

Update on the Public Company Accounting Oversight Board (PCAOB)

Presented To:

Georgia Society of CPAs
North Perimeter Chapter
April 21, 2009

Presented By:

Robert F. Dow, Esq.
Arnall Golden Gregory LLP
171 17th Street, NW, Suite 2100
Atlanta, Georgia 30363-1031
404.873.8706

©2009 Arnall Golden Gregory LLP
All rights reserved

robert.dow@agg.com



Attorneys at Law | www.agg.com

1

Members of the PCAOB Board

The SEC appoints the Chair and members of the PCAOB.
The current members are:

- Chair – Mark W. Olson, former member of Federal Reserve Board and former Ernst & Young partner
- Daniel L. Goelzer, CPA and attorney, former SEC general counsel
- Willis D. Gradison, Jr., former Ohio Congressman (R)
- Steven B. Harris, former Staff Director and Chief Counsel of the United States Senate Banking, Housing and Urban Affairs Committee under Chairman Paul S. Sarbanes
- Charles D. Niemeier, CPA and attorney, chief accountant of the SEC's enforcement division



Attorneys at Law | www.agg.com

2

Members of the PCAOB Board



Mark W. Olson



Daniel L. Goelzer



Willis D. Gradison, Jr.



Steven B. Harris



Charles D. Niemeier

Attorneys at Law | www.agg.com



3

Auditor Registration



Attorneys at Law | www.agg.com

4

PCAOB Audit Firm Registration System

- A CPA firm must register if it issues reports on public companies or “plays a substantial role”
- Electronic filing of lengthy application; PCAOB has 45 days to review
- Confidential treatment of certain information – everything else is publicly available
- Firms doing SEC audits were required to be registered by 10/22/03
- Unregistered firm may reissue prior report but must not issue new report
- Beginning in 2009 – must register if auditing any registered broker-dealer.



Attorneys at Law | www.agg.com

5

“Substantial Role”

CPA firm “plays a substantial role in the preparation or furnishing of an audit report” if it performs:

- “Material services” that a public accounting firm uses in issuing all or part of its report or
- Performs audit procedures for a subsidiary of component that constitutes 20% of consolidated assets or revenues
- “Material services” = 20% of engagement hours or fees



Attorneys at Law | www.agg.com

6

Registration (4/14/09)

- 1,968 firms registered
- 35 pending applications (2 in Georgia)
- 19 applications denied
- 6 firms seeking withdrawal

Attorneys at Law | www.agg.com



7

Profile of Registered Firms

- Approx. 1070 U.S. firms
 - 36 based in Georgia
- Approx. 900 Foreign firms in 86 nations, including
 - 72 United Kingdom
 - 53 in Canada
 - 54 Hong Kong
 - 43 Australia
 - 58 India
 - 35 France
 - 44 Germany
 - 47 China
- 12 firms with over 100 SEC clients
- Over 1,530 have <5 SEC clients
- 58% have no SEC clients

Attorneys at Law | www.agg.com



8

Recent and Proposed Audit Standards



Attorneys at Law | www.agg.com

9

AS No. 6: Evaluating Consistency of Financial Statements

- PCAOB adopted 1/29/08; SEC approval 9/16/08
- PCAOB adopted the standard primarily in response to two developments:
 - FASB adoption of SFAS No. 154, "Accounting Changes and Error Corrections," and
 - FASB's proposed SFAS on Hierarchy of GAAP (later adopted as SFAS No. 162)
- The PCAOB removed the GAAP hierarchy from its audit standards



Attorneys at Law | www.agg.com

10

AS No. 6: Evaluating Consistency of Financial Statements

(cont'd)

- This new standard and related amendments update the auditor's responsibilities to
 - Evaluate and report on the consistency of a company's financial statements and
 - Align the auditor's responsibilities with SFAS No. 154
- Gives the requirements for the periods to be addressed in the audit report
- Requires the auditor's report to indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement



Attorneys at Law | www.agg.com

11

AS No. 6: Periods Covered in Evaluating Consistency

Financial Statement Years Covered in Report

Only current year

Two or more years

What to Evaluate?

Current financials consistent with prior year

Report on consistency between those years and with the immediately preceding year



Attorneys at Law | www.agg.com

12

Proposed Standard – Engagement Quality Review

- Objective of review:
 - Evaluate judgments made
 - Evaluate conclusions reached
 - Determine whether to provide concurring approval
- Qualifications of engagement quality reviewer
- Engagement quality review process

Attorneys at Law | www.agg.com



13

Proposed Standard – Engagement Quality Review *(cont'd)*

- Concurring approval of audit opinion
 - Not allowed if there is a “significant engagement deficiency”
- Documentation

Attorneys at Law | www.agg.com



14

Staff Audit Practice Alert on Audit Considerations in the Current Economic Environment

The Staff Audit Practice Alert discusses the following six matters:

- Overall audit considerations
- Auditing fair value measurements
- Auditing accounting estimates
- Auditing the adequacy of disclosures
- Auditor's consideration of a company's ability to continue as a going concern
- Additional audit considerations for selected reporting areas



Attorneys at Law | www.agg.com

15

Overview of the Proposed Standards

PCAOB proposed the following risk assessment standards:

- Audit Risk in an Audit of Financial Statements
- Audit Planning and Supervision
- Identifying and Assessing Risks of Material Misstatement
- The Auditor's Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Consideration of Materiality in Planning and Performing an Audit
- Audit Evidence



Attorneys at Law | www.agg.com

16

Audit Planning and Supervision



- The auditor's responsibilities for planning the audit, including
 - Assessing matters that are important to the audit, and
 - Establishing an appropriate audit strategy and audit plan
- The responsibilities of the engagement partner and other engagement team members for supervising and reviewing the work of the engagement team



Attorneys at Law | www.agg.com

17

The Auditor's Responses to the Risks of Material Misstatement

- The auditor's responsibilities for responding to the risks of material misstatement in
 - The general conduct of the audit and
 - Specific audit procedures



Attorneys at Law | www.agg.com

18

Evaluating Audit Results



- The auditor's responsibilities re the process of evaluating the results of the audit to form the opinion(s) to be presented in the auditor's report
- This process includes evaluating uncorrected misstatements and control deficiencies identified during the audit



Attorneys at Law | www.agg.com

19

Consideration of Materiality in Planning and Performing an Audit



- The auditor's responsibilities for applying the concept of materiality
- As described by the federal securities laws, in planning the audit and determining the scope of the audit procedures



Attorneys at Law | www.agg.com

20

Audit Evidence



- The auditor's responsibilities regarding designing and applying audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report
- The principles for determining the sufficiency and appropriateness of audit evidence

Audit Risk in an Audit of Financial Statements

- Components of audit risk
- The auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance in an audit of financial statements



Audit Risk

- *Audit Risk* is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated
- $AR = \text{Misstatement Risk} + \text{Detection Risk}$



Misstatement Risk

- $MR = IR + CR$
- *Inherent Risk* – the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls
- *Control Risk* – the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, either individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control

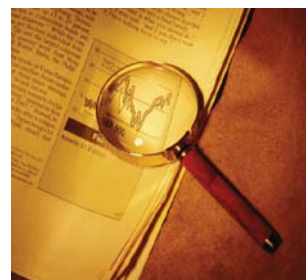
Control Risk

- Control risk is a function of the effectiveness of the design and operation of internal control



Detection Risk

- Detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, either individually or in combination with other misstatements
- Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor



Identifying and Assessing Risks of Material Misstatement

- The auditor's responsibilities for identifying and assessing risks of material misstatement
- The risk assessment process includes
 - Information-gathering procedures to identify risks and
 - Analysis of the identified risks
- Obtaining an understanding of the company, its environment, and its internal control



Attorneys at Law | www.agg.com

27

Performing Risk Assessment Procedures

The auditor's risk assessment procedures should include:

- Obtaining an understanding of the company and its environment
- Obtaining an understanding of internal control over financial reporting



Attorneys at Law | www.agg.com

28

Performing Risk Assessment Procedures

(cont'd)

- Considering information from the client acceptance and retention evaluation, past audits, and other engagements
- Performing analytical procedures
- Conducting a discussion among engagement team members regarding the risks of material misstatement, and
- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement



Attorneys at Law | www.agg.com

29

TOP AUDIT DEFICIENCIES IN SEC ENFORCEMENT ACTIONS: 1987-1997

Problem Area	Percentage (Number) of Cases
1. Gathering sufficient audit evidence	80% (36 cases)
2. Exercising due professional care	71% (32)
3. Demonstrating appropriate level of professional skepticism	60% (27)
4. Interpreting or applying requirements of GAAP	49% (22)
5. Designing audit programs and planning engagement (inherent risk issues, non-routine transactions)	44% (20)
6. Using inquiry as form of evidence (relying too much on this method)	40% (18)
7. Obtaining adequate evidence related to the evaluation of significant management estimates (failing to gather sufficient evidence)	36% (16)
8. Confirming accounts receivable	29% (13)
9. Recognizing/disclosing key related parties	27% (12)
10. Relying on internal controls (rely too much/failing to react to known control weaknesses)	24% (11)

Source: Journal of Accountancy, April 2001



Attorneys at Law | www.agg.com

30

Top 10 Restatement Reasons

1. Debt, warrants and equity security issues
2. Cash flow statement classification errors
3. Expense reporting issues
4. Deferred and stock-based compensation issues
5. Tax-related issues
6. Acquisitions, mergers, disposals
7. Liabilities, payables, reserves, accruals issues
8. Revenue recognition issues
9. Accounts/loans receivable, investments, cash issues
10. Consolidation issues, including VIE and off-B/S issues

Source: PCAOB 11/17/08



31

Attorneys at Law | www.agg.com

2007 Treasury Study: Financial Statement Elements (1997-2006)

	<u>Restatements</u>	<u>% of Total</u>
Revenue	1,314	20%
Core Expenses	2,639	40%
Non-Core Expenses	2,202	33%
Debt and Interest	732	11%
Reclass/Disclosure	478	2%
Asset Valuation	356	5%
Taxes	350	5%
Total	6,633	100%*

* Sums to more than 100% because some companies have more than one restatement issue



32

Attorneys at Law | www.agg.com

Restatement Case Study – Error – Tenneco

- Tenneco restated its financials for the 3 years ending 2006 due to an error in accounting for interest rate swaps
- Error discovered during PCAOB inspection of Deloitte
- Error in application of SFAS No. 133 on Derivatives
 - Used “hedge” accounting for interest rate swaps
 - Not qualified to do so
- Restated interest expense by more than \$6M



Attorneys at Law | www.agg.com

33

Restatement Case Study – Error – Tenneco

(cont'd)

Audit Risks:

- Complex area of accounting
- Complex contractual arrangements
- Did the company have sufficient expertise?



Attorneys at Law | www.agg.com

34

Restatement Case Study – Fraud – Gemstar-TV Guide



Henry C. Yuen
CEO, Gemstar-TV Guide International

Gemstar restated its financials for the 3 years ending 2002 after alleged fraud in its revenue recognition

- Restated revenue by \$357M
- CEO fired, pled guilty, fined
- Company settled with SEC for \$10M



35

Attorneys at Law | www.agg.com

Restatement Case Study – Fraud – Gemstar-TV Guide

(cont'd)

- Gemstar manipulated revenue in three ways:
 - Record revenue of expired, disputed or non-existent agreements
 - Revenues from round-tripping or non-monetary transactions
 - Shifted revenues from other divisions to its IPG sector



36

Attorneys at Law | www.agg.com

Restatement Case Study – Fraud – Gemstar-TV Guide

(cont'd)

- Charged KPMG, a partner, two former partners and a manager on the Gemstar audit
- Sanctions:
 - \$10 million to firm
 - Individuals barred from SEC practice
 - Additional training on revenue recognition issues and materiality
 - Adopt new policies re: consultation with national office



Attorneys at Law | www.agg.com

37

Restatement Case Study – Fraud – Gemstar-TV Guide

(cont'd)

- SEC says KPMG
 - Knew or should have known:
 - ✓ The revenue recognition was improper
 - ✓ Footnote disclosure was wrong
 - Over-relied on management representations
 - Failed to exercise professional skepticism
 - Failed to adequately assess qualitative materiality



Attorneys at Law | www.agg.com

38

Restatement Case Study – Fraud – Gemstar-TV Guide

(cont'd)

- Audit Risks:
 - Revenue recognition – always a sensitive area
 - Rapid growth and acquisitions
 - Compensation arrangements gave executives substantial incentives to inflate results
 - Were there indications of weak control environment and tone at the top?



Attorneys at Law | www.agg.com

39

Upcoming Standard-Setting Priorities

- Fair value and specialists
- Audit confirmations
- Related party transactions



Attorneys at Law | www.agg.com

40

Inspections



41

Attorneys at Law | www.agg.com

Audit Deficiencies – Reports on Inspections (December 2008)

After 4 years of inspections of the largest firms, PCAOB found these problem areas:

- Revenues
- Accounting estimates
- Fair value
- Analytical procedures
- Audit sampling
- Materiality and audit differences
- Foreign affiliates



42

Attorneys at Law | www.agg.com

Jaspers + Hall, P.C.

- Firm has 5 CPAs, 28 public co. audits
- Five deficient audits identified
- Quality control issues
- Resulted in enforcement action

Attorneys at Law | www.agg.com



43

PCAOB ENFORCEMENT



Claudius Modesti
PCAOB Director of Enforcement and Investigations

Attorneys at Law | www.agg.com



44

Sanctions for Violations

- Penalties
 - ✓ Up to \$15 million for firm
 - ✓ Up to \$750,000 for individual
- Temporary or permanent suspension of registration
- Person's disassociation from firm
- Limitations on firm's activities
- Require an independent monitor to observe and report
- Censure
- Additional education



Attorneys at Law | www.agg.com

45

Recent Items of Focus

- Independence issues
- Inappropriate reliance on other firm's work
- Failure to obtain sufficient evidence (especially revenue and valuation)
- Inadequate consideration of fraud
- Documentation issues



Attorneys at Law | www.agg.com

46

Deloitte & Touche LLP and Christopher Anderson (10/31/08)

- Audited Navistar
- Inadequate audit procedures for revenue recognition
- \$17M restatement
- Sanctions against Anderson:
 - \$24K fine
 - One-year suspension
 - Additional year: limited to role as assistant

Attorneys at Law | www.agg.com



47

Internal Controls and Smaller Reporting Companies

Attorneys at Law | www.agg.com



48

Updated Compliance Dates for Internal Control Rules

		Management Report	Auditor Attestation
		Fiscal Years ending on or after:	
Large accelerated filers	Domestic issuers	11/15/04	11/15/04
	Foreign private issuers	07/15/06	07/15/06
Accelerated filers	Domestic issuers	11/15/04	11/15/04
	Foreign private issuers	07/15/06	07/15/07
Non-accelerated filers		12/15/07	12/15/09
New public company		2d 10-K	2d 10-K



Attorneys at Law | www.agg.com

49

PCAOB Guidance Related to Internal Control Over Financial Reporting (“ICFR”)

- PCAOB Guidance for Auditors of Smaller Public Companies (1/23/09)
- Goal of new guidance: Improve efficiency and effectiveness of compliance related to ICFR under SOX 404
- PCAOB received 23 comment letters



Attorneys at Law | www.agg.com

50

Smaller Company Guidance

- Scaling the Audit for Smaller, Less Complex Companies
- Evaluating Entity-Level Controls
- Assessing the Risk of Management Override and Evaluating Mitigating Actions
- Evaluating Segregation of Duties and Alternative Controls
- Auditing Information Technology Controls in a Less Complex IT Environment
- Considering Financial Reporting Competencies and Their Effects on Internal Control
- Obtaining Sufficient Competent Evidence When the Company has Less Formal Documentation
- Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies



Attorneys at Law | www.agg.com

51

Example 8-1 – Pervasive Deficiencies and Testing of Controls

Scenario: A small company has a two-person staff that handles all of the accounting and financial reporting duties. The staff is competent in routine financial reporting matters but has difficulty with more complex accounting matters, such as valuation of stock-based compensation and income tax calculations and disclosures. The lack of competencies in these areas has resulted in adjustments based on the auditor's identification of material misstatements.



Attorneys at Law | www.agg.com

52

Example 8-1 – Pervasive Deficiencies and Testing of Controls

(cont'd)

Audit Approach: Based on the auditor's experience with the company, she expects that controls over the valuation/allocation and disclosures related to stock-based compensation and income taxes will not be effective. For those assertions, the auditor obtains evidence about the respective controls during a walkthrough of the related process. Also, misstatements in those assertions were detected in the financial statement audit, and she observes that the controls failed to prevent or detect those misstatements. Based on this evidence, she concludes that the controls over those assertions are not effective.

With respect to routine financial reporting processes, such as cash receipts and disbursements, the auditor plans to perform tests of the selected controls to obtain enough evidence to support a conclusion that the respective controls are effective.



Attorneys at Law | www.agg.com

53

U.S. Chamber of Commerce Small Company Survey (Public Float – \$75M or Less)

Looking ahead to December 2008, do you expect that the costs associated with your company's compliance with section 404 will be in alignment with the benefits of SOX 404 Compliance?

I expect costs will greatly exceed the benefits – 65.7%

I expect costs will moderately exceed benefits – 23.7%

I expect costs will be in alignment with benefits – 6.5%

I expect benefits will greatly exceed costs – 1.2%

Source: U.S. Chamber of Commerce/Research and Analysis Center, November 8, 2007



Attorneys at Law | www.agg.com

54

U.S. Chamber of Commerce Small Company Survey (Public Float – \$75M or Less)

(cont'd)

Looking ahead to December 2008, to what extent do you expect compliance with SOX 404 will allow your company and your company's outside auditors to detect and prevent material fraud?

- To a great extent – 4.1%
- To a moderate extent – 32.0%
- Very little at all – 58.6%
- Fraud likelihood could actually increase – 1.2%
- Unsure – 4.1%

Source: U.S. Chamber of Commerce/Research and Analysis Center, November 8, 2007

Attorneys at Law | www.agg.com



55

Audit Committee Survey on Oversight

How satisfied are you with your audit committee's knowledge and oversight of the activities surrounding the responsibility of management and the external auditors to report on the company's internal control over financial reporting?

- Very Satisfied – 48%
- Somewhat Satisfied – 40%
- Needs Improvement – 12%
- Not Sure – 0%

Source: KPMG Audit Committee Institute

Attorneys at Law | www.agg.com



56

ICFR Reporting for Smaller Companies in 2007

- Over 150 smaller companies did not properly comply with ICFR rules
- Over 90 smaller companies failed to file any ICFR report
- Most of these received SEC comment letters

Attorneys at Law | www.agg.com



57

Smaller Reporting Companies – SEC Comment Letters

- “It does not appear that your management has performed its assessment . . .”
- “We ask that you complete your evaluation and amend your filing within 30 days”

Attorneys at Law | www.agg.com



58

AGG's Securities and Corporate Governance Practice

Arnall Golden Gregory LLP counsels public and private companies, as well as officers, directors, investors, and underwriters, in matters regarding transactions, compliance and corporate governance. Our clients include entrepreneurial private companies, as well as companies listed on NYSE, NASDAQ, AMEX and OTC Bulletin Board. We work together with those clients to provide solutions that make sense given their goals and resources.

We regularly counsel companies and underwriters in a variety of complex securities transactions, including initial and follow-on public offerings, "going private" and "roll-up" transactions, mergers, PIPES offerings, and private offerings.



Attorneys at Law | www.agg.com