Recent SEC and PCAOB Accounting, Auditing and Reporting Developments

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Atlanta Chapter
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Public Company Accounting Oversight Board (PCAOB)
Members of the PCAOB Board

The SEC appoints the Chair and members of the PCAOB. The current members are:

- Chairman – James R. Doty, former SEC general counsel and partner of law firm Baker Botts
- Lewis H. Ferguson, former general counsel of PCAOB and partner at Gibson Dunn
- Daniel L. Goelzer, CPA and attorney, former SEC general counsel
- Jay D. Hanson, CPA, former National Director of Accounting at McGladrey & Pullen, and EITF member
- Steven B. Harris, former Staff Director and Chief Counsel of the United States Senate Banking, Housing and Urban Affairs Committee under Chairman Paul S. Sarbanes
Members of the PCAOB Board

James R. Doty
Lewis H. Ferguson
Daniel L. Goelzer
Jay D. Hanson
Steven B. Harris
Dodd-Frank Act: Impact on PCAOB

- Full authority to regulate auditors of broker-dealers
- Authority to share confidential information with foreign regulators
- No SOX 404 audit required for small public companies
Questions

• How much regulation is “too much”?
• How much regulation is “too little”?
• Where are we now on that spectrum?
• Where are we going?
Auditor Registration
PCAOB Audit Firm Registration System

- A CPA firm must register if it issues reports on public companies or “plays a substantial role”
- Electronic filing of lengthy application; PCAOB has 45 days to review
- Confidential treatment of certain information – everything else is publicly available
- Firms doing SEC audits were required to be registered by 10/22/03
- Beginning in 2009 – must register if auditing any registered broker-dealer.
Registration (11/30/11)

- 2,363 firms registered
- 40 pending applications
- 33 applications denied (2 in Georgia)
- 39 firms seeking withdrawal (2 in Georgia)
- 900 foreign firms
Time for a Quiz
Trivia Quiz

How many registered firms have their headquarters in Georgia?

• 46
• 89
• 35
• 23
Trivia Quiz

What percent of global marketization of US traded companies are audited by the Big 4 firms?

a) 97.8%

b) 86.3%

c) 69.7%

d) 78.4%
Auditing Standards and Guidance
PCAOB Considers Substantial Changes to Standard Audit Report

Quote from Chairman Doty:

Embedded in investors' call for more information from the auditor, is a call for auditors to better serve investors. I dare say most auditors don't see investors as their direct or even ultimate masters, unless they are dealing with a private investor, such as to conduct due diligence for a potential acquisition.
The proposed amendments would:

- require registered public accounting firms to disclose the name of the engagement partner in the audit report,
- amend the Board's Annual Report Form to require registered firms to disclose the name of the engagement partner for each audit report already required to be reported on the form, and
- require disclosure in the audit report of other accounting firms and certain other participants that took part in the audit.
Concept Release on Requiring Engagement Partner to Sign the Audit Report

- Would personal signature requirement enhance audit quality?
- Recommendation of Treasury Committee
- EU Directive requires partner signature
- PCAOB abandoned the signature idea
Four alternatives for possible changes to the standard auditor’s report:

- Auditor’s Discussion and Analysis (AD&A) – a supplemental report to discuss auditors’ view on significant matters regarding the audit and the financial statements, such as audit risks, management’s judgments, accounting practices or contentious issues; covering many of the items discussed with the audit committee.
Concept Release on Possible Changes to the Auditor’s Report (cont’d)

- Required and Expanded Use of Emphasis Paragraphs – required to be added to the audit report to discuss matters such as management judgments and estimates and areas with significant measurement uncertainty.

- Auditor Assurance on Other Information Outside the Financial Statements – require auditors to provide assurance on MD&A, non-GAAP information and earnings releases.

- Clarification of the Standard Auditor’s Report – concepts could be clarified in the report, such as reasonable assurance, auditor’s responsibility for fraud and financial statement disclosures, and auditor independence.
Frequently Mentioned Concerns about Changing the Auditor's Reporting Model

• Expanding the auditor's role and the possibility of "dueling information" between preparer and auditor
• Adversely impacting the audit committee's governance role
• Impairing the three-way communication between auditor, audit committee and management
• Risk of additional boilerplate language
• Maintaining confidentiality of company information
• Increased costs
• Potential increase in legal liability of accounting firms
• Possible adverse effect on auditor independence
• Little incremental improvement in audit quality
Staff Audit Practice Alert No. 9: Assessing and Responding to Risk in the Current Economic Environment (12/6/11)

- This practice alert discusses issues posed by the current economic situation and highlights certain requirements in the new risk assessment standards. The alert is organized into four sections:
  1) considering the impact of economic conditions on the audit;
  2) auditing fair value measurements and estimates;
  3) the auditor's consideration of a company's ability to continue as a going concern; and
  4) auditing financial statement disclosures.
Asks the following questions about whether the Board should propose a mandatory firm rotation requirement:

- Does the current “audit client-payor” model create a fundamental conflict of interest and, if so, would mandatory audit firm rotation eliminate or significantly mitigate that conflict?
- What are the advantages, disadvantages and potential unintended consequences of mandatory audit firm rotation?
- What are the costs of audit firm rotation and how can those costs be mitigated?
• To what extent have some audit committees already adopted policies that provide for the periodic rotation of the outside auditors and what are the experiences of those audit committees that have implemented such policies?

• Are there alternatives to audit firm rotation that would meaningfully enhance auditor independence, objectivity and professional skepticism?

• Rather than pursue potential proposals to require firm rotation, should the PCAOB seek to address its concerns regarding independence through its current inspection programs or, at a minimum, allow more time to evaluate the impact of recent additions to the Board’s auditing standards?
A second set of questions seeks input as how such rules should be structured:

- What is an appropriate rotation period and, in particular, what would be the advantages and disadvantages associated with requiring rotation after periods of 10 years or greater?

- Should PCAOB require rotation for all audits, for only larger clients that are issuers, or for some other subset of audit clients?
• What would be the significant transition and implementation issues associated with mandatory firm rotation, including (1) the impact on competition for audit engagements; (2) the impact on the market for providing non-audit services to clients; (3) the ability and capacity of firms to staff new engagements appropriately; (4) whether multinational audits would pose unique challenges; and (5) if the early years of a new engagement pose a higher audit risk, how that risk can be mitigated.
Chinese Reverse Mergers (CRM)

- PCAOB issued Research Note: “Activity Summary and Audit Implications for Reverse Mergers Involving Companies from China Region” 3/14/11
- SEC Staff comments on reverse merger issues at Small Business Forum
- CRMs generally involve merging a private operating (Opco) company into a public shell
- Total of 603 reverse mergers identified; of those 159 are CRMs
- Many CRMs trade only on the OTCBB or Pink Sheets
CRM Transaction

- Control Group
- Public Shareholders
- Opco (in PRC)
- Public Shell
- Investors

Flow:
- Control Group to Opco (in PRC)
- Opco (in PRC) to Public Shell (Merge)
- Public Shareholders to Issue Shares
- Investors to $ Shares

Note: Arnall Golden Gregory LLP
CRM Result

Control Group owns 51%

Public Shareholders own 3%

Investors own 46%

Combined Company
Chinese Reverse Mergers (CRM) – Auditing Issues

- Most are audited by smaller CPA firms subject to lower scrutiny
- PRC blocking some PCAOB efforts to inspect PRC audit firms
- Auditor may be relying heavily on local PRC firm
- Internal controls of operating company not audited and may be non-existent
Chinese Reverse Mergers (CRM) – SEC Accounting and Reporting Issues

- Accounting acquirer is the private operating company (opco)
- Lack of transparency for opco history
- Providing historical opco financials for all periods
- Reverse merger accounting – valuation of assets
- What does it mean to “own” property in PRC?
- Historical share trading data for shell is meaningless
Trivia Quiz

Which audit firm audited the most CRMs:

- UHY
- Malone Bailey
- BDO
- Friedman LLP
- PWC
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

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
- Effective for audits of fiscal years beginning on or after December 15, 2010
Enhancements to Risk Assessments and Responses

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

According to Audit Analytics, how many public company restatements occurred in 2010?

(a) 1215  
(b) 735  
(c) 438  
(d) 1795
Upcoming Standard-Setting Priorities

- Fair value and specialists
- Audit confirmations
- Related party transactions
- Communications with audit committees
- Subsequent events
Inspections
Firm Inspections as of September 2011

- More than 1,600 firm inspections
- Includes over 301 foreign firms in 36 jurisdictions
- Reviewed over 7,000 audit financial statements
- Almost 50% of the reports showed quality control or audit performance problems
Trivia Quiz

How many audit firms are subject to annual inspection in 2011?

a) seven
b) eleven
c) nine
d) six
AJ Robbins, P.C.
(3/31/10)

- Firm has 6 CPAs, 33 public co. audits
- Two deficient audits identified
- Quality control issues
Some Recent “Clean” Inspection Reports

- Habif Arogeti & Wynne
- Porter Keadle Moore, LLP
- Hancock, Askew & Co.
- Frazier & Deeter, LLC
- Windham Brannon, P.C.
Things to Consider When Your Firm is Inspected

- Get organized
- Do not alter documents!
- Cooperation and transparency
- Communication with client
- Be mindful of potential enforcement actions
- Proactively respond to PCAOB staff comments
PCAOB ENFORCEMENT

Claudius Modesti
PCAOB Director of Enforcement and Investigations
Sanctions for Violations

- **Penalties**
  - Up to $15 million for firm
  - Up to $750,000 for individual
- Temporary or permanent suspension of registration
- Person’s disassociation from firm
- Limitations on firm’s activities
- Require an independent monitor to observe and report
- Censure
- Additional education
Enforcement Actions

- PCAOB has authorized formal investigations and settled 39 disciplinary orders
- Revoked the registration of 19 firms
- Barred 30 CPAs from association with a registered firm
- Numerous ongoing investigations not made public
Recent Items of Focus

• Inappropriate reliance on other firm’s work
• Failure to obtain sufficient evidence (especially revenue and valuation)
• Inadequate consideration of fraud
• Inappropriate alterations to workpapers
• Failure to cooperate with inspection or investigation
PricewaterhouseCoopers International
(4/5/11)

• PWC India audited Satyam Computer Services
• Massive fraud later discovered
• Respondent accused of
  – deficiencies in audit confirmations enabled the fraud
  – pervasive quality control problems
• Sanctions:
  – $2.5M in fines
  – Limits on new engagements
  – Independent monitor
  – Censure
What if Your Firm Receives a PCAOB Enforcement Inquiry?

- Consult counsel
- Preserve documents
- Do not mislead the investigator
- Answer questions carefully (see first bullet above)
- Realistic self-evaluation – what went wrong
Recent Issues Raised in the Securities and Exchange Commission (SEC)

Mary Shapiro
Staff Remarks at AICPA Conference

- Better blocking and tackling to improve audit quality
- Audit committees should be asking tough questions
- Auditor skepticism is essential for investor confidence
- Tell investors what’s going on
- High quality disclosure
- Fair value documentation
The Role of the Accounting Profession in Preventing a Financial Crisis

- Testimony by SEC and PCAOB at Senate Subcommittee
- Improving accounting standards
- Transparency in financial disclosure
- Better quality controls for audits
- Greater accountability for audit firms
- Draw a distinction between audit failure and risky business model
Loss Contingencies Status Update

- FASB deferred action on proposed standard to supersede old FASB No. 5
- SEC staff discussed loss contingency issues at 2011 AICPA conference
  - Lack of disclosure for reasonably possible losses
  - Omission of loss estimate due to lack of certainty
  - Inconsistencies with other external communications
  - Lack of historical disclosures when settlements disclosed
  - Lengthy factual recitations
GAAP Requirement: ASC 450, Contingencies

Disclose:

- Nature of the contingency
- Amount or range of reasonably possible losses in excess of amount accrued

Note: Lack of precision and confidence in estimate does not justify absence of disclosure
SEC Requirement: 
S-K Item 103, Legal Proceedings

Disclose certain facts of the material pending legal proceeding:

- Name of court
- Date instituted
- Principal parties
- Description of matter
- Relief sought

MD&A discussion also may be required
SEC Comments on Disclosures of Loss Contingencies

- SEC staff comments suggest they are skeptical of:
  - The reasonably possible loss extending to the amount claimed
  - Estimates not changing over time
  - Estimates that cannot be made even though the contingency is close to being satisfied
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<td>1 MD&amp;A</td>
<td>21%</td>
<td>12%</td>
<td>19%</td>
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<tr>
<td>2 Executive compensation &amp; corporate governance</td>
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<td>18%</td>
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<td>3 Pro-forma</td>
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<tr>
<td>4 Segment reporting</td>
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<td>9 Commitments &amp; contingencies</td>
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<td>10 Oil and gas disclosures</td>
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* 2011 figures are through August 31

Source: Grant Thornton
Frequent SEC MD&A Comments

- Explain the business reasons for trends
- Critical accounting estimates
  1. Discuss factors that cause variability in the estimates
  2. Discuss assumptions used
- Results of operations – discuss key drivers of changes
  - Quantify all causes for changes in key metrics
- Going concern
  1. What circumstances led to the going concern opinion
  2. How will we get out of this mess
- Address the need for capital and key liquidity indicators
Goodwill Impairment –
Areas of Staff Comment

Lack of interim impairment tests given existence of factors such as:

- Going concern opinion
- Cease & desist orders or other regulatory agreements
- Significant net losses and further deterioration expected
- Management changes
- Market capitalization significantly below book value of equity
- Full valuation allowance on deferred tax assets
SEC Cybersecurity Guidance

- Issued on 10/13/11
- Increasing risks and costs associated with cyber attacks and lack of security
- Review adequacy of disclosures
- Risk factor disclosure
  - consider probability of incidents
  - what costs and consequences?
SEC Cybersecurity Guidance
(cont’d)

- MD&A
  - known trends and uncertainties
  - increases to expenditures

- Legal proceedings – any material proceedings regarding cyber attacks?

- Business – impact on business segments
Comment Letter Trends – Non-GAAP Measures

• Requirements:
  – Describe relevance of the measure
  – How does management use the measure?
  – How should investors use the measure?
  – Limitations on the measure
  – Non-comparability among companies
  – Include appropriate reconciliation to net income or operating cash flows

• Common pitfalls:
  – Inappropriate use of the term “pro forma”
  – Inappropriate items being excluded from non-GAAP measure
  – GAAP amounts are not given equal or greater prominence to non-GAAP amounts

Source: PricewaterhouseCoopers
AGG’s Securities and Corporate Governance Practice

Arnall Golden Gregory LLP counsels public and private companies, as well as officers, directors, investors, and underwriters, in matters regarding transactions, compliance and corporate governance. Our clients include entrepreneurial private companies, as well as companies listed on NYSE, NASDAQ, AMEX and OTC Bulletin Board. We work together with those clients to provide solutions that make sense given their goals and resources.

We regularly counsel companies and underwriters in a variety of complex securities transactions, including initial and follow-on public offerings, “going private” and “roll-up” transactions, mergers, PIPES offerings, and private offerings.