



CENTER FOR AUDIT QUALITY

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CAQ WEBCAST

Smaller Firm Matters: The PCAOB's Perspective

May 18, 2010

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Today's Presentation

Today's program is designed to provide you with first-hand perspectives from the PCAOB on:

- ❑ Economic Trends and Related Risks

- ❑ Standard-Setting Activities, including:
 - Recent Board Actions
 - Audit Practice Alert No. 5 – Significant Unusual Transactions
 - Other Standard-Setting Activities
 - Standing Advisory Group

- ❑ Common PCAOB Inspection Issues for Smaller Firms

Today's Panelists

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Economic Outlook & US GAAP Developments

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Overview

1. Economic Outlook
2. Issuer Challenges
3. Small Firm Challenges
4. Accounting and Audit Hot Topics
5. Managing Complexity

2007-2008: Very High Risk Scenario

- Main features of 2007-2008 scenario:
 - Banking crisis
 - Slowed Production
 - Recession
 - Deflationary forces



- Governments around the world acted:
 - Swiftly
 - In a coordinated fashion
 - Very creatively

- Very strong monetary and fiscal stimuli

Core Inflation

	2009	2010
Jan	0.0%	2.7%
Feb	0.2%	2.2%
Mar	-0.4%	2.4%
Apr	-0.7%	1.8%
May	-1.3%	1.7%
Jun	-1.4%	1.6%
Jul	-2.1%	
Aug	-1.5%	
Sep	-1.3%	
Oct	-0.2%	
Nov	1.8%	
Dec	2.8%	

... a Bounce in Risky Assets

...Consolidation in the Housing Market

Change in Housing Prices

	Composite 20 Index	San Francisco Index
2005	14.5%	13.6%
2006	0.4%	-1.2%
2007	-8.6%	-10.6%
2008	-16.7%	-29.2%
2009	-0.3%	9.6%

Source: Case-Shiller Index



2006 was the last profitable year for most home builders.

Will homebuilders be able to apply net operating losses to previous earnings? (There is a two year limit).

... US growth recovery

Gross Domestic Product (Annual)	Growth Rate*
2005	6.5%
2006	6.0%
2007	5.1%
2008	2.6%
2009	-1.3%
2010	2.4%
2011	3.1%
2012	3.3%

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

- Huge decrease in inventories
 - An abnormally low level due to manufacturing production levels.
- Large rebound in 4th quarter 2009 and 1st quarter 2010



Inventory Accounting

Portion of fixed production overhead attributable to excess capacity should be expensed as it incurs.

It may not be allocated and capitalized as cost of inventory.

Determining whether production is abnormally low requires significant judgment and depends on facts and circumstances.

Looking Forward: Baseline Scenario

But...

Unemployment is likely to be higher nationally...

...Multi speed recovery

2010 GDP projection	
US	3.1%
Euro zone	1.0%
Japan	1.9%
China	10.0%
Emerging markets	6.3%
World	4.2%

Source: IMF. April 2010. World Economic Outlook.

Consumers and Government are Deep Into Debt...So Expect Lower Consumption and Spending Levels.

- Consumers will try to repay debt.
- This depresses economic growth.
- But so far the consumer has proven more resilient than expected.



What are consequences for retail and media and advertising?

General Government Debt (Percent of GDP)

Country	2007 (Pre-Crisis)	2009	2010	2014
United States	62.1%	83.2%	92.6%	106.4%
G - 20	62.4%	76.1%	82.1%	86.6%
Advanced G-20 Countries	78.8%	100.6%	109.7%	119.7%
Emerging G -20 Countries	37.5%	38.8%	40.2%	36.4%

*Fiscal projections reflect staff's estimates, based on authorities' policy intentions as stated in the EU Pre-Accession Program document. They do not include measures taken by the government in July 2009 to improve the fiscal position.

Source: International Monetary Fund

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

- Lower spending
- Higher taxes
- Inflation
 - But expected to be very subdued for at least a year
- Weak dollar
 - Unless “flight to quality”
- Lower economic growth

- Economy (US and World) has imbalances
 - How will we navigate the transition?
 - Deflation to inflation
 - Spend to save



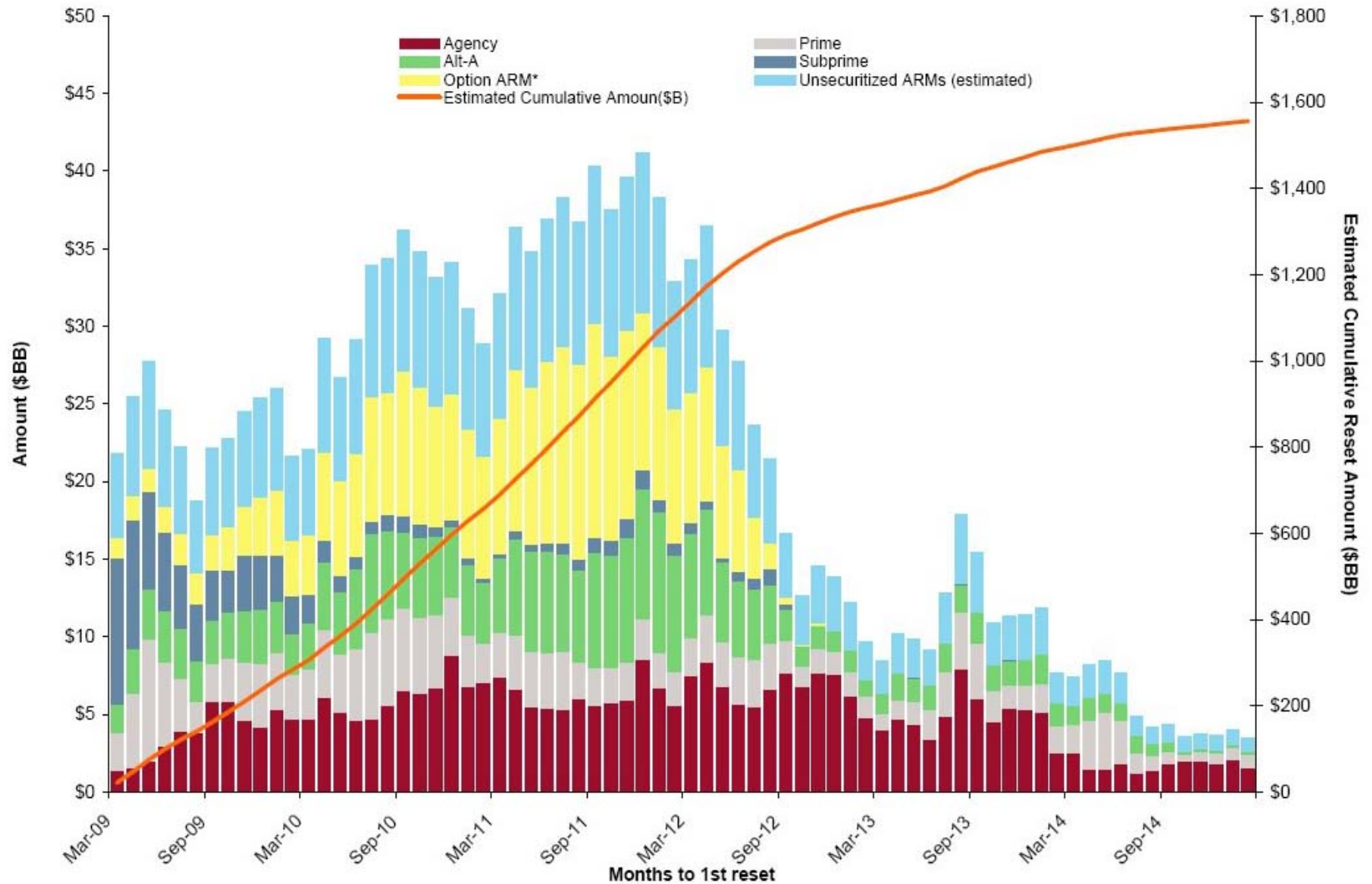
Foreign Currency Translation & US Dollar volatility

Foreign currency fluctuations has increasingly cited as a reason for changes in operating results.

Use exchange rates at the time of the cash flow to report foreign subsidiaries cash flows.

A weighted average can be used. However, due to volatility a simple average may not yield correct result.

Residential Mortgage Rate Resets



*Option ARMs show estimated recast schedule based on current negam rate; Source: Credit Suisse (US Mortgage Strategy), LoanPerformance, FH/FN/GN

On the Other Hand,

- Financial institutions have raised capital
- They may ramp up lending
 - But do not expect to return to the high pre-crisis leverage levels



Banking industry

Coverage ratio (loan loss reserves / bad loans) declined dramatically in 2009.

Insurance companies have large amounts of Level 3 Assets.

Potential Implications for Issuers

- ❑ Decreased wage growth
- ❑ Commodity input cost increases
- ❑ Higher taxes and/or higher inflation
- ❑ We may see:
 - Divestitures
 - Bankruptcies
 - M&A activities



Business Combinations

Acquired Assets and assumed liabilities are measured at fair value on acquisition date.

Acquirer given one year to account for facts and circumstances that existed at that date.

These are accounted for as purchase price adjustments.

Potential Risk: purchase price adjustments could reflect losses from post acquisition deterioration.

Client Pressures

- Aggressive earnings expectations
- Challenging fundamentals
- Restricted access to credit
- Refinancing risk / rising rates
- Regulatory uncertainty
- Volatility
- Employee turnover

Audit Firm Pressures

- Heightened audit risk
- Complexity
- Greater focus on judgment
- Audit fees
- Audit hours

Selected Hot Topics

- ❑ Fair Value Measurement
- ❑ Revenue Recognition
- ❑ Transfer and Consolidation
- ❑ Fraud
- ❑ Risk Assessment

Fair Value Measurements

- FSP FAS 157-4 (ASC 820-10-65): *Determining Fair Value When the Volume and Level of Activity Have Significantly Decreased and Identifying Transactions That are not Orderly*
 - Volume
 - Orderliness
- FSP FAS 115-2 and 124-2 (ASC 320-10-35): *Recognition and Presentation of Other-Than-Temporary Impairment*
 - Applies to debt securities (except disclosure requirements)
 - If no intent / ability to hold – full impairment through earnings
 - If holding:
 - OTTI credit loss – recognized in earnings
 - Rest of OTTI loss – charge to OCI
 - Disclose methodology and key inputs for credit loss
- DCF analysis
- ICFR

Fair Value Measurements (cont'd)

FAS 157 - nonfinancial assets and liabilities:

- Examples of assets & liabilities covered:
 - Arising from a business combination under FAS 141(R)
 - Reporting units' goodwill or indefinite-lived intangible assets in an impairment assessment under FAS 142
 - Nonfinancial long-lived assets in an impairment assessment under FAS 144
 - Asset retirement obligations under FAS 143
 - Nonfinancial liabilities for exit/disposal activities under FAS 146
- Implementation challenges
 - Fewer observable inputs
 - Principal market
 - Highest and best use

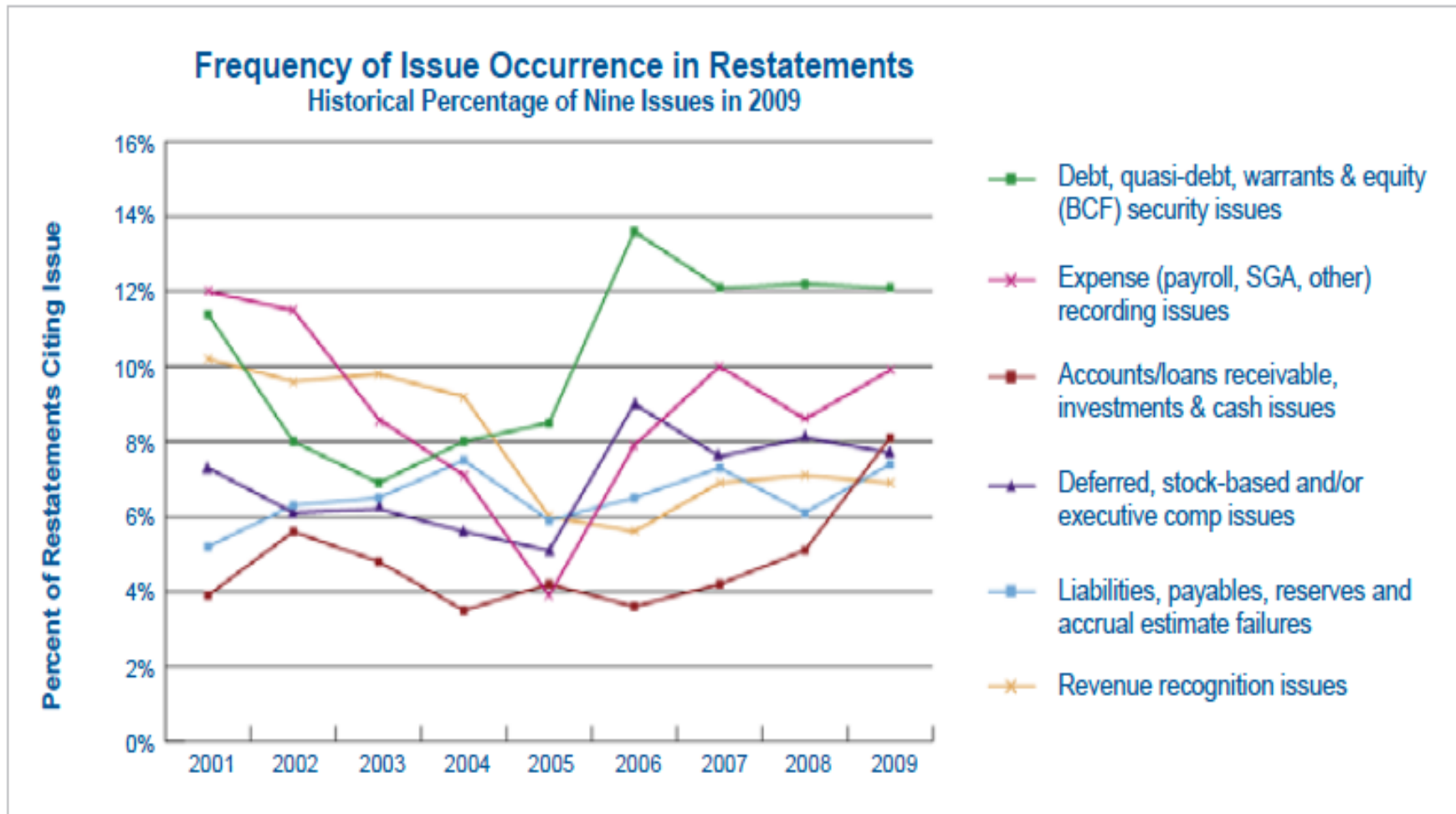
Volatility: U.S. Market



Revenue Recognition

- EITF 08-1 (ASU 2009-13)
 - Separation criteria for multiple element no longer requires VSOE for undelivered elements, use best estimate of selling price
- EITF 09-3 (ASU 2009-14)
 - Modifies SOP 97-2 to scope out tangible elements and software elements critical to essential functionality of non-software elements
- Both effective no later than fiscal years beginning on or after 6/15/10

2009 Restatements



Transfer and Consolidation

- ❑ FAS 166 (ASU 860) amends FAS 140
- ❑ FAS 167 (ASU 810) amends FIN 46(R)
- ❑ Eliminates QSPEs
- ❑ Previous two-tiered model focused on control (FAS 140) and risk / reward (FIN 46(R))
- ❑ New model is focused on control
- ❑ Risk / reward hurdle has been lowered

Fraud Risk

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

Risk Assessment

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

Managing Complexity

- ❑ Sufficient understanding of transaction, including terms, economics, rights, obligations, risks and rewards
- ❑ Adequate accounting resources: knowledgeable, experienced and unbiased
- ❑ Ongoing auditor discussions
- ❑ Early issue identification and evaluation
- ❑ Management and Audit Committee involvement
- ❑ Potentially more than one correct answer
- ❑ Financial statement transparency
- ❑ Disclosures

PCAOB Recent Standard-Setting Activities

Jennifer A. Rand
Deputy Chief Auditor
Office of the Chief Auditor

What We Will Cover

- Recent Board Actions
 - Auditing Standard No. 7 - *Engagement Quality Review*
 - Proposed Auditing Standards - *The Auditor's Assessment of and Response to Risk*
 - Proposed Auditing Standard - *Communications with Audit Committees*
- Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*
- Other Standard-Setting Activities
- Standing Advisory Group

Auditing Standard No. 7

Engagement Quality Review

AS No. 7 – *Engagement Quality Review*

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

AS No. 7 – *Engagement Quality Review*

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

AS No. 7 – *Engagement Quality Review*

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

Staff Question and Answer

Auditing Standard No. 7, *Engagement Quality Review*

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

Proposed Auditing Standards, *The Auditor's Assessment of and Response to Risk*

Risk Assessment

- Reproposed December 17, 2009
- Comment period ended on March 2, 2010
- Twenty-three comment letters received
- Available through PCAOB website at <http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx>

Risk Assessment

Significant changes to repropoed standards from original proposal:

- Alignment with Auditing Standard No. 5
 - Incorporates the requirements from AS No. 5 related to identifying and assessing risks of material misstatement that also apply to financial statement audits.
 - Excludes requirements related only to the audit of internal control over financial reporting.
- Emphasis on the consideration of fraud
 - Emphasizes that assessing and responding to risk of fraud is an integral part of an audit.
 - Incorporates the requirements for identifying and responding to risks of material misstatement due to fraud and evaluating audit results from AU sec. 316
- Enhancing the requirements for evaluating disclosures

Risk Assessment

- Proposes seven new standards:
 - Audit Risk
 - Audit Planning and Supervision
 - Consideration of Materiality in Planning and Performing an Audit
 - Identifying and Assessing Risks of Material Misstatement
 - The Auditor's Responses to the Risks of Material Misstatement
 - Evaluating Audit Results
 - Audit Evidence

Proposed Auditing Standard, *Communications With Audit Committees*

Communications With Audit Committees

- ❑ Board issued proposed standard on March 29, 2010; comment period ends on May 28, 2010
- ❑ Proposed standard available at http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf
- ❑ Primary objectives of the proposed standard are to:
 - Enhance the relevance and effectiveness of communications between the auditor and the audit committee
 - Emphasize the importance of effective, two-way communications between the auditor and the audit committee

Communications With Audit Committees

- ❑ Retains the requirements from AU sec. 380, *Communication with Audit Committees*
- ❑ Adapts requirements from AU sec. 310, *Appointment of the Independent Auditor*
- ❑ Includes SEC-required communications for accounting-related matters

Communications With Audit Committees

- ❑ Adds a requirement to communicate an overview of audit strategy and timing of the audit
- ❑ Enhances communications regarding accounting policies, practices and estimates
- ❑ Changes requirements regarding timing of communications
- ❑ Requires a written engagement letter
- ❑ Adds a requirement to evaluate the adequacy of the two-way communication process

**Staff Audit Practice Alert No. 5,
*Auditor Considerations
Regarding Significant Unusual
Transactions***

Staff Audit Practice Alert No. 5

- ❑ Issued April 7, 2010
- ❑ The Alert reminds auditors of their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions
- ❑ Responsibilities described in the Alert include –
 - Identifying and assessing risks of material misstatement
 - Responding to risks of material misstatement
 - Consulting others
 - Evaluating financial statement presentation and disclosure
 - Communicating with audit committees
 - Reviewing interim financial information
- ❑ Available through PCAOB website at http://pcaobus.org/News/Releases/Pages/04072010_SAPA.aspx

Other Standard-Setting Activities

Other Standard-Setting Activities*

- ❑ Confirmations (Concept Release issued April 14, 2009)
- ❑ Requiring the Engagement Partner to Sign the Audit Report (Concept Release issued July 28, 2009)
- ❑ Application of the Sarbanes-Oxley Act's Provision on "Failure to Supervise"
- ❑ Related Parties
- ❑ Specialists
- ❑ Fair Value Measurements and Other Accounting Estimates

* Activities subject to change based on emerging issues

Other Standard-Setting Activities*

- ❑ Principal Auditor
- ❑ Quality Controls Standards, Including Quality Controls Over the Work of Affiliated Firms
- ❑ Applicability of SECPS Requirements to all Registered Firms
- ❑ Going Concern
- ❑ Subsequent Events

* Activities subject to change based on emerging issues

Standing Advisory Group

Standing Advisory Group

- The Board looks to the SAG to provide *advice* and *insight* as to the need to formulate new standards or change existing standards
- Meets two to three times a year
 - April 7-8, 2010 meeting
 - Discussed Principal Auditor, Auditor's Reporting Model
 - Next meetings – July 15, 2010, October 14-15, 2010
 - All previous SAG meeting agendas, briefing papers, and webcasts are located at www.pcaobus.org/Standards/SAG/Pages/SAGMeetingArchive.aspx
- Board is seeking nominations for the 2011-2012 term; deadline for submissions is June 17, 2010 (see http://pcaobus.org/News/Releases/Pages/05032010_NominationsForSAG.aspx)

Keeping Current with Standard-Related Activities

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>

Common PCAOB Inspection Issues for Smaller Firms

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Topics

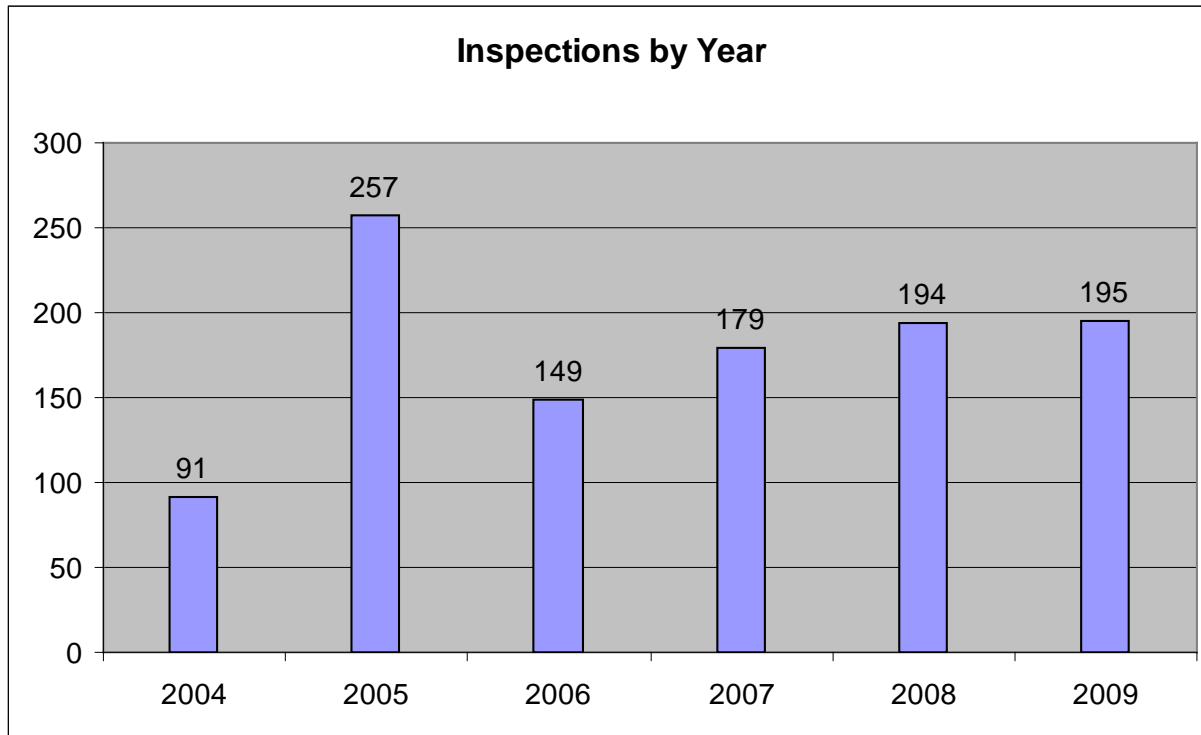
- ❑ Overview of Domestic Triennial Firms
- ❑ Common Inspection Observations
- ❑ Audits of Internal Control Over Financial Reporting

Overview of Domestic Triennial Firms

- As of April 27, 2010, approximately 1,540 domestic triennial firms were registered with the PCAOB*
 - Of those firms, over 600 are subject to inspection
- Conducted over 1,100 domestic triennial firm inspections
 - To date, inspected over 3,000 issuer audits
- Over 965 final inspection reports have been issued

* Includes approximately 530 firms that registered because they audit nonpublic broker-dealers.

Overview of Domestic Triennial Firms



Inspections by Year by Firm Size								
No. of Issuers	2004	2005	2006	2007	2008	2009	Total	%
Total 0 - 5	47	229	38	102	123	102	641	60%
Total 6 - 15	24	22	35	42	31	40	194	18%
Total 16 - 25	12	0	37	16	12	16	93	9%
Total 26 +	8	6	39	19	28	37	137	13%
Total Inspections	91	257	149	179	194	195	1,065	100%

Common Inspection Observations

- ❑ Issued Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms (October 22, 2007)
- ❑ Identified 11 significant or frequent auditing or quality-control deficiencies
 - 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

Common Inspection Observations

□ Revenue

- Complex or specialized revenue-recognition principles not adequately addressed
- Inappropriate reliance on management representations without corroboration regarding appropriateness of revenue recognition
- Over-reliance on poorly designed analytical procedures
- Inappropriate use of testing accounts receivable or inventory as a “proxy” for testing revenue recognition

Common Inspection Observations

□ Equity Transactions

- Insufficient evaluation of the reasonableness of fair value assigned to equity-based transactions for goods/services (employees or nonemployees)
- Insufficient testing of assumptions used to value options or warrants (e.g., volatility factor)
- Inappropriate reliance upon management's decision to determine fair value based on other sources besides market value

Common Inspection Observations

- Use of Other Auditors
 - Portion of financial statements audited by principal auditor
 - Insufficient planning, supervision, review, and addressing of significant audit areas when other auditors used as assistants
 - Firm is responsible to perform additional procedures if the decision is made not to reference the other auditor's report
 - An engagement completion document consistent with AS No. 3
 - Obtain the proper representation from the firm that it is independent under both PCAOB standards and SEC rules
 - List of fraud risks and procedures
 - Schedule of audit adjustments
 - Information that may affect consolidation or combining of accounts
 - Internal control over financial reporting (significant deficiency or material weaknesses)
 - Management representation letter
 - Auditor communications

Common Inspection Observations

- Business Combinations and Impairment of Assets
 - Inadequate testing of estimate of fair values assigned to assets acquired
 - Inadequate testing of allocation of the purchase price to the assets acquired and liabilities assumed
 - Inappropriate evaluation of client's accounting for and reporting of a business combination (e.g., common control merger, asset acquisition as business combination)
 - Unaware of certain terms contained in the merger agreement (e.g., contingent considerations)

Common Inspection Observations

- Going Concern Considerations
 - Insufficient going concern analysis despite warning signs, such as recurring losses, negative working capital, or accumulated capital deficits
 - No evaluation of management's plans to mitigate going concern conditions, or likelihood such plans could be implemented
 - Address lack of disclosure of going concern conditions or management's plan

Common Inspection Observations

- Related Party Transactions
 - Testing of the nature, economic substance, and business purpose of transactions with related parties not effective
 - Address lack of disclosure of related party transactions

Common Inspection Observations

- Use of the Work of Specialists
 - Inadequate consideration of relationship between issuer and specialist which may impact the objectivity of the specialist
 - Inadequate understanding of assumptions and testing of underlying data used by the specialist

Common Inspection Observations

□ Service Organizations

- Firm did not assess the operating effectiveness of user controls identified by the service auditor
- Firm did not consider whether the service auditor's report provided sufficient evidence regarding the effectiveness of controls to support the assessed level of control risk
- If the SAS 70 report did not cover the entire period under audit, the Firm did not make inquiries regarding the possible changes in service organization controls

Common Inspection Observations

□ Independence

- The auditor is prohibited from providing bookkeeping and other services related to the accounting records or financial statements of the audit client, such as -
 - Preparing the audit client's financial statements that are filed with the SEC or that form the basis of financial statements filed with the SEC
 - Maintaining or preparing the audit client's accounting records
 - Preparing or originating source data underlying the audit client's financial statements
- The auditor is not independent when he or she enters into an indemnity agreement with the issuer audit client that -
 - Seeks to provide the auditor immunity from liability for his or her own negligent acts, whether of omission or commission, or
 - Seeks to have the audit client release, indemnify or hold harmless the auditor from any liability and costs resulting from knowing misrepresentations by the audit client's management

Audits of Internal Control Over Financial Reporting

- Status of 404(b) for Non-Accelerated Filers
 - On October 2, 2009, the SEC deferred 404(b) requirement for non-accelerated filers – now required for years ending after June 15, 2010
 - Approximately 3,500 non-accelerated filers
 - Since 2007, non-accelerated filers have been reporting on ICFR
 - 25% of these filers have reported material weaknesses in ICFR during the first two years of reporting under 404(a)
 - H. R. 4173 would amend the Sarbanes-Oxley Act to exempt non-accelerated filers from ICFR audits

Audits of Internal Control Over Financial Reporting

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

Forum on Auditing in the Small Business Environment

- Six remaining small business forums planned for 2010
 - San Francisco (May 20, 2010)
 - New York (July 29, 2010)
 - Jersey City (July 30, 2010)
 - Irvine (September 30, 2010)
 - Dallas (November 2, 2010)
 - Miami (December 1, 2010)
- For more information, visit the PCAOB website
 - www.pcaobus.org/Featured/Pages/SmallBusinessForums.aspx

Questions?

Thank you for participating!

Please visit us at
www.theCAQ.org

or call

1-888-817-3277