

# Forum on Auditing in The Small Business Environment

April 21, 2009

Santa Monica, CA

# Opening Remarks

Daniel Goelzer  
PCAOB Board Member  
April 21, 2009  
Santa Monica, CA

# Caveat

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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

Martin F. Baumann

Chief Auditor and Director of Professional  
Standards

April 21, 2009

Santa Monica, CA

# Today's Agenda

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

# Current Economic Environment

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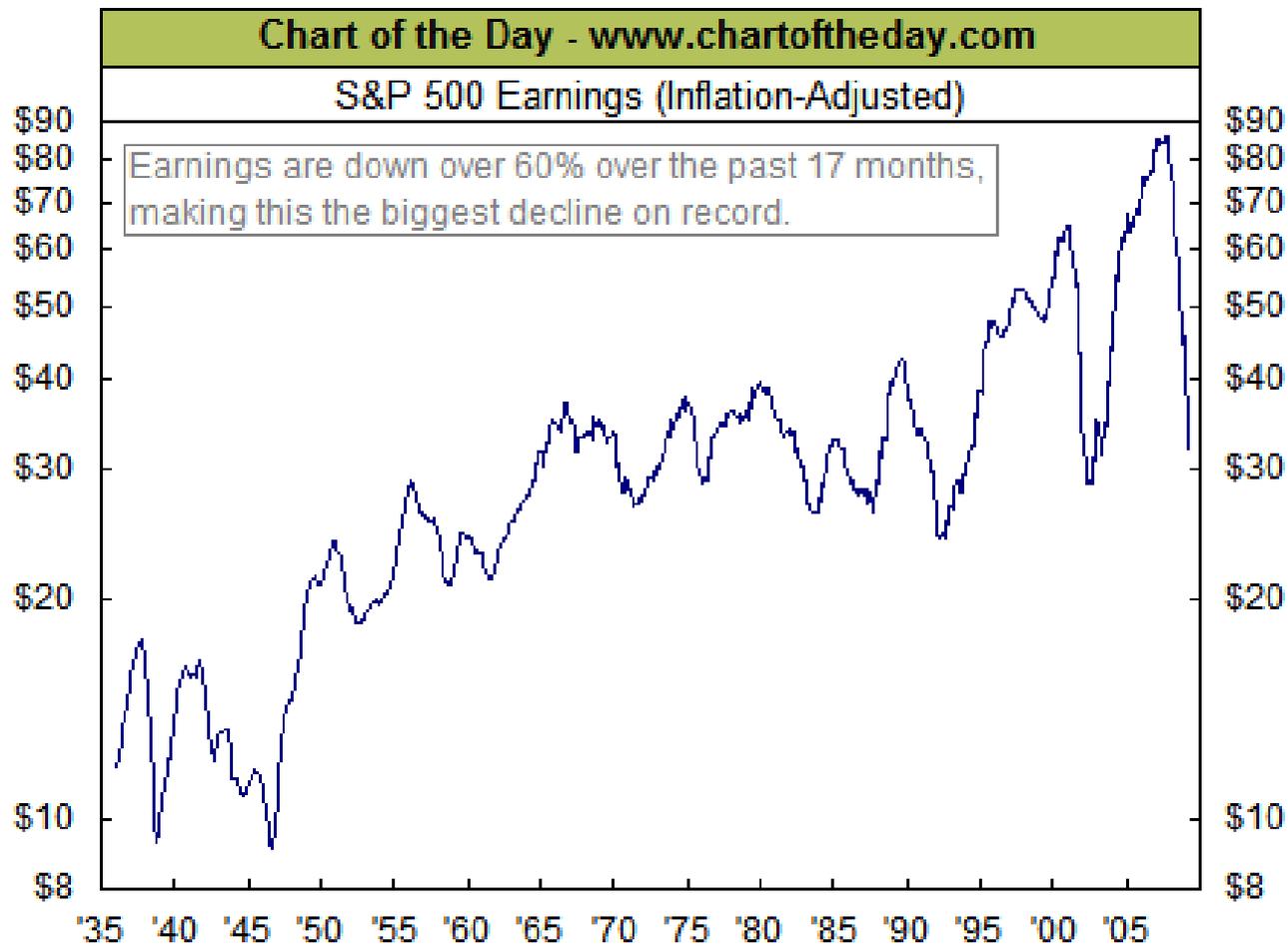
- ❑ Financial turmoil
- ❑ Falling earnings
- ❑ Housing / foreclosures
- ❑ Unemployment
- ❑ Consumer spending
- ❑ Restricted access to credit
- ❑ Volatility

# Financial Turmoil: World Stock Markets

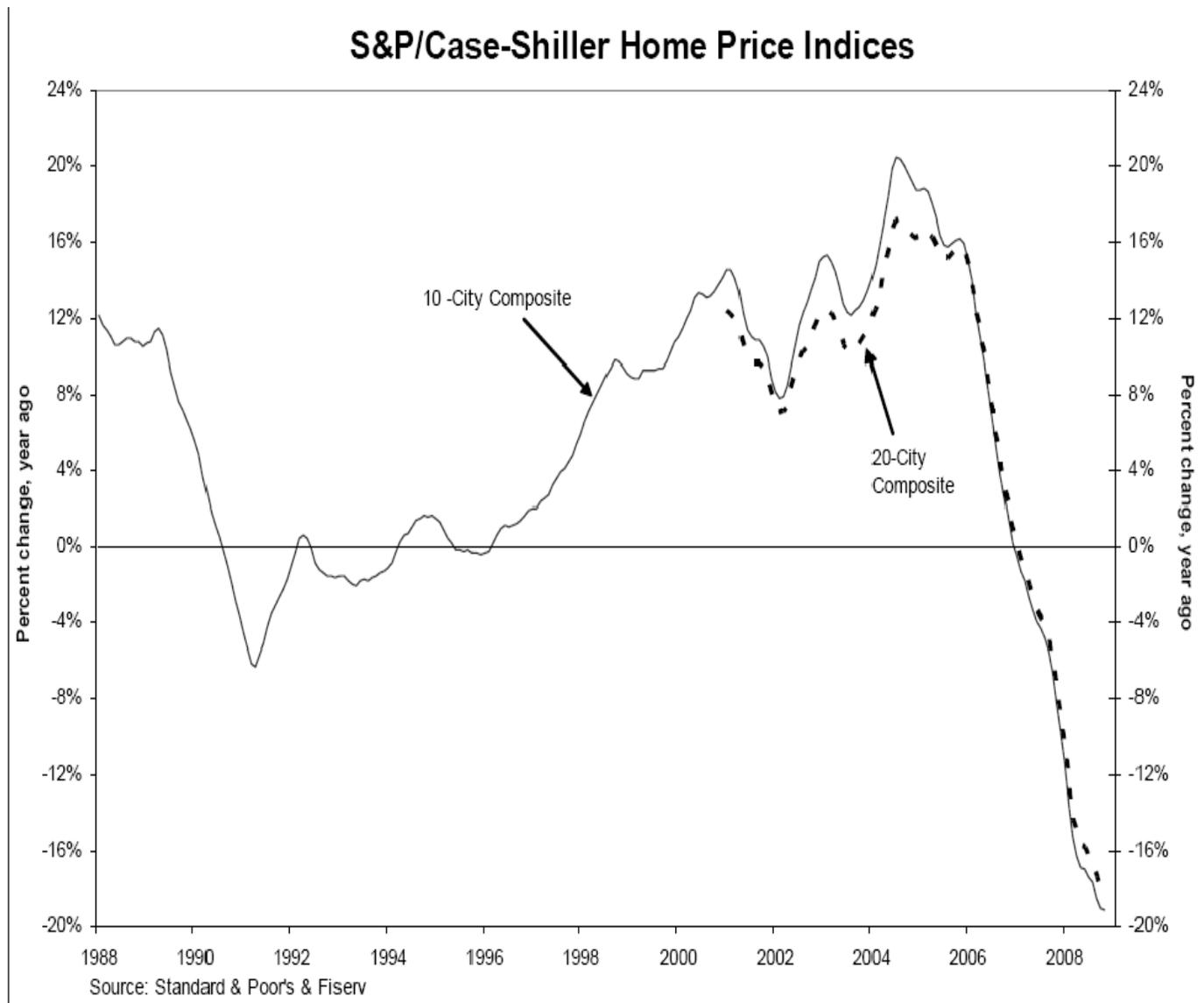
MSCI AC World Index - April 30, 1996 through April 2, 2009



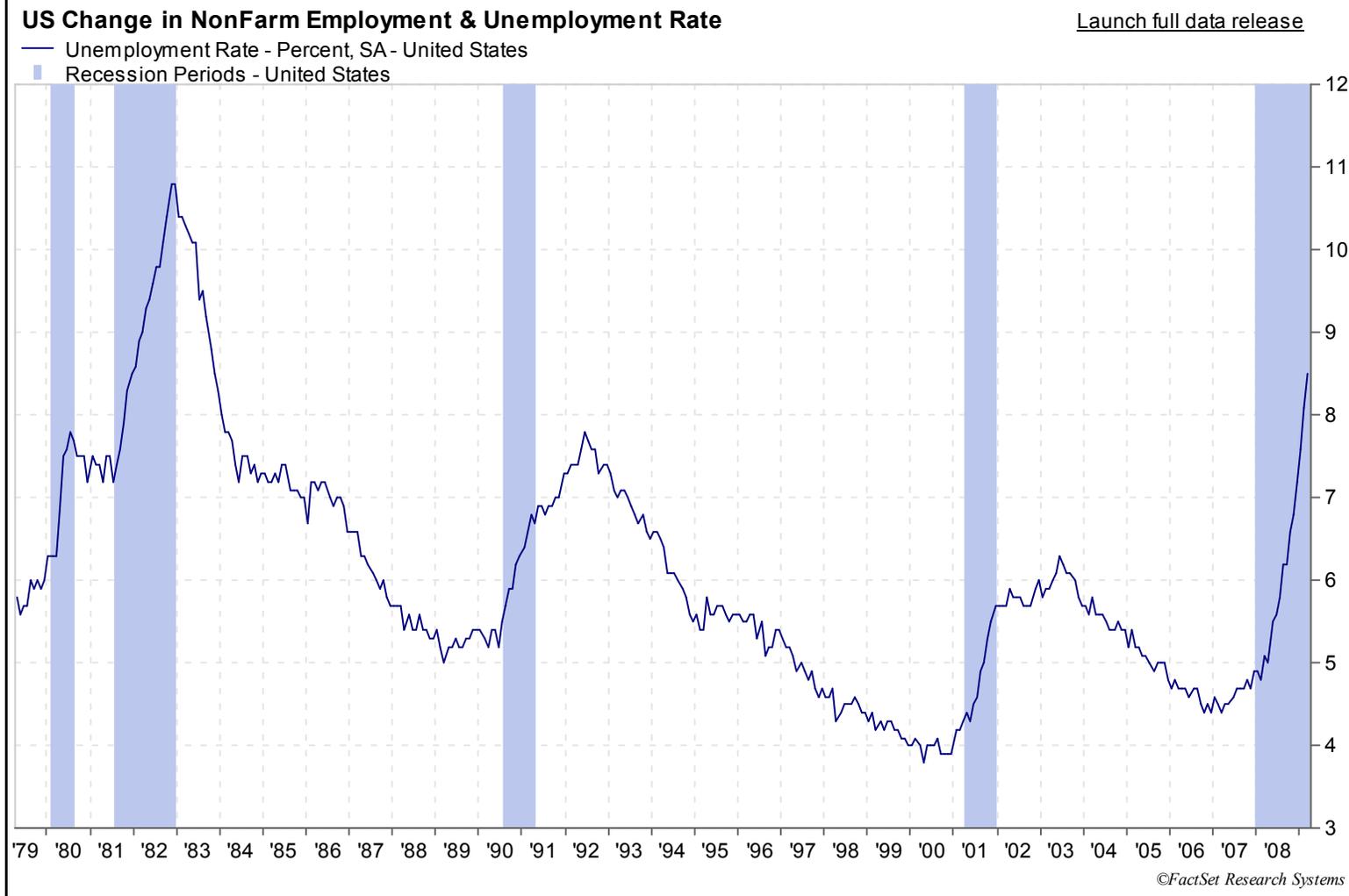
# Falling Earnings



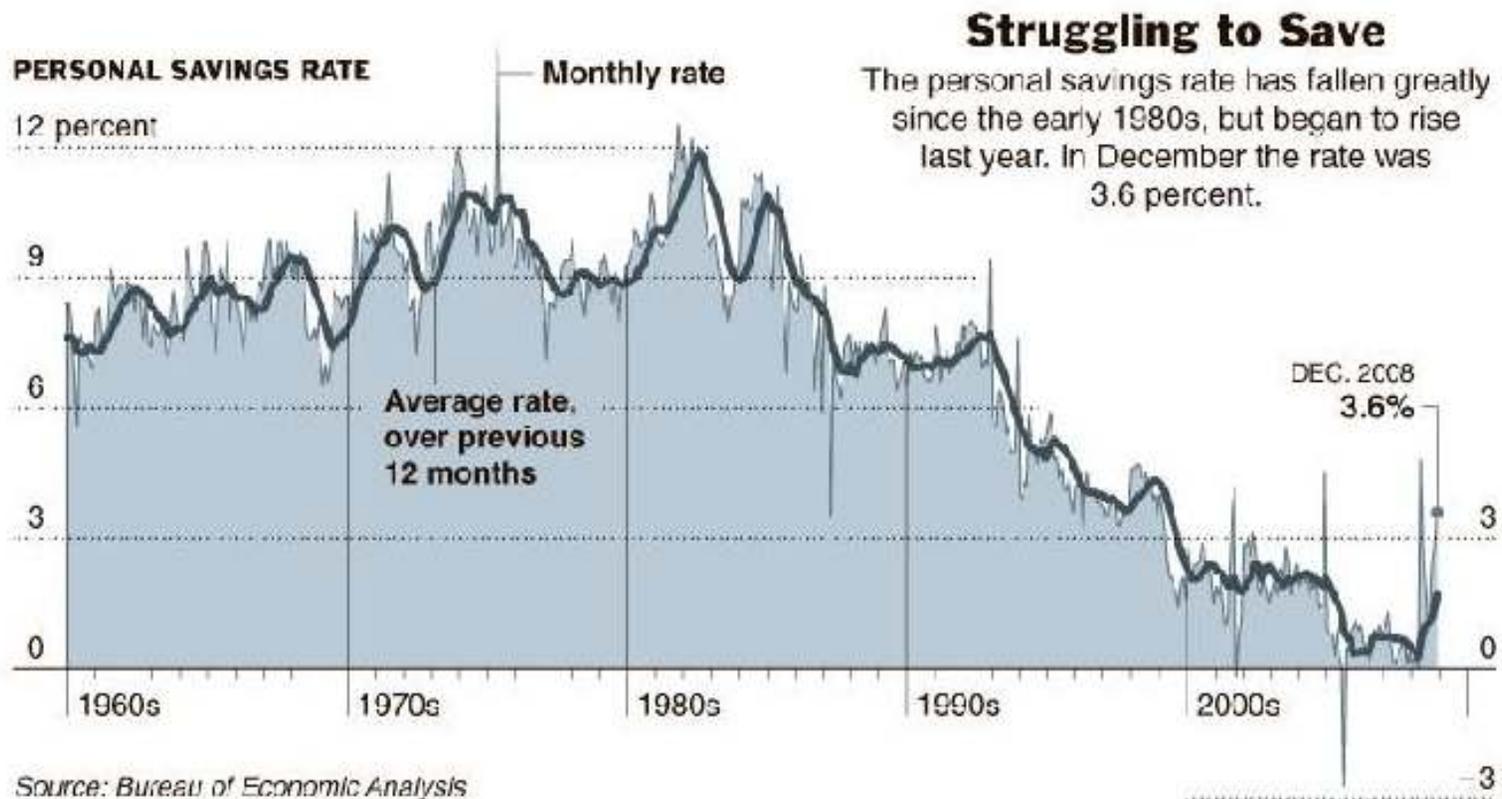
# Housing / Foreclosures



# Unemployment



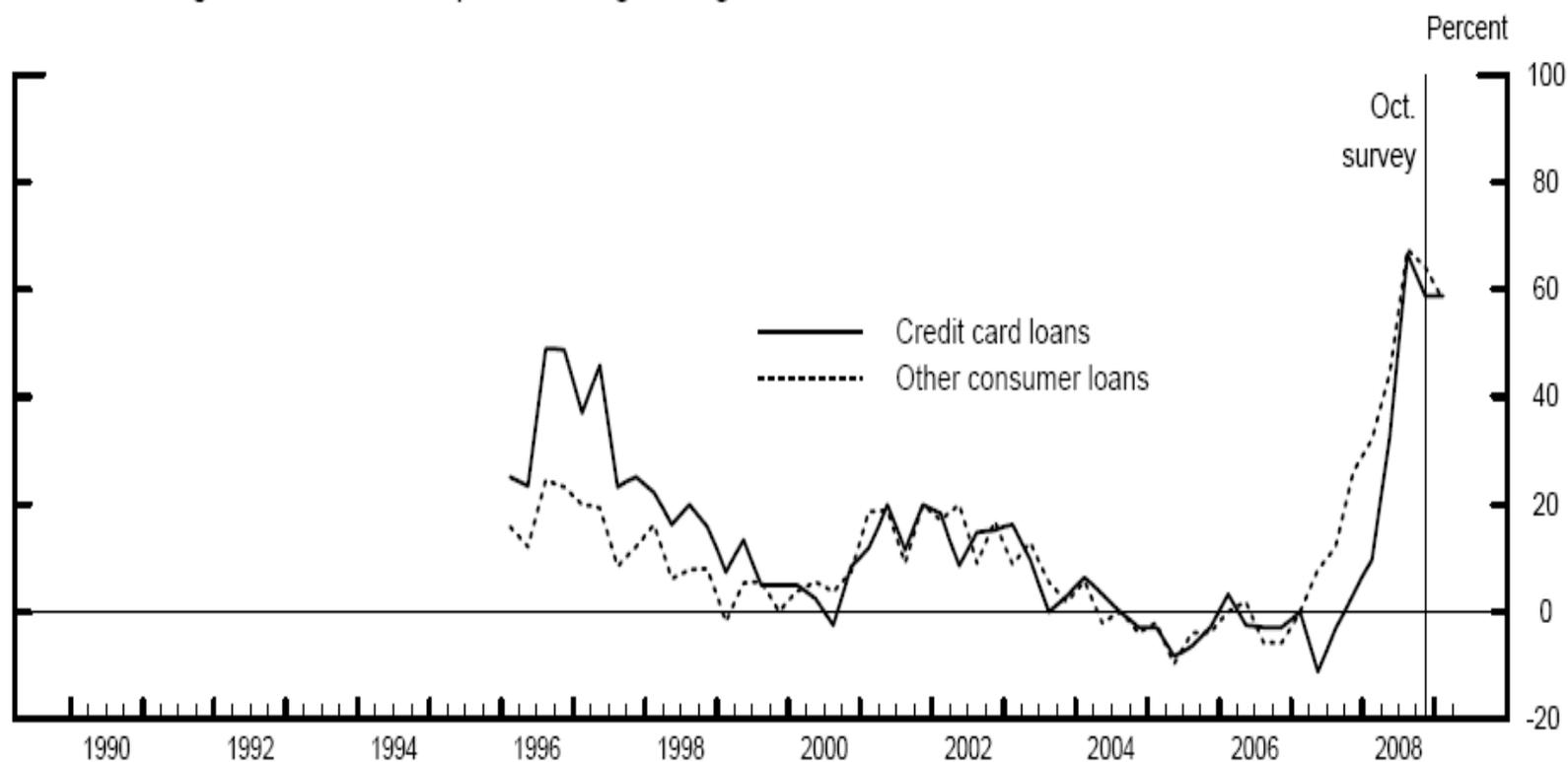
# Consumer Spending



# Restricted Access to Credit

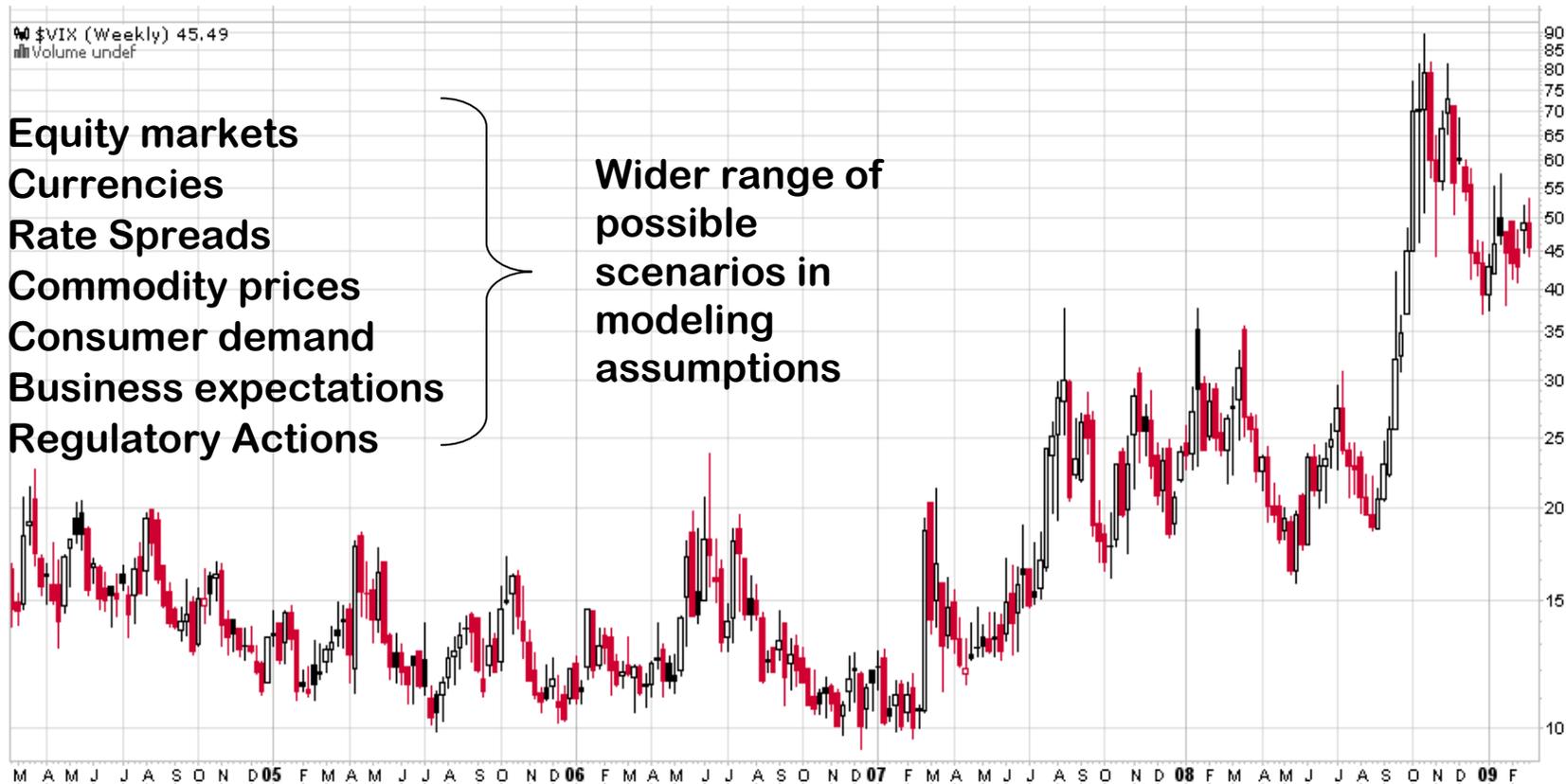
January 2009 senior loan officer opinion survey on bank lending practices

Net Percentage of Domestic Respondents Tightening Standards for Consumer Loans



Source: *Federal Reserve Board*

# Volatility: U.S. Market



# Accounting and Auditing Hot Topics

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- ❑ 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

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- ❑ Elevated fraud risk in the current environment = need to expand audit procedures
  - 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)

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## 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 2, 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)

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- Implications of the FSPs for auditors:
  - Reviews of interim financial information
  - Audits of financial statements, including integrated audits
  - Disclosures
  - Auditor reporting considerations

# Fair Value Measurements (cont'd)

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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 141R
  - 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

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

# Securitization Accounting

- ❑ Proposed statements to amend FAS 140 and FIN 46 (R)
- ❑ FAS 140 – removes the QSPE and exception for applying FIN 46(R) to QSPEs, enhances disclosures
- ❑ FIN 46(R) – amends guidance regarding consolidation of QSPEs, 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
- ❑ Final statement expected in Q1 2009
- ❑ 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

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- ❑ Proposed FAS 162R
- ❑ 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

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- ❑ 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

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- ❑ 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
<b>Big 4</b>	2,922	503	17%
<b>Next 4</b>	1,195	415	35%
<b>Small Firms</b>	7,276	3,203	44%
<b>Total</b>	<b>11,393</b>	<b>4,121</b>	<b>36%</b>

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 <sup>1</sup>	3.5%	4.7%	6.2%	5.7%	9.0%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

<sup>1</sup> Foreign firms not affiliated with the Large 8 firms

# Top 10 Restatement Reasons for 2008

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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 <sup>1</sup>	174	4.9	79	45.4	9.3
<b>Total</b>	<b>3,526</b>	<b>100.0</b>	<b>852</b>	<b>24.2</b>	<b>100.0</b>

<sup>1</sup> 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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Chief Auditor and Director of Professional Standards

April 21, 2009

Santa Monica, CA

# Annual and Special Reporting

Mary Peters  
Office of General Counsel  
April 21, 2009  
Santa Monica, CA

# Rules on Periodic Reporting by Registered Public Accounting Firms

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- ❑ Adopted June 10, 2008
- ❑ Effective 60 days after SEC approval
- ❑ 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

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

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

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- ❑ Audit reports
- ❑ Certain legal proceedings
- ❑ Certain relationships
- ❑ Licenses and certifications
- ❑ Changes in the firm or the firm's Board contact person

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

- Adopted July 29, 2008
- Effective 60 days after SEC approval
- 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)
  - A deadline for filing the form, and
  - Certain representations
- Continuity of registration is automatic, without the need for Board action.
- Review the rules if you are planning any such transaction
  - If deadlines for filing Form 4 are not met, the registration process using Form 1 will be required along with Board action.

# Questions?

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# Break

(15 minutes)

# Update on Standards- Setting Activities

Bella Rivshin  
Office of the Chief Auditor  
April 21, 2009  
Santa Monica, CA

# What We Will Cover

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- Proposed Standards
  - Engagement quality review
  - Risk assessment
- Staff Audit Practice Alert No. 3
- Internal Control Reporting Developments
- Current Standards-setting Priorities
- Standing Advisory Group



# **Proposed Auditing Standard – Engagement Quality Review**

# Background

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- ❑ Existing PCAOB concurring review standard is not applicable to registered firms that were not members of the AICPA SECPS
- ❑ New EQR standard
  - Originally proposed in February 2008
  - Reproposed on March 4, 2009
    - Comment period ended on April 20, 2009

# Applicability and Objective

- The new EQR standard would be –
  - Applicable to all registered firms
  - Required for each audit and interim review conducted pursuant to the standards of the PCAOB
- Objective of the review
  - To perform an evaluation of significant judgments made and conclusions reached by the engagement team in order to determine whether to provide concurring approval of issuance
- Concurring approval of issuance would be required before the engagement report is issued

# Reviewer Qualifications

- Under the new proposal, the reviewer may be –
  - Partner or individual in an equivalent position in the firm, or
  - Any qualified individual outside the firm
- Reviewer must be an associated person of a registered firm
- Competence –
  - Reviewer “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”

# Reviewer Qualifications

- ❑ Must be *independent* of the company, perform the engagement quality review with *integrity*, and maintain *objectivity* in performing the review
- ❑ Should not –
  - make decisions on behalf of the engagement team;
  - assume any of the responsibilities of the engagement team; or
  - supervise the engagement team on the engagement under review
- ❑ May use assistants in performing the EQR
  - The assistants also must be independent, objective, and perform review with integrity

# Engagement Quality Review Process

- 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

# 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
  - Significant engagement deficiency exists when –
    - In an *audit*: (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB,
    - In an *interim review*: (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.

# Documentation

- Documentation of the EQR should “contain sufficient information to identify”:
  - Engagement quality reviewer and assistants
  - Documents reviewed
  - Significant discussions held (date, specific matters, substance)
  - Date of concurring approval of issuance / reasons for not providing approval
- The requirements in AS No. 3 related to document retention, and subsequent changes to documentation apply to EQR

# Proposed Effective Date

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- ❑ EQR for audits – fiscal years ending on or after December 15, 2009
- ❑ EQR for interim reviews – fiscal years beginning after December 15, 2009
- ❑ Release, proposed auditing standard and comments received are available at [http://www.pcaobus.org/Rules/Rulemaking/Docket%2025/2009-03-04\\_Release\\_No\\_2009-001.pdf](http://www.pcaobus.org/Rules/Rulemaking/Docket%2025/2009-03-04_Release_No_2009-001.pdf)



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

# Proposed Auditing Standards Related to Risk Assessment

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- ❑ 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

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- ❑ 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

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



# **Staff Audit Practice Alert No. 3 – Audit Considerations In the Current Economic Environment**

# Topics of discussion

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- ❑ Overall audit considerations
- ❑ Auditing fair value measurements
- ❑ Auditing accounting estimates
- ❑ Auditing the adequacy of disclosures
- ❑ Consideration of a company's ability to continue as a going concern
- ❑ Additional audit considerations for selected financial reporting areas

# Overall Audit Considerations

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- Planning considerations
  - Modification of planned procedures
  - Reassessment of audit risks
  - Areas of special consideration
- Fraud risk considerations
  - Risk factors
    - Incentives and pressures
    - Opportunities
  - Response to risks

# Overall Audit Considerations

- ❑ Internal control considerations
  - Entity-level controls
  - Controls over significant accounts and disclosures
  - Controls over identified risks of material misstatement due to fraud and management override of controls
  - Loss of personnel
- ❑ Effect on substantive procedures
- ❑ Communication with audit committees

# Auditing Fair Value Measurements

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- ❑ Auditor's responsibility - fair value measurements and disclosures in conformity with GAAP
- ❑ Possible matters of importance for auditors when considering fair value measurements
- ❑ Staff Audit Practice Alert No. 2

# Auditing Accounting Estimates

- ❑ Auditor's responsibility - evaluating reasonableness of accounting estimates
- ❑ Approaches to testing estimates
  - Review and test the process used by management to develop the estimate
  - Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate
  - Review subsequent events or transactions occurring prior to the date of the auditor's report.
- ❑ Other considerations
  - Management bias
  - Retrospective review

# Auditing the Adequacy of Disclosures

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- ❑ Auditor's responsibility – consider if a particular matter should be disclosed
- ❑ Risks and uncertainties
- ❑ Other disclosures required in financial statements
- ❑ Other information in documents containing audited financial statements

# Going Concern

- ❑ Auditor's responsibility - evaluate substantial doubt about a company's ability to continue as a going concern
- ❑ Auditor's evaluation
  - Negative trends
  - Possible financial difficulties
  - Internal matters
  - External matters
- ❑ Management's plans
- ❑ Effect on auditor's report

# Additional Audit Considerations

- ❑ Credit derivatives
- ❑ Derivatives
- ❑ Deferred tax assets
- ❑ Goodwill, intangible assets and other long-lived assets
- ❑ Other-than-temporary impairment
- ❑ Pension and other postretirement benefits
- ❑ Inventory
- ❑ Receivables
- ❑ Revenue recognition
- ❑ Consolidation
- ❑ Contingencies and guarantees
- ❑ Debt obligations
- ❑ Restructuring
- ❑ Share-based payments



# **Internal Control Reporting Developments – Guidance for Auditors of Smaller Companies**

# Non-Accelerated Filer Deadlines

- ❑ 404(a) – a non-accelerated filer must begin to provide management’s report on internal control over financial reporting in an annual report it files for its first fiscal year ending on or after December 15, 2007
- ❑ 404(b) – a non-accelerated filer must begin to provide the auditor attestation report in the annual report it files for its first fiscal year ending on or after December 15, 2009

# Overview

- Staff guidance finalized January 23, 2009
  - Preliminary Staff views issued October 17, 2007; 23 comments received
- Staff guidance on AS No. 5 –
  - Discusses how direction on scaling in AS No.5 may be applied to audits of smaller, less complex companies
  - Does not establish new requirements
  - All audits must follow AS No. 5
- Developed in cooperation with auditors
- Staff consulted with CFOs of smaller companies

# Areas of Focus

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- ❑ Use of entity-level controls to achieve control objectives
- ❑ Risk of management override
- ❑ Implementation of segregation of duties and alternative controls
- ❑ Use of information technology
- ❑ Maintenance of financial reporting competencies
- ❑ Nature and extent of documentation

# Segregation of Duties and Alternative Controls

- ❑ Smaller, less complex companies' approach to segregation of duties:
  - Despite personnel limitations, some companies might still divide incompatible functions by using the services of external parties;
  - Other companies might implement alternative controls intended to achieve the same objectives as segregation of duties for certain processes
- ❑ It is generally beneficial to identify concerns related to segregation of duties early in the audit process
- ❑ When management implements alternative controls that address the same objectives as segregation of duties, the auditor should evaluate whether the alternative controls effectively meet the related controls objectives

# Maintenance of Financial Reporting Competencies

- ❑ Smaller, less complex companies can face challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting
- ❑ The evaluation of the competence is one aspect of evaluating the control environment and the operating effectiveness of controls
- ❑ Some smaller, less complex companies might not have personnel on staff with experience in certain complex accounting matters that are encountered
  - A company might engage outside professionals to provide the necessary expertise
  - When assessing the competence, the auditor may consider the combined competence of company personnel and other parties that assist with functions related to financial reporting

# Nature and Extent of Documentation

- In a smaller, less complex company, documentation of processes and controls might take a variety of forms
  - For example, information about processes and controls may be found in memoranda, questionnaires, software manuals or job descriptions
- Obtaining sufficient evidence about the operating effectiveness of controls can be challenging when there is limited documentation of their operation
  - In those situations, inquiry combines with other procedures, such as observations of activities, inspection of documentation produced or used by the controls, and reperformance of certain controls, might provide sufficient evidence about whether a control is effective



# Standards-Setting Priorities

# Standards-Setting Priorities\*

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

\* 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/default.aspx>
- 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 - <http://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](mailto: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:  
<http://www.pcaobus.org/About/Pages/RSSFeeds.aspx>

# Questions?

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# Lunch

(75 minutes)

# **Case Studies on Auditing in the Small Business Environment**

# Presenters

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- ❑ Mark West, Deputy Director, Division of Registration and Inspections
- ❑ John Abell, Assistant Director, Division of Enforcement and Investigations

# Agenda

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

# Summary of Domestic Small Firm Program

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- 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

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## □ 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

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- ❑ 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 – Heath Tech, Inc.

## Background

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- ❑ 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 – Heath 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)*

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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

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- ❑ 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

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- ❑ 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

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- *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

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- ❑ 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

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- ❑ 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

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- ❑ 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

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- *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

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- ❑ 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)*

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- ❑ 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

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- ❑ 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

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- ❑ 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

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- *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

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- ❑ 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

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- ❑ 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

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- ❑ 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))*

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- *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
- <http://www.pcaobus.org/Standards/>

## □ SEC

- Independence Rules – Regulation S-X, Rule 210.2-01  
<http://www.sec.gov/info/accountants/independref.shtml>
- Frequently Asked Questions (updated 8/07)  
<http://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?

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**Break**

(15 minutes)



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# **SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers**

*Jennifer Thompson, Accounting Branch Chief  
Division of Corporation Finance*



# *Agenda*

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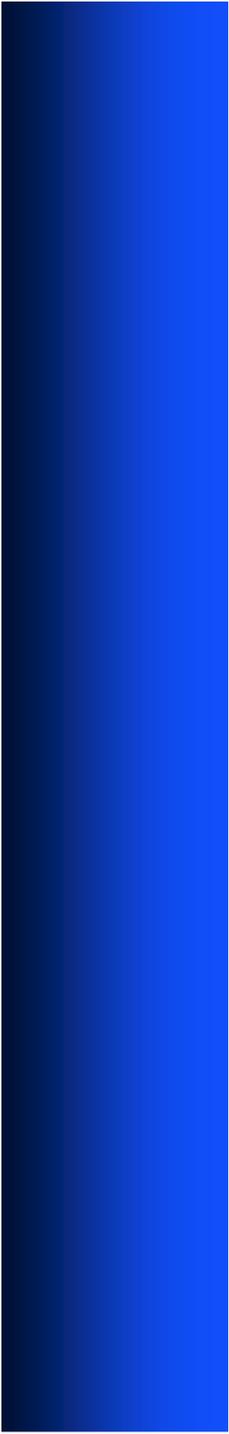
- ❖ **Overview**
- ❖ **Recent Developments**
- ❖ **The Comment Letter Process**
- ❖ **Financial Reporting Issues Frequently Raised in Comment Letters**
- ❖ **Resources**



# *Disclaimer*

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



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# *Overview*

# ***Division of Corporation Finance (DCF)***

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*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.”*

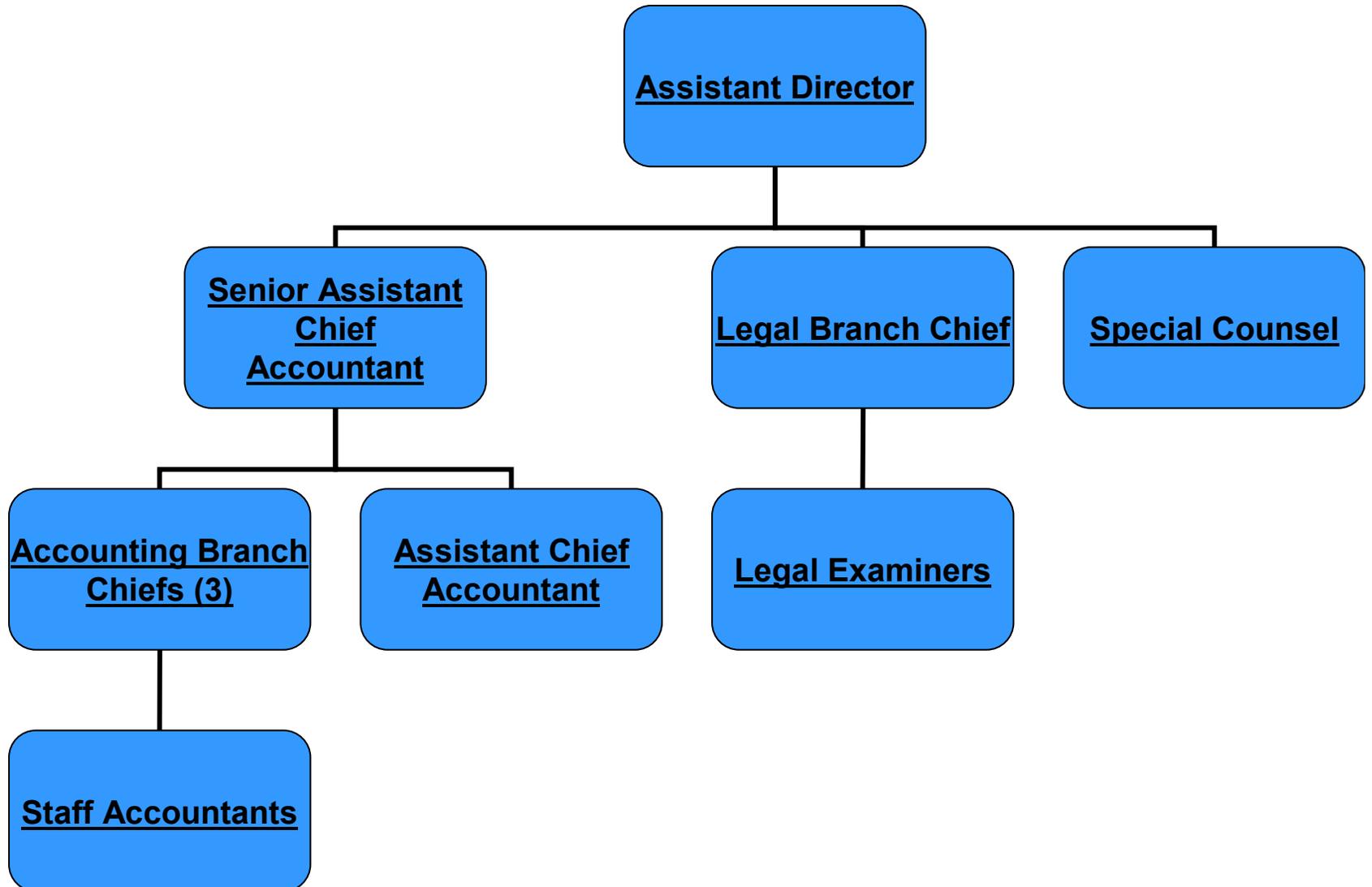
- ❖ **Review the disclosure documents filed by public companies (including initial registrations)**
- ❖ **Provide interpretive assistance to companies on SEC rules and forms**
- ❖ **Propose new and revised rules to the Commission**

## *Organization*

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

# ***Division of Corporation Finance (DCF) Industry Groups***

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# *Corporation Finance Office of the Chief Accountant*

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## *Provides technical support to industry groups*

- ✓ Consultations from the Staff on technical matters
- ✓ Registrant's request for reconsideration of Staff comments
  - u May include OCA
- ✓ Restatements

## *Pre-filing submissions ([dcaoletters@sec.gov](mailto: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***

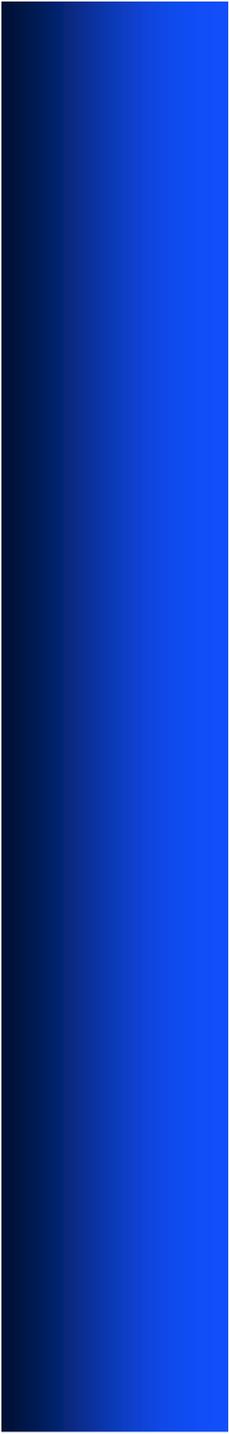
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- ✓ **Carries out the day-to-day work to assist the Commission in its oversight role over the FASB, which the Commission has designated as a private-sector accounting standard setter**
- ✓ **Also carries out oversight responsibilities related to the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

# ***DCF — Office of Small Business Policy***

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- v 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.***
- v 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.***
- v Develops rulemaking initiatives and assists in other rulemaking that may affect smaller and private companies.***



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# *Recent Developments*

# *Key SEC Developments*

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## *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*

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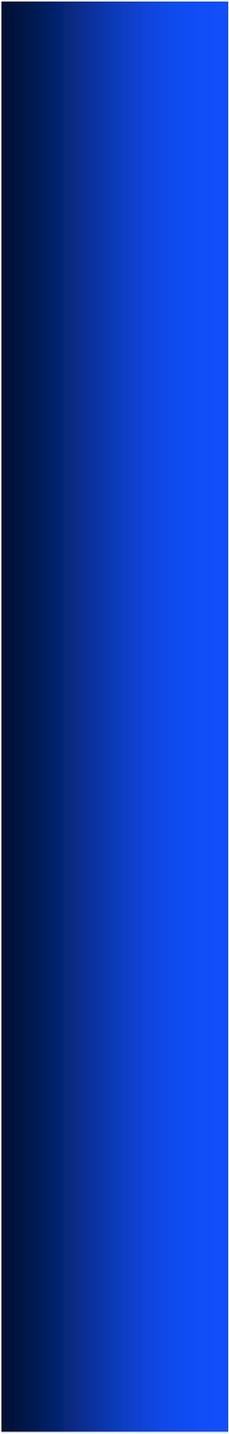
## *Staff Initiatives*

- ❖ **Division of Corporation Finance Financial Reporting Manual**
  - ❖ [www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml](http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml)
- ❖ **Corporation Finance Compliance and Disclosure Interpretations**
  - ❖ [www.sec.gov/divisions/corpfin/cfguidance.shtml](http://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](http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm)
  - ❖ **March 2008 --**  
[www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm](http://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](http://tts.sec.gov/cgi-bin/corp_fin_interpretive)

# *Key US GAAP Developments*

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- ❖ **Fair Value Accounting – SFAS 159 and 157**
  - ◆ **FASB Staff Position FAS 157-e – *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed***
- ❖ **EITF 07-5: *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock***
- ❖ **Business Combinations and Noncontrolling interests– SFAS 141(R) and SFAS 160**
  - ◆ **Effective for fiscal years beginning on or after 12/15/08**
- ✓ **FASB Accounting Standards Codification -- [asc.fasb.org](http://asc.fasb.org)**
  - ◆ **Expected to Officially Launch on July 1, 2009**
- ❖ ***REMINDER*: SAB 74 – Requires disclosure regarding impact of new standards**



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# *The Comment Letter Process*

# *Comment Letter Process*

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## *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*

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## *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*

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## *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*

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## *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**



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***Financial Reporting Issues  
Frequently Raised in Comment  
Letters***

# ***Financial Reporting Issues Frequently Raised in Comment Letters***

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*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*

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## *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*

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## *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)*

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*Release Nos. 33-6835 and 33-8350*

## *Best Practices*

- ✓ **Executive-level overview (including discussion of impact of current economic conditions)**
- ✓ **Critical accounting estimates**
  - u **Provide insight into the quality and variability of financial information (including fair value measurements)**
  - u **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)*

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## **v Liquidity and capital resources**

- u Enhanced analysis and explanation of the sources and uses of cash**
  - | Consider categories reported on statement of cash flows**
- u Address going concern matters**
- u Discuss liquidity known trends - Item 303(a)(1) of Regulation S-K**
- u Discuss the prospective sources of and need for capital**
- u Consider enhanced disclosure regarding debt instruments, guarantees and related covenants**

# *Reverse Mergers & “Back Door” Registrations*

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*What is a “back door” registration?*

*Frequent Areas of Comment:*

- ✓ **Required Form 8-K items not filed**
  - u **Including Item 4.01 Form 8-K (Change in Accountants)**
- ✓ **Form 10 information**
  - u **Financial Statements due within 4 business days (no 71-day extension)**
- ✓ **Financial statement updates on Form 8-K**
  - u **Interpretation of Rule 13a-1**
- ✓ **Shell Company Exchange Act Reporting Requirements**

# *Reverse Mergers & “Back Door” Registrations*

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- ✓ **Internal Control over Financial Reporting**
- ✓ **Audit Issues**
  - u **PCAOB Standards**
  - u **Domestic auditors of foreign operating companies**
- ✓ **Accounting acquirer’s audited F/S presented for all historical periods in subsequent reports**
  - u **Earnings per share recast to reflect exchange ratio**
  - u **Eliminate retained earnings of shell or legal acquirer**
  - u **Common stock of shell or legal acquirer continues**

# ***Business Combinations***

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## ***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**

# ***Business Combinations***

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## *Purchase Price Allocation*

- ✓ **Allocated to all assets and liabilities acquired based upon fair value**
  - u **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*

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## *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***

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***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**

## ***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**

# ***Restricted Net Assets of Subsidiaries***

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## ***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**

## ***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**

# *Equity Transactions*

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## *Fair Value Determination*

- ✓ If publicly traded in an active market, use quoted market price
  - u If discounts are appropriate under the circumstances, they should be supported by objective evidence
- ✓ If stock not publicly traded in active market
  - u Contemporaneous equity transactions with third parties
  - u Fair value of the services or goods provided may be used to measure the transaction, if more reliable
  - u Consider SFAS No. 157 & FSP SFAS 157-3 – 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*

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## *Examples of Common Related Party Transactions:*

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

*Measurement*

*Disclosure*

# *Smaller Reporting Company Status*

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## 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***

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## ***Conclusions***

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

## ***Incomplete definition of DC&P***

- v 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)*

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## *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
  - u Statement of management's responsibility for establishing and maintaining adequate ICFR
  - u Identification of the acceptable framework used in management's evaluation
  - u Management's assessment of effectiveness, including disclosure of all material weaknesses
  - u Statement regarding auditor attestation
- ✓ 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)*

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*Disclosures companies should consider when material weakness exists*

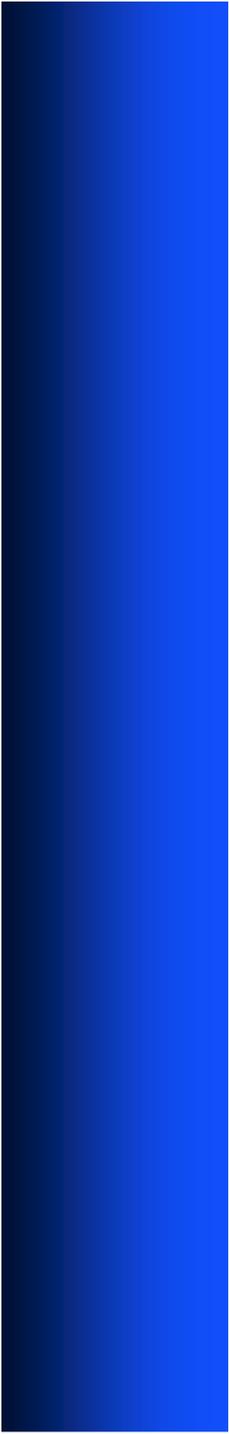
- ✓ **Nature of the material weakness**
- ✓ **Impact of control deficiency on the company's financial reporting and its ICFR**
- ✓ **Current plans, if any, or actions already undertaken to remediate the material weakness (note Item 308 (c) of Regulation S-K)**
- ✓ **Disclosures should be detailed and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

# *Internal Controls over Financial Reporting (ICFR)*

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## *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)**



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# *Resources*

# *Resources*

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## *SEC Website – [www.sec.gov](http://www.sec.gov)*

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



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# *Questions???*

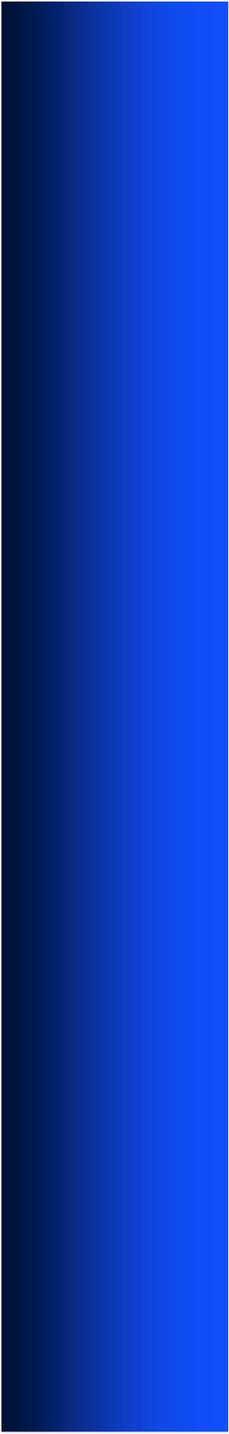
## *Key Telephone Numbers*

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

**DCF Office of Chief Counsel (202) 551-3500**

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

**Office of Small Business Policy (202) 551-3460**



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# *Appendix*

# *Financial Statement Classification*

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*Registrants that qualify as smaller reporting companies reporting under Article 8 of Regulation S-X*

- v Need not apply the other form and content requirements in Regulation S-X except:**
  - u Report and qualifications of the independent accountant (Article 2)**
  - u Description of accounting policies (Rule 4-08(n))**
  - u Companies engaged in oil and gas producing activities (Rule 4-10)**
- v Guidance outside of Regulation S-X continues to apply that may result in comments. For example:**
  - u Equity vs. non-equity (EITF Topic D-98 and SFAS No. 150)**
  - u Operating, investing, and financing cash flows (SFAS No. 95)**
  - u Discontinued operations (SFAS No. 144)**
  - u Stock-based compensation expense (SAB Topic 14F)**

# *Financial Statement Classification*

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## *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)**
  - u **Rule 5-02 - balance sheets**
  - u **Rule 5-03 – income statements**
- ▼ **These additional rules most often result in comments relating to Rule 5-03**
  - u **Components of revenue**
  - u **Cost of sales**
  - u **Classification of share-based payments**
  - u **Operating vs. non-operating**

# *General Reporting Requirements*

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## *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:**
  - u **If a reporting company, all reports must have been filed**
  - u **Company expects to report income from continuing operations before taxes for the current year**
  - u **Company has reported income from continuing operations before taxes in at least one of the two previous years**

# *Revenue Recognition*

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## *Common Areas of Comment*

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

# ***Embedded Conversion Options and Freestanding Warrants***

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## ***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)***

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## *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 01-6**
      - **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 01-6 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)*

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## *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
  - u 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 01-6)

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

# *Form 8-K*

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*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*

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*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”**

# ***CEO/CFO Certifications***

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*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)*

- v SEC Release 33-8238 (June 2003) permitted exclusion of:**
  - u introductory language in paragraph 4 referring to responsibility for establishing and maintaining ICFR**
  - u Paragraph 4(b) (certifying officer has designed or supervised the design of ICFR)**
- v Starting with first period in which management is required to assess ICFR, these statements can no longer be excluded**

# ***Audit Reports***

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*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?

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# Closing Remarks and Wrap-Up

Daniel Goelzer  
PCAOB Board Member  
April 21, 2009  
Santa Monica, CA