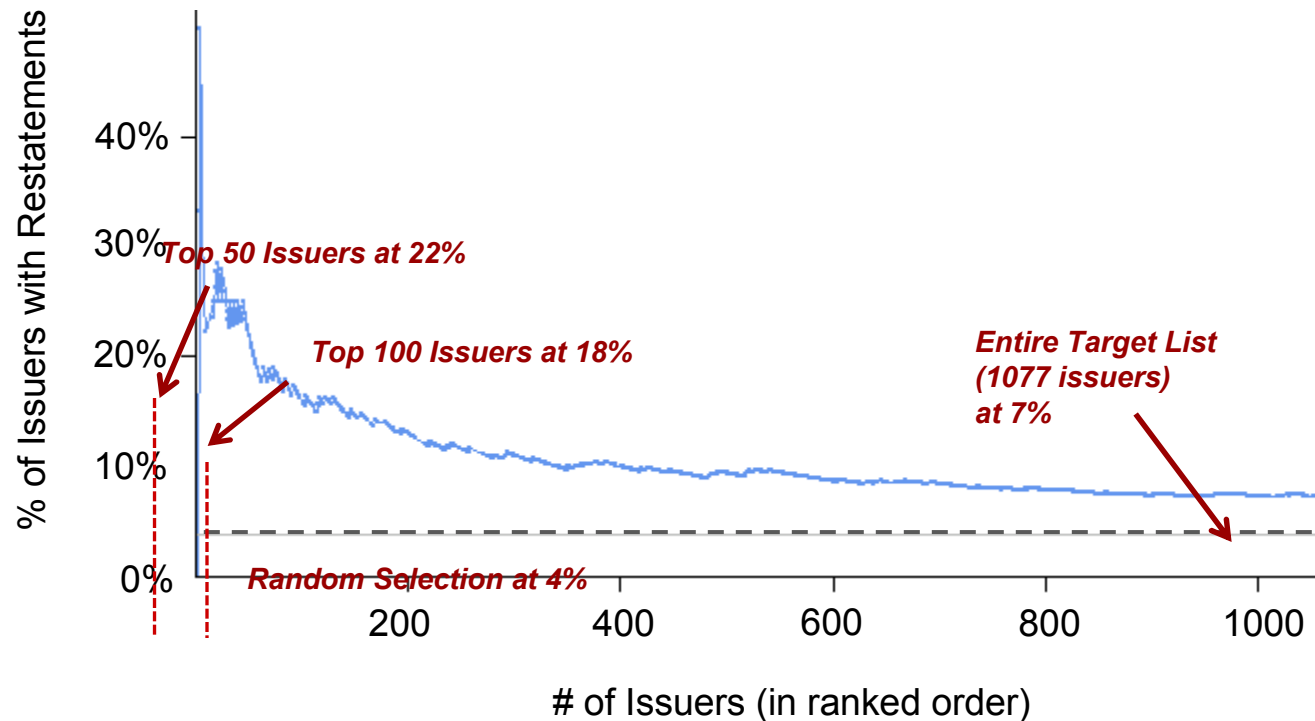
Quant Model

Produce a list of higher risk issuer audits for consideration by PCAOB Inspections for their annual inspections using quantitative (data mining) techniques.

- The goal is to identify issuer audits with elevated risk of audit failure (companies with undetected misstatements)
- The quantitative model algorithm identifies patterns in attributes of issuers who restated in the past and looks for the same patterns in current issuers
- ORA also highlights aspects of financial statements and other qualitative factors for each issuer audit that drive their presence in the high risk list (enhancing inspections' ability to perform a more focused inspection of the audit); can we identify likely restatement types for these issuer audits?
- The list is rank-ordered to reflect the relative probabilities of undetected financial statement misstatements

2009 Quant Model Back-testing

2009 Inspection Year Quant Model
on FY '06 Test Data (6158 issuers)



Hit rate (% of correctly flagged misstaters) declines with lower rank in the target list (backtested on 2006 data)

Peer-Reviewed Research

- We examine the impact of PCAOB inspections on client turnover at triennial firms during the First Cycle – paper is currently undergoing academic peer review
- In particular: Do firm with inspections findings:
 - Resign from more clients?
 - Be dismissed from more clients?
 - Gain more new clients?
- We have access to non-public inspections data and are also able to include the Part II findings in our analysis

Results

- Deficient PCAOB inspections' reports were significantly associated with the firms' decision to resign from issuer audits
 - Could be explained by reputational/compliance concerns
 - May have been trying to avoid comments in future inspections by resigning from "risky" audits
- PCAOB inspections' reports do not seem to be correlated with issuers' decisions to dismiss their auditors
 - However, a publicly available measure of audit quality, partner-to-staff ratio, was significantly correlated with dismissals
- Firms that received at least 1 public Part 1 comment were significantly more likely to receive new issuer-audits in the period following the release of their PCAOB inspections' reports

Findings

- We have some indication that there was a demand for firms that were perceived to provide lower quality audits
 - It could also be the case that there was a demand for lower cost audits and that there is a correlation between audit fees and audit quality
 - We will test this hypothesis in future versions of the paper

Macro Backdrop Drives Risk Assessment

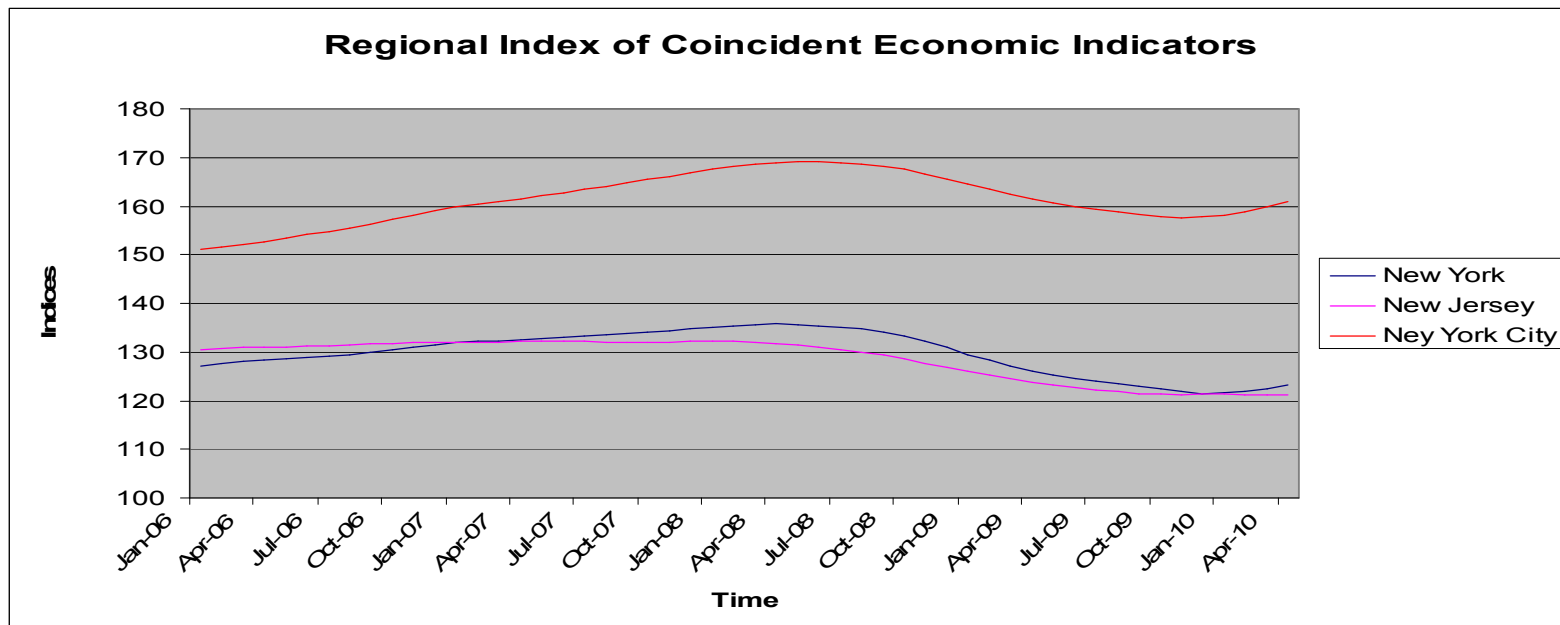
- Recovery on the way but
 - Growth slow as different sectors (public and private) of the economy are trying to reduce their debt burden weighing in aggregate demand
 - Inflation subdued, Fed rates near zero
 - Weakening of housing market, but prices remain above recession lows
- Financing environment improved
 - Ramping up of lending activities
 - Less reliance on short-term financing
- Set back to global recovery from European sovereign debt crisis
 - Flight to safety of US assets – dollar rising
- “Multispeed recovery”
 - With austerity measures in developed countries looking for growth in China

Macro Backdrop; cont'd

- Uncertainty over medium term
 - Continued growth but risks remain through shortfall of aggregate demand and fiscal and monetary policy options limited
 - Continued downward pressure on inflation and risk free rates
 - Unemployment will be higher nationally
- Threat of spillovers from Eurozone sovereign debt crisis
 - Depending on the Euro scenario
- Issuer Economics expect
 - Decreased wage growth
 - Higher taxes
 - “Creative destruction”

New York-New Jersey Region

- ❑ Region experienced severe economic downturn starting in 2008
 - Significant job losses in several key sectors financial services, construction and manufacturing
- ❑ Economic conditions began to show signs of improvement in Fall 2009



Regional Economic Outlook

- The regional economic outlook is uncertain
 - Continued improvement in national economic activity should lead to regional economic growth
 - But, regional economic activity hinges critically on activity in the financial services sector
 - each job in the securities industry is estimated to create two additional jobs in NYC
 - the industry is an important source of state tax revenue
- Pending financial reform may hinder growth in financial services

Other Emerging Risks: Euro zone

- ❑ Greek tragedy; the epicenter of the Financial Crisis moves from banks to European sovereign debt
- ❑ Resource constraints and demographics
- ❑ Will a collapsing Euro collapse European banks?
- ❑ Implications for the US economy
 - Credit crisis
 - Exports
 - The dollar

Other Emerging Risks: GAAP “Tsunami”

- ❑ Modifications to the accounting rules have added significant new discretion to the model
 - Consolidations
 - Transfers and servicing
 - Fair value
 - Revenue recognition
 - More to come
- ❑ Convergence moving forward in 11 separate projects
- ❑ “Principles” or rules with increasing optionality?
 - ASC 860 and the SFAS 140 notion of “control.”
 - Repo 105s,
 - On-balance sheet securitizations
- ❑ The importance of disclosure

Questions?





Update on Standard- Setting Activities

Dee Mirando-Gould
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July 29, 2010
New York, NY

What We Will Cover

- Recent Board Actions
 - Auditing Standard No. 7 - *Engagement Quality Review*
 - Proposed Auditing Standards - *The Auditor's Assessment of and Response to Risk*
 - Proposed Auditing Standard - *Communications with Audit Committees*
 - Proposed Auditing Standard - *Confirmation*
- Guidance
 - Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*
 - Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm*
- Other Standard-Setting Activities
- Standing Advisory Group



Auditing Standard No. 7

Engagement Quality Review

AS No. 7 – *Engagement Quality Review*

- ❑ Supersedes existing requirements for concurring reviews (former SEC Practice Section requirement §1000.08(f) and Appendix E)
- ❑ Applies to all registered firms
 - Firms that were not members of the AICPA SEC Practice Section as of April 16, 2003 were not required to perform concurring reviews
 - Under AS No. 7, all registered firms conducting audits in accordance with PCAOB standards are required to perform an EQR
- ❑ Available through PCAOB website at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_7.aspx

AS No. 7 – *Engagement Quality Review*

- Requires EQR for audits and interim reviews conducted pursuant to the standards of the PCAOB (AS 7.1)
 - Tailored requirements for the EQR of audits (AS 7.9-.13) and the EQR of interim reviews (AS 7.14-.18)
- Requires concurring approval of issuance prior to granting permission to the client to use the engagement report (AS 7.13, and .18)

AS No. 7 – *Engagement Quality Review*

- AS No. 7 is applicable for both the EQR of audits and the EQR of interim reviews for fiscal years beginning on or after December 15, 2009
 - Calendar year-end companies
 - Interim reviews for March 31, 2010
 - Audits for December 31, 2010
 - June 30 year-end companies
 - Interim reviews for September 30, 2010
 - Audits for June 30, 2011

Staff Question and Answer

Auditing Standard No. 7, *Engagement Quality Review*

- Staff Q&A issued on February 19, 2010
- Addresses one question –
 - Question – Does the standard require documentation of all of the interactions between the EQR and the engagement team, including all of the interactions before a matter is identified as a significant engagement deficiency?
 - Answer – No. The example on page 21 of the adopting release illustrates how the documentation requirements of AS No. 7 should be applied once a reviewer concludes that a significant engagement deficiency exists.
- Available through PCAOB website at http://pcaobus.org/Standards/QandA/2010-02-19_EQR_QA%20_2.pdf



Proposed Auditing Standards, *The Auditor's Assessment of and Response to Risk*

Risk Assessment

- ❑ Reproposed December 17, 2009
- ❑ Comment period ended on March 2, 2010
- ❑ Twenty-three comment letters received
- ❑ Available through PCAOB website at <http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx>

Risk Assessment

Significant changes to repropose standards from original proposal:

- Alignment with Auditing Standard No. 5
 - Incorporates the requirements from AS No. 5 related to identifying and assessing risks of material misstatement that also apply to financial statement audits.
 - Excludes requirements related only to the audit of internal control over financial reporting.
- Emphasis on the consideration of fraud
 - Emphasizes that assessing and responding to risk of fraud is an integral part of an audit.
 - Incorporates the requirements for identifying and responding to risks of material misstatement due to fraud and evaluating audit results from AU sec. 316
- Enhancing the requirements for evaluating disclosures

Risk Assessment

- Proposes seven new standards:
 - Audit Risk
 - Audit Planning and Supervision
 - Consideration of Materiality in Planning and Performing an Audit
 - Identifying and Assessing Risks of Material Misstatement
 - The Auditor's Responses to the Risks of Material Misstatement
 - Evaluating Audit Results
 - Audit Evidence



Proposed Auditing Standard, *Communications With Audit Committees*

Communications With Audit Committees

- ❑ Board issued proposed standard on March 29, 2010; comment period ended on May 28, 2010
- ❑ Proposed standard available at <http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket030.aspx>
- ❑ Primary objectives of the proposed standard are to:
 - Enhance the relevance and effectiveness of communications between the auditor and the audit committee
 - Emphasize the importance of effective, two-way communications between the auditor and the audit committee

Communications With Audit Committees

- ❑ Retains the requirements from AU sec. 380, *Communication with Audit Committees*
- ❑ Adapts requirements from AU sec. 310, *Appointment of the Independent Auditor*
- ❑ Includes SEC-required communications for accounting-related matters

Communications With Audit Committees

- ❑ Adds a requirement to communicate an overview of audit strategy and timing of the audit
- ❑ Enhances communications regarding accounting policies, practices and estimates
- ❑ Changes requirements regarding timing of communications
- ❑ Requires a written engagement letter
- ❑ Adds a requirement to evaluate the adequacy of the two-way communication process



Proposed Auditing Standard, *Confirmation*

Confirmation

- ❑ Board issued proposed standard on July 13, 2010; comment period ends on September 13, 2010
- ❑ Proposed standard available at <http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx>
- ❑ Primary objective of the auditor is to:
 - Obtain relevant and reliable audit evidence when designing and performing confirmation procedures

Confirmation

- ❑ Requires confirmation procedures for specific accounts
- ❑ Enhances requirements for confirmation procedures
- ❑ Reflect changes in technology

Confirmation

- Requires confirmation procedures
 - For receivables that arise from credit sales, loans, and other transactions
 - For cash and other relationships with financial institutions
 - In response to significant risks that relate to relevant assertion that can be adequately addressed by confirmation procedures

Confirmation

- Enhances requirements for confirmation procedures
 - Maintaining control over the confirmation process
 - Supplement negative confirmation requests with other substantive procedures
 - Determine that confirmation requests are properly addressed

Confirmation


- Enhances requirements for confirmation procedures (cont'd)
 - Evaluation
 - Perform appropriate alternative procedures for non-responses
 - Investigate exceptions in confirmation responses
 - Assess reliability of confirmation responses
 - Additional procedures for electronic confirmation responses
 - Evaluate disclaimers and restrictive language



**Staff Audit Practice Alert No. 5,
*Auditor Considerations Regarding
Significant Unusual Transactions***

Staff Audit Practice Alert No. 5

- ❑ Issued April 7, 2010
- ❑ The Alert reminds auditors of their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions
- ❑ Responsibilities described in the Alert include –
 - Identifying and assessing risks of material misstatement
 - Responding to risks of material misstatement
 - Consulting others
 - Evaluating financial statement presentation and disclosure
 - Communicating with audit committees
 - Reviewing interim financial information
- ❑ Available through PCAOB website at <http://pcaobus.org/Standards/Pages/Guidance.aspx>



**Staff Audit Practice Alert No. 6,
*Auditor Considerations Regarding Using
the Work of Other Auditors and Engaging
Assistants From Outside the Firm***

Staff Audit Practice Alert No. 6

- ❑ Issued July 12, 2010
- ❑ The practice alert reminds registered firms of their obligations when using the work of other firms or using assistants engaged from outside the firm.
 - Describes the circumstances under which the firm issuing the audit report may use the work and reports of another auditor.
 - Auditors who engage assistants from outside the firm are governed by the same standards regarding planning the audit and supervising assistants that apply when audit work is performed by assistants who are partners of, or employed by, the auditor's firm.
- ❑ Available through PCAOB website at <http://pcaobus.org/Standards/Pages/Guidance.aspx>



Other Standard-Setting Activities

Other Standard-Setting Activities*

- ❑ Requiring the Engagement Partner to Sign the Audit Report (**Concept Release issued July 28, 2009**)
- ❑ Application of the Sarbanes-Oxley Act's Provision on "Failure to Supervise"
- ❑ Related Parties
- ❑ Specialists
- ❑ Fair Value Measurements and Other Accounting Estimates

* Activities subject to change based on emerging issues

Other Standard-Setting Activities*

- ❑ Principal Auditor
- ❑ Quality Controls Standards, Including Quality Controls Over the Work of Affiliated Firms
- ❑ Applicability of SECPS Requirements to all Registered Firms
- ❑ Going Concern
- ❑ Subsequent Events

* Activities subject to change based on emerging issues



Standing Advisory Group

Standing Advisory Group

- The Board looks to the SAG to provide *advice* and *insight* as to the need to formulate new standards or change existing standards
- Meets two to three times a year
 - April 7-8, 2010 meeting
 - Discussed Principal Auditor, Auditor's Reporting Model
 - July 15, 2010
 - Discussed Broker-Dealer Audit Considerations, FASB/IASB Projects and Potential Impact on Auditors
 - Next meeting – October 14-15, 2010
 - All previous SAG meeting agendas, briefing papers, and webcasts are located at <http://.pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx>
- Board seeks nominations annually



Keeping Current with Standard-Related Activities

Keeping Current with Standard-Related Activities

- Our Web site – <http://www.pcaobus.org/Standards/Pages/default.aspx>
 - PCAOB standards and related rules, including interim standards
 - PCAOB proposed standards
 - Staff Questions and Answers
 - Staff Audit Practice Alerts
 - Standing Advisory Group
- Contact us at info@pcaobus.org
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our Web site at
<http://pcaobus.org/About/Pages/Subscribe.aspx>

Questions?



Break

(15 minutes)

Auditing Internal Controls and IT Control Issues in Smaller Public Companies

Greg Wilson and Bill Powers
Division of Registration and Inspections
July 29, 2010
New York, NY

Discussion Topics

- ❑ Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”
 - Status of 404 (b) for Non-Accelerated Filers
- ❑ Auditors’ Responsibility related to Internal Controls
- ❑ Auditing Internal Controls and IT Control Issues
 - What AS No. 5 says
 - Guidance for Auditors of Smaller Public Companies
 - IT control risks and IT controls
 - Experiences to-date
- ❑ Summary and Conclusion

Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”

- ❑ Calendar year 2004 was first year reporting on ICFR under Auditing Standard No. 2 (AS No. 2) for SEC Accelerated Filers
- ❑ May 2006, PCAOB announces intent to revise AS No. 2
- ❑ June 12, 2007, AS No. 5 issued to supersede AS No. 2
- ❑ Years ended after December 15, 2007, Non-accelerated filers began reporting under 404(a)
- ❑ On October 2, 2009, SEC (again) defers, ***for the last time***, 404(b) requirement for non accelerated filers – now required for years ending after June 15, 2010

Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”

- Board’s primary objectives in AS No. 5
 - Focus the audit of internal control on the most important matters
 - Eliminate procedures that are unnecessary to achieve the intended benefits
 - Make the audit clearly scalable to fit any company’s size and complexity
 - Simplify the standard

Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”

- Status of 404 (b) for Non-Accelerated Filers
 - Defined – Public Float < \$75 Million (Approximately 3,500 Non-accelerated Filers)
 - Since 2007, Managements Of Non-accelerated Filers Have Been Reporting On ICFR
 - 1 In 4 Managements Have Reported Material Weaknesses In ICFR In First Two Years Of Management Reports
 - H. R. 4173 Would Amend Sarbanes-Oxley To Exempt Non-accelerated Filers From ICFR Audit
 - Current Legislative Status

Auditors' Responsibility Related to Internal Control

- Second Standard of Field Work (AU 150)
 - “A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed.” (AU 150.02)
- AU 319 *“Consideration of Internal Control in a Financial Statement Audit”*
 - Provides guidance about the auditor’s consideration of internal control in an audit of financial statements in accordance with generally accepted auditing standards.

Auditors' Responsibility Related to Internal Control

□ AS No. 5

- “...the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management’s assessment.” (Para 3, AS No. 5)

Auditing Internal Controls and IT Control Issues

□ What AS No. 5 Says

■ Planning the Audit

- Opinions on the financial statements and internal control over financial reporting
 - Although objectives of both audits are not identical, the auditor must plan and perform the work to achieve the objectives of both audits (i.e. integrated audit).
- Risk assessment underlies entire audit process
- Scaling the audit
- Assessing the risk of fraud
- Using the work of others

Auditing Internal Controls and IT Control Issues

□ What AS No. 5 Says (Cont'd)

- Top Down Approach
 - Start at financial statement level
 - Focus on risk of material misstatement
 - Identify entity level controls (ELCs)
 - Identify significant accounts and disclosures and relevant assertions
 - Understand likely sources of misstatement

Auditing Internal Controls and IT Control Issues

□ What AS No. 5 Says (Cont'd)

■ Testing Controls

- Test controls important to the auditor's conclusion
- Test design effectiveness
- Test operating effectiveness
- Evidence to support design and operating effectiveness
- Nature, timing and extent of tests of controls
- Special considerations in subsequent years

Auditing Internal Controls and IT Control Issues

□ What AS No. 5 Says (Cont'd)

- “...auditor also should understand how IT affects the company’s flow of transactions.”
(Para 36, AS No. 5)
- Auditor should apply AU sec. 319
- Internal Control
 - IT General Controls
 - Application Controls

Auditing Internal Controls and IT Control Issues

□ What AS No. 5 Says (Cont'd)

■ Evaluating Identified Control Deficiencies

- Evaluate individually or in combination
- Audit not required to search for deficiencies less severe than material weaknesses
- **Severity does not depend on misstatement occurring**
- BUT, on reasonable possibility of a misstatement
- Compensating controls should be evaluated and tested when considering a material weakness

Auditing Internal Controls and IT Control Issues

□ What AS No. 5 Says (Cont'd)

■ Wrapping Up

- Forming an opinion
- Obtaining written representations
- Communication to management and the audit committee

Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says (Cont'd)
 - Reporting on Internal Control
 - Separate or combined reports permissible
 - Report date
 - Material weaknesses
 - Subsequent events

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies
 - Staff Views – *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*
 - Published on January 23, 2009
 - The guidance explains how auditors can apply the principles in AS No. 5 to audits of smaller, less complex public companies

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
 - Evaluating Entity-Level Controls
 - Auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective ICFR
 - Auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
 - Assessing Risk of Management Override
 - Additional opportunities of override exist because
 - Senior management is extensively involved in operations
 - There are fewer levels of management
 - Controls that might address risk of management override
 - Maintaining integrity and ethical values
 - Monitoring of controls over journal entries
 - Increased oversight by audit committee
 - Whistleblower program

Auditing Internal Controls and IT Control Issues

□ Guidance for Auditors of Smaller Public Companies (Cont'd)

- Evaluating Segregation of Duties and Alternative Controls
 - Fewer employees – therefore limited opportunities to segregate duties
 - Auditor can evaluate involvement of external parties
 - Auditor can evaluate alternative controls, including
 - Management review
 - Management oversight
 - ELC

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
 - Auditing Information Technology
 - Possible characteristics
 - Off-the-shelf software commonly used
 - Few users and few dedicated IT personnel
 - DOD issues with Security Administration
 - End-user computing prevalent
 - IT-generated reports used in manual controls
 - Reliance on Service Organizations
 - Will discuss few IT control risks and IT controls

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls
 - Security Administration/Segregation of Duties
 - Security administration performed by financial executive.
 - Not enough people to achieve adequate segregation of duties.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
 - Security Administration/Segregation of Duties
 - Periodic independent review of “user ID provisioning” process.
 - Periodic independent review of segregation of duties.
 - Frequency dependent upon results of periodic reviews.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
 - End-user computing
 - Data/formulas on spreadsheets used in financial reporting may not be secured.
 - Interfaces from financial process systems to end-user computing systems for financial reporting may not be complete/accurate.
 - Queries used in financial reporting process may be incorrect.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
 - End-user computing
 - Evaluate locking scheme over formula cells.
 - Evaluate access controls over spread sheets (secured server?)
 - Evaluate end-to-end controls over critical systems interfaces.
 - Evaluate change management process over query development and changes.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
 - Using reports produced by computer systems
 - Reports used for audit procedures produced by computer systems may contain data that is not complete and/or accurate.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
 - Using reports produced by computer systems.
 - Identify key reports used in audit procedures (control procedures/substantive procedures).
 - Either test IT general controls and application controls over data that flows into those reports --- or ---
 - Substantively test a sample of transactions from the report to the source.

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
 - Considering Financial Reporting Competencies
 - Smaller companies may use outside professionals because of the lack of internal expertise
 - Auditor should consider management oversight over the work of outside professionals
 - Who evaluates the professional qualifications
 - Who makes key judgments
 - What controls exist over their work

Auditing Internal Controls and IT Control Issues

□ Guidance for Auditors of Smaller Public Companies (Cont'd)

- Obtaining Sufficient Competent Evidence When the Company has Less Formal Documentation
 - Depending on risk, inquiry combined with other procedures might provide sufficient evidence of control effectiveness
 - Consider using walkthroughs to understand the flow of transactions if management documentation is limited
 - Consider other documentation of processes and controls e.g., what company uses to run its business

Auditing Internal Controls and IT Control Issues

□ Guidance for Auditors of Smaller Public Companies (Cont'd)

- Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies
 - Pervasive deficiencies may adversely affect other controls, but pervasive deficiencies do not necessarily prevent an auditor from expressing an opinion on ICFR
 - Even if auditor cannot express an opinion on ICFR, he or she might be able to opine on financial statements

Experiences to-date

- Pilot of 5 Triennially Inspected Firms with Accelerated Filers
 - Strengths
 - Top-down risk based approach
 - Risk assessment to identify important controls to test
 - Use of work of others including evaluation of competency and objectivity

Experiences to-date

- Pilot of 5 Triennially Inspected Firms with Accelerated Filers
 - Areas for continued focus
 - Various issues related to use of SAS 70 reports
 - Limited focus on IT general controls
 - Documentation of tests of controls
 - Scoping issues related to systems, applications, reports, spreadsheets

Summary and Conclusion

- ❑ Auditors have always had responsibility related to internal controls; AS No. 5 builds on that.
- ❑ ICFR has “stabilized” with the issuance of AS No. 5; questions remain relative to applicability to non-accelerated filers.
- ❑ AS No. 5 is a top-down risk-based approach that is scalable to smaller public companies.
- ❑ PCAOB publication provides guidance on

Summary and Conclusion

- ❑ IT general controls are a “pervasive” part of internal control and have a relationship to ICFR audits and financial statement audits.
- ❑ Auditors should consider IT risks are present in less complex IT environments.
- ❑ Results from prior year pilot program indicate that small firms have successfully transitioned to AS No. 5 --- with some areas to continue to focus on.

Questions?



Lunch

(60 minutes)

Case Studies on Auditing in the Small Business Environment

Presenters

- ❑ Marion Koenigs, Associate Director, Accountant, Division of Enforcement and Investigations
- ❑ George Botic, Deputy Director, Division of Registration and Inspections

Agenda

- ❑ Summary of Domestic Small Firm Program
- ❑ Overview of the Division of Enforcement and Investigations
- ❑ Case Studies on Auditing in the Small Business Environment

Summary of Domestic Small Firm Program

- ❑ Conducted 1,065 domestic small firm inspections between 2004 and 2009
 - Inspected over 2,900 issuer audits between 2004 and 2009
- ❑ To date, over 960 domestic small firm inspection reports have been issued final
- ❑ Issued “Report on the PCAOB’s 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms” (October 22, 2007)

Common Inspection Observations

- ❑ Significant or frequent auditing or quality-control deficiencies were observed in -
 - Revenue
 - Related-Party Transactions
 - Equity Transactions
 - Business Combinations and Impairment of Assets
 - Going-Concern Considerations
 - Loans and Accounts Receivable (including allowance accounts)
 - Service Organizations
 - Use of Other Auditors
 - Use of the Work of Specialists
 - Independence
 - Concurring Partner Review

Overview of the Division of Enforcement and Investigations

- ❑ Who we are
- ❑ Our role within the PCAOB
- ❑ Differences between an Inspection and an Investigation
- ❑ Disciplinary Actions
- ❑ Common threads in Disciplinary Orders

Case Studies on Auditing in the Small Business Environment

□ Refer to handouts

- #1 – Game Distribution, Inc.
- #2 – Turtle Telecom, Inc.
- #3 – Magic Materials, Inc
- #4 – Reliable Refrigerators, Inc.
- #5 – Active Life, Inc.

Restrictions on Use

- ❑ Information not necessarily compiled from inspection observations
- ❑ Information intended to provide considerations and does not represent requirements of the PCAOB
- ❑ Specific procedures that may be performed in a given situation are determined on facts and circumstances

Case Study #1 – Game Distribution, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2009 financial statements of Game Distribution, Inc.
- ❑ Game sells and distributes games to retailers
- ❑ During 2009, Game acquired Up-and-Coming Game Distribution, Inc. (“Little Game”) in a business combination
- ❑ Stock issued as consideration for the acquisition was valued for accounting purposes based on the \$5 per share agreement-date price, although the acquisition-date price was \$6 per share
- ❑ Game primarily wanted Little Game’s valuable trademarks and customer relationships

Case Study #1 – Game Distribution, Inc.

Background

- ❑ Purchase agreement includes contingent consideration to be paid to Little Game's former shareholder based on earnings for the two-year period following the acquisition date
- ❑ Game recorded the contingent consideration at its acquisition-date fair value
- ❑ Game engaged a specialist to assist in valuing the trademarks acquired
- ❑ Game recorded the trademarks as intangible assets based on the specialist's valuation report
- ❑ All other tangible assets acquired and liabilities assumed were recorded at their acquisition-date fair values
- ❑ Unallocated purchase price was recorded as goodwill

Case Study #1 – Game Distribution, Inc.

Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test the purchase price allocation and the fair values assigned to assets and liabilities*
- The audit procedures performed by the engagement team included -
 - Obtained and scanned a copy of the purchase agreement
 - Obtained and reviewed a copy of the specialist's report
 - Relied upon the expertise of the specialist and assessed methods and assumptions used as reasonable
 - Obtained management's representations that the purchase price allocation and related fair values assigned were appropriate

Consideration Transferred (ASC 805)

ASC 805-30-30-7 [FAS 141R paragraph 39] states that the consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer.

Customer Relationships (ASC 805)

- ❑ ASC 805-10-20 [FAS 141R paragraph 3k] states that an asset is *identifiable* if it either arises from contractual rights or is separable
- ❑ ASC 805-20-55-23 [FAS 141R paragraph A39] states that if an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights.
- ❑ ASC 805-20-55-27 [FAS 141R paragraph A42] states that a customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable.

Contingent Consideration (ASC 805)

ASC 805-10-55-25 [FAS 141R paragraph A87] states that if it is not clear whether payments to selling shareholders are part of the business combination, the acquirer should consider the following indicators (as well as others not listed):

- continuing employment
- duration of continuing employment

Use of the Work of a Specialist (AU 336.12)

The auditor should -

- Obtain an understanding of the methods and assumptions used by the specialist
- Make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and
- Evaluate whether the specialist's findings support the related assertions in the financial statements

Case Study #2 – Turtle Telecom, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2009 financial statements of Turtle Telecom, Inc.
 - This will be your firm's first audit of the company
- ❑ Turtle has annual grants of "plain vanilla" stock options for which it estimates fair value using the Black-Scholes-Merton formula
- ❑ Historical volatility is used to estimate expected volatility of stock price
 - Future volatility is not expected to differ from past
 - The options are not traded thus no implied volatility
 - Turtle has been a thinly-traded public company for 20 years with no periods of extreme volatility in stock price
- ❑ Expected volatility set at 20% based on high and low stock prices for each quarter over past two years

Case Study #2 – Turtle Telecom, Inc.

Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test stock option valuation*
- The audit procedures performed by the engagement team included –
 - Evaluated consistency of process used
 - Evaluated engagement team skills and knowledge
 - Evaluated reasonableness of valuation model used
 - Evaluated reasonableness of assumptions used, including:
 - Determined that the 20 % expected volatility is based on quarterly highs and lows for past two years
 - Verified accuracy and completeness of underlying data
 - Obtained management’s representation that option value was computed in accordance with GAAP

Share-Based Payment Guidance

- PCAOB Staff Questions and Answers: *Auditing the Fair Value of Share Options Granted to Employees* (October 17, 2006):
 - A7 states that the expected term and expected volatility assumptions have the highest risk because they involve the greatest amounts of judgment and have a significant effect on the estimated fair value.

Share-Based Payment Guidance

- ❑ SEC Staff Accounting Bulletin No. 107, section D.1. Question 4 states that exclusive use of historical volatility is acceptable when:
 - No reason to believe future volatility over expected term is likely to differ from past;
 - Computation of historical volatility uses simple average;
 - Sequential period of historical data at least equal to expected term is used; and
 - Sufficient number of price observations is used.

Share-Based Payment Guidance

- ❑ SEC Staff Accounting Bulletin No. 107, section D.1. Question 2, item 3 states:
 - Weekly or monthly price observations are generally more appropriate than daily for thinly traded companies.
- ❑ Other applicable guidance
 - ASC Topic 718 Compensation – Stock Compensation [FASB Statement No. 123(R), *Share-Based Payment*]
 - AU Section 328, *Auditing Fair Value Measurements*
 - AU Section 342, *Auditing Accounting Estimates*

Case Study #3 – Magic Materials, Inc.

Background

- ❑ Your Firm has been engaged to audit the consolidated financial statements of Magic Materials, Inc. for the year ended December 31, 2009
- ❑ Magic has one operating subsidiary located in Brazil
 - The foreign subsidiary specializes in manufacturing and distribution of special purpose building materials
- ❑ Approximately 42% of the assets and 48% of revenue reflected in the consolidated financial statements are associated with the foreign subsidiary
- ❑ The foreign subsidiary will be audited by a foreign firm located in Brazil

Case Study #3 – Magic Materials, Inc.

Scenario 1

- ❑ During the planning phase, your Firm determined it would be able to serve as principal auditor and may use the work and report of the foreign firm
- ❑ Your Firm determined it was impracticable to travel to Brazil due to cost and time constraints
 - Instead, your Firm obtained copies of the foreign firm's work papers, all of which were in English
- ❑ The engagement team obtained a copy of the audited financial statements of the foreign subsidiary (Brazilian GAAP), including the foreign firm's auditor's report (Brazilian GAAS)
 - Your Firm does not intend to reference the foreign firm's auditor's report in its opinion on the issuer's consolidated financial statements

Case Study #3 – Magic Materials, Inc.

Scenario 2 - Change in Background

- ❑ The engagement team obtained a copy of the audited financial statements of the foreign subsidiary (US GAAP), including the foreign firm's auditor's report (PCAOB Standards)

Part of Audit Performed by Other Auditors

(AU 543)

- Decision whether the auditor may serve as principal auditor and use the work and reports of other independent auditors
 - Participation must be sufficient to enable the firm to serve as the principal auditor if significant parts of the audit are performed by other auditors
- Form and content of the principal auditor's report
 - No reference is made to the other auditor's work or report if principal auditor assumes responsibility for the work of the other auditor
 - If the principal auditor assumes no responsibility for the work of the other auditor, reference should be included and should indicate clearly the division of responsibility
- Firm is responsible to perform additional procedures if the decision is made not to reference the other auditor's report

Case Study #4 – Reliable Refrigerators, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2009 financial statements and internal control over financial reporting of Reliable Refrigerators, Inc.
 - This will be your firm's first audit of the company
- ❑ The issuer sells refrigerators on a standalone basis and with installation services
- ❑ The issuer does not sell installation services for refrigerators bought from other vendors
- ❑ Big Red, Reliable's top selling product, is typically listed in sales invoices at a price of \$900 with installation at \$10 and the customer entitled to a refund of \$10 if installation is unsatisfactory

Case Study #4 – Reliable Refrigerators, Inc. Background

- ❑ Reliable management asserts it is probable that installation services will be completed satisfactorily based on experience
- ❑ Other third-party retailers in the area provide installation of Big Red for approximately \$50
- ❑ Reliable recognizes \$900 in revenue upon delivery of Big Red and \$10 in revenue upon installation

Case Study #4 – Reliable Refrigerators, Inc.

Background

- ❑ Controller approves customer orders before entered in system
- ❑ Upon installation, installation team calls accounting personnel to provide installation information
- ❑ Installation information is entered in system and must match sales information in system for installation revenue to be recognized
- ❑ CFO reviews monthly reports

Case Study #4 – Reliable Refrigerators, Inc.

Scenario 1

- *You, the engagement partner, are meeting with the audit manager to discuss the plan to audit revenue*
- The audit manager has concerns about . . .
 - Ability of Reliable’s IT staff to produce special reports needed for the audit
 - Whether to test controls for the entire audit period or for just a few days around the “as of” date for the Firm’s ICFR opinion – and what difference does it make anyway?
 - How to get the audit testing done in time for Reliable’s press release scheduled for 3 weeks after year-end

Case Study #4 – Reliable Refrigerators, Inc.

Scenario 1

- ❑ Will you be able to resolve the audit manager's concern about the special reports needed for the audit?
- ❑ Are there other IT matters you and the audit manager should be considering during your discussion?
- ❑ How will you explain to the audit manager the differences in approaches to testing controls over revenue?
- ❑ What will you suggest your audit manager consider in planning and executing the audit to meet the tight deadline?

Case Study #4 – Reliable Refrigerators, Inc.

Scenario 2

- ❑ Your Firm is in the execution stage of its integrated audit of Reliable's financial statements and internal control over financial reporting
- ❑ You have determined that the relevant assertions of occurrence and valuation are important and should be tested
- ❑ Engagement team received data indicating fair value of installation services is \$26 based on cost of service

Case Study #4 – Reliable Refrigerators, Inc.

Scenario 2

- ❑ Control procedures performed by the engagement team included –
 - Reviewed CFO’s initials on monthly computer generated reports of sales, gross margins, and inventory turnover by product line
 - Reviewed Controller’s signature on a random sample of 25 customer orders selected throughout the year
 - IT audit consultant performed a “test of one” over the automated application controls over matching of sales data
 - Obtained management’s representation that management tested ICFR and concluded it was effective

Case Study #4 – Reliable Refrigerators, Inc.

Scenario 2

- Substantive procedures performed by the engagement team included –
 - Performed non-substantive analytical procedures
 - Selected a sample of five sales transactions before and after year end and reviewed supporting documentation
 - Selected a sample of 15 deferred revenue items and agreed to installation documents supporting proper inclusion
 - Obtained management’s representation that revenue was recognized in accordance with GAAP

Revenue Recognition (ASC 605-25)

- ASC 605-25-25-5 [Paragraph 9 of EITF 00-21] states that in an arrangement with multiple deliverables, the delivered item should be considered a separate unit of accounting if all of the following criteria are met:
 - The delivered item has value to the customer on a standalone basis (i.e., it is sold separately by any vendor or the customer could resell the delivered item on a standalone basis);
 - There is objective and reliable evidence of the fair value of the undelivered item; and
 - If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor.

Revenue Recognition (ASC 605-25)

- ASC 605-25-30-7 [Paragraph 16 of EITF 00-21] states as follows:
 - Contractually stated prices for individual products or services in an arrangement with multiple deliverables should not be presumed to be representative of fair value.
 - The best evidence of fair value is the price of a deliverable when it is regularly sold on a standalone basis.
 - Fair value evidence often consists of vendor-specific objective evidence (VSOE) of fair value.
 - Third-party evidence of fair value is acceptable if VSOE of fair value is not available.
 - For example, prices of the vendor's or any competitor's largely interchangeable products or services in sales to similarly situated customers.

Revenue Recognition (ASC 605-25)

NOTE:

ASC Subtopic 605-25, Revenue Recognition – Multiple-Element Arrangements, was amended by Accounting Standard Update No. 2009-13 in October 2009. The amendments in this Update will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. Such amendments are not reflected in this case study.

Case Study #5 – Active Life, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2009 financial statements of Active Life, Inc.
 - This will be your firm's first audit of this issuer
- ❑ The issuer is a development stage company in retail sporting goods
- ❑ The issuer's accounting, financial reporting, and SEC reporting resources are limited

Case Study #5 – Active Life, Inc.

Background

□ Scenario 1

- Issuer prepared adjusted general ledger and footnote disclosures from which the engagement team prepared the financial statements
- Independence issue?

□ Scenario 2

- Issuer prepared draft 10-K with incomplete stock-based compensation footnote data and asked engagement team to prepare that data for the footnote.
- Independence issue?

Case Study #5 – Active Life, Inc.

Independence Guidance

- ❑ Regulation S-X, Rule 2-01(c)(4) Non-audit services. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:
 - (i) Bookkeeping or other services related to the accounting records or financial statements of the audit client. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:
 - (A) Maintaining or preparing the audit client's accounting records;
 - (B) Preparing the audit client's financial statements that are filed with the Commission or that form the basis of financial statements filed with the Commission; or
 - (C) Preparing or originating source data underlying the audit client's financial statements.

Questions?





Break

(15 minutes)

Annual and Special Reporting

Mary Sjoquist
Office of Communications
July 29, 2010
New York, NY

Rules on Periodic Reporting by Registered Public Accounting Firms

- ❑ Adopted by PCAOB on June 10, 2008
- ❑ Approved by SEC on August 13, 2009
- ❑ Effective December 31, 2009
- ❑ Require firms to report certain information annually
- ❑ Require special reporting regarding certain specified events within 30 days of the event.
- ❑ Succeeding to the status of a predecessor entity.

Rules on Periodic Reporting by Registered Public Accounting Firms

□ Fees

- Due by July 31 following the filing of the Annual Report
- Exception—not registered by March 31 of the year in question
- \$100,000 for firms with 500 issuer audit clients and 10,000 personnel
- \$25,000 for firms with 200 issuer clients and 1000 personnel
- \$500 for all other firms

Rules on Periodic Reporting by Registered Public Accounting Firms--Annual Reporting

Form 2 includes –

- ❑ General information concerning the firm
- ❑ Audit clients and audit reports
- ❑ Offices and affiliations
- ❑ Personnel
- ❑ Certain relationships
- ❑ Acquisitions
- ❑ Affirmation of consent

Rules on Periodic Reporting by Registered Public Accounting Firms--Special Reporting

Form 3 triggering events and disclosures include –

- ❑ Name change
- ❑ Audit reports (withdrawn a report or consent, or crossed 100 issuer threshold)
- ❑ Certain legal proceedings
- ❑ Bankruptcy
- ❑ Certain relationships
- ❑ Licenses and certifications
- ❑ Changes in the firm's Board contact person
- ❑ Catch-up Form 3s were due February 1, 2010.

Reporting Rules on Succeeding to a Predecessor Firm's Registration Status

- ❑ Adopted July 28, 2008
- ❑ Approved by SEC August 13, 2009
- ❑ Effective December 31, 2009
- ❑ Allow firms whose structure has changed to retain registration status under two scenarios:
 - A registered firm changes its legal form of organization or jurisdiction in which it operates
 - A registered firm is acquired by an unregistered firm or merges with another firm or firms to create a new legal entity

Reporting Rules on Succeeding to a Predecessor Firm's Registration Status

- The rules provide for:
 - A form to be filed (Form 4),
 - Within 14 days after the event,
 - With certain representations
- Continuity of registration is automatic, without the need for Board action.
- If deadline for filing Form 4 is not met, the registration process using Form 1 will be required along with Board action.

Confidential Treatment Requests

- ❑ **Confidential Treatment Requests are limited on new forms**
 - Board has determined that certain information will never qualify
 - In practice, this means no check box is available to request confidential treatment
- ❑ **To request confidential treatment:**
 - Firm must represent that information is not public AND
 - Firm must provide a detailed explanation of how the information is proprietary OR
 - Firm must provide a detailed explanation of how the information is protected from public disclosure by applicable law, and must provide a publicly available citation to or a copy of the law

New Web-based System

- ❑ **New system replaces old registration system**
 - Access using old username and password
 - For username and password help contact registration-help@pcaobus.org
- ❑ **All forms must be filed using this new system**
 - Forms 2 and 3 can be filed using XML
 - Form 4 is a web based form only
- ❑ **Technical Specifications**
 - Minimum Requirements: IE 6.0, Firefox 2.0
 - IE 8.0 works, Firefox 3.5 does not work yet
 - Exhibits should be filed in one of three formats:
 - PDF
 - GIF
 - JPEG

Questions?





SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

Disclaimer

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. Therefore, the views expressed today are those of the speaker, and do not necessarily reflect the views of the Commission or the other members of the Staff of the Commission.



Agenda

- ❖ **Overview**
- ❖ **Resources**
- ❖ **The Comment Letter Process**
- ❖ **Recent Developments**
- ❖ **Financial Reporting Issues Frequently Raised in Comment Letters**



Overview

Overview

Mission – “To see that investors are provided with material information in order to make informed investment decisions — both when a company initially offers its stock to the public and on a regular basis as it continues to give information to the marketplace.”

- ❖ **Selectively review the disclosure documents filed by public companies (including initial registrations)**
- ❖ **Provide interpretive assistance to companies on SEC rules and forms**
- ❖ **Propose new and revised rules to the Commission**

Organization

- ❖ **11 industry groups**
- ❖ **Legal and Regulatory Policy Offices**



Resources

Resources

Best of the Website --

www.sec.gov/divisions/corpfin.shtml

- ❖ **General**

- ❖ **Filing Review Process**

- ❖ **Statutes, Rules, and Forms**

- ❖ **Compliance & Disclosure Interpretations**

- ❖ **What's New?**

- ❖ **Information for Small Businesses -**

- www.sec.gov/info/smallbus.shtml**

Resources

Best of the Website (cont) --

❖ Information for Accountants -

www.sec.gov/divisions/corpfin/cfreportingguidance.shtml

- **DCF Financial Reporting Manual**
- **Staff Accounting Bulletins**
- **Publicly Released Staff Comment Letters**
- **SEC Staff Speeches**
 - **E.g. “Best Practices for Working with the SEC Staff” --**
www.sec.gov/news/speech/2009/spch120609ac-ms.pdf
- **Other Frequently Requested Material**
 - **Presentation from last year’s forums**
 - **Letters to Industry (a/k/a “Dear CFO Letters”)**
 - **Areas of Frequent Staff Comment —Financial Institutions --**
www.sec.gov/news/speech/2009/slides1209slh.pdf

Resources

Whom do I contact for assistance and how?

- ❖ **Comment process – Disclosure Operations Staff**
 - Names and number will be on comment letter
- ❖ **Staff interpretation or informal question**
 - **Financial Reporting – CF Office of the Chief Accountant at (202)551-3400**
 - **Small Business Policy – CF Office of Small Business Policy (202) 551-3460**
 - **Submit request through online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive**

Resources

Formal Requests related to financial reporting

- ❖ **Pre-filing accommodations/waivers/interpretations of reporting requirements**
- ❖ **Address to the DCF Chief Accountant**
- ❖ **Mail or email to dcaoletters@sec.gov**
- ❖ **Clearly state issue and relief sought**
- ❖ **Clearly state facts and relate them to analysis of issue**
- ❖ **Clearly state the basis for relief**

Formal consultations on the application of GAAP should be sent to - OCA@sec.gov

- ❖ **www.sec.gov/info/accountants/ocasubguidance.htm**



The Comment Letter Process

Comment Letter Process

Filings Subject to Staff Review

- ❖ Selected by the DCF non-public screening criteria and Sarbanes-Oxley Section 408 requirements
- ❖ IPOs
- ❖ Other registration statements
- ❖ Annual reports
- ❖ Proxy statements
- ❖ Item 4.01 and Item 4.02 Forms 8-K

Comment Letter Process

Types of Comments

- ❖ Request for additional supplemental information
- ❖ Provide additional or different disclosure in a future filing
- ❖ Amend filing to revise financial statements or disclosure
- ❖ No further comments letter

Comment Letter Process

Best Practices for Resolving Issues

- ❖ **Prepare a thorough response**
 - **Do not immediately assume staff disagrees with accounting treatment**
 - **i.e. Disclosure may not provide sufficient information to evaluate**
 - **Key response to initial comment**
 - **Indicate specifically where revisions have been made**
 - **Discuss supporting authoritative literature in detail**
- ❖ **Inform Staff if you are unable to respond by the requested date**
- ❖ **Document accounting decisions contemporaneously**
- ❖ **Furnish all correspondence with the Staff on EDGAR**



Recent Developments

Key SEC Developments

Commission Actions

- ❖ *Modernization of Oil and Gas Reporting*
 - Effective for filings after January 1, 2010
- ❖ *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*
- ❖ *Proxy Disclosure Enhancements*
 - Effective for filings after February 28, 2010
- ❖ *Interpretive Guidance on Disclosure Related to Business or Legal Developments Regarding Climate Change*
- ❖ *Commission Statement in Support of Convergence and Global Accounting Standards*

Key SEC Developments

Staff Initiatives

- ❖ **Division of Corporation Finance Financial Reporting Manual Updates**
- ❖ **Corporation Finance Compliance and Disclosure Interpretations on Non-GAAP Financial Measures**
 - <http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm>
- ❖ **Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses**
 - www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm
- ❖ **SEC Staff Announcement, EITF Topic D-110: Escrowed Share Arrangements and the Presumption of Compensation**

Other Recent Developments

FASB Accounting Standards Codification -- asc.fasb.org

- ❖ **Launched on July 1, 2009 and effective for fiscal periods ending after 9/15/09**
- ❖ **SEC Interpretive Release No. 33-9062A -- *Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification***
- ❖ **Reconsider accounting policy disclosures and GAAP references**
- ❖ **References to SEC Guidance should not change**

Accounting Standards Update—Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements

- ❖ **Revision to EITF D-86**



*Financial Reporting Issues
Frequently Raised in Comment
Letters*

Financial Reporting Issues Frequently Raised in Comment Letters

- ❖ *Management's Discussion & Analysis*
- ❖ *Reverse Mergers & "Back Door" Registrations*
- ❖ *Business Combinations*
- ❖ *Goodwill, Intangible and Long-Lived Assets*
- ❖ *Predecessor Financial Statements*
- ❖ *Equity Transactions*
- ❖ *Embedded Conversion Options and Freestanding Warrants*
- ❖ *Revenue Recognition*
- ❖ *Smaller Reporting Company Status*
- ❖ *Disclosure Controls and Procedures*
- ❖ *Internal Control over Financial Reporting*
- ❖ *Form 8-K*

Management's Discussion & Analysis (MD&A)

Release Nos. 33-6835 and 33-8350

Results of Operations

- ❖ **What has happened during the period and why?**
 - **Underlying drivers for changes in operating results**

Liquidity

- ❖ **Sources and uses of cash**
 - **What are our bills and how will we pay them?**
 - **Prospective sources of and need for capital**
- ❖ **Going concern matters**

Early warning disclosures – Item 303(a)(3)(ii) of Regulation S-K

Reverse Mergers & “Back Door” Registrations

What is a “back door” registration?

Frequent Areas of Comment:

- ❖ **Required Form 8-K items not filed**
 - **Including Item 4.01 Form 8-K (Change in Accountants)**
- ❖ **Form 10-type information in Form 8-K**
 - **Financial Statements due within 4 business days (no 71-day extension)**
- ❖ **Financial statement updates on Form 8-K**
 - **Staff Interpretation of Exchange Act Rule 13a-1**
- ❖ **Internal Control over Financial Reporting**
 - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

Reverse Mergers & “Back Door” Registrations

Illustration of Staff Interpretation of Rule 13a-1

- ❖ **Reverse Merger occurs in January 2010**
- ❖ **Both the public shell company (accounting acquiree) and nonpublic operating company (accounting acquirer) have calendar year-ends**
- ❖ **12/31/09 Form 10-K would include the financial statements of the public shell company**
- ❖ **Financial Statements of the operating company included in the Form 8-K would only include 12/31/08 audited financial statements and 9/30/09 unaudited interim financial statements**
- ❖ **3/31/10 Form 10-Q would include financial statements of the operating company**
- ❖ ***Issue* – The 12/31/09 annual financial statements of the operating company were never filed**
- ❖ ***Solution* – File an amended Form 8-K containing all information that would be required had the operating company filed a 12/31/09 Form 10-K**
- ❖ ***NOTE:* Both 2009 and 2010 Forms 10-K would need to comply with SOX 404 requirements**

Reverse Mergers & “Back Door” Registrations

Accounting acquirer’s audited F/S presented for all historical periods in subsequent reports

- ❖ **Earnings per share recast to reflect exchange ratio**
- ❖ **Eliminate retained earnings of shell or legal acquirer**
- ❖ **Common stock of shell or legal acquirer continues**

Audit Issues

- ❖ **PCAOB Standards**
- ❖ **Domestic auditors of foreign operating companies**

Reverse Mergers & “Back Door” Registrations

Recapitalization Example

- ❖ The transaction was consummated 4/1/09
- ❖ Shell has 100,000 shares o/s @ 3/31/09 (\$1 par)
- ❖ OpCo has 100,000 shares o/s @ 3/31/09 (\$2 par)
- ❖ Shell issues 400,000 shares for 100% of OpCo
- ❖ Post-recap entity has no other equity transactions from 4/1/09 – 6/30/09
- ❖ Post-recap entity has net income of \$300,000 for the period from 4/1/09 – 6/30/09

Reverse Mergers & “Back Door” Registrations

**OpCo SSE 1/1/08 -
3/31/09**

| | Number of Shares | Shares at Par (\$2) | APIC | Retained Earnings (Deficit) | Total |
|--|-----------------------------|--------------------------------|-----------------------|--|-------------------------|
| 1/1/08 | 60,000 | 120,000 | 600,000 | 300,000 | 1,020,000 |
| Shares issued for services 7/1/08 | 20,000 | 40,000 | 110,000 | | 150,000 |
| Net Income | | | | 250,000 | 250,000 |
| 12/31/08 | 80,000 | 160,000 | 710,000 | 550,000 | 1,420,000 |
| Shares issued for cash 2/1/09 | 20,000 | 40,000 | 190,000 | | 230,000 |
| Net Income | | | | 200,000 | 200,000 |
| 3/31/09 | <u>100,000</u> | <u>200,000</u> | <u>900,000</u> | <u>750,000</u> | <u>1,850,000</u> |

Reverse Mergers & “Back Door” Registrations

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09

| | Number of Shares | Shares at Par (\$1) | APIC | Retained Earnings (Deficit) | Total |
|--------------------------------------|---------------------|------------------------|---------|-----------------------------------|-----------|
| 1/1/08 | 240,000 | 240,000 | 480,000 | 300,000 | 1,020,000 |
| Shares issued for services 7/1/08 | 80,000 | 80,000 | 70,000 | | 150,000 |
| Net Income | | | | 250,000 | 250,000 |
| 12/31/08 | 320,000 | 320,000 | 550,000 | 550,000 | 1,420,000 |
| Shares issued for cash 2/1/09 | 80,000 | 80,000 | 150,000 | | 230,000 |
| Net Income | | | | 200,000 | 200,000 |
| 3/31/09 | 400,000 | 400,000 | 700,000 | 750,000 | 1,850,000 |
| Recapitalization 4/1/09 | 100,000 | 100,000 | 25,000 | | 125,000 |
| Net Income | | | | 300,000 | 300,000 |
| 6/30/09 | 500,000 | 500,000 | 725,000 | 1,050,000 | 2,275,000 |

Business Combinations

Purchase Price Allocation

- ❖ **Allocated to all assets and liabilities acquired generally based upon fair value**
 - **Consider all separately identifiable intangible assets**
- ❖ **Fair value of securities issued**

Determination of Accounting Acquirer

- ❖ **Consideration of all factors (ASC 805-10-55-11 to 15)**

Disclosures and Separate Financial Statements

- ❖ **Rule 3-05/8-04 of Regulation S-X**

Goodwill, Intangible and Long-Lived Assets

Goodwill and Indefinite-Lived Intangible Assets

- ❖ Allocation to reporting units
- ❖ Impairment
 - Annual testing date vs. interim impairment tests
 - 2-step testing method and how FV is estimated

PP&E and Intangible Assets

- ❖ Capitalization
- ❖ Useful lives and amortization methods
- ❖ Impairment

Predecessor Financial Statements

- ❖ **Registrant succeeds to substantially all of the business of another entity**
- ❖ **Registrant's own operations are relatively insignificant**
- ❖ **Common in SPAC mergers**
- ❖ **Financial Statements consistent with Rules 3-01 and 3-02 of Regulation S-X or Rule 8-02 and 8-03 of Regulation S-X**

Predecessor Financial Statements

Example

- ❖ **Shell company merges with an operating company in a transaction accounted for as a purchase.**
- ❖ **Transaction date: October 14, 2009**
- ❖ **Combined company has a calendar year-end**
- ❖ **Merger Form 8-K for requirements:**
 - **Audited financial statements of the operating company as of December 31, 2008 and December 2007 and for the years ended December 31, 2008, December 31, 2007 and December 31, 2006**
 - **Unaudited interim financial statements as of and for the six months ended June 30, 2009.**
 - **December 31, 2006 information not required for SRCs**

Predecessor Financial Statements

Example (Cont.)

- ❖ ***Presentation in Form 10-K for the Year Ended December 31, 2009 :***
 - **Audited financial statements of the combined company as of and for the year ended December 31, 2009, but the statements of operations and cash flows will only include the operating company from October 14, 2009.**
 - **Pre-merger audited statements of operations and cash flows of the operating company for the year ended December 31, 2008 (and 2007 if not an SRC) and the period from January 1, 2009 to October 13, 2009 (i.e. no gap in audited periods). The 2009 stub period must be audited.**
 - **Complete set of notes should be provided for each entity.**
 - **Pre-merger financial statements should be clearly labeled as predecessor financial statements.**
 - **Corresponding Managements' Discussion and Analysis**

Equity Transactions

Fair Value Determination

- ❖ If publicly traded in an active market, use quoted market price
 - If discounts are appropriate under the circumstances, they should be supported by objective evidence
- ❖ If stock not publicly traded in active market
 - Contemporaneous equity transactions with third parties
 - Fair value of the services or goods provided may be used to measure the transaction, if more reliable
 - Consider management's judgment -- ASC 820-10-35 (FSP SFAS 157-3 and 157-4)

Disclosure

- ❖ All major assumptions used to value stock options, warrants and other equity instruments
 - Footnotes
 - MD&A (critical accounting estimates)
 - Sensitivity analysis

Embedded Conversion Options and Freestanding Warrants

Scope

- ❖ Applies to all contracts that are indexed to, and potentially settled in a company's own stock (e.g., warrants, many conversion options)

Common Pitfalls

- ❖ Cash settlement provisions
- ❖ Insufficient authorized shares
- ❖ No limit on # of shares to be delivered
- ❖ Incorrect conclusion on whether instrument is indexed to a company's own stock
 - “Ratchet Provisions” -- paragraphs 33 and 34 of ASC 815-40-55 (Example 8 of EITF 07-5)

Embedded Conversion Options and Freestanding Warrants (cont'd)

Valuation Issues

- ∨ Inappropriate model being used to value the bifurcated embedded derivatives
 - Black-Scholes may not be appropriate in many situations given complex features and terms of conversion option (e.g. combined embedded derivatives)

Evaluate the provisions of your agreements (Debenture, warrant, reg. rights, anti-dilution provisions, etc.) carefully

Revenue Recognition

Policy disclosures (i.e., SAB 104)

- ❖ Avoid “Boilerplate” disclosures
- ❖ Disclosure should be specific to each of company’s revenue streams

FASB ASC 605-25 – Multiple-Element Arrangements

- ❖ Allocation of consideration

FASB ASC 605-45 – Gross versus Net Revenue Recognition

- ❖ Consider and weigh all indicators

FASB ASC 605-50 – Customer Payments and Incentives

- ❖ Recognition
- ❖ Classification

Smaller Reporting Company Status

Transition to Smaller Reporting Company status

- ❖ Public float < \$50 million on last business day of Q2
 - May reflect change immediately
 - If public float = \$0, < \$40 million audited annual revenues
- ❖ Still considered an accelerated filer for remainder of year

Transition to larger reporting company status

- ❖ Public float \geq \$75 million on last business day of Q2
- ❖ If public float = \$0, \geq \$50 million audited annual revenues
 - May wait until Q1 of next fiscal year

Common Comment Areas on Disclosure Controls & Procedures

Conclusions

- ❖ Disclosure should state DC&P conclusion in clear and unqualified language – effective or not effective
- ❖ “Adequate” or “Effective except for...” are inappropriate
- ❖ “Effective” DC&P conclusion when ICFR conclusion is “ineffective”
- ❖ Consider reassessing conclusions upon the filing of any amendments

Incomplete definition of DC&P

- ❖ If definition is included, should conform exactly to Item Exchange Act Rule 13a-15 (note definition is not required)

Internal Control over Financial Reporting (ICFR)

Management Reports under Item 308(a) of Regulation S-K

- ❖ Separate evaluation *and assessment* from evaluation of disclosure controls and procedures
- ❖ All four elements in Item 308(a) must be addressed in disclosure
- ❖ ICFR cannot be “effective” if material weakness exists
- ❖ Clear conclusion (either “effective” or “ineffective”)

SOX Section 302 Certifications should not deviate from specific form and content in Item 601(b)(31)(i) of Regulation S-K

- ❖ Include all paragraphs (including paragraph 4(b))

Internal Control over Financial Reporting (ICFR)

Disclosures that companies should consider when material weakness exists (see SEC Release No. 33-8810)

- ❖ **Nature of the material weakness (i.e. identification of the deficiency)**
- ❖ **Impact of control deficiency on the company's financial reporting and its ICFR**
- ❖ **Current plans, if any, or actions already undertaken to remediate the material weakness (note Item 308 (c) of Regulation S-K)**
- ❖ **Disclosures should be detailed and specific for each material weakness identified**

Form 8-K

All Item 4.01 and Item 4.02 8-K filings reviewed for strict compliance

Frequent Item 4.01 comments

- ❖ **Failure to specify whether former accountants resigned, declined to stand for re-election, or were dismissed and the date**
- ❖ **Identification of “going concern opinions”**
- ❖ **Disclosure of disagreements in most recent interim period**
- ❖ **Exhibit 16 letter**
- ❖ **Reverse acquisitions**
- ❖ **Accounting firm mergers**

Form 8-K Compliance and Disclosure Interpretations

- ∨ **www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm**

Form 8-K

Most Item 4.02 comments relate to Item 4.02(a)

- ❖ **Triggering event other than non-reliance conclusion (e.g., completion of restatement)**
- ❖ **Unclear statement regarding non-reliance**
- ❖ **Brief description of facts lacking or unclear**
- ❖ **“Stealth restatements”**
 - **See Exchange Act Form 8-K Compliance and Disclosure Interpretation 215.01**



Questions???

Key Telephone Numbers

Corporation Finance Office of Chief Accountant (202) 551-3400

Corporation Finance Office of Chief Counsel (202) 551-3500

SEC Office of the Chief Accountant (202) 551-5300

Corporation Finance Office of Small Business Policy (202) 551-3460



Appendix

Recapitalization Example

- ***The transaction was consummated 4/1/09***
 - Shell has 100,000 shares o/s @ 3/31/09
 - OpCo has 100,000 shares o/s @ 3/31/09
 - Shell issues 400,000 shares for 100% of OpCo
- ***Other Information***
 - Post-recap entity has no other equity transactions from 4/1/09 – 6/30/09
 - Post-recap entity has net income of \$300,000 for the period from 4/1/09 – 6/30/09

Recapitalization Example

| | Shell | OpCo |
|---|-------------------|---------------------|
| Balance Sheets @ 3/31/09 | | |
| Cash | \$ 200,000 | \$ 50,000 |
| Assets Other than Cash | | 2,000,000 |
| Total Assets | \$ 200,000 | \$ 2,050,000 |
| | | |
| Liabilities | \$ 75,000 | \$ 200,000 |
| | | |
| Shell Common Stock (\$1 par) 100,000 shares o/s | 100,000 | |
| OpCo Common Stock (\$2 par) 100,000 shares o/s | | 200,000 |
| APIC | 125,000 | 900,000 |
| Retained Earnings (Deficit) | (100,000) | 750,000 |
| Total Equity | 125,000 | 1,850,000 |
| | | |
| Total Liabilities & Equity | \$ 200,000 | \$ 2,050,000 |

Shell SSE 1/1/08 - 3/31/09

| Shell SSE 1/1/08 - 3/31/09 | Number of Shares | Shares at Par (\$1) | APIC | Retained Earnings (Deficit) | Total |
|---|-----------------------------|--------------------------------|----------------|--|-----------------|
| 1/1/08 Shares issued for services 2/1/08 | 40,000 | 40,000 | | (60,000) | (20,000) |
| | 30,000 | 30,000 | 60,000 | | 90,000 |
| Net Loss | | | | (10,000) | (10,000) |
| 12/31/08 Shares issued for cash | 70,000 | 70,000 | 60,000 | (70,000) | 60,000 |
| 3/1/09 | 30,000 | 30,000 | 65,000 | | 95,000 |
| Net Loss | | | | (30,000) | (30,000) |
| 3/31/09 | 100,000 | 100,000 | 125,000 | (100,000) | 125,000 |

OpCo SSE 1/1/08 - 3/31/09

| OpCo SSE 1/1/08 - 3/31/09 | Number of Shares | Shares at Par (\$2) | APIC | Retained Earnings (Deficit) | Total |
|--|-----------------------------|--------------------------------|----------------|--|------------------|
| 1/1/08 | 60,000 | 120,000 | 600,000 | 300,000 | 1,020,000 |
| Shares issued for services 7/1/08 | 20,000 | 40,000 | 110,000 | | 150,000 |
| Net Income | | | | 250,000 | 250,000 |
| 12/31/08 | 80,000 | 160,000 | 710,000 | 550,000 | 1,420,000 |
| Shares issued for cash 2/1/09 | 20,000 | 40,000 | 190,000 | | 230,000 |
| Net Income | | | | 200,000 | 200,000 |
| 3/31/09 | 100,000 | 200,000 | 900,000 | 750,000 | 1,850,000 |

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09

| | Number of Shares | Shares at Par (\$1) | APIC | Retained Earnings (Deficit) | Total |
|--------------------------------------|---------------------|------------------------|----------------|-----------------------------------|------------------|
| 1/1/08 | 240,000 | 240,000 | 480,000 | 300,000 | 1,020,000 |
| Shares issued for services 7/1/08 | 80,000 | 80,000 | 70,000 | | 150,000 |
| Net Income | | | | 250,000 | 250,000 |
| 12/31/08 | 320,000 | 320,000 | 550,000 | 550,000 | 1,420,000 |
| Shares issued for cash 2/1/09 | 80,000 | 80,000 | 150,000 | | 230,000 |
| Net Income | | | | 200,000 | 200,000 |
| 3/31/09 | 400,000 | 400,000 | 700,000 | 750,000 | 1,850,000 |
| Recapitalization 4/1/09 | 100,000 | 100,000 | 25,000 | | 125,000 |
| Net Income | | | | 300,000 | 300,000 |
| 6/30/09 | <u>500,000</u> | <u>500,000</u> | <u>725,000</u> | <u>1,050,000</u> | <u>2,275,000</u> |

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09 (cont'd)

OpCo received 4 shares for each o/s share: Exchange Ratio of 4:1

| | | |
|---|-------------|--|
| A | \$1 | Equals par value of Shell |
| B | 80,000 | Use 4 for 1 Exchange Ratio. 20,000 shares x 4 = 80,000 |
| C | \$80,000 | 80,000 shares x \$1 par value = \$80,000 |
| D | \$70,000 | \$150,000 from (E) below - \$80,000 from (C) above |
| E | \$150,000 | No change from OpCo pre-recap SSE |
| F | \$200,000 | No change from OpCo pre-recap SSE |
| G | \$200,000 | No change from OpCo pre-recap SSE |
| H | 400,000 | Should agree to number of shares issued to OpCo by Shell |
| I | \$400,000 | 400,000 shares x \$1 par value = \$400,000 |
| J | \$700,000 | \$1,850,000 from (L) below - \$750,000 from (K) below - 400,000 from (I) above |
| K | \$750,000 | No change from OpCo pre-recap SSE |
| L | \$1,850,000 | No change from OpCo pre-recap SSE |
| M | 100,000 | Number of o/s shares at Shell pre-recap |
| N | \$100,000 | 100,000 shares x \$1 par value = \$100,000 |
| O | \$25,000 | \$125,000 from (P) below - \$100,000 from (N) above |
| P | \$125,000 | Net assets of shell pre-recap |

Shell & OpCo Historical EPS

Shell Pre-Recap Historical EPS

| | 12/31/08 | 03/31/09 |
|--------------------------------------|-------------|-------------|
| Net Loss | \$ (10,000) | \$ (30,000) |
| EPS | \$ (0.15) | \$ (0.38) |
| Weighted Average Number of Shares | 67,500 | 80,000 |

OpCo Pre-Recap Historical EPS

| | 12/31/08 | 03/31/09 |
|--------------------------------------|------------|------------|
| Net Income | \$ 250,000 | \$ 200,000 |
| EPS | \$ 3.57 | \$ 2.14 |
| Weighted Average Number of Shares | 70,000 | 93,333 |

Solution: Continuing Entity EPS

| | 12/31/08 | 03/31/09 | 06/30/09 |
|--|-------------------|-------------------|-------------------|
| Net Income | \$ 250,000 | \$ 200,000 | \$ 500,000 |
| EPS | \$ 0.89 | \$ 0.54 | \$ 1.15 |
| Weighted Average Number of Shares | 280,000 | 373,332 | 436,667 |

Embedded Conversion Options and Freestanding Warrants

Analysis

- ❖ **Is the instrument within scope of ASC 480-10-15 (SFAS 150)?**
- ❖ **Analyze under ASC 815 (SFAS 133) – two routes**
 - 1. Freestanding**
 - **Analyze whether a derivative under SFAS 133**
 - **Perform ASC 815-40 (EITF 00-19) and ASC 815-40-15 (EITF 07-5) analysis to see if scope exception in ASC 815 is available**
 - **If scope exception met, account for as equity**
 - **If no scope exception met, and the option meets the definition of a derivative, account for as a derivative liability (ASC 815/SFAS 133)**

Embedded Conversion Options and Freestanding Warrants (cont.)

2. Embedded

- Perform ASC 815-40 (EITF 00-19) and ASC 815-40-15 (EITF 07-5) analysis to see if scope exception in ASC 815 is met for conversion option
- If scope exception is met, no bifurcation required, but consider BCF under ASC 470-20 (EITF 98-5 and 00-27)
- If no scope exception is met, and the definition of a derivative is met, account for as a derivative liability (all embedded derivatives should be combined and accounted for as a single compound embedded derivative)

Questions?



Closing Remarks and Wrap-Up

Steven Harris
PCAOB Board Member
July 29, 2010
New York, NY