

Forum on Auditing in The Small Business Environment

November 7, 2006

New York, NY

Opening Keynote Address

November 7, 2006

New York, NY

Overview of the PCAOB and "Hot Topics"

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Caveat

Although much of the information that will be provided to you has been made public by the Board via Releases and the like, there also will be views expressed that 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.

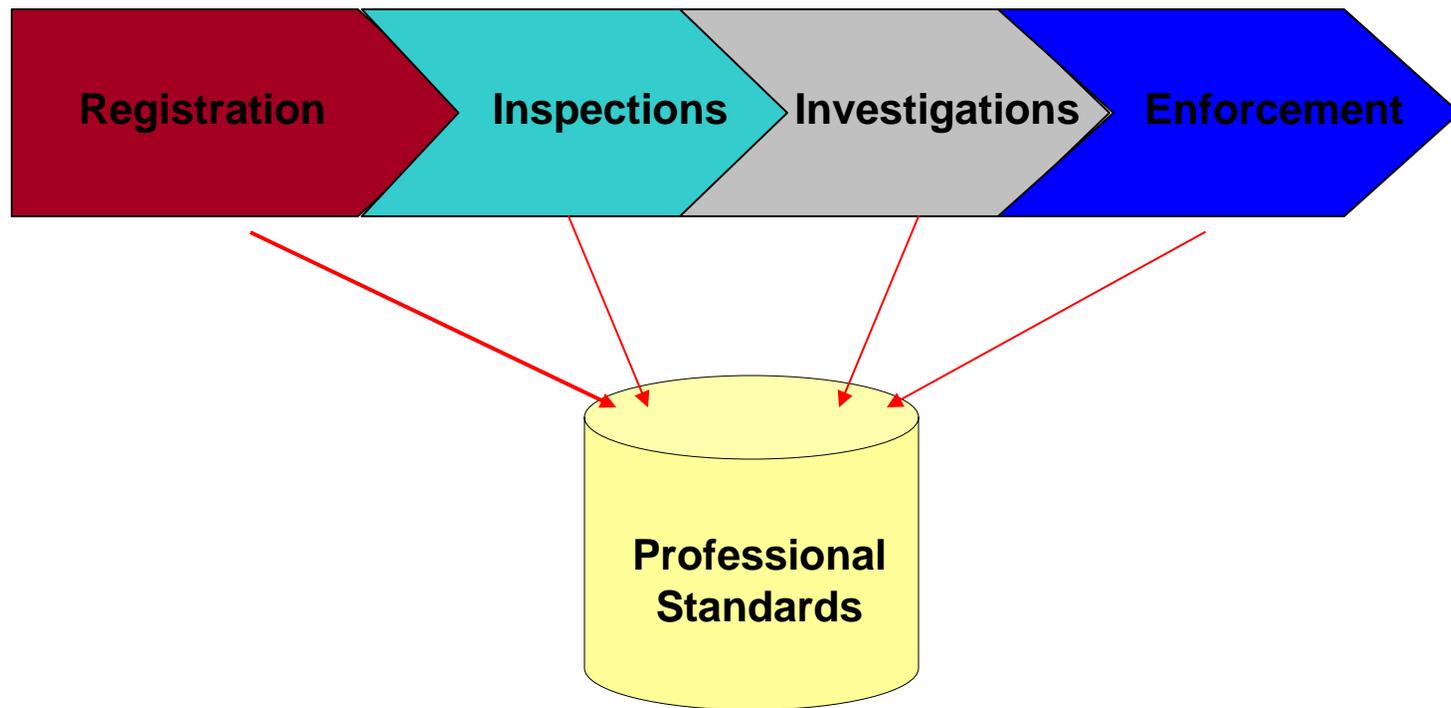
Objectives of this Presentation

- ❑ Brief overview of the PCAOB
- ❑ Interplay between Inspections, Standards and Enforcement
- ❑ Most frequently encountered inspection observations - "hot topics"
- ❑ Audit committees and auditor independence

PCAOB's Mission

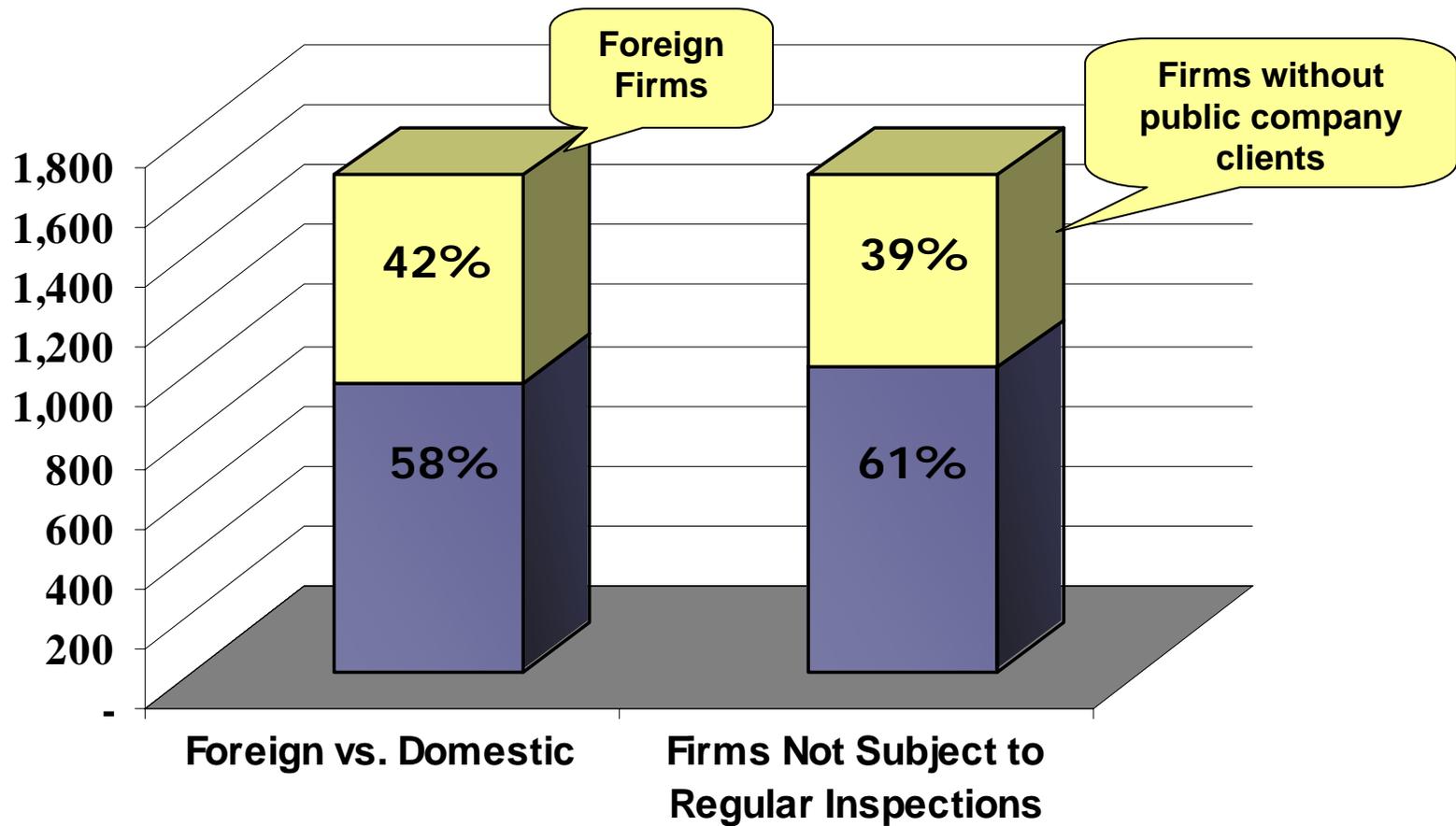
The Board's mission is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports of public companies.

The PCAOB in a Nutshell



Registered Firms

Approximately 1,650 Registered Firms



Inspections Progress

- Of the approximately 1,700 registered firms, approximately 1,000 are subject to regular inspections
 - Must take place annually for firms that issue audit reports for more than 100 US-traded companies
 - Firms that issue audit reports for 100 or fewer US-traded companies must be inspected at least once every three years
- Since inception
 - Completed fieldwork on more than 465 domestic inspections
 - Issued more than 370 reports
 - Looked at portions of the audits of over 2,000 public companies

Inspection Reports

- Draft inspection reports are issued once fieldwork is complete and after the inspection team's observations and related inspection report have been reviewed
 - Firms have 30 days to respond to our draft inspection reports
- After the 30-day response period expires and the report is approved by the Board, the final inspection report will be issued
 - The entire inspection report is provided to the firm and the SEC
 - The public portions of inspection reports are posted on the PCAOB's web site (www.pcaobus.org), including the public part of firm responses

Inspection Reports – Overview of Reports for Small Firms

- Part I - public
 - Part I provides overview of firm size, legal structure and summary of inspection observations
- Part II
 - Part II.A details the inspection observations and is nonpublic
 - Part II.B discusses criticisms of, and potential defects in, the firm's quality control policies and practices and may become public
 - Part II.C discusses other audit performance issues and is nonpublic

Inspection Reports - Overview of Reports for Small Firms (cont'd)

□ Part III - nonpublic

- This section provides guidance on addressing quality control criticisms:
 - It is the Firm's responsibility to address the criticisms and potential defects described in Part II of the report
 - If the quality control criticisms are not addressed in 12 months, portions of Part II may become public
- Certain reports may recommend that the Firm review the audits not inspected
- Certain reports may include an imminent disciplinary paragraph

□ Part IV – public

- May include portions or all of the firm's response to the draft report

12-Month Remediation

- ❑ Final inspection report triggers 12-month remediation cycle
 - Transmittal letter to accompany final inspection report
- ❑ Communication throughout process
- ❑ Correlation between quality control observations and audit performance deficiencies
- ❑ Provide documentation in support of remedial actions
- ❑ Final notification

Inspections Process

- On May 1st the PCAOB issued a statement on the Board's inspections approach for 2006
 - Focus on efficiency of ICFR audits in four areas:
 - Integration with financial statement audit
 - Use of top-down approach
 - Assessment and response to identified risks
 - Using the work of others

Inspections Process

- The inspections process will occur at three distinct levels:
 - Meetings with senior firm leadership
 - National office inspection procedures
 - Engagement inspection procedures
- The PCAOB inspections team will:
 - Use an integrated approach to inspections
 - Be extensively trained in ICFR to ensure efficiency and consistency
 - Will extensively collaborate with the Standards division

Impact of Inspections on Standards and Enforcement

- ❑ Inspectors' observations help identify areas to be addressed by the Board for potentially new auditing standards and evaluate compliance with currently existing standards
- ❑ Nature and type of observations as well as conduct of the firm impacts whether a matter is referred to the Division of Enforcement and Investigations

Standards-setting Overview

The Sarbanes-Oxley Act directs the Board to establish

- Auditing standards
- Attestation standards
- Quality control standards
- Ethics standards
- Independence standards

Auditing Standards and Selected Rules Issued to Date

- ❑ Auditing Standard No. 1 – References in Auditors' Reports to the Standards of the PCAOB
- ❑ Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements
- ❑ Auditing Standard No. 3 – Audit Documentation
- ❑ Auditing Standard No. 4 – Reporting on Whether a Previously Reported Material Weakness Continues to Exist
- ❑ Rule 3101 – Certain Terms – "Must vs. Should"
- ❑ Rules 3501 to 3524 – Ethics and Independence

Standards-setting Priorities*

- ❑ AS2 Revision
- ❑ Principles of Reporting (to address FASB No. 154 and the GAAP hierarchy)
- ❑ Engagement Quality Review
- ❑ Risk Assessment, including fraud risk assessment
- ❑ Related Parties (including consideration of fraud risk factors)
- ❑ Confirmations (including consideration of fraud risk factors)
- ❑ Specialists (including how specialists are used in fair value measurements)

* Activities subject to change based on emerging issues.

Examples of Consultations with Standards

- ❑ Independence
- ❑ Engagement quality review (concurring partner)
- ❑ Audit documentation requirements

Division of Enforcement and Investigations

- ❑ DEI consists of attorneys, accountants and support staff
- ❑ All are based in Washington, DC

Enforcement and Investigations

- The Board may investigate possible violations by registered public accounting firms or their associated persons of
 - any provision of the Sarbanes-Oxley Act
 - the rules of the Board
 - the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants, or
 - professional standards
- The Board may impose appropriate sanctions if violations are found

Sources of Investigations

- Issuer disclosures
 - Auditor changes
 - Restatements
- Public news sources
- Tips
- Other regulators
- Other PCAOB divisions and offices
 - Office of Research & Analysis
 - Division of Registration and Inspections

Inspections Referred to DEI

- Firms may be referred for investigation or disciplinary proceedings where there are serious concerns about
 - the firm's commitment to conducting audits with sufficient care, or
 - the firm's ability to conduct audits with sufficient competence

Investigations

- ❑ The Board conducts informal inquiries and formal investigations
- ❑ With formal investigations, the Board may demand testimony or document production from audit firms and associated persons, and may request testimony or documents from any other person (e.g., public company audit clients)
- ❑ Audit firms and associated persons are required to testify and produce information
- ❑ Individuals may assert Fifth Amendment rights against self-incrimination, but the Board may draw adverse inferences if appropriate

Investigations (cont'd)

- ❑ PCAOB may share information with the SEC, DOJ and other agencies enumerated in the Act
- ❑ Coordination with SEC Enforcement is standard practice in PCAOB enforcement matters
- ❑ Otherwise, the Act requires confidentiality of information

Common Types of Investigations

- Violations of professional standards
 - "Audit failure" — issuer's financial statements are not in accordance with GAAP and the auditor should have detected the misstatement
 - Not limited to matters involving GAAP departures
- Independence violations

After the Investigation

- Upon completion of investigation
 - Staff typically will communicate what it views as the alleged violations, and provide the firm or individual an opportunity to respond to staff's position

Disciplinary Proceedings and Hearings

- ❑ The Board will conduct on-the-record hearings to determine whether firms or associated persons should be disciplined
- ❑ Hearings will not be public, unless otherwise ordered by the Board for good cause shown, with the consent of the parties to such hearing
- ❑ Any sanctions imposed will be public and can be appealed first to the SEC and then to the appropriate federal courts

Sanctions

- In a disciplinary proceeding, the Board may
 - suspend or permanently bar an individual from association with a registered public accounting firm
 - temporarily or permanently limit the activities, functions, or operations of a firm or person
 - appoint an independent monitor
 - impose a civil money penalty
 - impose a censure, require additional professional education or training, or impose any other sanction per Board rules

PCAOB Center for Enforcement Tips, Complaints and Other Information

- ❑ Web site: www.pcaobus.org/Enforcement/
- ❑ E-mail: tips@pcaobus.org
- ❑ Letter PCAOB Complaint Center
 1666 K Street, NW
 Washington, DC 20006
- ❑ FAX: 202-862-0757
- ❑ Telephone: 800-741-3158

Inspections "Hot Topics"

1. Revenues
2. Expenses
3. Estimates
4. Contractual arrangements
5. Equity transactions
6. Inventory
7. Going concern
8. Internal control
9. Principal auditor
10. Concurring partner
11. Independence

1. Revenues

- ❑ No or insufficient testing of revenue recognition
- ❑ Tests of transactions but no basis for sample size selections
- ❑ No cut-off testing when transactions occurred at or near year end
- ❑ Reliance on analytics but no evidence obtained to corroborate management's representations

2. Expenses

- ❑ Analytical review of income statement with no corroborating evidence to support management representations
- ❑ Agreed salary and wage expense to 941 form

3. Estimates

- ❑ Allowance for doubtful accounts
 - No or insufficient testing of collectibility of A/R
- ❑ Valuation allowances
 - No valuation allowance of deferred tax asset despite evidence that asset may not be recoverable

3. Estimates (cont'd)

□ Impairment charges

- Issuer has poor financial prospects yet no testing performed to evaluate amortization period and/or impairment of asset
- Asset considered impaired shortly after it was acquired
- No evidence that annual goodwill impairment test was performed or, if performed, no testing of management assumptions

4. Contractual Arrangements

- Business combinations
 - No testing whether purchase price is appropriately allocated to net assets acquired
 - No testing whether transaction accounted for properly
 - Issuer omits material disclosures of the business combination

4. Contractual Arrangements (cont'd)

- Joint ventures
 - No consideration whether JV should be consolidated
 - Inadequate disclosure of the JV arrangement
 - No assessment of the parties to the JV agreement
- Debt agreements
 - No testing of compliance with debt covenants or appropriateness of long-term debt classification
 - No awareness of debt covenants – agreement not obtained or not reviewed

5. Equity Transactions

- Fair value
 - Stock for services and stock for assets
 - Debt issued with detachable warrants
 - Notes converted into common stock

6. Inventory

- ❑ Flawed lower-of-cost-or-market testing
- ❑ Obsolescence testing
- ❑ Capitalization of costs

7. Going Concern

- ❑ No evaluation of firm's ability to continue for next 12 months

8. Internal Control

- ❑ Reliance on system-generated reports
 - No or insufficient testing of the completeness and accuracy of the report
- ❑ Service auditor's reports
 - Accounting function of a significant area outsourced to a third party (e.g., payroll, employee retirement plan)
 - No service auditor's report obtained and no testing of controls at either the user or service organization
 - Service auditor report obtained but provides no evidence about operating effectiveness of relevant controls at the service organization
 - Service auditor report from prior year relied upon

9. Principal Auditor

- Back-door registrations
 - Operating company merges with a public non-operating shell company
 - Auditor of shell company opines on the merged entity
 - Auditor did not perform procedures to accept responsibility for work performed by other auditor

10. Concurring Partner

- Qualifications of reviewer
 - Reviewer does not have sufficient technical competence and/or experience
- Timing of review
 - Review points are not addressed by the engagement team prior to release of the audit opinion
- Documentation
 - No evidence that review performed

11. Independence

- Firm provides one or more of the following services:
 - Bookkeeping services
 - Maintains general ledger
 - Posts adjustments to general ledger
 - Combines general ledgers from several subsidiaries and records elimination and other consolidating entries
 - Prepares trial balance
 - Calculates income tax provision including deferred tax valuation allowance
 - Preparation of financial statements
 - Prepares certain/all financial statements
 - Prepares footnotes to audited financial statements
 - Valuation services
- The Firm does not confirm its independence with the audit client

Audit Committees and Auditor Independence

- Appointment, compensation, and oversight of the work of the audit firm
 - Pre-approval of audit and non-audit services
 - Assessment of auditor independence

Auditor Independence is Governed by –

- ❑ SEC Auditor Independence Rules (17 CFR 210.2-01)
- ❑ PCAOB Independence and Ethics Standards
 - Interim standards (AICPA ET secs. 101, 102, 191, and ISB Standards No. 1, 2, and 3)
 - Look to SEC auditor independence rules when SEC rules are more restrictive
 - Permanent ethics and independence rules

SEC Overarching Independence Principles

Does the auditor/client relationship or the provision of services –

- Create a mutual or conflicting interest?
- Place the auditor in the position of auditing his or her own work?
- Result in the auditor acting as management or an employee of the audit client?
- Place the auditor in a position of being an advocate for the audit client?

Prohibited Non-Audit Services

- ❑ Bookkeeping or other services related to the accounting records or financial statements of the audit client
- ❑ Financial information system design and implementation
- ❑ Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- ❑ Actuarial services
- ❑ Internal audit outsourcing services
- ❑ Management functions
- ❑ Human resources
- ❑ Broker-dealer, investment adviser, or investment banking services
- ❑ Legal services
- ❑ Expert services unrelated to the audit

Bookkeeping Services*

The auditor is prohibited from –

- Maintaining or preparing the audit client's accounting records
- 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
- Preparing or originating source data underlying the audit client's financial statements

* includes other services related to the accounting records or financial statements of the audit client

Other Independence Restrictions

- ❑ Financial interests in audit client
- ❑ Business relationships with audit client
- ❑ Employment relationships with audit client
- ❑ Contingent fee arrangements
- ❑ Audit client hiring an audit engagement team member within a certain timeframe into a financial reporting oversight role
- ❑ Partner rotation on the audit engagement
- ❑ Partner compensation for selling non-audit services

Recent PCAOB Ethics and Independence Rules

Rules cover three distinct areas* –

- Core ethics and independence requirements (Rules 3502 and 3520)
- Specific services that impair the auditor's independence
 - Contingent fees (Rule 3521)
 - Tax transactions (Rule 3522)
 - Tax services to persons in a financial reporting oversight role (Rule 3523)
- Additional communication requirements with audit committees as they relate to permissible tax services (Rule 3524)

* Definitions of terms used in the independence rules are located in Rule 3501

Reference Materials Relating to Independence

□ SEC

- Independence Rules – 17 CFR Section 210.2-02
www.sec.gov/info/accountants/independref.shtml
- Frequently Asked Questions (12/13/04)
www.sec.gov/info/accountants/independref.shtml
- Interpretations Relating to Independence – SEC Codification of Financial Reporting – Section 602.02. Not available on SEC website.

□ PCAOB

- Ethics and Independence Rules
- Interim Independence Standards
- Interim Quality Control Standards
 - SECPS Requirement 1000.08(o) and Appendix L – Independence Quality Controls
- www.pcaobus.org/standards/

Communications Between Auditors and Audit Committees

- ❑ Certain matters required by AU 380, *Communications with Audit Committees*
- ❑ Auditor communications about independence
- ❑ Illegal acts and fraud
- ❑ Internal control-related matters
- ❑ Interim financial information

Keeping Current with PCAOB

- Our Web site - www.pcaobus.org
 - List of registered firms
 - Inspection reports
 - PCAOB standards, including interim standards
 - Enforcement disciplinary proceedings
- 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:

www.pcaobus.org/News_and_Events/Updates/subscribe.aspx

Questions?

Panel Discussion on Best Practices for Audit Committee, Auditor and Financial Executive Relationships

November 7, 2006

New York, NY

Panel Participants

□ Moderator

- Mary Sjoquist, Board Counsel, PCAOB

□ Panelists

- Paula Cholmondeley, Audit Committee Chair, Albany International
- Eric Balzer, CFO, Ramtron International
- Rick Ueltschy, Partner, Crowe Chizek

Current Developments - Internal Control over Financial Reporting

November 7, 2006

New York, NY

Requirements for Internal Control Over Financial Reporting

- ❑ Maintain books, records, and accounts in reasonable detail that accurately and fairly reflect the issuer's transactions
- ❑ Sarbanes-Oxley Act: Section 404
 - Requirements:
 - Management report on internal control over financial reporting
 - Audit of management's assessment

Internal Control Over Financial Reporting - Post Implementation Activities

- ❑ April 13, 2005 - Year 1 Roundtable
- ❑ May 16, 2005 - Additional guidance published by PCAOB and SEC
- ❑ November 30, 2005 - Report on initial implementation of Auditing Standard No. 2
- ❑ May 10, 2006 - Year 2 Roundtable
- ❑ May 17, 2006 - Four-point plan to improve implementation of internal control reporting requirements

2005 Board Policy Statement

- ❑ Amplifies key themes in May 16, 2005 staff questions and answers
- ❑ Describes how the auditor can provide timely advice on accounting and internal control over financial reporting issues to management of the companies they audit

Staff Questions & Answers – May 16, 2005

- Topics addressed include –
 - Top-down approach
 - Risk assessment
 - Integrated audit
 - Using the work of others

SEC/PCAOB Roundtable – May 10, 2006

- Roundtable focus was on the experiences from the second year of implementation
 - What we have learned so far
 - How we can improve the process going forward
- Objective - provided opportunity for the Board and Commissioners to hear from all of the market participants in one setting (investors, issuers and auditors)
- Multiple panels addressed different issues including management's assessment, the integrated audit and the effect on the market
- Web cast of event at www.pcaobus.org

PCAOB Four-Point Plan to Improve ICFR Audit Efficiency and Effectiveness

- ❑ Amend Auditing Standard No. 2 (next slide)
- ❑ Emphasize efficiency during PCAOB Inspections
- ❑ Implementation ***guidance*** and ***education*** for auditors of smaller companies
- ❑ Continuation of PCAOB Forums on Auditing in the Small Business Environment

Potential Amendments to Auditing Standard No. 2

Preserve principles and ensure focus on areas that pose higher risk of fraud or material error

- Incorporate key concepts from May 2005 guidance
- Revisit auditor role in management's assessment
- Clarify definitions
- Reconsider "strong indicators"
- Guide more use of work of others
- Clarify materiality and scoping decisions
- Allow for use of experience from prior years

COSO Internal Control Framework



The Committee of Sponsoring Organizations of the Treadway Commission

SPONSORING ORGANIZATIONS



- ❑ Committee of Sponsoring Organizations of the Treadway Commission
 - AICPA, American Accounting Association (AAA), Financial Executives International (FEI), Institute of Internal Auditors (IIA), and Institute of Management Accountants (IMA)
- ❑ *Internal Control - Integrated Framework* (1992)
 - Criteria for effective internal control
 - Control objectives relating to financial reporting, compliance, and operations
 - Internal control components for financial reporting include: control environment, risk assessment, control activities, information and communication, and monitoring

COSO - Internal Control over Financial Reporting - Guidance for Smaller Public Companies

- ❑ Guidance issued June 2006
- ❑ Focus on internal control over financial reporting
- ❑ Principles drawn from the 1992 framework
- ❑ Illustrative approaches and examples

www.coso.org

SEC's Next Steps: 404 Implementation

- Issue guidance for issuers:
 - Concept release – Issued July 11; Open meeting scheduled for December 13, 2006
 - Consideration of additional guidance from COSO
 - Issuance of guidance to management to assist in performing a top-down, risk-based assessment
- Extension of the Section 404(a) filing date for non-accelerated filers to fiscal years ending on or after December 15, 2007
- Proposed extension of the Section 404(b) filing date for non-accelerated filers to fiscal years ending on or after December 15, 2008

Looking Forward

- ❑ Don't delay!
- ❑ Establish responsibility and timeline
- ❑ Become familiar with the key principles of AS No. 2, staff questions and answers, Board policy statement, SEC implementation rules, and COSO guidance
- ❑ Understand management's plans for its assessment and documentation
- ❑ Look out for proposed Auditing Standard No. 2 amendment
 - The Board encourages comments on the proposed amendment

Questions?

Open Discussion

November 7, 2006

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