

Forum on Auditing in The Small Business Environment

May 3, 2006

San Antonio, Texas

Opening Keynote Address

May 3, 2006

San Antonio, Texas

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.

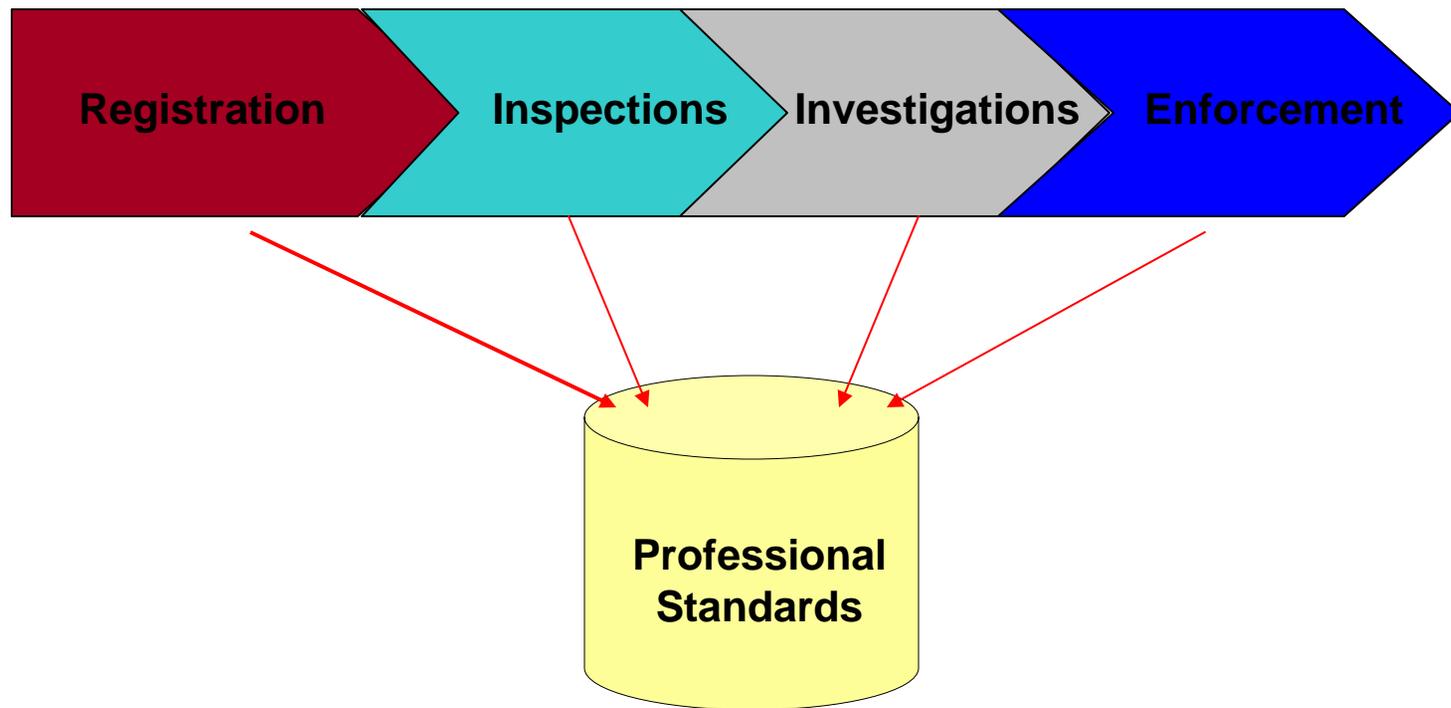
Objectives of this Presentation

- ❑ 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

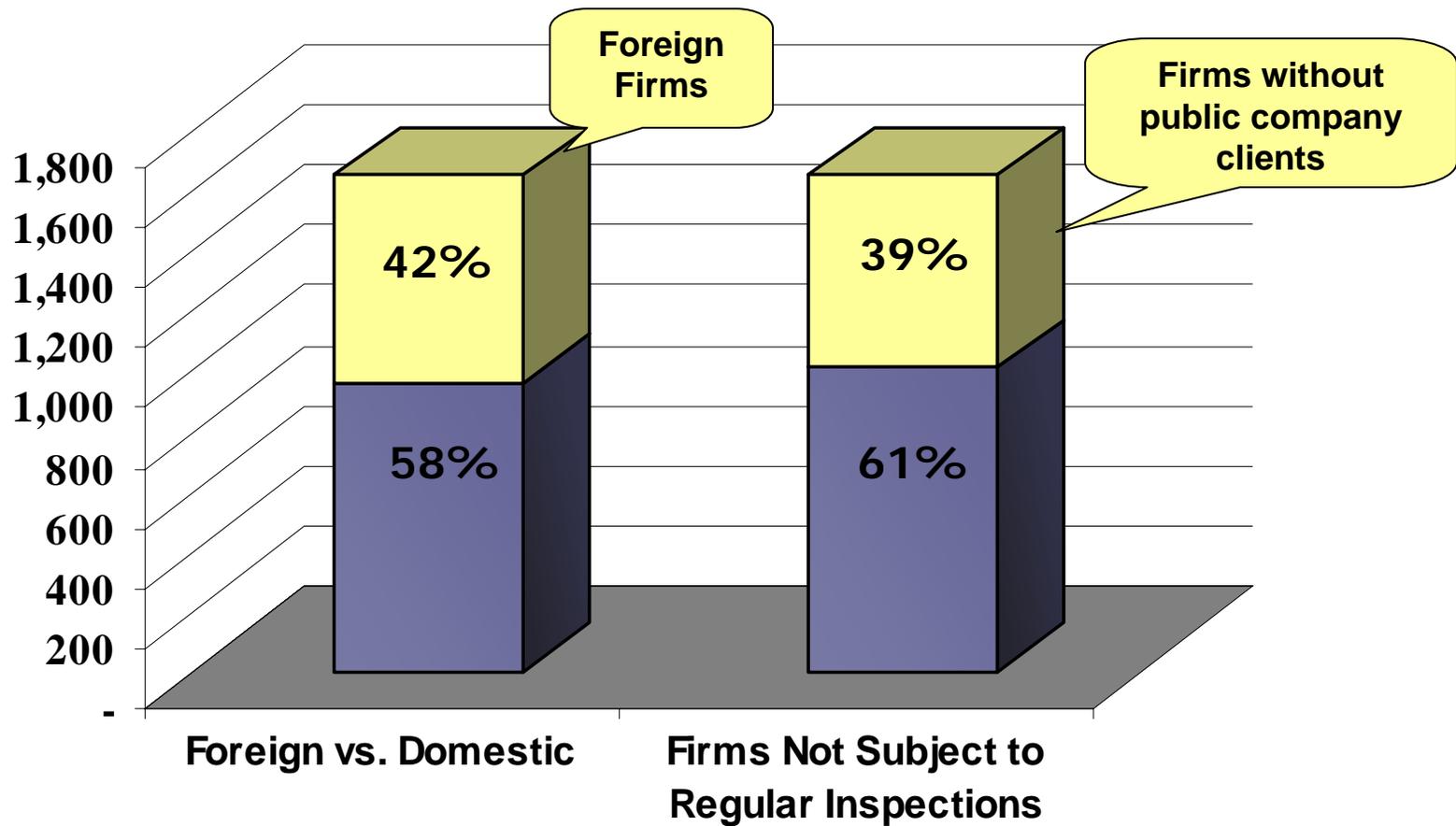
The Board's mission is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports of public companies.

The PCAOB in a Nutshell



Registered Firms

Approximately 1,650 Registered Firms



Inspections Progress

- Of the approximately 1,650 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 350 inspections
 - Issued more than 220 reports
 - Looked at portions of the audits of over 1,800 public companies

Inspection Reports - Drafts

- Draft inspection reports are issued once fieldwork is complete and after the inspection team's observations and related inspection report have been reviewed
 - Comment forms provide the foundation of the inspection report
 - Firms have 30 days to respond to our draft inspection reports

Inspection Reports – Overview of Reports for Small Firms

□ Four sections

■ 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

Inspection Reports - Final

- 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, the SEC and the appropriate state regulators
 - The public portions of inspection reports are posted on the PCAOB's website (www.pcaobus.org), including the public part of firm responses

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

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 enforcement action is taken

Standards-setting Overview

The Sarbanes-Oxley Act directs the Board to establish

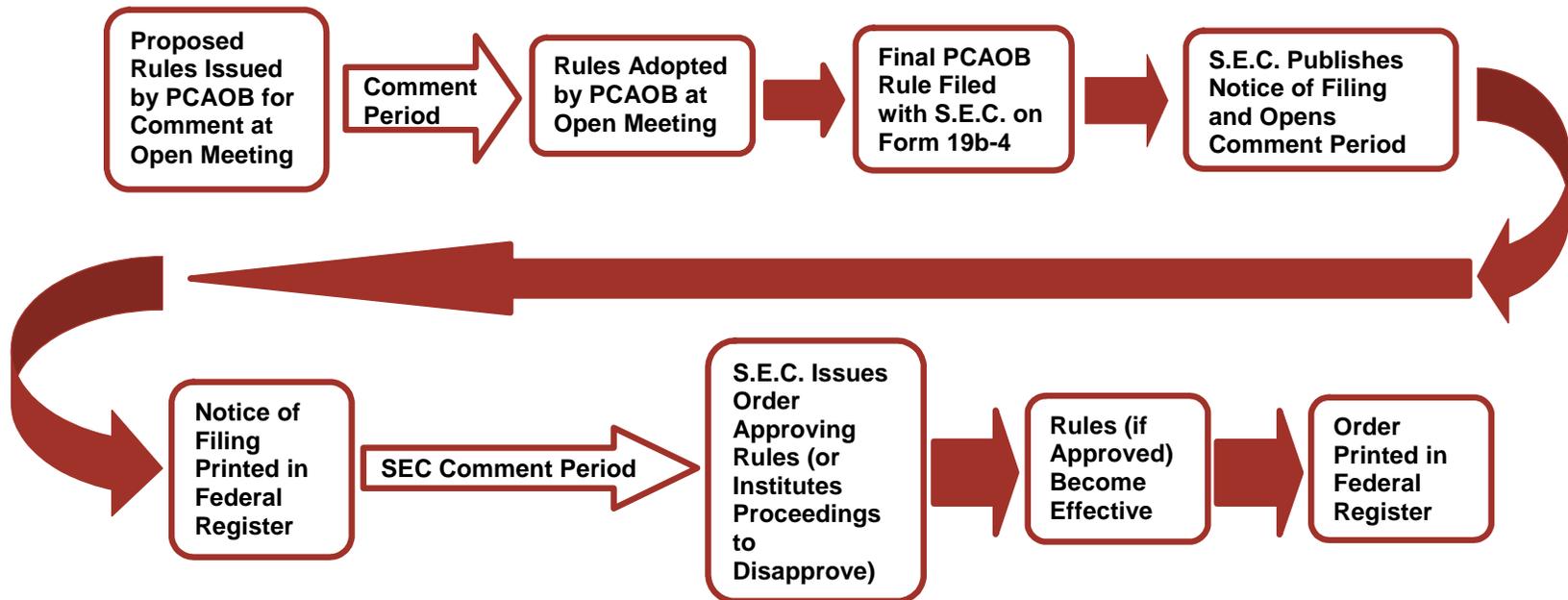
- Auditing standards
- Attestation standards
- Quality control standards
- Ethics standards
- Independence standards

Standards-setting Information Gathering Sources

- ❑ Standing Advisory Group ("SAG")
- ❑ PCAOB inspection observations
- ❑ PCAOB enforcement cases
- ❑ Office of Research and Analysis
- ❑ Roundtables on selected issues
- ❑ Ad hoc task forces and working groups
- ❑ Academic research
- ❑ Other sources

Standards-setting Process

PCAOB Typical Rulemaking Process



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 Activities*

- ❑ Engagement quality review (concurring partner)
- ❑ Fraud
- ❑ Communications with audit committees
- ❑ Principles of reporting
- ❑ Fair value
- ❑ Risk assessment
- ❑ Quality control
- ❑ Codification of PCAOB standards/authority of PCAOB interim standards

*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

- 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

What Prompts a Referral from Inspections to DEI?

- ❑ Numerous deficiencies on each issuer audit client inspected
- ❑ Firm not cooperative
 - Difficulty scheduling inspection
 - Personnel not available during course of inspection procedures
- ❑ Engagement partners assigned to dozens of audit clients in various industries
- ❑ Firm indicated in response to comment form and draft report that issuer would restate for certain of the inspection observations
 - Issuer never restates
- ❑ Firm had not corrected deficiencies noted from prior peer review

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

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 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. Revenue
2. Expenses
3. Estimates
4. Contractual arrangements
5. Equity transactions
6. Inventory
7. Going concern
8. Internal control
9. Principal auditor
10. Concurring Partner

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 and loan loss reserves
 - No or insufficient testing of collectibility of A/R, Loans Receivable
- ❑ 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 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

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

Questions?

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

May 3, 2006

San Antonio, Texas

Panel Participants

□ Moderator

- Joanne O'Rourke Hindman, Board Advisor
PCAOB

□ Panelists

- Gerald M. Czarnecki, Audit Committee Chair,
Del Global Technologies Corp.
- Robert D. Hardy, SVP CFO, U.S. Concrete,
Inc.
- Todd Van der Wel, Partner, Moss-Adams
LLP

Current Developments - Internal Control over Financial Reporting

May 3, 2006

San Antonio, Texas

Topics

- ❑ Requirements for Internal Control Over Financial Reporting
- ❑ PCAOB Sources of Information
 - Board Policy Statement
 - Staff Questions & Answers
 - Report on Initial Implementation
- ❑ SEC Reference Material
- ❑ COSO Update
- ❑ SEC Advisory Committee on Smaller Public Companies
- ❑ Looking Forward

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
 - Effective dates:
 - Accelerated filers (U.S.): first fiscal year after November 15, 2004
 - Non-accelerated filers: first fiscal year after July 15, 2007

Reporting Results – Through Year 2

- ❑ 5.6% of accelerated filers reported material weakness in internal control in 2006 vs. 15.4% in 2005
- ❑ Restatements and auditor adjustment continue to be associated with many of the material weaknesses
- ❑ In both years - most common issues related to the application of GAAP:
 - Tax accounting (38% in 2006 vs. 32% in 2005),
 - Revenue recognition (30% vs. 32%),
 - Inventory/cost of sales (25% vs. 27%)
- ❑ Lease accounting was less of an issue in the current year, but still an issue for some (10% vs. 17%)

Data is per Audit Analytics, through 12/31/05 for 2005 and through 3/31/06 for 2006

Information about Audits of Internal Control

- ❑ Auditing Standard No. 2
- ❑ Conforming Amendments Resulting from Auditing Standard No. 2
- ❑ Board Policy Statement
- ❑ Staff Questions and Answers
- ❑ Report on Initial Implementation

www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx

Board Policy Statement – May 16, 2005

- ❑ Integrating the Audit
- ❑ Use of auditor judgment
- ❑ Timely communications with audit clients about accounting issues
- ❑ Approach to inspections

Staff Questions & Answers – May 16, 2005

- ❑ Top-down approach (Q&A 38)
- ❑ Role of risk assessment (Q&A 39-40)
- ❑ Integrating the audit (Q&A 50)
- ❑ Scope and extent of testing matters (Q&A 41-53)
- ❑ Using the work of others (Q&A 54)

Report on Initial Implementation of AS2 – November 30, 2005

- Highlights issues identified through the Board's monitoring
 - Firms faced many challenges in the first year
 - Some audits were not as effective or efficient as AS2 intended
- Discussion of concepts related to
 - Evaluating Deficiencies
 - Definition of Material Weakness

Report on Initial Implementation of AS2 - Efficiency and Effectiveness

- Efficiency
 - Integrating the Audit
 - Top-Down Approach
 - Risk Based Approach
 - Using the Work of Others
 - Walkthroughs
- Effectiveness
 - Compensating Controls
 - Controls over Presentation and Disclosures

SEC Reference Material on Section 404

- ❑ Implementing rules
- ❑ Other Commission releases
- ❑ Staff guidance
- ❑ Other information

www.sec.gov/spotlight/soxcomp.htm

COSO Internal Control Framework



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

Draft Guidance from COSO

- *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting* (draft, October 2005)
 - Focus on internal control over financial reporting
 - Principles drawn from the 1992 framework
 - Illustrative approaches and examples

www.coso.org

PCAOB Comment Letter on COSO Draft Guidance

- ❑ Make all comments publicly available
- ❑ Re-focus guidance on management's responsibilities regarding internal control
- ❑ Make the guidance simpler and easier to use
- ❑ Make sure that attributes, approaches, and examples are appropriate for smaller public companies

SEC Advisory Committee on Smaller Public Companies

- ❑ Composed of representatives of smaller public companies and professionals who work with smaller public companies
- ❑ Primary areas of focus
 - Accounting standards
 - Internal control over financial reporting
 - Corporate governance and disclosure
 - Capital formation

SEC Advisory Committee Activities

□ Activities to date

- Online survey and public meetings
- Formal recommendations to SEC
- Other "proposed preliminary recommendations" under consideration

□ Future Activities

- Final recommendations and report to the SEC

www.sec.gov/info/smallbus/acspc.shtml

Concepts Discussed by Advisory Committee

□ Smaller Public Companies

- Includes definitions of microcap companies and small companies – these definitions are based on market capitalization

□ Recommends that smaller public companies not be subjected to Section 404 to the same extent as larger public companies

- Exempt most microcap, and some small, companies from all of the 404 requirements
- Exempt the largest microcaps (by revenue) and most small companies from the external audit requirement in Section 404

Looking forward

- SEC/PCAOB Roundtable – May 10, 2006
 - Focus of the roundtable is on the experiences from the second year of implementation
 - What we have learned so far
 - How we can improve the process going forward
 - Provides an opportunity for the Board and Commissioners to hear from all of the market participants in one setting (investors, issuers and auditors)
 - Multiple panels will address different issues including managements assessment, the integrated audit and the effect on the market
 - Event will be held in Washington DC, but shown via web cast at pcaobus.org during the event

Questions?

Open Discussion

May 3, 2006

San Antonio, Texas