

Forum on Auditing in The Small Business Environment

November 6, 2006

New York, NY

Opening Keynote Address

November 6, 2006

New York, NY

Overview of the PCAOB and "Hot Topics"

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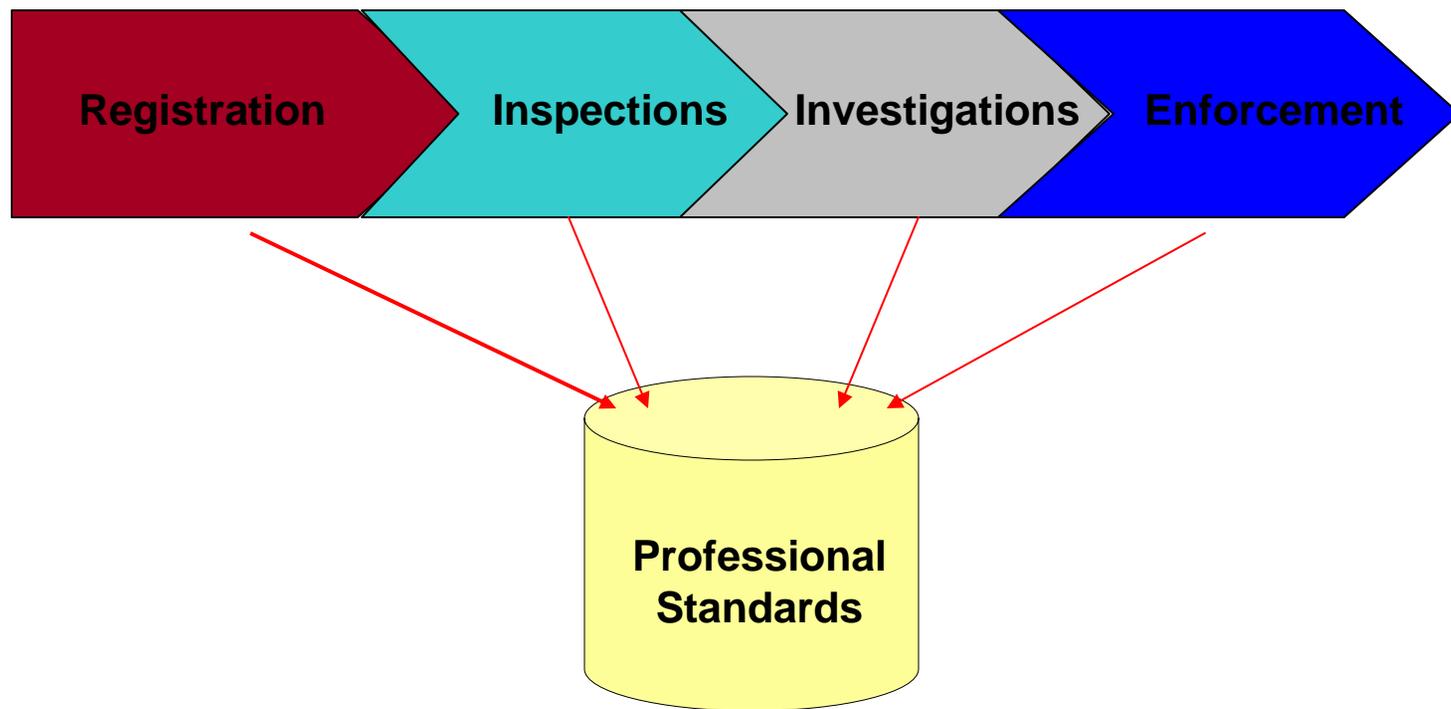
Caveat

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

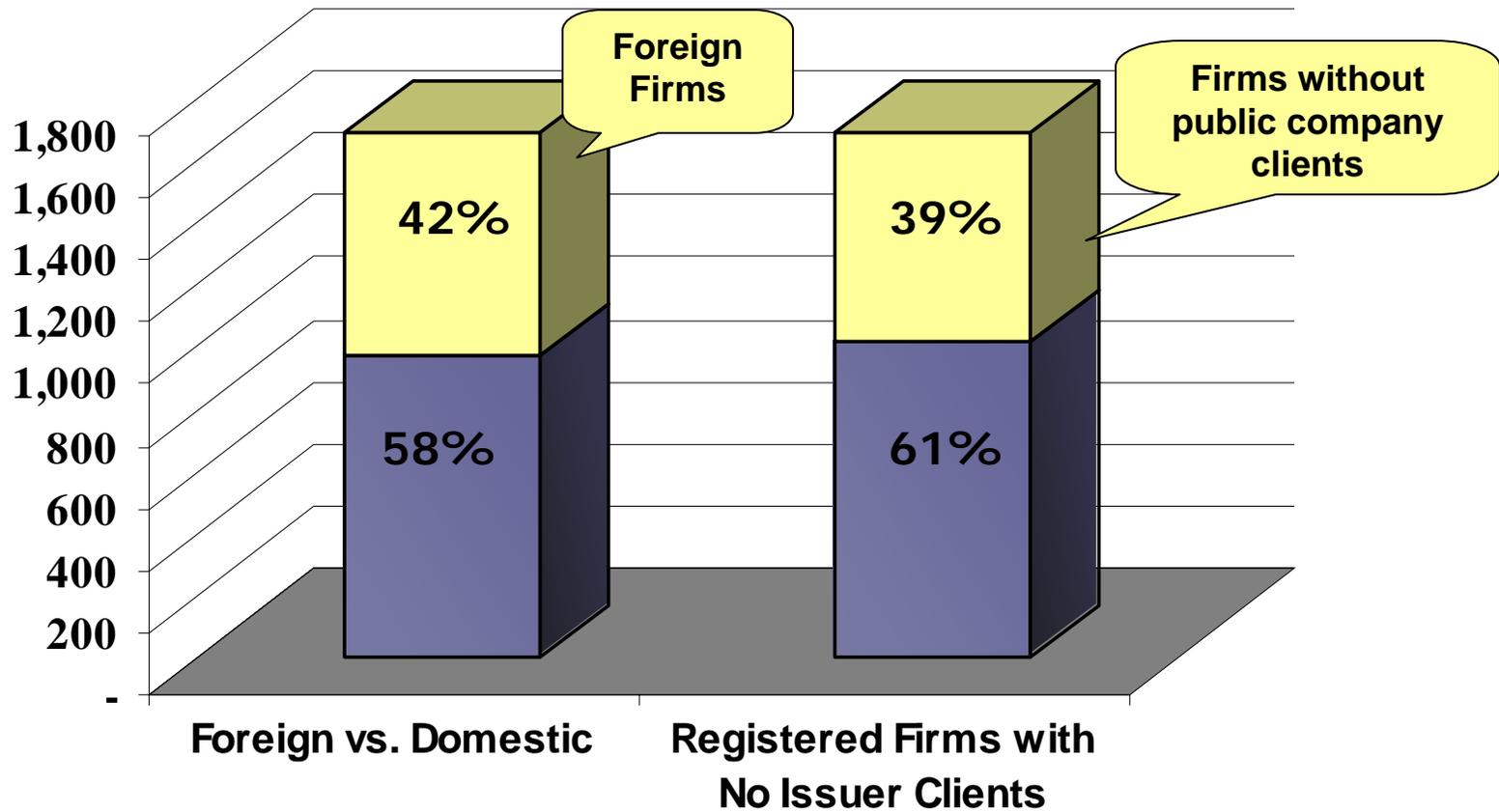
- ❑ Brief overview of the PCAOB
- ❑ Interplay between Inspections, Standards and Enforcement
- ❑ Most frequently encountered inspection observations - "hot topics"

The PCAOB in a Nutshell



Registered Firms

Approximately 1,700 Registered Firms



PCAOB Proposed* Rules for Annual and Special Reporting

- Section 102(d) of SOX provides that each registered public accounting firm shall submit an annual report to the PCAOB
 - PCAOB proposed* rules on May 23, 2006
The rules establish a framework for reporting:
 - Annually using **Form 2**
 - Within 14 days of the occurrence of certain events using **Form 3**

Form 2 – Annual Reporting

- ❑ On an annual basis registered firms must provide general information about the identity of the firm and location of its offices
- ❑ Firms are also required to provide information related to three broad categories
 - The firm's issuer-related practice
 - Internal and external resources used by the firm to conduct audits of issuers
 - Significant new relationships
- ❑ Annual affirmation that the firm consents to cooperate with the PCAOB is also required
- ❑ Form 2 will be due on June 30 with reporting covering the 12-month period ending March 31

Form 3 – Special Reporting

- Form 3 is required to be filed within 14 days of the occurrence of certain triggering events such as:
 - A change in the number of issuer audit clients to either more than 100 clients or less than 101 clients
 - An audit report that has been withdrawn by the firm and the issuer has failed to report it to SEC
 - An issuer has made unauthorized use of the firm's name
 - The firm and/or certain associated persons have become a defendant(s) in certain types of criminal proceedings
 - The firm's contact person/information has changed

Form 4 – Succeeding to the Registration Status of a Predecessor Firm

- ❑ Establishes the ability and process for a new legal entity to succeed to the registration status of a predecessor
- ❑ Complete and file a timely Form 4
 - Affirm cooperation
 - Accept responsibility
- ❑ Succession may be outright or transitional for a period of up to 90 days

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

12-Month Remediation

- ❑ Final inspection report triggers 12-month remediation cycle for quality control deficiencies
 - 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

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 with respect thereto, including the rules of the Commission issued under the Act, 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

- Situations in which the Board may use its investigative resources instead of relying on its supervisory processes in inspections
 - the firm's commitment to conducting audits with sufficient care, or
 - the firm's ability to conduct audits with sufficient competence

Investigations

- ❑ The Board staff 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)
- ❑ Individuals may assert Fifth Amendment rights against self-incrimination, but the Board may draw adverse inferences if appropriate

Investigations (cont'd)

- ❑ The Act requires confidentiality of information
- ❑ 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

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

Common Types of Investigations (cont'd)

- ❑ Failure to cooperate with an inspection or investigation
 - May result in a separate disciplinary proceeding
 - Need not wait for conclusion of investigation relating to underlying violations
 - Sanctions available to Board are similar to those for other Board disciplinary proceedings
 - Staff usually will communicate what it views as non-cooperation

After the Investigation

- Upon completion of investigation
 - Staff typically will communicate in writing what it views as the alleged violations, including laws and rules violated and facts supporting the violations
 - Staff typically will provide the firm or individual two weeks to respond in writing to staff's position
 - Staff typically will discuss settlement of disciplinary proceedings with proposed respondents

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 can be appealed 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

Auditing Revenues

- Auditing challenges
 - Complicated area
 - Numerous technical references
- Revenue is usually a significant account, so substantive procedures must be applied (AU sec. 319, as amended*)
- Analytical procedures (AU sec. 329, as amended*)
 - Precision level appropriate for degree of assurance
 - Expectations and differences quantified
 - Test completeness and accuracy of underlying reports
 - Consider potential management override
 - Management explanations corroborated
- Audit sampling (AU sec. 350)
- Cutoff and revenue recognition (AU sec. 316)

* Amended by the Board in Conforming Amendments resulting from Auditing Standard No. 2

Auditing Revenues (cont'd)

- ❑ Understand client and industry, revenue composition, terms of revenue transactions, and relevant accounting principles
- ❑ Presumption that improper revenue recognition is a fraud risk
- ❑ Consider:
 - Confirming with customers the contract terms and the absence of side agreements
 - Asking sales/marketing personnel or in-house legal counsel about sales near period-end and any unusual terms or conditions
 - Visiting one or more locations at period-end to observe shipments (or returns) and performance of cutoff procedures
 - Testing controls, especially when sales are electronically initiated and processed

2. Expenses

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

Auditing Expenses

- Auditing challenges
 - Verifying completeness and classification
- Substantive procedures must be applied to significant accounts (AU sec. 319, as amended*)
- Analytical procedures (AU sec. 329, as amended*)
- Audit sampling (AU sec. 350)

* Amended by the Board in Conforming Amendments resulting from Auditing Standard No. 2

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

Auditing Estimates

- Auditing challenges
 - Complex accounting
 - Significant judgment involved
- AU secs. 342 and 328 (and other standards)
 - Three approaches
 - Test management's process
 - Develop independent estimate
 - Review subsequent events
- Consider management bias (AU secs. 312, 342, and 316)
 - Retrospective review of prior-year estimates (AU sec. 316.64)
- Using a specialist (AU sec. 336)

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

Auditing Contractual Arrangements

- Auditing challenges
 - Complexity of
 - Terms and conditions of agreements
 - Accounting, including purchase price allocations and related valuations
 - Requires judgment and possibly use of a specialist
- Auditing identified intangible assets
 - AU sec. 328 *Auditing Fair Value Measurements*
 - AU sec. 342 *Auditing Accounting Estimates*
- Auditing contingent consideration

Auditing Contractual Arrangements (cont'd)

- Evaluating significant transactions (AU sec. 316.66)
 - Consider economic substance of transaction (AU sec. 411.06)
 - Evaluate bias in selection and application of accounting principles (AU sec. 316.50)
- Understand business purpose (AU sec. 316.67)
 - Is the transaction overly complex in form?
 - Has management discussed the nature of the transaction and its accounting with the audit committee or board of directors?
 - Does management emphasize the need for a particular accounting treatment rather than the underlying economics of the transaction?
 - If the transaction involves unconsolidated related parties, including special purpose entities, has it been reviewed and approved by the audit committee or board of directors?
 - Does the transaction involve previously unidentified related parties or parties that lack the substance or financial strength to support the transaction without assistance from the issuer?

5. Equity Transactions

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

Auditing Equity Transactions

- Auditing challenges
 - Often involves fair value (AU secs. 328, 342, 336)
 - Accounting standards numerous and complex
 - Lack of market data
- Auditing FAS 123R application
 - Expected volatility and expected term are key drivers of compensation expense
 - Review and test process used to develop these estimates (AU sec. 342)

6. Inventory

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

Auditing Inventory

- Auditing challenges
 - Verifying existence and valuation, including estimate for obsolescence reserve
- Testing accounting records (AU sec. 319.65 and AU sec. 326.16)
- Evaluating adjustments to inventory (AU sec. 326.19, as amended, and AU 316.61)

7. Going Concern

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

Auditing Going Concern

- Auditing challenges (AU sec. 341)
 - Determining whether there is substantial doubt about entity's ability to continue as going concern one year after F/S date
- Evaluate management's plans to mitigate going concern risk
- Assess likelihood that plan can be implemented
- Review subsequent events
- Confirmation with related and third parties of financial support arrangements

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

Auditing Internal Control

- Auditing challenges
 - Linking of control risk assessment, nature and extent of control testing, control testing results, and substantive testing
 - Evaluating effectiveness of IT controls
- Tests of controls in a financial statement audit (AU sec. 319, as amended*)
- Evaluation of controls of service organizations (AU sec. 324.13-.16)

* Amended by the Board in Conforming Amendments resulting from Auditing Standard No. 2

Auditing Internal Control (cont'd)

- Consider AS No. 2 conforming amendments to AU sec. 319, *Analytical Procedures*
 - For significant risks of material misstatement, it is unlikely that substantive analytical procedures alone will be sufficient
 - When designing substantive analytical procedures, auditor should evaluate risk of management override
 - Auditor should test design and operating effectiveness of controls over financial information used in substantive analytical procedures (or perform other procedures to support completeness and accuracy of underlying information)

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

Audit Considerations for Principal Auditor

- ❑ Deciding whether the auditor can serve as principal auditor (AU sec. 543.02)
- ❑ Deciding whether principal auditor can make reference in report to audit of another auditor (AU sec. 543, as amended*)
- ❑ Using other auditors to perform a portion of the audit for the auditor (AU secs. 230 and 311)

* Amended by the Board in Conforming Amendments resulting from Auditing Standard No. 3

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

Audit Considerations for Concurring Partner

- ❑ SEC Practice Section rules – Incorporated by PCAOB Rule 3400T as they existed on April 16, 2003
- ❑ Section 1000.08(f) Appendix E
 - Qualifications of concurring partner
 - Nature, timing, and extent of concurring partner reviews
 - Documentation of concurring partner review
 - Quarterly reviews

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

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?

Auditing and Independence Standards Update

November 6, 2006

New York, NY

What We Will Cover

- ❑ **Internal Control Over Financial Reporting**
- ❑ **Audit Documentation**
- ❑ **Other Recent Guidance**
- ❑ **Auditor Independence**

Internal Control Over Financial Reporting Update

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

Especially for Auditors of Smaller Public Companies...

- ❑ Guidance and education for auditors of smaller public companies
- ❑ Continue the Forums on Auditing in the Small Business Environment

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

Auditing Standard No. 3

- *Audit Documentation*

Auditing Standard No. 3 – *Audit Documentation*

- For relevant financial statement assertions, auditors must document
 - Procedures performed
 - Evidence obtained
 - Conclusions reached (par. 6)

Experienced Auditor

- Documentation must have sufficient information to enable an *experienced auditor*, having no previous connection with the engagement, to understand the work performed, evidence obtained, and conclusions reached
 - An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the A&A issues relevant to the industry. (par. 6)

Audit Documentation

- If there is insufficient documentation in the working papers, auditor must *demonstrate* procedures performed, evidence obtained, and conclusions reached (par. 9)
 - Auditor must have persuasive other evidence
 - Oral evidence, alone, is not sufficient and may be used only to *clarify* other written evidence

Engagement Completion Document

- ❑ All significant findings or issues to be documented in an *engagement completion document* (par. 13)
- ❑ Examples of *significant findings or issues* include:
 - Significant matters involving selection, application, and consistency of GAAP
 - Audit adjustments
 - Disagreements among engagement team members
 - Significant difficulty in applying auditing procedures
 - Any matters that could result in modification of auditor's report

Multi-Location Audits

- ❑ The office of the firm issuing the auditor's report must ensure that *all* audit documentation is prepared and retained (par. 18)
- ❑ Certain documentation related to the work performed by other auditors must be obtained prior to the report release date. Such documentation includes:
 - Engagement completion document
 - Schedule of audit adjustments
 - Significant deficiencies/material weaknesses
 - Matters to be communicated to the audit committee

Definitions of Dates

- Two new dates defined in this standard
 - *Report release date* – the date the auditor grants permission to use the auditor's report in connection with the issuance of the financial statements (par. 14)
 - *Documentation completion date* – not more than 45 days after the report release date (par. 15)

45-day Period to Assemble Work Papers

- During this period auditor can
 - Discard superseded drafts of memoranda, financial statements, and other documents
 - Discard duplicates of documents
 - Correct minor edits in the working papers

Other Recent Guidance

PCAOB Auditing Standard No. 4 – Reporting on Elimination of a Material Weakness

- ❑ Management may voluntarily request report
- ❑ Potential uses and benefits of such reports
- ❑ Auditor's responsibilities in issuing report
- ❑ Report is neither an opinion nor an update of an opinion on overall effectiveness of ICFR
- ❑ Effective for financial audits of years ending on or after November 15, 2005

Staff Q&As: Adjustments to Financial Statements Audited by Predecessor

- Addresses situations in which adjustments are made to prior-period financial statements when there has been a change of auditors
- Provides the staff's views on auditing of the adjustments by
 - Predecessor auditor
 - Successor auditor
- Reporting considerations

Staff Audit Practice Alert: Matters Related to Timing and Accounting for Option Grants

- ❑ Advises auditors that some issuers' practices related to stock options grants may have audit implications
- ❑ Discusses factors that may be relevant to assessing the risks relating to those matters
 - Based on existing requirements of PCAOB standards and relevant laws
 - Includes accounting, auditing, and certain legal considerations
- ❑ Applies to
 - Current audits
 - Involvement with registration statements
 - Previously-issued opinions

Staff Q&As: Auditing the Fair Value of Employee Share Options

- ❑ Purpose is to help auditors implement PCAOB's existing auditing standards when auditing the fair value of employee share options
- ❑ Provides factors for assessing risk, e.g., when an assumption has the effect of reducing fair value below what it would have been had the company used unadjusted historical information

Staff Q&As: Auditing the Fair Value of Employee Share Options (cont'd)

- ❑ Provides guidance for evaluating reasonableness of company's process
- ❑ Focus on evaluating reasonableness of expected term and expected volatility assumptions
- ❑ Provides additional guidance about use of specialists
- ❑ Limited to auditing fair value measurements for compensation cost

Auditor Independence

Auditor Must be Independent in Fact and Appearance

Second general auditing standard states –

- ❑ "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." (AU sec. 220.01)
- ❑ "To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners." (AU sec. 220.03)

Auditor Independence is Governed by –

- ❑ SEC Auditor Independence Rules (17 CFR 210.2-01)
- ❑ AICPA Code of Professional Conduct, Ethics secs. 101, 102, and 191
- ❑ PCAOB Interim Independence and Ethics Standards
 - Adopted 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

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

Management Functions

- ❑ The auditor is prohibited from acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for 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

□ 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/

□ 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 web site.

Questions?

PCAOB Inspections Process: What Can Be Expected

November 6, 2006

New York, NY

Mission of the New York Regional Office

- ❑ Integrate into national PCAOB mission of inspecting the large firms (> 100 Issuer clients)
- ❑ Inspect the small firms in the region
- ❑ Support small firm inspection process in other PCAOB offices
- ❑ Support other PCAOB initiatives

New York Office - Number of Registered Firms by State

New York	123
New Jersey	40
Massachusetts	27
Connecticut	11
New Hampshire, Maine, Rhode Island, Vermont	<u>8</u>
Total	209

Inspection Approach

- ❑ Regional small firm inspection approach
- ❑ Size of inspection team based on number of issuer audit clients and offices
- ❑ Certain inspections are conducted at a PCAOB office and the inspection team follows up with the firm telephonically
- ❑ Some inspections may be completed in less than a week or may last several weeks
- ❑ Inspections focus on audit performance and quality control

Lifecycle of an Inspection

- ❑ Contact firm
- ❑ Inspection commencement date determined
- ❑ Formal letter issued with document request
- ❑ Engagements and offices selected for review
- ❑ Quality control assessment and engagement reviews
- ❑ Comment forms prepared, reviewed by firm, and responded to
- ❑ Draft report prepared by inspection staff
- ❑ Draft report made available to firm
- ❑ Firm has 30 days to respond to draft report
- ❑ Board issues final report to firm, SEC and certain state licensing boards
- ❑ Firm has 12 months to cure the quality control criticisms

Contact Firm – Document Request

- Purpose is to obtain information about the firm, its professional staff and issuer clients. For example:
 - Firm demographic information
 - List of individuals who manage the firm and their biographies
 - Firm's quality control policies and procedures, including current year's internal inspection and/or peer review results
 - List of issuer audit clients
 - List of former issuer audit clients that changed auditors from your firm
 - List of issuer audit clients that restated their financial statements

Quality Control Assessment

- ❑ Tone at the top
- ❑ Independence
- ❑ Partner compensation
- ❑ Practice monitoring (internal programs and peer review results)
- ❑ Concurring partner reviews
- ❑ Client acceptance and retention
- ❑ Training
- ❑ Audit methodology
- ❑ Work of other auditors
- ❑ Alternative practice structure

Engagement Reviews

- Meet with engagement partner
- Review of audit work papers
 - Audit areas selected based on inspector's judgment
 - Engagement team personnel should be available to answer questions
- Comment forms issued at the conclusion of the inspection
 - Ensure that facts are accurately described
 - If firm chooses to respond, must do so in 10 business days

Draft Inspection Report

- Inspection team prepares draft inspection report
 - Several layers of review
 - Factual accuracy of report scrutinized
 - Firm's response to comment forms reviewed again
 - Inspection report may not include all comment forms
 - Comment may not meet criteria for inclusion in report
 - Inspection observation reworded
 - New observation
 - Quality control deficiencies

Draft Inspection Report – Firm Response

- ❑ Firm has 30 days to respond to draft report
 - Firm's responsibility to ensure response received within the 30-day period
 - Another opportunity to respond to the inspection observations
 - Can impact the inspection report
- ❑ Firm response treated similarly to inspection report
 - Part I is public
 - Part II is nonpublic
 - Contact person provided in transmittal letter
 - No draft responses accepted
- ❑ Guidelines for response preparation
 - Information provided with transmittal letter
 - Confidentiality requests
 - Factual inaccuracies in report

Final Inspection Report

- Report presented to the Board
 - Several layers of review (similar process as to draft inspection report)
 - After review completed, the report is submitted to the Board
 - The Board determines whether the report may be made final
- Public part of report posted on the web site, provided to the SEC and any state(s) in which the firm is licensed

Example Inspection Report with Observations

Part I Inspection Procedures and Certain Observations Public

- A – Review of Audit Engagements
- B – Review of Quality Control System

Part II Detailed Discussion of Inspection Results

- A – Insufficiently Supported Audit Opinions **Non Public**
- B – Issues Related to Quality Controls **Non Public ***
 - 1. Audit Performance
 - 2. Independence
 - 3. Monitoring and Addressing Identified Weaknesses
- C – Other Audit Performance Issues **Non Public**

*Subject to 12-month remediation process

Part III Post Inspection Procedures All Non Public

- A – Addressing Quality Control Criticisms
- B – Additional Assessment of Audits *
- C – Imminent Disciplinary Proceeding *

*Sections B and C of Part III are only included in the report, if appropriate

Part IV Response of the Firm to Draft Inspection Report **Public/Non Public ***

* Portions of firm's response may be non public

12-Month Remediation Process

- Final inspection report accompanied by a transmittal letter
 - Provides contact information
 - Guidelines for communicating with PCAOB during this process
 - Reference to PCAOB Release No. 1004-2006-077, The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports (March 21, 2006)
 - Encourages firm to start a dialogue as soon as practicable
 - Firm should be proactive during remediation period
 - Quality control criticisms may become public if not adequately addressed by firm

12-Month Remediation Process

□ Firm response

- Written submission should address each quality control criticism or potential defect
- Describe steps/actions taken or planned
- Narrative should be supported with documentary evidence, where possible
- Must be received within 12-month period from the release of the final report

□ Periodic notification

- 6 month reminder letter
- 60 day reminder letter

Questions?

Open Discussion

November 6, 2006

New York, NY