

Forum on Auditing in The Small Business Environment

November 3, 2009

Denver, CO

Opening Remarks

Daniel L. Goelzer
PCAOB Acting Chairman
November 3, 2009
Denver, CO

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.



Small Business Forum
Denver, Colorado
November 3, 2009
Andres Vinelli and Joe St. Denis

PCAOB
Public Company Accounting Oversight Board



Agenda

- Economic outlook
- GAAP/Audit Risk update



Industry Sectors of Issuer Clients – Denver SBF

Registered Firms**	20
Issuer Clients	515
Financials	107
Unassigned	69
Information Technology	57
Consumer Discretionary	55
Energy	51
Industrials	41
Health care	38
Materials	38
Misc.Financial Services	28
Consumer Staples	22
Telecommunication Services	5
Utilities	4
	515



Roadmap

- The credit crisis and policy response
- Current economic situation
- Looking forward: Baseline scenario
- Implications

The recession started in December of 2007...

This year we are experiencing a deflationary environment

Table of Inflation Rates by Month and Year (2000 - 2010)

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2000	2.7%	3.2%	3.8%	3.1%	3.2%	3.7%	3.7%	3.4%	3.5%	3.4%	3.4%	3.4%	3.4%
2001	3.7%	3.5%	2.9%	3.3%	3.6%	3.2%	2.7%	2.7%	2.6%	2.1%	1.9%	1.6%	2.8%
2002	1.1%	1.1%	1.5%	1.6%	1.2%	1.1%	1.5%	1.8%	1.5%	2.0%	2.2%	2.4%	1.6%
2003	2.6%	3.0%	3.0%	2.2%	2.1%	2.1%	2.1%	2.2%	2.3%	2.0%	1.8%	1.9%	2.3%
2004	1.9%	1.7%	1.7%	2.3%	3.1%	3.3%	3.0%	2.7%	2.5%	3.2%	3.5%	3.3%	2.7%
2005	3.0%	3.0%	3.1%	3.5%	2.8%	2.5%	3.2%	3.6%	4.7%	4.3%	3.5%	3.4%	3.4%
2006	4.0%	3.6%	3.4%	3.5%	4.2%	4.3%	4.1%	3.8%	2.1%	1.3%	2.0%	2.5%	3.2%
2007	2.1%	2.4%	2.8%	2.6%	2.7%	2.7%	2.4%	2.0%	2.8%	3.5%	4.3%	4.1%	2.8%
2008	4.3%	4.0%	4.0%	3.9%	4.2%	5.0%	5.6%	5.4%	4.9%	3.7%	1.1%	0.1%	3.8%
2009	0.0%	0.2%	-0.4%	-0.7%	-1.3%	-1.4%	-2.1%	-1.5%	-1.3%	-0.6%	0.8%	2.8%	-0.5%
2010	2.5%	2.3%	2.1%	2.0%									

Source: U.S. Inflation Calculator

2009 annual infaltion rates are calculated using estimated values for September - December 2009.

Estimates are shaded in gray and provided by the financial forecast center.

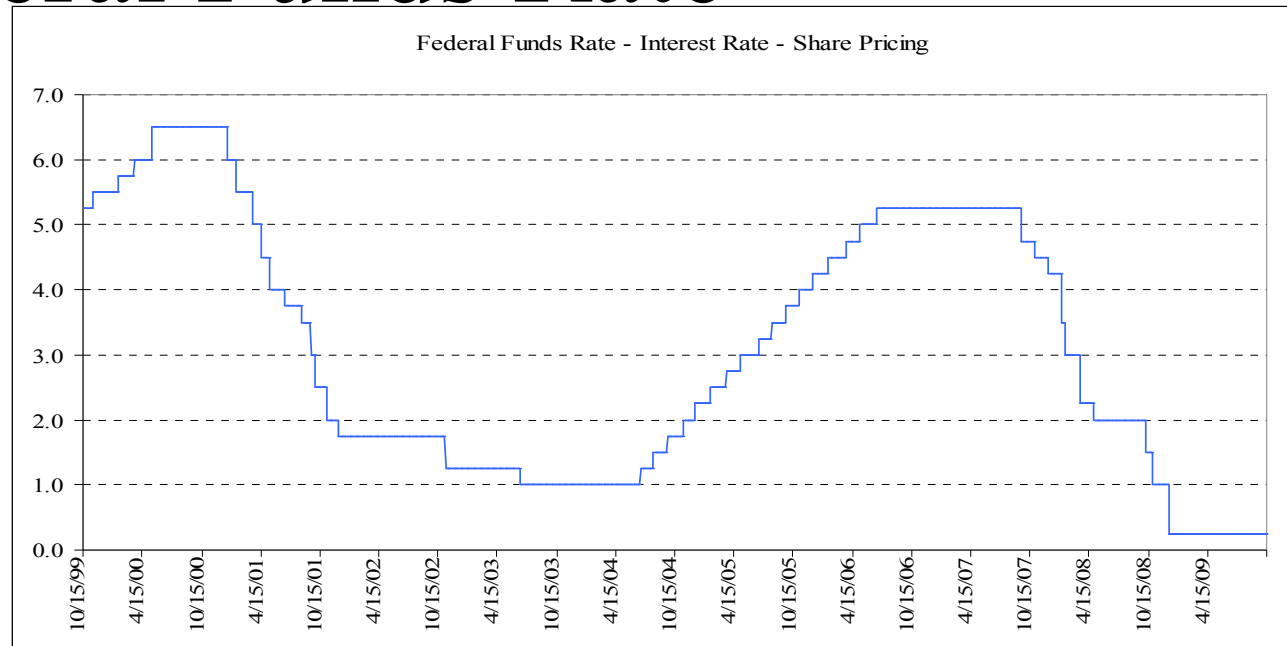
- In 2009 the US has experienced deflationary conditions. Economic theory suggests that deflation happens when the aggregate expenditure falls short of what is required to produce GDP that would ensure full employment. This theory aligns with the current US economic situation in which we are seeing slowed GDP growth and high unemployment.



2007-2008: Very High Risk Scenario

- Main features:
 - Banking crisis
 - Recession
 - Deflationary forces
- Governments around the world acted swiftly, in a coordinated fashion
- Very strong monetary and fiscal stimuli

U.S. Monetary Stimulus: Federal Funds Rate



- The federal funds rate fluctuates with the economy. The decreases with the federal funds rate align with the economic downturn of 2001 and the recession which began in December of 2007.



Strong Monetary Stimulus...

Average Yields for US Treasuries

Date	1 Year	5 Year	10 Year	20 Year
2009	0.5%	2.2%	3.2%	4.1%
2008	1.8%	2.8%	3.7%	4.4%
2007	4.5%	4.4%	4.6%	4.9%
2006	4.9%	4.7%	4.8%	5.0%

Source: www.ustreas.gov

- We have seen declines in the returns for US treasuries.
- The decline has been more extreme in short term securities due to accommodative Federal Reserve policies.

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

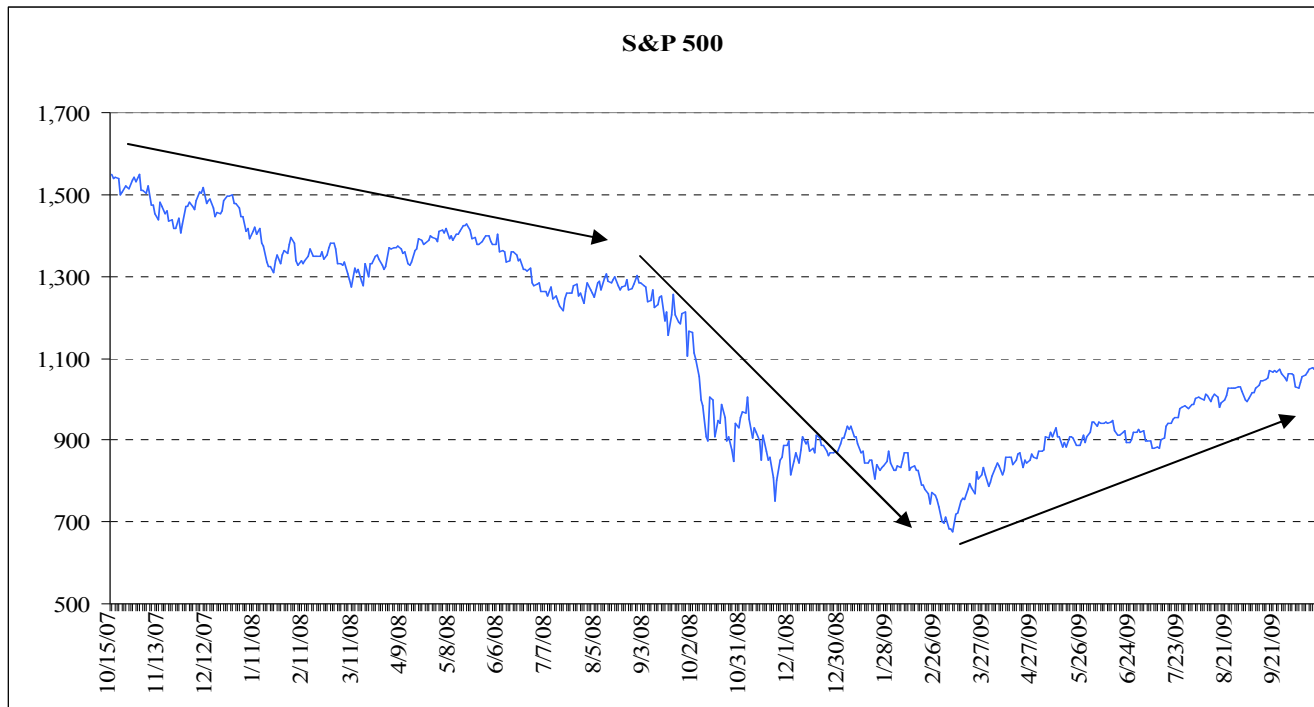
Summary of Receipts, Outlays, and Surpluses or Deficits (in millions)

Year	Total			On-Budget			Off-Budget			As Percentage of GDP		
	Receipts	Outlays	Suplus or Deficit	Receipts	Outlays	Suplus or Deficit	Receipts	Outlays	Suplus or Deficit	Receipts	Outlays	Suplus or Deficit
2000	2,025,457	1,789,216	236,241	1,544,873	1,458,451	86,422	480,584	330,765	149,819	20.9%	18.4%	2.5%
2001	1,991,426	1,863,190	128,236	1,483,907	1,516,352	(32,445)	507,519	346,838	160,681	19.8%	18.5%	1.3%
2002	1,853,395	2,011,153	(157,758)	1,338,074	1,655,491	(317,417)	515,321	355,662	159,659	17.9%	19.4%	-1.5%
2003	1,782,532	2,160,117	(377,585)	1,258,690	1,797,108	(538,418)	523,842	363,009	160,833	16.5%	20.0%	-3.5%
2004	1,880,279	2,293,006	(412,727)	1,345,534	1,913,495	(567,961)	534,745	379,511	155,234	16.3%	19.9%	-3.6%
2005	2,153,859	2,472,205	(318,346)	1,576,383	2,069,994	(493,611)	577,476	402,211	175,265	17.6%	20.2%	-2.6%
2006	2,407,254	2,655,435	(248,181)	1,798,872	2,233,366	(434,494)	608,382	422,069	186,313	18.5%	20.4%	-1.9%
2007	2,568,239	2,728,940	(160,701)	1,933,150	2,275,303	(342,153)	635,089	453,637	181,452	18.8%	20.0%	-1.2%
2008	2,524,326	2,982,881	(458,555)	1,866,280	2,508,130	(641,850)	658,046	474,751	183,295	17.7%	21.0%	-3.3%
2009	2,156,654	3,997,842	(1,841,188)	1,501,784	3,479,621	(1,977,837)	654,870	518,221	136,649	15.1%	28.1%	-13.0%
2010	2,332,645	3,591,076	(1,258,431)	1,649,422	3,041,947	(1,392,525)	683,223	549,129	134,094	15.8%	24.4%	-8.6%
2011	2,685,358	3,614,774	(929,416)	1,966,273	3,047,386	(1,081,113)	719,085	567,388	151,697	17.3%	23.3%	-6.0%
2012	3,075,328	3,632,747	(557,419)	2,317,712	3,047,482	(729,770)	757,616	585,265	172,351	18.7%	22.1%	-3.4%
2013	3,305,141	3,817,463	(512,322)	2,501,165	3,205,650	(704,485)	803,976	611,813	192,163	18.9%	21.8%	-2.9%
2014	3,480,124	4,016,020	(535,896)	2,636,281	3,370,689	(734,408)	843,843	645,331	198,512	18.9%	21.8%	-2.9%

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

Estimates are shaded in gray.

... and a Bounce in Risky Assets



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

Consolidation in the Housing Market

Composite 20 Index

2005	% Change in Housing Prices	2006	% Change in Housing Prices	2007	% Change in Housing Prices	2008	% Change in Housing Prices	2009	% Change in Housing Prices
January 2005	0.92%	January 2006	0.23%	January 2007	-0.50%	January 2008	-0.50%	January 2009	-2.79%
February 2005	1.17%	February 2006	0.37%	February 2007	-0.37%	February 2008	-0.37%	February 2009	-2.21%
March 2005	1.57%	March 2006	0.23%	March 2007	-0.28%	March 2008	-0.28%	March 2009	-2.15%
April 2005	1.62%	April 2006	0.57%	April 2007	-0.23%	April 2008	-0.23%	April 2009	-0.56%
May 2005	1.61%	May 2006	0.51%	May 2007	-0.21%	May 2008	-0.21%	May 2009	0.50%
June 2005	1.54%	June 2006	0.25%	June 2007	-0.34%	June 2008	-0.34%	June 2009	1.43%
July 2005	1.35%	July 2006	0.07%	July 2007	-0.36%	July 2008	-0.36%	July 2009	1.61%
August 2005	1.20%	August 2006	-0.16%	August 2007	-0.68%	August 2008	-0.68%		
September 2005	1.22%	September 2006	-0.18%	September 2007	-0.85%	September 2008	-0.85%		
October 2005	1.03%	October 2006	-0.19%	October 2007	-1.38%	October 2008	-1.38%		
November 2005	0.79%	November 2006	-0.37%	November 2007	-2.09%	November 2008	-2.09%		
December 2005	0.50%	December 2006	-0.65%	December 2007	-2.11%	December 2008	-2.11%		
Yearly Change	15.52%	Yearly Change	0.67%	Yearly Change	-9.03%	Yearly Change	-18.61%	Yearly Change	-4.19%

Source: Case-Shiller Index

Denver Index

2005	% Change in Housing Prices	2006	% Change in Housing Prices	2007	% Change in Housing Prices	2008	% Change in Housing Prices	2009	% Change in Housing Prices
January 2005	-0.05%	January 2006	-0.06%	January 2007	-0.91%	January 2008	-1.54%	January 2009	-2.71%
February 2005	0.22%	February 2006	-0.22%	February 2007	-0.74%	February 2008	-1.16%	February 2009	-1.72%
March 2005	0.08%	March 2006	-0.14%	March 2007	-0.49%	March 2008	-0.05%	March 2009	0.14%
April 2005	0.84%	April 2006	0.26%	April 2007	0.49%	April 2008	0.86%	April 2009	1.48%
May 2005	0.72%	May 2006	0.75%	May 2007	1.08%	May 2008	0.97%	May 2009	1.32%
June 2005	0.66%	June 2006	0.83%	June 2007	1.30%	June 2008	1.49%	June 2009	2.54%
July 2005	0.56%	July 2006	0.57%	July 2007	0.83%	July 2008	0.77%	July 2009	1.47%
August 2005	0.53%	August 2006	0.01%	August 2007	0.34%	August 2008	-0.02%		
September 2005	0.30%	September 2006	-0.45%	September 2007	-0.92%	September 2008	-1.27%		
October 2005	0.07%	October 2006	-0.74%	October 2007	-1.70%	October 2008	-1.46%		
November 2005	-0.12%	November 2006	-0.70%	November 2007	-2.01%	November 2008	-1.08%		
December 2005	-0.02%	December 2006	-0.39%	December 2007	-1.78%	December 2008	-1.50%		
Yearly Change	3.85%	Yearly Change	-0.28%	Yearly Change	-4.47%	Yearly Change	-4.00%	Yearly Change	2.43%

Source: Case-Shiller Index



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.

Economy is More Stable Now...

for Instance, for Metro Denver

Indicator	Monthly/Quarterly Direction	Annual Direction
Nonfarm Employment Growth	Up	Down
Percent of Companies Hiring (Denver Area)	Down	Down
Unemployment Rate	Up	Up
Initial Unemployment Insurance Claims	Up	Up
Total Retail Sales	Down	Down
Consumer Confidence Index	Down	Down
Hotel Occupancy	Up	Down
DIA Passengers	Up	Down
Bloomberg Colorado Index	Up	Up
Dow Jones Industrial Average	Up	Up
Home Sales (closed)	Up	Down
Median Home Price (Denver-Aurora MSA)	Down	Down
Foreclosures	Up	Down
Residential Building Permits (Total)	Down	Down
Apartment Vacancy Rate	Up	Up
Office Vacancy Rate (with Sublet)	Same	Up
Industrial Vacancy Rate (with Sublet)	Down	Up
Retail Space Vacancy Rate (with Sublet)	Up	Up
Positive Changes	7 of 18	3 of 18

Looking Forward: Baseline Scenario

Gross Domestic Product (GDP)

Gross Domestic Product (Annual)	GDP in Billions of Current Dollars	Growth Rate*
2000	9,708	
2001	10,060	3.6%
2002	10,378	3.2%
2003	10,804	4.1%
2004	11,504	6.5%
2005	12,235	6.4%
2006	13,010	6.3%
2007	13,642	4.9%
2008	14,222	4.3%
2009		-2.6%
2010		2.3%
2011		2.9%
2012		3.2%

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.

- The current recession accounts for the negative estimated GDP growth in 2009.
- By 2010 experts expect GDP growth to be positive and to continue to increase through 2012.
- However, the estimates from the White House expects GDP growth to exceed the previous 20 year average of 5.5 percent by 2012

But Unemployment will be Higher Nationally...

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2000	4.0%	4.1%	4.0%	3.8%	4.0%	4.0%	4.0%	4.1%	3.9%	3.9%	3.9%	3.9%
2001	4.2%	4.2%	4.3%	4.4%	4.3%	4.5%	4.6%	4.9%	5.0%	5.3%	5.5%	5.7%
2002	5.7%	5.7%	5.7%	5.9%	5.8%	5.8%	5.8%	5.7%	5.7%	5.7%	5.9%	6.0%
2003	5.8%	5.9%	5.9%	6.0%	6.1%	6.3%	6.2%	6.1%	6.1%	6.0%	5.8%	5.7%
2004	5.7%	5.6%	5.8%	5.6%	5.6%	5.6%	5.5%	5.4%	5.4%	5.5%	5.4%	5.4%
2005	5.2%	5.4%	5.2%	5.2%	5.1%	5.1%	5.0%	4.9%	5.0%	5.0%	5.0%	4.8%
2006	4.7%	4.8%	4.7%	4.7%	4.7%	4.6%	4.7%	4.7%	4.5%	4.4%	4.5%	4.4%
2007	4.6%	4.5%	4.4%	4.5%	4.5%	4.6%	4.7%	4.7%	4.7%	4.8%	4.7%	4.9%
2008	4.9%	4.8%	5.1%	5.0%	5.5%	5.6%	5.8%	6.2%	6.2%	6.6%	6.8%	7.2%
2009	7.6%	8.1%	8.5%	8.9%	9.4%	9.5%	9.4%	9.7%	9.8%	9.8%	9.9%	10.0%
2010	10.0%	10.1%	10.1%	10.1%								

Source: Bureau of Labor and Statistics.

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

- Increases in unemployment that began in 2008.
- In 2008 and 2009, respectively we have seen average unemployment rates at 5.8 and 9.0 percent.
- These rates are well over the 5.0 percent average unemployment seen since 2000.
- Unemployment is bound to deteriorate after we emerge from the recession

... and Regionally

	Jun 2009 (p)		2009 YTD Avg.		2008 YTD Avg.		2004	1999
	Labor Force	Unemploy Rate	Labor Force	Unemploy Rate	Labor Force	Unemploy Rate	Annual Avg. Unemploy Rate	Annual Avg. Unemploy Rate
Metro Denver	1,544.9	7.8%	1536.8	7.5%	1542.4	4.6%	5.8%	2.4%
Adams County	227.9	9.0%	226.5	8.8%	225.6	5.1%	6.5%	2.7%
Arapahoe County	313.9	7.7%	311.5	7.5%	313	4.6%	5.7%	2.1%
Boulder County	176.3	6.6%	177.7	6.1%	179.2	3.9%	4.9%	2.6%
Broomfield County*	30.8	7.5%	30.5	7.0%	30.8	4.3%	5.8%	
Denver County	325.5	8.5%	323.6	8.4%	323.5	5.1%	6.6%	3.1%
Douglas County	158.7	6.7%	157.5	6.4%	159.1	4.0%	4.7%	1.4%
Jefferson County	311.8	7.5%	309.5	7.3%	311.2	4.4%	5.4%	2.2%
Colorado	27,723.9	7.8%	2713.4	7.5%	2715.6	4.6%	5.6%	2.9%
United States	155,921	9.7%	154,178	9.0%	153,543	5.3%	5.5%	4.2%

*Broomfield County was formed in November 2001 from parts of Adams, Boulder, Jefferson, and Weld Counties.

Source: Colorado Department of Labor and Employment, Labor Market Information. (p) = preliminary

- Colorado's YTD unemployment rate of 7.5 percent is well below the national average of 9.0 percent in June.

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

Outstanding Consumer Credit

	2004	2005	2006	2007	2008
Total	19.3%	19.0%	18.6%	18.7%	18.2%
Major holders					
Commercial banks	6.1%	5.8%	5.7%	5.9%	6.2%
Finance companies	4.3%	4.2%	4.1%	4.3%	4.0%
Credit unions	1.9%	1.9%	1.8%	1.7%	1.7%
Federal government and Sallie Mae	0.7%	0.7%	0.7%	0.7%	0.8%
Savings institutions	0.8%	0.9%	0.7%	0.7%	0.6%
Nonfinancial business	0.5%	0.5%	0.4%	0.4%	0.4%
Pools of securitized assets	5.0%	5.0%	5.1%	5.0%	4.6%
Major types of credit					
Revolving	7.2%	7.0%	6.9%	7.1%	6.9%
Commercial banks	2.7%	2.5%	2.5%	2.6%	2.7%
Finance companies	0.4%	0.5%	0.6%	0.6%	0.5%
Credit unions	0.2%	0.2%	0.2%	0.2%	0.2%
Federal government and Sallie Mae	-	-	-	-	-
Savings institutions	0.2%	0.3%	0.3%	0.3%	0.3%
Nonfinancial business	0.1%	0.1%	0.1%	0.0%	0.0%
Pools of securitized assets	3.4%	3.3%	3.2%	3.3%	3.1%
Nonrevolving	12.1%	12.0%	11.7%	11.6%	11.3%
Commercial banks	3.4%	3.2%	3.2%	3.3%	3.4%
Finance companies	3.8%	3.7%	3.5%	3.7%	3.5%
Credit unions	1.7%	1.7%	1.6%	1.5%	1.4%
Federal government and Sallie Mae	0.7%	0.7%	0.7%	0.7%	0.8%
Savings institutions	0.6%	0.6%	0.4%	0.3%	0.3%
Nonfinancial business	0.4%	0.4%	0.4%	0.4%	0.4%
Pools of securitized assets	1.5%	1.7%	1.9%	1.7%	1.4%

Source: www.federalreserve.gov

... and Regionally.

Retail Spending Metro Denver Area

	Month of April - 09	Month of March - 09	Month of April - 08	YTD Total 2009	YTD Total 2008	YTD Total % Change	Annual Growth 2004	Annual Growth 1999
% of Retail Spending in Metro Denver	60.5%	58.6%	60.3%	59.3%	59.0%			
Metro Denver	5,803,873	6,801,729	6,922,656	24,337,518	27,443,558	-11.3%	7.4%	7.0%
Adams County	1,003,090	1,057,745	1,279,121	4,005,211	4,825,104	-17.0%	11.7%	10.5%
Arapahoe County	1,183,288	1,483,290	1,317,331	4,926,088	5,455,936	-9.7%	2.6%	10.2%
Boulder County	536,637	687,119	605,517	2,377,142	2,513,423	-5.4%	2.1%	4.1%
Broomfield County*	111,879	125,777	113,381	438,667	486,035	-9.7%	49.4%	
Denver County	1,675,818	1,920,748	2,066,547	7,154,442	7,960,372	-10.1%	8.1%	2.2%
Douglas County	433,603	496,226	505,532	1,794,371	1,987,442	-9.7%	16.9%	18.3%
Jefferson County	859,558	1,030,824	1,035,227	3,641,597	4,215,246	-13.6%	3.8%	7.3%
Colorado	9,590,975	11,608,940	11,487,790	41,021,595	46,549,319	-11.9%	7.8%	7.4%

*Broomfield County was formed in November 2001 from parts of Adams, Boulder, Jefferson, and Weld Counties.

Source: Colorado Department of Labor and Employment, Labor Market Information. (p) = preliminary

- Slow retail spending throughout Colorado.
- Adams County has experienced the greatest decrease in retail spending.
- Metro Denver has experienced a smaller decrease in retail spending than the state of Colorado as a whole.



Weak Consumers

- Consumers will try to repay their debts
- This depresses Economic Growth
- Government will not fully compensate because...

Government Debt is Up Not Only in the US but Globally

General Government Debt (Percent of GDP)

Country	2007 (Pre-Crisis)	2009	2010	2014
Argentina	67.9%	50.4%	50.6%	48.4%
Australia	8.5%	13.7%	19.1%	25.9%
Brazil	67.7%	70.1%	68.5%	62.2%
Canada	64.2%	75.6%	76.6%	65.4%
China	20.2%	20.9%	23.4%	21.3%
France	63.8%	77.4%	83.8%	95.5%
Germany	63.6%	79.8%	86.8%	91.4%
India	80.5%	83.7%	85.0%	73.4%
Indonesia	35.1%	31.1%	31.0%	28.4%
Italy	103.5%	117.3%	123.2%	132.2%
Japan	187.7%	217.4%	226.2%	239.2%
Korea	29.6%	35.8%	42.0%	39.4%
Mexico	38.2%	49.2%	50.3%	44.5%
Russia	7.4%	7.3%	7.8%	7.3%
Saudi Arabia	18.5%	14.6%	12.6%	9.4%
South Africa	28.5%	29.0%	30.5%	29.5%
Turkey*	39.4%	46.9%	50.7%	58.1%
United Kingdom	44.1%	68.6%	82.2%	99.7%
United States	63.1%	88.8%	99.8%	112.0%
G - 20	62.4%	76.1%	82.1%	86.6%
Advanced G-20 Countries	78.8%	100.6%	109.7%	119.7%
Emerging Market 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

- As you can see from the data US Government debt as a percentage of GDP has increased during the recession.
- The trend of increased government debt as a percentage of GDP has on average held constant in all G-20 countries. Exceptions include: Argentina, Indonesia, and Saudi Arabia.



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

- Lower Spending
- Higher Taxes
- Inflation
- Weak Dollar
- Lower economic growth



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

But Risks Remain, such as Commercial Real Estate

August 2009	Commercial Forecast		
	2008	2009	2010
Office			
Vacancy Rate	13.4%	16.0%	18.9%
Net Absorbtion ('000sq. ft.)	12,271	(75,023)	(47,229)
Completions ('000 sq. ft.)	68,187	57,690	27,197
Inventory ('000,000 sq. ft.)	3,480	3,577	3,605
Rent Growth	-0.4%	-14.1%	-10.0%
Industrial			
Vacancy Rate	10.4%	13.3%	15.1%
Net Absorbtion ('000sq. ft.)	(57,241)	(299,520)	(111,987)
Completions ('000 sq. ft.)	179,613	76,398	48,751
Inventory ('000,000 sq. ft.)	12,923	12,999	13,048
Rent Growth	-0.8%	-11.4%	-11.7%
Retail			
Vacancy Rate	9.7%	11.9%	13.0%
Net Absorbtion ('000sq. ft.)	(7,315)	(25,896)	(3,620)
Completions ('000 sq. ft.)	26,286	12,767	6,454
Inventory ('000,000 sq. ft.)	1,621	1,665	1,672
Rent Growth	-2.0%	-6.1%	-4.9%
Multi-Family			
Vacancy Rate	5.7%	7.3%	6.9%
Net Absorbtion ('000sq. ft.)	24,390	30,066	246,432
Completions ('000 sq. ft.)	220,773	168,279	64,634
Inventory ('000,000 sq. ft.)	14	14	14
Rent Growth	2.9%	-1.5%	0.8%

source: National Association of Realtors

- Commercial real estate is expected to continue to decline through 2010
- The current recession has lead to increased vacancy rates and fewer completions predicted for 2009 and 2010
- The decline could be more dramatic
- Other risks include further deterioration in residential housing, a dollar “hard landing”



Colorado

- Housing and unemployment situations are less severe in Colorado than nationwide.
- Good local business climate
 - Colorado was recently ranked the 3rd best state for business according to annual rankings by CNBC.com
 - CNBC's study was based on 10 categories including: cost of business, workforce, quality of life, economy
 - transportation, technology and innovation, education, business friendliness, access to capital, and cost of living
 - In a similar study done by Forbes.com Colorado was

ranked #5

Colorado Public Issuers: Audits Per Industry Sector

	10/01/2008 - 9/28/2009	Going Concern Opinions	10/01/2007 - 9/31/2008	Going Concern Opinions
Education and Health Services	1.8%	1.1%	1.1%	0.8%
Financial Activities	30.7%	37.4%	26.9%	31.8%
Information	7.4%	6.0%	8.3%	8.5%
Leisure and Hospitality	2.8%	2.2%	2.2%	1.7%
Manufacturing	23.3%	17.6%	27.1%	22.5%
Natural Resources and Construction	15.5%	13.7%	15.8%	11.9%
Professional and Business Services	12.4%	13.7%	11.1%	13.6%
Trade, Transportation, and Utilities	5.7%	7.7%	7.2%	8.9%
Other Services	0.4%	0.5%	0.3%	0.4%
% of Small Firm Audits	100.0%	100.0%	100.0%	100.0%

Source: Audit Analytics

- The financial activities and manufacturing sectors account for over 50 percent of audits done by triennial audit firms



Business Sectors Expect...

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



Financing Environment Expect...

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



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

GAAP Developments



Roadmap

- Fair Value Measurements
- Transfer and Consolidation
- Revenue Recognition
- Subsequent Events/Going Concern
- Government Programs



Fair Value

- 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*
 - Draws a clear distinction between volume of transactions and orderliness of transactions
 - Orderly transactions are transactions that
 - Are exposed to the market for a period prior to the measurement date
 - Allow for usual and customary marketing activities
 - Fair value still equals exit price even where there are significant decreases in volume
 - However, significant decreases in volume can be an indicator of disorderly market conditions
 - If the market is disorderly, consider use of a different approach (i.e. DCF)
- Q: Are issuers' systems prepared to handle the DCF analysis?*
- Q: ICFR implications?*



Fair Value (cont'd)

- FSP FAS 115-2 and FAS 124-2 (ASC 320-10-35);
Recognition & Presentation of Other-than-Temporary Impairments
 - Applies only to debt securities (except disclosure requirements)
 - If no intent/ability to hold – full impairment through earnings
 - If holding
 - OTTI “credit loss” – recognized in earnings
 - Remainder of OTTI loss – charge to OCI
 - Disclose methodology and key inputs for credit loss



Fair Value (cont'd)

- Here's what you have to do:
 - Determine the discounted present value of expected cash flows based on a reasonable discount rate,
 - Compare this amount to book value; if DCF is less than book value, the difference should be charged to income (“credit loss”),
 - Determine the full fair value of the asset,
 - If the full fair value is less than the DCF, the difference is debited to OCI,
 - If the full fair value is greater than DCF, the difference is *credited* to OCI,
 - For held-to-maturity securities, the OCI amount is amortized to book value using the effective yield method.

Q: Are companies' systems prepared to deal with this?

Q: Any potential ICFR issues?



Fair Value (cont'd)

■ Example

- Acme Gasket Co. holds a bond in its AFS portfolio with an amortized cost of \$100,000
- Fair value is \$80,000
- Discounted PV of cash flows is \$90,000
- Acme intends to sell the security

Q: Is there an other-than-temporary impairment?



Fair Value (cont'd)

A: Yes – the OTTI is \$20,000 to earnings

Q: What if Acme had the ability and intent to hold?

A: Credit loss of \$10,000 (cost – DCF) to earnings

- Market loss of \$10,000 to OCI
- If HTM, amortize OCI based on effective yield

Q: What if FV = \$95,000?

A: Credit loss of \$10,000 (cost – DCF) to earnings

- Market (gain) of (\$5,000) to OCI

- *Q: Do you book a market gain to OCI for HTM?*



Fair Value (cont'd)

- FSP FAS 107-1 and APB 28-1 amends the disclosure requirements of FAS 107 and APB 28
 - Applies to public entities only
 - Quarterly disclosure of fair value measurements for financial instruments
 - Disclosure of valuation methods and significant assumptions
- Effective date – for all three April 9, 2009 FSPs
 - Prospective for periods ending after June 15, 2009
 - Early adoption allowed for periods ending after March 15, 2009



Fair Value (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



Fair Value (cont'd)

Other recent FASB guidance (cont'd):

- A proposed ASU requiring additional disclosures on sensitivities of measurements to key inputs and transfers of items between the fair value measurement levels

Expected future FASB guidance:

- Application guidance - will address recoveries of other-than-temporary impairments (reversals)



Transfer and Consolidation

- **Codification Section 860; SFAS 166, *Accounting for Transfers of Financial Assets*** amends SFAS 140
- **Codification Section 810; SFAS 167** amends FIN 46(R), *Accounting for Variable Interest Entities*
- 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



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



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
- Implementation challenges
 - 4 methods




Revenue Recognition: Consensus on Two EITF Issues Ratified

- 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 15 June 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 15 June 2010



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



Disclosure Requirements

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



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



“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



Subsequent Events

- SFAS 165 – requires that management disclose the date through which subsequent events have been evaluated for potential effects on the financial statements
- Applies to public entities
- Recognized vs. non-recognized subsequent events (Type 1, Type 2)
- Financial statements issued vs. available to be issued
- Problematic for incorporation by reference
 - Keeping current vs. extending fieldwork



Going Concern

- FASB project clarifies management's responsibilities
- Currently the FASB has not reached consensus on the terms “substantial doubt” and “going concern.”
- May end up being a disclosure standard
- Does not affect anything in AU 341



Government Programs

- TARP Capital Purchase Program (CPP)
 - \$180B taxpayer money into 280 public companies
- TALF non-recourse funding for MBS collateral
 - Repo eligible collateral into the FRBNY
 - Attest report must be provided as to the eligibility of collateral
- Other government programs?



Questions?



Update on Standard- Setting Activities

Greg Scates
Office of the Chief Auditor
November 3, 2009
Denver, CO

What We Will Cover

- Recent Board Actions
 - Auditing Standard No. 7 - *Engagement Quality Review*
 - Concept Release – *Requiring the Engagement Partner to Sign the Audit Report*
- Other Standard-Setting Activities
- Keeping Current with Standard-Related Activities



Auditing Standard No. 7

Engagement Quality Review

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 would be required to perform an EQR

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)

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 an 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.

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)

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)

Question: How does the requirement in AS 7.8 work with the SEC partner rotation requirements?

AS No. 7 – *Engagement Quality Review*

Specifically 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-.18)

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?

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?

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)

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)

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?

AS No. 7 – *Engagement Quality Review*

- ❑ Adopted standard is not final until approved by the U. S. Securities and Exchange Commission
- ❑ Release, auditing standard and appendices available at <http://www.pcaobus.org/Standards/Proposed Standards and Related Rules.aspx>



Concept Release

Requiring the Engagement Partner to Sign the Audit Report

Requiring the Engagement Partner to Sign the Audit Report

- ❑ Board issued a concept release on July 28, 2009
- ❑ 45 day comment period ended on September 11, 2009
- ❑ Analyzing comment letters
- ❑ Concept release and comment letters available at <http://www.pcaobus.org/Standards/ProposedStandardsandRelatedRules.aspx>



Other Standard-Setting Activities

Other Standard-Setting Activities*

- Complete Proposed Standards
 - Risk assessment
- Staff Guidance
 - Staff Questions and Answers – *References to Authoritative Accounting Guidance in PCAOB Standards*
 - Staff Practice Alert no. 4 - *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments*
- Active Projects
 - Confirmations
 - Fair value and specialists
 - Related parties

* Activities subject to change based on emerging issues

Other Standard-Setting Activities*

- Active Projects (cont'd)
 - Communication with audit committees
 - 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



Keeping Current with Standard-Related Activities

Keeping Current with Standard-Related Activities

- Our Web site - www.pcaobus.org/Standards/index.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:

www.pcaobus.org/News_and_Events/Updates/subscribe.aspx

Questions?



Break

(15 minutes)

Auditing Standard No. 5

Overview of Requirements and Implementation Guidance

Greg Wilson and Bill Powers
Division of Registration and Inspections
November 3, 2009
Denver, CO

Discussion Topics

- ❑ Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”
- ❑ Overview of Requirements of AS No. 5 and Implementation Guidance
 - What the standard says
 - Guidance for auditors of smaller public companies
 - Our experiences to-date

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 2005, PCAOB announces intent to revise AS No. 2
- ❑ June 12, 2007, AS No. 5 issued to supersede AS No. 2
- ❑ On October 2, 2009, SEC (again) defers, ***for the last time***, 404(b) requirement for non accelerated filers – now required for years ending after June 15, 2010

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

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

What the Standard Says

- Planning the Audit
 - Opinions on the financial statements and internal control over financial reporting
 - Risk assessment underlies entire audit process
 - Scaling the audit
 - Assessing the risk of fraud
 - Using the work of others

What the Standard Says

- 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

What the Standard Says

□ Testing Controls

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

What the Standard Says

- 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

What the Standard Says

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

What the Standard Says

- Reporting on Internal Control
 - Separate or combined reports permissible
 - Report date
 - Material weaknesses
 - Subsequent events

Guidance for Auditors of Smaller 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
- ❑ Does not change the fundamental principles in the preliminary staff views issued in October 2007

Staff Guidance

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

Staff Guidance

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

Staff Guidance

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

Staff Guidance

Auditing Information Technology

- ❑ Off-the-shelf software commonly used
- ❑ Few users and few dedicated IT personnel
- ❑ End-user computing prevalent
- ❑ IT-generated reports used in manual controls

Staff Guidance

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

Staff Guidance

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

Staff Guidance

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, and even if auditor cannot express an opinion on ICFR, he or she might be able to opine on financial statements

Experiences to-date

- Planning the Audit
 - Initial issue of separate audits minimized
 - Improved focus on procedures that address highest areas of risk
 - Based on limited view, small firms have grasped concepts of scaling the audit
 - Fraud brainstorming meetings more useful held earlier in the audit process

Experiences to-date

□ Planning the Audit (cont'd)

- Controls over risk of fraud, particularly GL, remains an area for improved engagement teams focus
- Using work of others based on risk has improved over time
- Evaluating objectivity of “others” remains an issue in many cases

Experiences to-date

□ Top Down Approach

- Early tendencies were to perform audits of ICFR from the bottom up
- Initial tendency to test all controls; evolved to current focus on testing important controls
- Early difficulty with ELCs - tended to be the “all-pro safety”
- Current recognition of importance of ELCs

Experiences to-date

- Top Down Approach (cont'd)
 - Initially, quantitative factors were primary driver of significant accounts
 - Qualitative factors currently being considered
 - Consider whether components of accounts have differing risks
 - ICFR auditing in a multi-location environment

Experiences to-date

□ Testing Controls

- Start with entity level controls
- Auditor should test controls important to their conclusion regardless of whether or not issuer tests those controls
 - Testing more or less controls than issuer
- Consider appropriate populations when designing tests of controls

Experiences to-date

- Testing Controls (cont'd)
 - Risk should be factored into tests of operating effectiveness of controls
 - Amount of evidence required
 - Use of the work of others
 - Multi-locations
 - Nature, timing and extent of tests

Experiences to-date

- Evaluating Identified Control Deficiencies
 - Control deficiency analysis in combination could be improved
 - No compensation for control deficiencies in control reliance audit strategies
 - Evaluators of deficiencies have not considered reasonable possibility of a misstatement going forward.

Experiences to-date

- Wrapping Up
 - Material weaknesses frequently tied to misstatements that have occurred
 - Obtaining management representations is not typically an issue
 - Occasionally not all required communication of deficiencies are made

Experiences to-date

- Reporting on Internal Control
 - Most auditors issue combined reports on financial statements and ICFR
 - In most cases, management's assessment of and auditor's opinion on ICFR are the same

AS No. 5 and Staff Guidance

AS No. 5 "Guidance"	Planning The Audit	Top Down Approach	Testing Controls	Evaluating Identified Deficiencies	Wrapping Up	Reporting on Internal Control
1. Scaling the Audit						
2. Evaluating ELC's						
3. Risk of Management Override						
4. Evaluating Segregation of Duties						
5. Auditing IT Controls						
6. Financial Reporting Competencies						
7. Less Formal Documentation						
8. Pervasive Control Deficiencies						

Questions?



Lunch

(60 minutes)

Case Studies on Auditing in the Small Business Environment

Presenters

- ❑ Desmond Mills, Associate Director, Accountant, Division of Enforcement and Investigations
- ❑ Mark West, Deputy Director of Inspections and Small Firm National Coordinator, Division of Registration and Inspections

Agenda

- ❑ Summary of Domestic Small Firm Program
- ❑ Case Studies on Auditing in the Small Business Environment

Summary of Domestic Small Firm Program

- Inspected 870 domestic small firms between 2004 and 2008
 - Inspected over 2,400 issuer audits between 2004 and 2008
- To date, 780 domestic small firm inspection reports have been issued final
- Issued “Report on the PCAOB’s 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms” (October 22, 2007)

Common Inspection Observations

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

Case Studies on Auditing in the Small Business Environment

- Refer to handouts
 - #1 - Health Tech, Inc.
 - #2 - Cheetah Computers, Inc.
 - #3 - Walrus Welders, Inc.
 - #4 - Elite Fit Corp.
 - #5 - Bailout Bank Corp.

Restrictions on Use

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

Case Study #1 – Health Tech, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2008 financial statements of Health Tech, Inc.
- ❑ Health Tech is a development stage company in the biopharmaceutical industry
 - Your Firm has not previously audited an issuer in this industry
- ❑ Intangible assets (patents) represented 70 percent of the issuer's total assets
 - The remaining useful life of the patents averaged four years
- ❑ The issuer engaged a specialist to evaluate whether the value of the patents was impaired
 - The specialist concluded no impairment existed at year end

Case Study #1 – Health Tech, Inc.

Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test the valuation of intangible assets-*
- The audit procedures performed by the engagement team included -
 - Obtained and reviewed a copy of the specialist's report
 - Relied upon the expertise of the specialist as evidence that the methods and assumptions used were reasonable
 - Obtained management's representation that the value assigned to the patents was appropriate and no impairment was necessary

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 – Cheetah Computers, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2008 financial statements of Cheetah Computers, Inc.
- ❑ The issuer sells customized computer hardware, software, and related support services
- ❑ Generally, products and services are sold in bundled arrangements and do not regularly sell on a stand-alone basis
- ❑ For multiple-element arrangements, the issuer allocated revenue to each element based upon the current list price if the element were to be sold separately
- ❑ Frequently, the issuer provided discounts to its customers based on geographic location

Case Study #2 – Cheetah Computers, Inc.

Scenario

- ❑ *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test revenue recognition-*
- ❑ The audit procedures performed by the engagement team included –
 - Performed non-substantive analytical procedures
 - Confirmed accounts receivable for the three largest customers
 - Selected a sample of 15 revenue transactions
 - Agreed contract elements of two new significant contracts to issuer's list price
 - Recalculated deferred revenue for a sample of five customers
 - Obtained management's representation that revenue was recognized in accordance with GAAP

Revenue Recognition Guidance (Multiple Elements)

- EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*
 - If an arrangement includes multiple elements, the total arrangement consideration may be allocated to the different elements and accounted for separately provided, among other things, that there is objective and reliable evidence of fair value for the undelivered elements
 - Best evidence of fair value is the price of a deliverable when it is regularly sold on a stand-alone basis
- Other applicable guidance
 - SOP 97-2, *Software Revenue Recognition*
 - SOP 98-9, *Modification of SOP 97-2, with Respect to Certain Transactions*

Case Study #3 – Walrus Welders, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2008 financial statements of Walrus Welders, Inc.
- ❑ The issuer specializes in plastic extrusion
- ❑ Revenue is recognized FOB shipping point
 - Title and risk of ownership transfers to the buyer at the time of shipment
- ❑ During the fourth quarter, the issuer sold its products for the first time in South America

Case Study #3 – Walrus Welders, Inc.

Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test revenue-*
- The audit procedures performed by the engagement team included –
 - Performed non-substantive analytical procedures
 - Confirmed a sample of accounts receivable (18 in total)
 - Selected a sample of five sales transactions before and after year end and reviewed supporting documentation
 - Obtained management’s representation that revenue was recognized in accordance with GAAP

Revenue Recognition (SAB 104)

- Revenue should not be recognized until it is realized or realizable and earned
 - Persuasive evidence of arrangement
 - Delivery has occurred or services have been rendered
 - Sellers price to the buyer is fixed or determinable
 - Collectibility is reasonably assured
- Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues
- Fixed price is a fee required to be paid at a set amount that is not subject to refund or adjustment

Case Study #4 – Elite Fit, Inc.

Background

- ❑ Your Firm has been engaged to audit the consolidated financial statements of Elite Fit, Inc. for the year ended December 31, 2008
- ❑ Elite Fit has one operating subsidiary located in China
 - The foreign subsidiary specializes in manufacturing and distribution of customized hardware to be installed into exercise equipment
- ❑ Substantially all of the assets, liabilities, and expenses reflected in the consolidated financial statements are associated with the foreign subsidiary
- ❑ The foreign subsidiary will be audited by a foreign firm located in China

Case Study #4 – Elite Fit, 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 China due to cost and time constraints
 - Instead, your Firm obtained copies of the foreign firm's work papers, all of which were in Chinese
- ❑ The engagement team obtained a copy of the audited financial statements of the foreign subsidiary, including the foreign firm's auditor's report
 - 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 #4 – Elite Fit, Inc.

Scenario 2 - Change in Background

- ❑ In this scenario, the foreign subsidiary is responsible for only one product line, which generated approximately 27 percent of the issuer's consolidated revenues
- ❑ In addition, your Firm discovered during its planning procedures that the engagement partner of the foreign firm had previously worked in the finance department of the foreign subsidiary

Case Study #4 – Elite Fit, Inc.

Scenario 2

- *In addition to the procedures described in Scenario 1, your Firm –*
 - Provided the foreign firm with programs containing the nature, timing, and extent of audit procedures to be performed, including materiality considerations
 - Obtained an engagement completion document (in English), which summarized significant issues and conclusions reached as well as a schedule of audit adjustments
 - Performed inquiries regarding potential independence conflicts

Case Study #4 – Elite Fit, Inc.

Scenario 3

- ❑ Let's go back to our original fact pattern where substantially all of the assets, current liabilities, and revenues were associated with the foreign subsidiary
- ❑ But, in this scenario, your Firm entered into an arrangement with the foreign firm to use the personnel of the foreign firm to assist with the planning and execution of audit procedures during fieldwork
- ❑ Assume your Firm performed all of the procedures described in both Scenario 1 and Scenario 2

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

Planning and Supervision (AU 311)

- ❑ The first standard of fieldwork requires that “the work is to be adequately planned and assistants, if any, are to be properly supervised”
- ❑ Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit
- ❑ Elements of supervision include
 - Instructing assistants
 - Keeping informed of significant problems encountered
 - Reviewing work performed

Case Study #5 – Bailout Bank, Inc.

Background

- ❑ Your Firm has been engaged to audit the December 31, 2008 financial statements of Bailout Bank, Inc.
- ❑ The Bank engaged a service organization to process financial transactions related to -
 - Residential mortgage loans
 - Customer deposits
 - Customer withdrawals
- ❑ In planning the audit, your Firm assessed control risk at below the maximum and planned to evaluate the operating effectiveness of the controls related to each of these processes.

Case Study #5 – Bailout Bank, Inc.

Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test each of these classes of transactions -*
- The audit procedures performed by the engagement team included –
 - Obtained and reviewed the service auditor’s report on the operating effectiveness of controls for the service organization
 - Sent negative confirmation requests to 50 customers to confirm account deposits
 - Sent positive confirmation requests to confirm the five largest residential mortgage loans entered into during the year

Service Organizations (AU 324)

- ❑ Obtain sufficient evidence regarding the effectiveness of controls to support assessed level of control risk
 - Assess a service organization's controls and how they interact with a user organization's controls
- ❑ Consideration of using a service auditor's report
 - The user auditor remains responsible for evaluating the evidence presented by the service auditor and for determining its effect on the assessment of control risk
 - Determine whether the specific tests of controls are relevant to assertions that are significant in the issuer's financial statements
 - Consider period of time covered by the service auditor's report
- ❑ Perform substantive tests over user organization controls that are relevant to support assessed level of control risk

Case Study #6 – Turtle Textiles, Inc.

Background

- ❑ Your Firm has been engaged to audit the January 31, 2009 financial statements of Turtle Textiles, Inc.
- ❑ The issuer designs, manufactures, and markets luxury silk-blend fabrics
- ❑ The current economy has impacted the issuer's ability to generate sales
 - Overall, sales declined by approximately 30 percent compared to prior year revenues
 - The issuer reported negative working capital in the current year
- ❑ Inventory on hand that exceeds two years requirements based on forecasted demand is considered excess and is reserved for 100 percent

Case Study #6 – Turtle Textiles, Inc.

Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test valuation of inventory -*
- The audit procedures performed by the engagement team included –
 - Performed a physical inventory observation
 - Gained an understanding of how management developed the inventory reserve
 - Performed price testing on raw materials
 - Performed non-substantive analytical procedures
 - Obtained management's representation that inventory was carried at lower of cost or market

Auditing Accounting Estimates (AU 342)

- Evaluate the reasonableness of the accounting estimate
 - Review and test the process used by management
 - Evaluate whether the assumptions are consistent with supporting data
 - Consider changes in the business or industry
 - Develop an independent expectation to corroborate the reasonableness of management's estimate
 - Review subsequent events or transactions

Case Study #7 – Active Life, Inc.

Background

- ❑ Your Firm has been engaged to audit the financial statements of Active Life, Inc.
- ❑ The issuer is a development stage company beginning its operations in the sporting goods retail industry
- ❑ The company does not have an experienced accounting department or person with extensive knowledge of SEC reporting requirements

Case Study #7 – Active Life, Inc.

Scenario 1

- ❑ The issuer provided your Firm with an adjusted general ledger
- ❑ Your Firm grouped the accounts and prepared the financial statements by using schedules provided by the issuer
- ❑ The footnote disclosures were prepared by the issuer

Case Study #7 – Active Life, Inc.

Scenario 2

- ❑ The issuer provided your Firm with a draft Form 10-KSB, including the required financial statements and related footnotes
- ❑ The stock-based compensation footnote was prepared by the issuer and included amounts carried forward from the prior year's Form 10-KSB
- ❑ The issuer asked your Firm if it could assist management to update the amounts for the current year footnote disclosure

Independence (Rule 210.2-01(c)(4)(1))

- *Bookkeeping or other services related to the accounting records or financial statements of the audit client*
 - Maintaining or preparing the audit client's accounting records
 - Preparing the audit client's financial statements that are filed with the SEC or that form the basis of financial statements filed with the SEC
 - Preparing or originating source data underlying the audit client's financial statements

Reference Materials Relating to Independence

□ PCAOB

- Ethics and Independence Rules
- Interim Independence Standards
- Interim Quality Control Standards
 - SECPS Requirement 1000.08(o) and Appendix L – Independence Quality Controls
- www.pcaobus.org/standards/index.aspx

□ SEC

- Independence Rules – Regulation S-X, Rule 210.2-01
www.sec.gov/info/accountants/independref.shtml
- Frequently Asked Questions (updated 8/07)
www.sec.gov/info/accountants/independref.shtml
- Interpretations Relating to Independence – SEC Codification of Financial Reporting – Section 602.02. Not available on SEC web site.

Questions?





Break

(15 minutes)

Annual and Special Reporting

Nancy Doty
Office of General Counsel
November 3, 2009
Denver, Colorado

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

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

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

Form 3 to "bring current" certain events that have occurred since filing of Form 1

- ❑ Due by February 1, 2010
- ❑ Contents, to the extent the event remains relevant to the firm:
 - Name change
 - Certain legal proceedings
 - Bankruptcy
 - Certain relationships
 - Licenses and certifications
 - Changes in the firm's Board contact person

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),
 - Within 14 days after the event,
 - With certain representations
- Continuity of registration is automatic, without the need for Board action.
- If deadline for filing Form 4 is not met, the registration process using Form 1 will be required along with Board action.
- If had a transaction since original Form 1 was filed, file Form 4 by January 14, 2010, or a new Form 1 may be required.

Questions?





SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

*Joel Parker, Accounting Branch Chief
Division of Corporation Finance*

Agenda

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

Disclaimer

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Overview

Division of Corporation Finance

(DCF)

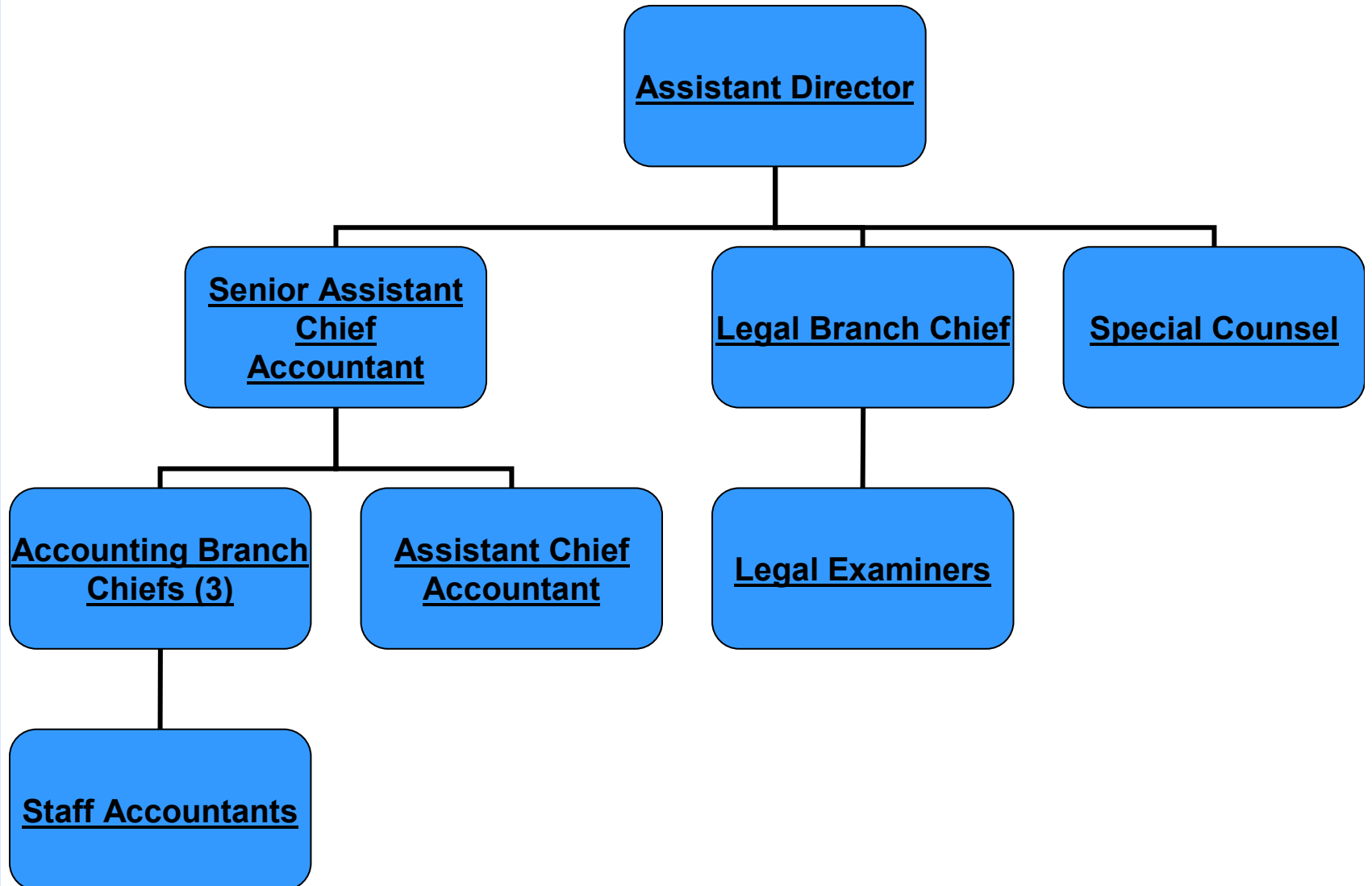
Mission – “To see that investors are provided with material information in order to make informed investment decisions — both when a company initially offers its stock to the public and on a regular basis as it continues to give information to the marketplace.”

- ❖ 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
- ❖ Legal and Regulatory Policy Offices

Division of Corporation Finance (DCF) Industry Groups



Corporation Finance Office of the Chief Accountant

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 (dcaoletters@sec.gov)

- ❖ Interpretations of reporting requirements
- ❖ Waivers/accommodations of reporting requirements
- ❖ Interpretations on the application of GAAP (in conjunction with OCA)

Rulemaking impacting financial reporting

SEC 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
- ❖ 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

DCF — Office of Small Business Policy

- ❖ **Answers questions on disclosure and other issues relating to smaller public companies, including those classified as "smaller reporting companies," and on limited, private, and intrastate offerings of securities.**
- ❖ **Acts as the Division's liaison to the state securities regulators on corporate finance issues and the Small Business Administration and serves as small business intermediary for the Commission.**
- ❖ **Develops rulemaking initiatives and assists in other rulemaking that may affect smaller and private companies.**



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

Public Availability of Comment Letters and Responses

- ❖ **Posted 45 days after completion of review**
- ❖ **Issuers will receive notification that review is complete**
- ❖ **Confidential treatment requests and Rule 83**
- ❖ **“Tandy” language in all letters**

Comment Letter Process

Best Practices for Resolving Issues

- ❖ **Prepare a thorough response**
 - **An invitation to 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**
- ❖ **All correspondence with the staff should be furnished on EDGAR**



Recent Developments

Key SEC Developments

Rulemaking

- ❖ *Interactive Data to Improve Financial Reporting (“XBRL”)*
 - Effective for fiscal periods ending on or after June 15, 2011 (quarterly reports) for all but large accelerated filers.
- ❖ *Modernization of Oil and Gas Reporting*
 - Effective for filings after January 1, 2010
- ❖ *Proposed Roadmap for the Potential Use of Financial Statements Prepared in Accordance With IFRS by U.S. Issuers*
- ❖ *Technical amendments to SEC Rules for SFAS 141R and SFAS 160*
- ❖ *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*
 - Defers attestation requirement to fiscal years ending on or after June 15, 2010

Key SEC Developments

Staff Initiatives

- ❖ **Division of Corporation Finance Financial Reporting Manual**
 - www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml
- ❖ **Corporation Finance Compliance and Disclosure Interpretations**
 - www.sec.gov/divisions/corpfin/cfguidance.shtml
- ❖ **Sample Letters Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)**
 - **September 2008 --**
www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm
 - **March 2008 --**
www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm
- ❖ **Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses**
 - **August 2009 -**
<http://www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm>

Key SEC Developments

- ❖ ***Corporation Finance Request Form for Interpretive Advice and Other Assistance***
 - https://tts.sec.gov/cgi-in/corp_fin_interpretive
- ❖ ***Staff Accounting Bulletins No. 111 and 112***
- ❖ ***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**
 - ❖ **Policy disclosures should now reference Codification if referring to anything**
- ❖ **References to SEC Guidance should not change**
- ❖ **New GAAP (i.e. amendments to Codification) will be via Codification Updates (SAB 74)**



*Financial Reporting Issues
Frequently Raised in Comment
Letters*

Financial Reporting Issues Frequently Raised in Comment Letters

Impact of the Financial Crisis on Financial Statements

Management's Discussion & Analysis

Reverse Mergers & "Back Door" Registrations

Business Combinations

Pro Forma Information

Equity Transactions

Related Party Transactions

Embedded Conversion Options and Freestanding Warrants

Smaller Reporting Company Status

Disclosure Controls and Procedures

Internal Control over Financial Reporting

Other (see Appendix)

Impact of the Financial Crisis on the Financial Statements

Goodwill and Indefinite-Lived Intangible Assets

- Identification of reporting units
- Annual testing date vs. interim impairment tests
- 2-step testing method and how FV is estimated
- Changes in methodologies or assumptions from last test

PP&E and Intangible Assets

- Triggering Events
- Methodology and key assumptions

Investments

- SFAS 157 (ASC 820-10) disclosures re: how you determine fair value
- OTTI considerations

Impact of the Financial Crisis on the Financial Statements

Accounts receivable

- Consider current events in estimating allowances for uncollectible accounts (“historical experience” may not be sufficient)

Inventory

- Lower of cost or market valuations - Impact of price reductions or reduced sales
- Obsolescence considerations

Deferred tax asset (valuation allowances)

Disclosure of Risks and Uncertainties (SOP 94-6) (ASC Topic 275)

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)**
 - **Discuss significant estimates and assumptions used by management when evaluating assets for recoverability**
- ❖ **Comparative results of operations that are thorough and address the key drivers of change**
- ❖ **Early warning disclosures – Item 303(a)(3)(ii) of Regulation S-K**

Management's Discussion & Analysis (MD&A)

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**
- ❖ **Discuss liquidity known trends - Item 303(a)(1) of Regulation S-K**
- ❖ **Discuss the prospective sources of and need for capital**
- ❖ **Consider enhanced disclosure regarding debt instruments, guarantees and related covenants**
- ❖ **Address the nature and extent of all restrictions**
 - **Explain how the restrictions limit the ability to transfer funds to its parent and the impact the restrictions have had and are expected to have on the parent's ability to meet its cash obligations**

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**
 - **Financial Statements due within 4 business days (no 71-day extension)**
- ❖ **Financial statement updates on Form 8-K**
 - **Interpretation of Exchange Act Rule 13a-1**
- ❖ **Shell Company Exchange Act Reporting Requirements**
- ❖ **Internal Control over Financial Reporting**
 - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

Reverse Mergers & “Back Door” Registrations

Illustration of Interpretation of Rule 13a-1

- ❖ Reverse Merger occurs in January 2009
- ❖ Both the public shell company (accounting acquiree) and nonpublic operating company (accounting acquirer) have calendar year-ends
- ❖ 12/31/08 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 12/31/07 audited financial statements and 9/30/08 unaudited interim financial statements
- ❖ 3/31/09 Form 10-Q would include financial statements of the operating company
- ❖ *Issue* – The 12/31/08 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 12/31/08 Form 10-K
- ❖ **NOTE:** Both 2008 and 2009 Forms 10-K would need to include management’s report on ICFR

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**

Business Combinations

Separate Financial Statements of an Acquired Business

- ❖ Rule 3-05 versus Rule 8-04 of Regulation S-X
- ❖ Determining Significance
- ❖ Periods Presented

Predecessor Financial Statements

- ❖ Registrant succeeds to substantially all of the business of another entity
- ❖ Registrant's own operations are relatively insignificant
- ❖ Financial statement requirements
- ❖ Common in SPAC mergers

Business Combinations

Purchase Price Allocation

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

Determination of Accounting Acquirer

- ❖ Consideration of all factors (par. A12 of SFAS 141(R) (ASC 805-10-55-12))

Disclosures

Pro Forma Information

Consideration of Article 11 of Reg. S-X Adjustments

- ❖ **Directly Attributable**
- ❖ **Have a continuing impact (pro forma income statement)**
- ❖ **Factually supportable**

Examples

MD&A

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 SFAS No. 157 & FSP SFAS 157-3 and 157-4 – management's judgment (ASC 820-10-35)

Disclosure

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

Related Party Transactions

Examples of Common Related Party Transactions:

- ❖ **Forgiveness of Debt**
- ❖ **Organization and Offering Costs – SAB 5D**
- ❖ **Contributed Services**

Measurement

Disclosure

Embedded Conversion Options and Freestanding Warrants

Analysis

- ❖ *Is the instrument within scope of SFAS 150 (ASC 480-10-15)?*
- ❖ *Analyze under SFAS 133 (ASC 815) – two routes*

1. Freestanding

- **Analyze whether a derivative under SFAS 133**
 - **Perform 00-19 (ASC 815-40) and EITF 07-5 (ASC 815-40-15) analysis to see if par. 11a scope exception in SFAS 133 is available**
 - **If scope exception met, account for as equity**
 - **If no scope exception met, account for as a derivative liability (SFAS 133/ASC 815)**

Embedded Conversion Options and Freestanding Warrants (cont.)

2. Embedded

- **Analyze whether a derivative requiring bifurcation under SFAS 133 (this often requires performing an EITF 00-19/EITF 07-5 Analysis to see if par. 11a scope exception in 133 is met for conversion options)**
 - **If scope exception is met, no bifurcation required, but consider BCF under EITF 98-5 and 00-27 (ASC 470-20)**
 - **If no scope exception is met, account for as a derivative liability (all embeddeds should be combined and**

Embedded Conversion Options and Freestanding Warrants (cont'd)

Scope of EITF 00-19 (ASC 815-40)

- Applies to all contracts that are indexed to, and potentially settled in a company's own stock (e.g., warrants, many conversion options)
- Paragraphs 12 through 32 do not apply to conventional convertible debt instruments

Common Pitfalls of EITF 00-19 (ASC 815-40)

- Cash settlement provisions
- Required to settle in registered shares
 - Registration Payment Arrangements are accounted for separately under FSP EITF 00-19-2 (ASC 825-20)
- Insufficient authorized shares
- No limit on # of shares to be delivered
- Incorrect conclusion on whether instrument is indexed to a company's own stock (EITF 07-5 / ASC 815-40-15)

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

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
 - Terms and features not properly defined, identified and disclosed

Smaller Reporting Company Status

Transition to Smaller Reporting Company status

- Public float < \$50 million on last business day of Q2
- If public float = \$0, < \$40 million audited annual revenues
 - May reflect change immediately in that 10-Q or wait until Q1 of next fiscal year
- Still considered an accelerated filer for remainder of year
 - Impacts filing deadlines and SOX 404(b)

Transition to larger reporting company status

- Public float \geq \$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

Form 10-KSB and other SB forms are no longer available (incl. amendments)

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 307 of Regulation S-K (note definition is not required)

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**
- ❖ **Clear conclusion (either “effective” or “ineffective”)**

Internal Controls over Financial Reporting (ICFR)

Disclosures companies should consider when material weakness exists

- ❖ **Nature of the material weakness**
- ❖ **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**



Resources

Resources

SEC Website – www.sec.gov

- ❖ **Division of Corporation Finance - www.sec.gov/divisions/corpfin.shtm**
- ❖ **Information for Small Businesses - www.sec.gov/info/smallbus.shtml**
- ❖ **Information for Accountants - www.sec.gov/divisions/corpfin/cfreportingguidance.shtml**
 - ***Corporation Finance Filing Review Process -- www.sec.gov/divisions/corpfin/cffilingreview.htm***
 - ***Division of Corporation Finance Financial Reporting Manual-- www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml***
 - ***Corporation Finance Compliance and Disclosure Interpretations-- www.sec.gov/divisions/corpfin/cfguidance.shtml***
 - **Presentation from last year's forums -- www.sec.gov/news/speech/2008/spch111708wc-slides.pdf**



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 Chief Accountant (202) 551-5300

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



Appendix

Financial Statement Classification

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/ASC 480-10-S99 and SFAS No. 150/ASC 480-10)**
 - **Operating, investing, and financing cash flows (SFAS No. 95/ASC 230-10)**
 - **Discontinued operations (SFAS No. 144/ASC 360-10)**
 - **Stock-based compensation expense (SAB Topic 14F)**

Financial Statement Classification

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**

Revenue Recognition

Common Areas of Comment

- ❖ **Policy disclosures (i.e., SAB 104)**
 - **Avoid “Boilerplate” disclosures**
 - **Disclosure should be specific to company’s revenue streams**
- ❖ **EITF 00-21 (ASC 605-25) – Multiple-Element Arrangements**
 - **May also relate to separate agreements negotiated together or in close proximity**
- ❖ **EITF 99-19 (ASC 605-45) – Gross versus Net Revenue Recognition**
 - **Consider and weight all indicators**

Form 8-K

*Form 8-K interpretations updated on June 26, 2008
at
<http://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm>*

*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**

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**

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

Questions?



Closing Remarks and Wrap-Up

Daniel L. Goelzer
PCAOB Acting Chairman
November 3, 2009
Denver, CO