PCAOB
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Forum on Auditing in the Small Business Environment

November 2, 2010

Dallas, TX

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Opening Remarks

Bill Gradison
Founding Board Member, PCAOB
November 2, 2010
Dallas, TX

Caveat

One of the benefits of today's session is that you will hear firsthand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff. Therefore, unless it is clear that the Board has authorized the statement, you should not attribute it to the Board or staff.

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Office of Research and Analysis: Risk-Based Selection and the Current Environment

Andres Vinelli
Chief Economist
Office of Research and Analysis

Topics

- Triennial Practice
  - Industry breakdown of issuers
  - The broker-dealer universe
- Risk Assessment
  - Triennial firm surveillance
    - IRA and quant model
  - Performance measurement
  - Impact assessment research
- Emerging Risks
  - Macro baseline scenario
    - Texas' economy
  - Alternative scenarios
  - The "GAAP tsunami"
    - The role of discretion

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Dallas Attendee Firms

Number of firms attending SBF	34
Number of firms with issuer clients	20
Number of firms with broker/dealer clients	20
Number of firms with issuer and broker/dealer clients	14
Number of firms with issuer clients only	6
Number of firms with broker/dealer clients only	6
Number of firms with no reported issuer or B/D clients	8

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Dallas Attendees: Firms Auditing Issuers

Number of firms attending Small Business Forum	34
Number of Firms with Issuer Clients	20
Total Number of Issuer Clients	197

	Issuer Count*	Market Cap ($ in millions)**
Consumer Discretionary	27	1152.198
Consumer Staples	13	174.207
Energy	41	4579.923
Financials	13	770.345
Health Care	22	865.139
Industrials	20	346.613
Information Technology	22	457.204
Materials	27	750.465
Telecommunication Services	4	24.46
Unassigned	6	4.932
Utilities	2	13.074
Grand Total	197	9,138.6

*Issuer Count based on Opinions Issued in 2009

**Market Cap as of September 30, 2010

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Dallas Attendees: Firms Auditing Broker/Dealers

- Number of firms with broker/dealer clients 20
- Total number of broker/dealer clients 70
- Total assets audited of broker/dealer clients
  - $1,279,033,086*

*Based on publicly available fiscal year 2009 data

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Broker-Dealer Industry: Total Assets are Highly Concentrated

Broker/Dealer	Total Assets ($MM)	% of Total	Firm	Subsidiary of an Issuer (Y/N)
GOLDMAN, SACHS & CO.	476,490	13.1	PricewaterhouseCoopers LLP	Y
J.P. MORGAN SECURITIES INC.	399,545	11.0	PricewaterhouseCoopers LLP	Y
CREDIT SUISSE SECURITIES (USA) LLC	326,348	8.9	KPMG LLP	Y
CITIGROUP GLOBAL MARKETS INC.	286,825	7.9	KPMG LLP	Y
UBS SECURITIES LLC	253,420	6.9	Ernst & Young LLP	Y
DEUTSCHE BANK SECURITIES INC.	244,413	6.7	KPMG LLP	Y
BARCLAYS CAPITAL INC.	240,429	6.6	PricewaterhouseCoopers LLP	Y
BANC OF AMERICA SECURITIES LLC	207,678	5.7	PricewaterhouseCoopers LLP	Y
BNP PARIBAS SECURITIES CORP.	171,735	4.7	Deloitte & Touche LLP	N
MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED	138,013	3.8	Deloitte & Touche LLP	Y
J.P. MORGAN CLEARING CORP.	105,884	2.9	PricewaterhouseCoopers LLP	Y
HSBC SECURITIES (USA) INC.	61,544	1.7	KPMG LLP	Y
ING FINANCIAL MARKETS LLC	43,585	1.2	Ernst & Young LLP	Y
NEWEDGE USA, LLC	40,849	1.1	Ernst & Young LLP	N
NATIONAL FINANCIAL SERVICES LLC	31,036	0.9	Deloitte & Touche LLP	N
CHARLES SCHWAB & CO., INC.	25,139	0.7	Deloitte & Touche LLP	Y
BNP PARIBAS PRIME BROKERAGE, INC.	23,672	0.6	Deloitte & Touche LLP	N
MF GLOBAL INC.	22,915	0.6	PricewaterhouseCoopers LLP	Y
UBS FINANCIAL SERVICES INC.	19,163	0.5	Ernst & Young LLP	Y
JEFFERIES & COMPANY, INC.	17,063	0.5	KPMG LLP	Y
Subtotal of Top Twenty Broker Dealers	**3,135,744**	**86.0**		
All Other Broker Dealers	511,185	14.0		
Grand Total	**3,646,929**	**100.0**		

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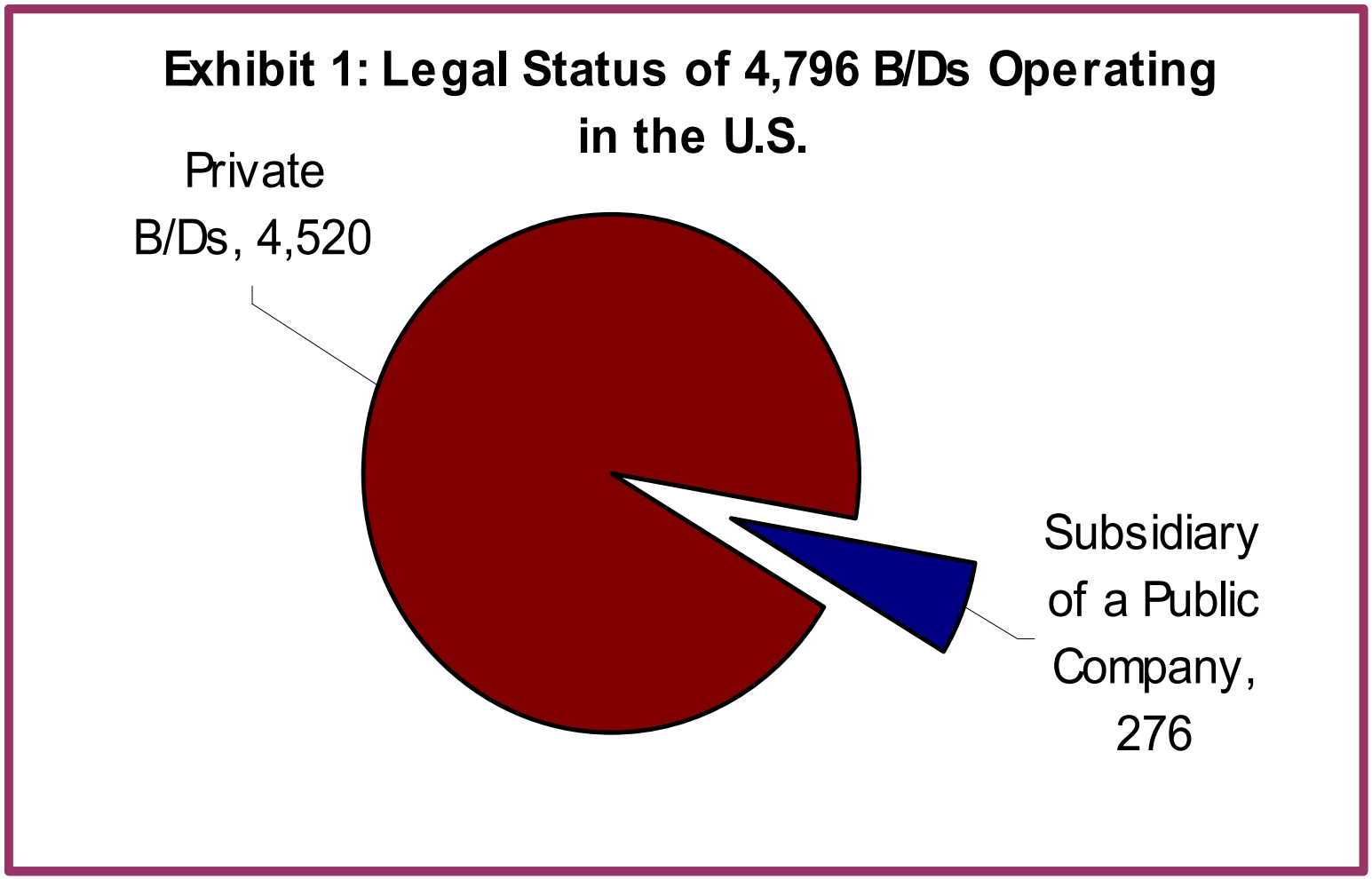
Broker-Dealers: Most are Private...



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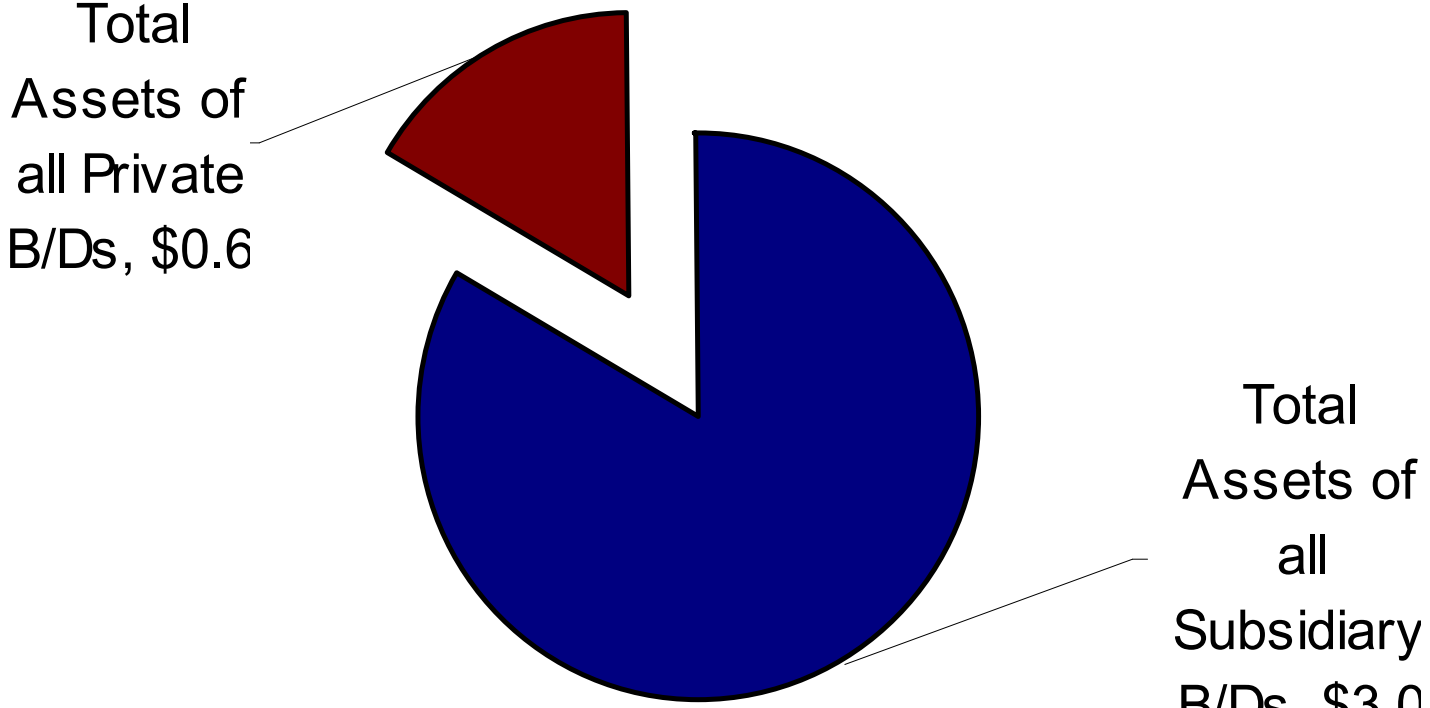
... But Most Assets are in B/D Subsidiaries of Public Issuers

Exhibit 2: B/D Total Assets by Type of B/D
($ trillion)



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Broker-Dealer Auditors

Firm	Total B/D Opinions	% of Total	B/D Total Assets ($MM)	% of Total	Average B/D Size ($MM)
Ernst & Young LLP	217	4.5	505,289	13.9	2,329
PricewaterhouseCoopers LLP	205	4.3	1,522,665	41.8	7,428
KPMG LLP	199	4.1	1,041,042	28.5	5,231
Deloitte & Touche LLP	171	3.6	480,622	13.2	2,811
Subtotal Big 4	**792**	**16.5**	**3,549,618**	**97.3**	**4,482**
BDO Seidman LLP	34	0.7	4,822	0.1	142
Crowe Horwath LLP	17	0.4	748	0.0	44
Grant Thornton LLP	44	0.9	2,145	0.1	49
McGladrey & Pullen LLP	122	2.5	50,973	1.4	418
Subtotal Next 4	**217**	**4.5**	**58,687**	**1.6**	**270**
Subtotal Large 8	**1,009**	**21.0**	**3,608,305**	**98.9**	**3,576**
Triennial	3,776	78.7	38,616	1.1	10
International	11	0.2	7	0.0	1
Grand Total	**4,796**	**100.0**	**3,646,928**	**100.0**	**760**

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Triennial Firms by B/Ds Audited

Firm	Total B/D Opinions	% of Total	B/D Total Assets ($MM)	% of Total	Registered with PCAOB
Breard & Associates Inc CPAs	102	2.7	145	0.4	Yes
CF & Co LLP	79	2.1	172	0.4	Yes
Rothstein Kass & Company PC	75	2.0	1,423	3.7	Yes
Fulvio & Associates LLP	70	1.9	399	1.0	Yes
Lerner & Sipkin CPAs LLP	53	1.4	181	0.5	Yes
Rubio CPA PC	51	1.4	35	0.1	Yes
Dunleavy & Company PC	49	1.3	193	0.5	Yes
Spicer Jeffries LLP	48	1.3	74	0.2	Yes
Ryan & Juraska	42	1.1	8,842	22.9	Yes
Citrin Cooperman & Company LLP	40	1.1	987	2.6	Yes
Eisner LLP	37	1.0	4,833	12.5	Yes
Weiser LLP	36	1.0	2,540	6.6	Yes
Phillip V George PLLC	30	0.8	11	0.0	Yes
Elizabeth Tractenberg CPA	29	0.8	14	0.0	Yes
JH Cohn LLP	26	0.7	139	0.4	Yes
Joseph Yafeh CPA	26	0.7	11	0.0	Yes
Brace & Associates PLLC	25	0.7	38	0.1	Yes
Brian W Anson CPA	25	0.7	35	0.1	Yes
Halpern & Associates LLC	25	0.7	164	0.4	Yes
Kempisty & Company CPAs PC	25	0.7	1,384	3.6	Yes
Subtotal - Firms Auditing >25 B/Ds	**893**	**23.6**	**21,619**	**56.0**	
37 Firms Auditing 10-24 B/Ds	542	14.4	7,035	18.2	
236 Firms Auditing 3-9 B/Ds	1,053	27.9	5,883	15.2	
214 Firms Auditing 2 B/Ds	428	11.3	2,786	7.2	
860 Firms Auditing 1 B/D	860	22.8	1,293	3.3	
Grand Total	**3,776**	**100.0**	**38,616**	**100.0**	

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Risk Assessment

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Office of Research and Analysis

- Business Intelligence
  - Data for surveillance and reporting
  - Quant model
  - Peer-reviewed research
- Surveillance
  - IRA (Internal Risk Application)
  - Monitor
  - International
- Risk Policy
  - Strategy
  - Standards
  - Quality control

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PCAOB Surveillance Programs

- Internal Risk Application (IRA)
- Quantitative Model

- Both are dynamic, evolving applications

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IRA

- Sourced from firm profiles maintained in the ORA Enterprise Data Warehouse
- 100+ scored screen components
- Scoring options allow the application to be "aimed" at specific industries or issues within sectors
- Unique to triennial firms: practice dynamics
  - Engagements/resignations/dismissals/referred work

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Quantitative Model

- Produces a list of higher risk issuer audits for consideration by PCAOB Inspections
  - Uses data mining techniques
- The algorithm identifies patterns in attributes of issuers who restated in the past and looks for the same patterns in current issuers
  - The goal is to identify issuer audits with elevated risk of audit failure (companies with undetected misstatements)
  - ORA also highlights aspects of financial statements and other qualitative factors for each issuer audit that drive their presence in the high risk list
    - This enhances inspections' ability to perform a more focused inspection of the audit
- The list is rank-ordered to reflect the relative probabilities of undetected financial statement misstatements

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Performance Measurement of our Risk Assessment Approach

- Measure "negative events"
  - Restatements
  - Litigation
  - SEC investigations
- Model back testing
- PCAOB inspection comments

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Historical Performance – All Selections

	2007	2008	2009	Totals
Issuer-Audits Inspected	437	347	371	1155
Issuer-Audits Inspected w/ Negative Events - Expanded Observation Period	105	58	42	205
Negative Event Rate for Issuer-Audits Inspected - Expanded Observation Period	24.0%	16.7%	11.3%	17.7%
Large 8 Negative Event Rate	8.3%	5.2%	4.5%	6.1%

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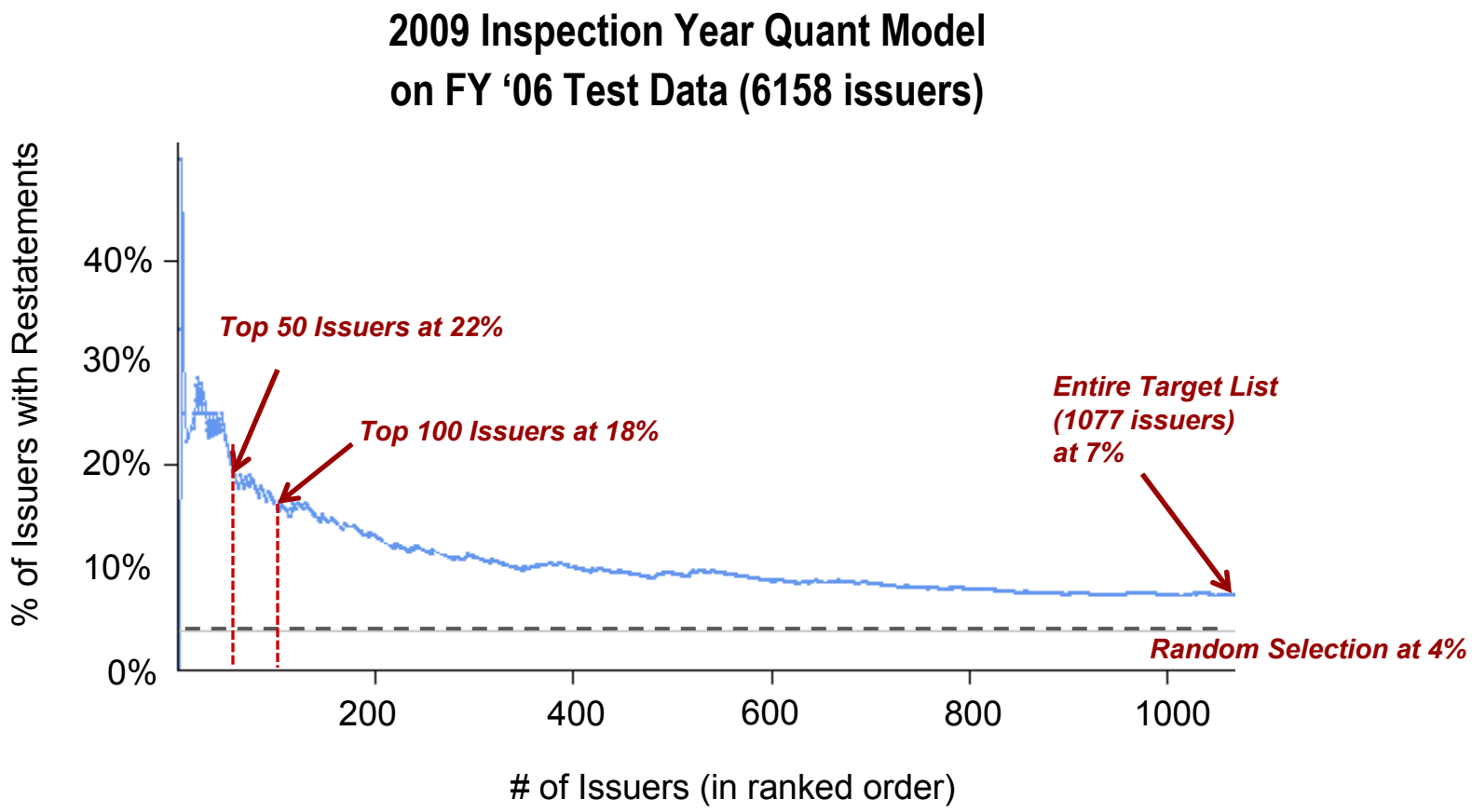
2009 Quant Model Back-Testing



Hit rate (% of correctly flagged misstaters) declines with lower rank in the target list (backtested on 2006 data)

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Impact Assessment: Peer-Reviewed Research

- We are interested in assessing the impact of our activities
- We examine the impact of PCAOB inspections on client turnover at triennial firms during the First Cycle
  - Paper is currently undergoing academic peer review
- In particular, do firms with inspections findings:
  - Resign from more clients?
  - Be dismissed from more clients?
  - Gain more new clients?
- We have access to non-public inspections data and are also able to include the Part II findings in our analysis

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Results

- Deficient PCAOB inspections' reports were significantly associated with the firms' decision to resign from issuer audits
  - Could be explained by reputational/compliance concerns
  - May have been trying to avoid comments in future inspections by resigning from "risky" audits

- PCAOB inspections' reports do not seem to be correlated with issuers' decisions to dismiss their auditors
  - However, a publicly available measure of audit quality, partner-to-staff ratio, was correlated with dismissals

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Results

- Firms that received at least one public ("Part 1") comment were more likely to receive new issuer-audits in the period following it

- We have some indication that there was a demand for firms that were perceived to provide lower quality audits
  - It could be the case that there was a demand for lower cost audits and that there might be a correlation between audit fees and audit quality

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Emerging Risks

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Macro Backdrop Drives Risk Assessment

- 2007-2008: Banking crisis + deflation + recession
- Governments around the world acted
  - Swiftly,
  - Creatively and
  - In a coordinated fashion
- Strong monetary and fiscal stimuli

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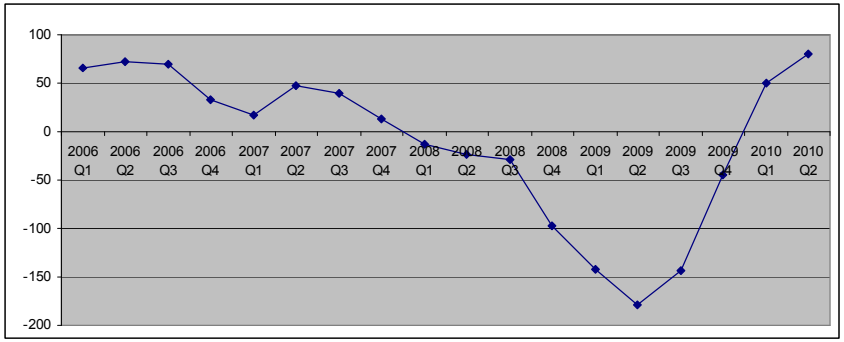
Effects of Strong Measures

Rebound in risky assets...
(S&P 500)

More stable housing market...
(Case-Shiller Housing Index)

2005	**14.5%**
2006	**0.4%**
2007	**-8.6%**
2008	**-16.7%**
2009	**-0.3%**
YTD Q2 2010	**2.3%**

Bounce in inventory cycle...
(change in private inventories)



... Out of recession by June 2009

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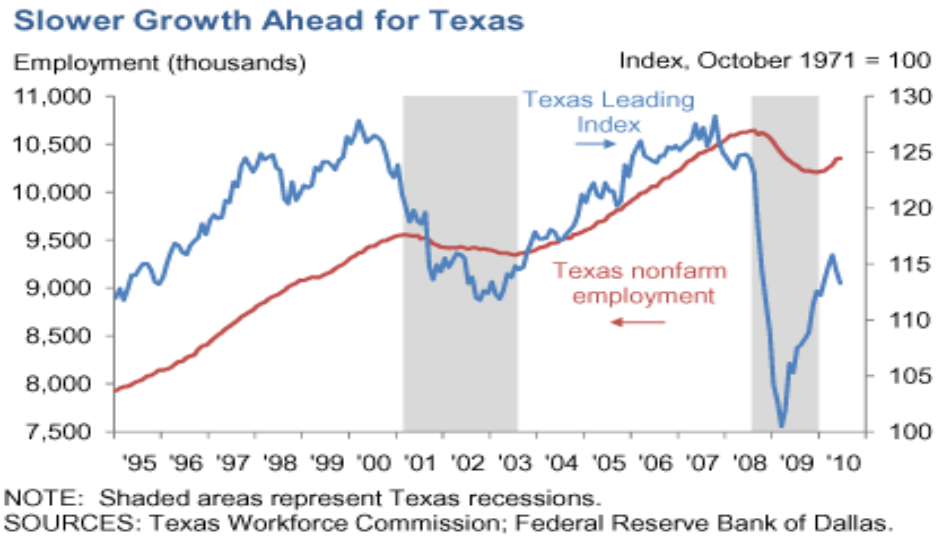
Regional Economic Outlook: Texas Expands, Maybe at a Slower Pace

- Texas Leading Index (Dallas Fed's composite of leading indicators)
  - April 2010: two-year high
  - Fell 1.2% in May and 0.9% in June
    - The trend suggests somewhat slower growth is on the horizon
    - Uncertainty seems to be a large factor in businesses' less-optimistic outlooks
- Employment:
  - June 2010: annualized growth of 0.8%
    - This is a sizeable slowdown from May's annualized growth of 7.5 %
    - However, May's figure was driven in part by Census hiring
  - Private employment fared better, up 2.1% pace in June 2010
    - Compared with over 3% the previous three months



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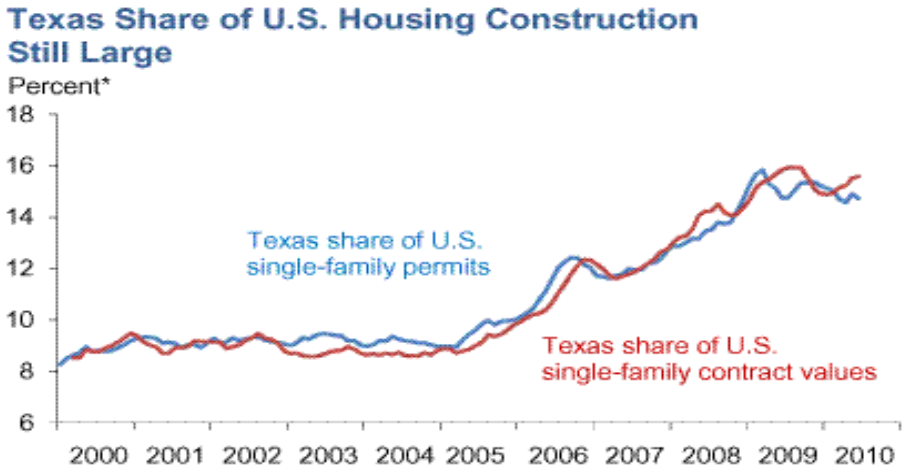
Regional Economic Outlook: Texas Housing Market

- More stable during last two years
- Weakened after homebuyer tax credits expired in April of 2010
  - Tax credits may have helped to prop up housing prices, at least in the short term
- Month-over-month existing-home sales fell 11% in June 2010
  - But remain 10% above a year ago



*Seasonally adjusted.
NOTE: Series smoothed using five-week moving average.
SOURCES: Census Bureau; F.W. Dodge; calculations and adjustments by the Federal Reserve Bank of Dallas.

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Baseline Scenario: Multispeed Recovery

- Weak but stable real estate market
- Deflation risk
- High and "sticky" unemployment

2010 GDP Projection (IMF)	
US	3.3%
Euro zone	1.0%
Japan	2.4%
China	10.5%
Emerging	6.8%
World	4.6%

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Baseline Scenario: Key Drivers

- Lower consumption
  - Weak consumer discretionary spending
- Government policy
  - Fed rates near zero
    - QE2
  - Need for fiscal stimulus?
    - Political constraints
    - Fiscal challenges (high fiscal deficit)
- Financial institutions fixing their balance sheets
  - Positive yield curve
  - Lending slow but gradually ramping up
  - Less reliance on short-term financing
- Small businesses struggling
  - High unemployment
- Increasing M&A activity
  - “Creative destruction”

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Short Term vs. Long Term

- Short term...
  - Deflation worries
  - Low economic growth & some risk of recession
  - Need to stimulate spending (limited room to raise taxes)
  - Relatively strong dollar (flight to safety)
- Long term...
  - Deleveraging
  - Inflation concerns
  - Higher taxes
  - Need to save more
  - Lower dollar
- Will transition be smooth or rough?
  - Risk Scenario: “Rough transitions”
    - From spending to savings (US) and vice versa (China)
    - From deflation to inflation
    - From fiscal deficit to surplus
    - “Bond vigilantes are back”: Interest rates up, dollar down
    - Increased volatility

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Alternative Scenarios

1. Scenario: *"Greek tragedy"*
   - Spillovers from Euro sovereign debt crisis
   - European bank troubles
   - Implications for the US economy
     - Exports
     - Credit crisis
     - The dollar
2. Scenario: *"Mall Blues"*
   - Commercial and/or Housing Real Estate worsening
3. Scenario: *"Turning Japanese"*
4. Scenario: *"This too shall pass"*
   - We grow out of our problems
     - So far the economy has done better than most pundits expected
     - Consumers have been more resilient than expected
   - Government is getting very cheap financing
   - Corporations have a lot of cash to spend
   - Banks may start lending

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Other Emerging Risks: GAAP "Tsunami"

- Modifications to the accounting rules have added significant new discretion to the model
  - Consolidations
  - Transfers and servicing
  - Fair value
  - Revenue recognition
  - More to come
- Convergence moving forward in 11 separate projects
- "Principles" or rules with increasing optionality?
  - ASC 860 and the SFAS 140 notion of "control."
    - Repo 105s,
    - On-balance sheet securitizations
- The importance of disclosure

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Questions?

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Update on Standard-Setting Activities

Keith Wilson
Office of the Chief Auditor
November 2, 2010
Dallas, TX

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What We Will Cover

- Recent Board Actions
  - Auditing Standard No. 7, *Engagement Quality Review*
  - Auditing Standards Nos. 8-15, *The Auditor's Assessment of and Response to Risk*
  - Proposed Auditing Standard, *Communications with Audit Committees*
  - Proposed Auditing Standard, *Confirmation*
  - Solicitation of Comments on Rulemaking Concepts, *Failure to Supervise*
- Guidance
  - Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*
  - Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm*
- Other Standard-Setting Activities
- Standing Advisory Group

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Auditing Standard No. 7

Engagement Quality Review

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AS No. 7 – *Engagement Quality Review*

- Supersedes existing requirements for concurring reviews (former SEC Practice Section requirement §1000.08(f) and Appendix E)
- Applies to all registered firms
  - Firms that were not members of the AICPA SEC Practice Section as of April 16, 2003 were not required to perform concurring reviews
  - Under AS No. 7, all registered firms conducting audits in accordance with PCAOB standards are required to perform an EQR
- Available through PCAOB website at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_7.aspx

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AS No. 7 – *Engagement Quality Review*

- Requires EQR for audits and interim reviews conducted pursuant to the standards of the PCAOB (AS 7.1)
  - Tailored requirements for the EQR of audits (AS 7.9-.13) and the EQR of interim reviews (AS 7.14-.18)
- Requires concurring approval of issuance prior to granting permission to the client to use the engagement report (AS 7.13, and .18)

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AS No. 7 – *Engagement Quality Review*

- AS No. 7 is applicable for both the EQR of audits and the EQR of interim reviews for fiscal years beginning on or after December 15, 2009
  - Calendar year-end companies
    - Interim reviews for March 31, 2010
    - Audits for December 31, 2010
  - June 30 year-end companies
    - Interim reviews for September 30, 2010
    - Audits for June 30, 2011

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

- Staff Q&A issued on February 19, 2010
- Addresses one question –
  - Question – Does the standard require documentation of all of the interactions between the EQR and the engagement team, including all of the interactions before a matter is identified as a significant engagement deficiency?
  - Answer – No. The example on page 21 of the adopting release illustrates how the documentation requirements of AS No. 7 should be applied once a reviewer concludes that a significant engagement deficiency exists.
- Available through PCAOB website at http://pcaobus.org/Standards/QandA/2010-02-19_EQR_QA%20_2.pdf

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Auditing Standards Nos. 8-15

The Auditor's Assessment of and Response to Risk

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Risk Assessment Standards Overview

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*
- Auditing Standard No. 15, *Audit Evidence*

http://pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx

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Risk Assessment Standards Overview

- Covers the entire audit process from initial planning activities to forming the opinions to be expressed in the auditor's report.
- Applies to both integrated audits and audits of financial statements only.
- Is effective for audits of fiscal years beginning on or after December 15, 2010, if approved by the SEC.

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Enhancements to Risk Assessments and Responses

- Establishes a process for obtaining evidence to support the auditor's risk assessments.
- Strengthens the requirements linking audit tests to the assessed risks.
- Promotes a more comprehensive evaluation of evidence obtained during the audit.
- Integrates fraud considerations into the core audit process.
- Focuses more audit attention on financial statement disclosures.

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Auditing Standard No. 8, *Audit Risk*

- Describes audit risk and the relationship among the various components of the audit risk.
- Discusses risk of material misstatement:
  - At the financial statement level.
  - At the assertion level.
- Emphasizes the importance of performing substantive procedures to reduce detection risk to an appropriately low level.

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Auditing Standard No. 9, *Audit Planning*

- Describes the auditor's responsibilities for properly planning the audit, including determining the audit strategy and audit plan.
- Requires an evaluation of the importance of certain matters to the company's financial statements and internal controls over financial reporting (ICFR) and their effect on the audit procedures.
- In multi-location engagements, establishes requirements for selecting locations for testing and determining the procedures to be performed based on the risk associated with the location.
- Requires the auditor to determine whether persons with specialized skill and knowledge are needed and, if so, the knowledge of the subject matter that the auditor needs.

Auditing Standard No.10, *Supervision of the Audit Engagement*

- Sets forth requirements for supervision of the audit engagement, especially the work of engagement team members.
- Describes responsibilities of the engagement partner and others who assist the engagement partner with supervision.
- Sets forth the nature and extent of supervisory activities necessary for proper supervision.
  - For example, the extent of supervision should be commensurate with the risk of material misstatement.

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Auditing Standard No.11, *Consideration of Materiality in Planning and Performing an Audit*

- Uses the concept of materiality that currently applies under the federal securities laws, which reflects a reasonable investor's perspective.
- Requires the auditor to:
  - Establish an appropriate materiality level for the financial statements as a whole.
  - Establish lower materiality levels for particular accounts and disclosures when misstatements of lesser amounts are likely to influence the judgment of a reasonable investor.
  - Determine tolerable misstatement at the account and disclosure level and, in multi-location engagements, for individual locations.
  - Reevaluate materiality level(s) when necessary based on circumstances or additional information.

Auditing Standard No.12, *Identifying and Assessing Risks of Material Misstatement*

- Establishes a process that prompts the auditor to "connect the dots" to identify and appropriately analyze the risks of error or fraud in the financial statements.
- Designed to be scalable based on the size and complexity of the company.
- Requires the auditor to obtain sufficient evidence that provides a reasonable basis for his or her assessments
- Includes procedures for identifying and assessing fraud risks.
- Includes new requirements related to forming expectations about disclosures and considering risks of omitted, incomplete, or inaccurate disclosures.

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Auditing Standard No.12, *Identifying and Assessing Risks of Material Misstatement*

- Risk assessment procedures include:
  - Obtaining an understanding of the company and its environment.
  - Obtaining an understanding of ICFR.
  - Considering information from client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company.
  - Performing analytical procedures.
  - Conducting a discussion among engagement team members regarding risks of material misstatement.
  - Inquiring of the audit committee, management, and others within the company about risks of material misstatement.

Auditing Standard No.12, *Identifying and Assessing Risks of Material Misstatement*

- Risk assessment involves:
  - Assessment of the risks of material misstatement due to error or fraud at the financial statement level and assertion level, including consideration of fraud risk factors.
  - Identification of significant accounts and disclosures and their relevant assertions.
  - Identification of significant risks, including fraud risks.

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Auditing Standard No.13, *The Auditor's Responses to the Risks of Material Misstatement*

- Requires the auditors to respond to risks of material misstatement due to error or fraud through:
  - Overall responses.
  - Responses involving the nature, timing, and extent of audit procedures.

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Auditing Standard No.13, *The Auditor's Responses to the Risks of Material Misstatement*

- Tests of controls
  - Required only when auditor plans to assess control risk below the maximum, except in certain specified situations.
  - More evidence is needed the greater the degree of reliance on controls.
  - Must obtain evidence for the entire period of reliance.
- Substantive procedures
  - Required for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.
  - The higher the risk, the more evidence is needed from substantive procedures.

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Auditing Standard No.13, *The Auditor's Responses to the Risks of Material Misstatement*

- Required responses to significant risks, including fraud risks, include:
  - Audit procedures that that are specifically responsive to the risks.
  - Substantive procedures that include tests of details.

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Auditing Standard No. 14, *Evaluating Audit Results*

- Describes the auditor's responsibilities regarding the process of:
  - evaluating the results of the audit to form the opinion on the financial statements, and
  - determining whether sufficient appropriate audit evidence has been obtained.

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Auditing Standard No. 14, *Evaluating Audit Results*

- The standard covers evaluation of:
  - The results of analytical procedures performed in the overall review of the financial statements.
  - Misstatements accumulated during the audit, including, in particular, uncorrected misstatements.
  - The qualitative aspects of the company's accounting practices.
  - Conditions identified during the audit that relate to the assessment of fraud risk.
  - The presentation of the financial statements, including the disclosures.
  - The sufficiency and appropriateness of the audit evidence obtained

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Auditing Standard No. 14, *Evaluating Audit Results*

- Examples of new or enhanced requirements include:
  - Special considerations for misstatements related to accounting estimates.
  - Expanded discussion of evaluating potential management bias in the amounts and disclosures in the financial statements.
  - Additional procedures regarding offsetting adjustments identified by management.

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Auditing Standard No. 15, *Audit Evidence*

- Describes what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.
- Discusses the concepts of sufficiency, appropriateness, relevance, and reliability of audit evidence.
- Discusses the auditor's responsibilities for selecting items for testing.

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Examples of Amendments to Existing PCAOB Standards

- AS No. 3, *Audit Documentation* – Among other things, requires a summary of identified risks, the assessment of those risks, and the auditor's responses to those risks, including linkage of the responses to the risks.
- AU sec. 329, *Substantive Analytical Procedures* – Amended standard discusses only analytical procedures performed as substantive procedures.
- AU sec. 350, *Audit Sampling* – Along with other conforming changes, expands the direction regarding determination of sample sizes when non-statistical sampling approaches are used.

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Examples of Amendments to Existing PCAOB Standards

- AU sec. 336, *Using the Work of Specialists* – Amended to specify that AS No. 10 applies to specialists employed by the firm and to situations in which persons with specialized skills in accounting and auditing participate in the audit.
- AU sec. 543, *Part of Audit Performed by Other Independent Auditors* – Amended to specify that AS No. 10 applies to situations not covered by AU sec. 543 in which other accounting firms or other accountants participate in the audit.
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* – Added a "roadmap" that references other standards containing requirements regarding the auditor's consideration of fraud.
  - Important principles regarding auditor's responsibility for fraud and more detailed requirements regarding the auditor's response to fraud risks remain in AU sec. 316.

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Proposed Auditing Standard

Communications With Audit Committees

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Communications With Audit Committees

- Board issued proposed standard on March 29, 2010; comment period ended on May 28, 2010
- Board held Roundtable on September 21, 2010; comment period extended to October 21, 2010
- Proposed standard available at http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket030.aspx
- Primary objectives of the proposed standard are to:
  - Enhance the relevance and effectiveness of communications between the auditor and the audit committee
  - Emphasize the importance of effective, two-way communications between the auditor and the audit committee

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Proposed Auditing Standard
Confirmation

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Confirmation

- Board issued proposed standard on July 13, 2010; comment period ended on September 13, 2010
- Proposed standard available at http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx
- Primary objective of the auditor is to:
  - Obtain relevant and reliable audit evidence when designing and performing confirmation procedures

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Solicitation of Comments on Rulemaking Concepts
Failure to Supervise

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Failure to Supervise

- On August 5, 2010, Board issued a concept release to solicit comment on possible rulemaking approaches to complement application of Section 105(c)(6), *Failure to Supervise*; comment period ends on November 3, 2010.
- Release available at http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket031.aspx
- Possible approaches to rulemaking:
  - Formulate a rule that in general terms requires assignment of responsibility and documentation of that assignment
  - Formulate a rule that identifies and defines various specific areas of supervisory responsibility and requires firms to assign responsibility in each area to specific individuals.

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Staff Audit Practice Alert No. 5

Auditor Considerations Regarding Significant Unusual Transactions

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Staff Audit Practice Alert No. 5

- Issued April 7, 2010
- The Alert reminds auditors of their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions
- Responsibilities described in the Alert include –
  - Identifying and assessing risks of material misstatement
  - Responding to risks of material misstatement
  - Consulting others
  - Evaluating financial statement presentation and disclosure
  - Communicating with audit committees
  - Reviewing interim financial information
- Available through PCAOB website at http://pcaobus.org/Standards/Pages/Guidance.aspx

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Staff Audit Practice Alert No. 6

Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm

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Staff Audit Practice Alert No. 6

- Issued July 12, 2010
- The practice alert reminds registered firms of their obligations when using the work of other firms or using assistants engaged from outside the firm.
  - Describes the circumstances under which the firm issuing the audit report may use the work and reports of another auditor.
  - Auditors who engage assistants from outside the firm are governed by the same standards regarding planning the audit and supervising assistants that apply when audit work is performed by assistants who are partners of, or employed by, the auditor's firm.
- Available through PCAOB website at http://pcaobus.org/Standards/Pages/Guidance.aspx

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Other Standard-Setting Activities

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Other Standard-Setting Activities*

- Requiring the Engagement Partner to Sign the Audit Report **(Concept Release issued July 28, 2009)**
- Application of the Sarbanes-Oxley Act's Provision on "Failure to Supervise" **(Concept Release issued August 5, 2010)**
- Related Parties
- Specialists
- Fair Value Measurements and Other Accounting Estimates

* Activities subject to change based on emerging issues

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Other Standard-Setting Activities*

- Principal Auditor
- Quality Controls Standards, Including SEC Practice Section Requirements
- Going Concern
- Subsequent Events
- Auditor's Reporting Model
- Audits of Broker-Dealers
- Attestation Reports under Regulation AB

* Activities subject to change based on emerging issues

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Standing Advisory Group

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Standing Advisory Group

- The Board looks to the SAG to provide *advice* and *insight* as to the need to formulate new standards or change existing standards
- Meets two to three times a year
  - April 7-8, 2010 meeting
    - Discussed Principal Auditor, Auditor's Reporting Model
  - July 15, 2010
    - Discussed Broker-Dealer Audit Considerations, FASB/IASB Projects and Potential Impact on Auditors
  - October 14-15, 2010
    - Discussed Quality Controls, FASB/IASB Projects and Potential Impact on Auditors, Failure to Supervise
  - All previous SAG meeting agendas, briefing papers, and webcasts are located at http://.pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx
- Board seeks nominations annually

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Keeping Current with Standard-Related Activities

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Keeping Current with Standard-Related Activities

- Our Web site – http://www.pcaobus.org/Standards/Pages/default.aspx
  - PCAOB standards and related rules, including interim standards
  - PCAOB proposed standards
  - Staff Questions and Answers
  - Staff Audit Practice Alerts
  - Standing Advisory Group
- Contact us at info@pcaobus.org
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our Web site at

  http://pcaobus.org/About/Pages/Subscribe.aspx

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Questions?

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Break

(15 minutes)

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Auditing Internal Controls and IT Control Issues in Smaller Public Companies

Bill Powers and Greg Wilson
Division of Registration and Inspections
November 2, 2010
Dallas, TX

Discussion Topics

- Auditors' Responsibility related to Internal Controls
- Auditing Internal Controls and IT Control Issues
  - What AS No. 5 says
  - Guidance for Auditors of Smaller Public Companies
    - IT control risks and IT controls
  - Experiences to-date
- Summary and Conclusion

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Auditors' Responsibility Related to Internal Control

- Second Standard of Field Work (AU 150)
  - "A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed." (AU 150.02)
- AU 319 *"Consideration of Internal Control in a Financial Statement Audit"*
  - Provides guidance about the auditor's consideration of internal control in an audit of financial statements in accordance with generally accepted auditing standards.

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Auditors' Responsibility Related to Internal Control

- AS No. 5
  - "…the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment." (Para 3, AS No. 5)

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Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says
  - Planning the Audit
    - Opinions on the financial statements and internal control over financial reporting
      - Although objectives of both audits are not identical, the auditor must plan and perform the work to achieve the objectives of both audits (i.e. integrated audit).
    - Risk assessment underlies entire audit process
    - Scaling the audit
    - Assessing the risk of fraud
    - Using the work of others

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Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says (Cont'd)
  - Top Down Approach
    - Start at financial statement level
    - Focus on risk of material misstatement
    - Identify entity level controls (ELCs)
    - Identify significant accounts and disclosures and relevant assertions
    - Understand likely sources of misstatement

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Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says (Cont'd)
  - Testing Controls
    - Test controls important to the auditor's conclusion
    - Test design effectiveness
    - Test operating effectiveness
    - Evidence to support design and operating effectiveness
    - Nature, timing and extent of tests of controls
    - Special considerations in subsequent years

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Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says (Cont'd)
  - "…auditor also should understand how IT affects the company's flow of transactions." (Para 36, AS No. 5)
  - Auditor should apply AU sec. 319
  - Internal Control
    - IT General Controls
    - Application Controls

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Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says (Cont'd)
  - Evaluating Identified Control Deficiencies
    - Evaluate individually or in combination
    - Audit not required to search for deficiencies less severe than material weaknesses
    - **Severity does not depend on misstatement occurring**
    - BUT, on reasonable possibility of a misstatement
    - Compensating controls should be evaluated and tested when considering a material weakness

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Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says (Cont'd)
  - Wrapping Up
    - Forming an opinion
    - Obtaining written representations
    - Communication to management and the audit committee

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Auditing Internal Controls and IT Control Issues

- What AS No. 5 Says (Cont'd)
  - Reporting on Internal Control
    - Separate or combined reports permissible
    - Report date
    - Material weaknesses
    - Subsequent events

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Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies
  - Staff Views – *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*
  - Published on January 23, 2009
  - The guidance explains how auditors can apply the principles in AS No. 5 to audits of smaller, less complex public companies

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Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
  - Evaluating Entity-Level Controls
    - Auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective ICFR
    - Auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
  - Assessing Risk of Management Override
    - Additional opportunities of override exist because
      - Senior management is extensively involved in operations
      - There are fewer levels of management
    - Controls that might address risk of management override
      - Maintaining integrity and ethical values
      - Monitoring of controls over journal entries
      - Increased oversight by audit committee
      - Whistleblower program

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
  - Evaluating Segregation of Duties and Alternative Controls
    - Fewer employees – therefore limited opportunities to segregate duties
    - Auditor can evaluate involvement of external parties
    - Auditor can evaluate alternative controls, including
      - Management review
      - Management oversight
      - ELC

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
  - Auditing Information Technology
    - Possible characteristics
      - Off-the-shelf software commonly used
      - Few users and few dedicated IT personnel
      - DOD issues with Security Administration
      - End-user computing prevalent
      - IT-generated reports used in manual controls
      - Reliance on Service Organizations
    - Will discuss few IT control risks and IT controls

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Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls
  - Security Administration/Segregation of Duties
    - Security administration performed by financial executive.
    - Not enough people to achieve adequate segregation of duties.

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Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
  - Security Administration/Segregation of Duties
    - Periodic independent review of "user ID provisioning" process.
    - Periodic independent review of segregation of duties.
    - Frequency dependent upon results of periodic reviews.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
  - End-user computing
    - Data/formulas on spreadsheets used in financial reporting may not be secured.
    - Interfaces from financial process systems to end-user computing systems for financial reporting may not be complete/accurate.
    - Queries used in financial reporting process may be incorrect.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
  - End-user computing
    - Evaluate locking scheme over formula cells.
    - Evaluate access controls over spread sheets (secured server?)
    - Evaluate end-to-end controls over critical systems interfaces.
    - Evaluate change management process over query development and changes.

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Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
  - Using reports produced by computer systems
    - Reports used for audit procedures produced by computer systems may contain data that is not complete and/or accurate.

Auditing Internal Controls and IT Control Issues

- IT Control Risks and IT Controls (cont'd)
  - Using reports produced by computer systems.
    - Identify key reports used in audit procedures (control procedures/substantive procedures).
    - Either test IT general controls and application controls over data that flows into those reports --- or ---
    - Substantively test a sample of transactions from the report to the source.

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
  - Considering Financial Reporting Competencies
    - Smaller companies may use outside professionals because of the lack of internal expertise
    - Auditor should consider management oversight over the work of outside professionals
      - Who evaluates the professional qualifications
      - Who makes key judgments
      - What controls exist over their work

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
  - Obtaining Sufficient Competent Evidence When the Company has Less Formal Documentation
    - Depending on risk, inquiry combined with other procedures might provide sufficient evidence of control effectiveness
    - Consider using walkthroughs to understand the flow of transactions if management documentation is limited
    - Consider other documentation of processes and controls e.g., what company uses to run its business

Auditing Internal Controls and IT Control Issues

- Guidance for Auditors of Smaller Public Companies (Cont'd)
  - Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies
    - Pervasive deficiencies may adversely affect other controls, but pervasive deficiencies do not necessarily prevent an auditor from expressing an opinion on ICFR
    - Even if auditor cannot express an opinion on ICFR, he or she might be able to opine on financial statements

Experiences to-date

- 2010 Triennially Inspected Firms with Accelerated Filers
  - Fourteen issuers inspected
  - Six ICFR/controls related comment forms
  - Fifteen instances of highly effective implementation of aspects of AS No. 5
  - Seventeen instances of less than effective implementation of aspects of AS No. 5

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Experiences to-date

- 2010 Triennially Inspected Firms with Accelerated Filers
  - Aspects of highly effective implementation
    - Nature, timing and extent of tests of controls
    - Use of work of others including evaluation of competency and objectivity
    - Risk assessment and entity level controls

Experiences to-date

- 2010 Triennially Inspected Firms with Accelerated Filers
  - Aspects of less than effective implementation
    - Risk assessment
    - Nature, timing and extent of tests of controls
    - Evaluating and reporting deficiencies

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Summary and Conclusion

- Auditors have always had responsibility related to internal controls; AS No. 5 builds on that.
- ICFR has "stabilized" with the issuance of AS No. 5; many concepts from AS No. 5 can be used for audits of non-accelerated filers or non-issuers.
- AS No. 5 is a top-down risk-based approach that is scalable to smaller public companies.

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Summary and Conclusion

- IT general controls are a "pervasive" part of internal control and have a relationship to ICFR audits and financial statement audits.
- Auditors should consider IT risks are present in less complex IT environments.
- Inspections conducted in 2010 indicate that triennially inspected firms have successfully transitioned to AS No. 5 --- with some areas to continue to focus on.

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Questions?

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Lunch

(60 minutes)

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Case Studies on Auditing in the Small Business Environment

Presenters

- Desmond Mills, Associate Director, Accountant, Division of Enforcement and Investigations
- Alan Skinner, Associate Director, Inspections, Division of Registration and Inspections

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Agenda

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

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Summary of Domestic Small Firm Program

- Conducted 1,065 domestic small firm inspections between 2004 and 2009
  - Inspected over 2,900 issuer audits between 2004 and 2009
- To date, over 960 domestic small firm inspection reports have been issued final
- Issued "Report on the PCAOB's 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms" (October 22, 2007)

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Common Inspection Observations

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

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Overview of the Division of Enforcement and Investigations

- Who we are
- Our role within the PCAOB
- Differences between an Inspection and an Investigation
- Disciplinary Actions
- Common threads in Disciplinary Orders

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Case Studies on Auditing in the Small Business Environment

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

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Restrictions on Use

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

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Case Study #1 – Game Distribution, Inc. Background

- Your Firm has been engaged to audit the December 31, 2009 financial statements of Game Distribution, Inc.
- Game sells and distributes games to retailers
- During 2009, Game acquired Up-and-Coming Game Distribution, Inc. ("Little Game") in a business combination
- Stock issued as consideration for the acquisition was valued for accounting purposes based on the $5 per share agreement-date price, although the acquisition-date price was $6 per share
- Game primarily wanted Little Game's valuable trademarks and customer relationships

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Case Study #1 – Game Distribution, Inc. Background

- Purchase agreement includes contingent consideration to be paid to Little Game's former shareholder based on earnings for the two-year period following the acquisition date
- Game recorded the contingent consideration at its acquisition-date fair value
- Game engaged a specialist to assist in valuing the trademarks acquired
- Game recorded the trademarks as intangible assets based on the specialist's valuation report
- All other tangible assets acquired and liabilities assumed were recorded at their acquisition-date fair values
- Unallocated purchase price was recorded as goodwill

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Case Study #1 – Game Distribution, Inc. Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test the purchase price allocation and the fair values assigned to assets and liabilities*
- The audit procedures performed by the engagement team included -
  - Obtained and scanned a copy of the purchase agreement
  - Obtained and reviewed a copy of the specialist's report
  - Relied upon the expertise of the specialist and assessed methods and assumptions used as reasonable
  - Obtained management's representations that the purchase price allocation and related fair values assigned were appropriate

Consideration Transferred (ASC 805)

ASC 805-30-30-7 [FAS 141R paragraph 39] states that the consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer.

Customer Relationships (ASC 805)

- ASC 805-10-20 [FAS 141R paragraph 3k] states that an asset is *identifiable* if it either arises from contractual rights or is separable
- ASC 805-20-55-23 [FAS 141R paragraph A39] states that if an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights.
- ASC 805-20-55-27 [FAS 141R paragraph A42] states that a customer relationship acquired in a business combination that does not arise from a contract may nevertheless be identifiable because the relationship is separable.

Contingent Consideration (ASC 805)

ASC 805-10-55-25 [FAS 141R paragraph A87] states that if it is not clear whether payments to selling shareholders are part of the business combination, the acquirer should consider the following indicators (as well as others not listed):

- continuing employment
- duration of continuing employment

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Use of the Work of a Specialist (AU 336.12)

The auditor should -

- Obtain an understanding of the methods and assumptions used by the specialist
- Make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and
- Evaluate whether the specialist's findings support the related assertions in the financial statements

Case Study #2 – Turtle Telecom, Inc. Background

- Your Firm has been engaged to audit the December 31, 2009 financial statements of Turtle Telecom, Inc.
  - This will be your firm's first audit of the company
- Turtle has annual grants of "plain vanilla" stock options for which it estimates fair value using the Black-Scholes-Merton formula
- Historical volatility is used to estimate expected volatility of stock price
  - Future volatility is not expected to differ from past
  - The options are not traded thus no implied volatility
  - Turtle has been a thinly-traded public company for 20 years with no periods of extreme volatility in stock price
- Expected volatility set at 20% based on high and low stock prices for each quarter over past two years

Case Study #2 – Turtle Telecom, Inc. Scenario

- *You, the review partner, have arrived at the client site to review the work performed by the engagement team to test stock option valuation*
- The audit procedures performed by the engagement team included –
  - Evaluated consistency of process used
  - Evaluated engagement team skills and knowledge
  - Evaluated reasonableness of valuation model used
  - Evaluated reasonableness of assumptions used, including:
    - Determined that the 20 % expected volatility is based on quarterly highs and lows for past two years
  - Verified accuracy and completeness of underlying data
  - Obtained management's representation that option value was computed in accordance with GAAP

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Share-Based Payment Guidance

- PCAOB Staff Questions and Answers: *Auditing the Fair Value of Share Options Granted to Employees* (October 17, 2006):
  - A7 states that the expected term and expected volatility assumptions have the highest risk because they involve the greatest amounts of judgment and have a significant effect on the estimated fair value.

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Share-Based Payment Guidance

- SEC Staff Accounting Bulletin No. 107, section D.1. Question 4 states that exclusive use of historical volatility is acceptable when:
  - No reason to believe future volatility over expected term is likely to differ from past;
  - Computation of historical volatility uses simple average;
  - Sequential period of historical data at least equal to expected term is used; and
  - Sufficient number of price observations is used.

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Share-Based Payment Guidance

- SEC Staff Accounting Bulletin No. 107, section D.1. Question 2, item 3 states:
  - Weekly or monthly price observations are generally more appropriate than daily for thinly traded companies.
- Other applicable guidance
  - ASC Topic 718 Compensation – Stock Compensation [FASB Statement No. 123(R), *Share-Based Payment*]
  - AU Section 328, *Auditing Fair Value Measurements*
  - AU Section 342, *Auditing Accounting Estimates*

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Case Study #3 – Magic Materials, Inc. Background

- Your Firm has been engaged to audit the consolidated financial statements of Magic Materials, Inc. for the year ended December 31, 2009
- Magic has one operating subsidiary located in Brazil
  - The foreign subsidiary specializes in manufacturing and distribution of special purpose building materials
- Approximately 42% of the assets and 48% of revenue reflected in the consolidated financial statements are associated with the foreign subsidiary
- The foreign subsidiary will be audited by a foreign firm located in Brazil

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Case Study #3 – Magic Materials, Inc. Scenario 1

- During the planning phase, your Firm determined it would be able to serve as principal auditor and may use the work and report of the foreign firm
- Your Firm determined it was impracticable to travel to Brazil due to cost and time constraints
  - Instead, your Firm obtained copies of the foreign firm's work papers, all of which were in English
- The engagement team obtained a copy of the audited financial statements of the foreign subsidiary (Brazilian GAAP), including the foreign firm's auditor's report (Brazilian GAAS)
  - Your Firm does not intend to reference the foreign firm's auditor's report in its opinion on the issuer's consolidated financial statements

Case Study #3 – Magic Materials, Inc. Scenario 2 - Change in Background

- The engagement team obtained a copy of the audited financial statements of the foreign subsidiary (US GAAP), including the foreign firm's auditor's report (PCAOB Standards)

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Part of Audit Performed by Other Auditors (AU 543)

- Decision whether the auditor may serve as principal auditor and use the work and reports of other independent auditors
  - Participation must be sufficient to enable the firm to serve as the principal auditor if significant parts of the audit are performed by other auditors
- Form and content of the principal auditor's report
  - No reference is made to the other auditor's work or report if principal auditor assumes responsibility for the work of the other auditor
  - If the principal auditor assumes no responsibility for the work of the other auditor, reference should be included and should indicate clearly the division of responsibility
- Firm is responsible to perform additional procedures if the decision is made not to reference the other auditor's report

Case Study #4 – Reliable Refrigerators, Inc. Background

- Your Firm has been engaged to audit the December 31, 2009 financial statements and internal control over financial reporting of Reliable Refrigerators, Inc.
  - This will be your firm's first audit of the company
- The issuer sells refrigerators on a standalone basis and with installation services
- The issuer does not sell installation services for refrigerators bought from other vendors
- Big Red, Reliable's top selling product, is typically listed in sales invoices at a price of $900 with installation at $10 and the customer entitled to a refund of $10 if installation is unsatisfactory

Case Study #4 – Reliable Refrigerators, Inc. Background

- Reliable management asserts it is probable that installation services will be completed satisfactorily based on experience
- Other third-party retailers in the area provide installation of Big Red for approximately $50
- Reliable recognizes $900 in revenue upon delivery of Big Red and $10 in revenue upon installation

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Case Study #4 – Reliable Refrigerators, Inc. Background

- Controller approves customer orders before entered in system
- Upon installation, installation team calls accounting personnel to provide installation information
- Installation information is entered in system and must match sales information in system for installation revenue to be recognized
- CFO reviews monthly reports

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Case Study #4 – Reliable Refrigerators, Inc. Scenario 1

- *You, the engagement partner, are meeting with the audit manager to discuss the plan to audit revenue*
- The audit manager has concerns about . . .
  - Ability of Reliable's IT staff to produce special reports needed for the audit
  - Whether to test controls for the entire audit period or for just a few days around the "as of" date for the Firm's ICFR opinion – and what difference does it make anyway?
  - How to get the audit testing done in time for Reliable's press release scheduled for 3 weeks after year-end

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Case Study #4 – Reliable Refrigerators, Inc. Scenario 1

- Will you be able to resolve the audit manager's concern about the special reports needed for the audit?
- Are there other IT matters you and the audit manager should be considering during your discussion?
- How will you explain to the audit manager the differences in approaches to testing controls over revenue?
- What will you suggest your audit manager consider in planning and executing the audit to meet the tight deadline?

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Case Study #4 – Reliable Refrigerators, Inc. Scenario 2

- Your Firm is in the execution stage of its integrated audit of Reliable's financial statements and internal control over financial reporting
- You have determined that the relevant assertions of occurrence and valuation are important and should be tested
- Engagement team received data indicating fair value of installation services is $26 based on cost of service

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Case Study #4 – Reliable Refrigerators, Inc. Scenario 2

- Control procedures performed by the engagement team included –
  - Reviewed CFO's initials on monthly computer generated reports of sales, gross margins, and inventory turnover by product line
  - Reviewed Controller's signature on a random sample of 25 customer orders selected throughout the year
  - IT audit consultant performed a "test of one" over the automated application controls over matching of sales data
  - Obtained management's representation that management tested ICFR and concluded it was effective

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Case Study #4 – Reliable Refrigerators, Inc. Scenario 2

- Substantive procedures performed by the engagement team included –
  - Performed non-substantive analytical procedures
  - Selected a sample of five sales transactions before and after year end and reviewed supporting documentation
  - Selected a sample of 15 deferred revenue items and agreed to installation documents supporting proper inclusion
  - Obtained management's representation that revenue was recognized in accordance with GAAP

Revenue Recognition (ASC 605-25)

- ASC 605-25-25-5 [Paragraph 9 of EITF 00-21] states that in an arrangement with multiple deliverables, the delivered item should be considered a separate unit of accounting if all of the following criteria are met:
  - The delivered item has value to the customer on a standalone basis (i.e., it is sold separately by any vendor or the customer could resell the delivered item on a standalone basis);
  - There is objective and reliable evidence of the fair value of the undelivered item; and
  - If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor.

Revenue Recognition (ASC 605-25)

- ASC 605-25-30-7 [Paragraph 16 of EITF 00-21] states as follows:
  - Contractually stated prices for individual products or services in an arrangement with multiple deliverables should not be presumed to be representative of fair value.
  - The best evidence of fair value is the price of a deliverable when it is regularly sold on a standalone basis.
  - Fair value evidence often consists of vendor-specific objective evidence (VSOE) of fair value.
  - Third-party evidence of fair value is acceptable if VSOE of fair value is not available.
    - For example, prices of the vendor's or any competitor's largely interchangeable products or services in sales to similarly situated customers.

Revenue Recognition (ASC 605-25)

NOTE:

ASC Subtopic 605-25, Revenue Recognition – Multiple-Element Arrangements, was amended by Accounting Standard Update No. 2009-13 in October 2009. The amendments in this Update will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. Such amendments are not reflected in this case study.

Case Study #5 – Active Life, Inc. Background

- Your Firm has been engaged to audit the December 31, 2009 financial statements of Active Life, Inc.
  - This will be your firm's first audit of this issuer
- The issuer is a development stage company in retail sporting goods
- The issuer's accounting, financial reporting, and SEC reporting resources are limited

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Case Study #5 – Active Life, Inc. Background

- Scenario 1
  - Issuer prepared adjusted general ledger and footnote disclosures from which the engagement team prepared the financial statements
  - Independence issue?
- Scenario 2
  - Issuer prepared draft 10-K with incomplete stock-based compensation footnote data and asked engagement team to prepare that data for the footnote.
  - Independence issue?

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Case Study #5 – Active Life, Inc. Independence Guidance

- Regulation S-X, Rule 2-01(c)(4) Non-audit services. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:
  - (i) Bookkeeping or other services related to the accounting records or financial statements of the audit client. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements, including:
    - (A) Maintaining or preparing the audit client's accounting records;
    - (B) Preparing the audit client's financial statements that are filed with the Commission or that form the basis of financial statements filed with the Commission; or
    - (C) Preparing or originating source data underlying the audit client's financial statements.

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Questions?

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Break

(15 minutes)

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Annual and Special Reporting

Mary Sjoquist
Director, Office of Communications
November 2, 2010
Dallas, TX

Rules on Periodic Reporting by Registered Public Accounting Firms

- Adopted by PCAOB on June 10, 2008
- Approved by SEC on August 13, 2009
- Effective December 31, 2009
- Require firms to report certain information annually
- Require special reporting regarding certain specified events within 30 days of the event.
- Succeeding to the status of a predecessor entity.

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Rules on Periodic Reporting by Registered Public Accounting Firms

- Fees
  - Due by July 31 following the filing of the Annual Report
  - Exception—not registered by March 31 of the year in question
  - $100,000 for firms with 500 issuer audit clients and 10,000 personnel
  - $25,000 for firms with 200 issuer clients and 1000 personnel
  - $500 for all other firms

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

Form 2 includes –

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

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

Form 3 triggering events and disclosures include –

- Name change
- Audit reports (withdrawn a report or consent, or crossed 100 issuer threshold)
- Certain legal proceedings
- Bankruptcy
- Certain relationships
- Licenses and certifications
- Changes in the firm's Board contact person
- Catch-up Form 3s were due February 1, 2010.

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

- Adopted July 28, 2008
- Approved by SEC August 13, 2009
- Effective December 31, 2009
- Allow firms whose structure has changed to retain registration status under two scenarios:
  - A registered firm changes its legal form of organization or jurisdiction in which it operates
  - A registered firm is acquired by an unregistered firm or merges with another firm or firms to create a new legal entity

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

- The rules provide for:
  - A form to be filed (Form 4),
  - Within14 days after the event,
  - With certain representations
- Continuity of registration is automatic, without the need for Board action.
- If deadline for filing Form 4 is not met, the registration process using Form 1 will be required along with Board action.

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Confidential Treatment Requests

- **Confidential Treatment Requests are limited on new forms**
  - **Board has determined that certain information will never qualify**
  - **In practice, this means no check box is available to request confidential treatment**
- **To request confidential treatment:**
  - **Firm must represent that information is not public AND**
    - **Firm must provide a detailed explanation of how the information is proprietary OR**
    - **Firm must provide a detailed explanation of how the information is protected from public disclosure by applicable law, and must provide a publicly available citation to or a copy of the law**

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New Web-based System

- **New system replaces old registration system**
  - Access using old username and password
  - For username and password help contact registration-help@pcaobus.org
- **All forms must be filed using this new system**
  - Forms 2 and 3 can be filed using XML
  - Form 4 is a web based form only
- **Technical Specifications**
  - Minimum Requirements: IE 6.0, Firefox 2.0
  - IE 8.0 works, Firefox 3.5 does not work yet
  - Exhibits should be filed in one of three formats:
    - PDF
    - GIF
    - JPEG

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Questions?

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SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

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Agenda

- Overview of the Division of Corporation Finance
- Recent Developments
- The Comment Letter Process
- Financial Reporting Issues Frequently Raised in Comment Letters
- Resources

Overview of the Division of Corporation Finance

Overview of the Division of Corporation Finance

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

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

Organization

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

Recent Developments

Key SEC Developments

Commission Actions

- ***Dodd-Frank Act Rulemaking and Studies***
  - **SEC seeking comment on regulatory initiatives required by Dodd-Frank Act**
  - **Section 404(b) for Non-Accelerated Filers**
- ***Facilitating Shareholder Director Nominations***
- ***Proxy Disclosure Enhancements***
  - **Includes changes to presentation and measurement of executive compensation for equity awards**
- ***Commission Statement in Support of Convergence and Global Accounting Standards***
  - **Two Notices of public comment on consideration of incorporating IFRS Into the financial reporting system for U.S. issuers**
- ***Short-Term Borrowings Proposed Rule and Interpretive Release***

Key SEC Developments

Staff Initiatives

- Division of Corporation Finance Financial Reporting Manual Updates
- Corporation Finance Compliance and Disclosure Interpretations on Non-GAAP Financial Measures
  - http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm
- Sample letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets

The Comment Letter Process

Comment Letter Process

Filings Subject to Staff Review

- Selected by the DCF non-public screening criteria and Sarbanes-Oxley Section 408 requirements
- IPOs
- Other registration statements
- Annual reports
- Proxy statements
- Item 4.01 and Item 4.02 Forms 8-K

Comment Letter Process

Types of Comments

- Request for additional supplemental information
- Provide additional or different disclosure in a future filing
- Amend filing to revise financial statements or disclosure
- No further comments letter

Comment Letter Process

Best Practices for Resolving Issues

- **Prepare a thorough response**
  - **Explain your position -- Do not immediately assume staff disagrees with accounting treatment**
    - **i.e. Disclosure may not provide sufficient information to evaluate**
  - **Key response to initial comment**
  - **Indicate specifically where revisions have been made**
  - **Discuss supporting authoritative literature in detail**
- **Inform Staff if you are unable to respond by the requested date**
- **Document accounting decisions contemporaneously**
- **Furnish all correspondence with the Staff on EDGAR**

Financial Reporting Issues Frequently Raised in Comment Letters

Financial Reporting Issues Frequently Raised in Comment Letters

- ***Management's Discussion & Analysis***
- ***Reverse Mergers & "Back Door" Registrations***
- ***Business Combinations***
- ***Goodwill, Intangible and Long-Lived Assets***
- ***Predecessor Financial Statements***
- ***Equity Transactions***
- ***Embedded Conversion Options and Freestanding Warrants***
- ***Revenue Recognition***
- ***Smaller Reporting Company Status***
- ***Disclosure Controls and Procedures***
- ***Internal Control over Financial Reporting***
- ***Form 8-K***

Management's Discussion & Analysis (MD&A)

Release Nos. 33-6835 and 33-8350

Results of Operations

- **What has happened during the period and why?**
  - **Underlying drivers for changes in operating results**

Liquidity

- **Sources and uses of cash**
  - **What are our bills and how will we pay them?**
  - **Prospective sources of and need for capital**
- **Going concern matters**

Early warning disclosures – Item 303(a)(3)(ii) of Regulation S-K

Reverse Mergers & "Back Door" Registrations

What is a "back door" registration?

Frequent Areas of Comment:

- **Required Form 8-K items not filed**
  - **Including Item 4.01 Form 8-K (Change in Accountants)**
- **Form 10-type information in Form 8-K**
  - **Financial Statements due within 4 business days (no 71-day extension)**
- **Financial statement updates on Form 8-K**
  - **Staff Interpretation of Exchange Act Rule 13a-1**
- **Internal Control over Financial Reporting**
  - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

Reverse Mergers & "Back Door" Registrations

Illustration of Staff Interpretation of Rule 13a-1

- **Reverse Merger occurs in January 2010**
- **Both the public shell company (accounting acquiree) and nonpublic operating company (accounting acquirer) have calendar year-ends**
- **12/31/09 Form 10-K would include the financial statements of the public shell company**
- **Financial Statements of the operating company included in the Form 8-K would only include 12/31/08 audited financial statements and 9/30/09 unaudited interim financial statements**
- **3/31/10 Form 10-Q would include financial statements of the operating company**
- ***Issue* – The 12/31/09 annual financial statements of the operating company were never filed**
- ***Solution* – File an amended Form 8-K containing all information that would be required had the operating company filed a 12/31/09 Form 10-K**
- ***NOTE*: Both 2009 (i.e. shell) and 2010 (i.e. OpCo) Forms 10-K would need to comply with SOX 404 requirements**
- **See FRM Paragraph 12220.1**

Reverse Mergers & "Back Door" Registrations

Accounting acquirer's audited F/S presented for all historical periods in subsequent reports

- **Earnings per share recast to reflect exchange ratio**
- **Eliminate retained earnings of shell or legal acquirer**
- **Common stock of shell or legal acquirer continues**

Audit Issues

- **PCAOB Standards**

Reverse Mergers & "Back Door" Registrations

Recapitalization Example

- The transaction was consummated 4/1/09
- Shell has 100,000 shares o/s @ 3/31/09 ($1 par)
- OpCo has 100,000 shares o/s @ 3/31/09 ($2 par)
- Shell issues 400,000 shares for 100% of OpCo
- Post-recap entity has no other equity transactions from 4/1/09 – 6/30/09
- Post-recap entity has net income of $300,000 for the period from 4/1/09 – 6/30/09

Reverse Mergers & "Back Door" Registrations

OpCo SSE 1/1/08 - 3/31/09

	Number of Shares	Shares at Par ($2)	APIC	Retained Earnings (Deficit)	Total
1/1/08	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/08	20,000	40,000	110,000		150,000
Net Income				250,000	250,000
12/31/08	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/09	20,000	40,000	190,000		230,000
Net Income				200,000	200,000
3/31/09	100,000	200,000	900,000	750,000	1,850,000

Reverse Mergers & "Back Door" Registrations

Post-Recapitalization Continuing Entity SSE
1/1/08 - 6/30/09

	Number of Shares	Shares at Par ($1)	APIC	Retained Earnings (Deficit)	Total
1/1/08	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/08	80,000	80,000	70,000		150,000
Net Income				250,000	250,000
12/31/08	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/09	80,000	80,000	150,000		230,000
Net Income				200,000	200,000
3/31/09	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 4/1/09	100,000	100,000	25,000		125,000
Net Income				300,000	300,000
6/30/09	500,000	500,000	725,000	1,050,000	2,275,000

Business Combinations

Determination of Accounting Acquirer

- Consideration of all factors (ASC 805-10-55-11 to 15)

Purchase Price Allocation

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

Contingent Consideration

Disclosures and Separate Financial Statements

- Business vs. Asset Determinations
- Rule 3-05/8-04 of Regulation S-X

Goodwill, Intangible and Long-Lived Assets

Goodwill and Indefinite-Lived Intangible Assets

- **Allocation to reporting units**
- **Impairment**
  - **Annual testing date vs. interim impairment tests**
  - **2-step testing method and how FV is estimated**

PP&E and Intangible Assets

- **Capitalization**
- **Useful lives and amortization methods**
- **Impairment**

Predecessor Financial Statements

- **Registrant succeeds to substantially all of the business of another entity**
- **Registrant's own operations are relatively insignificant**
- **Common in SPAC mergers**
- **Financial Statements consistent with Rules 3-01 and 3-02 of Regulation S-X or Rule 8-02 and 8-03 of Regulation S-X**
- **In post-transaction Exchange Act reports:**
  - **Predecessor periods should be audited up to acquisition date.**
  - **Registrant financial statements may also be required unless there is only nominal income statement activity**

Predecessor Financial Statements

Example

- Shell company merges with an operating company in a transaction accounted for as a purchase.
- Transaction date: October 14, 2009
- Combined company has a calendar year-end
- Merger Form 8-K for requirements:
  - Audited financial statements of the operating company as of December 31, 2008 and December 2007 and for the years ended December 31, 2008, December 31, 2007 and December 31, 2006
  - Unaudited interim financial statements as of and for the six months ended June 30, 2009.
  - December 31, 2006 information not required for SRCs

Predecessor Financial Statements

Example (Cont.)

- ***Presentation in Form 10-K for the Year Ended December 31, 2009 :***
  - **Audited financial statements of the combined company as of and for the year ended December 31, 2009, but the statements of operations and cash flows will only include the operating company from October 14, 2009.**
  - **Pre-merger audited statements of operations and cash flows of the operating company for the year ended December 31, 2008 (and 2007 if not an SRC) and the period from January 1, 2009 to October 13, 2009 (i.e. no gap in audited periods). The 2009 stub period must be audited.**
  - **Complete set of notes should be provided for each entity.**
  - **Pre-merger financial statements should be clearly labeled as predecessor financial statements.**
  - **Corresponding Managements' Discussion and Analysis**

Equity Transactions

Fair Value Determination

- If publicly traded in an active market, use quoted market price
  - If discounts are appropriate under the circumstances, they should be supported by objective evidence
- If stock not publicly traded in active market
  - Contemporaneous equity transactions with third parties
  - Fair value of the services or goods provided may be used to measure the transaction, if more reliable
  - Consider management's judgment -- ASC 820-10-35 (FSP SFAS 157-3 and 157-4)

Disclosure

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

Embedded Conversion Options and Freestanding Warrants

Scope

- Applies to all contracts that are indexed to, and potentially settled in a company's own stock (e.g., warrants, many conversion options)

Common Pitfalls

- Cash settlement provisions
- Insufficient authorized shares
- No limit on # of shares to be delivered
- Incorrect conclusion on whether instrument is indexed to a company's own stock
  - "Ratchet Provisions" -- paragraphs 33 and 34 of ASC 815-40-55 (Example 8 of EITF 07-5)

Embedded Conversion Options and Freestanding Warrants (cont'd)

Valuation Issues

- **Inappropriate model being used to value certain derivatives**
  - **Black-Scholes may not be appropriate in many situations given complex features and terms of conversion option (e.g. combined embedded derivatives)**

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

Revenue Recognition

Policy disclosures (i.e., SAB 104)

- **Avoid "Boilerplate" disclosures**
- **Disclosure should be specific to each of company's revenue streams**

FASB ASC 605-25 – Multiple-Element Arrangements

- **Allocation of consideration**

FASB ASC 605-45 – Gross versus Net Revenue Recognition

- **Consider and weigh all indicators**

FASB ASC 605-50 – Customer Payments and Incentives

- **Recognition**
- **Classification**

Smaller Reporting Company Status

Transition to Smaller Reporting Company status

- **Public float < $50 million on last business day of Q2**
  - **May reflect change immediately**
  - **If public float = $0, < $40 million audited annual revenues**
- **Still considered an accelerated filer until Form 10-K**
  - **Attestation report on ICFR is not required in 10-K**

Smaller Reporting Company Status

Transition to larger reporting company status

- Public float ≥ $75 million on last business day of Q2
- If public float = $0, ≥ $50 million audited annual revenues
- May wait until Q1 of next fiscal year for disclosure purposes
- Accelerated filer for purposes of 10-K including inclusion of attestation report on ICFR

Common Comment Areas on Disclosure Controls & Procedures

Conclusions

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

Incomplete definition of DC&P

- If definition is included, should conform exactly to Item Exchange Act Rule 13a-15 (note definition is not required)

Internal Control over Financial Reporting (ICFR)

Management Reports under Item 308(a) of Regulation S-K

- **Separate evaluation *and assessment* from evaluation of disclosure controls and procedures**
- **All four elements in Item 308(a) must be addressed in disclosure**
- **ICFR cannot be "effective" if material weakness exists**
- **Clear conclusion (either "effective" or "ineffective")**

SOX Section 302 Certifications should not deviate from specific form and content in Item 601(b)(31)(i) of Regulation S-K

- **Include all paragraphs (including paragraph 4(b))**

Internal Control over Financial Reporting (ICFR)

Disclosures that companies should consider when material weakness exists (see SEC Release No. 33-8810)

- **Nature of the material weakness (i.e. identification of the deficiency)**
- **Impact of control deficiency on the company's financial reporting and its ICFR**
- **Disclosures should be detailed and specific for each material weakness identified**

Changes in Internal Control Financial Reporting

- **Change in conclusion on effectiveness should be accompanied with some change in control**
- **Avoid boilerplate disclosure**

Substantially all operations outside U.S.

Form 8-K

Frequent Item 4.01 comments

- Failure to specify whether former accountants resigned, declined to stand for re-election, or were dismissed and the date
- Identification of “going concern opinions”
- Disclosure of disagreements in through termination date
- Exhibit 16 letter
- Reverse acquisitions
- Accounting firm mergers

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**
- **See Exchange Act Form 8-K Compliance and Disclosure Interpretation 215.01**

Resources

Resources

Best of the Website --
www.sec.gov/divisions/corpfin.shtml

- **General**
  - **Filing Review Process**
  - **Statutes, Rules, and Forms**
  - **Compliance & Disclosure Interpretations**
  - **What's New?**
- **Information for Small Businesses - www.sec.gov/info/smallbus.shtml**

Resources

Best of the Website (cont) --

- **Information for Accountants - www.sec.gov/divisions/corpfin/cfreportingguidance.shtml**
  - **DCF Financial Reporting Manual**
  - **Staff Accounting Bulletins**
  - **Publicly Released Staff Comment Letters**
  - **SEC Staff Speeches**
    - **E.g. "Best Practices for Working with the SEC Staff" -- www.sec.gov/news/speech/2009/spch120609ac-ms.pdf**
  - **Other Frequently Requested Material**
    - **Presentation from last year's forums**
    - **Letters to Industry (a/k/a "Dear CFO Letters")**
    - **Areas of Frequent Staff Comment —Financial Institutions -- www.sec.gov/news/speech/2009/slides1209slh.pdf**

Resources

Whom do I contact for assistance and how?

- **Comment process – Disclosure Operations Staff**
  - **Names and number will be on comment letter**
- **Staff interpretation or informal question**
  - **Financial Reporting – CF Office of the Chief Accountant at (202)551-3400**
  - **Small Business Policy – CF Office of Small Business Policy (202) 551-3460**
  - **Submit request through online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive**

Resources

Formal Requests related to financial reporting

- **Pre-filing accommodations/waivers/interpretations of reporting requirements**
- **Address to the DCF Chief Accountant**
- **Mail or email to *dcaoletters@sec.gov***
- **Clearly state issue and relief sought**
- **Clearly state facts and relate them to analysis of issue**
- **Clearly state the basis for relief**

Formal consultations on the application of GAAP should be sent to - OCA@sec.gov

- **www.sec.gov/info/accountants/ocasubguidance.htm**

Questions???

Key Telephone Numbers

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

Corporation Finance Office of Chief Counsel (202) 551-3500

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

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

Appendix

Recapitalization Example

- ***The transaction was consummated 4/1/09***
  - **Shell has 100,000 shares o/s @ 3/31/09**
  - **OpCo has 100,000 shares o/s @ 3/31/09**
  - **Shell issues 400,000 shares for 100% of OpCo**
- ***Other Information***
  - **Post-recap entity has no other equity transactions from 4/1/09 – 6/30/09**
  - **Post-recap entity has net income of $300,000 for the period from 4/1/09 – 6/30/09**

Recapitalization Example

Balance Sheets @ 3/31/09	Shell	OpCo
Cash	$ 200,000	$ 50,000
Assets Other than Cash		2,000,000
Total Assets	$ 200,000	$ 2,050,000
Liabilities	$ 75,000	$ 200,000
Shell Common Stock ($1 par) 100,000 shares o/s	100,000	
OpCo Common Stock ($2 par) 100,000 shares o/s		200,000
APIC	125,000	900,000
Retained Earnings (Deficit)	(100,000)	750,000
Total Equity	125,000	1,850,000
Total Liabilities & Equity	$ 200,000	$ 2,050,000

Shell SSE 1/1/08 - 3/31/09

Shell SSE 1/1/08 - 3/31/09	Number of Shares	Shares at Par ($1)	APIC	Retained Earnings (Deficit)	Total
1/1/08	40,000	40,000		(60,000)	(20,000)
Shares issued for services 2/1/08	30,000	30,000	60,000		90,000
Net Loss				(10,000)	(10,000)
12/31/08	70,000	70,000	60,000	(70,000)	60,000
Shares issued for cash 3/1/09	30,000	30,000	65,000		95,000
Net Loss				(30,000)	(30,000)
3/31/09	100,000	100,000	125,000	(100,000)	125,000

OpCo SSE 1/1/08 - 3/31/09

OpCo SSE 1/1/08 - 3/31/09	Number of Shares	Shares at Par ($2)	APIC	Retained Earnings (Deficit)	Total
1/1/08	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/08	20,000	40,000	110,000		150,000
Net Income				250,000	250,000
12/31/08	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/09	20,000	40,000	190,000		230,000
Net Income				200,000	200,000
3/31/09	100,000	200,000	900,000	750,000	1,850,000

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09

	Number of Shares	Shares at Par ($1)	APIC	Retained Earnings (Deficit)	Total
1/1/08	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/08	80,000	80,000	70,000		150,000
Net Income				250,000	250,000
12/31/08	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/09	80,000	80,000	150,000		230,000
Net Income				200,000	200,000
3/31/09	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 4/1/09	100,000	100,000	25,000		125,000
Net Income				300,000	300,000
6/30/09	500,000	500,000	725,000	1,050,000	2,275,000

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09 (cont'd)

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

A	$1	Equals par value of Shell
B	80,000	Use 4 for 1 Exchange Ratio. 20,000 shares x 4 = 80,000
C	$80,000	80,000 shares x $1 par value = $80,000
D	$70,000	$150,000 from (E) below - $80,000 from (C) above
E	$150,000	No change from OpCo pre-recap SSE
F	$200,000	No change from OpCo pre-recap SSE
G	$200,000	No change from OpCo pre-recap SSE
H	400,000	Should agree to number of shares issued to OpCo by Shell
I	$400,000	400,000 shares x $1 par value = $400,000
J	$700,000	$1,850,000 from (L) below - $750,000 from (K) below - 400,000 from (I) above
K	$750,000	No change from OpCo pre-recap SSE
L	$1,850,000	No change from OpCo pre-recap SSE
M	100,000	Number of o/s shares at Shell pre-recap
N	$100,000	100,000 shares x $1 par value = $100,000
O	$25,000	$125,000 from (P) below - $100,000 from (N) above
P	$125,000	Net assets of shell pre-recap

Shell & OpCo Historical EPS

Shell Pre-Recap Historical EPS

	12/31/08	03/31/09
Net Loss	$ (10,000)	$ (30,000)
EPS	$ (0.15)	$ (0.38)
Weighted Average Number of Shares	67,500	80,000

OpCo Pre-Recap Historical EPS

	12/31/08	03/31/09
Net Income	$ 250,000	$ 200,000
EPS	$ 3.57	$ 2.14
Weighted Average Number of Shares	70,000	93,333

Solution: Continuing Entity EPS

	12/31/08	03/31/09	06/30/09
Net Income	$ 250,000	$ 200,000	$ 500,000
EPS	$ 0.89	$ 0.54	$ 1.15
Weighted Average Number of Shares	280,000	373,332	436,667

Solution: Continuing Entity EPS (cont'd)

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

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

Embedded Conversion Options and Freestanding Warrants

Analysis

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

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

Embedded Conversion Options and Freestanding Warrants (cont.)

2. **Embedded**
   - **Perform ASC 815-40 (EITF 00-19) and ASC 815-40-15 (EITF 07-5) analysis to see if scope exception in ASC 815 is met for conversion option**
   - **If scope exception is met, no bifurcation required, but consider BCF under ASC 470-20 (EITF 98-5 and 00-27)**
   - **If no scope exception is met, and the definition of a derivative is met, account for as a derivative liability (all embedded derivatives should be combined and accounted for as a single compound embedded derivative)**

Questions?

PCAOB
Public Company Accounting Oversight Board

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Closing Remarks and Wrap-Up

Bill Gradison
Founding Board Member, PCAOB
November 2, 2010
Dallas, TX