Forum on Auditing in The Small Business Environment

October 30, 2008
Philadelphia, PA
Opening Remarks

Bill Gradison
PCAOB Board Member
October 30, 2008
Philadelphia, PA
Caveat

One of the benefits of today's session is that you will hear first-hand 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.
Panel Discussion on What Audit Committees Should Know about the Work of the PCAOB

October 30, 2008
Philadelphia, PA
What Audit Committees Should Know about the Work of the PCAOB

- **Keynote:**
  - Dan Goelzer, Board Member, PCAOB

- **Panelists:**
  - John Lawler, CEO, Sterling Wealth Management, Inc.
  - Steve Barry, Audit Partner, KPMG
Accounting Hot Topics

1. Financial Markets Turmoil
2. Fair Value
3. Other Than Temporary Impairment (OTTI)
4. Other Impairment Risks
5. Off-balance Sheet Accounting
6. Revenue Recognition
7. Top 10 Restatement Reasons
8. Going Concern Considerations
9. Loss Contingencies
10. IFRS
11. XBRL
12. CIFiR
13. Treasury Committee
Financial Markets Turmoil

- Breakdown in underwriting standards
- Erosion of market discipline in securitizations
- Flaw in credit rating agencies assessment of structured products
- Weakness in risk management practices
- Regulatory policies and disclosure practices that failed to mitigate these weaknesses
- Contagion
Market Turmoil: Contagion

It’s not just subprime collateral:
- Prime conforming loans
- Credit card receivables
- Auto loans
- Availability of credit
- Consumer spending
Market Turmoil: Contagion (cont’d)

And the effects are far-reaching:

- Financial institutions of course, but also
- Pension plans
- Mutual funds
- Corporate balance sheets
Market Turmoil: Contagion (cont’d)

Some of the most affected companies:
- Countrywide – acquired by Bank of America
- Bear Stearns – acquired by JPMorgan with $29 billion of Treasury support
- Fannie Mae – under Federal conservatorship
- Freddie Mac – under Federal conservatorship
- Lehman Brothers – filed for bankruptcy, certain parts of the business acquired by Barclays plc
- AIG – obtained an $85 billion credit line from the Treasury to facilitate orderly sale of businesses followed by a $38 billion cash collateral from Treasury
- Merrill Lynch – acquired by Bank of America
- Morgan Stanley – received $9 billion in investment from Mitsubishi, converts to bank holding company
- Goldman Sachs – received $5 billion investment from Berkshire Hathaway, converts to bank holding company
- Washington Mutual – largest bank failure, assets and deposits acquired by JPMorgan
- Wachovia – sold to Wells Fargo, following initial announcement of sale to Citigroup
Fair Value: Issues

- Training, bias, controls
- Valuation complexity
- FAS 157 / 159
- OTTI and Other Impairment Issues
- Disclosures
Fair Value: FAS 157

- Doesn’t increase the use of fair value accounting
- Adds new measurement requirements
  - Exit price
  - Principle (or most advantageous market)
  - Market participant view
  - Highest and best use
  - Fair value hierarchy
  - Many other nuances
- Adds new disclosure requirements
Fair Value: Additional Guidance

- CAQ White Paper
  - Illiquid instruments
- PCAOB Practice Alert # 2
  - Classification of fair value measurements
  - Use of specialists
  - Use of pricing services
  - AU 328 / 332 / 336 / 324 / 342
- SEC/FASB Joint Press Release
- FSP FAS 157-3
FSP FAS 157-3 Overview

- Effective immediately, applies to periods for which financial statements have not been issued, including interim periods
- Clarifies the application of FAS 157 by providing an example to illustrate key considerations in determining the fair value of a financial asset in an inactive market
- Application requires significant judgment
- Account as a change in estimate under FAS 154 but no need to provide required disclosures
Key Issues in FSP FAS 157-3

- Does not change the intent of FAS 157
- Use of third-party pricing quotes
- Level 3 never “trumps” Level 2 measurements
- Distressed transactions
- Disclosures
Other Than Temporary Impairment (OTTI)

- HTM and AFS Securities
- Highly subjective
- FSP FAS 115-1 and 124-1, EITF 99-20, SAB 59
- Time and extent fair value below cost
  - Intent and ability to hold
  - Prospects of the issuer
- SEC letter to FASB regarding OTTI assessment of perpetual preferred securities
Another new standard, (FAS 159) provides companies with the *option* to elect fair value accounting for financial assets and liabilities.

- Election permitted on a contract-by-contract basis
- Concern expressed by users of financial statements regarding comparability
- Some potential abuses have been observed and addressed
- Continued requirement for OTTI evaluation
Other Impairment Risks

- Loans
- Long-lived assets
- Goodwill
- Deferred tax assets
- Inventory
Off Balance Sheet Accounting

- Structured transactions create complex accounting and audit issues
- Auditor skepticism needed
- FAS 140 / FIN 46(R)
FAS 140

- Governs whether a transfer of financial assets is eligible for sale accounting and removal from the balance sheet

- Depends largely on whether the transferor has surrendered control; paragraph 9:
  - A - Legal isolation
  - B - Transferee has no constraints
  - C - Transferor has relinquished control

- After FAS 140, consider applicability of FIN 46(R), except for QSPEs
FIN 46(R)

- Governs whether the transferee should be consolidated
  - Is the transferee a variable interest entity (VIE)?
  - Who is the primary beneficiary (if there is one)?
- Model is based primarily on risks and rewards
- Analysis is done initially at inception, and subsequently whenever there is a “reconsideration event”
- Reconsideration analysis must take into account current market conditions
Off-Balance Sheet Issues: Proposed Amendments to Accounting Guidance

- Proposed amendments to existing guidance:
  - FAS 140 – removes the QSPE concept and exception from applying FIN 46(R) to QSPEs, enhances disclosures
  - FIN 46(R) – amends guidance regarding consolidation of QSPEs, enhances disclosures
  - Effective in 2010

- Proposed new guidance:
  - FSP FAS 140-e and FIN 46(R)-e Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities – enhances disclosures by public entities regarding transfers of financial assets and involvement with variable interest entities
  - Effective immediately
Revenue Recognition

- SEC’s top questioned accounting area
- Allowance for sales returns, rebates, chargebacks, etc.
- Collaboration agreements
- Multi-element arrangements
- Vendor rights and obligations
- Presentation of product and service revenues
Top 10 Restatement Reasons

1. Debt, warrants & equity security issues
2. Cash flow statement classification errors
3. Expense reporting issues
4. Deferred and stock-based compensation issues
5. Tax-related issues
6. Acquisitions, mergers, disposals
7. Liabilities, payables, reserves, accruals issues
8. Revenue recognition issues
9. Accounts/loans receivable, investments, cash issues
10. Consolidation issues, including VIE and off-B/S issues
Going Concern Considerations

- Guidance found in AU 341, *An Entity’s Ability to Continue as a Going Concern*
- Going concern is assumed in the absence of contrary information
- Evaluate substantial doubt about an entity’s ability to continue as a going concern for a reasonable period of time, *not to exceed one year beyond the date of the financial statements*
- Consider certain conditions and events that may indicate a substantial doubt:
  - Negative trends
  - Other indicators of possible financial difficulties
  - Internal matters
  - External matters
- Consider management’s plans for dealing with adverse conditions, including prospective information and assumptions, as related to:
  - Disposal of assets
  - Borrowing money or restructuring debt
  - Reducing or delaying expenditures
  - Increasing ownership equity
Going Concern Considerations (cont’d)

- When substantial doubt exists, consider effect on financial statements and related disclosures:
  - Conditions and events giving rise to substantial doubt and their effect
  - Management’s evaluation and mitigating factors
  - Possible discontinuance of operations
  - Management’s plans, including prospective info
  - Information about asset and liability amounts

- Auditor’s report includes explanatory paragraph when substantial doubt exists

- Required documentation:
  - Conditions and events that lead to substantial doubt
  - Significant elements of management’s plans to overcome conditions & events
  - Procedures performed and evidence obtained to evaluate management’s plans
  - Conclusion about existence of substantial doubt, possible effects on the financial statements and adequacy of related disclosures
  - Conclusion about need for explanatory paragraph
Loss Contingencies

- **FAS 141(R) Business Combinations**
  - Issued in Dec. 2007, effective in 2009
  - FV recognition of non-contractual loss contingencies if “more likely than not” that a liability exists

- **Proposed amendments to FAS 5 & 141(R) delayed**
  - Issued in June 2008, to be effective after 2008
  - Expanded disclosures about loss contingencies
  - Required estimate of maximum exposure to loss
  - Disclosure of certain remote losses
  - Alternative amendment being developed
Steps toward expanding the use of IFRS in the US
- Elimination of US GAAP reconciliation for foreign private issuers who use IFRS as adopted by the IASB
- SEC Concept Release allowing US issuers to file under IFRS
- SEC Proposed Roadmap to adoption of IFRS by US issuers
- IFRS roundtable hosted by the SEC and FASB
- Canada is adopting IFRS in 2011

Issues:
- Education and training
- Addressing specific issues/differences (e.g. LIFO)
- Future role of FASB and SEC
- IASB funding, governance and oversight
- Consistent application of IFRS
IFRS (cont’d)

- SEC unanimously voted Aug. 27 to propose:
  - A roadmap for potential mandatory adoption of IFRS by US issuers beginning in 2014, and
  - A rule allowing the optional use of IFRS by qualifying US issuers as early as fiscal years ending after Dec 15, 2009

- Roadmap to potential mandatory adoption:
  - If certain milestones are achieved by 2011, then the SEC will consider a mandatory IFRS conversion date
  - Milestones: improvements in IFRS, funding of IASCF, enhancement of XBRL for IFRS, IFRS education in US
  - Possible timeframe: 2014 for large accelerated filers; 2015 for accelerated filers; 2016 for non-accelerated filers

- Optional early adoption – limited eligibility
- Proposed rule not yet published
XBRL

- Updated US GAAP taxonomies released
  - Preparer’s XBRL guide available
  - IFRS taxonomies
  - SEC XBRL-tools
- SEC Proposed Rule on use of XBRL
  - Mandatory
  - Phased-in
- Auditor assurance
CIFiR

- Also known as the Pozen Committee
- Launched in August 2007
- Created to tackle complexity in financial disclosures
- Addressing:
  - Substantive complexity
  - Standard setting
  - Audit process and compliance
  - Delivering financial information
- Final report issued August 1, 2008
CIFiR: Final Recommendations

Substantive Complexity

- GAAP should be based on business activities, not industries, and similar activities should be accounted for in a similar manner.

- GAAP should be based on a presumption that scope exceptions should not exist (i.e. GAAP should not provide additional optionality).

- No bright lines.
CIFiR: Final Recommendations (cont’d)

- **Standard-Setting Process**
  - User / investor involvement in the standard-setting process is key to improved financial reporting
  - SEC should assist the Financial Accounting Foundation (FAF) in its guidance over the FASB
  - SEC to encourage FASB to further improve standard-setting process and timeliness
  - Reduction in number of parties interpreting GAAP and issuing implementation guidance
Audit Process and Compliance and Delivering Financial Information

- SEC or FASB should supplement existing guidance related to materiality and correction of errors
- Accounting and audit “statement of policy” regarding how the SEC and PCAOB evaluate the reasonableness of judgment
- Mandatory phase-in of XBRL
- Did not recommend assurance on XBRL at this time
Treasury Committee

- Purpose - develop recommendations to:
  - Increase investor protection and
  - Enhance sustainability of public company auditing profession
- Final report issued early October 2008
- Key recommendations of the Human Capital Subcommittee:
  - Develop and continuously update a market-driven academic curriculum for accounting students
  - Ensure sufficient supply of accounting and tax faculty
  - Improve the representation of minorities in the profession
Key recommendations of the Firm Structure and Finances Subcommittee:

- Create a center to share fraud prevention/detection experiences
- Encourage states to adopt CPA mobility provisions
- Explore the possibility of firms appointing independent members to firm boards
- Urge SEC to require disclosure of reason for: 1) any auditor change; 2) audit partner change prior to rotation period end.
- Urge PCAOB to consider: 1) improvements in the auditor’s report; and 2) mandating the engagement partner’s signature on the auditor’s report.
Key recommendations of the Concentration and Competition Subcommittee:

- Promote the growth of smaller auditing firms
- Promote better understanding and compliance with independence rules
- Develop key indicators of audit quality and effectiveness for possible public disclosure by audit firms
- Urge the PCAOB to monitor potential sources of catastrophic risk which would threaten audit quality
Managing Complexity

- Complete understanding of transaction, including terms, economics, rights, obligations, risks and rewards
- Adequate accounting resources: knowledgeable, experienced and unbiased
- Ongoing auditor discussions
- Issue identification and evaluation
- Management and Audit Committee involvement
- Potentially more than one correct answer
- Financial statement transparency
Emerging Accounting and Auditing Issues

Martin F. Baumann
Director, Office of Research and Analysis
October 30, 2008
Philadelphia, PA
Ethics Resource Center’s
National Workplace Ethics Surveys

PCAOB Forum on Auditing in the Small Business Environment

October 30, 2008

Patricia J. Harned, Ph.D.
President, Ethics Resource Center
Roadmap

- Research Methodology
- Key Findings
- Ethics Risk
- Implications
- Discussion
About ERC

- Non-profit; established 1922
- Dedicated to the advancement of high ethical standards & practices
- Key activities
  - Independent research
  - Analyze current & emerging issues in capital markets
  - Benchmarks for program impact
  - Inform public dialogue on ethics
About the NWES

- Fifth in a longitudinal study since 1994
  - Business, Government and Nonprofit reports
  - 13,500 participants overall, 3452 in 2007
- Nationally representative
- Telephone poll of employee perceptions
- U.S. benchmark
  - Measures trends in workplace ethics & compliance
  - Assesses program effectiveness
  - Identifies ethics risk
  - Highlights strategies that improve ethics
About the NWES

- **Areas of emphasis for the research:**
  - 1994 → State of programs
  - 2000 → Change in status
  - 2003 → Leadership actions
  - 2005 → Impact of programs & culture
  - 2007 → Reduction of ethics risk
Research Findings
Observed misconduct has returned to pre-Enron levels

High-profile corporate debacles, followed by SOX

Observed Misconduct by Year of Study

*All data that follows comes from Ethics Resource Center's National Business Ethics Survey*
Publicly-traded and privately-held companies experience equal levels of misconduct.

US Government Average = 56%

US Nonprofit Average = 55%

Observed Misconduct in Public vs. Private Companies
Small companies experience less misconduct

US Government Average = 56%

US Nonprofit Average = 55%

2007 NWES Average = 56%

Observed Misconduct according to Company Size

- Small: 53%
- Medium: 56%
- Large: 61%

Publicly-traded Company Type

<table>
<thead>
<tr>
<th>Publicly-traded Company Type</th>
<th>Percent observing misconduct</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>53%</td>
</tr>
<tr>
<td>Medium</td>
<td>56%</td>
</tr>
<tr>
<td>Large</td>
<td>61%</td>
</tr>
</tbody>
</table>
In general, misconduct occurs at all levels of management.

2007 NBES
Average = 56%

Observed Misconduct according to Management Level

Percent observing misconduct

0% 20% 40% 60% 80% 100%

Top Management Middle Management First Line Supervisor Non-Management

47% 57% 60% 55%
The pattern of misconduct by management levels differs in large organizations.

2007 NBES Average = 56%

Observed Misconduct according to Management Level in Differently Sized Companies
Breaches related to financial fraud remain controlled.
Fraud is equally common across all sectors.

<table>
<thead>
<tr>
<th>Observed Fraud</th>
<th>Business sector</th>
<th>Government sector</th>
<th>Nonprofit Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alteration of documents</td>
<td>5%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Alteration of financial records</td>
<td>5%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Lying to customers, vendors, or the public</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>Lying to employees</td>
<td>20%</td>
<td>21%</td>
<td></td>
</tr>
<tr>
<td>Misreporting of hours</td>
<td>17%</td>
<td>17%</td>
<td>19%</td>
</tr>
</tbody>
</table>
Fraud occurs in all sizes of organizations.

<table>
<thead>
<tr>
<th>Types of Fraud</th>
<th>Small org</th>
<th>Medium org</th>
<th>Large org</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alteration of documents</td>
<td>4%</td>
<td>8%</td>
<td>6%</td>
</tr>
<tr>
<td>Alteration of final records</td>
<td>5%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>Misreporting hours</td>
<td>18%</td>
<td>19%</td>
<td>14%</td>
</tr>
</tbody>
</table>

Observed Fraud according to Size of Organization
Alteration of financial documents is observed most often at lower levels in publicly-traded companies.
There has been little improvement in reporting misconduct.

Still more than 2 of 5 employees who observe misconduct choose not to report it.
The higher the management level, the more likely employees are to report observed misconduct.
Hotlines are rarely used as the method of reporting.

Chosen Method of Reporting:

- Supervisor: 13%
- Higher management: 34%
- Other responsible person (Includes ethics officer): 3%
- Someone outside organization: 5%
- Hotline: 3%
- Other: 43%

Methods Used for Reporting Misconduct
Supervisors receive most reports of financial fraud.

Recipients of Financial Fraud Reports

- Higher Management: 48%
- Other responsible person (including ethics officer): 16%
- Someone outside organization: 24%
- Other: 7%
- Hotline: 4%
- Supervisor: 1%
Mitigating Ethics Risk
High Misconduct + Low Reporting = Ethics Risk
Impact of an Effective Program

Strong Culture +
Well-implemented Program
=
Greatest Reduction
in Ethics Risk
Well-Implemented Programs

- Employees acknowledge company standards
- Employees believe company encourages ethical conduct
- Employees are willing to seek ethics advice
- Employees are prepared to address situations inviting misconduct
- Employees deliver bad news to management
- Employees are rewarded for following ethics standards
- Success through questionable means NOT rewarded
Well-implemented programs drive higher reports of misconduct.

**Observed Misconduct according to Quality of Implementation**
One-quarter of US workforce indicates a well-implemented ethics and compliance programs.
Ethical Culture

Strong ethical culture involves four components:

1. Ethical leadership
2. Supervisor reinforcement
3. Peer commitment to ethics
4. Embedded ethical values
Strong ethical culture has the greatest impact in reducing misconduct.
Fewer than one in ten employees perceive a strong ethical culture.
Driving Down the Risk

Higher Ethics Risk

U.S. Companies with Average Ethics Programs and Cultures

Driving Down the Risk

Impact of Programs and Culture

Lower Ethics Risk

U.S. Companies with Strong Ethics Programs and Cultures

Putting self above org
Lying to employees
Abusive behavior
Abuse of internet
Misreporting work time
Lying to stakeholders
Discrimination
Safety violations
Theft
Improper hiring
Sexual harassment
Products below specs
Environmental violations
Insider information misuse
Document alteration
Altering financial records
Bribery
Competitor information misuse
Government & Nonprofit Variations

- **Government**
  - Similar levels of misconduct, especially fraud
  - Higher reporting, but same patterns
  - Programs make more of a difference, but culture still matters more

- **Nonprofits**
  - Similar (and yet highest) misconduct
  - Largest influence from governance
  - More programs?
  - Best impact of programs & culture
ERC Model of a Healthy Organization

Well-Implemented Program → Strong Ethical Culture

Program Targets:
- Reduced Pressure for Misconduct
- Decrease in Observed Misconduct
- Increased Reporting of Misconduct
- Reduced Retaliation for Reporting

Result: Reduced Ethics Risk
Potential Implications
Implications

- Even in smaller orgs, tone at the top matters
  - But tone comes from the tops
- Training promotes independence
  - But culture reduces conflicts
- Compliance prevents further growth of financial fraud
  - But ethical culture nearly eliminates it
Tone at the Top

- Talks about the importance of workplace ethics and doing the right thing (formally & informally)
- Models ethical behavior
- Keeps promises and commitments
- Supports employees in following ethics standards
- Holds others accountable for violations
Driving Down the Risk

Higher Ethics Risk

- Abuse
- Lying to employees
- Discrimination
- Reporting hours of worked
- Lying to stakeholders
- Safety
- Improper hiring practices
- Self-interest over organizational
- Sexual harassment
- Internet abuse
- Stealing
- Misuse of internal info
- Environmental
- Provision of goods and services
- Alternation of documents
- Financial records
- Competitors inside info
- Bribes

Lower Ethics Risk

Impact of Tone at the Top

- U.S. Companies with Negative Tone
- U.S. Companies with Positive Tone

Abuse
- Lying to employees
- Discrimination
- Reporting hours of worked
- Lying to stakeholders
- Safety
- Improper hiring practices
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Driving Down the Risk
CEOs are most commonly believed to be top management in businesses.

Perceived Top Management
Training does not seem to reduce conflicts of interest, but culture makes a difference.
Assessing Ethics/Compliance

- **Recommendations:**
  - Confidential surveys (not HR surveys)
  - Representation of all levels of management
  - Program measures beyond awareness
  - Metrics for leadership *action*
  - Benchmarks
  - Metrics for pressure, misconduct, and ability to raise bad news
Ethics in Risk Assessment

- Ethics as an element of business and audit risk?
  - Promotion of a culture that encourages auditor integrity and audit quality
  - Management awareness of issues
Additional Information

- www.ethics.org
- 703-647-2185
- pat@ethics.org
Ethics Resource Center’s
National Workplace Ethics Surveys

PCAOB Forum on Auditing in the Small Business Environment

October 30, 2008

Patricia J. Harned, Ph.D.
President, Ethics Resource Center
Inspections and Standards-setting Activities
Presenters

- George Botic, Division of Registration and Inspections
- Keith Wilson, Office of the Chief Auditor
Inspections Activities
Inspections Milestones
As of September 30, 2008

- Approximately 1000 domestic small firms are registered with the PCAOB
- Performed over 825 inspections of domestic small firms to date
  - Over 60 percent of these firms had five or fewer issuer audit clients
  - Only 10 percent of these firms had greater than 26 issuer audit clients
  - Conducted engagement file reviews of portions of approximately 2300 issuer audits
- Plan to perform approximately 200 domestic small firm inspections during 2008
- Over 665 domestic small firm reports have been issued as final to date
Possible Consequences of an Inspection Report

- The entire inspection report is provided to the firm, the SEC and appropriate state regulators.
- Firms may be required to perform follow-up procedures on the audit deficiencies included in the report (subject to AU 390/561).
  - May result in restatement of an issuer’s financial statements if material misstatement is detected.
- Possible violations of securities laws, independence rules, GAAP violations or illegal acts are referred to the appropriate authorities through a Rule 4004 report.
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
Audit Committee Considerations

- **Revenue recognition** -
  - Ensure significant revenue contracts are reviewed for unique terms and conditions
  - Inquire about significant (or unusual) transactions recorded at the end of a reporting period
  - Understand unique characteristics of specialized industries
  - Understand impact of current accounting guidance on revenue recognition
Business combinations -

- Ensure agreements are reviewed for specific terms and conditions that may impact accounting
- Understand determination of purchase price
  - Valuation of non-cash consideration (e.g., warrants, preferred stock, convertible stock)
- Understand allocation of the purchase price to the assets acquired and liabilities assumed
  - Identification of intangible assets
  - Need for valuation specialist
- Ensure appropriate accounting literature is applied (e.g., common control merger, asset acquisition, business combination)
Audit Committee Considerations

- Impairment of goodwill and other long-lived assets -
  - Ensure annual goodwill impairment test is performed
  - Understand events or changes in circumstances which may indicate that long-lived assets may not be recoverable
  - Understand reasonableness of estimates (e.g., assumptions, projections, forecasts)
Audit Committee Considerations

- Independence –
  - Understand the nature and extent of non-audit services provided by the issuer’s independent accountants
  - Understand various independence rules (e.g., SEC requirements, PCAOB Standards)
  - Prohibited services (e.g., preparation of financial statements and related footnotes, providing bookkeeping or other services related to accounting records or financial statements)
  - Communications required by PCAOB Rule 3526, Communication With Audit Committees Concerning Independence
Standards-Setting Activities
Overview

- New and proposed standards and related guidance
  - Internal control over financial reporting
  - Communications about independence
  - Amendment to Rule 3523
  - Engagement quality review
  - Risk assessment

- Standards setting priorities
Internal Control Over Financial Reporting

  - Focuses the internal control audit on the most important matters
  - Eliminates procedures that are unnecessary to achieve the intended benefits
  - Makes the audit scalable to fit any company's size and complexity
  - Simplifies the standard

- Guidance for Auditors of Smaller Public Companies
Rule 3526, *Communication With Audit Committees Concerning Independence*, supersedes ISB No. 1 and its interpretations.

- Requires auditor to communicate to the audit committee relationships that may reasonably be thought to bear on the auditor's independence:
  - Prior to accepting an initial engagement
  - Annually thereafter
Communication Requirements

- In writing
- Discuss with the audit committee the potential effects of the relationships
- Document the substance of the discussion
- Annually must affirm to the audit committee in writing that the audit firm is independent in compliance with Rule 3520
Tax Services to Executives

- Amended Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*
  
  - Prohibition was amended to apply only to the professional engagement period
  
  - Objective of change was to avoid unnecessary restriction on choice of auditor
Engagement Quality Review

- Would apply to all registered firms and all engagements conducted pursuant to the standards of the PCAOB
- Some features similar to interim standard
  - Competence
  - Independence, integrity and objectivity
  - Standard procedures
- Some features are different
  - Explicit risk focus
  - Concurring approval of issuance
Concurring Approval of Issuance

- Reviewer must not provide concurring approval of issuance if he or she knows, or should know based on the requirements of the standard, that –
  - Team failed to obtain sufficient competent evidence
  - Team reached an inappropriate conclusion
  - The report is not appropriate, or
  - The firm is not independent
Proposed Auditing Standards Related to Risk Assessment

- Audit Risk in an Audit of Financial Statements
- Audit Planning and Supervision
- Identifying and Assessing Risks of Material Misstatement
- The Auditor's Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Consideration of Materiality in Planning and Performing an Audit
- Audit Evidence
- Conforming Amendments
Proposed Auditing Standards Related to Risk Assessment

- Reflect more risk-based audit approaches
- Enhance the integration of the audit of financial statements with audit of internal control over financial reporting
- Integrate the auditor’s current responsibilities for considering fraud
- Reduce unnecessary differences with risk assessment standards of other standard-setters
Proposed Auditing Standards Related to Risk Assessment

- 120-day comment period ends on February 18, 2009
Other Standards-Setting Projects

- Fair value and specialists
- Confirmations
- Related parties

* Activities subject to change based on emerging issues
Keeping Current with Inspections and Standards

- Our Web site - www.pcaobus.org
  - Inspection Reports
  - PCAOB standards and related rules, including interim standards
  - PCAOB proposed standards
  - Staff Questions and Answers
  - 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: www.pcaobus.org/About/Pages/RSSFeeds.aspx
Questions?
SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

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October 30, 2008
Agenda

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

Divisions and Offices reporting to the Office of the Chairman

- Four Divisions
  - Corporation Finance
  - Enforcement
  - Investment Management
  - Trading and Markets

- Eighteen Offices
  - Chief Accountant (includes Interactive Disclosure)
  - Compliance Inspections and Examinations
  - Economic Analysis
  - 15 Others
Division of Corporation Finance (DCF)

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.”

- 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
- Support Offices
DCF – Chief Accountant’s Office

**Provides technical support to industry groups**
- Consultations from the Staff on technical matters
- Registrant’s request for reconsideration of Staff comments
  - May include OCA
- Restatements

**Pre-filing submissions**
- Interpretations of reporting requirements
- Waivers/accommodations of reporting requirements
- Interpretations on the application of GAAP (in conjunction with OCA)

**Rulemaking impacting financial reporting**
Office of the Chief Accountant

- Carries out the day-to-day work to assist the Commission in its oversight role over the FASB, which the Commission has designated as a private-sector accounting standard setter.
- Also carries out oversight responsibilities related to the PCAOB.
- Consults with registrants and auditors regarding the application of accounting, auditing, and independence standards.
  - [www.sec.gov/info/accountants/ocasubguidance.htm](http://www.sec.gov/info/accountants/ocasubguidance.htm)
- OCA and DCF work together closely on:
  - Consultations on certain technical matters relating to the application of GAAP.
  - Rulemaking impacting financial reporting.
  - Consultations from registrants:
    - Pre-clearance
    - Staff comments.
Recent Developments
Smaller Reporting Company Relief and Simplification

**Effective date -- February 4, 2008**

**The reasons for the change are:**

- Expand eligibility to use scaled disclosure
- Reduce unnecessary complexity by aligning the categories of “small business issuers” and “non-accelerated filers”
- Simplify disclosure requirements by including scaled disclosure requirements in Regulations S-K and S-X

*Does not change the level of disclosure required in most cases*
Smaller Reporting Company Relief and Simplification

**Key Changes**

- **New Threshold -- $75 million in public float**
  - Revenues of $50 million if public float is zero
- **“A la Carte” Disclosures**
- **Financial statement requirements**
  - Two years of audited balance sheets
  - Interim filings must contain most recent year-end balance sheet
  - Rule 3-05 amended to raise threshold at which only two years of financial statements are required from $25 million in revenues to $50 million in revenues
- **Eliminates use of SB forms**
Smaller Reporting Company Relief
and Simplification

Where can I find more information?

- The final rule release --

- The Small Entity Compliance Guide --

- Smaller Reporting Company Compliance and Disclosure Interpretations --

- Division of Corporation Finance Office of Small Business Policy – (202) 551-3460
Other SEC Key Developments

- **Sarbanes-Oxley**
  - Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers (Release 33-8934)
    - Delays Section 404(b) requirement until fiscal years ending after 12/15/09
  - Costs and Benefits Study of Sarbanes-Oxley Act Section 404 (Press Release 2008-8)

- **International Financial Reporting Standards**
  - eXtensible Business Reporting Language (XBRL)
  - Committee on Improvements to Financial Reporting recommendations (CIFiR)
Key US GAAP Developments

- **Fair Value Accounting – SFAS 159 and 157**
  - Effective for fiscal years beginning on or after 11/15/07
  - Letters on SFAS 157 disclosures –
  - FSP 157-3 – Determining FV of a Financial Asset When the Market for That Asset is Not Active

- **Business Combinations and Noncontrolling interests – SFAS 141(R) and SFAS 160**
  - Effective for fiscal years beginning on or after 12/15/08

- **FASB Accounting Standards Codification -- [asc.fasb.org](http://asc.fasb.org)**
  - One-year Verification Phase

- **SAB 74 – Requires disclosure regarding impact of new standards**
The Comment Letter Process
Comment Letter Process

Filings Subject to Staff Review

- Selected by the SEC’s confidential internal screening criteria and Sarbanes-Oxley requirements
- IPOs
- Other registration statements
- Annual reports
- Proxy statements
- Item 4.01 and Item 4.02 Form 8-Ks
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 on Exchange Act Filings
Comment Letter Process

Best Practices for Resolving Issues

- Prepare a thorough response
  - An invitation to a dialogue
  - 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
Financial Reporting Issues
Frequently Raised in Comment Letters
Financial Reporting Issues Frequently Raised in Comment Letters

Revenue Recognition
Business Combinations (incl. Reverse Mergers)
Equity Transactions
Embedded Conversion Options and Warrants
Management’s Discussion and Analysis
Forms 8-K on Item 4.01 and Item 4.02
Internal Controls over Financial Reporting
Certifications
Audit Reports
Other Areas (see Appendix)
Revenue Recognition

Common Areas of Comment

- Policy disclosures (i.e., SAB 104)
  - “Boilerplate” disclosures
  - Disclosure should be specific to company’s revenue streams
- EITF 00-21 – Multiple-Element Arrangements
- EITF 99-19 – Gross versus Net Revenue Recognition
Business Combinations

Business combination or asset purchase

- EITF 98-3
- Rule 11-01(d) of Regulation S-X

Purchase Price Allocation

- Allocated to all assets and liabilities acquired based upon fair value
- Fair value of securities issued

Disclosures

- Annual vs. Interim periods
**Business Combinations**

**Reverse Acquisitions/Recapitalizations**

- Determination of the accounting acquirer
  - Consider all factors in paragraph 17 of SFAS 141
- Cost of the acquired entity
  - Depends on whether it is a business combination or recapitalization
- 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
- Form 8-K requirements
Business Combinations

Entities Under Common Control

- Net assets of acquiree are recorded at historical basis
- Determining control group

Separate Financial Statements of an Acquired Business

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

Predecessor Financial Statements

- Registrant succeeds to substantially all of the business of another entity
- Registrant’s own operations are relatively insignificant
Equity Transactions

Fair Value Determination

- If publicly traded, use quoted market price
  - Generally, no discounts for illiquidity, trading restrictions or block discounts.
- If stock not publicly traded
  - Contemporaneous equity transactions with third parties
  - Fair value of the services or goods provided may be used to measure the transaction, if more reliable

Disclosure

- All major assumptions used to value stock options, warrants and other equity instruments
  - Footnotes
  - MD&A (critical accounting estimates)
  - Consider sensitivity analysis
Embedded Conversion Options and Freestanding Warrants

Primary issues:

- Bifurcation of conversion option
- Classification as liability or equity

Instruments involved:

- Convertible debt
- Convertible preferred stock
- Freestanding warrants to buy registrant’s stock
Embedded Conversion Options and Freestanding Warrants (cont’d)

Analysis

- Is the instrument within scope of SFAS 150?
- Analyze under SFAS 133 – two routes
  1. Freestanding
     - Account for as a derivative under SFAS 133
     - Perform 00-19 Analysis
       - Account for as equity
       - Account for as a liability
  2. Embedded
     - Do not bifurcate under SFAS 133 (this often requires performing an EITF 00-19 Analysis which may require bifurcation)
       - Consider ASR 268 and APB 14
       - BCF under EITF 98-5 and 00-27
       - Bifurcate – Account as derivative liability (SFAS 133)
Embedded Conversion Options and Freestanding Warrants (cont’d)

Scope of EITF 00-19

- Applies to all contracts that are indexed to, and sometimes settled in a company’s own stock
- Does not apply to conventional convertible debt instruments

Common Pitfalls of EITF 00-19

- Cash settlement provisions
- Required to settle in registered shares
- Insufficient authorized shares
- No limit on # of shares to be delivered
- Silence to settlement terms assumes cash settlement

Evaluate the provisions of your agreements (Debt, warrant, reg. rights, etc.) carefully
Management’s Discussion & Analysis (MD&A)

Release Nos. 33-6835 and 33-8350

Best Practices

- Executive-level overview (including discussion of impact of current economic conditions)
- Critical accounting estimates
  - Provide insight into the quality and variability of financial information (including fair value measurements)
- Comparative results of operations that are thorough and address the causal factors of change
- Liquidity and capital resources
  - Enhanced analysis and explanation of the sources and uses of cash
    - Consider categories reported on statement of cash flows
  - Address going concern matters
  - Consider enhanced disclosure regarding debt instruments, guarantees and related covenants.
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
- Reverse acquisitions
- Accounting firm mergers
- Exhibit 16 letter
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”
Internal Controls 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
- Disclosures when material weakness exists
  - Nature of the material weakness
  - Impact of material weakness on company’s financial reporting and 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
Internal Controls over Financial Reporting (ICFR)

**Auditor attestation under Item 308(b) of Regulation S-K**

- **No specific requirement for location in filing**
  - Generally in close proximity to financial statement opinion or management’s report

- **Not currently required for non-accelerated filers**

- If auditor attestation not included, registrant must include statement that ICFR has not been attested to by auditor (See Item 308T of Regulation S-K)
CEO/CFO Certifications

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

Internal control over financial reporting (ICFR)

- SEC Release 33-8238 (June 2003) permitted exclusion of:
  - introductory language in paragraph 4 referring to responsibility for establishing and maintaining ICFR
  - Paragraph 4(b) (certifying officer has designed or supervised the design of ICFR)

- Starting with first period in which management is required to assess ICFR, these statements can no longer be excluded
Audit Reports

Auditor must be PCAOB registered accountant that meets all of the requirements of Article 2

Audit reports must be filed for all financial statements required to be audited

If audit report refers to the report(s) of another auditor(s), the registrant must include those reports in the filing
Resources
Resources

**SEC Website** – [www.sec.gov](http://www.sec.gov)
- Information for Accountants - [www.sec.gov/about/offices/oca.htm](http://www.sec.gov/about/offices/oca.htm)
- Division of Corporation Finance - [www.sec.gov/divisions/corpfin.shtml](http://www.sec.gov/divisions/corpfin.shtml)

**FASB Website** – [www.fasb.org](http://www.fasb.org)

**SEC Regulations Committee** -- [thecaq.org/resources/secregs.htm](http://thecaq.org/resources/secregs.htm)
Questions???

Key Telephone Numbers

DCF Chief Accountant’s Office (202) 551-3400
DCF Office of the Chief Counsel (202) 551-3500
DCF Office of Small Business Policy (202) 551-3460
Office of the Chief Accountant (202) 551-5300

Kevin L. Vaughn – (202) 551-3643
Appendix
Registrants that qualify as smaller reporting companies reporting under Article 8 of Regulation S-X

- Need not apply the other form and content requirements in Regulation S-X except:
  - Report and qualifications of the independent accountant (Article 2)
  - Description of accounting policies (Rule 4–08(n))
  - Companies engaged in oil and gas producing activities (Rule 4–10)

- Guidance outside of Regulation S-X continues to apply that may result in comments. For example:
  - Equity vs. non-equity (EITF Topic D-98 and SFAS No. 150)
  - Operating, investing, and financing cash flows (SFAS No. 95)
  - Discontinued operations (SFAS No. 144)
  - Stock-based compensation expense (SAB Topic 14F)
Registrants that do not qualify to report under Article 8 of Regulation S-X

- Subject to more detailed classification rules (e.g., Article 5 of Regulation S-X for commercial and industrial companies)
  - Rule 5-02 - balance sheets
  - Rule 5-03 – income statements
- These additional rules most often result in comments relating to Rule 5-03
  - Components of revenue
  - Cost of sales
  - Classification of share-based payments
  - Operating vs. non-operating
General Reporting Requirements

Registration Statements - Rule 8-08 of Regulation S-X

- Financial Statements must be current as of the date of the filing
- Financial statements must be as of a date less than 135 days to be declared effective
- If the smaller reporting companies effective date falls after 45 days but within 90 days of the fiscal year end, audited financial statements are not required provided the following:
  - If a reporting company, all reports must have been filed
  - Company expects to report income from continuing operations before taxes for the current year
  - Company has reported income from continuing operations before taxes in at least one of the two previous years
Disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act is recorded, processed, summarized and reported, within the time periods specified in the Commission’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.
Common DC&P Comment Areas

**Insufficient conclusions**
- Disclosure should state DC&P conclusion in clear and unqualified language – effective or not effective
- “Adequate” or “Effective except for…” are inappropriate

**Incomplete definition of DC&P**
- If definition is included, should conform exactly to Item 307 of Regulation S-K
- However, definition is not required

**“Reasonable assurance” language**
- Disclosures regarding design and conclusion on DC&P should be consistent with conclusion
Management’s Report on Internal Control over Financial Reporting
Management’s Report on Internal Control over Financial Reporting

Current Status (Where are we now?)
Recent Developments
Staff observations
Overview of Management’s Assessment
**Current Status (Where are we now?)**

*Provide Management’s Assessment Only*
- Nonaccelerated Filers
- Years Ended After 12/15/07

*Provide BOTH Management’s Assessment and Auditor’s Attestation*
- Accelerated Filers
- Large Accelerated Filers
- All Companies beginning with years ending after 12/15/09

*Exceptions*
- New Public Companies
- Business Combinations (as it relates to acquired business)
- Other
Recent Developments

404(a): SEC’s Guidance for Management

- Interpretive Guidance approved by Commission on May 23, 2007
- Issued - “Sarbanes-Oxley Section 404: A Guide for Small Business”
- Both available on SEC website at: http://www.sec.gov/spotlight/soxcomp.htm

404(b): PCAOB’s Guidance for Auditors

- Auditing Standard No. 5 (AS 5)
  - Approved by PCAOB on May 24, 2007
  - Approved by Commission on July 25, 2007
- Draft Issued – “Preliminary Staff Views – Guidance for Auditors of Smaller Public Companies”
Recent Developments

404(b): Deferral of Compliance for Non-Accelerated Filers

- Provides additional one-year deferral (years ending after 12/15/09)

Cost-Benefit Study
Top 5 Deficiencies for First-timers

- **Companies began but did not finish their assessment**
- **Companies were silent as to whether they did an evaluation and assessment**
- **Companies did not believe they were required to conduct an evaluation**
- **Companies did not perform an assessment because they consummated a reverse merger or were a shell company**
- **Companies appear to have performed an assessment but did not disclose a conclusion**
Comment Letters

- Comments sent to numerous registrants who did not comply with Section 404(a)
- Assessment must be completed and filing must be amended
- Exclusion of management’s report is a material deficiency
  - Company is not considered timely or current for use of certain forms
  - Question 115.02 of Regulation S-K Compliance and Disclosure Interpretations
Other Staff Observations

Conclusions

- Two conclusions are required (DCP and ICFR)
- Must explicitly state whether they are effective or ineffective

Material Weakness Disclosures

- Is not transparent to allow reader to determine pervasiveness and impact on financial statements
- “Lagging Indicator”
- Narrowly focused on financial statement line item
  - e.g. “material weakness related to income taxes”
- Remediation disclosures identify additional material weaknesses or broader impact

Identification of Acceptable Framework

- Management’s Guidance is not a framework
SEC Interpretive Guidance for Management

**Key Attributes**

- Principles-based
- Directs efforts to highest risks of material misstatement of financial statements
- Allows evaluation processes tailored to facts and circumstances
- Provides guidance on supporting evidence and documentation
- Provides guidance for evaluating deficiencies
- Does not replace control frameworks
- Voluntary
Overview of Management’s Assessment

Overview

- Phase 1
  - **Identify the financial reporting risks and the controls that adequately address these risks**

- Phase 2
  - **Determine the evidence needed to support the assessment, based on an evaluation of ICFR risk, and evaluate the operating effectiveness of the controls identified in Phase 1**

- Phase 3
  - **Report on the effectiveness of ICFR and disclose any material weaknesses**
Questions?

- Office of Chief Accountant -- 404smallbusiness@sec.gov.
- Division of Corporation Finance's Office of Small Business Policy
  - [http://www.sec.gov/info/smallbus/reachsec.htm](http://www.sec.gov/info/smallbus/reachsec.htm)
  - smallbusiness@sec.gov
  - (202) 551-3460
Closing Remarks and Wrap-Up

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October 30, 2008
Philadelphia, PA