Forum on Auditing in the Small Business Environment

April 28, 2011

Boston, MA

Opening Remarks

Daniel L. Goelzer
Board Member, PCAOB
April 28, 2011
Boston, MA

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: Emerging Risks in the Current Environment

Andres Vinelli
Chief Economist
Office of Research and Analysis

Topics

- Today's audience
- Emerging risks
  - Macro baseline scenario
  - The "GAAP tsunami"
  - Chinese reverse mergers
  - Trends in audit fees

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Attendee Firms Boston

Number of firms attending SBF	30
Number of firms with issuer clients	11
Number of firms with broker/dealer clients	17
Number of firms with issuer and broker/dealer clients	6
Number of firms with issuer clients only	5
Number of firms with broker/dealer clients only	11
Number of firms with no reported issuer or B/D clients	8

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Attendees Boston:
Firms Auditing Issuers

Number of firms attending Small Business Forum	30
Number of firms with Issuer Clients	11
Total Number of Issuer Clients	158

	Issuer Count*	Market Cap ($ in Millions)**
Consumer Discretionary	16	514
Consumer Staples	4	99
Energy	1	2
Financials	43	2,550
Health Care	27	1,594
Industrials	17	949
Information Technology	30	709
Materials	3	168
Telecommunication Services	4	227
Utilities	2	160
Unassigned	11	64
Grand Total	158	7,036

*Issuer Count Based on Opinions Issued 2010

**Market Cap as of February 28, 2011

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Attendees Boston: Firms Auditing Broker/Dealers

- Number of firms with broker/dealer clients 17
- Total number of broker/dealer clients 91
- Total assets audited of broker/dealer clients
  - $215,634,854*

*Based on publicly available fiscal year 2010 data

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
- Out of recession by June 2009

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Forecasters' View of Main Economic Indicators

	Real GDP	Unemployment	Headline CPI	Risk of Negative GPD Quarter
2010 (actual)	2.8	9.6	1.2	
2011:Q1	3.6	9.3	2.5	6.3
2011:Q2	3.5	9.2	1.3	7.1
2011:Q3	3.1	9	1.8	9.3
2011:Q4	3.4	8.8	1.8	10.7
2012:Q1	3.1	8.7	2	11.4
2011	3.2	9.1	1.7	
2012	3.1	8.5	2	
2013	3.0	7.8	2.1	
2014	3.4	7.3		

WSJ economist poll: 3.5%
GS: 3.4%
IMF: 2.66%

Source: Survey of Professional Forecasters by Philadelphia Fed (First Quarter 2011). All figures in percentages

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Projected World Growth: 4.5%

"Two Speed recovery"

Source: IMF's World Economic Outlook (April 2011)

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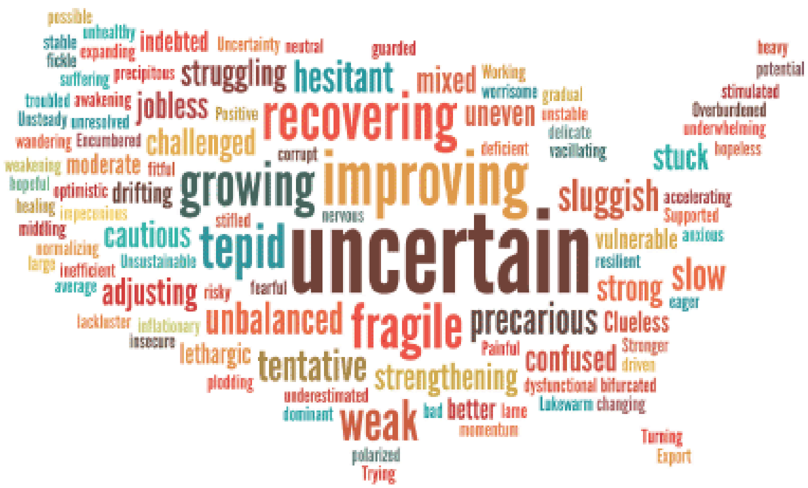
The Pulse of Economics Bloggers

Today

How do you assess the overall condition of the U.S. economy right now?
(open text response)



[Kauffman Economic Outlook—2011 Q1]

...and six months ago

How do you assess the overall condition of the U.S. economy right now?
(open text response)

[Kauffman Economic Outlook—2010 Q4]

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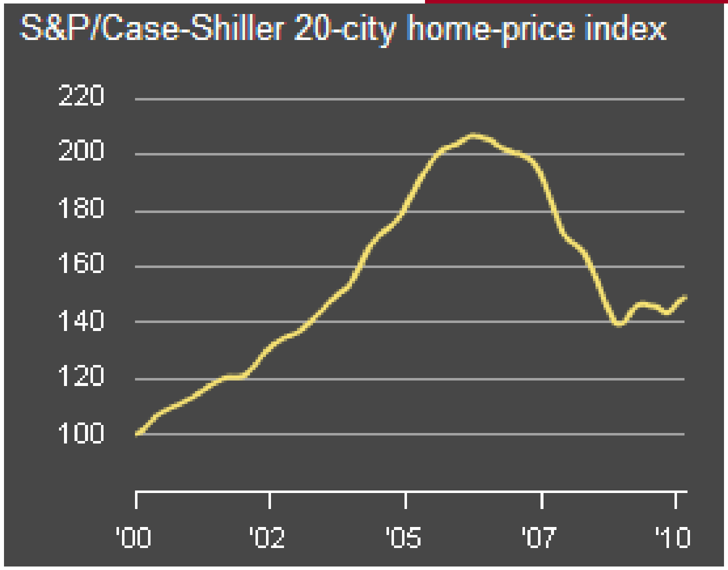
Housing

Housing has been moving sideways...



...and is forecasted to keep doing so for the next 2 years.

Index	2011 (Q4/Q4 Percent Change)			2012 (Q4/Q4 Percent Change)		
	N	Mean	Median	N	Mean	Median
S&P/Case-Shiller: U.S. National	13	-0.6	0.4	13	1.3	2
S&P/Case-Shiller: Composite 10	2	-0.9	-0.9	2	2.1	2.1
S&P/Case-Shiller: Composite 20	6	-0.9	-0.6	6	1	1.4
FHFA: U.S. Total	6	-1	-1.3	6	3.5	3.7

Boston Housing Market

Source: Boston Case-Shiller: http://blog.redfin.com/boston

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Housing Drivers

- Affordability (home price to income). Back to pre-bubble levels ('89-'03 average, Moody's)
- Rates. Low but increasing.
- Lending standards. Tight but softening.
- Inventory. High but decreasing.

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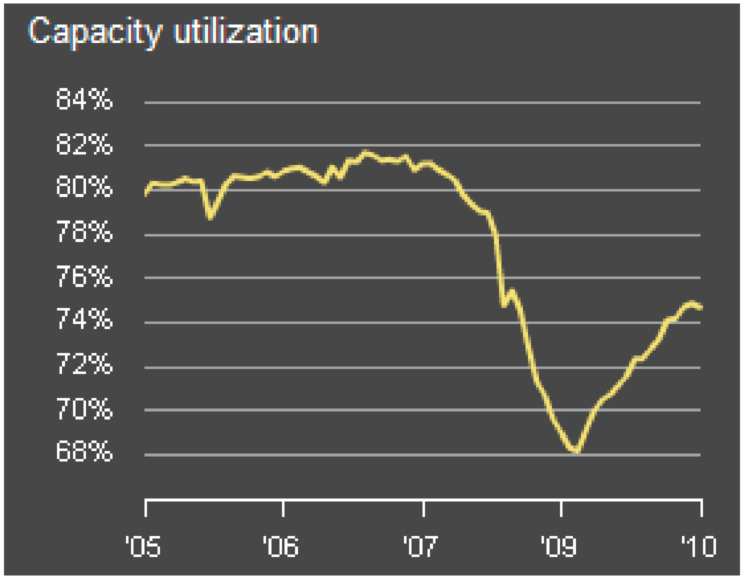
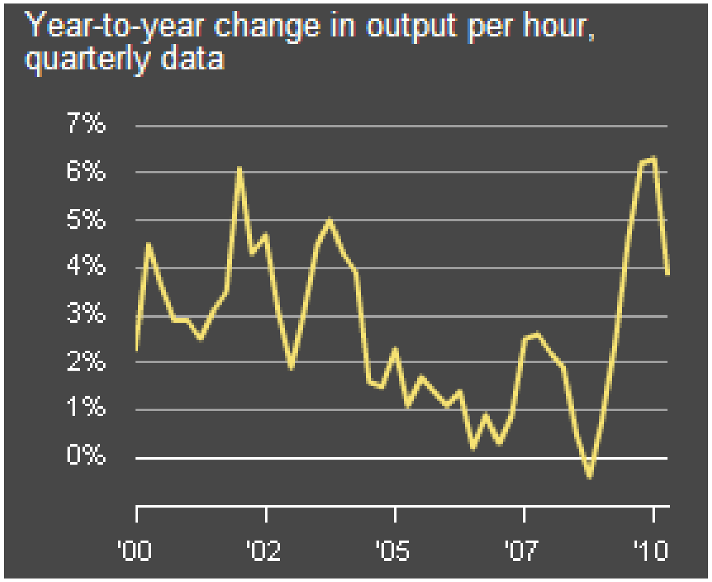
Capacity Utilization and Productivity





Capacity utilization is up...
...but there is still slack

There have been immense growth in productivity...
...but we may be hitting the ceiling

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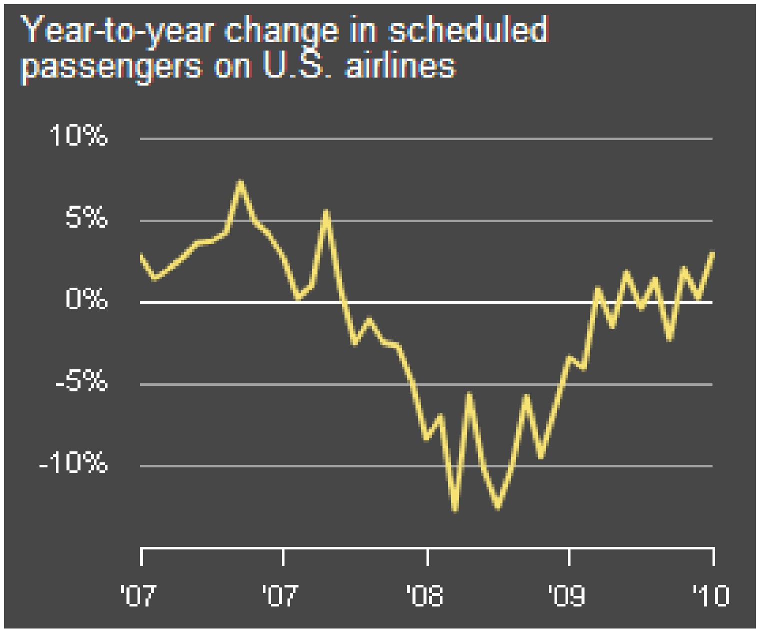
Consumers



Consumers

- Have proven to be more resilient than most analyst have anticipated
- Continue to be pessimistic...
- ...But less so than before.

Job Market

- Job holders no longer worried that “they are next”
- People quitting jobs a little more.
- Raise in wages coming, but slowly.

Consumer Spending

- Up 4.4% in Q4
- Provided the biggest contribution to growth.
- Rate of increase, nearly 2x that of Q3
- Quickest clip in almost 5 years

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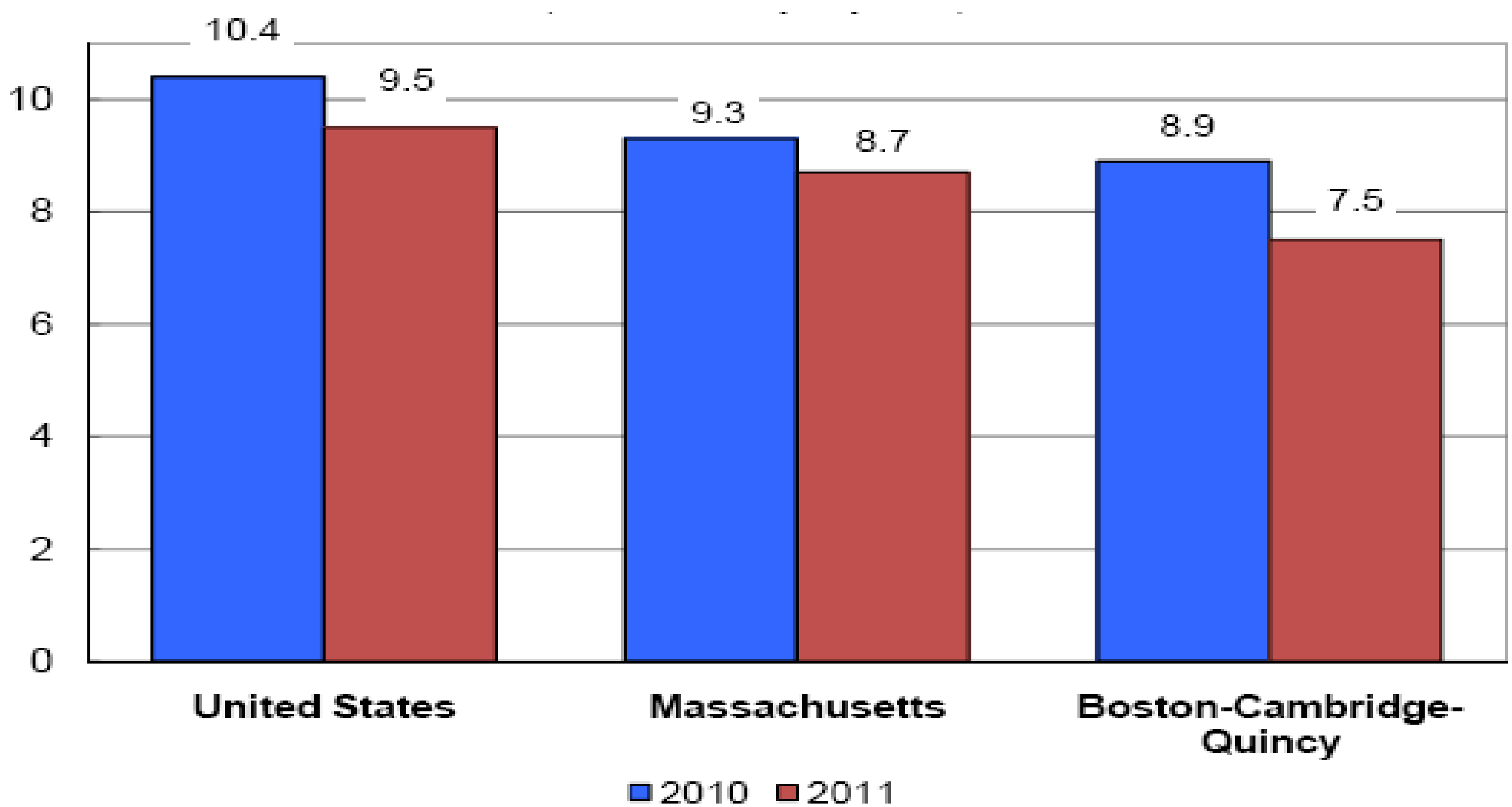
Unemployment Rate



Source: Bureau of Labor Statistics (data is not seasonally adjusted)

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Wage Growth vs. Inflation

Employment Cost Indexes, private industry (December 2005 = 100)

Index and area	Dec 2009	Dec 2010	Percent change
Total Compensation			
United States	110.2	112.5	2.1
Northeast	111.0	113.6	2.3
New England	111.5	114.1	2.3
Boston	-	-	2.2
Wages and Salaries			
U.S. City Average	110.8	112.8	1.8
Northeast	111.1	113.4	2.1
New England	112.1	114.3	2.0
Boston	-	-	2.0

Note: Dash indicates data not available.

Consumer Price Indexes (1982-84 = 100)

Index and area	Jan 2010	Jan 2011	Percent change
All Urban Consumers			
U.S. City Average	216.687	220.223	1.6
Northeast Region	232.294	235.969	1.6
Boston	237.266	239.814	1.1
Urban Wage Earners & Clerical Workers			
U.S. City Average	212.568	216.400	1.8
Northeast Region	229.744	233.914	1.8
Boston	237.999	240.540	1.1

Source: Bureau of Labor Statistics

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Commodities

- Commodity prices remain robust
  - Emerging market demand
  - Geopolitical risks
- Important impact on some sectors/activities/prices
- But not enough to trigger inflation in next 2 years...
  - Estimates of price increases due to oil price increases are much more muted since the 1980s (Blanchard et al.)
  - 50% oil shocks: Added 3.1% in 70s, only 0.3% since 80s
  - GS estimates recent food price increases will add 0.5% to headline CPI by mid-year
- ... or to induce funds rate hikes by the Fed
  - Taylor rule points to no hikes in next 2 years

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Corporate Sector

- Solid balance sheets
- Corporate earnings still strong
  - Up 28% from last year
  - Sales up 7.7%
- Leading indicators rose in January for 7th month
- Differentiation between large and small
- Last year we forecast a resurgence of M&A activity

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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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Reverse Mergers Involving Companies in the China Region

- Chinese Reverse Merger (CRM) Activity
  - Identified 159 CRM transactions vs. 56 IPOs for period between 1/1/2007 and 3/31/2010
  - Market cap of CRM companies less than half of the market cap of IPO Chinese companies
  - 67% companies with $50M revenues or less
  - 65% companies with $50M total assets or less

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Market Cap of Chinese IPOs vs. CRM Transactions

Mainland China IPO Companies by Market Capitalization as of March 31, 2010

Market Capitalization	# of Companies	% of Companies	Total Market Capitalization (in $ millions)	% of Market Capitalization	Average Market Capitalization per Company (in $ millions)
$0	0	0%	$0	0%	$0
$1 - $10,000,000	0	0%	$0	0%	$0
$10,000,001 - $75,000,000	7	13%	$310	1%	$43
$75,000,001 - $700,000,000	35	62%	$8,842	33%	$253
$700,000,001 +	14	25%	$18,069	66%	$1,291
Total	**56**	**100%**	**$27,221**	**100%**	**$486**

Chinese Reverse Merger Companies by Market Capitalization as of March 31, 2010

Market Capitalization	# of Companies	% of Companies	Total Market Capitalization (in $ millions)	% of Market Capitalization	Average Market Capitalization per Company (in $ millions)
$0	24	15%	$0	0%	$0
$1 - $10,000,000	28	18%	$65	1%	$2
$10,000,001 - $75,000,000	54	34%	$2,058	16%	$38
$75,000,001 - $700,000,000	53	33%	$10,720	83%	$202
$700,000,001 +	0	0%	$0	0%	$0
Total	**159**	**100%**	**$12,843**	**100%**	**$81**

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CRM Companies by Revenue and Assets

Chinese Reverse Merger Companies by Revenue

Company Size by Revenues	# of Companies	% of Companies	Total Revenues (in $ millions)	% of Revenues
$0	43	27%	$0	0%
$1 - $50,000,000	64	40%	$1,324	17%
$50,000,001 - $100,000,000	34	22%	$2,443	31%
$100,000,001 +	18	11%	$4,158	52%
Total	**159**	**100%**	**$7,925**	**100%**

Chinese Reverse Merger Companies by Assets

Company Size (Assets)	# of Companies	% of Companies	Total Assets (in $ millions)	% of Assets
$0	38	24%	$0	0%
$1 - $50,000,000	66	41%	$1,417	16%
$50,000,001 - $100,000,000	30	19%	$2,083	24%
$100,000,001 +	25	16%	$5,326	60%
Total	**159**	**100%**	**$8,826**	**100%**

Auditors of CRM Companies

- Auditor Requirements
- Auditor of CRM Companies
  - 74% CRM companies audited by US firms
  - 94% CRM companies audited by triennial firms
- Audit Implications
  - Inherently complex transactions
  - Challenges in applying U.S. GAAP
  - PCAOB Audit Practice Alert No. 6

Trends in Audit Fees

- We observed that a number of issuers that reported audit fees paid for fiscal year 2009 which were lower than the amounts paid for fiscal 2008 audits.
- To identify whether or not these observations were an indication of a trend for the overall universe of public company issuers, we collected the audit fee data reported by a sample of 1,500 issuers for fiscal years 2005 to 2009.
  - Since an engagement between an audit firm and an issuer can include services beyond the financial audit, we also collected non-audit fee data.
  - Data comes from SEC Filings
- This allows us to summarize audit fee changes from 2008 to 2009, and compare the results to prior years.

Sample

- To ensure issuers of various sizes (based on market capitalization as of December 31, 2000) were represented, the sample set includes the following:
  - Large 500 comprises the 500 issuers with the largest market capitalization;
  - Middle 500 comprises 500 randomly selected issuers with market capitalization above $500 million, but not included in the Large 500 sample subset; and
  - Small 500 comprises 500 randomly selected issuers with market capitalization below $500 million.

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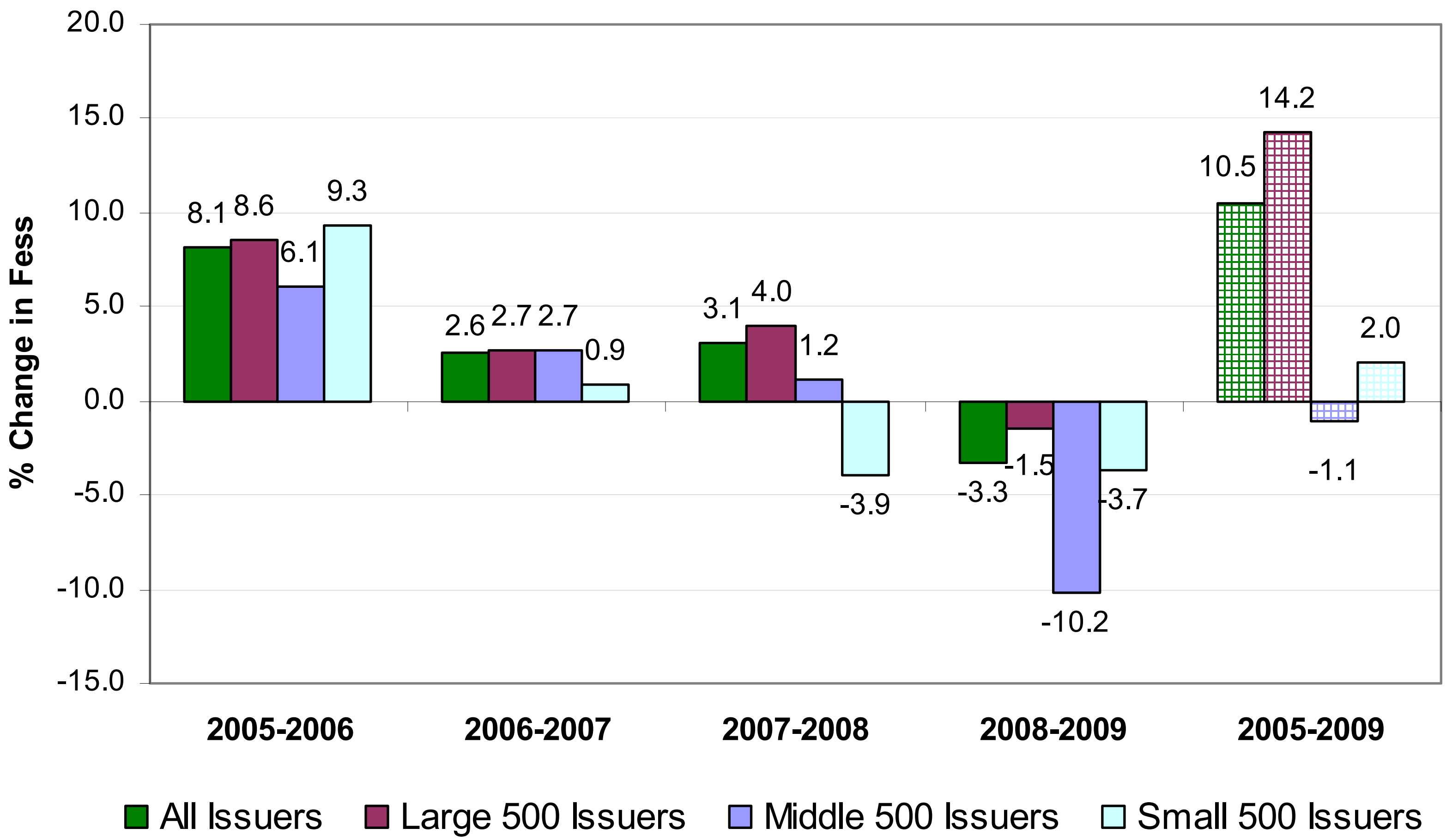
Findings

- Audit fees paid by our sample for fiscal year 2009, declined by 3.3% from amounts paid for 2008.
- It was the only period between fiscal years 2005 and 2009 when these issuers, as a group, reported a decline in audit fees.

Percentage Change in Audit Fees Segmented by Market Capitalization



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Sectors

- Audit fee changes also varied by GICS sector. Fees reported by issuers in the Financials sector for 2009 were 9% higher than 2008 amounts, while the Information Technology sector reported a 12% decrease in audit fees for the same period.
- The annual amounts paid for non-audit fees consistently represented approximately 11% of the total amount of audit and non-audit fees paid each year.
- We make no assertions about audit quality that may result from an increase or decrease in fees.

Questions?

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Update on Standard-Setting Activities

Keith Wilson
Deputy Chief Auditor
April 28, 2011
Boston, MA

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What We Will Cover

- Risk Assessment Standards
  - Including discussion of case studies
- Other Standard-Setting Activities

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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.
- Approved by the SEC on December 23, 2010. Effective for audits of fiscal years <u>beginning on or after December 15, 2010.</u>

Risk Assessment Standards Overview

- Establishes a process for obtaining evidence to support the auditor’s risk assessments.
- Strengthens the requirements linking audit tests to the assessed risks.
- 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*

- 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.

Auditing Standard No.12 – Risk Assessment Procedures

- 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.

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Auditing Standard No.12 – 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.

Case Study on Risk Assessment

- Refer to the Case Study on Olympus Parchment, Inc. (OPI).
- Questions:

1. In light of the background information and additional information obtained during the audit, what are some likely sources of potential misstatement of OPI's financial statements?
2. What risks of material misstatement might be considered significant 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.

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.

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:
  - Analytical procedures in the overall review.
  - Misstatements accumulated during the audit.
  - Qualitative aspects of the company's accounting practices.
  - Conditions identified that relate to the assessment of fraud risk.
  - Presentation of the financial statements, including disclosures.
  - Sufficiency and appropriateness of 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.

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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Other Standard-Setting Activities*

- Communications with Audit Committees
- Confirmation
- Broker-Dealers
- Auditor's Reporting Model
- Signing the Auditor's Report
- Assignment and Documentation of Supervisory Responsibilities within a Firm

* Activities subject to change based on emerging issues

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Other Standard-Setting Activities

- Using the Work of Other Independent Auditors
- Related Parties
- Specialists & Third-Party Pricing Sources
- Fair Value Measurements and Other Accounting Estimates
- Practice Alerts and Staff Guidance
- Codification of PCAOB Auditing Standards

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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)

Update for Broker-Dealer Auditors and Audit Firm Reporting

Mary M. Sjoquist
Director, Office of Outreach and Small Business Liaison

April 28, 2011

Boston, MA

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PCAOB Statistics

- Total firms registered—2,426
- US registered firms—1,525
- Foreign registered firms—901
- Auditors of BDs registered since 2009—544
  - Approximately 70 foreign registered BDs
  - Approximately 5,200 registered BDs
- Withdrawals—605

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Pre-Dodd-Frank

- Sarbanes-Oxley provided that auditors of BDs would be required to register with the PCAOB
- SEC provided an exemption from this oversight until December 2008
- For fiscal years ending after 12/31/08, BD's financial statements were required to be audited by a PCAOB-registered firm
- Dodd-Frank extended PCAOB's authority to include oversight of auditors of BDs

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Dodd-Frank--Funding

- Funding
  - The Act provides that the Board must allocate the accounting support fee equitably among not only issuers but also brokers and dealers (see section 109(d))
  - The Board may establish different classes of issuers and of brokers and dealers for funding purposes (sections 109(g) and 109(h)(2))
  - The amount due from a broker or dealer must be in proportion to the net capital of the broker or dealer (before or after any adjustments), compared to the total net capital of all brokers and dealers (before or after any adjustments), in accordance with the rules of the Board (see section 109(h)(3))

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Proposed Funding Rules

- Fee is proposed to be based on "tentative net capital," which under the SEC's Rules is net capital before deducting certain securities haircuts and charges for certain commodities transactions (see SEC Rule 15c3-1(c)(15))
- A class of brokers and dealers, each with tentative net capital less than $5 million, would be allocated a share of zero
  - Represents 86% of FINRA registered brokers and dealers or 1.1% of the industry's total net capital
  - 640/4,600 would share in the fee

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Dodd-Frank--Inspections

- Dodd-Frank expanded the PCAOB's inspection authority to include audits of registered securities brokers and dealers.
- Gave PCAOB the authority to:
  - Differentiate among different classes of BDs
  - Consider whether different inspection schedules would be appropriate with respect to auditors that issue audit reports only for brokers or dealers that do not receive, handle, or hold customer securities or cash or are not members of the Securities Investor Protection Corporation (section 104(a)(2)(B))
  - Exempt any public accounting firm from such an inspection program; the firm would not be required to register with the Board (section 104(a)(2)(D))

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Proposed Temporary Inspection Rules

- Establish an interim program to assist in making fully informed judgments on permanent rules
- The interim program will focus on assessing compliance with the rules and standards that applied to the inspected work at the time the audit work was done.
  - Pursuant to SEC statement, audits will continue under GAAS as promulgated by the ASB
- Applicable rules and standards may change during this interim program if and when the SEC amends Rule 17a-5

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Output from interim inspection program

- Annual report on observations obtained during inspection
- These reports would not be firm specific
- Under the interim program, the PCAOB would identify and address with the inspected firm any significant issues in its audit work
- Where appropriate, potential violations by brokers or dealers would be referred to the SEC and/or FINRA

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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

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

- Allows firms whose structure has changed to retain registration status under two scenarios:
  - A registered firm changes its legal form of organization or jurisdiction in which it operates
  - A registered firm is acquired by an unregistered firm or merges with another firm to create a new legal entity

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

- The rules provide for:
  - A form to be filed (Form 4),
  - 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 more limited on these forms than on the registration application form
  - 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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Questions?

Understanding Internal Control and IT Control Issues in Smaller Public Companies

Greg Wilson and Bill Powers
Division of Registration and Inspections
April 28, 2011
Boston, MA

Discussion Objectives

- Provide an overview of sections in AS No. 9, AS No. 12 and AS No. 13 related to internal control over financial reporting (including IT general controls)
- Use discussion as a means to raise risk issues that may be faced by small companies
- Identify control approaches that may be used to mitigate discussed risks

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Discussion Topics

- Auditors' responsibility related to internal control
- Obtaining an understanding of internal control over financial reporting
- Audit responses
- Summary and conclusion

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Presentation Conventions

- Sections and quotes from standards are presented in plain font
- *Discussion points relevant to audits of smaller companies are presented in italicized and underlined font*

Auditors' Responsibility Related to Internal Control

- AS No. 5 *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*
  - "…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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Auditors' Responsibility Related to Internal Control (for audit periods beginning after 12/15/2010)

- AS No. 9 *Audit Planning*
  - "The auditor should develop and document an audit plan that includes a description of:
    a. The planned nature, timing and extent of risk assessment procedures;
    b. The planned nature, timing, and extent of tests of controls and substantive procedures; …" (Para 10, AS No. 9)

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Auditors' Responsibility Related to Internal Control **(for audit periods beginning after 12/15/2010)**

- AS No. 12 *Identifying and Assessing Risks of Material Misstatement*
  - "The auditor should obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures." (Para 18, AS No. 12)

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Auditors’ Responsibility Related to Internal Control (for audit periods beginning after 12/15/2010)

- AS No. 12 *Identifying and Assessing Risks of Material Misstatement*
  - “The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company; the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.” (Para 19, AS No. 12)

Auditors' Responsibility Related to Internal Control (for audit periods beginning after 12/15/2010)

- AS No. 12 *Identifying and Assessing Risks of Material Misstatement*
  - Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented." (Para 20, AS No. 12)

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Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Components of internal control
  - The control environment
  - The company's risk assessment process
  - Information and communication
  - Control activities
  - Monitoring of controls

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Factors that may affect the nature, timing and extent of procedures to understand ICFR
  - Size and complexity of the company
    - *Fewer business lines*
    - *Less complex business process*
    - *Senior management extremely involved in operations*
    - *Fewer levels of management*
    - *Fewer employees – limited opportunity to segregate duties*
  - Existing knowledge of the company's ICFR
    - *Entity level controls*
    - *Risk of management override*
    - *Prior period audit adjustments*

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Factors that may affect the nature, timing and extent of procedures to understand ICFR (cont'd)
  - Nature of the company's controls, including the company's use of IT
    - *Management focus – reviews, reconciliations*
  - Nature and extent of changes in systems and operations
    - *Business segments*
    - *Territories/customers*
    - *Product lines*
  - Nature of the company's documentation
    - *Informal; limited documentation*

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Obtaining an understanding of internal control includes:
  - Evaluating the design effectiveness of controls relevant to the audit
    - *Controls address relevant assertions*
    - *Controls address risks of material misstatements if operating properly*
  - Determining whether the controls have been implemented
    - *Inquiry, observation, inspection of relevant documentation*
  - Walkthroughs
    - *Though not required, may be effective way to develop understanding and assess risk*

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Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- The company's risk assessment process
  - What is management's process for
    - Identifying risks relative to financial reporting objectives, including risks of material misstatement
    - Assessing likelihood and significance of misstatements resulting from those risks
    - Deciding on actions to address risks
  - *Assess management's activities, NOT auditors' activities*

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Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Information and communication
  - Understand information systems and related business processes relevant to financial reporting
    - Business processes
    - Classes of transactions
    - Manual and automated procedures and related accounting information by which transactions are initiated, authorized, process and recorded
    - Period end financial reporting process
  - *Likely sources of misstatement*

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Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Information and communication
  - Understand how IT affects the company's flow of transactions
    - Extent of manual and automated procedures and controls
      - *Dependence on vendor for changes to programs and reports for packaged software*
    - Relevant assertions for significant accounts and disclosures affected by automated initiation, authorization, processing and recording of transactions
      - *Automated application controls*
      - *Electronic audit evidence*
    - IT general controls (ITGCs) related to the effective operation of automated controls and production of computer generated information

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Information and communication
  - Specific risks to a company's internal control over financial reporting resulting from IT:
    - Inaccurately process data; processes inaccurate data
    - Unauthorized access to data
    - IT personnel having access privileges beyond those necessary to performed their assigned duties

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Information and communication
  - Specific risks to a company's internal control over financial reporting resulting from IT:
    - Unauthorized changes to data in master files
    - Failure to make necessary changes to systems or programs
    - Inappropriate manual intervention
    - Potential loss of data or inability to access data as required

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Information and communication
  - *Examples of specific risks to a company's internal control over financial reporting resulting from IT:*
    - *Few users and limited dedicated IT staff*
    - *Segregation of duty issues*
      - *Security administration*
      - *IT staff*
      - *Users*

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Information and communication
  - *Examples of specific risks to a company's internal control over financial reporting resulting from IT:*
    - *Prevalence of end user computing*
      - *Spread sheet and access databases*
      - *Customizable reports from packaged software*
    - *Computer generated information (CGI) used in tests of controls and substantive procedures*

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Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Control Activities
  - Obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement
    - Use knowledge of presence or absence of control activities obtained through developing understanding of other components of ICFR
    - Determine the degree to which to devote additional attention to rely on control activities
    - *Availability of staff to perform control activity procedures*

Obtaining an Understanding of Internal Control over Financial Reporting (ICFR)

- Monitoring OF Controls
  - Obtain understanding of major types of activities that the company uses to:
    - Monitor the effectiveness of its internal controls over financial reporting
    - Initiate corrective actions related to its controls
  - Understand sources of information used in monitoring controls
    - *Competence*
    - *Independence*

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Performing Risk Assessment Procedures

- Identify and assess the risks of material misstatement
- Revision of risk assessment
  - Continuous throughout the audit
  - Dependent on audit evidence obtained

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Auditors' Responsibility Related to Internal Control (for Audits starting after 12/15/2010)

- AS No. 13 *The Auditor's Response to the Risks of Material Misstatement*
  - "If the auditor plans to assess control risk at less than the maximum by relying on controls, and the nature, timing, and extent of planned substantive procedures are based on the lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance." (Para 17, AS No. 13)

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AUDIT RESPONSES

- Overall responses – engagement level considerations
  - Make appropriate assignments of significant engagement responsibilities
    - *Availability of competent IS audit staff*

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AUDIT RESPONSES

- Responses involving nature, timing, and extent of audit procedures
  - More persuasive audit evidence is needed the higher the auditor's assessment of risk
  - Take into account the likelihood and magnitude of potential misstatements
  - In an integrated audit, design the testing of controls to accomplish the objectives of both audits
    - ***<u>Not required to audit for deficiencies less severe than material weaknesses</u>***

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AUDIT RESPONSES

- Responses involving nature, timing, and extent of audit procedures (cont'd)
  - For significant risks the auditor should perform substantive procedures, including tests of details
  - For fraud risks the auditor should perform substantive procedures that are responsive to the assessed risks of fraud
  - If the auditor selects certain controls intended to address the assessed risk of fraud
    - Effective during the entire period of reliance
  - *Dependence on completeness and accuracy of underlying data*

TESTING CONTROLS

- Determine which controls to test
  - *Entity Level Controls*
  - *Business process controls*
  - *IT general controls*
  - *Special considerations for prior year's work*
- Testing design effectiveness of controls
  - *Available documentation of control design*
- Testing operating effectiveness of controls
  - *Available evidence of operation of control*

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TESTING CONTROLS

- *Entity Level Controls*
  - *Control environment controls*
  - *Monitoring other controls*
  - *Direct entity level controls*
- *Business process controls*
  - *Control activities to ensure that transactions are properly initiated, authorized, recorded, processed and reported*

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TESTING CONTROLS

- *IT general controls*
  - *Systems implementation*
  - *Program and system change management*
  - *Access controls*
  - *Computer operations*

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TESTING CONTROLS

- *Testing IT general controls to address specific risks to a company's internal control over financial reporting resulting from IT*
- *Specific risk - Few users and limited dedicated IT staff*
  - *IT governance procedures should be well documented*
  - *Contracts with reputable vendors, suppliers and consultants should be in place and reviewed periodically for appropriate service level performance*
  - *Periodic reviews by independent third parties should be conducted*

TESTING CONTROLS

- *Testing IT general controls to address specific risks to a company's internal control over financial reporting resulting from IT*
- *Specific risk - Segregation of duty issues*
- *Alternate Controls*
  - *Periodic independent review of "user ID provisioning" process.*
  - *Periodic independent review of segregation of duties.*
  - *Frequency dependent upon results of periodic reviews.*

TESTING CONTROLS

- *Testing IT general controls to address specific risks to a company's internal control over financial reporting resulting from IT*
- *Specific risk - Prevalence of end user computing*
- *Controls*
  - *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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TESTING CONTROLS

- *Testing IT general controls to address specific risks to a company's internal control over financial reporting resulting from IT*
- *Specific risk - Computer generated information (CGI) used in tests of controls and substantive procedures*
- *Controls*
  - *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.*

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TESTING CONTROLS

- *Testing IT general controls to address specific risks to a company's internal control over financial reporting resulting from IT*
- *Specific risk –The impact that IT general control deficiencies have on the audit of ICFR and/or the audit of financial statements not considered*
- *Controls*
  - *Use knowledgeable IS auditor to assess impact*
  - *Deficiencies should be related to financial system processing*
  - *Assess risk of automated procedures, controls, and computer generated information (CGI)*
  - *Perform alternate audit procedures to mitigate risks*

TESTING CONTROLS

- Obtaining evidence from tests of controls
  - *Inquiry*
  - *Observation*
  - *Inspection of relevant documentation*
  - *Re-performance*
- Assessing control risk
  - At maximum
  - Below the maximum

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TESTING CONTROLS

- Nature of tests of controls
  - *Based on extent of planned reliance on control*
    - ***Inquiry***
    - ***Observation***
    - ***Inspection of relevant documentation***
    - ***Re-performance of a control***
- Timing of tests of controls
  - *Interim testing/roll-forward procedures*
- Extent of tests of controls
  - *Sampling*
  - *Tests of one*

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ASSESSING CONTROL RISK

- Evaluate
  - Evidence from all sources
    - *Using the work of others*
  - Misstatements detected during audit of financial statements
    - *Determine cause and re-assess ICFR*
  - Control design or control operating deficiencies
    - *Evaluate individually and in combination*
    - *Audit response (e.g., compensating controls, expanded audit procedures)*

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ASSESSING CONTROL RISK

- Assess control risk at ***maximum*** for relevant assertions
  - Controls missing, inappropriately designed or not operating effectively
  - Insufficient evidence obtained
- When controls do not operate effectively
  - Test additional controls that address the same assertion
  - Revise planned substantive procedures

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ASSESSING CONTROL RISK

- Assess control risk at ***below maximum*** for relevant assertions
  - Controls to achieve relevant assertions for significant accounts or disclosures
    - Effectively designed
    - Effectively operating throughout period of reliance

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Summary and Conclusion

- Auditors have always had responsibility related to internal controls; AS No. 5 and AS No. 8 through AS No. 15 continue to build on that.
- Assessment of control risk may have a significant effect on the nature, timing and extent of other audit procedures in support of relevant assertions for significant accounts or disclosures.
- PCAOB publication provides guidance on scaling AS No. 5 to small public companies. Certain aspects of AS No. 5 would be applicable to risk assessment and the auditor's responses as described in AS No. 8 through AS No. 15

Summary and Conclusion

- IT general controls are a "pervasive" part of internal control and have a relationship to financial statement audits and integrated audits.
- Auditors should consider IT risks that are present in less complex IT environments.

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Questions?

Lunch

(60 minutes)

Case Studies on Auditing in the Small Business Environment

Presenters

- John Abell, Associate Director, Accountant, Division of Enforcement and Investigations
- George Botic, Deputy Director, Division of Registration and Inspections
- Keith Wilson, Deputy Chief Auditor, Office of the Chief Auditor

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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 over 1,240 domestic small firm inspections between 2004 and 2010
  - Inspected over 3,300 issuer audits between 2004 and 2010
- To date, over 1,100 domestic small firm inspection reports have been issued final
- Issued "Report on the PCAOB's 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms" (October 22, 2007)

Common Inspection Observations

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

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Overview of the Division of Enforcement and Investigations

- Who we are
- Our role within the PCAOB
- Stages of an Investigation
- Recent Disciplinary Action Topics
  - Confirmation procedures
  - Non-Cooperation

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Case Studies on Auditing in the Small Business Environment

- Refer to handouts
  - #1 - Olympus Parchment, Inc. (Part 1 - discussed in standard-setting update)
  - #2 - Olympus Parchment, Inc. (Part 2)
  - #3 – Reliable Game Company, Inc.
  - #4 – Small But Solid Bancorp
  - #5 – Durable Transmissions, Inc.

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Restrictions on Use

- *Information not necessarily compiled from inspection observations*
- *Information intended to provide considerations and <u>does not</u> 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 #2 – Olympus Parchment, Inc. Part 2

- Risks of Material Misstatement
  - Accounts receivable and revenue could be overstated due to granting of incentives to customers that affect revenue recognition (including bill-and-hold or channel stuffing arrangements).
  - Accounts receivable (net of relevant allowance) also could be overstated due to financial distress of a major customer.
  - Inventory could be overvalued due to obsolescence of certain product (excess inventory of specialty calendars)
  - Disclosures regarding bank liabilities might be inaccurate or inadequate (including possible going concern uncertainties).
  - Goodwill associated with the recent acquisition could be misstated.

Case Study #2 – Olympus Parchment, Inc. Part 2

- Considerations regarding overall responses:
  - What should the auditor consider regarding assignment of staff and level of supervision in light of the identified risks?
  - What should the auditor do to incorporate an element of unpredictability?
- Considerations regarding nature, timing and extent of procedures:
  - How should the auditor tailor his or her audit procedures in light of the identified risks?
  - In what areas are substantive tests of details necessary?

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Case Study #3 – Reliable Game Company Background

- Your Firm has been engaged to audit the December 31, 2010 financial statements of Reliable Game Company, Inc. ("Company")
- Company consists of two operating segments, Reliable Refrigerators ("Reliable"), distributes refrigerators to consumers, and Game Distribution ("Game"), distributes non-electronic games to retailers
- For goodwill impairment test purposes, management views the Company as a single reporting unit engaged in distribution
- Over the past three years, Reliable's net income has increased while Game's net loss has increased
- All goodwill relates to Game
- The Company's market capitalization is $20 million based on stock price with no apparent control premium

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Case Study #3 – Reliable Game Company Background

- Annual goodwill impairment test date is October 1, although the Company decided to use November 30th for the first time in 2010 for convenience
- Step one of impairment test using discounted cash flow analysis resulted in $35 million in fair value for the Company compared to book equity of $30 million with no impairment
- The DCF was based on 10 percent revenue growth and five percent expense reduction each year for 10 years with five percent discount rate
- Board approved five year forecast using two percent annual revenue growth and three percent annual expense reduction

Case Study #3 – Reliable Game Company Scenario

- *You, the engagement partner, have arrived at the client site to review the work performed by the engagement team on the goodwill impairment test*
- The audit procedures performed by the engagement team included -
  - Obtained a copy of the DCF analysis and checked the clerical accuracy without exception;
  - Agreed the carrying value of equity used in the step one test to the financial statements;
  - Obtained management's representations that the goodwill impairment test and related fair value measurement were performed in accordance with GAAP; and
  - Work papers indicate: "Methods and assumptions . . . appear reasonable. No further test work is deemed necessary."

Goodwill (ASC 350)

ASC 350-20-35-34 [FAS 142 paragraph 30] states, in part:

A reporting unit is an operating segment or one level below an operating segment (referred to as a component).17

17 For purposes of determining reporting units, an operating segment is as defined in paragraph 10 of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information.*

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Segments (ASC 280)

ASC 280-10-50-1 [FAS 131 paragraph 10] states, in part:

An *operating segment* is a component of an enterprise:

a. That engages in business activities from which it may earn revenues and incur expenses,

b. Whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

c. For which discrete financial information is available.

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Goodwill (ASC 350)

ASC 350-20-35-28 [FAS 142, paragraph 26] states, in part:

Goodwill of a reporting unit shall be tested for impairment on an annual basis and between annual tests in certain circumstances. The annual goodwill impairment test may be performed any time during the fiscal year provided the test is performed at the same time every year.

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Goodwill (ASC 350)

ASC 350-20-35-22 & 23 [FAS 142, paragraph 23] states, in part:

The fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. . .

An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.

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Auditing Fair Value (AU 328.26)

The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:

a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information.
b. The fair value measurement was determined using an appropriate model, if applicable.
c. Management used relevant information that was reasonably available at the time.

Auditing Fair Value (AU 328.36)

To be reasonable, the assumptions on which the fair value measurements are based, individually and taken as a whole, need to be realistic and consistent with:

a. The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances;
b. Existing market information;
c. The plans of the entity, including what management expects will be the outcome of specific objectives and strategies;

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Case Study #4 – Small But Solid Bancorp Background

- Your Firm has been engaged to audit the December 31, 2010 financial statements of Small But Solid Bancorp (the "Bank")
  - This will be your firm's first audit of the Bank
- The Bank is a regional commercial bank
- During 2010, the Bank dealt with the following significant judgmental accounting matters:
  - The valuation of residential mortgage-backed securities
  - The valuation of troubled customer loans
  - A goodwill impairment
  - Modification of stock option terms
- The Bank's 10-K is due March 31, 2011

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Case Study #4 – Small But Solid Bancorp Scenario 1

- Your Firm is in the beginning stage of planning its audit of the Bank's financial statements for the year ended December 31, 2010.
- You are the engagement partner on the Bank audit and have over 25 years of experience auditing publicly-held regional banks.
- You have just arrived in your managing partner's office to discuss the assignment of an engagement quality reviewer to the Bank engagement.
- Your managing partner has done some homework on the subject and presents you with the following options for the engagement quality reviewer

Case Study #4 – Small But Solid Bancorp Scenario 1

- A manager of the Firm with 10 years experience auditing publicly-held regional banks – high level of knowledge and competence in accounting, auditing, financial reporting, and SEC rules and regulations
- A partner of the Firm with 25 years experience providing tax services to publicly-held regional banks – expert on tax issues of regional banks and is liked by the Bank's CEO and CFO
- A partner of the Firm with 30 years experience auditing publicly-held manufacturing companies – no bank experience but is the Firm's Director of Accounting and Auditing
- An accounting professor at state university with 30 years experience auditing publicly-held banks at large accounting firm from which he retired five year ago – wrote a highly regarded book entitled, How to Audit a Publicly-Held Regional Bank
- Your managing partner wants to keep the fees within the Firm

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Engagement Quality Review (AS 7)

Auditing Standard No. 7, *Engagement Quality Review* ("AS 7"), paragraph 3 states, in part:

An engagement quality reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) must be a partner or another individual in an equivalent position. The engagement quality reviewer may also be an individual from outside the firm.

Engagement Quality Review (AS 7)

AS 7, paragraph 5 states:

The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.

Engagement Quality Review (QC 40)

QC Section 40, *The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-in-Charge of an Attest Engagement* ("QC 40"), paragraph .07 states, in part:

The practitioner-in-charge of an engagement to audit the financial statements of a public company would be expected to have certain technical proficiency in SEC reporting requirements . . . This would include, for example, experience in the industry and appropriate knowledge of SEC and ISB rules and regulations, including accounting and independence standards.

Engagement Quality Review (QC 40)

QC 40, paragraph .08 states:

Technical Proficiency—Practitioners-in-charge of an engagement should possess an understanding of the applicable accounting, auditing, and attest professional standards including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages.

Case Study #4 – Small But Solid Bancorp Scenario 2

- Your Firm is in the execution stage of its audit of the Bank's financial statements for the year ended December 31, 2010.
- You are the engagement partner on the Bank engagement.
- You are currently out-of-town in a very important all-day meeting with another client.
- While in the meeting, you receive a text message from your audit manager on the Bank engagement.
- The text indicates that the Bank's CFO needs you to meet with him today to get the Firm's agreement with management's position on its accounting for a stock option modification.
- Your audit manager suggests in his text message that the engagement quality reviewer attend the meeting in your place since he is available today to attend the meeting and is certainly capable of making this decision.

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Engagement Quality Review (AS 7)

AS 7, paragraph 7 states:

To maintain objectivity, the engagement quality reviewer and others who assist the reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team. The engagement partner remains responsible for the engagement and its performance, notwithstanding the involvement of the engagement quality reviewer and others who assist the reviewer.

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Case Study #4 – Small But Solid Bancorp Scenario 3

- Your Firm completed its audit of the Bank's financial statements for the year ended December 31, 2010.
- You are the Firm's Partner-in-Charge of Quality Control and you are conducting an internal inspection of the Firm's completed audit of the Bank.
- The key facts for your review of the EQR portion of the engagement are as follows.
- On March 31, 2011, time to file the 10-K, the engagement partner was wrapping up loose-ends on the engagement when his attention turned to the EQR.
- The engagement quality reviewer provided written review questions and comments on March 30th.
- As of the engagement partner's inquiry on March 31st, no one had addressed those questions and comments.

Case Study #4 – Small But Solid Bancorp Scenario 3

- The Bank's CFO was ready to file the 10-K and was waiting on the engagement partner.
- The engagement partner quickly reviewed the engagement quality reviewer's questions and comments and determined they were addressed by the audit work performed.
- The engagement partner notified the CFO that he could file the 10-K.
- On April 4, 2011, the engagement partner provided the engagement quality reviewer with written responses to each of his questions and comments which they also then discussed by phone.

Case Study #4 – Small But Solid Bancorp Scenario 3

- Following the discussion, the engagement partner received a fax from the engagement quality reviewer of a single page with his printed name and signature, a list of the documents he reviewed, and his approval of issuance dated April 4, 2011.
- The list of reviewed documents included the following –
  - Planning including risk assessments;
  - Summaries of unrecorded and recorded audit differences;
  - Financial statements, audit report, and 10-K;
  - Written communications with the audit committee and management;
  - Assessment of Firm's independence.
- The engagement partner filed this fax document in his desk file for the 2010 Bank audit engagement.

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Engagement Quality Review (AS 7)

AS 7, paragraph 10 states, in part:

In an audit, the engagement quality reviewer should:

a. Evaluate the significant judgments that relate to engagement planning . . .
b. Evaluate the engagement team's assessment of, and audit responses to, significant risks . . .
c. Evaluate the significant judgments made about
    1) the materiality and disposition of corrected and uncorrected identified misstatements, and
    2) the severity and disposition of identified control deficiencies
d. Review the engagement team's evaluation of the firm's independence . . .
e. Review the engagement completion document . . .

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Engagement Quality Review (AS 7)

AS 7, paragraph 10 states, in part:

In an audit, the engagement quality reviewer should:

f. Review the financial statements, management's report on internal control, and the related engagement report

g. Read other information in documents containing the financial statements to be filed with the SEC . . .

h. . . . review the documentation, including conclusions, of such consultations [on difficult or contentious matters]

i. . . . evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties

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Engagement Quality Review (AS 7)

AS 7, paragraph 13 states:

In an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

Engagement Quality Review (AS 7)

AS 7, paragraph 19 states, in part:

Documentation of an engagement quality review should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard, including information that identifies:

a. The engagement quality reviewer . . .
b. The documents reviewed by the engagement quality reviewer . . .
c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

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Engagement Quality Review (AS 7)

AS 7, paragraph 20 states:

Documentation of an engagement quality review should be included in the engagement documentation.

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Case Study #5 – Durable Transmissions, Inc. Background

- Your Firm has been engaged to audit the December 31, 2010 financial statements of Durable Transmissions, Inc.
  - This will be your firm's first audit of this issuer
- Durable manufactures and sells transmissions to automobile manufacturers
- Revenue is a significant account and the risk of material misstatement is high
- Receipt of purchase orders for each sales transaction is Durable's standard practice

Case Study #5 – Durable Transmissions, Inc. Background

- Shipping terms are FOB destination
- Third-party carrier provides electronic confirmation of delivery
- Revenues are recognized at time of shipment
- Large volume of shipments near year-end
- Durable has a new volume rebate program for its customers and records a rebate liability based on an estimate believed to be reasonable

Case Study #5 – Durable Transmissions, Inc. Scenario 1

- *You, the engagement partner, have arrived at the client site to review work performed by the engagement team in area of revenue.*
- Audit procedures performed included -
  - Performed high-level analytical procedures of sales, gross margin, and inventory turnover
  - Performed accounts receivable confirmation testing and a physical inventory observation as of year end
  - Obtained management's representation that revenue was recognized in accordance with GAAP

Case Study #5 – Durable Transmissions, Inc. Scenario 1

- The engagement team also informs you of the following two specific matters:
  - A week before Durable's year end, Customer A placed an order over the phone, but didn't submit a purchase order since the customer was awaiting finance department approval. Approval and the purchase order were received after year-end. The product was delivered and revenue recognized prior to year-end.
  - Customer B is experiencing financial difficulties and is not making payments on amounts past due. Near year end, Durable shipped product to this customer and recognize revenue upon shipment.

Case Study #5 – Durable Transmissions, Inc. Scenario 2

- Your Firm has now completed the 2010 audit of Durable and is starting to plan for the 2011 audit
- For 2011, Durable has changed its process for revenue recognition to include a three-way match of:
  - Sales invoice billed to the customer;
  - Binding purchase order received from the customer; and
  - Electronic notice of product delivery from the third-party carrier
- The three-way match is an automated control within an off-the-shelf software package
- Revenue is only recognized once the three-way match is completed

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Case Study #5 – Durable Transmissions, Inc. Scenario 2

- In planning the 2011 audit, the audit manager is uncertain about:
  - Whether to test and rely on the three-way match control
  - Whether testing should be performed on general controls over the system that performs the three-way match
- How would you respond to the audit manager's concerns?

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Revenue Recognition (SAB 104)

- Staff Accounting Bulletin No. 104, *Revenue Recognition*, (SAB 104) states in part that the staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:
  - Persuasive evidence of an arrangement exists;
  - Delivery has occurred or services have been rendered;
  - The seller's price to the buyer is fixed or determinable; and
  - Collectibility is reasonably assured

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Revenue Recognition (SAB 104)

SAB 104, A.2. Question 1, Interpretive Response, states, in part:

Generally the staff believes that, in view of Company A's business practice of requiring a written sales agreement for this class of customer, persuasive evidence of an arrangement would require a final agreement that has been executed by the properly authorized personnel of the customer. In the staff's view, Customer Beta's execution of the sales agreement after the end of the quarter causes the transaction to be considered a transaction of the subsequent period. Further, if an arrangement is subject to subsequent approval (e.g., by the management committee or board of directors) or execution of another agreement, revenue recognition would be inappropriate until that subsequent approval or agreement is complete.

Revenue Recognition (SAB 104)

SAB 104, A.3.a., Interpretive Response, states, in part:

> The staff believes that delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer's purchase order or sales agreement. Typically this occurs when a product is delivered to the customer's delivery site (if the terms of the sale are "FOB destination") or when a product is shipped to the customer (if the terms are "FOB shipping point").

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Revenue Recognition (SAB 104)

SAB 104, footnote 5, states, in part:

> A "fixed fee" as a "fee required to be paid at a set amount that is not subject to refund or adjustment."

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Revenue Recognition (ASC 605-50-25-7)

ASC 605-50-25-7 [EITF Issue No. 01-9, *Accounting for Consideration given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*, paragraph 30] states, in part:

> . . . if the amount of future rebates or refunds cannot be reasonably estimated, a liability shall be recognized for the maximum potential amount of the refund or rebate… the following factors may impair a vendor's ability to make a reasonable estimate:
>
> - Relatively long periods in which a particular rebate or refund may be claimed
> - The absence of historical experience with similar types of sales incentive programs
> - The absence of a large volume of relatively homogeneous transactions.

Substantive Analytical Procedures (AU 329)

- AU Section 329, *Substantive Analytical Procedures*, paragraph .09, states, in part:

  > The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

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Substantive Analytical Procedures (AU 329)

- AU Section 329, *Substantive Analytical Procedures*, paragraph .19, states:

  Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. The level of detail that is appropriate will be influenced by the nature of the client, its size and its complexity. Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. Disaggregation helps reduce this risk.

Questions?

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Break

(15 minutes)

SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

Disclaimer

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

Agenda

- Overview of the Division of Corporation Finance
- Recent Developments
- The Comment Letter Process
- Frequent Staff Comment Areas
- 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

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

Recent Developments

Key SEC Developments

Commission Actions

- ***Dodd-Frank Act Rulemaking and Studies***
- ***Proxy Access***
- ***Commission Statement in Support of Convergence and Global Accounting Standards***
  - ***Work Plan***
- ***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
- Dear CFO Letters
- Staff Accounting Bulletins

The Staff Review 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**
- **Other**

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

Best Practices for Resolving Issues

- Prepare a thorough response
  - Do not assume staff disagrees with accounting treatment
  - 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
- Call the staff if you do not understand a comment or need further clarification
- Document accounting decisions contemporaneously
- Furnish all correspondence with the Staff on EDGAR

Frequent Staff Comment Areas

Frequent Staff Comment Areas

- MD&A Disclosure
- Reverse Mergers & “Back Door” Registrations
- Business Combinations
- Predecessor Financial Statements
- Equity Transactions
- Embedded Conversion Options and Freestanding Warrants
- Disclosure Controls and Procedures
- Internal Control over Financial Reporting
- Form 8-K
- Other

Management's Discussion & Analysis (MD&A)

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 applicable SOX 404 requirements**
- **See FRM Section 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**

Predecessor Financial Statements

- Registrant succeeds to substantially all of the business of another entity
- Registrant's own operations are relatively insignificant
- Common in mergers involving Special-Purpose Acquisition Companies
- Financial Statements consistent with Rules 3-01 and 3-02 of Regulation S-X or Rules 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
  - Black-line registrant and predecessor

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 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 ("Smaller Reporting Companies")

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 Management's 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

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 (anti-dilution provisions, warrant, reg. rights, etc.) carefully

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 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

- **<u>Separate</u> 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) as opposed to the accounting**
- **Impact of control deficiency on the company's financial reporting and its ICFR**
- **Disclosures should be detailed and specific for each material weakness identified**

Material changes in ICFR

- **Changes in circumstances without disclosures of changes in internal controls**
- **Change in conclusion on effectiveness should be accompanied with some change in internal control**
- **Avoid boilerplate disclosure**

Internal Control over Financial Reporting (ICFR)

ICFR for registrants with substantially all their operations outside U.S.

Evaluating

- **Background and training of CFO or other person(s) responsible for maintaining books and records and preparing financial statements**
- **Seek information:**
  - **Specific nature of U.S. GAAP experience**
  - **Specific roles / duties of person with U.S. GAAP experience**
  - **Services performed by a third party CPA or consultants – specific nature, extent**

Form 8-K – Item 4.01

- **New CDI – Regulation S-K Section 111 and 211; Exchange Act Form 8-K, Section 114 and 214; and and Section 4530 of the FRM**
- **Failure to specify whether former accountants resigned, declined to stand for re-election, or were dismissed and the date**
- **Disclosure of disagreements through termination date**
- **Exhibit 16 letter**
- **Reverse acquisitions**
- **Accounting firm mergers**

Form 8-K – Item 4.01

Section 4530 of the FRM:

- **Subsequent interim period**
- **No reportable events**
- **Remediation of internal control deficiencies**
- **Material weakness or significant deficiency in ICFR**
- **Going concern**
- **Explanatory paragraph in report on ICFR**
- **Revocation of accountant's PCAOB registration**
- **Time period preceding resignation, declination or dismissal**

Form 8-K – 4.02

- **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**

Other

- Audit Report Signatures
- SRC status

Resources

Resources

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

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 Chief Accountant at (202) 551-3400 or submit request through online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive**
  - **Small Business Policy – CF Office of Small Business Policy (202) 551-3460**
  - **Legal questions - OCC at 202-551-3500**
  - **EDGAR question – EDGAR Filer Support at 202-551-8900**

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?

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

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

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. **<u>Freestanding</u>**
     - **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. **<u>Embedded</u>**

- **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 beneficial conversion feature 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

Closing Remarks and Wrap-Up

Daniel L. Goelzer
Board Member, PCAOB
April 28, 2011
Boston, MA