



Update on PCAOB and Internal Controls Audits

**Georgia Society of CPAs
North Perimeter Chapter**

November 20, 2007

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1. Presentation
2. Excerpts from PCAOB Guidance, October 17, 2007
3. Sample Small Company Disclosure of Material Weakness
4. Profile for Securities Practice Group
5. Profile for Robert F. D. Dow

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INTERNAL CONTROL OVER FINANCIAL REPORTING ("ICFR")



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Regulatory Guidance Related to Internal Control Over Financial Reporting

- SEC interpretive guidance for management (6/27/07)
- SEC revised definitions of material weakness and significant deficiency (8/27/07)
- PCAOB Auditing Standard No. 5 (AS 5) (11/15/07)
- PCAOB Rule: Pre-Approval of Internal Control Non-Audit Services (7/27/07)



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Regulatory Guidance Related to Internal Control Over Financial Reporting

(cont'd)

- PCAOB Preliminary Guidance for Auditors of Smaller Public Companies (10/17/07)
- Goal of new guidance: Improve efficiency and effectiveness of compliance related to ICFR under SOX 404



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IMA Testimony to H.O.R. on SOX Regulations (6/5/07)

Paul Sharman listed major deficiencies in SEC guidance:

1. Perpetuates high cost
2. High rate of "prediction errors"
3. Relationship with external auditors
4. Unfair playing field
5. Quality Bar set too high
6. Heightened risk of legal liability



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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	12/15/08
New public company		2d 10-K	2d 10-K



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U.S. House Passed Section 404 Delay for Non-Accelerated Filers

- U.S. House of Representatives passed an amendment to the SEC's appropriations bill
- Bill would limit the agency's ability to require Section 404 compliance by non-accelerated filers for all of fiscal 2008 (that is, through 9/30/08)
- IMA issued a statement in support of proposed delay
- Senate did not pass the delay proposal



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SEC Guidance

- Interpretive guidance for management
- Principles-based and focused on a top-down, risk-based approach
- Based on two principles:
 - Management should evaluate controls to determine if there is a reasonable possibility that a material misstatement would not be prevented or detected in a timely manner
 - Evaluation of controls should be based on management's assessment of risk associated with those controls
- No requirement to change if an effective process is already in place ("safe harbor")

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SEC Guidance – Benefits for Management

- More focused approach to promote efficiency
- Smaller companies can scale and tailor their evaluation methods to fit their own facts and circumstances
- Not every control must be identified; just those that adequately address assessed risk
- Provides guidance for management to support a risk-based evaluation process

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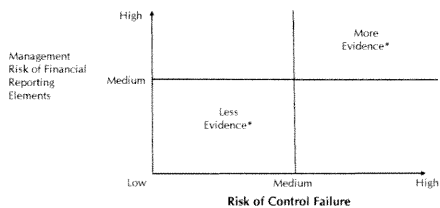
SEC Guidance – Management’s Assessment

- Management must assess the risk of a misstatement of a financial reporting element (financial reporting risk)
- Management must identify controls to address each financial reporting risk
- Management must assess the risk of failure of the controls

SEC Guidance – Management’s Assessment *(cont'd)*

- In determining the misstatement risk of a financial reporting element, factors to be considered include:
 - Level of judgment required to determine the recorded amount
 - Susceptibility to fraud
 - Complexity in underlying accounting requirements
 - Environmental factors, such as technological and/or economic changes

Determining the Sufficiency of Evidence Based on ICFR Risk



* The references to "more" or "less" include both the quantitative and qualitative characteristics of the evidence (that is, its sufficiency).

Evaluating Deficiencies

Risk factors for evaluation include:

- The nature of the financial reporting involved (e.g., suspense accounts and related party transactions involve greater risk)
- The susceptibility of the related asset or liability to loss or fraud (i.e., greater susceptibility increases risk)
- The subjectivity, complexity, or extent of judgment required to determine the amount involved



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Evaluating Deficiencies

(cont'd)

- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant
- The interaction of the deficiencies – multiple deficiencies affecting the same financial statement amounts or disclosures
- The possible future consequences of the deficiency



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Special Indicators of a Material Weakness

- Identification of fraud, whether or not material, on the part of senior management
- Restatement of previously issued financial statements
- Identification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's ICFR
- Ineffective oversight of the company's external financial reporting and ICFR by the company's audit committee



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Some Unresolved Questions

- Does the SEC provide enough guidance?
- Will the intended cost efficiencies be achieved?
- Will management's evaluation method dovetail with the auditor's approach?
- Does the new guidance make it too "easy" for management to cut corners?



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PCAOB Guidance

- AS 5 supersedes AS 2
- Effective for fiscal years beginning after 11/15/07
- Principles-based standard emphasizing a top-down, risk-based integrated approach to the audit
- Requires external auditors to focus testing on material financial reporting risks
- Allows for flexibility and scaling of ICFR audits based on the company's size and complexity



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PCAOB Guidance – Major Changes

- Primary focus of auditor should be areas of highest risk
- Allows prior knowledge and experience to be taken into account during the risk assessment and scoping process
- Allows external auditors to rely on the work of management and others, based on risk, competency, and objectivity
- Increased emphasis on fraud controls



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PCAOB Guidance – Major Changes

(cont'd)

- Focuses multi-location testing requirements on risk, rather than coverage
- Recalibrates walkthrough requirements
- Revised definitions of material weakness and significant deficiency
- Eliminates requirement to report on management's assessment of ICFR

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PCAOB Guidance – Definitions

AS 5 includes these definitions:

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company financial reporting.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

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PCAOB Rule Regarding Audit Committee (AC) Approval of Non-Audit Services

In connection with AC approval of non-audit ICFR services, auditor must:

- Describe in writing to the AC of the issuer the scope of the service
- Discuss with the AC the potential effects of the service on the independence of the firm
- Document the substance of its discussion with the AC of the issuer

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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



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PCAOB Guidance for Auditors of Smaller Public Companies

- Published 10/17/07
- Comments due 12/17/07
- Staff's views on applying ASS to smaller companies



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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



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Example 3-1 – Audit Committee Assessment of Risk of Override

Scenario: The audit committee of a small utility company discusses in executive session at least annually its assessment of the risks of management override of internal control, including motivations for management override and how those activities could be concealed. The committee reviews the functioning of the company's whistleblower process and related reports; from time to time inquires of managers not directly responsible for financial reporting (including personnel in sales, procurement, and human resources, among others); and obtains information regarding concerns about ethics or indications of management override of internal controls.



Example 3-1 – Audit Committee Assessment of Risk of Override

(cont'd)

Audit Approach: In this situation, the auditor can draw upon several sources of evidence to evaluate the audit committee's assessment of the risk of management override. The auditor might attend selected meetings of the audit committee where the risks of override and whistleblower programs are discussed or review minutes of meetings where those matters are discussed. In connection with its inquiries of the audit committee about the risk of fraud, as required by AU sec. 316, the auditor can discuss matters relating to the risk of override, including how the audit committee assesses the risk of management override, what information, if any, the audit committee has obtained about possible management override, and how the audit committee's concerns about the risk of management override have been addressed. This information can inform the auditor's consideration of the risk of management override and the testing of mitigating controls.



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.



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.

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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
 - 20 essential principles for effective ICOFR
 - Guidance for specific control objectives, templates, and examples used in practice

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Disclosure of Material 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

See, e.g., 3d Systems Corp. Form 10-K/A (8/2/07)
<http://www.sec.gov/Archives/edgar/data/910638/0000095014407007147/g08695kae10vkza.htm#1115>

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Foamex, Inc. (7/11/05)

- First administrative SEC action for failing to maintain ICFR
- Cited for deficient controls
- Settlement agreement to bolster ICFR



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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



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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



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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



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GSCPA Survey on SOX 404 (Sept. 2006)

- Do you believe that SOX 404 is cost justified for companies?
Yes – 26.3% No – 55.3% Not Sure – 18.4%
- Do you believe that SOX 404 is effective in preventing fraud?
Yes – 36.8% No – 36.8% Not sure – 21.1%
No response – 5.3%

Number of respondents: 38



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IIA Survey (Sept. 2007)

- Will the new Standard and Guidance lead to cost savings?
14% Yes – significant
57% Yes – modest savings
14% No
14% No response for your company?
- Do you believe that SOX 404 is effective in preventing fraud?
46% Yes
43% No
11% Not Sure

[IIA Conference, Atlanta 9/10/07]

Results: 28 surveyed



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Audit Committee Survey on Internal Audit

- I am confident that my company's Chief Audit Executive (Internal Audit) would directly report to the audit committee any controversial issues involving senior management
 - Agree - 79.31%
 - Disagree - 6.90%
 - Not sure - 10.34%
 - We do not have an internal audit function - 3.45%

Source: KPMG Audit Committee Institute



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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%



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PCAOB ENFORCEMENT



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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



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Thomas Benson, CPA (6/29/07)

- Audited Conversion Technologies, a Kennesaw, GA based company
- Company under investigation for financial statement fraud
- Insufficient audit work on bonds and note
- Sanctions
 - Firm's registration revoked
 - Barred from public company audits



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OPTION BACKDATING



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Some Issues to Consider for Public Companies

- Errors in past disclosure documents
- Possible restatements of financial statements
- Possible book and records violations
- Disclosure controls
- Late or missing reports for options grants
- Section 10A – reporting illegal acts

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Issues for Both Public and Private Companies

- Failure to meet tax qualifications (ISO and 409A)
- Possible breach of fiduciary duty – “cheap stock” and dilution
- Compliance with stock plan documents
- Documenting proper corporate approvals
- How to satisfy your contractual obligations to option holders while “fixing” the tax and accounting problems

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Forms of Option Dating Abuses

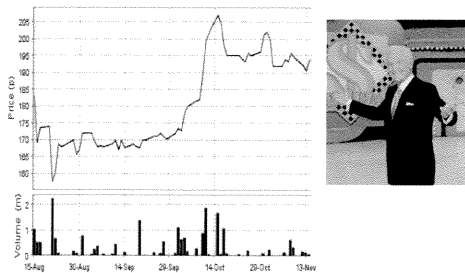
- Backdating grants
- Forward dating grants
- Springloading
- Bullet dodging
- Pre-hire grants
- Exercise date backdating
- Contrast these with: innocent administrative errors

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The Object of Option Backdating *to make Sure the "Price is Right"*



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Option Backdating

- Accounting and Reporting Implications
 - Measurement of compensation cost occurs at a different date than the date the exercise price was established (may result in an in-the-money option)
 - If plan does not permit grants of in-the-money options:
 - Must determine whether and when a legal grant has occurred
 - Consider the possibility of variable accounting through the exercise date
 - Potential restatement – how to deal with errors in periods not presented in the latest financial statements?

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SEC Guidance (9/27/06)

- Effective date for options should be the date when the terms are known with finality
- If all of the paperwork is not available to document the purported grant date, the company must use all available relevant information to form a reasonable conclusion as to the actual grant date
- The appropriate option plan documents must be consulted to determine the proper procedure to effectively complete the grant

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Option Backdating – PCAOB Guidance

PCAOB Guidance on Auditing Stock Options

- Issued in July 2006
- Auditor must test management's assertions about the timing of option grants



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Option Backdating – PCAOB Guidance

(cont'd)

In general, when auditing the fair value of employee share options, the auditor should:

- Obtain an understanding of the process used to develop the estimated fair value of employee share options
- Assess the risk of misstatement related to the fair value of employee share options, and
- Perform testing on the company's estimated value of employee share options



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Option Backdating – PCAOB Guidance

(cont'd)

- Testing includes:
 - Evaluating the consistency of the process
 - Evaluating the reasonableness of (1) the company's model and (2) the assumptions used in the model, such as expected term and expected volatility, and
 - Verifying the accuracy and completeness of the data underlying the fair value measurements



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Special Rule for Stock Option Restatements

January 2007 SEC guidance provides conditions to allow a company to avoid amending prior years' 10-Ks:

- Filing the new year 10-K within 2 weeks
- Explanatory note
- Restated selected financial data
- 3 years' audited restated financial statements
- Report costs associated with any additional prior years
- Robust MD&A discussion of restatement
- Specified additional footnote disclosures

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Option Backdating – SEC Action

SEC Enforcement Actions on Options:

- More than 150 companies under various levels of investigation
- Several CEOs, CFOs, other executives forced to resign and may face charges

Also, DOJ has a special task force for pursuing backdating cases

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Stock Option Investigations

Companies have disclosed:

- Internal investigations 264
- SEC investigations 132
- Department of Justice 60
- Shareholder suits 134
- Executive departures 49
- Restatements 141
- Material weakness 62

Source: Glass Lewis & Co. (4/30/07)

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SEC Enforcement

Antonia Chion, Associate Director, identified factors that the Division of Enforcement will consider in evaluating option backdating cases:

- How egregious was the conduct?
- What is the quality of the evidence?
 - e.g., is there evidence of alteration or falsification?
- The duration of the conduct (number of instances of backdating)?
- What is the quantitative materiality of unrecorded compensation expense?

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SEC Enforcement

(cont'd)

- Is there a restatement and, if so, how large?
- Scienter – What is the knowledge of the individuals?
- Is there evidence of concealment, obstruction or lying?
- Does anyone have money in pocket?
- Did other non-options misconduct occur?
- What about cooperation and remedial acts?

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What Do These People Have in Common?

Steven J. Landmann
Gary C. Gerhardt
David Kreinberg



Patti P. Tay
Fred Anderson
Gary L. Fischer
Sharlene Abrams
Douglas Smith
Michael Byrd
Antonio Canova

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A Really Bad Idea

Language accompanying option grant agreement:

"Our goal is to ensure the best possible out-come for the employees receiving options in this grant. For this reason we will be delaying the communication of the annual grant information for a little longer. I will let you know as soon as we have the grant date and strike price. At that time we will email your approval spreadsheets so you and your management team can let the employees know the detail of their grants."



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Anatomy of a Backdating Case: Engineered Support Systems

- Alter records to disguise grant dates
- Undisclosed repricing
- Immediately vested in-the-money options
- Issued options in excess of authorized amounts
- Misrepresentation to auditors



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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.



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- *Criteria for investigation.* For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control's precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.
- *Predictability of expectations.* Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts. The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.

When assessing the precision of an entity-level control, the auditor also should take into consideration contradictory audit evidence, such as misstatements in the relevant assertion that are identified by the auditor.

Effect of Entity-Level Controls on Testing of Other Controls

The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls. For example, if the auditor has designed an audit approach with an expectation that certain entity-level controls (e.g., controls in the control environment) will be effective and those controls are not effective, the auditor might re-evaluate the planned audit approach and decide to expand his or her audit procedures.

On the other hand, the auditor's evaluation of some entity-level controls can result in a reduction of his or her testing of other controls, such as controls over corresponding relevant assertions. The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls.

Example 2-1 – Monitoring the Effectiveness of Other Controls

Scenario: A small public video game developer conducts business in the United States and other countries, requiring the company to maintain a multitude of bank accounts. A staff accountant is charged with performing bank reconciliations for the accounts according to a predetermined schedule (some of the accounts have a different closing date). Through inquiries of management, the auditor learns that the company's chief financial officer ("CFO"), who is an experienced accountant, periodically reviews the bank reconciliations prepared by the staff accountant as a means to determine –

- whether reconciliations are being prepared on a timely basis;

- the nature of reconciling items identified through the process; and
- whether reconciling items are investigated and resolved on a timely basis.

Audit Approach: The CFO's review is a check of the staff accountant's work rather than a reperformance of the reconciliation, so the review is not sufficiently precise to detect misstatements. However, the CFO's review could influence the auditor's assessment of risk. The auditor obtains evidence about the CFO's review through inquiry and document inspection, evaluates the review's effectiveness, and determines the amount of direct testing of the reconciliation controls that is needed based on the assessed level of risk. If the auditor concludes that the CFO's review is effective, she could reduce the direct testing of the reconciliation controls, absent other indications of risk.

Example 2-2 – Entity-Level Controls Related to Payroll Processing

Scenario: A manufacturer of alternative fuel products and systems for the transportation market has union labor, supervisors, managers, and executives. All plants run two shifts six days a week, with each having approximately the same number of employees.

The chief financial officer ("CFO") has been with the company for ten years and thoroughly understands its business processes, including the payroll process, and reviews weekly payroll summary reports prepared by the centralized accounting function. With the company's flat organizational design and smaller size, the CFO's background with the company and his understanding of the seasons, cycles, and workflows, and close familiarity with the budget and reporting processes, the CFO quickly identifies any sign of improprieties with payroll and their underlying cause – whether related to a particular project, overtime, hiring, layoffs, and so forth. The CFO investigates as needed to determine whether misstatements have occurred and whether any internal control has not operated effectively, and takes corrective action.^{7/} Based on the results of audit procedures relating to the control environment and controls over management override, the auditor observes that the CFO demonstrates integrity and a commitment to effective internal control.

Audit Approach: The auditor evaluates the effectiveness of the CFO's reviews, including the precision of those reviews. She inquires about the CFO's review process and obtains other evidence of the review. She notes that the CFO's threshold for

^{7/} Adapted from the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") publication, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* (June 2006) ("COSO Small Companies Guidance"), Volume II: Guidance, page 90.

If the auditor identifies indications of management override of controls, he or she should take such indications into account when evaluating the risk of override and the effectiveness of mitigating actions.

Example 3-1 – Audit Committee Assessment of Risk of Override

Scenario: The audit committee of a small utility company discusses in executive session at least annually its assessment of the risks of management override of internal control, including motivations for management override and how those activities could be concealed. The committee reviews the functioning of the company's whistleblower process and related reports; from time to time inquires of managers not directly responsible for financial reporting (including personnel in sales, procurement, and human resources, among others); and obtains information regarding concerns about ethics or indications of management override of internal controls.⁷¹

Audit approach: In this situation, the auditor can draw upon several sources of evidence to evaluate the audit committee's assessment of the risk of management override. The auditor might attend selected meetings of the audit committee where the risks of override and whistleblower programs are discussed or review minutes of meetings where those matters are discussed. In connection with its inquiries of the audit committee about the risk of fraud, as required by AU sec. 316, the auditor can discuss matters relating to the risk of override, including how the audit committee assesses the risk of management override, what information, if any, the audit committee has obtained about possible management override, and how the audit committee's concerns about the risk of management override have been addressed. This information can inform the auditor's consideration of the risk of management override and the testing of mitigating controls.

⁷¹ Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 26.

could be entity-level controls. Chapter 2 discusses the auditor's evaluation of entity-level controls at a smaller, less complex company.^{4/} Example 4-1 below and Example 5-1 in Chapter 5 illustrate the testing of certain types of alternative controls.

If the auditor applies a top-down approach, starting at the financial statement level and evaluating entity-level controls, the auditor might identify controls that address the risk of misstatement for one or more relevant assertions. In those cases, the auditor could select and test those entity-level controls rather than test the process controls that could be affected by inadequate segregation of duties.

Example 4-1 – Alternative Controls over Inventory

Scenario: A provider of office furnishings and equipment uses a locked storeroom to store certain key components. The person responsible for the components has access both to the storeroom and the related accounting records. To address the risks related to undetected loss of components, the manager responsible for purchasing performs periodic spot-checks of the components and reconciles them to the related accounting records. The components also are included in the company's year-end inventory count. IT access controls are implemented to prevent the person responsible for the components from entering transactions or modifying related account balances.^{5/}

Audit approach: The auditor observes the company's year-end inventory counting process. He inspects documentation for some of the periodic spot-checks and the related reconciliations. For discrepancies in the counts or reconciliations inspected, he performs inquiries and inspects the accounting records to determine whether those items were appropriately resolved. Relevant IT access controls are evaluated in connection with the evaluation of IT general controls. (See Chapter 5.)

^{4/} As discussed in Chapter 2, controls related to the control environment and controls over the risk of management override are particularly important to the effective functioning of the controls performed by senior management. Chapter 3 discusses assessing the risk of management override and evaluating mitigating controls.

^{5/} Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 26.

Consideration of Deficiencies in General Controls on Tests of Other Controls

Sometimes, the auditor might identify deficiencies in the IT general controls that support automated controls or IT-dependent controls. The significance of an IT general control deficiency should be considered when evaluating the effectiveness of the related automated or IT-dependent controls.

In some situations, an automated or IT-dependent control might be effective even if deficiencies exist in IT general controls. For example, despite the presence of deficient program change controls, the auditor might directly test the related automated control, giving consideration to the risk associated with the deficient change controls in his or her risk assessment and audit strategy. If the testing results were satisfactory, the auditor could conclude that the automated controls operated effectively at that point in time. On the other hand, deficient program change controls might result in unauthorized changes to application controls, in which case the auditor could conclude that the application controls are ineffective.

Example 5-1 – IT-Dependent Controls

Scenario: A company has a small finance department that, because of staffing constraints, is unable to segregate certain incompatible duties related to transactional data and processing. Due to the lack of segregation of duties, the company has identified certain accounting processes and applications as having higher risk of misstatement. As a result, the company implemented an alternative control, e.g. senior management performs a number of business process reviews and analyses as detective controls over transaction processing.

The company has a small IT department that supports a packaged financial reporting system. Since the company uses packaged software, and there have been no changes to the system or processes in the past year, the relevant IT general controls are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors. Management uses several system-generated reports in the business performance reviews, but these reports are embedded in the application and programmed by the vendor and cannot be altered.

Audit Approach: The auditor determines that senior management personnel performing the business process reviews and analyses are not involved with incompatible functions or duties that impair their ability to detect misstatements. Based on the auditor's knowledge of the financial reporting system and understanding of the transaction flows affecting the relevant assertions, the auditor selects for testing certain process reviews and analyses and certain controls over the completeness and accuracy of the information in the reports used in management's reviews. The tests of controls could include, for example –

- Evaluating management's review procedures including assessing whether

those controls operate at an appropriate level of precision. (See Chapter 2.)

- Evaluating how the company assures itself regarding the completeness and accuracy of the information in the reports used by management in the reviews. Matters that might be relevant to this evaluation include how the company determines that –
 - the data inputs into the report are accurate and complete. This might be accomplished through testing controls over the initiation, processing and recording of the respective transactions that feed into the report.
 - the relevant computer settings established by the software user are consistent with the objectives of management's review. For example, if management's review is based on items in an exception report, the reliability of the report depends on whether the settings for reporting exceptions are appropriate.

The auditor also evaluates the IT general controls that are important to the effective operation of the IT-dependent controls (such as the access controls and operations controls previously described).

Categories of IT Controls

The remaining sections of this chapter discuss major categories of IT controls and considerations for testing them in a smaller, less complex IT environment.

General Controls

General controls are broad controls over general IT activities, such as security and access, computer operations, and systems development and system changes.

Security and Access

Security and access controls are controls over critical applications, supporting databases, and networks that help ensure that access to applications and data is restricted to authorized personnel.

In a small, less complex IT environment, security administration is likely to be centralized and policies and procedures might be documented informally. A small number of people or a single individual typically supports security administration and monitoring on a part-time basis. Controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data, and applications tend to be

In gathering evidence to support this evaluation, the auditor could hold discussions with both management and the outside professional, perhaps while obtaining an understanding of the period-end financial reporting process. The auditor also could examine documentation that provides support for management's oversight of the outside professional.^{4/}

Example 6-1 – Assistance from Outside Professionals

Scenario: A small developer of analytical software products does not have an individual with strong tax accounting expertise on staff. To support the CFO, who with a basic knowledge of tax accounting prepares a preliminary income tax provision, the company retains a third-party accounting firm (not its auditor) to review the provision. Management is satisfied that the third-party accounting firm has the proper skills and staff assigned to do this work. After the necessary changes are made pursuant to the accounting firm's review, the company's CFO reviews the tax provision and compares the results to expectations based on past periods, budgets, and knowledge of business operations.^{5/}

Audit Approach: The auditor observes that management identifies risks to financial reporting related to accounting for income taxes and engages a qualified professional to provide technical assistance. Further, the auditor inspects the engagement letter, other correspondence between the company and the third-party firm, and the tax schedules and other information produced by the third-party firm. The auditor also evaluates the controls over the completeness and accuracy of the information furnished by the company to the third-party firm. The auditor also assesses whether the third-party accounting firm has the proper skills and staff assigned to do this work.

^{4/} Refer to Chapter 7 for discussion of how the auditor can obtain sufficient evidence when less formal documentation is available.

^{5/} Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 34.

Example 7-1 – Obtaining Information about Processes and Controls

Scenario: A small manufacturer in the electronics industry periodically makes large purchases of specialty components. The company has established procedures covering the initiation, authorization, and recording of these purchases, although the company has not developed an in-depth policies and procedures manual. The company's procedures provide for completion of a form that describes the product requirements and payment terms and indicates how to record the purchase. The forms are reviewed and approved by the CEO and CFO before the purchase is executed. When the goods are received, they are matched with the purchase form and accounted for as indicated on the form.

Audit Approach: The auditor inspects a copy of a completed purchase form and related documentation to obtain an initial understanding of the flow of the purchase transactions. She follows up with inquiries of personnel involved in the process of authorizing, sending, and accounting for the purchases and traces the recording of the transactions through the accounting system. She summarizes her understanding of the transaction flow in a memo and includes a copy of a purchase form in the workpapers. The auditor uses her understanding of the purchase process to plan and perform tests of selected controls over the purchases.

Example 7-2 – Obtaining Evidence about Operating Effectiveness of Controls

Scenario: An important control that management relies on with respect to the period-end financial reporting process is the CFO's review of the quarterly financial statements prepared by the controller. The CFO does not create separate documentation of her review but does retain copies of the financial statements with her handwritten notes and other markings for reference purposes. She sends her review comments to the controller via email, and the company's email system retains the email messages. If errors are identified, the controller prepares adjusting entries, which are approved by the CFO.

Each quarter, the CFO and controller prepare and present to the audit committee a financial package, explaining significant trends in the company's financial condition, operating results, and cash flows, as well as comparisons to budgeted amounts and comparable prior periods.

Audit Approach: The auditor can draw upon multiple sources of audit evidence to evaluate whether the control is in place and operating effectively to detect errors in the period-end financial reporting process. He can make inquiries of the CFO to obtain an understanding of the frequency, nature, timing, and level of precision^{7/} of the CFO's review. He can corroborate this understanding and evaluate the operating effectiveness of the review by, for selected items, inspecting copies of the reviewed drafts of the financial statements, reviewing comments sent to the controller, and reviewing adjusting entries and supporting information. He can also talk to other employees to find out if the CFO contacts them to ask questions, what types of questions are asked, and how those questions are resolved. In addition, he can read the information in the financial package delivered to the audit committee and might observe the CFO's financial review with the audit committee, if the auditor attends the meetings in connection with the audit.

^{7/} Level of precision is discussed in more detail in Chapter 2.

Example 8-2 illustrates a situation in which the auditor is unable to obtain sufficient evidence to express an opinion on internal control.

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.^{6/}

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.

^{6/} Chapter 7 discusses financial reporting competencies in more detail, including approaches that smaller, less complex companies might take to enhance their financial reporting competencies.

Example 8-2 –Lack of Sufficient Audit Evidence

Scenario: A development stage company is devoted exclusively to research and development for a new product and currently generates no revenue. The financial staff consists of a CFO and accounting clerk. The company's principal accounting records consist of a checkbook and payroll records, and the company has no documentation of policies and procedures. Most of its controls are undocumented supervisory checks by the CFO.

Late in the fourth quarter, a management dispute results in the resignation of the CFO and termination of the accounting clerk. Management hires an accountant on a temporary contract basis to prepare financial statements from the company's existing records and to help the company establish appropriate controls over its financial reporting functions. However, most of these controls were implemented near or shortly after year-end.

Audit Approach: As the auditor begins trying to obtain an understanding of the company's internal control and evaluate entity-level controls, she notes that there is minimal information available about the controls that existed at year-end. Because of the turnover in financial reporting personnel, the auditor is unable to perform inquiries, observations, or other procedures to understand the flow of transactions and related controls in significant processes. The auditor identifies some material weaknesses, but she determines that the lack of evidence results in a scope limitation because she cannot obtain reasonable assurance that all of the existing material weaknesses are identified.

Accordingly, the auditor ceases further audit procedures in the audit of internal control. The auditor's report on internal control contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses that she identified.

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ITEM 7. FINANCIAL STATEMENTS

Our financial statements appear at the end of this report beginning with the Index to Financial Statements on page F-1 of this report.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no disagreements with auditors for any and all of the fiscal years hereby presented.

ITEM 8A. CONTROLS AND PROCEDURES

Management's Report on Assessment of Internal Control Over Financial Reporting

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As of December 2005, the Company carried out an evaluation, with the participation of management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the disclosure controls and procedures pursuant to the Exchange Act Rule 13a-15(b). Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of December 31, 2005 because of the material weaknesses disclosed below in "Management's Report on Internal Control over Financial Reporting."

In light of these material weaknesses, the Company performs additional analyses and other pre and post-closing procedures to ensure that our consolidated financial statements are presented fairly in all material respects in accordance with generally accepted accounting principles in the United States. These procedures include monthly business reviews led by our Chief Executive Officer and monthly operating and financial statement reviews by various levels of our management team, including our executive officers. Accordingly, management believes that the consolidated financial statements and schedules included in this Form 10-KSB fairly present in all material respects our financial position, results of operations and cash flows for the periods presented.

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rule 13a-15(f). The Company's internal controls over financial reporting are designed to provide reasonable assurance concerning the reliability of

financial data used in the preparation of our financial statements. All internal control systems, no matter how well designed, have inherent limitations and may not prevent or detect misstatements. Controls considered to be operating effectively in one period may become inadequate in future periods because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 using the criteria described in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. As a result of our assessment, Management has identified one material weakness, as described below, and therefore has concluded that our internal controls over financial reporting were not effective as of December 31, 2006.

A material weakness is defined within the Public Company Accounting Oversight Board's Auditing Standard No. 2 as a control deficiency or combination of control deficiencies that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

In the process of its assessment, our management identified the following material weaknesses in our internal control over financial reporting:

1. Accounting and Finance Personnel Weaknesses --The operation of the Chinese subsidiaries is in China, hence the presentation of their financial statements does not fully comply with the USGAAP. The Company had insufficient resources to perform the accounting and financial reporting functions and such resources lacked the appropriate level of accounting knowledge, experience and training in the application of accounting principles generally accepted in the United States of America and were inadequately supervised. The lack of sufficient and adequately trained accounting and finance personnel resulted in an ineffective segregation of duties relative to key financial reporting functions.

Since December 2005, the Company has tested the internal control structure and has identified several controls, including those controls listed above, as material weaknesses that require further remediation. The Company will continue the implementation of policies, processes and procedures regarding the review of complex, non-routine transactions and the hiring of additional accounting personnel.

Management believes that the controls and procedures will continue to improve as a result of the further implementation of these measures. The Company's management has identified the steps necessary to address the material weaknesses existing as of 2006 described above, as follows:

1. Hiring additional accounting and operations personnel and engaging outside contractors with technical accounting expertise, as needed, and reorganizing the accounting and finance department to ensure that accounting personnel with adequate experience, skills and knowledge relating to complex, non-routine transactions are directly involved in the review and accounting evaluation of our complex, non-routine transactions;
2. Involving both internal accounting and operations personnel and

outside contractors with technical accounting expertise, as needed, early in the evaluation of a complex, non-routine transaction to obtain additional guidance as to the application of generally accepted accounting principles to such a proposed transaction;

3. Documenting to standards established by senior accounting personnel and the principal accounting officer the review, analysis and related conclusions with respect to complex, non-routine transactions; and
4. Requiring senior accounting personnel and the principal accounting officer to review complex, non-routine transactions to evaluate and approve the accounting treatment for such transactions.
5. Interviewing prospective new Directors for our Board including a member who is appropriately credentialed as a financial expert with a goal to establish both an Audit and Compensation committee as well as sufficient independent Directors.
6. Evaluating the internal audit function in relation to the Company's financial resources and requirements.

The Securities and Exchange Commission, or the SEC, as required by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring every public company to include a management report on such company's internal controls over financial reporting and we are required to be compliant with Section 404 by July 2007. The Company will begin to execute the remediation plans identified above in the first fiscal quarter of 2006 and will attempt to be compliant with Section 404 by July 2007.

There was no change in our internal control over financial reporting during the year ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting, other than the remediation measures which are described above.