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Forum on Auditing in the Small Business Environment

May 20, 2010

San Francisco, CA

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Opening Remarks

Bill Gradison
PCAOB Board Member
May 20, 2010
San Francisco, CA

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.

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Economic Outlook & US GAAP Developments

Andres Vinelli
Office of Research and Analysis

Tim Gustafson
Office of Research and Analysis

What we will cover

- Economic Outlook
- US GAAP Developments

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Industry Sectors of Issuer Clients – San Francisco

Firms	**15**
Issuer Clients	**475**
Consumer Discretionary	**41**
Consumer Staples	**15**
Energy	**2**
Financials	**74**
Health Care	**66**
Industrials	**50**
Information Technology	**75**
Materials	**2**
Telecommunication Services	**4**
Misc. Financial Services	**140**
Utilities	**6**
Grand Total	**475**

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Roadmap

- The credit crisis and policy response
- Current baseline scenario
  - “Multispeed recovery”
  - Implications

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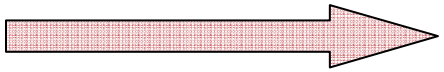
2007-2008: Very High Risk Scenario

- The “Big Recession” started in December of 2007
- Main features of 2007-2008 scenario:
  - Banking crisis
  - Slowed Production
  - Recession
  - Deflationary forces



	2009	2010
Jan	0.0%	2.7%
Feb	0.2%	2.2%
Mar	-0.4%	2.4%
Apr	-0.7%	1.8%
May	-1.3%	1.7%
Jun	-1.4%	1.6%
Jul	-2.1%	
Aug	-1.5%	
Sep	-1.3%	
Oct	-0.2%	
Nov	1.8%	
Dec	2.8%	

- Governments around the world acted:
  - Swiftly
  - In a coordinated fashion
  - Very creatively
- Very strong monetary and fiscal stimuli

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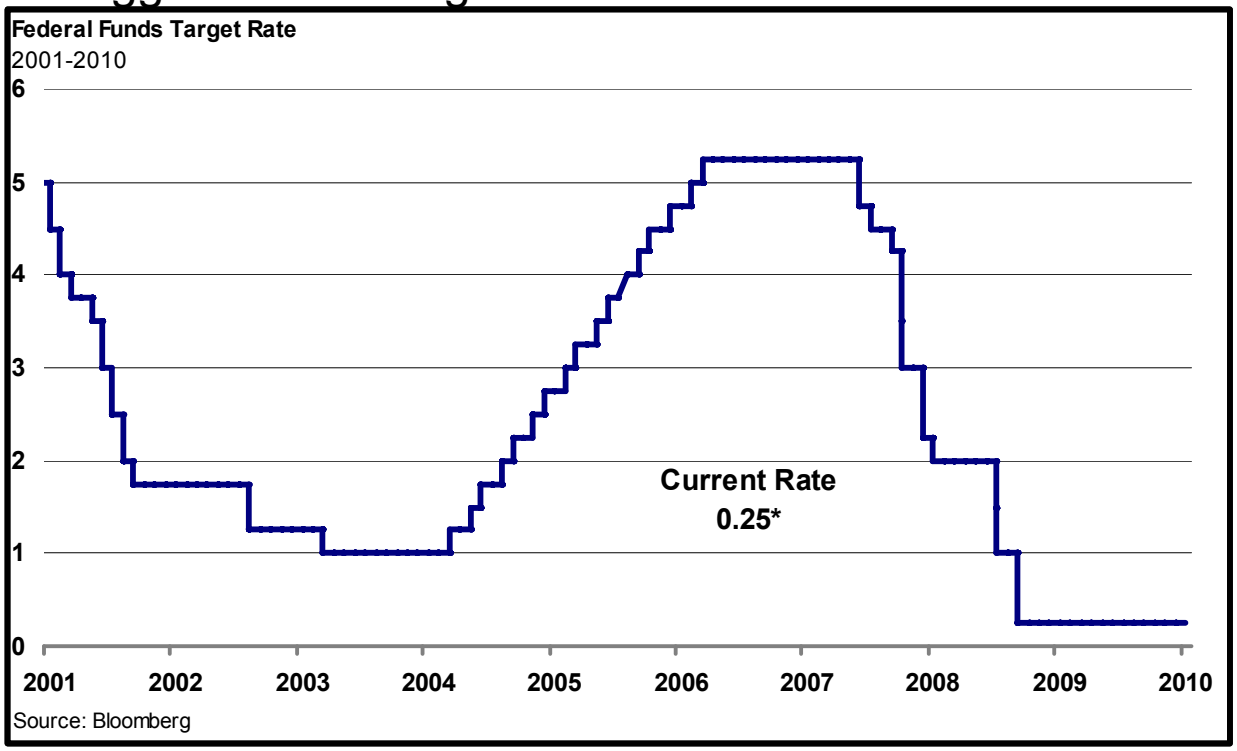
Strong Monetary Stimulus...

- Aggressive cutting of Federal Funds Rate



- Declines in yields of US treasuries.

Average Yields for US Treasuries

Date	1 Year	10 Year
2010	0.4%	3.75%
2009	0.5%	3.3%
2008	1.8%	3.7%
2007	4.5%	4.6%
2006	4.9%	4.8%

Source: www.ustreas.gov

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...and Bold Fiscal Policy (Increases in Government Spending)

Summary of Reciepts, Outlays, and Surpluses or Deficits (in millions)

Year	As Percentage of GDP		
	Receipts	Outlays	Suplus or Deficit
2007	18.5%	19.6%	-1.2%
2008	17.5%	20.7%	-3.2%
2009	14.8%	24.7%	-9.9%
2010	14.8%	25.4%	-10.6%
2011	16.8%	25.1%	-8.3%
2012	18.1%	23.2%	-5.1%
2013	18.6%	22.8%	-4.2%
2014	19.0%	22.9%	-3.9%

Source: Historical Tables, Budget of the U.S. Government fiscal 2010

Estimates are shaded in gray.

- Largely driven by GDP loss, not by bailout costs.

Accounting for Government Programs: Troubled Asset Relief Program ("TARP")

FDIC Position – acquisition of a troubled banking institution should be accounted for as an indemnification asset under FAS 141R.

SEC Position – acquisition of a troubled banking institution should be accounted for as indemnification assets, under FAS 141R, or as a derivative under FAS 133.

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... and a Bounce in Risky Assets

- Financial markets re-priced assets given the avoidance of the depression scenario

What are consequences for pensions?

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Consolidation in the Housing Market

Change in Housing Prices

	Composite 20 Index	San Francisco Index
2005	14.5%	13.6%
2006	0.4%	-1.2%
2007	-8.6%	-10.6%
2008	-16.7%	-29.2%
2009	-0.3%	9.6%

Source: Case-Shiller Index

2006 was the last profitable year for most home builders.

Will homebuilders be able to apply net operating losses to previous earnings? (There is a two year limit).

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Inventories

- Huge decrease in inventories
  - An abnormally low level due to manufacturing production levels.
- Large rebound in 4th quarter 2009 and 1st quarter 2010
- Technically, we might have been out of the recession since around June 2009

Portion of fixed production overhead attributable to excess capacity should be expensed as it incurs.

It may not be allocated and capitalized as cost of inventory.

Determining whether production is abnormally low requires significant judgment and depends on facts and circumstances.

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But Small Businesses are Struggling

- Small businesses are doing much worse at the present than in previous business cycles
  - Not just in absolute terms but also relative to larger businesses.
  - The small business index published by the National Federation of Independent Business looks far less robust than other indices.
- This is in part because of poor access to financing
  - Bank credit is still tight.
  - Unlike large firms, which often have access to the commercial paper and corporate bond markets, small businesses rely mostly on bank loans for funding.
  - Commercial and industrial bank loans, the primary source of funds for small firms, have continued to contract at faster and faster rates in recent months.
  - If this is at least partly due to the credit supply restrictions, it implies that small firms have failed to benefit from the improvements in credit market functioning that have helped their large counterparts.

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Looking Forward: Baseline Scenario

Gross Domestic Product (Annual)	Growth Rate*
2005	6.5%
2006	6.0%
2007	5.1%
2008	2.6%
2009	-1.3%
2010	2.4%
2011	3.1%
2012	3.3%

Source: Historical Tables, Budget of the U.S. Government fiscal 2010

Estimates provided by Philadelphia Fed - Survey of Professional Forecasters. Estimated growth rates are shaded in gray.

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A Multispeed Recovery

2010 GDP projection	
US	**3.1%**
Euro zone	**1.0%**
Japan	**1.9%**
China	**10.0%**
Emerging markets	**6.3%**
World	**4.2%**

Source: IMF. April 2010. World Economic Outlook.

- Low risk of a relapse ("W")

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But Unemployment will be Higher Nationally...

Year	Apr
2005	5.2%
2006	4.7%
2007	4.5%
2008	5.0%
2009	8.9%
2010	9.7%

Source: Bureau of Labor and Statistics.

Estimates are shaded in gray and provided by the Financial Forecast Center

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... and Regionally

Unemployment

	2006	2007	2008	2009
San Francisco County	4.2%	4.2%	5.2%	9.0%
Metropolitan Statistical Area	3.9%	4.0%	5.0%	8.7%
California	4.9%	5.3%	7.2%	11.4%
United States	4.6%	4.6%	5.8%	9.3%

Source: State of California Employment Development Department

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Furthermore, Consumers are Deep Into Debt…So Expect Lower Consumption Levels.

- Consumers will try to repay debt.
- This depresses economic growth.
- But so far the consumer has proven more resilient that expected.

What are consequences for retail and media and advertising?

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Government will not Fully Compensate because Debt is Up

General Government Debt (Percent of GDP)

Country	2007 (Pre-Crisis)	2009	2010	2014
United States	62.1%	83.2%	92.6%	106.4%
G - 20	62.4%	76.1%	82.1%	86.6%
Advanced G-20 Countries	78.8%	100.6%	109.7%	119.7%
Emerging G -20 Countries	37.5%	38.8%	40.2%	36.4%

*Fiscal projections reflect staff's estimates, based on authorities' policy intentions as stated in the EU Pre-Accession Program document. They do not include measures taken by the government in July 2009 to improve the fiscal position.

Source: International Monetary Fund

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This May Result in a Combination, for the Medium Term, of

- Lower spending
- Higher taxes
- Inflation
  - But expected to be very subdued for at least a year
- Weak dollar
  - Unless flight to quality
- Lower economic growth

- Economy (US and World) has imbalances
  - How will we navigate the transition?
  - Deflation to inflation
  - Spend to save

Foreign Currency Translation & US Dollar volatility

Foreign currency fluctuations has increasingly cited as a reason for changes in operating results.

Use exchange rates at the time of the cash flow to report foreign subsidiaries cash flows.

A weighted average can be used. However, due to volatility a simple average may not yield correct result.

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On the Other Hand,

- Financial institutions are fixing their balance sheets
  - Federal reserve policy is highly supportive
- They may ramp up lending
  - But do not expect to return to huge pre-crisis leverage levels

Banking industry

Coverage ratio (loan loss reserves / bad loans) declined dramatically in 2009.

Banks may not carrying enough reserves to account for bad loans.

Insurance companies have large amounts of Level 3 Assets.

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But Risks Remain, such as Commercial Real Estate (CRE)

August 2009	Commercial Real Estate		
	2008	2009	2010
Office Vacancy Rate	13.4%	15.8%	18.3%
Industrial Vacancy Rate	10.4%	13.2%	15.2%
Retail Vacancy Rate	9.7%	11.9%	13.0%
Multi-Family Vacancy Rate	5.7%	7.3%	7.6%

Source: National Association of Realtors

- The recession has led to increased vacancy rates and fewer completions predicted for 2009 and 2010.
- Commercial real estate is expected to continue to decline through 2010.

CRE

Fair value

Accounting for CRE...

- Loans
- Securities
- Properties

Off-balance sheet entities

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California

- Despite the recent economic trends California remains an attractive state for businesses and individuals:
  - California has the 8th largest economy in the world, with a gross domestic product of $1847 billion.
  - The health care industry will provide economic growth through 2011. The health services industry is expected to add over 22K jobs. Demand is driven by the state's ever-increasing population.
  - The upward trend in population growth will help spur demand for housing, furniture, and appliances. This will provide a bigger boost when credit conditions improve.

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California Public Issuers: Audits Per Industry Sector

	04/01/2008-3/31/2009	Going Concern Opinions	4/1/2009-3/31/2010	Going Concern Opinions
Consumer Discretionary	14.4%	56.7%	13.4%	50.0%
Consumer Staples	3.9%	38.5%	4.0%	31.6%
Energy	3.3%	81.8%	2.7%	76.9%
Financials	14.7%	11.1%	17.4%	8.4%
Health Care	15.8%	47.2%	15.1%	43.1%
Industrials	12.2%	46.3%	14.2%	42.6%
Information Technology	21.8%	36.1%	20.5%	30.6%
Materials	6.2%	66.7%	6.1%	58.6%
Misc. Financial Services	0.3%	50.0%	0.6%	33.3%
Telecommunication Services	1.0%	71.4%	0.4%	100.0%
Unassigned	4.9%	78.8%	4.2%	80.0%
Utilities	1.5%	60.0%	1.5%	42.9%
% of Small Firm Audits	100.0%	100.0%	100.0%	100.0%

Audit Analytics

- The financial activities, consumer discretionary, and health care sectors account for over 70 percent of audits done by triennial audit firms

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Business Sectors Expect…

- Weakness in consumer discretionary spending
- Weakness in imports
- Strength in exports
- Strength in commodities

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Financing Environment Expect…

- Ramping up of lending activities
  - Small Bank lending plan.
- Less reliance on short term financing
- Bringing some securitization/off-balance sheet activities back on to balance sheet
  - “Simple is Good”

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Issuer Economics Expect…

- Decreased wage growth
- Commodity input cost increases
- Higher taxes and/or higher inflation
- "Creative Destruction"
  - Shedding unprofitable business lines
  - Bankruptcies
  - Higher cost-based M&A activities

Business Combinations

Acquired Assets and assumed liabilities are measured at fair value on acquisition date.

Acquirer given one year to account for facts and circumstances that existed at that date.

These are accounted for as purchase price adjustments.

Risk: purchase price adjustments could erroneously reflect losses from post acquisition deterioration.

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US GAAP Developments

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Roadmap

- Fair Value Measurements
- Improvement to Fair Value Disclosure
- Transfer and Consolidation
- Revenue Recognition

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Fair Value Measurements

- FSP FAS 157-4 (ASC 820-10-65); *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are not Orderly*
- FSP FAS 115-2 and FAS 124-2 (ASC 320-10-35); *Recognition & Presentation of Other-than-Temporary Impairments*
- FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments

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Fair Value Measurements (cont'd)

Other recent FASB guidance:

- FSP EITF 99-20-1 amending the impairment guidance in EITF Issue No. 99-20 on beneficial interests
- A proposed ASU (FAS 133 DIG Issue No. C22) clarifying the embedded credit derivative scope exception in paragraph 14B of FAS 133
- ASU 2009-12 on applying fair value to interests in alternative investments
- ASU 2009-5 clarifying the principles of FAS 157 on the measurement of liabilities

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Improvements to Fair Value Disclosures

- FASB Issued ASU 2010-06, amends ASC 820
  - Disclosure of transfers into and out of Level 1 and 2
  - Disclosure about purchases, sales, issuances, and settlements relating to Level 3
  - Clarifies level of disaggregation and disclosure of inputs and valuation techniques used to measure fair value
  - Postretirement benefit plan assets - requires disclosure by classes of assets instead of major category
  - Effective for the first reporting period (including interim periods) beginning after December 15, 2009, except for the requirement to provide the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis, which will be effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Transfer and Consolidation

- **Codification Section 860; SFAS 166, *Accounting for Transfers of Financial Assets*** amends SFAS 140
- **Codification Section 810; SFAS 167, *Accounting for Variable Interest Entities*** amends FIN 46(R)
- Eliminates the Qualified Special Purpose Entity
- Previous two-tiered model focused on both control (SFAS 140) and risk/reward (FIN 46(R))
- New model is focused on control
- Risk/rewards hurdle has been lowered

Transfer and Consolidation (cont'd)

- SFAS 166 – Amends SFAS 140
  - Eliminates beneficial interest language from paragraph 9
  - Eliminates the QSPE
  - Loosens the requirements regarding obtaining legal opinions
    - CAUTION
  - Results of ORA study
    - 225 financial institutions 6/30/09 Forms 10-Q
    - Fewer than 10 provided meaningful numerical disclosure

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Transfer and Consolidation (cont'd)

- SFAS 167 – Amends FIN 46(R)
  - Continuous monitoring – no more Reconsideration Events
  - "Qualitative Approach" to counter criticisms of FIN 46(R)
  - Variable interests have:
    - "Power to Direct" the activities of the VIE
    - Exposure to "gains and losses that could potentially be significant" to the VIE
  - The real difference is in the shift of emphasis from risk/reward
  - Will this provide structuring opportunities?
    - Control vs. Risk/Reward
    - Par. 14G of SFAS 167
    - SEC Speeches at AICPA Conference
  - Implementation challenges
    - 4 methods

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Deferral of FAS 167 for Certain Investment Funds & Other Amendments

- Deferral of FAS 167 for certain investment entities with the attributes of entities subject to the "Investment Companies Guide" (ASC 946) and for registered money market funds (MMF) and unregistered MMFs that operate in a similar manner, even if they are being financially supported by the reporting company
- Clarifies that a quantitative approach should not be the only consideration when evaluating whether a decision maker or service contract is a variable interest entity
- Related parties should be considered in applying all of the decision maker and service contract criteria
- Same effective date as FAS 167

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Revenue Recognition

- EITF 08-1 “Revenue Arrangements with Multiple Deliverables”
- ASU No. 2009-13
- Amends Subtopic 605-25
  - EITF 00-21
- Adoption no later than fiscal years beginning on or after June 15, 2010

- EITF 09-3 “Certain Revenue Arrangements that Include Software Elements”
- ASU No. 2009-14
- Amends Subtopic 985-605
  - SOP 97-2
- Adoption no later than fiscal years beginning on or after June 15, 2010

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Changes to Separation Criteria

- EITF 00-21 established three criteria
  - Standalone value to the customer of the delivered items
  - Objective and reliable evidence of fair value of the undelivered elements
  - If the arrangement includes a general right of return relative to the delivered item(s), the delivery of the undelivered item(s) must be probable and within the control of the vendor

- EITF 08-1 retains only two of the criteria
  - Standalone value to the customer of the delivered items
  - If the arrangement includes a general right of return relative to the delivered item(s), the delivery of the undelivered item(s) must be probable and within the control of the vendor

Changes in Methodology Used to Allocate Transaction Consideration

- Under EITF 00-21 allocate the total arrangements consideration based on relative fair value
- Evidence of fair value includes
  - VSOE
  - Third Party Evidence
- If objective and reliable evidence of fair value exist for only the undelivered elements
  - Residual method allowed

- EITF 08-1 allocates the total arrangements consideration based on relative selling price
- Evidence of selling price includes
  - VSOE
  - Third Party Evidence
  - Best Estimate
- Must make estimate, the residual method is no longer an option

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Example #1

- Telecom Switch, Installation Services and 12 months Consulting Services for $80,000
- Telecom Switch has standalone value
- Do not have VSOE or TPE for Telecom Switch, Installation Services or Consulting Services
- Best Estimate of Selling Price: Telecom Switch - $75,000; Installation Services - $3,000 and Consulting Services - $18,000
- Telecom Switch delivered and installed in Q4'2009

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EITF 00-21

	VSOE or TPE	Allocation of Fee
Telecom Equipment	N/A	N/A
Installation Services	N/A	N/A
Consulting Services	N/A	N/A
	-	80,000

Only one unit of acc't

Timing of Revenue Recognition

	Q4'09	Q1'10	Q2'10	Q3'10	Total
Telecom Equipment	N/A	N/A	N/A	N/A	N/A
Installation Services	N/A	N/A	N/A	N/A	N/A
Consulting Services	N/A	N/A	N/A	N/A	N/A
	20,000	20,000	20,000	20,000	80,000

Amortized over period of delivery

EITF 08-1

	Best Estimate of Selling Price		Allocation of Fee
Telecom Equipment	75,000	78%	62,500
Installation Services	3,000	3%	2,500
Consulting Services	18,000	19%	15,000
	96,000	100%	80,000
Discount			(16,000)

Allocate fee based on relative selling price

Timing of Revenue Recognition

	Q4'09	Q1'10	Q2'10	Q3'10	Total
Telecom Equipment	62,500				62,500
Installation Services	2,500				2,500
Consulting Services	3,750	3,750	3,750	3,750	15,000
	68,750	3,750	3,750	3,750	80,000
Discount	(13,750)	(750)	(750)	(750)	(16,000)

Discount is allocated on pro-rata basis to all deliverables

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Example #2

- Telecom Switch, Installation Services and 12 months Consulting Services for $80,000
- Telecom Switch has standalone value
- Do not have VSOE or TPE for Telecom Switch or Installation Services. VSOE for Consulting Services $18,000
- Best Estimate of Selling Price: Telecom Switch - $75,000; Installation Services - $3,000 and Consulting Services - $18,000
- Telecom Switch delivered and installed in Q4'2009

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EITF 00-21	VSOE or TPE	Allocation of Fee
Telecom Equipment	N/A	N/A
Installation Services	N/A	N/A
Consulting Services	18,000	18,000
	18,000	80,000

Discount is implicitly allocated to delivered elements (i.e. $78K - $62K = $16K

	Timing of Revenue Recognition				
	Q4'09	Q1'10	Q2'10	Q3'10	Total
T. Equip and Install.	62,000	-	-	-	62,000
Consulting Services	4,500	4,500	4,500	4,500	18,000
	66,500	4,500	4,500	4,500	80,000

Allocated fee based on residual method.

EITF 08-1	Best Estimate of Selling Price		Allocation of Fee
Telecom Equipment	75,000	78%	62,500
Installation Services	3,000	3%	2,500
Consulting Services	18,000	19%	15,000
	96,000	100%	80,000
Discount			(16,000)

Allocate fee based on relative selling price

	Timing of Revenue Recognition				
	Q4'09	Q1'10	Q2'10	Q3'10	Total
Telecom Equipment	62,500				62,500
Installation Services	2,500				2,500
Consulting Services	3,750	3,750	3,750	3,750	15,000
	68,750	3,750	3,750	3,750	80,000
Discount	(13,750)	(750)	(750)	(750)	(16,000)

Discount is allocated on pro-rata basis to all deliverables

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Disclosure Requirements

- Quantitative and qualitative
- Changes that impact timing or amount of revenue recognition

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ASU No. 2009-14: Certain Revenue Arrangements That Include Software Elements

- Modifies scope of SOP 97-2 for tangible products containing software elements and non-software elements to scope out the following:
  - Tangible elements always out of scope
  - Software element of tangible products outside scope if the software elements and non-software elements function together to deliver the products ***essential functionality***
  - Undelivered elements related to the non-software components

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“Essential Functionality”

- If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product
- The evaluation of whether or not the tangible product and software are functioning together is performed at the product level, not the model level
- An entity may sell the software on a standalone basis. The separate standalone sale of the software does not cause a presumption that the software is not essential to the functionality of the tangible product
- Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product’s functionality
- The non-software elements of the tangible product must substantively contribute to the tangible product’s essential functionality; that is, the tangible product should not simply provide a mechanism to deliver the software to the customer

Allocation Between Out of Scope and In Scope Deliverables

- First allocate between in and out of scope deliverables based on the relative-selling-price guidance in ASC 605-25
- Second allocate to in-scope deliverables based on ASC 985-605
- Both ASU 2009-13 and 2009-14 must be adopted at the same time and under the same transition method

EITF Developments
Final Consensus Reached

- Issue 08-9 – Milestone Method of Revenue Recognition
- Issue 09-B – Consideration of an Insurer's Accounting for Majority-Owned Investments When Ownership is Through a Separate Account
- Issue 09-F – Casino Based Jackpot Liabilities

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EITF Developments
Final Consensus Reached - Continued

- Issue 09-I – Effect of a Loan Modification When the Loan is Part of a Pool that is Accounted for as a Single Asset
- Issue 09-J – Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in which the Underlying Equity Security Trades
- *The final consensus on each of these issues was ratified by the FASB at it 3/31/10 meeting; the ASU's will amend the ASC and become final authoritative accounting guidance*

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Questions?

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Update on Standard-Setting Activities

Dee Mirando-Gould
Office of the Chief Auditor
May 20, 2010
San Francisco, CA

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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*
- Other Standard-Setting Activities
- Standing Advisory Group

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Auditing Standard No. 7

Engagement Quality Review

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AS No. 7 – *Engagement Quality Review*

- Supersedes existing requirements for concurring reviews (Appendix E)

- Applies to all registered firms
  - Under Appendix E, firms that were not members of AICPA SECPS as of April 16, 2003 were not required to perform an EQR
  - Under AS No. 7, all registered firms conducting audits in accordance with PCAOB standards are required to perform an EQR

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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)

  Question: What if a registered firm audits a broker dealer that is not an issuer?

- Requires concurring approval of issuance prior to granting permission to the client to use the engagement report (AS 7.13, and .18)

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AS No. 7 – *Engagement Quality Review*

Reviewer Qualification Requirements:

- Must be an associated person of a registered firm (AS 7.3)

  Note: A person not already associated with a registered firm would become associated if he or she (1) receives compensation for the EQR from the firm issuing the report, or (2) performs the EQR as agent for the firm issuing the report.

- May be from outside the firm that issues the engagement report (AS 7.3)

  Note: A waiver from the Board is no longer necessary to engage a non-partner outside reviewer.

AS No. 7 – *Engagement Quality Review*

Reviewer Qualification Requirements (Cont'd):

- A reviewer from the firm that issues the engagement report must be a partner or another individual in an equivalent position (AS 7.3)

  Note: At a firm that is not organized as a partnership, "an individual in an equivalent position" is someone with the degree of authority and responsibility of a partner in a firm that is organized as a partnership.

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AS No. 7 – *Engagement Quality Review*

Reviewer Qualification Requirements (Cont'd):

- Must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review (AS 7.5)

- Must be independent of the company, perform the engagement quality review with integrity, and maintain objectivity in performing the review (AS 7.6)

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AS No. 7 – *Engagement Quality Review*

Reviewer Qualification Requirements (Cont'd):

- "Cooling-Off" Period: The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer (AS 7.8)
- Exemption: Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Reg. S-X are exempt from this "cooling-off" period requirement (AS 7.8)

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AS No. 7 – *Engagement Quality Review*

Specific Required Procedures:

- To evaluate significant judgments made and conclusions reached by the engagement team in forming the overall conclusion on the engagement and preparing the engagement report, the reviewer should -
  - Hold discussions with the engagement team, and
  - Review documentation

  (AS 7.9 and .14)

Question: Is the reviewer required to hold discussions with every member of the engagement team?

Question: Is the reviewer required to review all engagement documentation?

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AS No. 7 – *Engagement Quality Review*

Concurring Approval of Issuance:

- The engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency (AS 7.12 and .17)

Question: Does AS No. 7 redefine "due professional care", which is described in AU sec. 230, Due Professional Care in the Performance of Work?

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AS No. 7 – *Engagement Quality Review*

Concurring Approval of Issuance (Cont'd):

- A *significant engagement deficiency* in an audit exists when -
  - (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB,
  - (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement,
  - (3) the engagement report is not appropriate in the circumstances, or
  - (4) the firm is not independent of its client.

(AS 7.12)

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AS No. 7 – *Engagement Quality Review*

Concurring Approval of Issuance (Cont'd):

- A *significant engagement deficiency* in an interim review exists when -
  - (1) the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement,
  - (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement,
  - (3) the engagement report is not appropriate in the circumstances, or
  - (4) the firm is not independent of its client.

(AS 7.17)

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AS No. 7 – *Engagement Quality Review*

Documentation of an EQR -

- Should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of the standard (AS 7.19)

Question: Is the reviewer required to document all discussions held during the EQR?

Question: Is the reviewer required to keep all of his/her review notes?

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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

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Staff Question and Answer
Auditing Standard No. 7, *Engagement Quality Review*

- 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.

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PROPOSED AUDITING STANDARDS

THE AUDITOR'S ASSESSMENT OF AND RESPONSE TO RISK

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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

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Risk Assessment

Significant changes to reproposed 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

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Proposed Auditing Standard

Communications With Audit Committees

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Communications With Audit Committees

- Proposed standard on March 29, 2010
- 60 day comment period ends on May 28, 2010
- Proposed standard available at http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket030.aspx

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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

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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

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Other Standard-Setting Activities

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Other Standard-Setting Activities*

Staff Guidance

- Staff Questions and Answers – *Auditing Standard No. 7, Engagement Quality Review*
- Staff Questions and Answers – *References to Authoritative Accounting Guidance in PCAOB Standards*
- Staff Practice Alert No. 5 - *Auditor Considerations Regarding Significant Unusual Transactions*

Active Projects

- Confirmations (Concept Release issued April 14, 2009)
- Communications with audit committees
- Related parties
- Accounting estimates, fair value measurements
- Specialists

* Activities subject to change based on emerging issues

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Other Standard-Setting Activities*

- Active Projects (cont'd)
  - Requiring the Engagement Partner to Sign the Audit Report (Concept Release issued July 28, 2009)
  - Supervision of accounting firms of their audit practices
  - Global quality controls standards, including control over work of affiliated firms
  - Principal auditor
  - Going concern
  - Subsequent events
  - Applicability of SECPS requirements to all registered firms

* Activities subject to change based on emerging issues

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Standing Advisory Group

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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
- Size (current) – 30 members and 6 observers
- Composition – Composed of individuals with a variety of backgrounds, including auditors, preparers of financial statements, investors, academics, and others

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Standing Advisory Group

- Meets two to three times a year
  - April 7-8, 2010 meeting
    - Discussed Principal Auditor, Auditor's Reporting Model
  - Next meetings – July 15, 2010, October 14-15, 2010
  - All previous SAG meeting agendas, briefing papers, and webcasts are located at www.pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx
- SAG members are appointed for two-year terms
- Nominations to the SAG are sought annually

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Keeping Current with Standard-Related Activities

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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

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Questions?

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Break

(15 minutes)

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Auditing Internal Controls and IT Control Issues in Smaller Public Companies

Greg Wilson and Bill Powers
Division of Registration and Inspections
May 20, 2010
San Francisco, CA

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

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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 ending after December 15, 2007, non-accelerated filers began reporting under 404(a)
- On October 2, 2009, SEC (again) deferred, ***for the last time***, 404(b) requirement for non-accelerated filers – now required for years ending after June 15, 2010

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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

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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
    - I 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

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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 Section 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 accounting standards.

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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)

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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

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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

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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

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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

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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

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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

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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

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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
    - IT control risks and IT controls

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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 spreadsheets (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

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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 scaling AS No. 5 to small public companies.

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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 which 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.

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Questions?

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Lunch

(60 minutes)

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Case Studies on Auditing in the Small Business Environment

Presenters

- John Abell, Assistant Director, Accountant, Division of Enforcement and Investigations
- Alan Skinner, Associate Director, Division of Registration and Inspections

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Agenda

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

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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)

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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

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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

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Case Studies on Auditing in the Small Business Environment

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

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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

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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

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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

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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

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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

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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.

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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.

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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*

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Case Study #3 – 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

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Case Study #3 – 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?

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Case Study #3 – 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.

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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

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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

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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

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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?

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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

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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

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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 – 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

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Case Study #5 – 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 #5 – 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)

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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

Questions?

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Break

(15 minutes)

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Annual and Special Reporting

Mary Sjoquist
Office of Communications
May 20, 2010
San Francisco, CA

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.

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--Annual Reporting

- Reporting period is April 1 through March 31 of each year
- Report is due by June 30
- Annual fee due by July 31

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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 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),
  - Within14 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.

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

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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

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Questions?

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SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

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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***
  - **Defers the auditor attestation requirement to fiscal years ending on or after June 15, 2010**
- ***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	100,000	200,000	900,000	750,000	1,850,000

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 ending December 31, 2008, December 31, 2007 and December 31, 2006
  - Unaudited interim financial statements as of and for the six months ending June 30, 2009
  - December 31, 2006 information not required for SRCs

Predecessor Financial Statements

Example (Cont.)

- ***Presentation in Form 10-K for the year ending December 31, 2009 :***
  - **Audited financial statements of the combined company as of and for the year ending 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 ending 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 carefully (Debenture, warrant, reg. rights, anti-dilution provisions, etc.)

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 ≥ $75 million on last business day of Q2
- If public float = $0, ≥ $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

Balance Sheets @ 3/31/09	Shell	OpCo
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	40,000	40,000		(60,000)	(20,000)
Shares issued for services 2/1/08	30,000	30,000	60,000		90,000
Net Loss				(10,000)	(10,000)
12/31/08	70,000	70,000	60,000	(70,000)	60,000
Shares issued for cash 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	500,000	500,000	725,000	1,050,000	2,275,000

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

Solution: Continuing Entity EPS (cont'd)

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

A	$250,000	No change from OpCo pre-recap Net Income
B	$0.89	$250,000 / 280,000 weighted avg. shares = $0.89
C	280,000	Use 4 for 1 Exchange Ratio. 70,000 OpCo pre-recap weighted avg. shares x 4 = 280,000 weighted avg. shares
D	$200,000	No change from OpCo pre-recap Net Income
E	$0.54	$200,000 / 373,332 weighted avg. shares = $0.54
F	373,332	Use 4 for 1 Exchange Ratio. 93,333 OpCo pre-recap weighted avg. shares x 4 = 373,332 weighted avg. shares
G	$1.15	$500,000 / 436,667 = $1.15
H	436,667	(320,000 shares x 6/6 = 320,000) + (80,000 shares x 5/6 = 66,667) + (100,000 shares x 3/6 = 50,000) = 436,667 weighted avg. shares

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?

PCAOB
Public Company Accounting Oversight Board

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Closing Remarks and Wrap-Up

Bill Gradison
PCAOB Board Member
May 20, 2010
San Francisco, CA