PCAOB
Public Company Accounting Oversight Board

Forum on Auditing in The Small Business Environment

December 4, 2007

Washington, DC

PCAOB
Public Company Accounting Oversight Board

Opening Keynote Address

Mark Olson
PCAOB Chairman

December 4, 2007

Washington, DC

Caveat

One of the benefits of today's session is that you will hear first-hand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff. Therefore, unless it is clear that the Board has authorized the statement, you should not attribute it to the Board or staff.

PCAOB
Public Company Accounting Oversight Board

Avoiding the Potholes During the Audit Process

December 4, 2007

Washington, DC

Presenters

- Bella Rivshin, Office of the Chief Auditor
- George Botic, Division of Registration and Inspections
- Mark Kaprelian, Division of Enforcement and Investigations

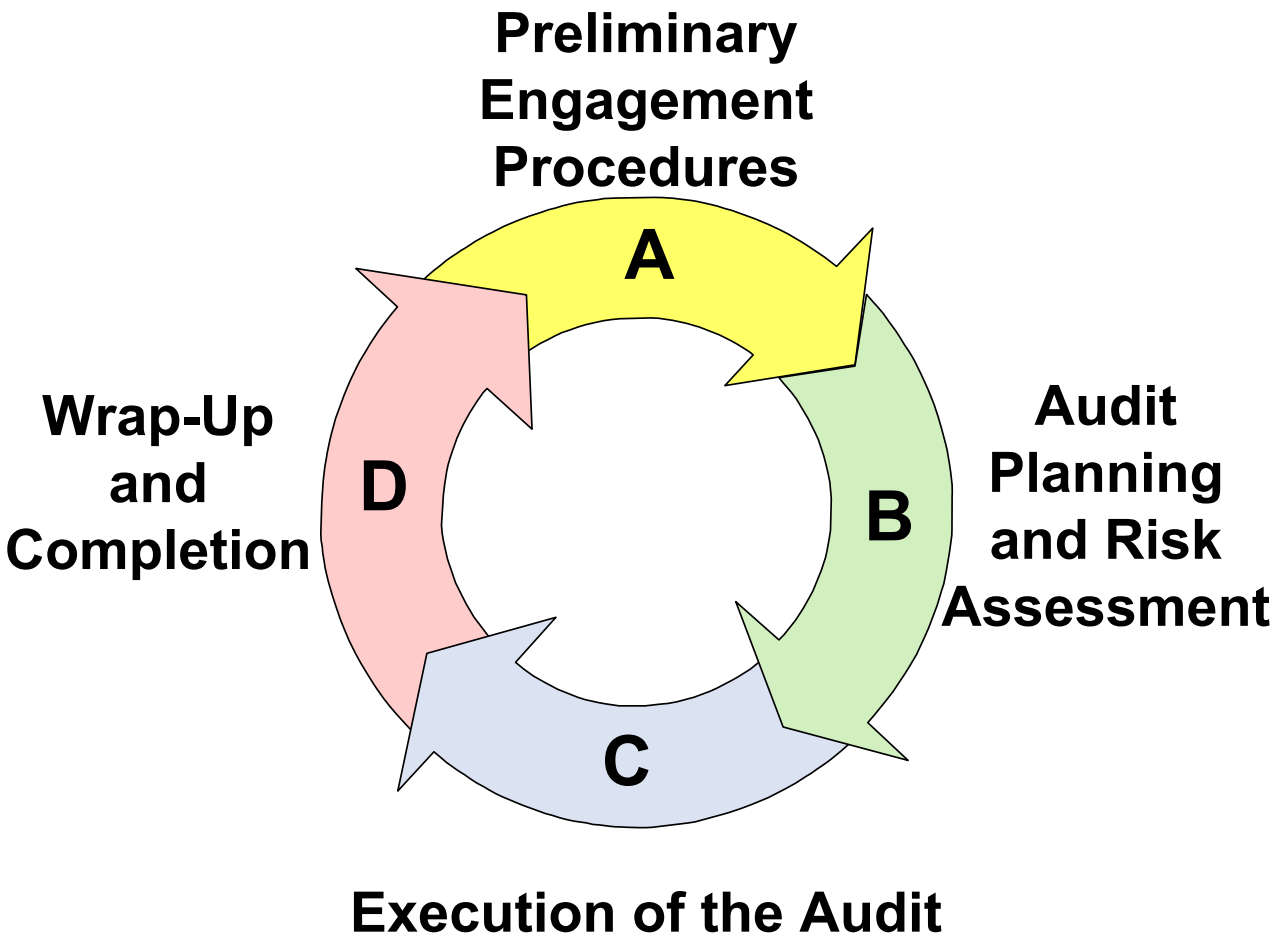
What We Will Cover

- Avoiding the potholes during the audit process
  - Overview of the audit process
  - Key aspects of audit quality
  - References to applicable literature

Small Firm Statistics

- Approximately 1,000 domestic small firms are registered with the PCAOB
  - Geographically dispersed
  - Diverse in size, number of issuers and number of offices
- Performed over 650 inspections of small firms to date
  - Conducted engagement file reviews of approximately 2,000 issuer audits
- There have been over 450 domestic small firm reports issued as final to date

The Audit Process



PCAOB
Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

Preliminary Engagement Procedures

Client Acceptance and Continuance

- Perform procedures to determine if the accounting firm should
  - Continue as the auditor of a current audit client or
  - Accept an issuer as a new audit client
- Focus on
  - Company and management
  - Firm
- Engagement terms - establish an understanding with the audit client regarding services to be performed

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?

Confirming Independence

- 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
  - Certain tax services
- Other independence restrictions
- Pre-approval of permissible non-audit services

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 exist to the rule

Other Independence Restrictions

- 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
- Partner compensation for selling non-audit services
- Partner rotation on the audit engagement
  - Lead and concurring partner – 5 years on, 5 years off
  - Other partner – 7 years on, 2 years off
  - Small firm exception – accounting firm with less than 5 audit issuer clients and less than 10 partners

Enforcement Case - Independence

- In the Matter of Susan E. Birkert, (November 14, 2007)
  - Engagement team member gave an acquaintance $5,000 to buy audit client's stock for her

Enforcement Case - Independence

- In the Matter of Kenny H. Lee, CPA Group, Inc. and Kwang Ho Lee, CPA (November 22, 2005)
  - Firm's engagement as auditor continued after firm principal accepted client's offer to serve on its board of directors

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

Source: SEC Frequently Asked Questions - Question 4 (issued December 13, 2004) (http://www.sec.gov/info/accountants/ocafaqaudind121304.htm#other), and SEC Codification of Financial Reporting – Section 602.02.f.i., *Indemnification by Client*

Pothole Alert - 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.

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 – Regulation S-X, Rule 210.2-01 www.sec.gov/info/accountants/independref.shtml
  - Frequently Asked Questions (updated 8/07) 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.

Audit Considerations for Principal Auditor

- Deciding whether the auditor can serve as principal auditor (AU sec. 543.02)
- Using other auditors to perform a portion of the audit for the auditor (AU secs. 230 and 311)

Principal Auditor Observations

- 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)

Enforcement Case - Principal Auditor

- In the Matter of PKF, AAER No. 2409 (April 12, 2006) (SEC cease-and-desist proceeding)
  - Firm used the work of other auditing firms to report on issuer's financial statements and did not refer to the work of the other firms in its audit report
  - Firm assumed complete responsibility for the work of the other auditing firms

Enforcement Case - Principal Auditor

- In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA (November 22, 2005)
  - On one audit, issuer separately engaging another audit firm to perform audit procedures on its financial statements. The other firm didn't issue an audit report, but rather provided its work papers to the Clyde Bailey firm. The other auditor's work constituted substantially all of the audit evidence supporting the Clyde Bailey firm's report.
  - On another audit, firm consulted with other auditor and relied on the other auditor's work papers, but did not plan or perform audit procedures sufficient to issue an audit report

PCAOB
Public Company Accounting Oversight Board

Audit Planning and Risk Assessment

Risk Assessment Procedures

- Obtain an understanding of the company and its environment
  - Includes obtaining an understanding of internal control over financial reporting
- Assess entity-level controls
- Perform preliminary analytical procedures
- Brainstorm about potential errors or fraud

Risk Assessment Procedures (cont'd)

- Inquire of management, audit committee, and others about the risk of misstatement
- Consider fraud risk factors
- Consider the results of quarterly reviews
- Assess risks
  - Risk of material misstatement
  - Risk of material weakness
- Identify significant accounts and relevant assertions
- Select controls to test

Auditor Response to Assessed Risks

- Overall responses
  - Assignment of staff
  - Level of supervision
  - Need for specialists
  - Level of professional skepticism
  - Appropriateness of planned audit strategy and scope
- Specific responses (audit plan)
  - Tests of controls
  - Tests of accounts and disclosures (substantive tests)

Enforcement Case – Consideration of Fraud

- In the Matter of Turner Stone & Company, LLP, et al. (December 19, 2006)
  - Assessment of risk of material misstatement due to fraud should be ongoing throughout the audit
  - Firm failed to reassess whether the nature of auditing procedures performed needed to be changed to obtain additional or more reliable corroborative information after being presented with numerous warning signs, such as
    - Unusual, significant year-end transactions
    - The involvement of a related party in a significant transaction
    - Questionable confirmations
    - Conflicting evidential matter concerning a significant transaction

Enforcement Case – Consideration of Fraud

- In the Matter of Thomas Benson and Thomas Benson, CPA (June 29, 2007)
  - Issuer recorded acquisition of bonds in the amount of $500 million issued by the Republic of Venezuela and a note valued at $310 million, which together totaled some 97 percent of reported assets
  - Auditor failed to respond appropriately to numerous warning signs, including:
    - Issuer did not make bond certificates available for inspection despite repeated requests, and did not receive interest contractually due
    - No evidence of payment for either the bonds or the note

Pothole Alert - Audit Documentation

- Use of standard audit programs not tailored for audits of public companies
- Firm unable to demonstrate procedures performed, evidence obtained, and conclusions reached
  - Lack of documentation is tantamount to "no performance"
  - Auditor may provide persuasive other evidence
    - Oral evidence, alone, is not sufficient and may be used only to *clarify* other written evidence

Auditing Standard No. 3, *Audit Documentation* - General Requirements

- For relevant financial statement assertions, audit documentation must contain sufficient information to enable an *experienced auditor,* having no previous connection with the engagement to understand the
  - Procedures performed,
  - Evidence obtained, and
  - Conclusions reached (par. 6)
- Audit documentation should
  - Demonstrate that the engagement complied with PCAOB standards
  - Support the basis for the auditor's conclusions concerning every relevant financial statement assertion, and
  - Demonstrate that the underlying accounting records agreed or reconciled with the financial statements (par. 5)
- The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached (par. 12)

Enforcement Case - Documentation

- In the Matter of Armando C. Ibarra, P.C., Armando C. Ibarra, Sr. and Armando C. Ibarra, Jr. (December 19, 2006)
  - Documentation deficiencies included the lack of any documentation regarding a discussion among engagement personnel regarding the risk of material misstatement due to fraud, which is required under PCAOB standards (AU sec. 316.83)

PCAOB
Public Company Accounting Oversight Board

Execution of the Audit

Tests of Accounts and Disclosures (Substantive Audit Procedures)

- Most inspection observations pertain to the "execution" phase of the audit, in particular, substantive and analytical audit procedures
- Inspection observations generally are characterized in three different ways:
  - Inappropriate application of GAAP
  - No evidence in the work papers and no persuasive other evidence that procedures were performed
  - Engagement team did not perform certain procedures

Common Inspection Observations

- Revenue recognition
- Business combinations
- Stock-based compensation
- Service organizations
- Confirmation procedures
- Going concern issues

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

Enforcement Case – Revenue Recognition

- In the Matter of Williams & Webster, P.S., et al. (June 12, 2007)
  - Failure to perform adequate audit procedures related to revenue
    - Confirmation procedures resulted in evidence that accounts receivable resulted from consignment arrangements, not sales
    - Even if transactions were sales, they were subject to a right of return which issuer did not account for in accordance with GAAP

Business Combinations

- Possible causes of business combination deficiencies
  - Inadequate testing of initial valuation of equity securities issued
  - 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)

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

PCAOB 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

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

Service Organizations

- Possible causes for deficiencies with use of service organizations
  - Firm does not consider whether the SAS 70 report provides sufficient evidence regarding the effectiveness of controls to support assessed level of control risk
  - Firm does not assess the operating effectiveness of user controls identified by the service auditor
  - If the SAS 70 report does not cover the entire period under audit, the Firm does not make inquiries regarding the possible changes in service organization controls

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

Enforcement Case – Confirmations

- In the Matter of Williams & Webster, P.S., et al. (June 12, 2007)
  - Audit evidence indicated at least 50 percent of the accounts receivable selected for confirmation were the result of consignment arrangements

Enforcement Case - Confirmations

- In the Matter of Armando C. Ibarra, P.C., Armando C. Ibarra, Sr. and Armando C. Ibarra, Jr. (December 19, 2006)
  - Repeated failure to confirm accounts receivable and failure to perform any procedures other than obtaining management representations

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

Evaluation of Audit Results

- Misstatements
  - Known and likely misstatements
  - Includes evaluation of –
    - Potential bias in accounting estimates
    - Appropriateness of the selection and application of accounting principles
- Control deficiencies
  - Likelihood and magnitude of misstatements
  - Control deficiencies, significant deficiencies, and material weaknesses
  - Indicators of material weaknesses
- Sufficiency of Audit Evidence

Pothole Alert – Bookkeeping Services

- 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

Related Party Transactions

- Considerations to address possible related party transactions
  - Identification of the existence of related parties
  - Identification of material transactions with related parties
  - Identification of material transactions that may be indicative of the existence of related parties
- Testing of the nature, economic substance, and business purpose of transactions with related parties
- Address applicable disclosure requirements

Audit Considerations for Concurring Partner Review

- SEC Practice Section, Section 1000.08(f), Appendix E – Concurring Partner Review Requirements
  - Qualifications of concurring partner
  - Nature, timing, and extent of concurring partner reviews
  - Documentation of concurring partner review
  - Quarterly reviews

Concurring Partner Review

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

Enforcement Case – Concurring Partner Review

- In the Matter of Williams & Webster, P.S., et al. (June 12, 2007)
  - Concurring partner approved the issuance of firm's audit report even though issues he identified were not properly addressed

Audit Documentation

- Engagement Completion Document
  - Auditor must identify all significant findings or issues in an *engagement completion document* (par. 13)
  - Examples of *significant findings* or *issues* include:
    - Significant matters involving selection, application and consistency of GAAP, including related disclosures
    - Audit adjustments
    - Disagreements among members of the engagement team
    - Circumstances that cause significant difficulty in applying auditing procedures
    - Any matters that could result in modification of auditor's report (par. 12)

Audit Documentation (cont'd)

- Record retention
  - Audit documentation must be retained for 7 years from the date auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements (report release date), unless a longer period of time is required by law. (par. 14)
  - Auditor should assemble a complete and final set of audit documentation not more than 45 days after the report release date (documentation completion date). (par. 15) 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 Documentation Requirements

- SEC Rule 2-06 of Regulation S-X, *Retention of Records Relevant to Audits and Reviews*
  - In addition to documentation that is required by Auditing Standard No. 3, auditors must retain memoranda, correspondence, communications, other documents and records (including electronic records), that are relevant to the audit or review and that:
    - Are created, sent, or received in connection with the audit or review, and
    - Contain conclusions, opinions, analyses, or financial data related to the audit or review

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.

Pothole Alert - Auditor's Report Related Issues

- Audit client uses the auditor's name in connection with the issuance of the company's financial statements *before* auditor is complete and report is issued
- Decision about whether principal auditor can make reference in report to audit of another auditor (AU sec. 543, as amended*)
- Evaluation of whether to include an explanatory paragraph in the auditor's report about the issuer audit client's ability to continue as a going concern

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

Enforcement Case – Unauthorized Use of Auditor's Name

- In the Matter of Reuben E. Price & Co. Public Accountancy Corp. (April 18, 2006)
  - Issuer filed financial statements including a document it claimed was an audit report with Form 10-KSB
  - Auditor had neither issued the audit report nor completed the audit at the time of the issuer's filing
  - Auditor did not inform issuer's Board of Directors as required under Section 10A(b)(2) of the Securities Exchange Act

Enforcement Case – Going Concern

- In the Matter of Armando C. Ibarra, P.C., Armando C. Ibarra, Sr. and Armando C. Ibarra, Jr. (December 19, 2006)
  - Repeated failure to use required language in going concern explanatory paragraph

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/About/Pages/RSSFeeds.aspx

Questions?

PCAOB
Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

Accounting Hot Topics

Martin F. Baumann
Director, Office of Research and Analysis
PCAOB
December 4, 2007
Washington, DC

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

- New fair value accounting standards
- Rapid shift in credit markets and liquidity
- Increasing financial innovation and complexity
- Limited auditor expertise in valuation concepts
- Potential bias of financial statement preparers
- Unique internal controls over fair value estimates
- Risk: complex, subjective valuations

Fair Value Accounting: FAS 157

- No new financial statement items that require fair value accounting
- New guidance on how to measure assets and liabilities at fair value; e.g.
  - Fair value measurement represents exit price rather than entrance price
  - Valuation based on highest and best use by market participants

Fair Value Accounting: FAS 159

- 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

Fair Value Accounting: White Papers

- Measurements of Fair Value in Illiquid (or Less Liquid) Markets
  - Market prices, even in a distressed market, can not be ignored
  - Fair value pre and post-FAS 157 should be conceptually similar
- Accounting for Underwriting and Loan Commitments
  - Commitments to underwrite securities or fund loans are subject to losses, either through mark to market accounting, impairment analysis, or contingent loss accounting (for certain loan commitments)
- Consolidation of commercial-paper conduits
  - Recent market events may warrant careful evaluation of the assumptions underlying FIN 46(R) analysis (e.g. expected losses)

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)
  - CDOs

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, <u>not the specialist</u>, 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

- SAB 108, *Considering the Effects of Prior Year Misstatements when Quantifying Current Year Financial Statements*, addresses quantifying materiality of financial 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

Questions?

PCAOB
Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

Current Developments in Internal Control over Financial Reporting

December 4, 2007

Washington, DC

Discussants

- Moderator
  - Joanne O'Rourke Hindman, Board Advisor
- Expert
  - Sharon Virag, Office of the Chairman

PCAOB
Public Company Accounting Oversight Board

Auditing Standard No. 5

Auditing Standard No. 5

- Integrating the Audits
- Planning the Audit
- Using a Top-Down Approach
- Testing Controls
- Evaluating Identified Deficiencies
- Wrapping-Up
- Reporting on Internal Control

Integrating the Audits

Integrating the Audits

- Audit of ICFR should be integrated with the audit of the financial statements.
- Objectives of the audits are not identical, and the auditor must plan and perform the work to achieve the objectives of both audits.

Integrating the Audits (cont'd)

- Auditor should design testing of controls to accomplish the objectives of both audits simultaneously
  - To obtain sufficient evidence to support the auditor's opinion on ICFR as of year-end, and
  - To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

PCAOB
Public Company Accounting Oversight Board

Planning the Audit

Planning the Audit

- Paragraph 9 provides a list of items the auditor should evaluate to determine how they will affect the auditor's procedures -
  - Knowledge of the company's ICFR obtained during other engagements performed by the auditor
  - Matters affecting the industry in which the company operates
  - The auditor's preliminary judgments about materiality, risk, and other factors
  - Control deficiencies previously communicated to the audit committee or management
  - Legal or regulatory matters of which the company is aware

Planning the Audit (cont'd)

- Factors that might indicate less complex operations include:
  - Fewer business lines;
  - Less complex business processes and financial reporting systems;
  - More centralized accounting functions;
  - Extensive involvement by senior management in the day-to-day activities of the business; and
  - Fewer levels of management, each with a wide span of control.

Role of Risk Assessment

- Risk assessment underlies the entire audit process described by AS No. 5, including -
  - The determination of significant accounts and disclosures and relevant assertions,
  - The selection of controls to test, and
  - The determination of the evidence necessary for a given control.

Scaling the Audit

- The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives.
- The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks.

Examples of Smaller Public Company Issues

- Six example areas where tailoring may be necessary –
  - Obtaining sufficient evidence with limited company documentation
  - Assessing entity-level controls
  - Evaluating risk of management override and mitigating actions
  - Evaluating controls implemented in lieu of segregation of duties
  - Evaluating financial reporting competencies
  - Evaluating information technology ("IT") controls

Addressing the Risk of Fraud

- Auditor should take into account the results of his or her fraud risk assessment.
- Auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud, including controls intended to address the risk of management override of other controls.

Using the Work of Others

- Auditor should evaluate the extent to which they will use the work of others.
- AU sec. 322 applies in an integrated audit of the financial statements and ICFR.
- The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use.

Using the Work of Others (cont'd)

- For the audit of internal control the auditor may use the work performed by, or receive direct assistance from -
  - Internal auditors,
  - Company personnel (in addition to internal auditors), and
  - Third parties.
- Extent to which the auditor may use the work of others depends on the risk associated with the control

Using a Top-Down Approach

Using a Top-Down Approach

- Auditor should use a top-down approach to the audit of ICFR to select the controls to test.
- Top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to ICFR.
- Auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions.

Identifying Entity-Level Controls

- Auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective ICFR.
- Auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

Identifying Significant Accounts and Their Relevant Assertions

- Auditor should identify significant accounts and disclosures and their relevant assertions.
- Auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures.
- Auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated.

Selecting Controls to Test

- Auditor should test controls that are important to the conclusion about whether the controls sufficiently address the risk of misstatement.
  - Might be more than one control that addresses the risk of misstatement to a particular relevant assertion.
  - One control might address the assessed risk of misstatement to more than one relevant assertion.

Testing Controls

Testing Design Effectiveness

- Auditor should test the design effectiveness of controls by determining whether the controls satisfy the control objectives and can effectively prevent or detect errors or fraud.
- Procedures the auditor performs to test design effectiveness include
  - Inquiry of appropriate personnel,
  - Observation of the company's operations, and
  - Inspection of relevant documentation.

Testing Operating Effectiveness

- Auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.
- Procedures the auditor performs to test operating effectiveness include
  - Inquiry of appropriate personnel,
  - Observation of the company's operations,
  - Inspection of relevant documentation, and
  - Re-performance of the control.

Special Considerations for Subsequent Years' Audits

- Auditor should incorporate knowledge obtained during past audits of ICFR
- Auditor should vary the testing of controls from year to year to introduce unpredictability and respond to changes.

PCAOB
Public Company Accounting Oversight Board

Evaluating Identified Deficiencies

Evaluating Identified Deficiencies

- Auditor must evaluate the severity of each control deficiency that comes to their attention
  - To determine whether the deficiencies, individually or in combination, are material weaknesses
- Auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

Definitions

- Alignment of terms between the standard and SEC's management guidance
- 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

Indicators of Material Weaknesses

- Indicators of material weaknesses in internal control over financial reporting include
  - Identification of fraud on the part of senior management
  - Restatement of previously issued financial statements
  - Identification by the auditor of a material misstatement in financial statements in the current period
  - Ineffective oversight by the company's audit committee

Wrapping-Up

Forming an Opinion

- Auditor should form an opinion on the effectiveness of ICFR by evaluating evidence obtained from all sources, including
  - Auditor's testing of controls,
  - Misstatements detected during the financial statement audit, and
  - Any identified control deficiencies.
- A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement.

Communicating Certain Matters

- Auditor must communicate, in writing, to management and the audit committee all material weaknesses identified.
- The written communication should be made prior to the issuance of the auditor's report on ICFR.
- Auditor also must communicate, in writing, to the audit committee any significant deficiencies.

Communicating Certain Matters (cont'd)

- Auditor also should communicate to management, in writing, all deficiencies (i.e., deficiencies that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when communication has been made.
- Auditor only communicates deficiencies which he or she is aware of.

PCAOB
Public Company Accounting Oversight Board

Reporting on Internal Control

Reporting on Internal Control

- Auditor may choose to issue a combined report or separate reports on the company's financial statements and ICFR.
- AS No. 5 includes example combined report
- Auditor should date the report no earlier than the date which the auditor has obtained sufficient competent evidence to support the opinion.
  - ICFR and F/S reports should be dated the same

Reporting on Internal Control (cont'd)

- If one or more material weaknesses exist(s), the auditor must express an adverse opinion on ICFR, unless there is a restriction on the scope of the engagement.
- Auditor should determine the effect the adverse opinion on ICFR has on the opinion on the financial statements.

Effective Date

- AS No. 5, Rule 3525, and the amendments are 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.

PCAOB
Public Company Accounting Oversight Board

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

Questions?

PCAOB
Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

Inspections Update: Navigating the Remediation Process

December 4, 2007

Washington, DC

Objectives of Presentation

- Overview of remediation process
- Steps involved in the remediation process
- Examples of satisfactory and unsatisfactory remediation responses
- Communications from the PCAOB

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 AU secs. 390 and 561 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

Step 3 – Evaluation of Firm Response

- PCAOB staff currently working on a FIFO basis
- If additional documentation or clarification is needed, PCAOB staff will contact firm
- Based upon information provided, the Director of Registrations and Inspections will make a recommendation to the Board
- Board reviews recommendation and decides if firm has satisfactorily remediated

Example - Firm in Remediation

Facts

- Part II.A of the report contains two audit performance deficiencies
  - Testing of A/R and the related allowance for doubtful accounts on two of the four issuers inspected
  - Testing related to the initial valuation of a recently acquired entity on two of the four issuers inspected
- Part II.B of the report contains four quality control criticisms
  - Technical competence, due care, and professional skepticism
  - Concurring partner
  - Auditor communications
  - Appropriate procedures for A/R and allowance inspection observations and valuation of an acquired entity
- Part III.B of the report requests that the firm conduct a review of the engagements not inspected

Example Response

- Firm provides the following response shortly after receiving the final report
  - Provides copies of work papers supporting subsequent audit procedures in the areas of A/R, allowance, and the valuation of the acquired net assets
  - Revises its QC practices to require a concurring partner checklist and provides a copy of the checklist
  - Provides CPE information on training provided on testing of A/R, allowance and SFAS No. 141
  - Revises its QC practices on the requirements of AU sec. 380 and ISB No. 1 and provides a copy of revised QC policy changes
  - Conducts independent review of the engagements not inspected and provides a copy of the procedures performed and conclusions reached

Communications from the PCAOB

- Initial transmittal letter that accompanies final report
- 6-month letter
- 60-day letter
- Final notification
- Letter from Division Director
- Letter from the Board

Questions?

PCAOB
Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

Open Discussion

December 4, 2007

Washington, DC