

PCAOB Forum on Auditing in the Small Business Environment

Daniel L. Goelzer
Board Member

June 23, 2005
Pittsburgh, Pennsylvania

Today's Presenters

- **Don Marlais, Special Counsel to Board Member Gillan**
- **Joanne O'Rourke Hindman, Special Advisor to Board Member Gillan**
- **Greg Scates, Associate Chief Auditor**

PCAOB Staff

- **Mark West – Associate Director, Inspections**
- **Heidi Michael – Associate General Counsel**
- **Mary Sjoquist – Special Counsel to Board Member Gradison**
- **Peter Schleck – Director, IOPA**

PCAOB Staff (continued)

- **Michael Shore – Assistant Public Affairs Director**
- **Todd Boyle – Manager, Inspections**
- **George Botic – Manager, Inspections**
- **Judith Primus – Sr. Admin. Assistant**
- **Jeanne Boylan – Sr. Admin. Assistant**

Additional Resource

INFO@PCAOBUS.ORG

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.

PCAOB Mission

- The Board’s mandate is to “***protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports***” of public companies.
- The Board has a unique regulatory structure
 - Operates as a private, non-profit corporation – NOT a governmental organization
 - SEC has oversight authority over the Board

PCAOB Overview

Don Marlais
Special Counsel to
Board Member Gillan
June 23, 2005

What is the PCAOB?

- Title I, Sarbanes-Oxley Act of 2002
- Non-profit, private sector regulator for auditor of companies publicly traded in the US
 - Subject to the oversight of the SEC
 - Appoints Members of the PCAOB Board
 - Annual Budget
 - Rules of the PCAOB
 - May appeal enforcement decisions to them

Why are we reaching out to Audit Committees?

- Sarbanes-Oxley Enhanced Role
 - Direct relationship with auditors
- Corporate Governance Initiatives:
 - NYSE, AMEX and NASDAQ
 - SEC
 - PCAOB
- Indirect Affect on Audit Committee Work

Why are we reaching out to Audit Committees?

- Allies in Overseeing Financial Reporting System
- Predominantly Funded by Public Companies
- Funding Statistics (2005):
 - Highest - \$2.9M Lowest - \$100
 - Top 100 companies paid about 46%
 - About 45% of companies paid \$1,000 or less (4300 out of 9600)

The Board and Public Companies

Four Functional Areas of Responsibility:

- Registration
- Inspections
- Enforcement
- Standard Setting

Registration

- Only firms that are registered with the PCAOB may conduct audits of public companies
 - As of June 13, 2005:
 - 1,520 Registered Firms
 - US – 935
 - International – 585 (78 different countries)
- Registration subjects firms to PCAOB jurisdiction
- What does this mean for Audit Committees?
 - Your company cannot file your 10-K, 10-KSB or other certain registration forms without using a PCAOB-registered firm

Registration

- What does this mean for Audit Committees? (continue)
 - Source of cumulative data on registered accounting firms
 - auditors,
 - clients,
 - litigation,
 - quality controls.
 - Non-confidential portions publicly available in the future (www.pcaobus.org).
- Registration with the PCAOB does not reflect a conclusion regarding the auditor's ability to perform quality audits.

Inspections

- Inspections assess a firm's compliance with the Act, the Board's and the SEC's rules and with professional standards.
- Regular inspections must take place annually for firms that audit more than 100 U.S. public companies.
- All other firms must be inspected once every 3 years.

Inspections

- In 2003, the Board conducted limited inspections of the largest four accounting firms.
- In 2004, regular inspections commenced:
 - U.S. firms with 100 or more U.S. public company clients
 - Approximately 90 small firms
- Current year inspections began May 2005
- Inspection Reports (public portion) are available on the Board's website at www.pcaobus.org

Issues Identified Across Companies

- Two Phase process –
 - Review of firm policies, methodologies;
 - Engagement reviews.
- Issues
 - Audit of fair values
 - Related party issues
 - Prohibited loans
 - Revenue recognition
 - Auditing of expenses
 - Independence
 - Going concern/development stage designation
 - Control of issuer use of reports
 - Understanding of contractual arrangements/substance of transactions
 - Principal auditor

Inspections

- What does this mean for Audit Committees?
 - Review of an audit engagement is a review of both the auditor's procedures and the client's financial statements.
 - Your company's financial statements may be scrutinized.
 - As part of reviewing audit engagements, we also look at how the auditor is fulfilling its responsibilities to the audit committee.
 - May talk to your Audit Committee Chair.

Enforcement

- PCAOB investigations may often examine both the public company's financial reporting and its auditor's work.
- The PCAOB may refer findings in an investigation to other authorities.
- PCAOB disciplinary proceedings may have indirect consequences for public companies.

Standard Setting

- The Sarbanes-Oxley Act directs the Board to establish:
 - Auditing and related attestation standards.
 - Quality control standards.
 - Ethical standards.
- The Board may also establish independence standards relating to the preparation of audit reports, including prohibiting new categories of non-audit services.
- Board uses an open process
 - Standing Advisory Group (“SAG”)
 - Ad Hoc Task Forces
 - Roundtables on selected issues

Standard Setting

- The Board has issued three new auditing standards:
 - PCAOB Auditing Standard No. 1 – Reference to the Board’s Standards in Audit Reports.
 - PCAOB Auditing Standard No. 2 – Audit of Internal Control.
 - PCAOB Auditing Standard No. 3 – Audit Documentation.
- Proposed Independence Rules
- Proposed Remediation Standard

Future Standard Setting

- What does this mean to Audit Committees?
 - Proposed auditor independence standard includes required communications by auditor to Audit Committee when Committee is considering approving tax services.
 - Possible Standards on Audit Committee Communications, likely to combine all existing requirements into one standard (improve consistency of application).
 - Proposed Standard on Auditor Reports of Remediation of ICFR

Questions



The Role of the Audit Committee in Assessing Internal Control

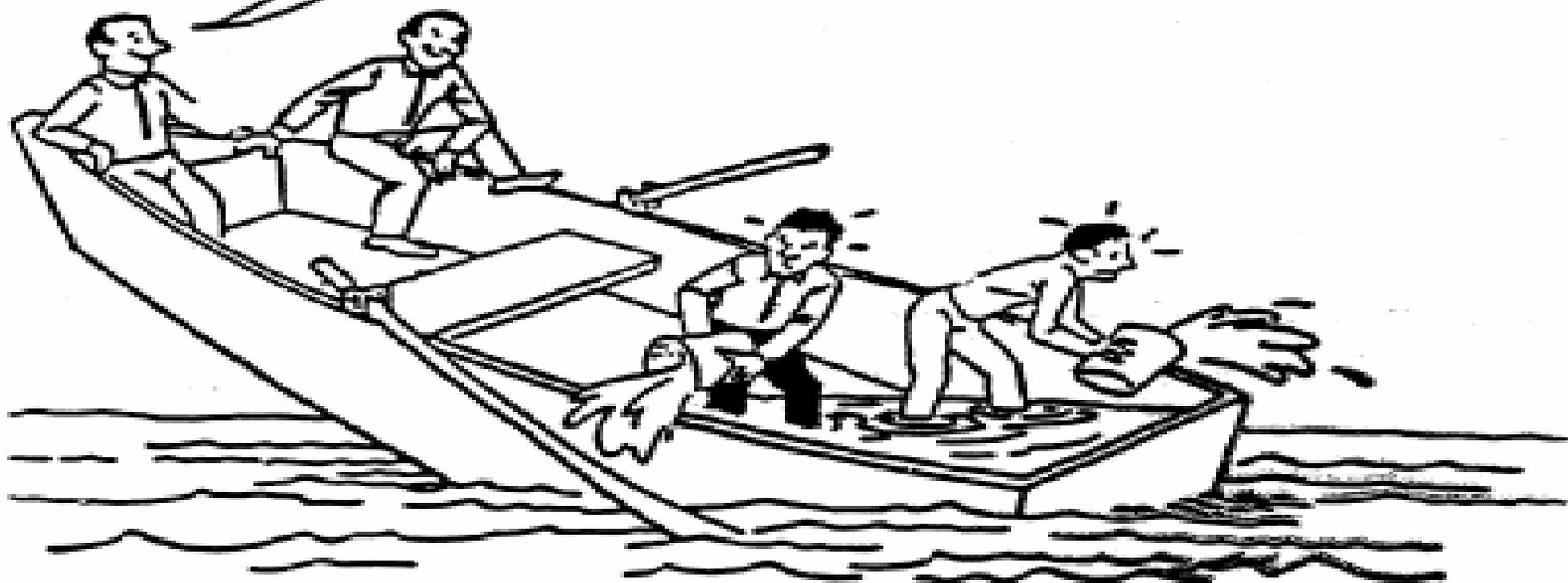
Joanne O'Rourke Hindman
Special Advisor to
Board Member Gillan
June 23, 2005

The Role of the Audit Committee...

“...is one of proactive oversight of the financial reporting and disclosure process and the results of that process. It cannot supplant the day-to-day responsibilities of management to ensure the accuracy of the financial statements. Rather the audit committee’s function is based, in part, on [its] ability ... to carry out the necessary level of due diligence, relying on experts such as the [CFO], Internal Auditor, and independent external auditors.”

– March 10, 2001 Speech by Lynn E. Turner, then Chief Accountant at the SEC

I'm sure glad the hole isn't in our end...



Objectives

- **Understanding internal control over financial reporting**
 - Understanding the COSO framework
- **Understanding management's §404 requirements and assessment process**
- **Understanding the audit committee's role**
- **Understanding the impact of a material weakness**
- **Understanding the auditor's AS2 requirements and process (next session)**

What is Internal Control?

Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations*
- *Compliance with applicable laws and regulations*
- *Reliability of financial reporting*

What is the “Framework” for Evaluation?

- Defined as the the set of criteria under which internal control procedures are assessed
 - SEC endorsed the standards recommended by 1992 COSO Report
 - COSO standards are not the only criteria that may satisfy the SEC rules

What is COSO?



SPONSORING ORGANIZATIONS



- **Committee of Sponsoring Organizations**
 - AICPA; American Accounting Association (AAA); Financial Executives International (FEI); Institute of Internal Auditors (IIA); and Institute of Management Accountants (IMA)
- **Formed in 1985 to sponsor the Treadway Commission**
 - National Commission on Fraudulent Financial Reporting

What is the COSO Integrated Framework?

“Internal control consists of five interrelated components. These are derived from the way management runs a business and are integrated with the management process.”

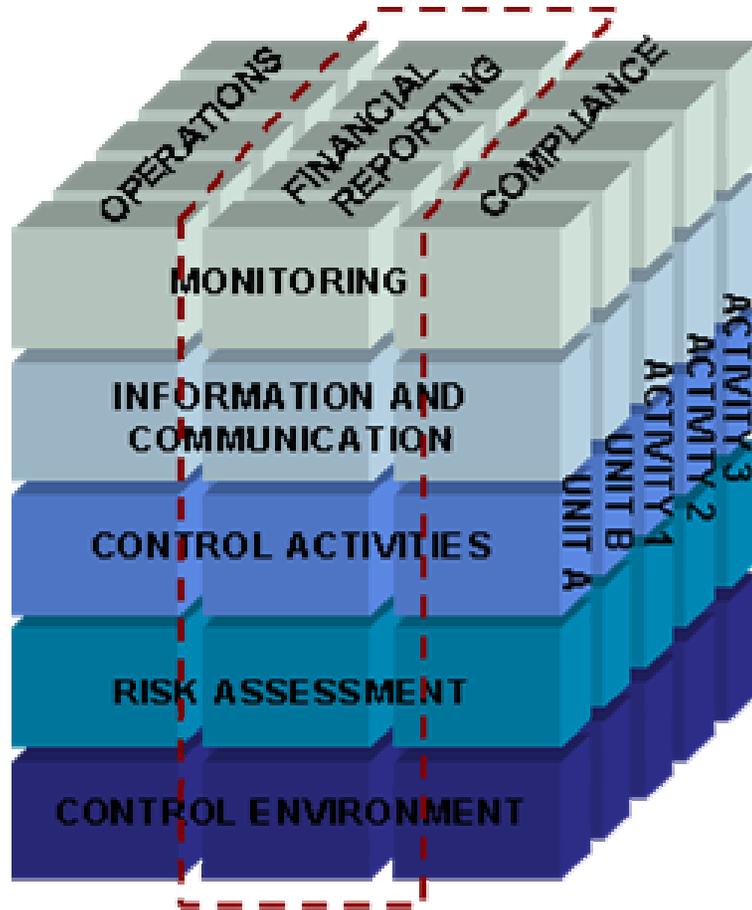
“Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control.”

*-- Committee of Sponsoring Organizations
of the Treadway Commission; 1992*

COSO Key Concepts

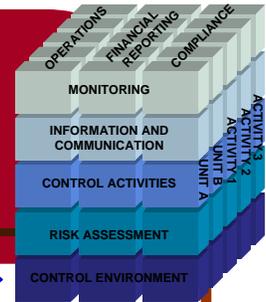
- Internal control is a ***process***. It is a means to an end, not an end in itself.
- Internal control is effected by ***people***. It's not merely policy manuals and forms, but people at every level of an organization.
- Internal control can be expected to provide only ***reasonable assurance***, not absolute assurance.
- Internal control is geared to the achievement of ***objectives*** in one or more separate but overlapping categories.
- While internal control is a process, its ***effectiveness*** is a state or condition of the process ***at one or more points in time***.

What are the Five Components?



- 1. Control Environment**
- 2. Risk Assessment**
- 3. Control Activities**
- 4. Information & Communication**
- 5. Monitoring**

Control Environment

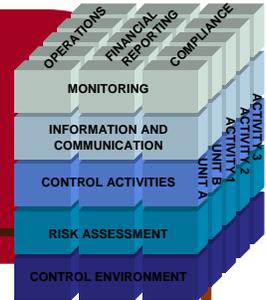


- **Tone of the organization**
- **Attributes of people employed**
 - **Level of Integrity**
 - **Ethical values**
 - **Competence**
- **Management's philosophy and operating style**
 - **Assignment of authority and responsibility**

“While every entity should embrace the concepts..., small and mid-size entities may implement the control environment factors differently than larger entities... Usually the fewer the levels of management, the faster the message is carried through an organization of what conduct is acceptable”

– COSO's Internal Control – Integrated Framework

Risk Assessment

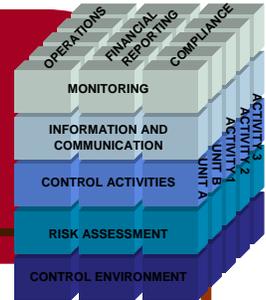


- Risk awareness and prevention
- Setting objectives
 - Mission or value statements
 - Overall strategy
 - Integrated with sales, production, marketing, financial, etc. to operate in concert

“The risk-assessment process is likely to be less formal and less structured in smaller entities..., but the basic concepts ... should be present in every entity, regardless of size.”

– COSO’s Internal Control – Integrated Framework

Control Activities



- **Establishing and implementing policies and procedures**
 - **Carry out the entity's objectives**
 - **Addresses the risk to achievement of objectives**
- **Occurs throughout the organization, at all levels and in all functions**
- **Approvals, authorizations, verifications, reconciliations, segregation of duties, etc.**

“Smaller entities may find that certain types of control activities are not always relevant because of highly effective controls applied by management of the small or mid-size entity.”

– COSO's Internal Control – Integrated Framework

Control Activities – Control Purpose

Preventive controls are generally preferred over **Detective** controls

- **Preventive Controls** focus on preventing errors or exceptions
 - *Standard policies and procedures*
 - *Proper segregation of duties*
 - *Authorization levels/approvals*
- **Detective Controls** are designed to identify an error or exception after it has occurred
 - *Exception reports*
 - *Reconciliations*
 - *Reviews of operating performance*



Control activities – Control Type

Automated controls are generally preferred over Manual controls

- **Automated Controls** operate through and within the information technology systems. They function systematically and work with a high degree of consistency.
- **Manual Controls** operate through human intervention. They are the most flexible but are also subject to human error.



Information and Communication



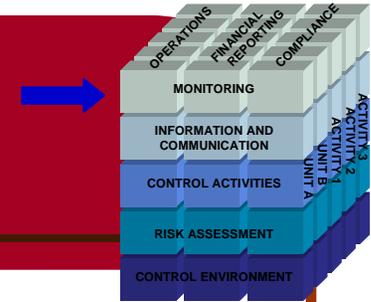
- **Systems of communications**
 - How information is identified, captured, exchanged and used on a timely basis
- **Information systems**
 - How reports are designed, produced, disseminated to make it possible to run and control the business

Are the **right people** getting the **right information** at the **right time**?

“Effective internal communication... may well be easier to achieve in a small or mid-size company...because of the smaller organizational size and its fewer levels...”

– COSO’s Internal Control – Integrated Framework

Monitoring



- **Assessing the quality of the system**
 - Ensures controls continue to operate effectively
 - Adjusts for changing environment
- **Ongoing monitoring activities**
 - Built into the normal, recurring activities
 - Performed on a real-time basis
- **Separate evaluations**
 - Periodically tested based on circumstances

“Ongoing monitoring activities of small to mid-size entities are more likely to be informal and involve the CEO and other key managers...[and] is typically a by-product of monitoring the business.”

– COSO’s Internal Control – Integrated Framework

What are the Evaluation Methods?

- SEC did not prescribe a single method
- Appropriate testing will “largely depend on the circumstances of the company”
- Inquiry, alone, will not provide an adequate basis for assessment
- Non-management personnel may be used, if supervised

What must be Examined?

SEC identified four controls that must be examined:

- ① Initiating, recording, processing and reconciling account balances, classes of transactions, and disclosures and related assertions in the financials
- ② Initiating and processing non-routine and non-systematic transactions
- ③ Selecting and applying appropriate accounting policies, and
- ④ Preventing, identifying and detecting fraud

Terms Used in Compliance

- **Entity level –**
 - Highest level(s) within the organization that dictate controls, sometimes referred to as “control units”.
- **Process or activity level –**
 - The various business cycles through which procedures are performed to execute transactions that eventually impact the financial statements.
- **Risk –**
 - The “what could go wrong” within a process. The inverse of risk is commonly referred to as the “control objective”.
- **Assertions –**
 - Financial reporting objectives (more on this next)
- **Key Controls –**
 - The controls in which the most reliance is placed with respect to mitigating risk. Not every control is a key control and requires testing.

Financial Statement Assertions

- **Existence** – Assets, liabilities and ownership interests exist as of a point in time
- **Occurrence** – Recorded transactions represent economic events that actually occurred during a stated period of time
- **Completeness** – All transactions and other events and circumstances that occurred during a specific period, and should have been recognized in that period, have, in fact, been recorded. Therefore, there are no unrecorded assets, liabilities or transactions and no omitted disclosures
- **Rights and Obligations** – Assets and liabilities reported on the balance sheet are bona fide rights and obligations of the entity as of that point in time
- **Valuation or Allocation** – Assets, liabilities, revenues and expenses are recorded at appropriate amounts in accordance with relevant accounting principles
- **Presentation and Disclosure** – Items in the statements are properly described and classified as well as fairly presented

How Does the Evaluative Process Work?

**Entity-level risk assessment
and project planning**

**Process identification
and evaluation**

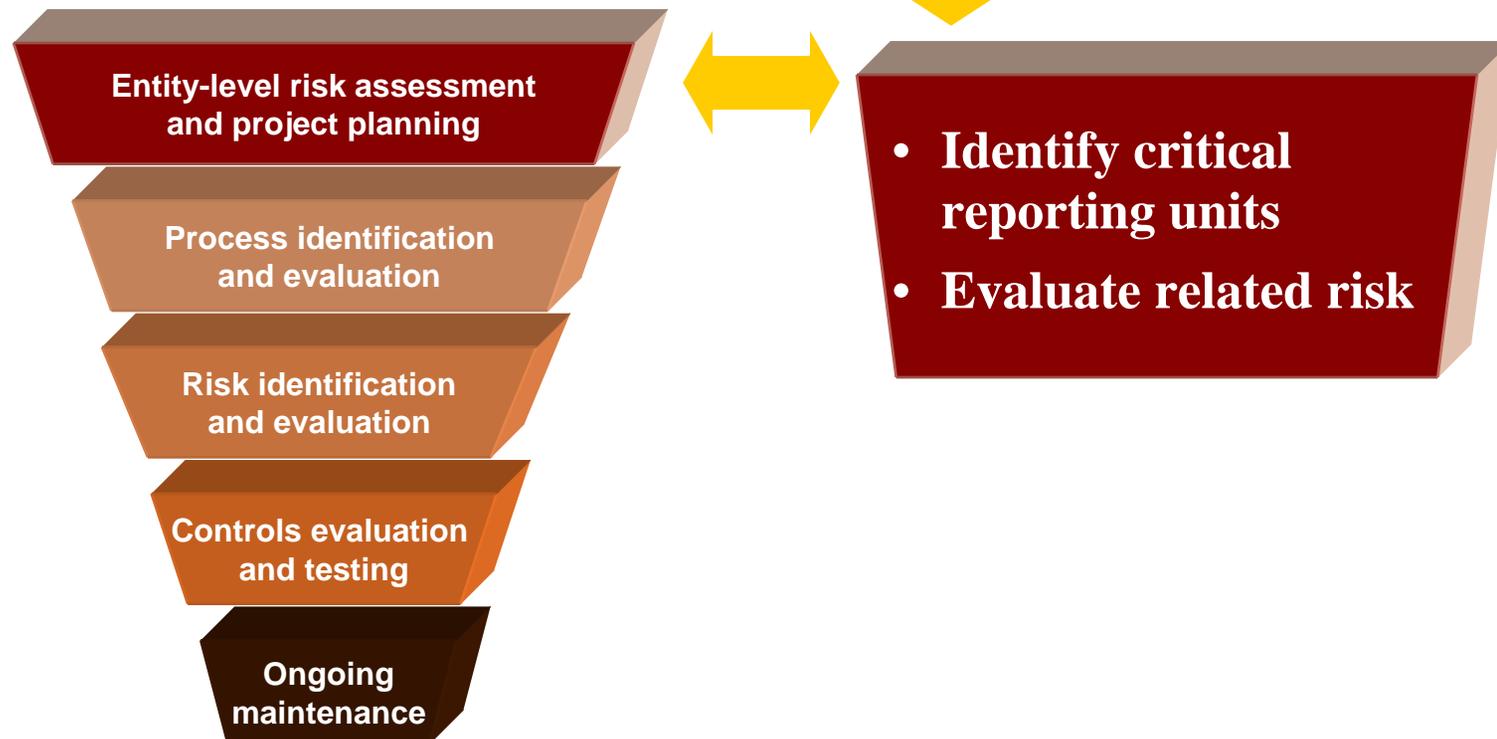
**Risk identification
and evaluation**

**Controls evaluation
and testing**

**Ongoing
maintenance**

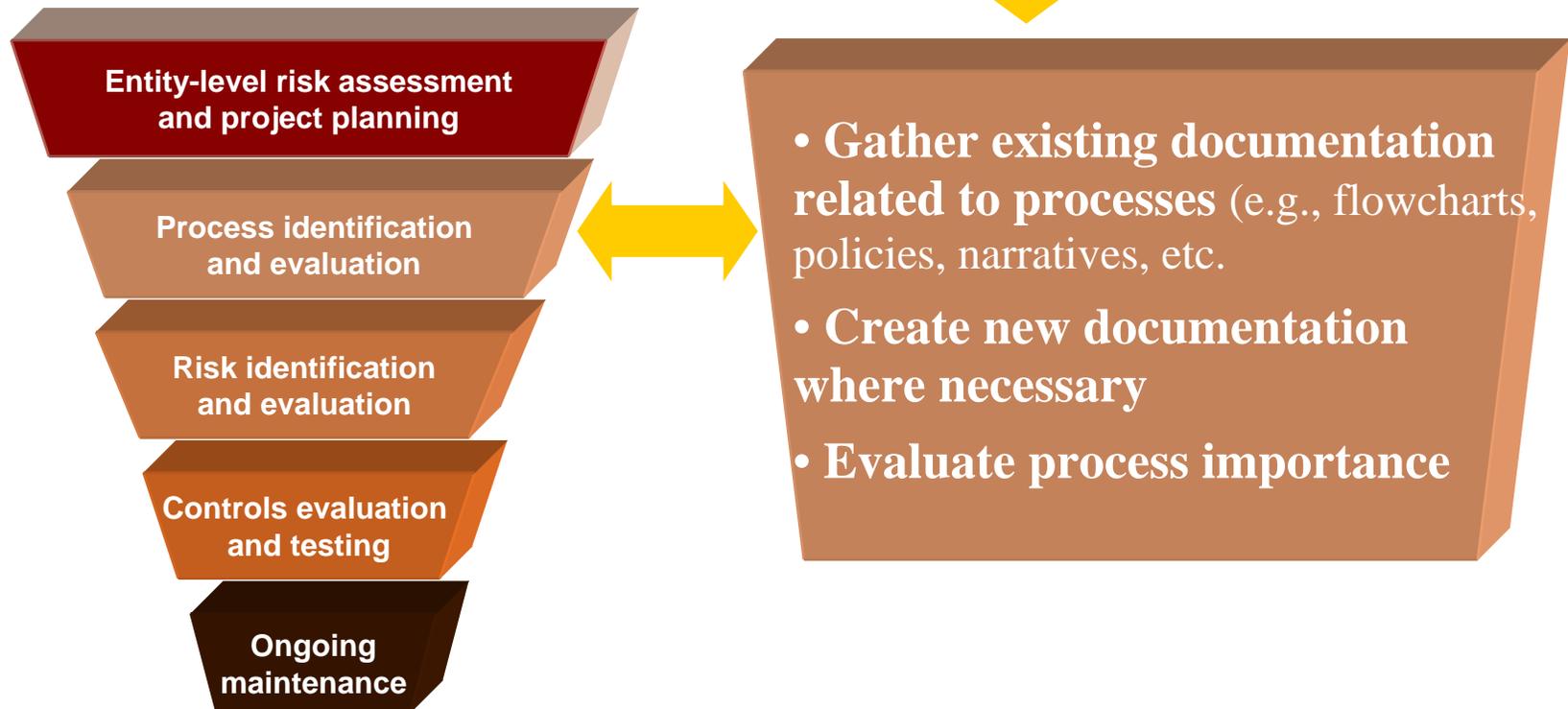
Entity-Level Prioritization

Where do we go?



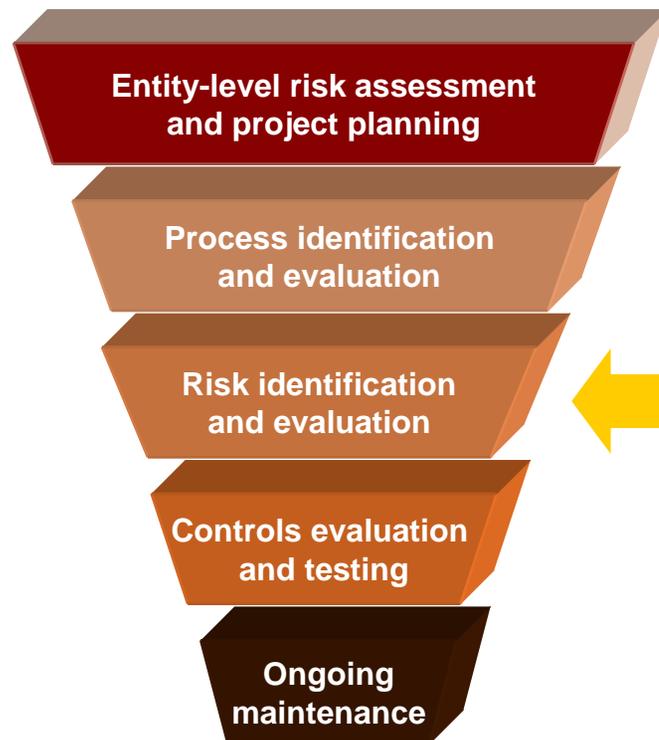
Process-level Prioritization

What do we focus on?



Risk Identification and Prioritization

What could go wrong?



-
- Identify potential risks within critical processes
 - Identify risk drivers and owners
 - Evaluate level of risk (e.g., significance and likelihood)
 - Link risks to the financial statements

Controls Evaluation and Prioritization

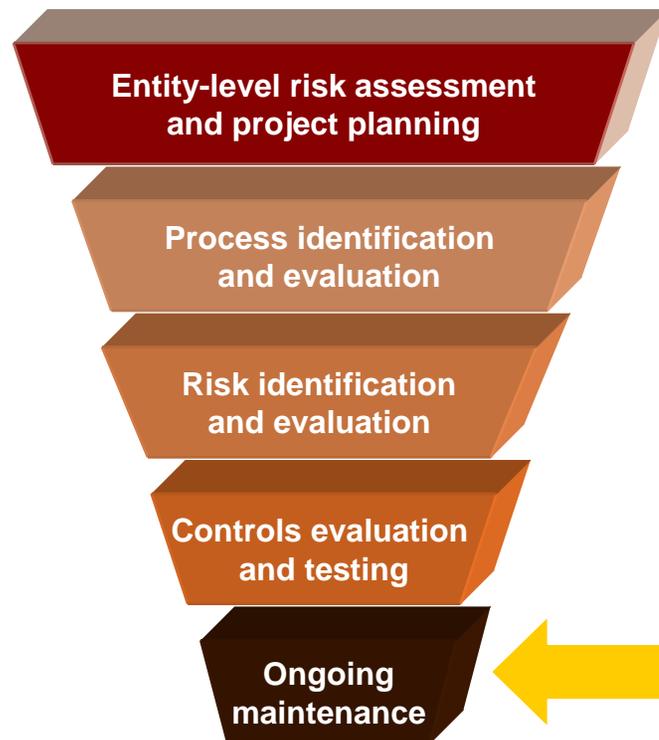
How do we control it?



-
- Identify controls that mitigate critical risks
 - Evaluate the design of those controls
 - Design and execute tests of critical controls
 - Identify potential improvements

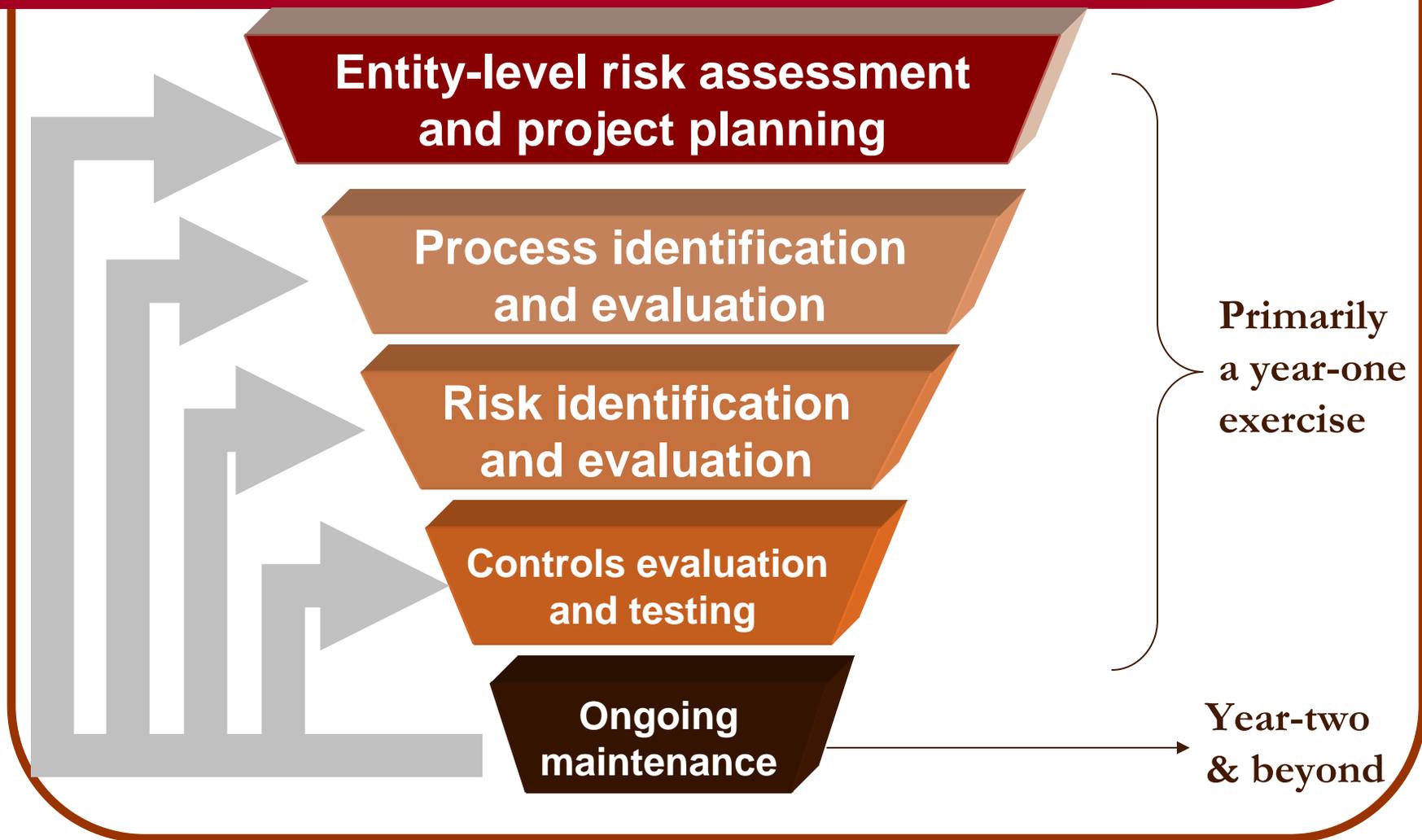
Ongoing Maintenance

How do we keep it working?



-
- **Plan ongoing maintenance and testing**
 - **Adjust as necessary for changing environment** (e.g., staff turnover, acquisitions, new product lines, etc.)

The §404 Process



Key Management Considerations

- ✓ Who should lead/participate in the process?
- ✓ What form should the documentation take?
- ✓ Who should complete the documentation?
- ✓ Who should perform the self-assessment?
- ✓ Who should do the training & who should be trained?
- ✓ What processes, systems and functions are included within the scope of internal controls over financial reporting?

Audit Committee Considerations

Ongoing Involvement

- Consider asking for progress reports that include:
 - Compliance approach taken including entities or units selected, processes selected and risks identified
 - Documentation gaps identified and corrective action taken and/or proposed
 - Weaknesses in internal controls identified and corrective action taken and/or proposed
 - The external auditors expectations and involvement to date

Audit Committee Considerations – Ongoing Involvement

- **Consider asking for progress reports from both management and the external auditor that include:**
 - **How the project is being staffed**
 - **Permanent staff, temporary staff, and/or consultants**
 - **Total hours spent to date and estimated hours to complete**
 - **Total costs of compliance to date and estimated cost to complete**
 - **Estimated completion date**

Audit Committee Considerations – Cautionary Notes

- **Ask both management and the external auditors to keep the audit committee up-to-date**
 - ☑ *404 Compliance should be an agenda item for every audit committee meeting until complete*
- **Ask for the appropriate amount of detail**
 - ☑ *Get enough information to understand and judge the effectiveness of the approach*
- **Make it clear that you don't want surprises**
 - ☑ *If significant concerns are identified ask both management and the external auditor to consider calling an emergency audit committee meeting*

Audit Committee Considerations – Adverse Internal Control Opinion

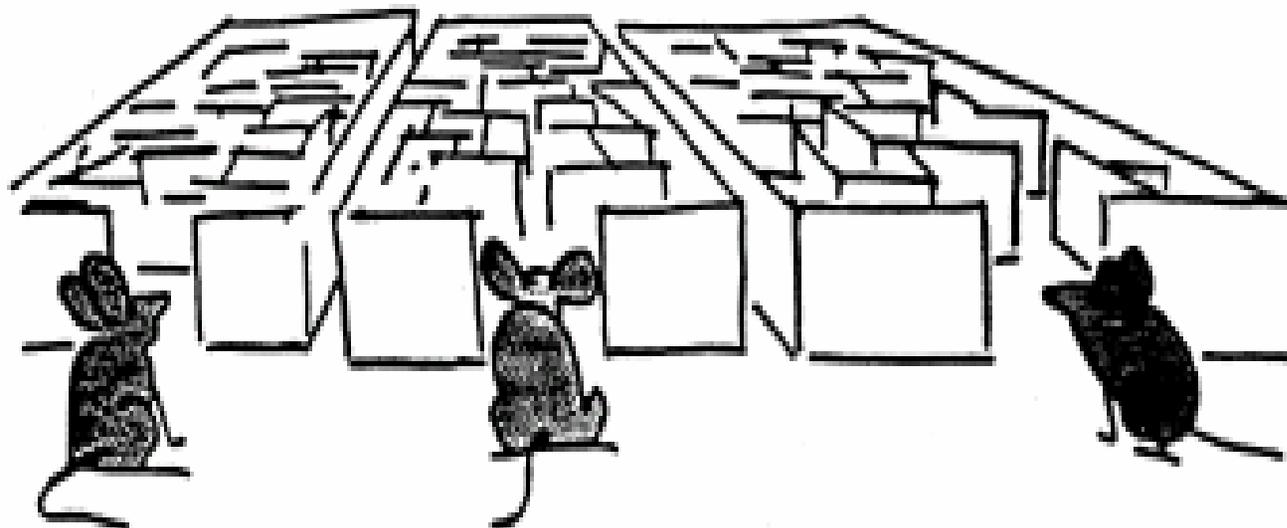
- **Understand the details behind the opinion**
 - What is the severity of the material weakness?
 - What is the potential financial statement impact – both annually and quarterly?
 - *How has management/auditor adjusted their closing/audit to make certain the financial statements are correct?*
 - What is management's remediation plan?
 - *How long will the remediation take?*
 - *How will management/auditor update the audit committee?*
 - How will the material weakness be disclosed?
 - *Anticipate the needs of the shareholders, analysts, lenders, etc.*
 - *Transparent disclosure includes a full discussion*
 - ➔ *Complete description; severity; remediation plan and timeframe; impact on the financials*

Audit Committee Considerations

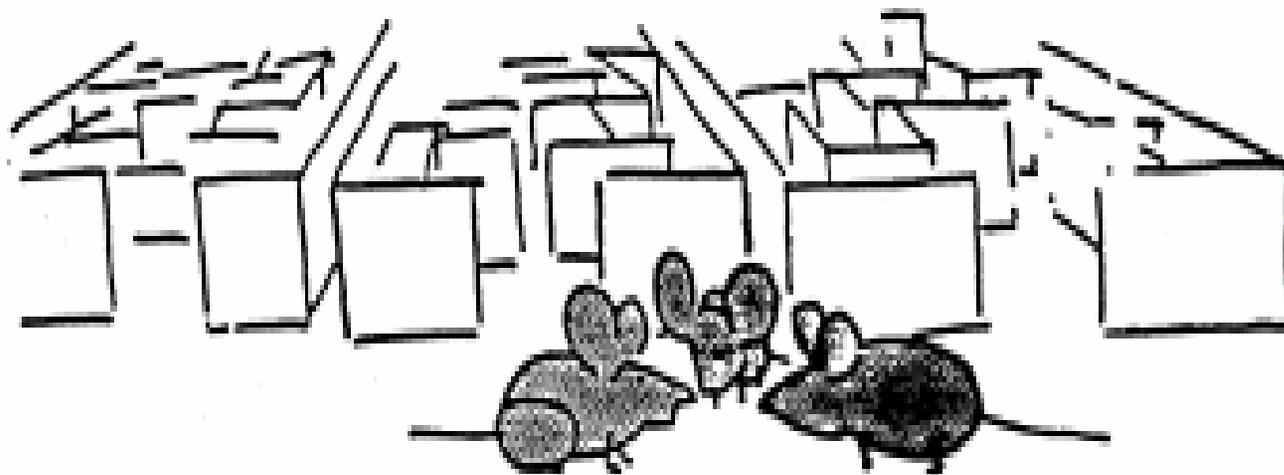
“The tone set by top management – the corporate environment or culture within which financial reporting occurs – is the most important factor contributing to the integrity of the financial reporting process.”

– Report of the National Commission on Fraudulent Financial Reporting, also known as the “Treadway Commission”, published in 1987

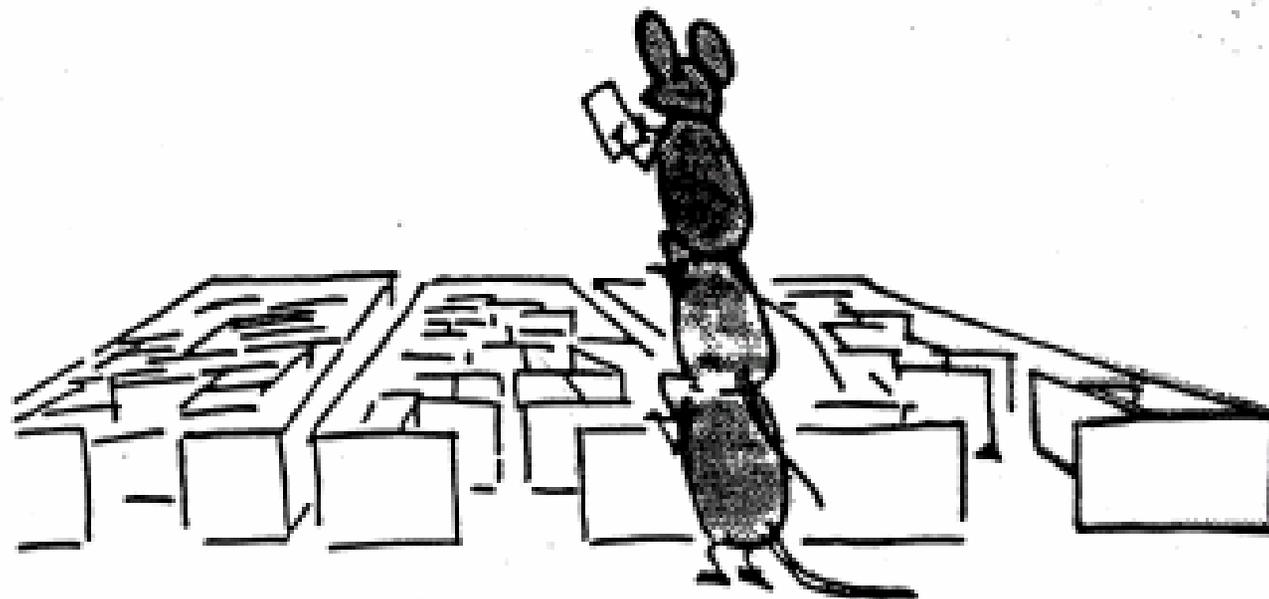
The Section 404 Maze



The Section 404 Team



The Section 404 Solution



Questions



Break

Auditing Internal Control Over Financial Reporting

Greg Scates
Associate Chief Auditor
June 23, 2005

The Internal Control Standard

PCAOB Auditing Standard No. 2 – *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statement*

Effective Date

- Effective for audits of public companies with fiscal years ending on or after **November 15, 2004** for accelerated filers
- For non-accelerated filers and foreign private issuers, effective for fiscal years ending on or after **July 15, 2006**

What We Will Cover

- **Summary of §404 Reporting to Date**
- **§404 & AS2 – Update of Recent Activities**
- **Small Business Issues**
- **Brief Overview of AS2 Requirements**
- **Questions & Answers (throughout)**

Summary of §404 Reporting to Date

- **Total §404 Reports as of May 24th**
- **§404 Reporting by Industry**
- **Material Weaknesses Reported**
 - By Accounting Area
 - By Internal Control Issue

Summary of §404 Reporting

(as of May 24, 2005)

	<u>Number</u>	<u>Percentage</u>
Issuers receiving unqualified opinion on internal control	2,607	87.63%
Issuers with ineffective internal control over financial reporting	366	12.30
Issuers receiving a disclaimer of opinion	2	.07
	<hr/> 2,975	<hr/> 100%

Source: Audit Analytics

§404 Reporting Results by Industry

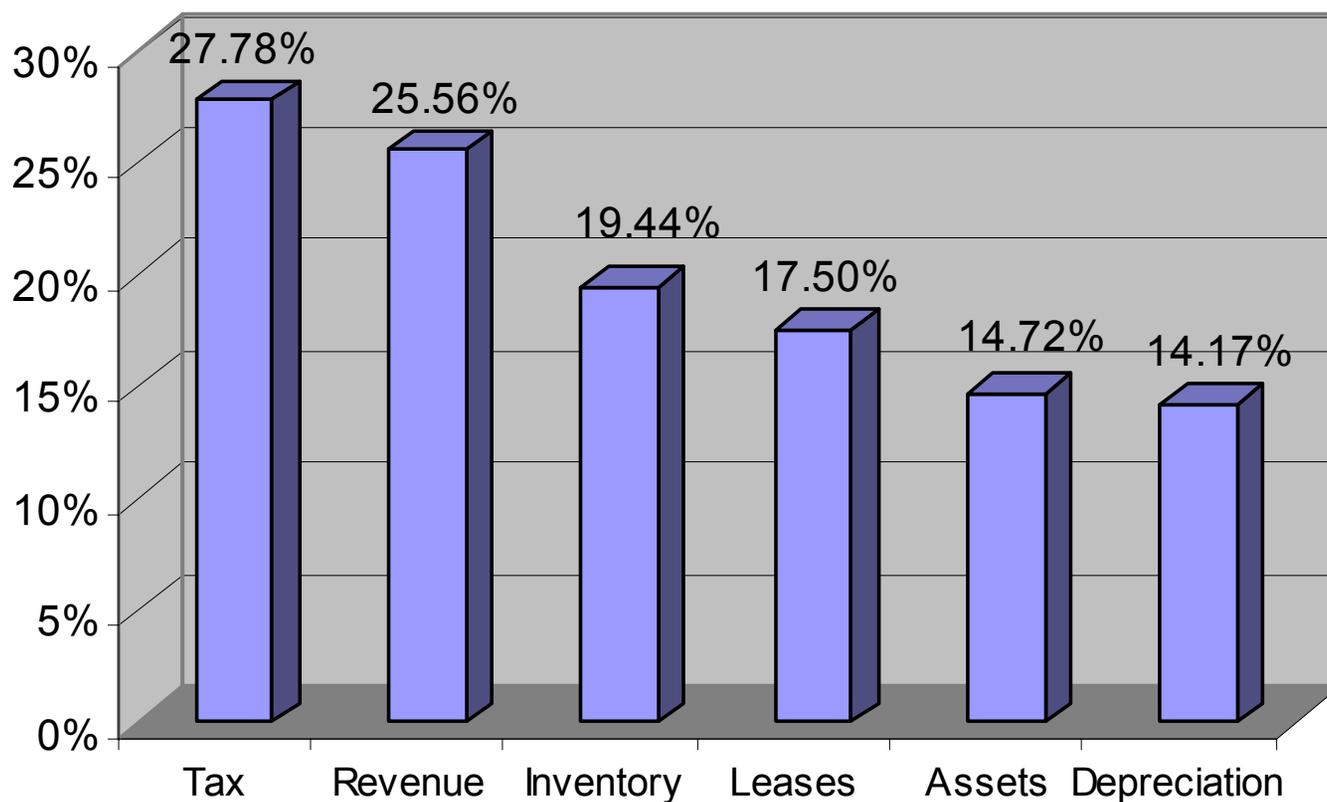
(as of May 24, 2005)

	Issuers Filing Reports <u>(% of 2,973)</u>	Issuers with MW <u>(% of 366)</u>
Manufacturing	31.75%	30.05%
Finance, Insurance, Real Estate	28.59	18.03
Services	14.50	20.49
Transportation, Communications, Utilities	11.57	10.93
Wholesale and Retail	7.97	13.94
Other	5.62	6.56
	100%	100%

Source: Audit Analytics

Material Weaknesses by Accounting Area

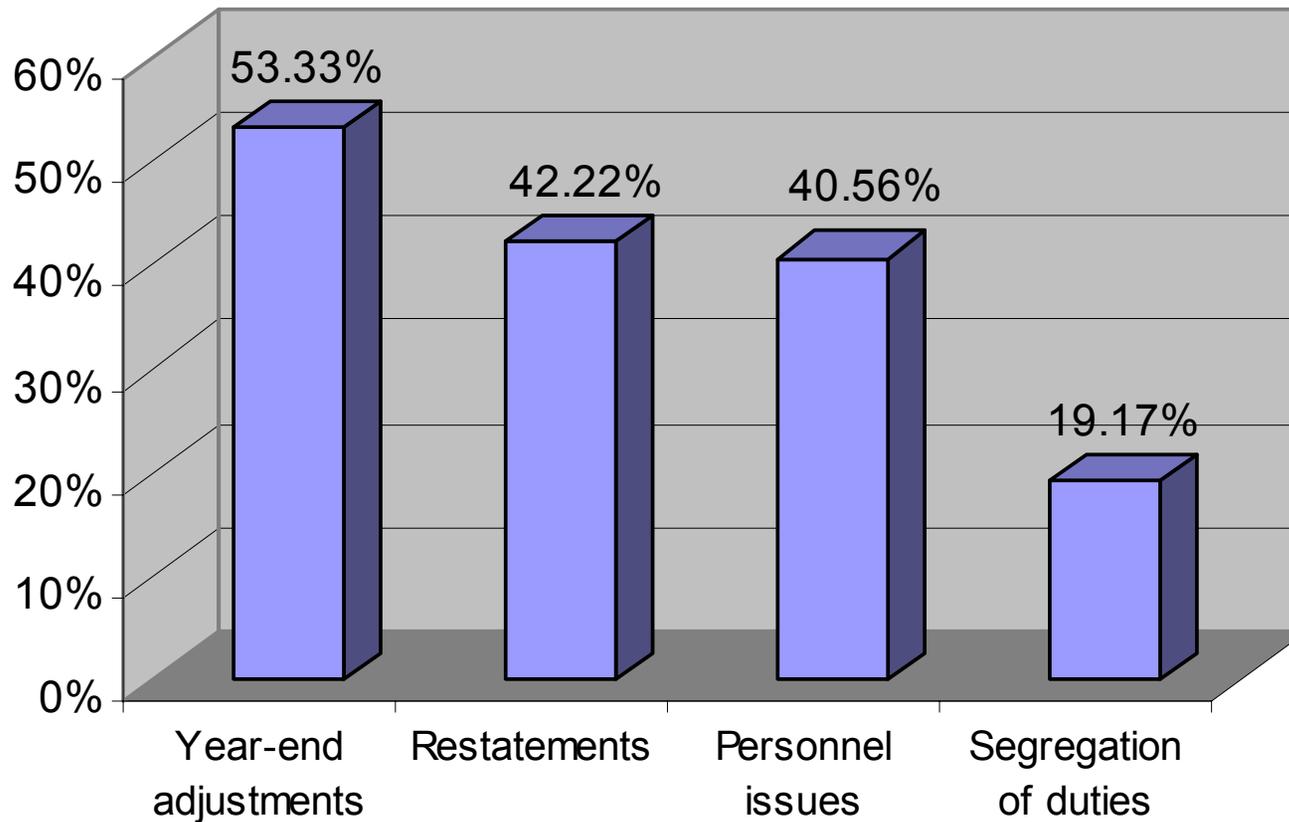
Based on 360 issuers reporting ineffective control over financial reporting



Source: Audit Analytics

Material Weaknesses by I/C Issue

Based on 360 issuers reporting ineffective control over financial reporting



Source: Audit Analytics

Update on Recent Activities

- **Implementation Concerns Expressed**
- **SEC and PCAOB Response to Concerns Expressed**
- **Key Principles of AS2 Reiterated**
- **PCAOB Policy Statement Issued May 16th**
- **Standing Advisory Group Discussion**

§404 and AS2 Concerns Expressed

- **Lack of trained staff**
- **Overly conservative approach**
- **Relationship with auditor more adversarial**
- **Unwillingness to apply judgment**
- **Tested only what could be measured and/or tested too much**
- **Did not use the work of others**
- **Documented too much**
 - If it's not documented, it didn't happen
- **The two audits were not integrated**
- **AS2 and/or COSO became the de facto standard for issuers**
 - Management didn't have a standard to apply
- **Confusion with respect to IT controls**

PCAOB Policy Statement – Issued May 16, 2005

- Integrate audits of internal control with audits of financial statements
- Exercise judgment to tailor audit plans to the risks facing individual clients
 - *Small companies do not need the same types of controls or the same audit process as do large multi-nationals*
 - *The PCAOB inspections will be consistent with this policy statement, and will not second-guess good faith exercises of audit judgment*
- Use a top-down approach that begins with company-level controls
- Use the flexibility of the standard to use the work of others as provided
- Engage in direct and timely communication with audit clients

SEC Staff Statement on ICFR – Issued May 16, 2005

- **Purpose of ICFR**
- **Reasonable assurance, risk-based, and scope of testing and assessment**
- **Evaluating internal control deficiencies**
- **Disclosures about material weaknesses**
- **Information technology issues**
- **Communications with auditors**
- **Issues related to small business and foreign private issuers.**

June SAG Meeting – Next Steps

- **AS2: need more experience (including non-accelerated filer experiences) before determining whether to re-open the standard**
 - *Unless the SEC's Advisory Committee on Smaller Public Companies recommends otherwise*
- **Guidance: weigh the costs that might be required to revise AS2 systems only recently developed, against the benefits that additional clarification might provide**

Small Business Issues

- **Relative Cost of Implementation**
- **Board Member Response**
- **AS2 Application in the Small Business Environment**
- **Other Small Business Initiatives Underway**

“Small companies do not need the same types of controls or the same audit process as do large multi-nationals”¹

- **Common complaint that the costs of 404 compliance are higher for smaller entities**
- **How did this come about?**
 - Smaller companies typically do not have strong controls
 - One-size-fits-all audit approaches taken
 - Time and personnel pressures from both management and the auditor
 - Needless increase in audit fees

¹– Dan Goelzer, PCAOB Board Member, April 29, 2005

Board Member Response

“It is certainly true that smaller, less complex businesses typically need less complex controls, and the work of the auditor should reflect that fact...however, Section 404 is likely to result in greater improvements in control and in greater increases in financial reporting reliability at smaller entities as a group, than at larger ones. This should, in turn, result in lower capital costs for these companies.”

– Dan Goelzer, PCAOB Board Member, April 29, 2005

AS2 Application in the Small Business Environment

- **No small business exemption in statute or auditing standard**
- **Current standard relies on COSO framework**
- **End result: one-size does not fit all. Auditors will exercise judgment:**
 - Less complex = internal controls that are less complex
 - May require less documentation
 - Amount of auditor's work is affected by quality of management's assessment as well as the quality and quantity of company documentation.

Other Small Business Initiatives Underway

- **Small Businesses**

- COSO Small Business Advisory Guidance Group – exposure draft anticipated this summer
- SEC Advisory Committee on Smaller Public Companies – second meeting June 16-17, 2005

Agenda Recap

- **Summary of §404 Reporting to Date**
- **§404 & AS2 – Update of Recent Activities**
- **Small Business Issues**
- ***Brief Overview of AS2 Requirements***
- **Questions & Answers (throughout)**

Overview of AS2 Requirements

- Planning the audit (¶39)
- Evaluating the management's assessment (¶40-46)
- Obtaining an understanding of I/C (¶47-87)
- Evaluating the effectiveness of both the design and operation of I/C (¶88-126)
- Forming an opinion on effectiveness of I/C (¶127-141)
- Reporting the results (¶162-199)

1) Planning the Audit

- **The audit of internal control must be properly planned and supervised**
- **In the planning phase the auditor should consider:**
 - **Prior knowledge of the company's system of internal control**
 - **Industry knowledge with respect to financial reporting practices, economic conditions, laws and regulations and technological changes.**
 - **Company knowledge with respect to its organization, operating characteristics, capital structure and distribution methods**
 - **Recent changes in operations or in internal controls**
 - **Preliminary judgments about materiality, risk, etc.**
 - **The number of significant business locations or units**

2) Evaluating Management's Assessment

- Auditor determines basis on which management reaches its conclusion on control effectiveness
 - Such as the COSO framework, which includes (1) control environment;(2) risk assessment; (3) control activities; (4) information & communication; and (5) monitoring
- Uses this knowledge and understanding of management's assessment process in planning his/her audit work
- More reliable management's assessment, the less costly the auditor's work needs to be
- Review of management's documentation of the system is a major component of evaluating the work

3) Obtaining an Understanding of I/C

- Auditor must gain an understanding of the design of the controls and operating effectiveness
- Inquiry of company personnel and review of management's assessment process
- Two aspects of understanding the design and operation of controls:
 - Walkthroughs for major classes of transactions
 - The role of the audit committee

Walkthroughs

- **The auditor should perform one “walkthrough” for each major class of transactions**
 - Walkthrough traces the transaction from its origination all the way through its inclusion into the financial statements.
- **Walkthroughs confirm the auditor’s understanding of:**
 - The flow of the transaction
 - Design of the controls surrounding the transaction (including all five components of the COSO framework)
 - Completeness of the transaction
 - Effectiveness of the controls surrounding the transaction
 - The fact that the controls are in place

The Role of the Audit Committee

- **Audit committee is an important element of the COSO framework addressing two of the five components**
 - Control environment and monitoring
- **The board of directors is responsible for evaluating committee effectiveness but the auditor should consider:**
 - Independence of the audit committee members
 - Clarity of audit committee's charter
 - Understanding of responsibilities
 - Involvement and interaction with all parties
 - Quality of questions and understanding of responses

4) Evaluating the Effectiveness of Both the Design and Operation of I/C

- **Testing is the heart of the audit**
 - Controls that are identified as addressing key assertions in the financial statements for all significant accounts should be tested
 - Includes interviews, observations, document reviews, and reperformance
 - Testing should vary from year to year
 - *But the auditor must obtain evidence for all relevant assertions for all significant accounts every year*
 - Reliance on the “work of others”
 - *Extent of reliance depends on both competence and objectivity*
 - *Work must be tested by the auditor*
 - *Nature of control is important to consider*
 - *Principal evidence must be obtained by the auditor*

5) Forming an Opinion on Effectiveness of I/C

- **The auditor must form an opinion on the effectiveness of controls and whether deficiencies exist**
 - All deficiencies should be reported in writing to management
 - All significant deficiencies must be reported in writing to management and the audit committee
- **The existence of a material weakness requires the issuance of an adverse opinion on internal control**
 - Auditor will also report on whether he or she agrees with management's assessment of internal control

Evaluating the Effectiveness of the Audit Committee

- Part of evaluating control environment and monitoring components of internal control.
- Communication requirement to Board of Directors.
- Special considerations apply to small businesses.

Internal Control Deficiency

- A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis (paragraph 8)

Internal Control Deficiency

- Evaluate significance of deficiency based on –
 - Likelihood that deficiency, or combination, could result in a misstatement
 - Magnitude of potential misstatement resulting from the deficiency, or combination of deficiencies

Evaluating Internal Control Deficiencies

A deficiency is considered a significant deficiency or material weakness if, either individually or in the aggregate, after considering compensating controls, the following criteria are met

Classification of Deficiency	Likelihood of Misstatement		Potential Magnitude of Misstatement
Control deficiency	Remote	OR	Inconsequential
Significant deficiency	More than remote	AND	More than inconsequential
Material weakness	More than remote	AND	Material

Strong Indicators of Material Weaknesses

- Restatements to correct a misstatement.
- Auditor identification of a material misstatement.
- Fraud by senior management (any amount).
- Significant deficiencies remain uncorrected after a reasonable period.
- Ineffective control environment.

Strong Indicators of Material Weaknesses

- Ineffective oversight by audit committee (or equivalent).
- Ineffective regulatory compliance function where violations could materially affect the reliability of financial reporting (complex, regulated entities).
- Ineffective internal audit or risk assessment function (large or highly complex organizations).

6) Reporting the Results

*The auditor must include **two** opinions:*

1. Opinion on management's assessment
 - If a material weakness is found, management's report can not conclude that internal control is effective
 - If management and the auditor disagree on whether there is a material weakness, the auditor would render an adverse opinion on management's assessment
 - The auditor's opinion is on management's assessment – **not** on management's **process** for assessing.

6) Reporting the Results

*The auditor must include **two** opinions:*

2. Opinion on the effectiveness of internal control over financial reporting
 - The auditor is permitted to express an unqualified opinion on effectiveness only if enough testing was done and no material weaknesses were found
 - If management did not fulfill their responsibilities regarding their assessment, the auditor must disclaim an opinion
 - Existence of a material weakness requires an adverse opinion

Example Reporting Scenarios

Situation	Management's report	Auditor's opinion on	
		Management's assessment	Effectiveness of ICOFR
No material weakness identified	Internal control effective	Unqualified	Unqualified
Material weakness identified by management and auditor	Internal control not effective	Unqualified	Adverse

Example Reporting Scenarios

Situation	Auditor's Report
Company has one or more material weaknesses, but management's assessment indicates internal control is effective	Issue adverse opinions on both management's assessment and internal control.
Management fails to fulfill its responsibilities regarding the internal control assessment	<ul style="list-style-type: none">• Communicate to management and the audit committee.• Disclaim opinions.• Consider possible additional auditor responsibilities

Example Reporting Scenarios

Situation	Auditor's Report...
Material accounts processed by a service organization (under contract since 2001). Management has attempted to fulfill its assessment responsibilities relative to the service organization but without success.	<ul style="list-style-type: none">• Treat as a material weakness and report accordingly.• Probably conclude that management has fulfilled their responsibilities, so audit opinion can be rendered.
Same as above, except that management has not sufficiently attempted to fulfill its responsibilities.	<ul style="list-style-type: none">• Communicate to management and the audit committee.• Disclaim opinions, and disclose material weakness.• Consider possible additional auditor responsibilities

Required Communications

- **Management's communication requirements** (§§ 142 – 144)
 - Written representation acknowledging management's responsibility
 - Statement that an assessment has been performed
 - Statement of management's conclusion
 - Statement that all deficiencies have been disclosed to the auditor
 - Description of any material fraud or fraud involving senior management
- **Auditor's communication requirements** (§§ 207 – 214)
 - Must communicate in writing all significant deficiencies and material weaknesses to **both** management and the audit committee
 - If significant deficiencies or material weaknesses exists because of ineffective oversight over financial reporting by the audit committee, the communication must be in writing to the board of directors
 - **All** deficiencies must be reported to management and should be reported in writing

Proposed Standard

- **March 31, 2005 – PCAOB proposed an Auditing Standard, *Reporting on the Elimination of a Material Weakness***
 - *Comment period ended May 16, 2005*
- **Hope to adopt final (and refer to the SEC for approval) by the end of next month**

Questions

