



The Public Company Accounting Oversight Board and Internal Control Reporting Under SOX 404

Presented to:

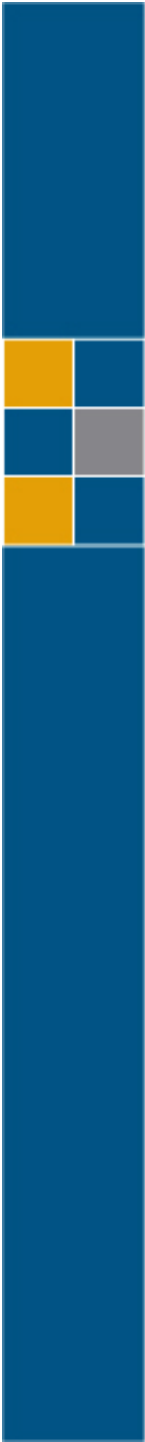
Georgia Society of CPAs
North Perimeter Chapter
September 19, 2006
Arnall Golden Gregory LLP
171 17th Street
Suite 2100
Atlanta, GA 30363

Presented by:

Robert F. Dow, Esq.
Arnall Golden Gregory LLP

Topics Covered

- The Members of the PCAOB
- Auditor Registration
- Inspections
- Enforcement
- Audit of Internal Control
- Other Audit Standards and Rules
- PCAOB Rulemaking Priorities



The Members of the PCAOB

The Members of the Board

The SEC appointed the Chair and members of the PCAOB. The members are:

- Chair –Mark W. Olson, member of Federal Reserve Board and former EY partner
- Kayla J. Gillan, former general counsel of the California Public Employees' Retirement System
- Daniel L. Goelzer, CPA and attorney, former SEC general counsel
- Charles D. Niemeier, CPA and attorney, chief accountant of the SEC's enforcement division
- Willis D. Gradison, Jr., former Ohio Congressman (R)



The Members of the Board



Mark W. Olson



Kayla J. Gillan



Daniel L. Goelzer



Charles D. Niemeier
Attorneys at Law | www.agg.com



Willis D. Gradison, Jr.





Auditor Registration

Attorneys at Law | www.agg.com



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

“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

Registration Results So Far (9/6/06)

- 1,693 firms registered
- 22 pending applications
- 18 applications denied
- 8 firms seeking withdrawal

Profile of Registered Firms

- Over 1000 U.S. firms
 - ▢ 26 based in Georgia
- Over 600 Foreign firms in 80 nations, including
 - ▢ 53 in Canada
 - ▢ 50 United Kingdom
 - ▢ 33 Australia
 - ▢ 24 France
 - ▢ 25 India
 - ▢ 20 China
- 9 firms with over 100 SEC clients
- Over 1,350 have <5 SEC clients
- 46% have no SEC clients

Inspections

“It’s most important to know, however, that we view our enforcement authority as but one tool within our toolbox. It is not necessarily the most important tool in every case, nor the first one that we reach for in all circumstances. Rather, we believe that the ability to affect change in auditor behavior that derives from our inspection authority is the tool that will be used most pervasively and most effectively.” Kay Gillan (6/20/05)

Inspection Reports

- Draft report to CPA firm – 30 days to respond
- Final report goes to CPA firm, SEC, and state boards
- Firm has 12 months to remedy any criticisms or defects in quality control system
- If fail to remedy, the criticisms and defects shall be made public
- Over 100 reports now posted on PCAOB website

Regional Offices to Support Inspections

Current locations

- Atlanta
- Dallas
- New York
- Orange County, California
- San Francisco
- Washington, D.C. (headquarters)
- Chicago
- Denver
- Northern Virginia

Plan for 2006

- Full inspection of Big 4 plus 5 others
 - ▢ 5% of Big 4 audit engagements
 - ▢ This is about 500-600 per firm
- Select about 280 other U.S. firms for inspection
- Begin inspections of non-U.S. firms

Quality Control Assessment

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

KPMG LLP (9/29/05)

- Selected 76 audits for review
- Cited deficiencies in 18 audits
 - ▢ Most involved insufficient audit procedures or evidence
 - ▢ Several misapplications of GAAP
 - ▢ Led to one restatement
- In a separate release, PCAOB stated that it remained confident that KPMG could perform high-quality audit

Deloitte & Touche LLP (10/6/05)

- Field work at 26 of 64 practice offices
- Cited deficiencies in 8 audits
 - ▮ Several misapplications of GAAP
 - ▮ Flawed “going concern” analysis
 - ▮ Led to three restatements
- In its response letter, D & T disputed some findings of the PCAOB

Chisholm, Bierwolf & Nilson, LLC (7/25/05)

- One office - Bountiful, Utah
- 3 partners + 3 accounting staff
- 67 issuer clients
- In 3 of 4 audits reviewed – “deficiencies of such significance that it appeared that the Firm did not obtain sufficient competent evidential matter to support its opinion”

Restatements

- More than 100 restatements in 2005 generated by PCAOB comments
- Misapplications of GAAP
 - ▮ Short-term liabilities
 - ▮ Lease accounting
- PCAOB cannot make a company restate – but can make life miserable if they don't
- Consider asking CPA firm to notify you if your file is under review

Enforcement

Features of a PCAOB Investigation

- Nonpublic investigation
- Can be a “informal inquiry” or “formal investigation”
- PCAOB can compel CPAs to testify
 - ▢ No one else allowed to attend except CPA’s attorney
- Sanctions for non-cooperation

Disciplinary Proceeding

According to Rule 5200, a proceeding will result from an investigation if a firm or associated person is alleged to have violated:

- Any provision of the Sarbanes-Oxley Act;
- Any rule of the Board
- The provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto; or
- Any professional standard.

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

PCAOB Brings its First Enforcement Action

- Goldstein and Morris
- Accused of concealing information during an inspection
- Sanctions
 - ▢ Firm's registration revoked
 - ▢ One partner barred from public company audits
 - ▢ Censure for two other CPAs



Audit of Internal Control

Updated Effective Dates for Internal Control Rules

- Domestic accelerated filers (AF) (generally issuers with a market cap in excess of \$75 million) had to comply for the fiscal year ending on or after 11/15/04
- However, those with market cap below \$700 million, had a one-time extension to file report 45 days after the annual reports for fiscal years ending 11/15/04 through 2/28/05
- See updated dates below
- No “grandfather” clause if you become AF mid-year

Updated Effective 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*	12/15/08*
*pending rule			

**Arnall
Golden
Gregory**

LLP

FAQ's from SEC

- Management may exclude an acquired business for a period not to exceed one year. (FAQ3)
- Management may exclude VIE's that existed prior to 12/15/03 and must be consolidated under FIN 46 if the Company (FAQ1):
 - ☐ Does not have a right to assess its controls and
 - ☐ Lacks the ability in practice to make an assessment
- The Company may elect not to disclose changes to internal controls made in preparation for its first SOX 404 report (FAQ9)

FAQ's from SEC

(cont'd)

- Auditor may provide limited assistance to management in documenting, making changes in internal control; audit committee must specifically approve (FAQ17)
- Management may rely on a SAS 70 type 2 report even if the service organization used the registrant's auditor, but the registrant may not engage its auditor to prepare the SAS 70 report (FAQ14)
- Management may not use an "except for" qualification (FAQ5)

FAQ's from PCAOB

- Management can give a draft of financial statements to auditor without indicating a significant deficiency if it makes clear to the auditor the incomplete state of the draft (FAQ7)
- Auditor does not have to perform a walkthrough at a client's service organization if the auditor can obtain sufficient evidence by other means (FAQ29)

FAQ's from PCAOB

(cont'd)

Testing controls (FAQ42)

- Some companies have identified “key” or “significant” controls
- The auditor does not necessarily have to test all such controls
- The auditor need only test those controls that the auditor identifies as controls over relevant assertions related to significant accounts

FAQ's from PCAOB

Top-down Approach (FAQ38)

- Identify significant accounts at financial statement or disclosure level
- Identify assertions relevant to each significant account
- Identify significant processes and major classes of transactions
- Identify points where error or fraud could occur
- Identify controls that prevent or detect error or fraud
- Link controls with significant accounts and assertions

FAQ's from PCAOB

(cont'd)

- Evaluating deficiencies (FAQ 28)
 - ▢ Situations in which management and the auditor do not have the ability to evaluate controls
 - ▢ Represents a control deficiency that must be evaluated
 - Transactions or events subject to those controls that are material would represent a material weakness
 - ▢ Auditor would need to determine whether management has fulfilled its responsibilities

FAQ's from PCAOB

Risk-Based Approach (FAQ39)

- Significant accounts Use risk factors in AS No. 2 to eliminate from consideration accounts with remote likelihood of containing material misstatement
- Relevant assertions Assertions that do not present meaningful risk of material misstatement are not relevant and should not be tested
- Using work of others As risk factors decrease in significance, need for auditor to perform own work decreases


FAQ's from PCAOB

(FAQ43) Scope of Testing – As risk associated with control decreases:

- Nature – persuasiveness of evidence needed decreases
- Timing – testing can be done farther from as-of date
- Extent – extensiveness of testing should decrease

PCAOB Policy Statement (5/16/05)

- Integrate audits of internal control with audits of financial statements
- Exercise judgment to tailor audit plans to the risks facing individual clients
 - ▢ Small companies do not need the same types of controls or the same audit process as do large multi-nationals



PCAOB Policy Statement

(5/16/05)

(cont'd)

- Use a top-down approach that begins with company-level controls
- Use the flexibility of the standard to use the work of others as provided
- Engage in direct and timely communication with audit clients

PCAOB Report on AS No. 2 Implementation **(11/30/05)**

Reasons why audits of ICOFR not efficient:

- Not enough integration of audits
- Not effective top-down approach
- Extent of testing not tailored for level of risk
- Inefficient/ineffective walk-throughs
- Not effective use of work of others

PCAOB Report on AS No. 2 Implementation

(11/30/05)

(cont'd)

Additional Guidance

- “More than remote” – a qualitative judgment, not a statistical concept
- “Strong indicators” not always a material weakness
- Don’t have to detect deficiencies that are not material weaknesses
- Evaluate compensating controls
- Integrate testing for both audits

Experience from First Two Years of SOX 404 Reports

	<u>Year 1</u>	<u>Year 2</u>
Companies reporting	3,900	3,000
% adverse opinion	16%	7%
Total weaknesses	1,500	400

Experience from First Year of SOX 404 Reports

- PWC study of 225 clients
 - ▮ 63,000 control problems (275 per company)
- Charles River Associates survey:
 - ▮ 271 deficiencies per company
 - ▮ 70% remediated

Sample SOX 404 Reports

The Good

Home Depot, Inc.

The Bad

General Motors Corporation

H&R Block, Inc.

The Ugly

Delphi Corporation

Flowserve Corporation

Common Themes

- Inadequate staffing
- Misapplication of accounting principles
- Revenue recognition
- Restatements
- Tax accruals
- Lease accounting
- Accounting for derivatives

Adverse Opinions – Impact on Debt Rating

Moody's separates weaknesses into two categories:

- Category A – Weakness in individual accounts or transaction process – generally no rating downgrade if there is an ability to remediate
- Category B – Company-level controls, control environment, financial reporting process, or ineffective personnel – may lead to a downgrade

Adverse Opinions – Impact on Debt Rating

(cont'd)

According to Moody's, through April 2006:

- ✓ 29 Rating actions
- ✓ 15 downgrades
- ✓ 6 lower rating outlook

Some downgraded companies:

- ✓ BearingPoint, Inc.
- ✓ Navistar Financial
- ✓ Saks, Inc.



Factors Likely to Lead to Moody's Rating Action

- Delinquent reports
- History of reporting problems
- Investigations into accounting practices
- Aggressive accounting practices
- Remediation plan not credible

Share Prices and Internal Control

Results from first two years

Companies reporting	Increase/Decrease in share price
Effective controls both years	26.67%
Ineffective year 1 and effective year 2	25.74%
Ineffective controls both years	(5.75%)
Russell 3000	18%

Source: May 2006 study by Lord & Benoit

Thoughts on Reporting Weaknesses

- Full description of the weakness
- How it was discovered
- How it will be remedied
- When it will be remedied
- Progress to-date
- Financial statement impact

How Effective has SOX been in Helping to Identify Financial Statement Fraud?

- Very effective – 3%
- Somewhat effective – 52%
- Not effective – 19%
- Neither hurts nor helps – 16%

Source: Oversight Systems Survey of Certified Fraud
Examiners

COSO Framework for Smaller Companies

- June 2006 – COSO issued: *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* ((see www.coso.org)
- Guidance on how small companies can most efficiently and effectively implement the COSO framework
- Features
 - ▢ 26 essential principles for effective ICOFR
 - ▢ Guidance for specific control objectives, templates, and examples used in practice

SEC Concept Release (7/11/06)

- Risk and control identification
- Management's evaluation
- Documentation to support evaluation

PCAOB Four-Point Plan

On May 17, 2006, PCAOB announced a 4-point initiative:

- Amend as No. 2
- Reinforce auditor efficiency through the inspection process
- Guidance and education for small company auditors
- Continue PCAOB forums on auditing small business

Potential Amendment to AS No. 2

- Incorporate key concepts from 5/16/05 guidance
- Clarify definitions of significant deficiency and material weakness
- Guide auditors on use of work of others
- Clarify materiality and scoping decisions
- Emphasize integration of audits
- Allow auditors' use of prior years experience to focus efficient work in subsequent years

Inspections Process

PCAOB Inspectors will evaluate:

1. Degree of integration of audits
2. Use of top-down approach
3. Proper assessment and response to identified risks
4. Using the work of others

Through these areas, inspectors will assess efficiency.

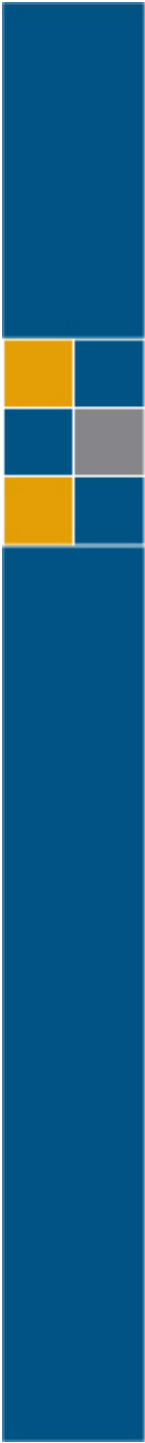
Using the Work of Others

- Objectivity and competence of internal auditors
- Extent of re-testing
- Consider risk assessment and control environment



PCAOB Standard – Elimination of a Material Weakness

- Express an opinion on whether the company has eliminated a previously reported material weakness
- Stand-alone engagement performed at request of the company
- Test design and operating effectiveness of the controls implemented to eliminate the weakness



Staff Audit Alert No. 1 Matters Related to Timing and Accounting for Option Grants (July 28, 2006)

Raises matters for auditors to consider relating to options:

- Possible misapplication of GAAP
- Accounting for contingencies
- Income tax issues
- Materiality – SAB99 – qualitative
- Possible illegal acts – Section 10A
- Risk assessment in planning auditing procedures
- Previously issued opinions



Other Auditing Standards and Rules

Standards Adopted to Date

- PCAOB Auditing Standard No. 1 – Reference to the Board’s Standards in Audit Reports
- PCAOB Auditing Standard No. 2 – Audit of Internal Control
- PCAOB Auditing Standard No. 3 – Audit Documentation
- PCAOB Auditing Standard No. 4 – Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Related Rules Adopted to Date

- “Transition, Interim Rules” – Certain AICPA rules in existence on April 16, 2003
- Definitions of “should” vs. “must”
- Ethics & Independence Rules concerning Tax Services & Contingency Fees



Audit Standard No. 4 - Remediation of Material Weaknesses

- Express an opinion on whether the company has eliminated a previously reported material weakness
- Stand-alone engagement performed at request of the Company
- Test design and operating effectiveness of the controls implemented to eliminate the weakness
- This standard is pending final approval from SEC

PCAOB Rule Re Tax Services

- Auditor may not perform the following tax services:
 - ☐ “Listed services” (IRS regulations)
 - ☐ “Conditional transaction” (IRS regulations)
 - ☐ “Aggressive Tax Positions”
- Also prohibited: Any type of service for a “contingent fee”

PCAOB Rule Re Tax Services

(cont'd)

- Aggressive Tax Position means:
 - ☐ Initially recommended by the tax advisor
 - ☐ A significant purpose of the transaction is tax avoidance, and
 - ☐ Proposed tax treatment is not at least more likely than not to be allowed under applicable tax laws



PCAOB Rulemaking Priorities

Standing Advisory Group (SAG)

- Established to assist in determining standard setting priorities
- 30 members with 2-year terms
 - ▢ Mixture of CPAs, industry, investor representatives, academics
- Meets at least once per quarter

Items on the Agenda

- Engagement quality review
- Applying COSO to smaller companies
- Hierarchy of GAAP
- Communications with audit committees
- Risk assessment
- Independent issues

PCAOB Considering a New Standard on Auditor-Audit Committee Communications

- Plethora of existing rules related to communication, e.g.:
 - ▢ SAS 60, 61 and 99, parts of others
 - ▢ Exchange Act Sec. 10A
 - ▢ SOX Sections 204, 301, 404
 - ▢ PCAOB Standard 2

PCAOB Considering a New Standard on Auditor-Audit Committee Communications

(cont'd)

- PCAOB staff views existing standards as inadequate
 - ▢ PCAOB staff prepared a white paper on this issue with a useful summary of existing standards (see copy on their web site at http://www.pcaobus.org/News_and_Events/Events/archive/2004-06-21-22.asp)



Staff Accounting Bulletin No. 108

SAB 108

“Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements”

SAB 108

(cont'd)

- Rejects exclusive use of “Rollover” or “Iron Curtain” approaches
- Must quantify the impact of correcting all misstatements
 - ✓ Carryover effects
 - ✓ Revising prior year misstatements

THE END