Forum on Auditing in The Small Business Environment

September 11, 2007
Atlanta, GA
Welcome Remarks

Kayla Gillan
PCAOB Board Member
September 11, 2007
Atlanta, GA
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.
Audit Pot Holes and Remediation

George Botic
Inspections
September 11, 2007
Atlanta, GA
What We Will Cover

- Client acceptance
  - Terms of the engagement
  - Independence
- Common inspection observations
  - Pothole alerts
- Audit wrap-up procedures
- Remediation
Preliminary Engagement Procedures
Client Acceptance and Continuance

- Auditor must consider types of services being provided to audit client
  - SEC and PCAOB independence requirements
- Engagement terms
  - Establish an understanding with the audit client regarding services to be performed
The auditor is prohibited from providing bookkeeping and other services related to the accounting records or financial statements of the audit client, such as -

- 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
Additional Non-Audit Services Prohibited by the SEC

- 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
Additional Non-Audit Services Prohibited by the SEC (cont.)

- Financial interests in audit client
- Business relationships with audit client
- Employment relationships with audit client
  - Accounting role
  - Financial reporting oversight role – cooling-off period
- Contingent fee arrangements
A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction that is -

- A confidential transaction; or
- An aggressive tax position transaction that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws (for example, a listed transaction)
PCAOB Rule 3523 - Tax Services to Persons in Financial Reporting Oversight Roles

- A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any tax service to a person in a financial reporting oversight role at the audit client or their immediate family member*
  - Financial reporting oversight role ("FROR") means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them
  - Several exceptions to the rule:
    - Excludes members of the board of directors when their oversight role is solely because of their membership on the board
    - Excludes person in a FROR at an affiliate if the affiliate is not material to the audit client or if the affiliate is audited by a different accounting firm
    - Provides 180-day transition period for persons who are promoted or hired into a FROR

* As of November 1, 2006, auditors must comply with Rule 3523 as it relates to tax services provided during the professional engagement period. The Board delayed the implementation date as it relates to tax services provided during the audit period to April 30, 2008, as long as the tax services are completed before the professional engagement period begins.
In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall –

- Describe, in writing, to the audit committee of the issuer the scope of the service, the fee structure for the engagement, and other certain information;
- Discuss with the audit committee of the issuer the potential effects of the services on the auditor's independence; and
- Document the substance of the discussion with the audit committee of the issuer.
Pothole Alert: Engagement Letter
Indemnification Clauses

- Accountant is not independent when he or she enters into an indemnity agreement with the issuer audit client that -
  - seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, or
  - seeks to have the audit client release, indemnify or hold harmless the auditor from any liability and costs resulting from knowing misrepresentations by the audit client's management

Problematic Indemnification Language

- X Company hereby agrees to release and indemnify the accounting firm and its directors and employees, and hold them harmless from all claims, liabilities, losses and costs arising in circumstances where there has been a knowing misrepresentation by a member of X Company's management, regardless of whether such person was acting in X Company's interest.
Audit Planning and Risk Assessment
Audit Planning

- Significant audit risk areas for your company
  - Accounting firm’s preliminary audit strategy and plan to address those risks
Pothole Alert: Principal Auditor

- **Back-door registrations ("reverse mergers")**
  - Operating company merges with a public non-operating shell company
    - Auditor of shell company opines on the merged entity
- **Registrant conducts principal operations abroad**
  - Foreign accounting firm audits subsidiary
  - Domestic accounting firm assumes complete responsibility for the work of other auditing firm and does not refer to the report of the other firm
- **Use of another firm’s staff ("out-sourced" audit staff)**
Execution – Tests of Controls; Tests of Accounts and Disclosures
Tests of Accounts and Financial Statement Disclosures

- Common inspection observations
  - Revenue recognition
  - Business combinations
  - Stock-based compensation
  - Confirmation procedures
  - Going concern issues
Pothole Alert: Revenue Recognition

Possible causes for revenue recognition deficiencies:

- Testing A/R is not a proxy for testing revenue recognition
- Important to review revenue contracts for terms and conditions that can impact revenue recognition
- Over-reliance on poorly designed analytical procedures
- Cannot rely solely on management representations or examination of client-prepared analyses
- Sample should be representative of the population of revenue transactions
Possible causes of business combination deficiencies

- Inadequate testing of initial valuation of equity securities issued (e.g., valuation report)
- No testing of allocation of the purchase price to the assets acquired and liabilities assumed
- Unaware of certain terms contained in the merger agreement (e.g., contingent considerations)
- No evaluation of appropriateness of recording goodwill or other intangibles and subsequently writing them off
- No testing of client's accounting for and reporting of a business combination (e.g., reverse merger, common control merger)
Pothole Alert: Stock-based Compensation

Possible causes of stock-based compensation deficiencies

- No testing of valuation of equity instruments issued for goods/services
- No testing of the accounting for transactions with non-employees (e.g., EITF 96-18)
- No testing of assumptions used to value options (e.g., volatility factor)
- Inadequate testing of existence and completeness of outstanding shares of common stock
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
PCAOB 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.
- 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.
Pothole Alert: Confirmation Procedures

- Possible causes of confirmation procedure deficiencies
  - No or insufficient alternative procedures performed for confirmations not received
  - Unresolved discrepancies from confirmation responses
  - Inadequate sample size to substantively test existence of A/R or loans receivable
  - No consideration or documentation of rationale for not confirming A/R
Pothole Alert: Going Concern Issues

- Possible deficiencies associated with going concern analyses
  - No going concern analysis performed despite warning signs, such as recurring losses, negative working capital, stockholders' deficit, debt coming due, declining sales prospects
  - Over-reliance on management's representations that additional sources of funding will be found
  - Going concern analysis focused upon the best case scenario
Wrap-Up and Completion Procedures
Considerations for Predecessor and Successor Auditor

- PCAOB Staff Questions & Answers - Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor (June 9, 2006)
  - 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
Pothole Alert: Communications with Audit Committees

- Certain matters related to the conduct of the audit are required to be communicated to the audit committee (or equivalent)
  - This information may help the A/C with understanding the scope and results of the audit and overseeing the financial reporting and disclosure process
  - Matters to be addressed include:
    - Significant accounting policies
    - Management judgments and accounting estimates
    - Audit adjustments
    - Audit adjustments about the quality of the entity’s accounting principles
    - Other information in documents containing audited financial statements
    - Disagreements with management
    - Consultation with accountants
    - Major issues discussed with management prior to retention
    - Difficulties encountered in performing the audit
Pothole Alert: ISB No. 1 – Independence Discussions with Audit Committees

At least annually, an auditor shall -

- disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;

- confirm in the letter that, in its professional judgment, it is independent of the company; and

- discuss the auditor's independence with the audit committee.
Remediation Process
Overview of Remediation Process

- Section 104 of the Sarbanes-Oxley Act and PCAOB Rule 4009 govern the process for addressing quality control criticisms
  - 12-month remediation process is triggered once the Board issues the final inspection report.
  - These criticisms or potential defects are made public only if they are not satisfactorily addressed by the firm before the 12-month period deadline.
    - The criticisms or potential defects will remain nonpublic if the quality control criticisms are satisfactorily addressed.
Step 1 - Final Inspection Report Issued

- A transmittal letter will accompany the final inspection report
  - It describes the remediation process and provides examples of documentation to be submitted to the PCAOB as part of its response
  - Contact name and number also provided
Step 2 - Responding to the Quality Control Observations

- Follow the guidance in the transmittal letter that accompanies the final inspection report
  - Written submission are strongly encouraged
  - Communicate with PCAOB staff if you have any questions

- Respond as early as practicable
  - PCAOB staff often requests clarification or additional information

- Firm must demonstrate that it has remediated the quality control observations before the 12-month deadline
Step 2 - Responding to the Quality Control Observations (cont'd)

- Each quality control criticisms or potential defect should be addressed separately
  - Documentary evidence of remediation efforts
- Submission should also include documentation related to follow-up procedures on the audit deficiencies included in the report
- Firm is not required to address the quality control criticisms
  - No response will result in Board making the quality control criticisms public
- If firm intends its response to the comment form(s) or draft inspection report to serve as its only submissions, submit a copy of that response and inform the PCAOB staff of that fact in writing
Questions?
Accounting Hot Topics

Martin F. Baumann
Director, Office of Research and Analysis
PCAOB
September 11, 2007
Atlanta, GA
Cautionary Disclaimer

- The views expressed here are those of the speaker and may not be consistent with the opinions of the PCAOB Board members or Staff.
Earnings Guidance

- Accounting is too complex to give guidance to the penny
- Results in managing the numbers rather than managing the business
- Give broader information about markets, products, people and strategies
Accounting Hot Topics

- Fair Value Accounting
- Complex Structured Transactions and Off-Balance Sheet Financing
- Asset Impairment
- Use of Specialists in Complex Accounting Areas
- Business Combinations
- Employee Stock Options
- Accounting for Uncertain Tax Positions
- Materiality of Accounting Misstatements
- Disclosure Challenges
- Leading Causes of Accounting Restatements
Fair Value Accounting

- Rapid shift in credit markets and liquidity
- Significant volatility and uncertainty have made valuations very complex
- Market prices, even in thin markets, cannot be ignored
Fair Value Accounting (cont’)

- Risk: Complex exploitable estimates
  - Limited auditor expertise in valuation concepts
  - Potential bias of financial statement preparers
  - Unique internal controls over fair value estimates

- New guidance on how to measure assets and liabilities at fair value (SFAS 157)
  - No new financial statement items that require fair value accounting
  - New concepts:
    - fair value measurement represents exit price rather than entrance price
    - valuation based on highest and best use by market participants
Fair Value Accounting (cont’)

Another new standard (SFAS 159) provides companies with the *option* to elect fair value accounting for financial assets and liabilities:

- Election permitted on a contract-by-contract basis
- Concern expressed by users of financial statements about comparability
- Some potential abuses have already been observed and addressed
Structured Finance

- Continued innovations in structured finance have resulted in more creative and complex financing methods.
- Accounting for structured transactions can be challenging and should be carefully considered prior to execution.
- Examples of structured transactions:
  - Leases
  - Joint ventures
  - Extinguishment or issuance of debt
  - Asset transfers (e.g. A/R securitization)
  - CDO’s
Structured Finance (contd.)

- Securitization challenges:
  - Determination of whether the transaction qualifies as a sale
  - Assessment of fair value of any interests or commitments retained by the transferors
  - Calculation of gain/loss on sale
  - Subsequent mark-to-market accounting and impairment testing
  - Clear disclosures of the nature and purpose of structured transactions

- Valuation of structured securities
Asset Impairment

- Timely periodic evaluation
- Some issuers late in recognizing charge
- Risks for management
  - Judgment in assessing recoverability of assets
  - Reasonableness of assumptions
  - Documentation of calculations/process
  - Consideration of using a specialist if expertise is missing
- Current fiscal quarter may present unique valuation challenges
Use of Specialists

- Specialists have been engaged to *assist* in calculating fair value and developing fair value assumptions for complex transactions.
- Management, *not the specialist*, is responsible for:
  - Accuracy of the fair value assessment
  - Reasonableness of assumptions
  - Verifying that the fair value calculation is in accordance with GAAP
Business Combinations

- Risk: Challenging accounting due to complex judgments
  - Purchase price determination
  - Contingent consideration
  - Payout arrangements
  - Valuation of assets and liabilities of acquired entity
  - Purchase price allocation

- SFAS 141 / SFAS 141(R), *Business Combinations*, is the principal existing guidance
Employee Stock Options

- Current guidance requires companies to recognize an expense for the fair value of share-based compensation
- Companies currently use mathematical models
- New market-based models proposed by financial institutions
- Companies need to periodically assess the appropriateness of inputs
  - Volatility has the largest effect in determining the value of the option, followed by expected life
  - Dividend yield and interest rate assumptions
Accounting for Uncertain Tax Positions

- New guidance over uncertainty in income taxes applies to all companies (public and private)

- Management challenges:
  - Evaluation of likelihood of tax positions being challenged
  - Introduces possibility of additional reserves in the financial statements
  - Standard is complex, requiring estimates and documentation
  - Importance of disclosures
Assessing Materiality of Accounting Misstatements


- Companies need to quantify misstatements using both the iron curtain and rollover approach and consider both quantitative as well as qualitative factors.
Disclosure Challenges

- Disclosure checklists
- Financial statements need to be transparent and present reliable and sufficient information to clearly reflect results of operations and financial condition of company
- Impact of current liquidity and credit environment should be considered in 2007 disclosures
Leading Causes of 2006 Restatements

- Increase in number of restatements over past 5 years
- Shift in size of companies filing restatements
- Most common types of errors:
  - Equity-transaction (30% of 2006 restatements)
  - Expense recognition (26%)
  - Misclassifications (25%)
  - Purchase accounting (11%)
  - Revenue recognition (11%)

(Note: companies can file restatements with more than one error type)
Summary

Important concepts to adequately address complex accounting issues:

- Need adequate accounting resources
- Ongoing auditor discussions
- Issue identification and evaluation
- Management and Audit Committee involvement
- Financial statement transparency
Panel Discussion on Difficult Audit Areas

September 11, 2007
Atlanta, GA
Panel Participants

- Moderator
  - Mary Sjoquist, Board Counsel, PCAOB
- Panelists
  - Wendy Luscombe, Audit Committee Member, Acadia Realty Trust, Zweig Fund and Zweig Total Return Fund
  - Sal Inserra, Partner, Porter Keadle Moore, LLP
  - C. Neil Lyons, CFO & Treasurer, RegeneRx Biopharmaceuticals, Inc.
Questions?
Panel Discussion on Current Developments in Internal Control over Financial Reporting

September 11, 2007
Atlanta, GA
Panel Participants

Moderator
- Kayla Gillan, Board Member, PCAOB

Panelists
- Keith Wilson, Office of the Chief Auditor
- Josh Jones, Securities and Exchange Commission
Improvements Resulting from the Amendment to Auditing Standard No. 2
Improvements Resulting from the Amendment to Auditing Standard No. 2

- Focus the internal control audit on the most important matters
- Eliminate procedures that are unnecessary to achieve the intended benefits
- Make the audit clearly scalable to fit any company's size and complexity
- Simplify the standard
Focus the Internal Control Audit on the Most Important Matters

- More clearly focuses auditors on identifying control weaknesses before they result in material misstatements
- Clarifies how auditors should use risk assessment to focus on the accounts, disclosures and their relevant assertions
- Emphasizes the importance of fraud risk and anti-fraud controls to assessing risk
Focus the Internal Control Audit on the Most Important Matters (cont'd)

- Outlines three broad categories of entity-level controls
- Emphasizes the importance of a company's control environment
- Emphasizes higher risk stages of financial statement preparation
Eliminate Procedures that Are Unnecessary to Achieve the Intended Benefits

- Removes the detailed requirements to evaluate management's evaluation process
- Requires the auditor to assess the risk related to the relevant assertion
- Permits consideration of knowledge obtained from the auditor's previous years' audits
Eliminate Procedures that Are Unnecessary to Achieve the Intended Benefits (cont'd)

- Removes barriers to using the work of others by eliminating the "principal evidence" provision
- Refocuses the multi-location direction on risk rather than coverage
- Clarifies that the top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test
Eliminate Procedures that Are Unnecessary to Achieve the Intended Benefits (cont'd)

- Allows auditors to tailor their top-down approach to the facts and circumstances of a particular engagement
- Focuses the performance requirements for a walkthrough on fulfilling certain important objectives
- Establishes a principle for evaluation and communication to the audit committee of control deficiencies
Make the Audit Clearly Scalable to Fit Any Company's Size and Complexity

- Discussion of scaling concepts throughout the standard
- Discussion of the attributes of smaller and less complex companies
  - Larger companies may have some business units or processes that may be less complex than others
Simplify the Standard

- Reduces granularity and redefines key terms in a simpler way
- Clarifies that the auditor's evaluation of materiality for an internal control audit is the same as the financial statement audit
- Alignment of terms between the standard and SEC's management guidance
Simplify the Standard (cont.)

- Material weakness – *reasonable possibility* that a material misstatement will not be prevented or detected on a timely basis
- Significant deficiency – less severe than a material weakness, yet important enough to merit attention
Effective Date

- AS No. 5, Rule 3525, and the amendments will be effective for audits of fiscal years ending on or after November 15, 2007.
- Earlier adoption is permitted.
- If continue to comply with AS No. 2 until superseded, then should apply the definition of "material weakness" contained in AS No. 5 rather than the definition in AS No. 2.
Guidance for Auditors of Smaller Companies
Guidance for Auditors of Smaller Companies

- Intended to address the implementation of the internal control auditing standard in a smaller public company environment
- Derived from practice experience
- Developed with auditors and small issuers
Improving Sarbanes-Oxley
Section 404 Implementation

Josh K. Jones
Professional Accounting Fellow
Office of the Chief Accountant
Professional Practice

U.S. Securities and Exchange Commission

September 10-11, 2007

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Agenda

Introductory Remarks and Background

Improving Implementation of SOX 404

- SEC’s New Interpretive Guidance For Management
- SEC’s Amendments to Regulation S-X
- Next Steps

Year Three Reporting Results
Background

Activities Preceding the New Interpretive Guidance for Management and the New PCAOB Auditing Standard

- 2005 and 2006 roundtables
- Recommendations of SEC Advisory Committee on Smaller Public Companies (April 2006)
- GAO report (April 2006)
- Commission announced next steps on Sox 404 improvement (May 2006)
- PCAOB announced four-point plan to improve Implementation (May 2006)
- Extensions for Sox 404 compliance
- COSO Guidance for Small Companies (July 2006)
## Amended Compliance Dates
**Adopted on December 15, 2006**

### Revised Compliance Dates and Final Rules Regarding the Internal Control Over Financial Reporting Requirements

<table>
<thead>
<tr>
<th></th>
<th>Accelerated Filer Status</th>
<th>Management's Report</th>
<th>Auditor's Attestation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U.S. Issuer</strong></td>
<td>Large Accelerated Filer OR Accelerated Filer ($75MM or more)</td>
<td>Already complying (Annual reports for fiscal years ending on or after November 15, 2004)</td>
<td>Already complying (Annual reports for fiscal years ending on or after November 15, 2004)</td>
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<td></td>
<td>Non-accelerated Filer (less than $75MM)</td>
<td>Annual reports for fiscal years ending on or after December 15, 2007</td>
<td>Annual reports for fiscal years ending on or after December 15, 2008</td>
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<td><strong>Foreign Issuer</strong></td>
<td>Large Accelerated Filer ($700MM or more)</td>
<td>Annual reports for fiscal years ending on or after July 15, 2006</td>
<td>Annual reports for fiscal years ending on or after July 15, 2006</td>
</tr>
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<td></td>
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</tr>
<tr>
<td><strong>U.S. or Foreign</strong></td>
<td>Newly Public Company</td>
<td>Second Annual Report</td>
<td>Second Annual Report</td>
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</table>
SEC’s New Interpretive Guidance for Management

Interpretive Guidance Proposed in December 2006

- Comment period ended February 26, 2007
- Over 200 comment letters received

Final Interpretive Guidance Approved by Commission on May 23, 2007
SEC’s New Interpretive Guidance for Management

Key Attributes of the Guidance

- Principles-based
- Directs efforts to highest risks of material misstatement of financial statements
- Allows evaluation processes tailored to facts and circumstances
- Provides guidance on supporting evidence and documentation
- Provides guidance for evaluating deficiencies
- Does not replace control frameworks
- Voluntary
SEC’s New Interpretive Guidance for Management - 

Overview of Guidance

1. Identifying Financial Reporting Risks and Controls
   - Identifying Financial Reporting Risks
   - Identifying Controls that Adequately Address Financial Reporting Risks
   - Supporting Evidence and Documentation

2. Evaluating Evidence of Operating Effectiveness of ICFR
   - Determining the Evidence Needed to Support the Assessment
   - Implementing Procedures to Evaluate Evidence of the Operation of ICFR
1. Identifying Financial Reporting Risks and Controls

Identifying Financial Reporting Risks

- Identify sources and potential likelihood of misstatements in the financial statements (i.e. “what could go wrong”)
  - Requirements of GAAP
  - Initiation, authorization, processing, recording and reporting of transactions and other adjustments
  - Vulnerability to fraudulent activity
  - Location specific risks
  - Internal and external risk factors impacting the business
- Determine those which could result in material misstatement (i.e. “financial reporting risks”)
- Tailor methods and procedures based on company characteristics
Identifying Controls that Adequately Address Financial Reporting Risks

- Identify controls needed to meet the objective of ICFR (i.e. reasonable assurance)
  - Controls that can effectively prevent or detect misstatements arising from financial reporting risks
  - Includes entity-level and other pervasive elements
- It may not be necessary to identify all controls within a process
- Other Considerations
  - Information technology
  - Evaluation efficiency
1. Identifying Financial Reporting Risks and Controls (continued)

**Identifying Controls (continued)**

- Consider How Entity-level Controls Relate to Financial Reporting Elements
  - Indirect effect on prevention or detection of misstatements
  - Identify possible breakdowns in lower-level controls
  - Adequate to address a financial reporting risk
Supporting Evidence and Documentation

- **Reasonable support for assessment of effectiveness of ICFR**
- **Form and extent will vary based on the size, nature, and complexity of the company**
- **Design of controls addressing financial reporting risks**
- **Entity-level and other pervasive elements of ICFR**
2. Evaluating Evidence of Operating Effectiveness of ICFR

Determining the Evidence Needed to Support the Assessment

- Evidence based on evaluation of ICFR risk
- ICFR risk considers characteristics of
  - Financial reporting element
  - Controls themselves
- Role of entity-level controls (e.g. control environment)
2. Evaluating Evidence of Operating Effectiveness of ICFR

Determining the Evidence Needed to Support the Assessment (continued)

Risk of Control Failure

<table>
<thead>
<tr>
<th>Misstatement Risk of Financial Reporting Element</th>
<th>Risk of Control Failure</th>
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<tbody>
<tr>
<td>More Evidence</td>
<td>High</td>
</tr>
<tr>
<td>Less Evidence</td>
<td>Medium</td>
</tr>
<tr>
<td>Medium</td>
<td>Low</td>
</tr>
</tbody>
</table>

High

Low
2. Evaluating Evidence of Operating Effectiveness of ICFR

Determining the Evidence Needed to Support the Assessment (continued)

- Misstatement risk of financial reporting elements:
  - Materiality
  - Susceptibility to material misstatement
    - Judgment required
    - Susceptibility to fraud
    - Complexity of accounting requirements
    - Changes in transactions nature or volume
    - Sensitivity to environmental factors
2. Evaluating Evidence of Operating Effectiveness of ICFR (continued)

Determining the Evidence Needed to Support the Assessment (continued)

- **Risk of control failure:**
  - Type of the control (i.e. manual, automated)
  - Complexity of the control
  - Risk of management override
  - Judgment required to operate control
  - Nature and materiality of misstatements controls are intended to prevent or detect
2. Evaluating Evidence of Operating Effectiveness of ICFR (continued)

Determining the Evidence Needed to Support the Assessment (continued)

- Risk of control failure (continued):
  - Competence of the personnel performing the control
  - Whether there have been any changes in key personnel
  - Extent of interaction with/reliance on the effectiveness of other controls (e.g. general IT controls)
  - Evidence of operation of control from prior year(s)
2. Evaluating Evidence of Operating Effectiveness of ICFR (continued)

Determining the Evidence Needed to Support the Assessment (continued)

- **Entity-level controls** (e.g. controls in the control environment) may influence:
  - Financial reporting risks
  - Risk of control failure

- **Not all controls have the same ICFR risk**
  - Therefore, the evidence can and should vary
2. Evaluating Evidence of Operating Effectiveness of ICFR (continued)

Determining the Evidence Needed to Support the Assessment (continued)

- Financial reporting elements with higher risk:
  - Related party transactions
  - Critical accounting policies and related critical accounting estimates
  - Requiring significant judgment, susceptibility to fraud, or complexity in underlying accounting

- ICFR risk is high when controls for these elements are
  - Subject to override
  - Involve significant judgment
  - Complex
Implementing Procedures to Evaluate Evidence of the Operation of ICFR

- **Sources of Evidence**
  - On-going monitoring activities (e.g. self-assessments)
  - Direct testing

- **Determining whether evidence is sufficient**
  - Quantity of evidence
  - Nature of evaluation procedures, including extent of direct testing
  - Period of time to which evidence relates
  - Objectivity of those involved

- **Daily Interaction**
  - May provide sufficient evidence in smaller companies
  - Most effective when:
    - Operation of control is centralized
    - Number of personnel involved is limited
Supporting Evidence and Documentation

- Must provide reasonable support for ICFR assessment
- Nature may vary based on ICFR risk
- Evidential matter generally includes
  - Methods and procedures for gathering and evaluating evidence
  - Basis for assessment of effectiveness
    - Controls related to financial reporting elements
    - Entity-wide and other pervasive elements
    - If applicable, basis for sufficiency of daily interaction
3. Reporting Considerations

- Evaluating Severity of Deficiencies
  - Material weaknesses considerations
    - Likelihood and magnitude
    - Indicators
- Material Weakness Disclosures
- Other Topics Addressed
  - Scope limitations
  - Restatements
Amendments to Regulation S-X

- **Definition of Material Weakness**
- **Required Accountant’s Attestation Report**
  - Requires auditor’s report express only one audit opinion (directly on the effectiveness of internal control over financial reporting)
- **Definition of “Significant Deficiency”**
Changes to SEC’s Final Interpretive Guidance from December Proposal

Alignment Between Guidance and New Audit Standard

- Material weakness definition and indicators
- Guidance for identifying financial reporting risks and controls that address the risks
- Factors for assessing risk for financial reporting elements and controls

- Role of Entity-level Controls
- Consideration of Fraud Risk
- Nature of On-going Monitoring
  - Objectivity considerations
Next Steps

- Ongoing monitoring as standards and guidance are implemented
SOX 404 Reporting Results
Year Three Filers (Companies with year-ends after 11/14/06 and filed through 7/31/07):
Approximately 3,807 filings

- 285 (7.49%) reported material weaknesses (i.e., ineffective ICFR)
  - Disproportionate number of smaller registrants (revenues below $500 million) had material weaknesses
  - 20% of registrants with ineffective ICFR were also ineffective during years 1 and 2

- Comparison to Years 1 & 2
  - 10.7% reported ineffective ICFR in Year 2
  - 16.3% reported ineffective ICFR in Year 1
## Ineffective ICFR: Financial Statement Elements Involved

<table>
<thead>
<tr>
<th>Financial Statement Elements</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes</td>
<td>33%</td>
<td>42%</td>
<td>32%</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>33%</td>
<td>41%</td>
<td>24%</td>
</tr>
<tr>
<td>Liabilities and payables</td>
<td>28%</td>
<td>38%</td>
<td>25%</td>
</tr>
<tr>
<td>Accounts and loans receivable</td>
<td>27%</td>
<td>34%</td>
<td>21%</td>
</tr>
<tr>
<td>PPE/Fixed/Intangible Assets Valuation</td>
<td>20%</td>
<td>37%</td>
<td>21%</td>
</tr>
<tr>
<td>Foreign/Related/Affiliated/Subsidiary Party Issues</td>
<td>15%</td>
<td>21%</td>
<td>18%</td>
</tr>
<tr>
<td>Inventory and cost of sales</td>
<td>28%</td>
<td>35%</td>
<td>18%</td>
</tr>
</tbody>
</table>
Ineffective ICFR: Other Specific Issues Identified

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting documentation, policy and/or procedures</td>
<td>94%</td>
<td>99%</td>
<td>99%</td>
</tr>
<tr>
<td>Material and/or numerous auditor / YE adjustments</td>
<td>55%</td>
<td>70%</td>
<td>68%</td>
</tr>
<tr>
<td>Restatement or nonreliance of company filings</td>
<td>51%</td>
<td>62%</td>
<td>25%</td>
</tr>
</tbody>
</table>
Questions?
Panel Discussion – Looking Ahead

September 11, 2007
Atlanta, GA
Panel Participants

- **Moderator**
  - Joanne O’Rourke Hindman, Board Counsel, PCAOB

- **Panelists**
  - Kayla Gillan, Board Member
  - Marty Bauman, ORA
  - Jennifer Rand, Standards
  - George Botic, Inspections
PCAOB Strategic Plan

- Adopted by Board on May 1, 2007
- Overview
  - Mission Statement
  - Vision
  - Core Values
  - Key Environmental Factors
  - Goals and Objectives
- Available at www.pcaobus.org
Goal 1: Promote investor confidence in audited financial statements of public companies through an effective use of a supervisory model of oversight of registered public accounting firms

Goal 2: Inform, educate and obtain feedback from a broad cross-section of the audit profession, market participants and other interested parties about the PCAOB’s oversight activities and best practices in the auditing profession

Goal 3: Further strengthen the effectiveness and coordination of auditor oversight efforts in the United States and abroad

Goal 4: Operate the PCAOB in a manner that recognizes its public mission and responsibility to exercise careful stewardship over its resources
Questions?
Open Discussion

September 11, 2007
Atlanta, GA