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# Presentation of the PCAOB's Investor Advisory Group Working Group on Going Concern

March 28, 2012

53

Going Concern

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## Agenda

1. Overview – Anniversary of Sarbanes-Oxley Act
2. History
3. Current – Survey
4. Recommendations

## Working Group Members

**Pete Nachtwey**, Chief Financial Officer, Legg Mason

**Damon Silvers**, Director of Policy and Special Counsel, AFL-CIO

**Anne Simpson**, Senior Portfolio Manager, Investment and Director of Corporate Governance, CalPERS

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54

## 10 Year Anniversary Sarbanes-Oxley The Market Before and After

S&P 500 (^GSPC) - SNP  
**1,415.67** +18.56(1.33%) 3:17PM EDT



## Ten Year Anniversary of Sarbanes-Oxley What did we gain?

- Public Company Accounting Oversight Board
- Regulatory Oversight of Auditors
- Section 404 Evaluation of Internal Controls
- CEO/CFO Certification of Internal Controls
- Improved Financial Reporting

## History

- Initiatives Over the Years
  - Going Concern Definition
  - Top 10 Bankruptcies, Top 10 Issuers – TARP
  - Going Concern Opinions
  - Financial Accounting Standards Board – Current Requirements
  - Enforcement
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## History – How we got to where we are...

- Cohen Commission
  - New Standard proposed
  - CFA weighs in
  - New SAS 59, Effective 1989
  - SOP 94-6
    - Exposure draft “watered down”
  - O’Malley Panel – August 2000
    - FASB recommendations
    - SEC urges FASB to act
  - FASB Project
    - Proposal October, 2008
    - Project Revised to disclosures only in 2012
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## Top Ten U.S. Bankruptcies 2001-2011

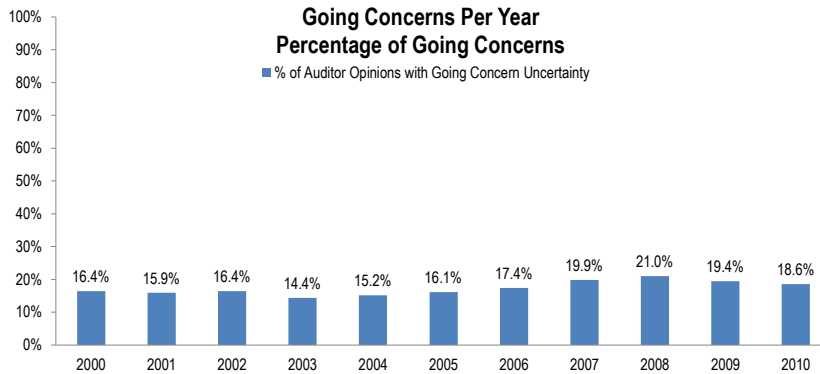
Top Ten Bankruptcies Issuers by Market Cap	Sector	Bankruptcy Filing Date	ICFR Effective	Going Concern	Opinion Signature Date After Bankruptcy Filing	ICFR Effective	Going Concern	Signing Auditor (Pre and Post Opinions)	Auditor Since
Lehman Brothers Holding (\$639B)	Financial	9/15/2008	Y	N	N/A	N/A	N/A	E&Y	1990
WorldCom, Inc. (\$103.9B)	Telecom	7/21/2002	N/A - though designated Max risk 1999-2001	N	N/A	N 2004	N/A	Arthur Anderson/ KPMG	1989 / engaged May 2002
General Motors (\$91.05B)	Industrials	6/1/2009	N	Y 2009	4/7/2010	N 2009	N	D&T	1918
CIT Group (\$80.45B)	Financial	11/1/2009	N 2004	N	12/10/2009	N 2010	N	PWC	2001
Enron (\$65.50B)	Energy	12/2/2001	N/A	N	N/A	N/A	N/A	Arthur Anderson	1946
Conseco Inc. (\$61.4B)	Financial/ Insurance	12/17/2002	N/A	N	2003	Y	Y 2003	PWC	1985
MF Global Holdings (\$41.05B)	Financial Derivatives Broker	10/31/2011	Y	N	N/A	N/A	N/A	PWC	2007
Chrysler (\$39.30B)	Auto Residential Mortgage Lending	4/30/2009	Y	N	04/30/2010	Y	N	D&T*	1947*
Thornburg Mortgage (\$36.5B)	Mortgage Lending	5/1/2009	Y	Y 2008	N/A	N/A	N/A	KPMG	2006
Pacific Gas and Electric (\$36.15B)	Utility	4/6/2001	N/A	Y 2000 - 2003	3/1/2002	Y	Y 2001, 2002, 2003	D&T	1999

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## Top Ten U.S. Issuers Receiving TARP Funds

Top Ten Issuers Receiving TARP Funds	Total Disbursed (\$M)?	First Date of TARP Disbursement	ICFR Effective	Going Concern	Opinion Signature Date After TARP Disbursement	ICFR Effective	Going Concern	Signing Auditor (Pre and Post Opinions)	Auditor Since
AIG <sup>4</sup>	69,835	9/16/2008	N	N	3/2/2009	Y	N	PwC	1980
General Motors <sup>5</sup>	50,745	12/29/2008	N	N	3/4/2009	N	Y	D&T	1918
Bank of America	45,000	10/28/2008	Y	N	2/25/2009	Y	N	PwC	1984
Citigroup	45,000	10/28/2008	Y	N	2/27/2009	Y	N	KPMG	1969
JPMorgan Chase	25,000	10/28/2008	Y	N	2/27/2009	Y	N	PwC	1965
Wells Fargo	25,000	10/28/2008	Y	N	2/23/2009	Y	N	KPMG	1931
Goldman Sachs	10,000	10/28/2008	Y	N	1/22/2009	Y	N	PwC	1926
Morgan Stanley	10,000	10/28/2008	Y	N	1/28/2009	Y	N	D&T	1997
PNC Financial Services	7,579	12/31/2008	Y	N	3/2/2009	Y	N	PwC	2006
U.S. Bancorp	6,599	11/14/2008	Y	N	2/23/2009	Y	N	E&Y	2003

Going Concern



Fiscal Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Going Concerns	2795	2998	2817	2552	2554	2709	2864	3300	3328	2994	2875
Total Auditor Opinions	16997	18819	17191	17766	16794	16784	16462	16610	15848	15395	15503
% of All Opinions	16.44%	15.93%	16.39%	14.36%	15.21%	16.14%	17.40%	19.87%	21.00%	19.45%	18.54%

NOTE – The majority of Going Concerns were issued for non-accelerated filers, i.e. 2010 -with only 46 for large accelerated filers, or < 3%, Audit Analytics, "Going Concern Overview", July 2011

b1

Going Concern

## Current Accounting Standards

- International Accounting Standards – IAS 1 Management shall make an assessment of an entity’s ability to continue as a going concern. Prepare financial statements on a going concern basis unless intend to liquidate or cease trading or no realistic alternative but to do so. Significant doubt on ability to continue as a going concern.
- Financial Accounting Standards Board - Currently no guidance in GAAP about going concern and/or the point in time at which an entity ceases to be a going concern

62

## FASB – Current requirements

- FASB Statement No 107 – Requires disclosures about Concentration of Credit Risk
- SOP-94-6-1 Requires disclosures if the Concentration makes the enterprise vulnerable to the risk of a near-term **severe impact**
  - Since hurdle was so high did not see disclosures
  - Risk and Uncertainties existing
    - Nature of Operations
    - Use of estimates in the preparation of financial statement
    - Certain significant estimates
    - Current vulnerability due to certain concentrations

## Auditing Standards and Guidance

- PCAOB Auditing Standards – GAAS AU 341
- International Auditing and Assurance Standards – ISA 570
- European Commission – “Impact Assessment – Amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts”
- Institute of Chartered Accountants in England & Wales – “Guidance for Directors of UK Companies 2009”
- American Institute of Certified Public Accountants – SAS 59 Redrafting

## Enforcement

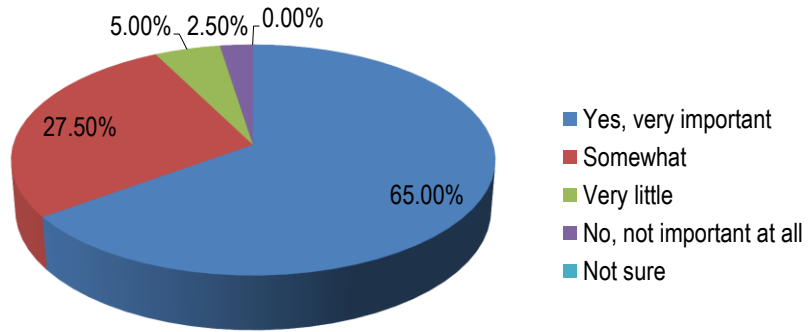
- Investors surprised by demise of companies during financial crisis without warnings or red flags
- Lack of going concern opinions
- Lack of disclosure of enforcement actions – so far
- Standards are only worthwhile when they are followed and enforced

## Going Concern Survey

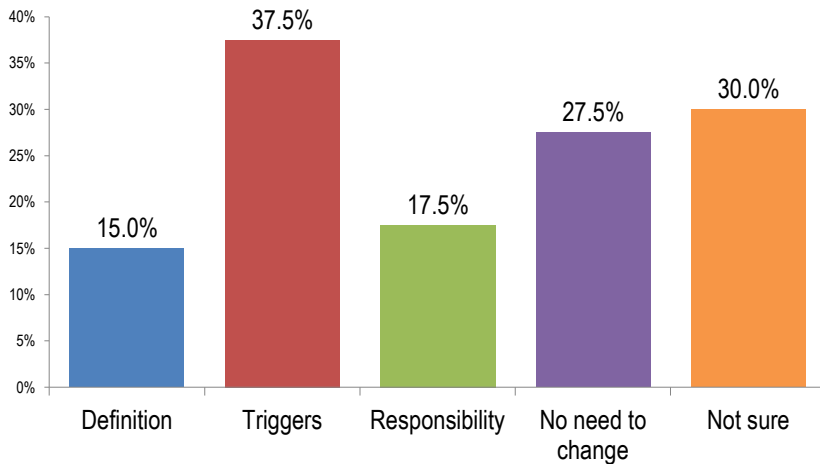
- Respondents included investors, some of whom were also members of:
  - Council of Institutional Investors (CII)
  - Chartered Financial Analyst (CFA)
  - International Corporate Governance Network (ICGN)
  - Asian Corporate Governance Network (ACGA)
  - Global Peer Group ESG Exchange
  - Global Investors Governance Network (GIGN)
  - 40 respondents to survey



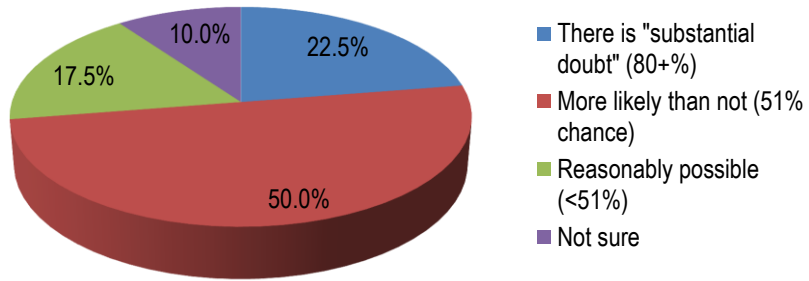
## Is the Concept Going Concern Important?



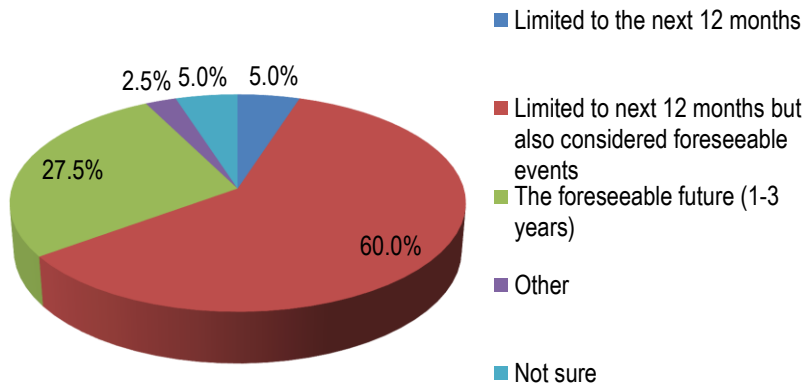
## Should There Be a Change in the Term Going Concern?



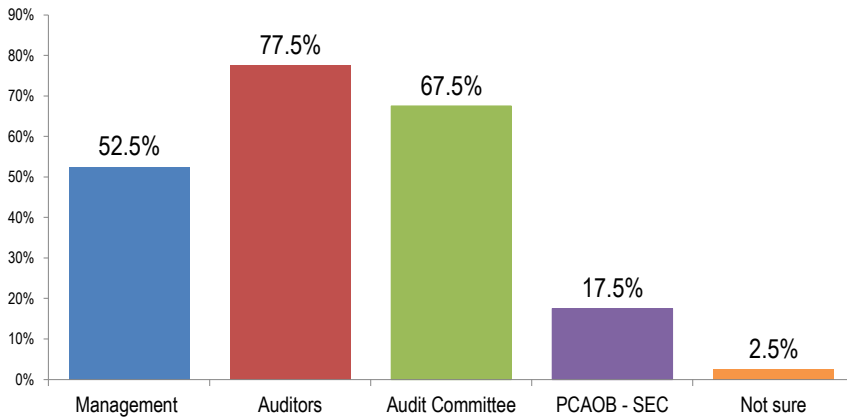
## When Should a Company Be Identified As a Going Concern?



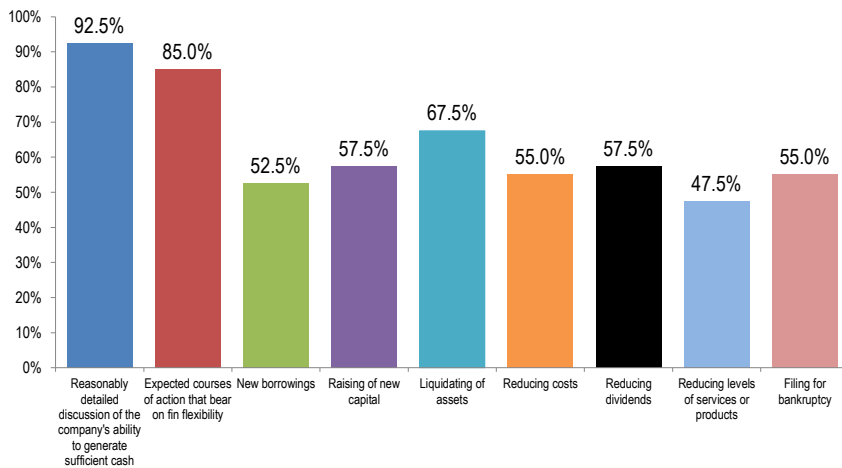
## Should the Assessment be Based on a Time Period Assessment?



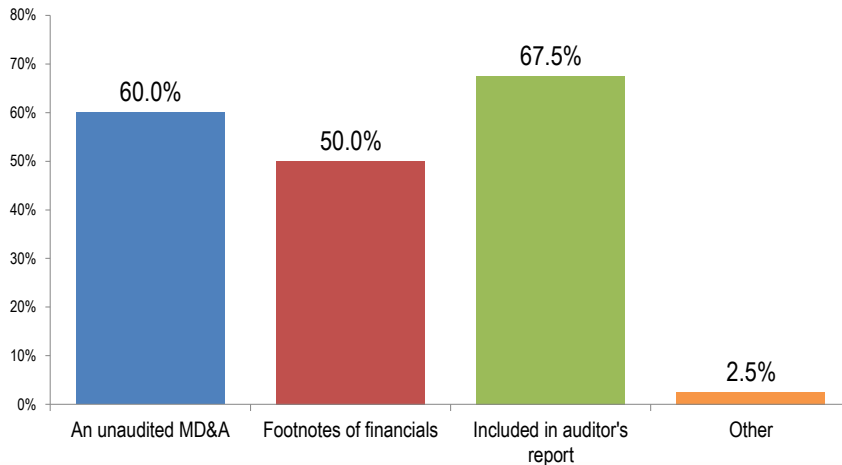
## Whose Responsibility to Report to Investors on Going Concern?



## What Disclosures Should be Provided to Investors?



## How Should This Information be Disclosed?



73

## Recommendations Disclosures - FASB

- Strengthen Going Concern Definition
- Require Management Disclosure – When aware of conditions and events that is reasonably foreseeable that an entity may not meet its obligations:
  1. If reasonably estimable – pertinent conditions and events giving rise to the assessment, including when event is anticipated to occur.
  2. Possible effects of conditions and events.
  3. Possible discontinuance of operations.
  4. Management's evaluation of the significance of conditions and events that bear on financial stability and any mitigating factors.
  5. Whether plans to mitigate events can be effectively implemented and the likelihood.
  6. Recoverability or classification of recorded asset amounts or the amounts of classification of liabilities.

74

## Current Issues with Auditing Standards - AU 341

- Lack of specific objectives auditor should achieve
- Auditor is not required to design their audit specifically to look for evidence with respect to Going Concern
- No requirement for auditor to communicate with audit committee
- Auditor not required to consider public domain information that is contrary to evidence management has presented.

## Current Issues with Auditing Standards Cont'd.

- No requirement for auditor to gain understanding and evidence of management's key assumptions in their plans for mitigating the risks associated with the business that may result in it being more likely than not it will fail.
- Auditor not required to conclude as to whether management's key assumptions provide a reasonable basis for management's conclusion.

## Recommendations – Audit Standards - PCAOB

- Refine Auditing Standards
  - Include basic objectives the PCAOB expects auditors to achieve
  - Auditors should be required to design the audit to obtain evidence with respect to Going Concern
  - Auditors should be required to consider evidence available to them in the public
  - Auditors should be required to understand the plan and its key assumptions, check for consistency of assumptions and data, recognize key omissions, understand factors specific to the industry, and see past historical trends of the company

## Recommendations – PCAOB

- Refine Auditing Standards
  - Auditors should be required to communicate to the audit committee how they reached their conclusion on going concern.
- Disclosures
  - Communicate to the audit committee whether or not they have concerns as to whether it is reasonable to expect the company may not continue as a Going Concern and basis for conclusion.
- Roles
  - Board should include a statement of basic objectives it expects the auditors to achieve and the process the audit committee uses in its oversight when there is a going concern issue.

## Recommendations – SEC

- Disclosure of not just risks, but also how risks are mitigated
  - in plain English
- Key Performance Indicators
  - Some but not all companies provide information in public domain
  - Factors critical to success and understanding of the company, its operations and cash flows
  - Varies greatly by industry, e.g.
    - Backlogs, sales per square foot and customer, plant utilization, tonnage shipped, etc.

## Summary Recommendations

- **Standard Setters - Strengthen Definition - Define Triggers**
  - Move auditing standard from Substantial Doubt to More Likely than Not
  - Require disclosure when Reasonable Possibility exists that the company is no longer a going concern
- **Independent auditor ultimately must make assessment**
  - Extend the period of evaluation to 12 months plus foreseeable events beyond 12 months
- **Key Performance Indicators**
  - Management to disclose in SEC filings
- **Audit Committee's Role**
  - Enhanced Communication between auditor and audit committee
  - Summary of discussion to shareowners
- **Regulators – Disclosures – Mitigating Risks**