

Forum on Auditing in The Small Business Environment

June 4, 2009

Philadelphia, PA

Opening Remarks

Daniel Goelzer
PCAOB Board Member
June 4, 2009
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.

Current Issues and Trends Impacting Audits

Brian Wolohan
Associate Director, Research
Office of Research and Analysis
June 4, 2009
Philadelphia, PA

Today's Agenda

1. Current Economic Environment
2. Accounting and Auditing Hot Topics
3. Selected Trends and Statistics Pertaining to Smaller Auditing Firms

Current Economic Environment

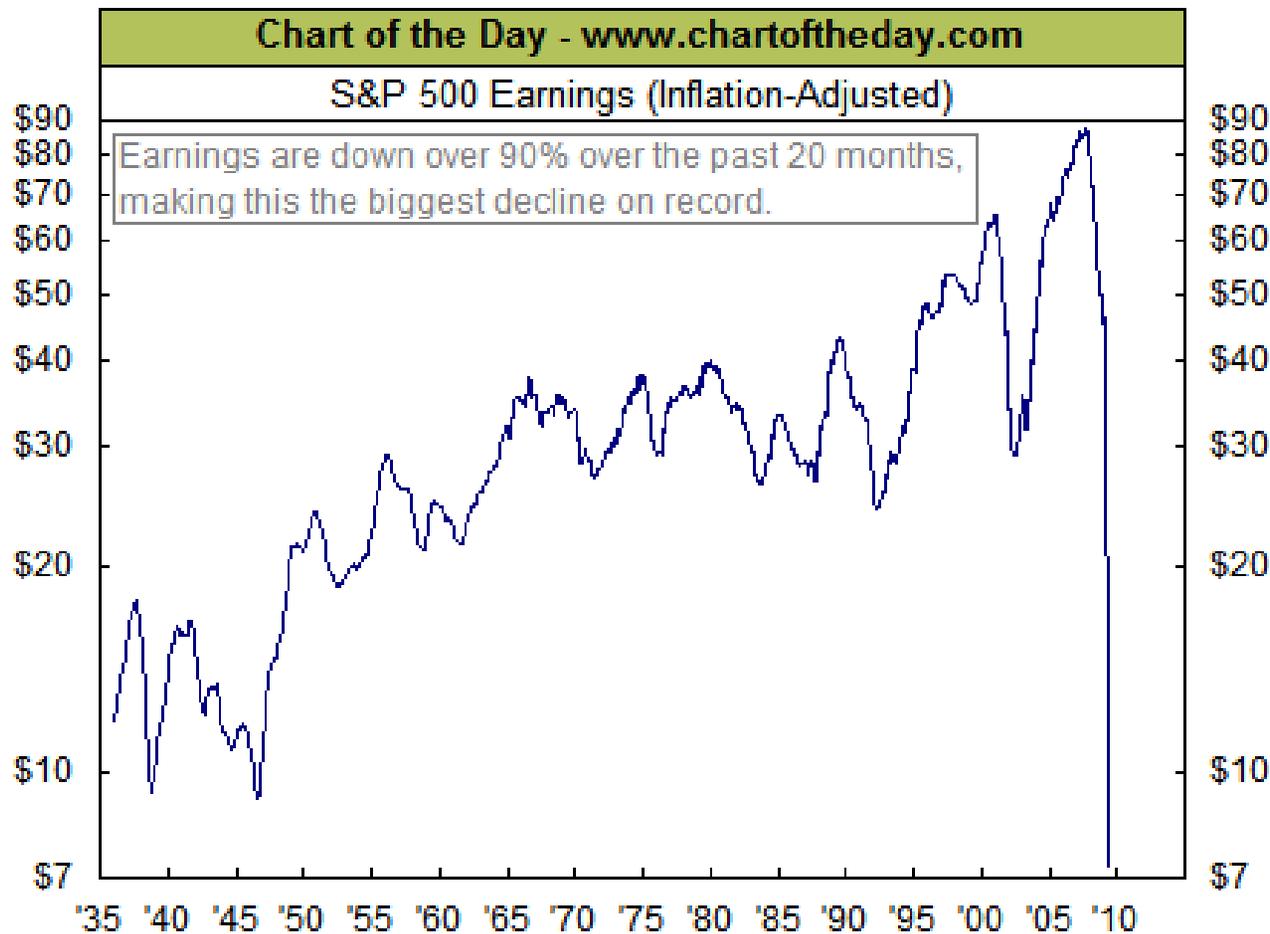
- ❑ Financial turmoil
- ❑ Falling earnings
- ❑ Housing / foreclosures
- ❑ Unemployment
- ❑ Consumer spending
- ❑ Restricted access to credit
- ❑ Volatility

Financial Turmoil: World Stock Markets

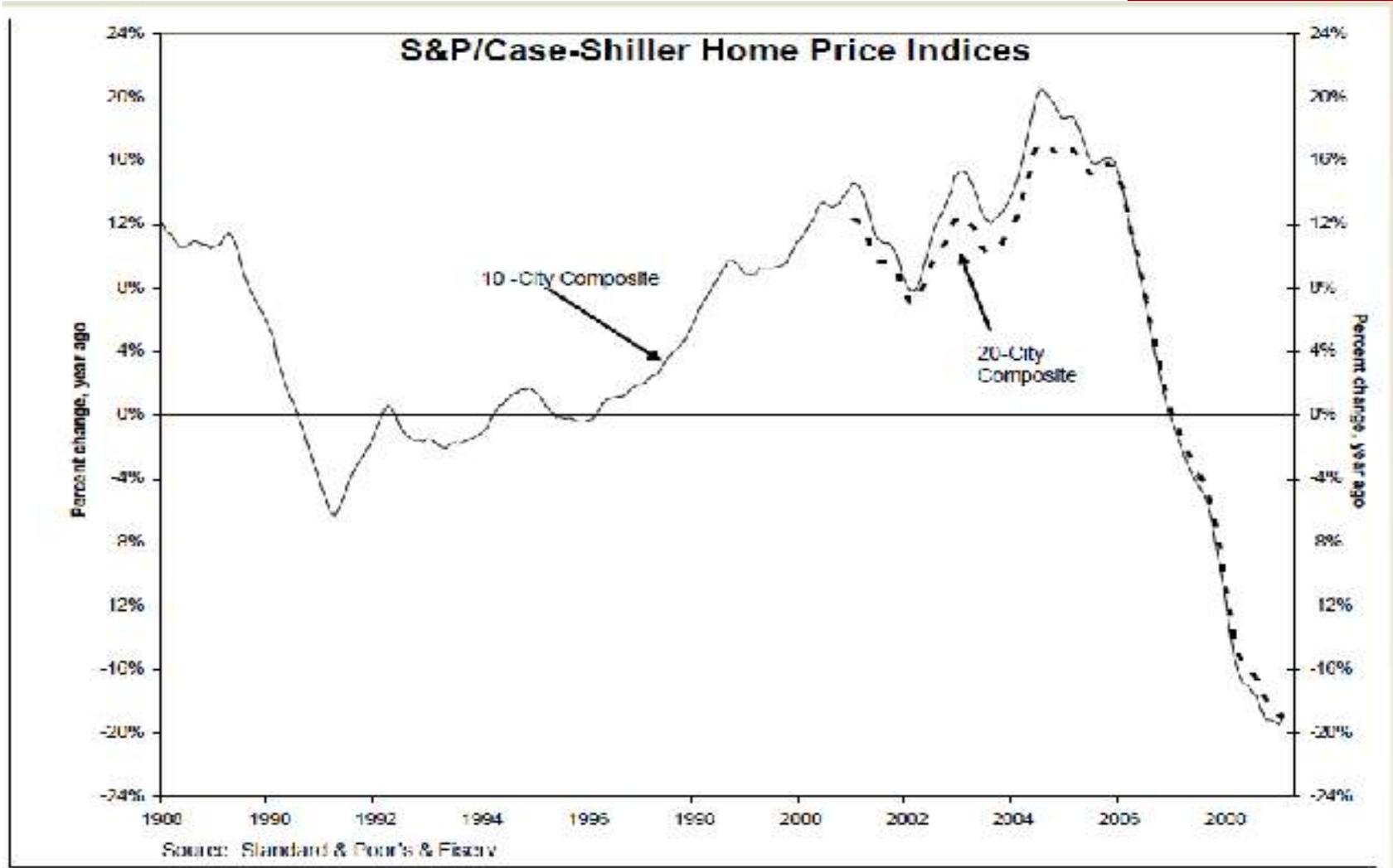
MSCI AC World Index - April 30, 1996 through May 15, 2009



Falling Earnings



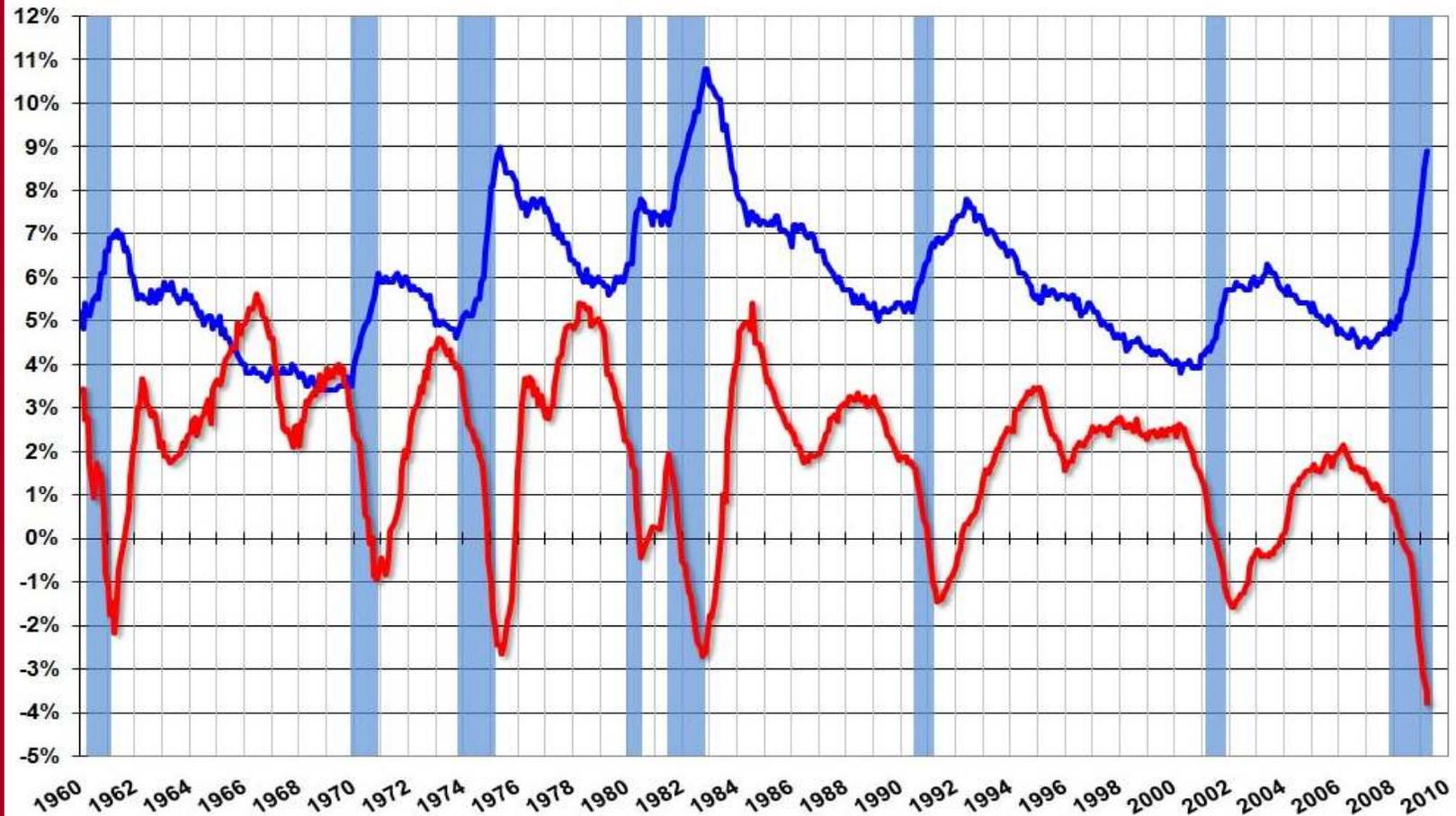
Housing / Foreclosures



Unemployment

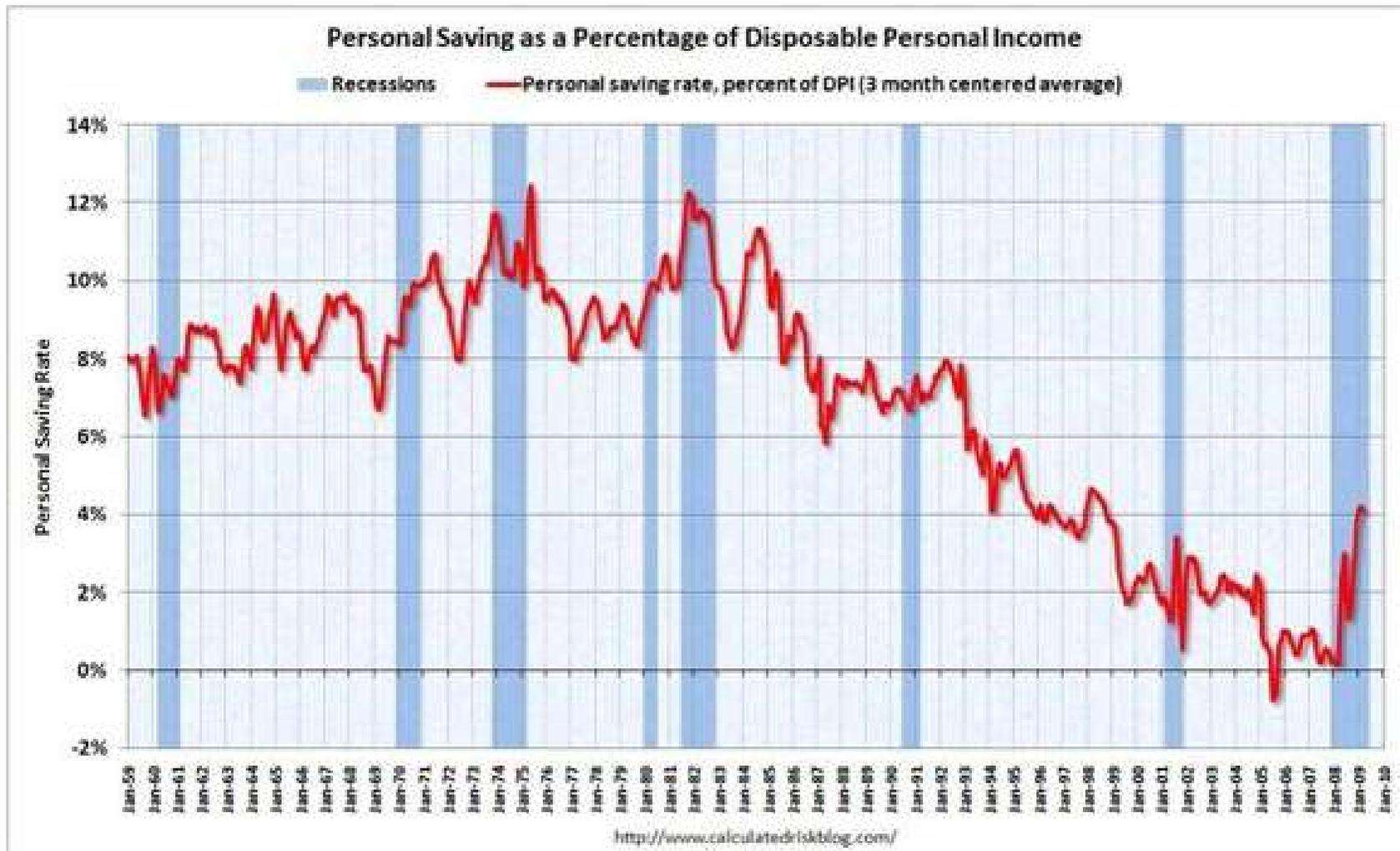
Employment Measures and Recessions

Recession Unemployment Rate YoY Change Employment



<http://www.calculatedriskblog.com/>

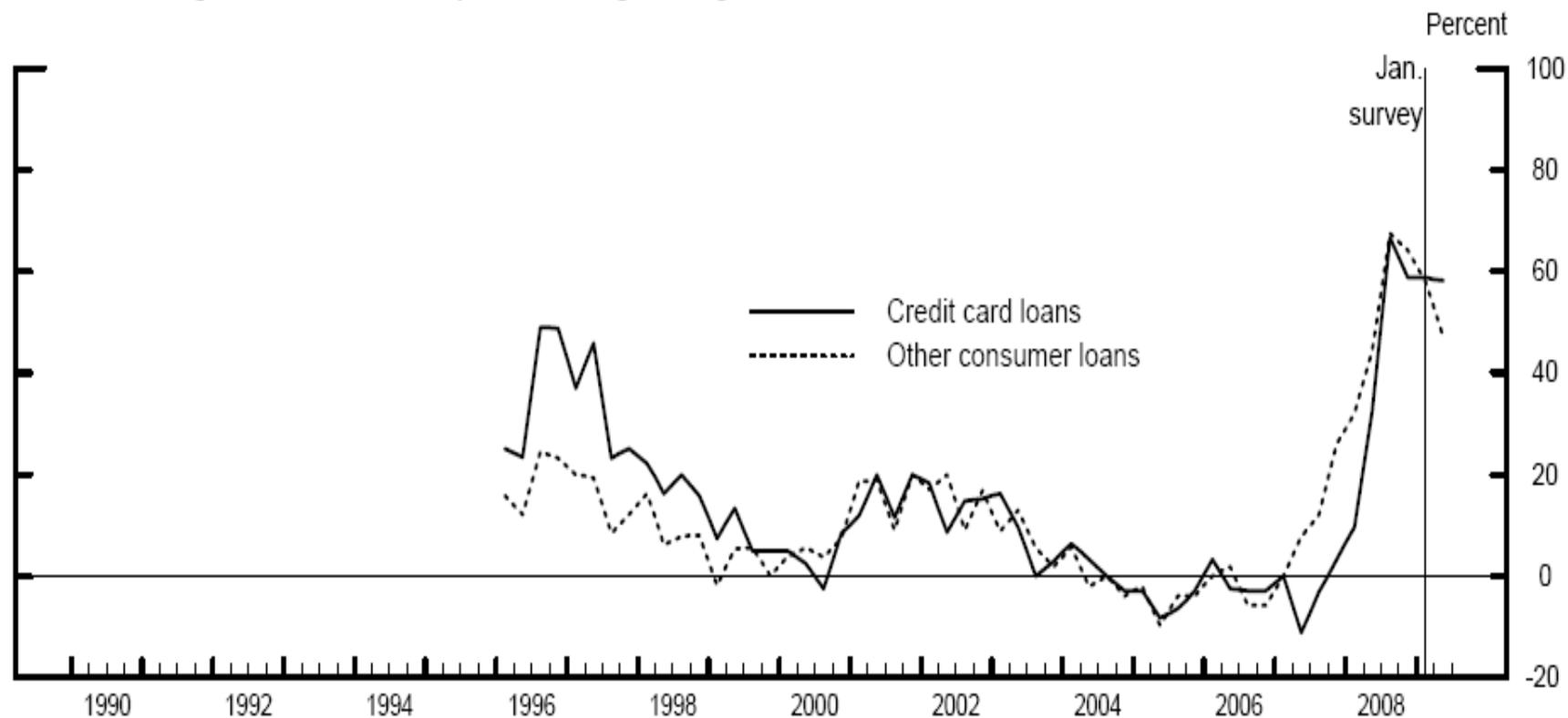
Consumer Spending



Restricted Access to Credit

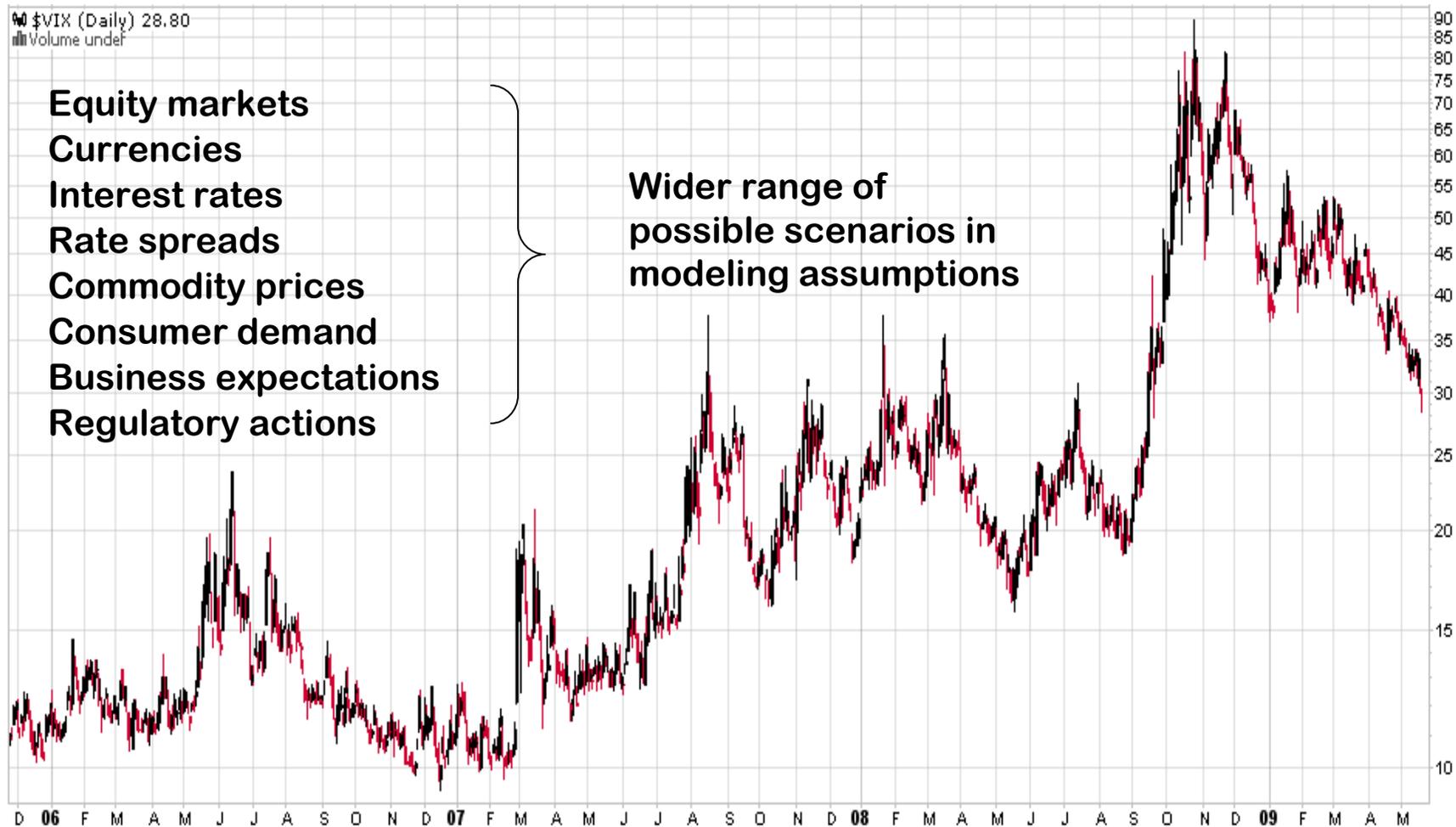
April 2009 senior loan officer opinion survey on bank lending practices

Net Percentage of Domestic Respondents Tightening Standards for Consumer Loans



Source: *Federal Reserve Board*

Volatility: U.S. Market



Accounting and Auditing Hot Topics

- ❑ Risk Assessment
- ❑ Fraud Risk
- ❑ Fair Value Measurements
- ❑ Pensions
- ❑ Securitization Accounting
- ❑ Business Combinations
- ❑ Loss Contingency Disclosures
- ❑ Going Concern
- ❑ FASB Codification
- ❑ TARP/ESP accounting issues

Risk Assessment

- Impact of financial crisis on the company
 - Cash flow and liquidity
 - Financing and debt covenants
 - Third-party exposure
- Effect of asset impairments
 - Investments
 - Inventories
 - Goodwill and intangibles
 - Deferred taxes
- SOP 94-6 disclosures
- Materiality

Fraud Risk

- Elevated fraud risk in the current environment:
 - Greater pressure and opportunity to commit fraud
 - New rationalizations for fraud
 - More frauds coming to light
- Financial statements hot spots
 - Improper revenue recognition – presumed fraud risk
 - Asset overstatement/liability understatement
 - Related party transactions
- Embezzlement

Fair Value Measurements

- Audit guidance
 - AU 328 Auditing Fair Value Measurements & Disclosures
 - AU 332 Auditing Derivative Instruments, Hedging Activities and Investments in Securities
 - AU 336 Using the Work of a Specialist
 - AU 342 Auditing Accounting Estimates
 - AU 324 Service Organizations
- PCAOB Practice Alert #2
 - Classification of fair value measurements
 - Use of specialists
 - Use of pricing services

Fair Value Measurements (cont'd)

Recent FASB guidance:

- ❑ An FSP amending the impairment guidance in EITF Issue No. 99-20 on beneficial interests
- ❑ A proposed FAS 133 Implementation Issue No. C22 clarifying the embedded credit derivative scope exception in paragraph 14B of FAS 133
- ❑ A proposed FSP clarifying the principles of FAS 157 on the measurement of liabilities

Fair Value Measurements (cont'd)

- An FSP on determining: 1) decreased volume and level of activity for an asset/liability and 2) when a transaction is not orderly
 - Objective - exit price in current market conditions
 - Factors for decreased activity
 - Circumstances for not orderly transactions
 - Changes in valuation techniques permissible
 - Continued need to understand broker quotes
 - New quarterly disclosure of changes in inputs and valuation techniques

Fair Value Measurements (cont'd)

- An FSP on recognition & presentation of other-than-temporary impairments
 - Applies only to debt securities
 - New trigger - intention or requirement to sell
 - If selling – full impairment through earnings
 - If not selling – impairment only if credit loss
 - OTTI credit loss – recognized in earnings
 - Rest of OTTI loss – charge to OCI
 - Disclose methodology and key inputs for credit loss

Fair Value Measurements (cont'd)

- An FSP amending 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 3 April 9, 2009 FSPs
 - Prospective for periods ending after June 15, 2009
 - Early adoption allowed for periods ending after March 15, 2009

Fair Value Measurements (cont'd)

- PCAOB Practice Alert #4:
 - Issued April 21, 2009
 - Reviews of interim financial information
 - Audits of financial statements, including integrated audits
 - Disclosures
 - Auditor reporting considerations

Fair Value Measurements (cont'd)

Expected future FASB guidance:

- ❑ Application guidance - will address recoveries of other-than-temporary impairments (reversals); applying fair value to interests in alternative investments
- ❑ Improving disclosures - will consider requiring additional disclosures on sensitivities of measurements to key inputs and transfers of items between the fair value measurement levels

Fair Value Measurements (cont'd)

FAS 157 - nonfinancial assets and liabilities:

- ❑ Effective for interim & annual periods after 11/15/08
- ❑ Examples of assets & liabilities covered:
 - Arising from a business combination under FAS 141(R)
 - Reporting units in a goodwill or indefinite-lived intangible assets in an impairment assessment under FAS 142
 - Nonfinancial long-lived assets in an impairment assessment under FAS 144
 - Asset retirement obligations under FAS 143
 - Nonfinancial liabilities for exit/disposal activities under FAS 146
- ❑ Implementation challenges

Pensions

- ❑ Impact of market developments
- ❑ FAS 158 requirements:
 - Balance sheet effect
 - Measurement date
- ❑ Discount rate
- ❑ Expected long-term rate of return
- ❑ Disclosures

Securitization Accounting

- ❑ Amended FAS 140 and FIN 46(R) standards
- ❑ FAS 140 – removes the concept of QSPEs (which were exempted from applying FIN 46(R)), enhances disclosures
- ❑ FIN 46(R) – amends guidance regarding determination of the primary beneficiary, reconsideration events, and enhances disclosures
- ❑ Effective in 2010

Business Combinations

- FAS 141(R) *Business Combinations* – some areas with significant changes:
 - Definition of a business - expanded
 - Acquisition costs - expensed
 - Income tax effects – DTA adjustments expensed
 - IPR&D – capitalized
 - Bargain purchases – result in gain
 - Effective for transactions after Dec. 15, 2008
- FSP FAS 141(R)-1
 - Contingent assets/liabilities - recognized at FV only if FV can be determined, otherwise use FAS 5

Loss Contingency Disclosures

- Proposed amendment to FAS 5 originally required expanded disclosures on:
 - estimate of “maximum exposure to loss”
 - “remote” contingent losses when certain conditions are met
 - prejudicial information exemption
- Alternative model being developed for field testing
- Roundtable held in early March

Going Concern

- ❑ Proposed FASB statement issued in Oct. 2008
- ❑ Comment period ended in Dec. 2008
- ❑ Objective – incorporates in GAAP:
 - Management’s responsibility for a going concern evaluation in preparing financial statements
 - Required disclosures when financial statements are not prepared on a going concern basis
- ❑ Time horizon – at least 12 months from the end of the reporting period
- ❑ AU 341 – reasonable period, not to exceed one year, from the date of the financial statements
- ❑ Going concern analysis in the current environment

FASB Codification

- ❑ Proposed FAS 162(R)
- ❑ Expected to be the single source of GAAP (other than SEC guidance) effective Jul. 1, 2009
- ❑ Establishes one level of authoritative GAAP – everything else is non-authoritative
- ❑ Reorganizes GAAP into topics and subtopics
- ❑ New FASB guidance will follow topical structure
- ❑ Effort to replace current GAAP references
- ❑ Can be accessed at: <http://asc.fasb.org/home>

TARP/ESP Accounting Issues

- ❑ Multitude of programs
- ❑ Classification of warrants
- ❑ Derivative accounting for any government guarantees
- ❑ FAS 157 aspects
- ❑ Effect of loan modifications (e.g. mortgages) on securitization accounting
- ❑ Income tax accounting

Small Firms and Non-accelerated Filers

- ❑ Trends in auditor changes
- ❑ Trends in restatements
- ❑ Non-accelerated Filers' ICFR Assessments

Auditor Changes

- Net change in issuer clients: Big 4 loss is small firms gain

Firm	2001	2002	2003	2004	2005	2006	2007	2008	Net Cumulative
Big 4 Firms (incl. Andersen)	(149)	(340)	(287)	(398)	(341)	(198)	(77)	(34)	(1,824)
Next 4 Firms	(5)	59	43	108	77	65	59	16	422
Small Firms	136	226	168	252	225	106	(8)	(22)	1,083

Auditor Changes (cont'd)

□ Higher risk engagements

Firm	2001 - 2008		
	Client Gains	Number Higher Risk	% Higher Risk
Big 4	2,922	503	17%
Next 4	1,195	415	35%
Small Firms	7,276	3,203	44%
Total	11,393	4,121	36%

Higher risk flags include: accounting and going concern issues, restatements, illegal acts, SEC investigations, bankruptcies and scope limitations, among others.

Restatements by Auditor

- Trend: growing percentage of restatements by clients of small firms

Firm	2004	2005	2006	2007	2008
Large 8 Firms	68.4%	66.0%	45.7%	46.5%	32.9%
Small Firms	28.1%	29.3%	48.1%	47.8%	58.1%
Foreign Firms ¹	3.5%	4.7%	6.2%	5.7%	9.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

¹ Foreign firms not affiliated with the Large 8 firms

Top 10 Restatement Reasons for 2008

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

Non-accelerated Filers' ICFR Assessments

- Scope of Analysis:
 - Management assessments of 3,526 non-accelerated filers (NAF)
 - For fiscal years ending after Dec. 15, 2007
 - Filings made through Sept. 30, 2008
- Key Findings:
 - Overall: 24.2% self-report ineffective ICFR
 - Compared to: 16.6% with adverse ICFR opinions in Year 1 of AS 2 and 6.6% with adverse ICFR opinions in 2007

Non-accelerated Filers' ICFR Assessments (cont'd)

- Current auditors of NAF with ineffective ICFR:

Firm	Assessments		Ineffective Assessments		
	Total	% of Total	Number	% Within Group	% of Total
Large 8 Firms	1,117	31.7	131	11.7	15.3
Small Firms	2,235	63.4	642	28.7	75.4
Foreign Firms ¹	174	4.9	79	45.4	9.3
Total	3,526	100.0	852	24.2	100.0

¹ Foreign firms not affiliated with the Large 8 firms

Non-accelerated Filers' ICFR Assessments (cont'd)

□ Top 7 material weakness areas:

Material Weakness Area	% Cited in NAF Ineffective ICFR Assessments	% Cited in Year 1 Adverse ICFR Opinions under AS 2
Accounting documentation, policy and/or procedures	96.5	93.0
Accounting personnel resources, competency/training	73.2	48.2
Segregations of duties/ design of controls (personnel)	55.4	23.8
Material and/or numerous auditor /YE adjustments	31.0	53.1
Ineffective or understaffed audit committee	22.4	2.1
Information technology processing/access issues	21.0	21.2
Untimely or inadequate account reconciliations	11.4	31.7

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

Current Accounting and Auditing Issues

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Questions?



Update on Standards- Setting Activities

Brian Degano
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June 4, 2009
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What We Will Cover

- Proposed Standards
 - Engagement quality review
 - Risk assessment
- Staff Audit Practice Alert No. 4
- Current Standards-setting Priorities
- Standing Advisory Group



Proposed Auditing Standard – Engagement Quality Review

Proposed Auditing Standard – Engagement Quality Review

- ❑ Supersede existing requirements for concurring reviews (Appendix E)
- ❑ Apply to all registered firms
- ❑ Require EQR for audits and interim reviews
- ❑ Require concurring approval of issuance prior to granting permission to the client to use the engagement report

Proposed Auditing Standard – Engagement Quality Review

- Proposed Reviewer Qualification Requirements
 - Must be an associated person of a registered firm
 - Must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the person who has overall responsibility for the same type of engagement
 - Must be independent of the company, perform the engagement quality review with integrity, and maintain objectivity in performing the review

Proposed Auditing Standard – Engagement Quality Review

- The new proposal would require performance of specific procedures to evaluate significant judgments made and conclusions reached by the engagement team, by –
 - Holding discussions with the engagement team, and
 - Reviewing documentation
- Procedures for the EQR of an interim review are tailored to reflect the difference between an audit and an interim review

Proposed Auditing Standard – Engagement Quality Review

- ❑ Release, proposed auditing standard and comments received are available at <http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket025.aspx>
- ❑ Comment period ended on April 20, 2009
- ❑ Thirty comment letters received



Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk

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

Proposed Auditing Standards Related to Risk Assessment

- ❑ 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

- ❑ Available through PCAOB website at <http://www.pcaobus.org/Rules/Rulemaking/Docket026.aspx>
- ❑ Comment period ended on February 18, 2009
- ❑ Thirty-three comment letters received



**Staff Audit Practice Alert
No. 4 – Auditor
Considerations Regarding
Fair Value Measurements,
Disclosures, and Other-
Than-Temporary
Impairments**

Staff Audit Practice Alert No. 4

- Objective
 - Inform auditors about potential implications on interim reviews and audits of new FASB guidance – FSP FAS 157-4, FSP 115-2, and FSP FAS 107-1
- Addresses following topics
 - Reviews of interim financial information
 - Audits of financial statements, including integrated audits
 - Disclosures
 - Auditor reporting considerations
- Available at :
http://www.pcaobus.org/Standards/QandA/04-21-2009_APA_4.pdf

Staff Audit Practice Alert No. 4

□ Interim Reviews

- Auditor should, if appropriate, include the implementation of the FSPs in inquiries of management
- Reminds auditor that implementation of the FSPs could represent a change in accounting estimate or change in accounting principal, which may be matters to communicate to audit committee

□ Audits of Financial Statements, Including Integrated Audits

- Reminds auditor of responsibilities under AU sec. 328, *Auditing Fair Value Measurements and Disclosures* and AU sec. 342, *Auditing Accounting Estimates*
- Auditor should evaluate the need to recognize impairment loss, and when impairment loss has been recognized, amount of impairment
- Reminds auditor of responsibility to communicate to audit committee

Staff Audit Practice Alert No. 4

- Disclosures – auditor should
 - Evaluate whether disclosures in accordance with new FSPs
 - Read other information accompanying interim and annual financial statements and consider whether that information or its presentation is materially inconsistent with financial statements
- Auditor Reporting Considerations
 - Reminds auditors that a change in accounting principal that has a material effect on the financial statements should be recognized in the auditor’s report through the addition of an explanatory paragraph



Standards-Setting Priorities

Standards-Setting Priorities*

- Complete Proposed Standards
 - Engagement quality review
 - Risk assessment
- Active Standards Projects
 - Confirmations
 - Fair value and specialists
 - Related parties

* Activities subject to change based on emerging issues



Standing Advisory Group

Standing Advisory Group

- ❑ The Board looks to the SAG to provide *advice* and *insight* as to the need to formulate new standards or change existing standards and opinions on the impact of proposed new or changed standards
- ❑ Size (current) – 33 members and 6 observers
- ❑ Composition – Composed of individuals with a variety of backgrounds, including auditors, preparers of financial statements, investors, academics, and others; to achieve this diversity, no one field of expertise will predominate among the SAG membership

Standing Advisory Group

- Meets two to three times a year
 - April 2, 2009 meeting
 - Discussed Audit Confirmations, Engagement Quality Review, and Going Concern
 - October 14-15, 2009 – next meeting
 - All previous SAG meeting agendas, briefing papers, and webcasts are located at
<http://www.pcaobus.org/Standards/SAG/Pages/>
- SAG members are appointed for two-year terms
- Nominations to the SAG are sought annually



Keeping Current with Standards-related Activities

Keeping Current with Standards

- Our Web site - www.pcaobus.org/Standards
 - 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/About/Pages/RSSFeeds.aspx

Questions?



Break

(15 minutes)

Auditing Standard No. 5 ***Where We've Been – and*** ***What We've Learned***

Greg Wilson and Bill Powers
Division of Registration and Inspections
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Philadelphia, PA

Discussion Topics

- ❑ Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”
- ❑ Selected topical areas of AS No. 5
 - Planning the audit
 - Top down approach
 - Testing controls
 - Evaluating identified deficiencies
 - Wrapping up
 - Reporting on internal control

Discussion Topics

- For each topical area of AS No. 5
 - What the standard says
 - Our experience to-date
 - Expected challenges for small firms and small issuers

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
- ❑ SEC defers 404(b) requirement for non accelerated filers – now required for years ending after December 15, 2009

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

Planning the Audit

- What the standard says
 - 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

Planning the Audit

- Our experience to-date
 - 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

Planning the Audit

- Our experience to-date (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

Planning the Audit

- Expected challenges for small firms and small issuers
 - Integrating procedures for opinions on internal controls over financial reporting and financial statements
 - Adopting control reliance audit strategies vs. testing for ICFR opinion and performing substantive procedures
 - Management's informal risk assessment processes and documentation of control procedures

Top Down Approach

- What the standard says
 - 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

Top Down Approach

- Our experience to-date
 - 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

Top Down Approach

- Our experience to-date (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

Top Down Approach

- Expected challenges for small firms and small issuers
 - Extensive involvement of senior management
 - Identifying entity level controls to test and assessing impact on process level testing
 - Effectiveness of “business process” or “management” reviews

Testing Controls

- What the standard says
 - 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

Testing Controls

- Our experience to-date
 - 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

Testing Controls

- Our experience to-date
 - 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

Testing Controls

- Expected challenges for small firms and small issuers
 - Division of duties issues with small staffs
 - Lack of formal or well main-maintained documentation (risk analysis, procedures, controls, control test results)
 - Small, centralized, non-complex IT organizations or use of application service providers (ASPs)

Testing Controls

- Expected challenges for small firms and small issuers (cont'd)
 - Paradigm shift from substantive audit approach to controls testing approach
 - Identifying and testing entity level controls and assessing impact on process level controls
 - Selecting important IT general controls

Evaluating Identified Control Deficiencies

- What the standard says
 - 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

Evaluating Identified Control Deficiencies

- Our experience to-date
 - 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.

Evaluating Identified Control Deficiencies

- Expected challenges for small firms and small issuers
 - IT general control deficiencies
 - Segregation of duties
 - Access controls
 - Business segregation of duties
 - Relying on computer generated reports

Wrapping Up

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

Wrapping Up

- Our experiences to-date
 - 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

Wrapping Up

- Expected challenges for small firms and small issuers
 - Knowing when you have obtained sufficient evidence to support the ICFR opinion
 - Identifying material weaknesses not tied to misstatements that have occurred

Reporting on Internal Control

- What the standard says
 - Separate or combined reports permissible
 - Report date
 - Material weaknesses
 - Subsequent events

Reporting on Internal Control

- Our experiences to-date
 - 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

Reporting on Internal Control

- Challenges for small firms and small issuers
 - Material weakness identified by auditor but not by management

Questions?



Lunch

(60 minutes)

Case Studies on Auditing in the Small Business Environment

Presenters

- George Botic, National Office Associate Director - Small Firm Program, Division of Registration and Inspections
- John Abell, Assistant Director, Division of Enforcement and Investigations

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.
- #6 - Turtle Textiles, Inc.
- #7 - Active Life, Inc.

Restrictions on Use

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

Case Study #1 – 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

□ 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)



SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

*Christopher White, Accounting Branch Chief
Division of Corporation Finance*



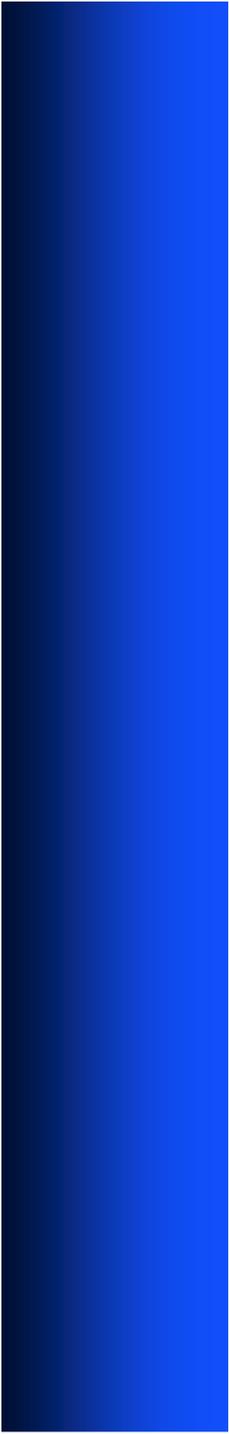
Agenda

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



Disclaimer

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Overview

Division of Corporation Finance (DCF)

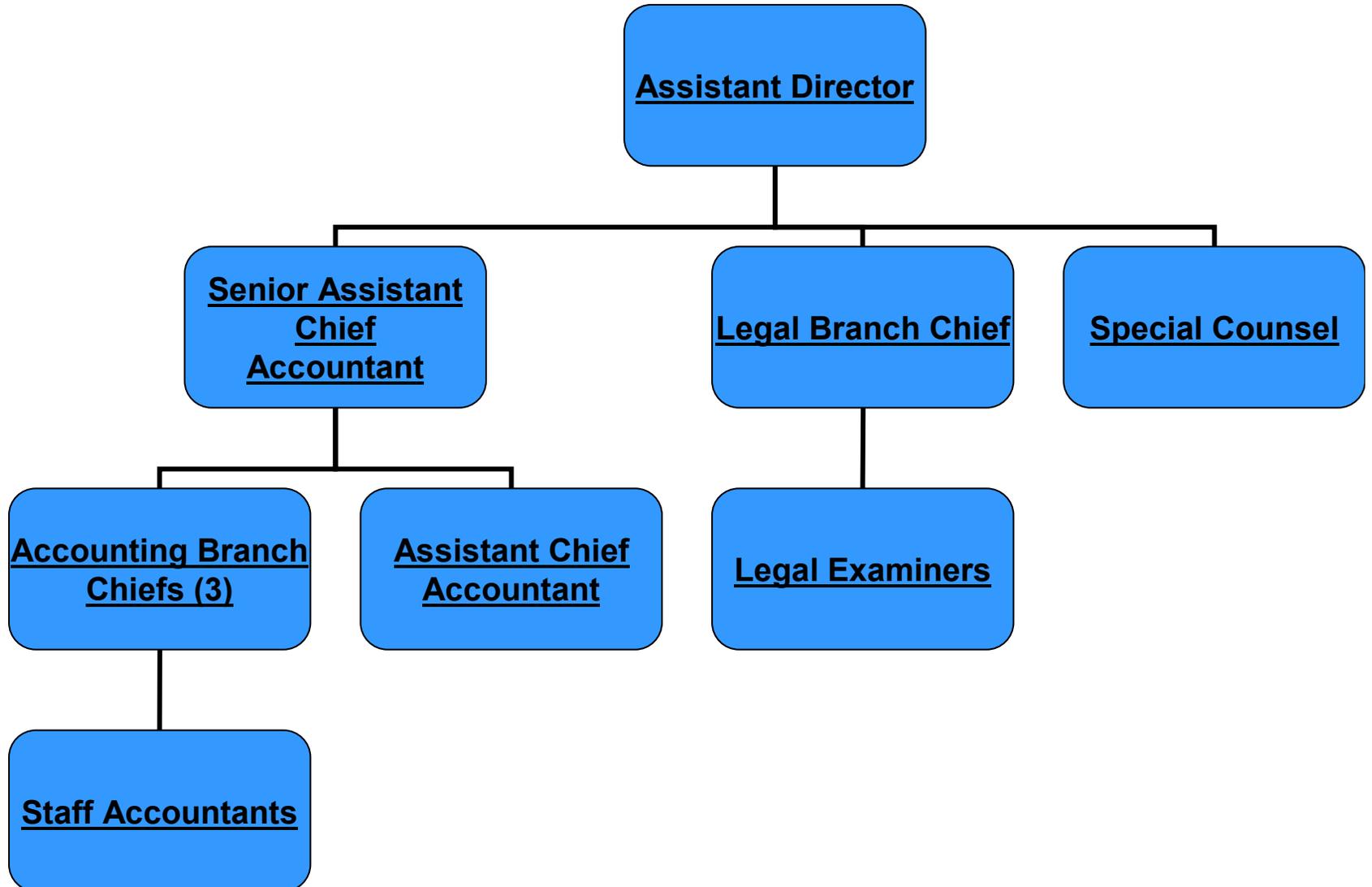
Mission – “To see that investors are provided with material information in order to make informed investment decisions — both when a company initially offers its stock to the public and on a regular basis as it continues to give information to the marketplace.”

- ❖ 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)

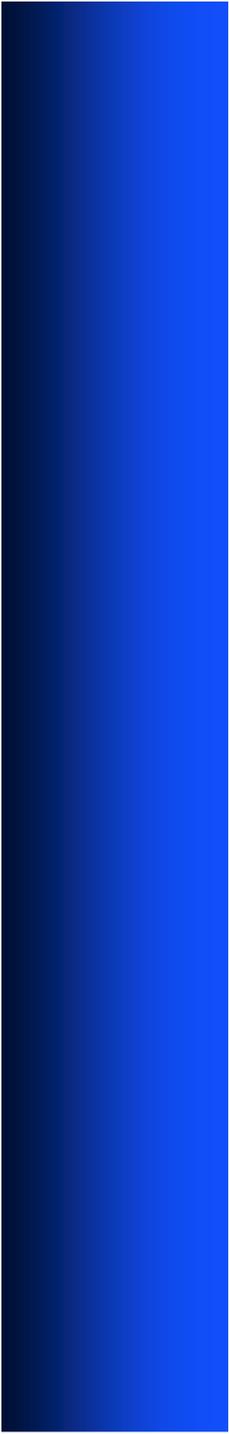
Rulemaking impacting financial reporting

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 ombudsman for the Commission.**
- ❖ **Develops rulemaking initiatives and assists in other rulemaking that may affect smaller and private companies.**



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
- ❖ *Foreign Issuer Reporting Enhancements*
- ❖ *Proposed Roadmap for the Potential Use of Financial Statements Prepared in Accordance With IFRS by U.S. Issuers*

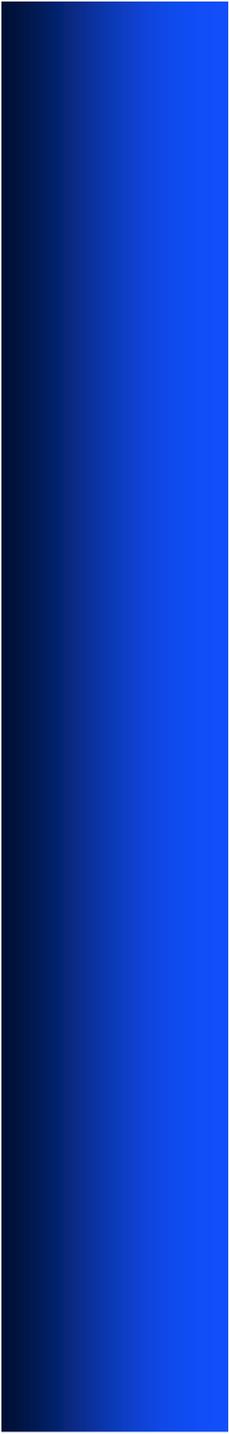
Key SEC Developments

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
- ❖ **Corporation Finance Request Form for Interpretive Advice and Other Assistance**
 - ❖ tts.sec.gov/cgi-bin/corp_fin_interpretive

Key US GAAP Developments

- ❖ **Fair Value Accounting – SFAS 159 and 157**
 - ◆ **FASB Staff Position FAS 157-4 – *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly***
 - ◆ **FSP FAS 107-1 and APB 28-1-- *Interim Disclosures about Fair Value of Financial Instruments***
 - ◆ **FAS 115-2 and FAS 124-2 -- *Recognition and Presentation of Other-Than-Temporary Impairments***
- ❖ **EITF 07-5: *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock***
 - ◆ **See Example 8**
- ❖ **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**
 - ◆ **Expected to Officially Launch on July 1, 2009**
- ❖ **REMINDER: SAB 74 – Requires disclosure regarding impact of new standards**



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

- ❖ Released on EDGAR beginning May 12, 2005
- ❖ For filings after August 1, 2004
- ❖ 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 filed on EDGAR



*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

Restricted Net Assets of Subsidiaries

Equity Transactions

Related Party Transactions

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 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)

Prepaid expenses (recoverability)

Disclosure of Risks and Uncertainties (SOP 94-6)

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 causal factors 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**

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 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

- ❖ **Audit Issues**
 - ◆ **PCAOB Standards**
 - ◆ **Domestic auditors of foreign operating companies**
- ❖ **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**

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))**

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

Restricted Net Assets of Subsidiaries

Parent's share of net assets that cannot be transferred in the form of loans, advances or dividends without the consent of a third party

- ❖ **The dollar amount of the restricted net assets determines the level of disclosure**

MD&A Liquidity Discussion

- ❖ **Address the nature and extent of all restrictions**
- ❖ **Explain how the restrictions limit the ability to transfer funds to its parent**
- ❖ **Explain the impact the restrictions have had and are expected to have on the parent's ability to meet its cash obligations**

Restricted Net Assets of Subsidiaries

Parent-Only Condensed Financial Statements

- ❖ Restricted net assets of consolidated subsidiaries exceed 25% of the parent's consolidated net assets
- ❖ Not required for Smaller Reporting Companies

Financial Statement Footnote

- ❖ Restricted net assets of consolidated and unconsolidated subsidiaries, *plus* the parent's equity in the undistributed earnings of equity method investees exceeds 25% of the parent's consolidated net assets
- ❖ Not required for Smaller Reporting Companies

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

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

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”)**
- ❖ **Explanation expected for effective DC&P conclusion when ICFR is ineffective**

Internal Controls over Financial Reporting (ICFR)

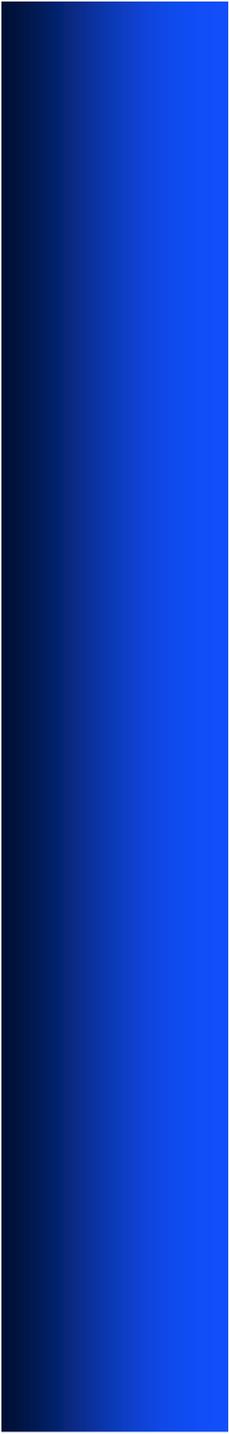
Disclosures companies should consider when material weakness exists

- ❖ **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**

Internal Controls over Financial Reporting (ICFR)

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

- ❖ **Not required for non-accelerated filers until annual reports for fiscal years ending on or after 12/15/09 (SEC Release 33-8934)**
- ❖ **Auditors report should disclose the impact of the material weakness (adverse ICFR opinion) on the financial statement audit opinion (AS 5, par. 92)**



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???

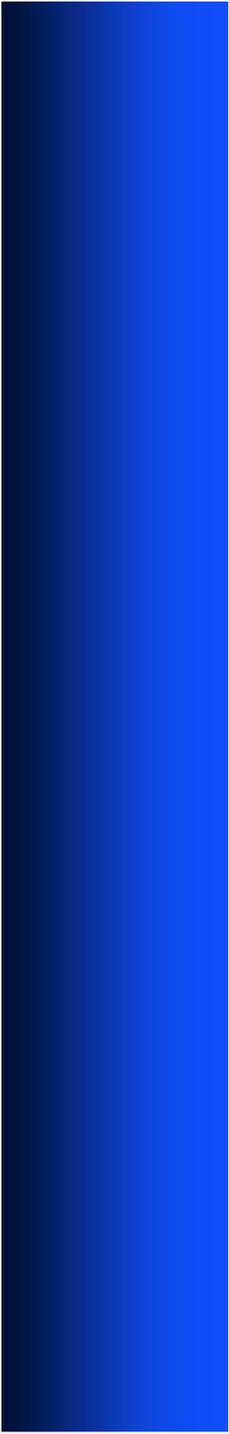
Key Telephone Numbers

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 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)**

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 – Multiple-Element Arrangements**
 - ◆ **May also relate to separate agreements negotiated together or in close proximity**
- ❖ **EITF 99-19 – Gross versus Net Revenue Recognition**
 - ◆ **Consider and weight all indicators**

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 in consideration of EITF 07-5
 - 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/EITF 07-5 Analysis which may require bifurcation)
 - Consider ASR 268/EITF D-98 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 potentially settled in a company's own stock
- ❖ Paragraphs 12 through 32 do not apply to conventional convertible debt instruments

Common Pitfalls of EITF 00-19

- ❖ Cash settlement provisions
- ❖ Required to settle in registered shares
 - ◆ Registration Payment Arrangements are accounted for separately under FSP EITF 00-19-2
- ❖ 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)

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

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 Goelzer
PCAOB Board Member
June 4, 2009
Philadelphia, PA