



CPCAF Alert #107 – June 16, 2006

DEAR CENTER MEMBERS

Highlights of the PCAOB's June 2006 Standing Advisory Group Meeting

The Public Company Accounting Oversight Board (PCAOB or the Board) held its Standing Advisory Group (SAG) meeting on June 12-13, 2006 in Washington, DC. The [SAG](#) is composed of 31 people representing the auditing profession, public companies, investors, and others and was convened by the Board to advise them on the establishment of auditing and related professional practice standards.

During this meeting, the SAG held discussions on the following topics:

- PCAOB's activities regarding Section 404 and Auditing Standard No. 2 (AS 2)
- Panel Discussion – Implementation of Section 404 and AS 2 as they relate to company-level controls and the auditor's involvement in management's assessment
- Panel Discussion – The Research Synthesis Program – research related to auditing fair value and auditor's risk assessments
- Panel Discussion – Implications of Internal Control Over Financial Reporting – Data and Analysis
- Emerging Issues – Stock Options Backdating

PCAOB's Activities – Section 404 and AS 2

Tom Ray, PCAOB's Chief Auditor and Director of Professional Standards, discussed their activities regarding Section 404 and AS 2 which included the May 17th announcement of their four-point plan. The PCAOB plans to undertake the following four initiatives:

1. Amend AS 2.
2. Reinforce auditor efficiency through PCAOB inspections.
3. Facilitate the development of guidance and education for auditors of small public companies.
4. Continuing PCAOB Forums on auditing in the small business environment.

Mr. Ray also indicated that the SEC announced actions it plans to take which include the following:

1. Guidance for companies.
2. SEC oversight of the revisions to AS 2.
3. SEC oversight of PCAOB's inspection program.
4. Extension of the compliance date for non-accelerated filers.

Mr. Ray specifically described the amendments to AS 2 the staff is contemplating in their recommendations to the Board and sought feedback from the SAG. Changes they are considering include:

- ***Incorporating key concepts and direction into AS 2 from previous guidance and clarifications; in particular the guidance issued on May 16, 2005 to ensure that the auditor's primary focus is on areas that pose higher risk of fraud or material error.***

May 16, 2005 PCAOB's policy statement included the following:

- Auditors should integrate their audits;
- Exercise judgment to tailor their audit plans to the risks facing individual audit clients instead of using standardized checklists;
- Use a top-down approach that begins with company-level controls to identify for further testing only those accounts and processes that are relevant to internal control over financial reporting;
- Use the risk assessment required by the standard to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;
- Take advantage of the significant flexibility the standard allows to use the work of others; and
- Engage in direct and timely communication with audit clients.

November 30, 2005 PCAOB issued a report on the initial implementation of AS 2, which reaffirmed and amplified the guidance issued on May 16, 2005 on effective and efficient implementation of the standard.

Mr. Ray indicated that the PCAOB has heard feedback from issuers and others including

participants at the May 10, 2006 roundtable that indicated that the full benefits of this guidance in terms of changing auditor behavior would not be seen unless it is reflected in the rule text itself. Accordingly, Mr. Ray indicated that the PCAOB believes that AS 2 will be strengthened by incorporating these key concepts and direction directly into AS 2.

In addition, with respect to the PCAOB Staff's question and answer (Qs and As) guidance, they plan to incorporate certain key concepts and direction from those Qs and As into AS 2 and eliminate those that are obsolete. They plan to retain the remainder as staff guidance. Areas that are planned to be included into AS 2 include the question and answer on rollforward testing and benchmarking.

- ***To clarify the auditor's role, if any, with respect to the evaluation process a company uses to reach its own conclusion about the effectiveness of company controls.***

The PCAOB scheduled a panel discussion during this SAG meeting (see below) to pursue how the PCAOB might clarify the auditor's role in this area.

- ***To clarify the definitions of significant deficiency and material weakness in internal control.***

The Board clarified, in its November 30, 2005 report, that the term "more than remote" which appears in the standard's definition of significant deficiency and material weakness means "at least reasonably possible." The staff will propose to revise the definitions to incorporate the term "reasonably possible" instead of "more than remote." They also plan to eliminate use of the term significant deficiency within the definition of material weakness because use of that term within the definition of material weakness has caused some confusion.

In addition, they plan to emphasize that neither the detection of significant deficiencies nor interim materiality should drive the scope of the work. Rather the auditor should use annual materiality considerations with the objective of obtaining reasonable assurance with regard to the detection of deficiencies that when aggregated with other deficiencies would represent material weaknesses.

- ***Reconsidering the "strong indicators of material weakness" to allow for more judgment in determining whether a deficiency exists.***

The PCAOB plans to retain the listing of strong indicators of a material weakness but to modify the construct such that they are not, by virtue of their existence, automatically significant deficiencies. This will permit more judgment in determining whether there are control deficiencies.

- ***Guiding auditors to increase their use of the work of others where appropriate.***

The PCAOB plans to reflect the clarifications noted in the May 16, 2005 Board policy statement and staff's questions and answers guidance. This will include an important clarification that was made which indicated that the auditor's evaluation as to whether he/she had obtained the principal evidence supporting his/her opinion. The Board stated that the auditor's evaluation of whether they had obtained the principal evidence was "primarily

qualitative.” This clarification was coupled with an explanation of how AS 2 permits auditors to use the work of others in a way that corresponds directly with the auditor’s assessment of the risk associated with the risk of particular controls.

In addition, the PCAOB plans to provide for even more flexibility in using the work of others. For example, existing AS 2 does not permit the auditor to use the work of others on controls in the control environment. The PCAOB staff plan to recommend that the Board permit auditors to use the work of others on controls in the control environment.

- ***Clarifying materiality and scoping decisions.***

The PCAOB plans to clarify that materiality is the same in relation to the financial statements and in an audit of internal control over financial reporting. They also plan to clarify that the application of materiality at the account level is the same as the concept of tolerable misstatement in a financial statement audit. Said differently, while materiality used to plan tests at the account level is less than the materiality at the financial statement level, it is not the same thing as what would be material to the account itself.

They plan to clarify that significant accounts should be the same for the audit of the financial statements and the audit of internal control over financial reporting.

- ***Emphasizing the integration of the audit of internal control with the audit of the financial statements.***

The PCAOB plans to incorporate key direction from the May 16, 2005 guidance into the standard. This includes stating in the standard itself that the auditor should design his/her testing of controls to accomplish the objectives of both audits simultaneously.

Other clarifications, for example, that significant accounts should be the same for the two audits, are also intended to emphasize integration.

- ***Allowing for and promoting auditor’s use of experience gained in previous years’ audits to focus and make most efficient the work in subsequent years.***

The PCAOB plans to add a section to AS 2 for special considerations for subsequent year audits. They plan to state in the standard that in some years some controls may not need to be tested beyond a walkthrough.

The PCAOB does not plan to amend AS 2 in the following areas:

- Guidance on independence considerations;
- Performing walkthroughs;
- Evaluating the effectiveness of audit committees; and
- Auditor’s responsibilities for evaluating management’s certification disclosures.

Panel Discussion – Implementation of Section 404 and AS 2

The SAG discussed two significant topics for possible amendments to AS 2 – the function of company-level controls in the auditor’s evaluation of internal control over financial reporting and the role of the auditor in evaluating the process that management uses to reach its own conclusion about the effectiveness of the company’s controls. Panel participants included: Craig Crawford, KPMG LLP, James DeLoach, Protivity Inc., Dan Montgomery, Ernst & Young LLP, and Pam Prior, Tasty Baking Company. (Click on the respective link to view the [briefing paper](#) on this topic.):

- **Company-Level Controls** – The panelists were asked to address the following matters:
 - How auditors and companies have linked company-level controls to the underlying processes and transactions and the resulting changes to the testing that otherwise would have been performed on lower-level controls;
 - Whether additional guidance would encourage auditors to rely more on company-level controls, when appropriate;
 - Whether a more precise definition of company-level controls might assist auditors and management in their duties;
 - Whether the principle in AS 2 that the testing of company-level controls alone is not sufficient for the purposes of expressing an audit opinion on the effectiveness of internal control over financial reporting is sound; and
 - Whether (and, if so, how) the auditor’s evaluation of company-level controls should affect the auditor’s ability to alternate testing of process and transaction level controls.

- **Auditor’s Involvement in Management’s Assessment of Internal Control** – The panelists were asked to address the following matters:
 - To what extent the auditor needs to understand management’s assessment process to make decisions about the following:
 - Whether management, as required by the SEC’s rules, has a basis for its conclusion
 - How to best make use of the work of others
 - How to make preliminary risk assessments;
 - The auditor’s role in determining whether management’s documentation of the company’s assessment of internal control over financial reporting is adequate;
 - Whether the adequacy of management’s assessment process should continue to be a necessary condition for the auditor to be able to form an opinion on the effectiveness of internal control over financial reporting;
 - Whether the auditor can obtain sufficient evidence to form an opinion about the effectiveness of internal control over financial reporting without regard to the adequacy of management’s assessment process; and

- Whether the auditor's opinion on management's assessment provides investors with additional useful information, beyond the information contained in the auditor's opinion on the effectiveness of internal control.

Panel Discussion – The Research Synthesis Program

A panel of academic auditing researchers discussed the Research Synthesis Program. The Board's Office of Chief Auditor has worked with the Auditing Section of the American Accounting Association (AAA) to initiate this program, which is designed to provide a synthesis of existing relevant research for selected PCAOB standards projects. The goal of the Research Synthesis Program is to accumulate existing research findings that are relevant to issues that the PCAOB may address in its standards. Academic researchers work in teams to prepare research syntheses related to standards-setting topics discussed with the SAG. Even though these teams are independent of the PCAOB and the PCAOB does not endorse or approve their work, the program is designed to be helpful to the PCAOB in formulating appropriate standards. They are also designed to be helpful to accounting and auditing researchers, educators, auditors, students, and others who have an interest in auditing or its economic and societal impact.

During the SAG meeting, the President of the Auditing Section of the AAA provided a brief overview of the Research Synthesis Program and members of two of the research synthesis teams – Auditor Risk Assessment and Audits of Fair Value – briefly described the nature and results of their research synthesis projects. The panel participants were Robert Allen, University of Utah, Mark Beasley, North Carolina State University, and Roger Martin, University of Virginia. Additional information about the research synthesis teams is available through the AAA's Auditing Section Web site and can be accessed at the following link: <http://aaahq.org/audit/index.htm>.

The [briefing paper](#) includes a list of the nine projects by research topic as well as the project assignments, team leaders and university affiliations.

Panel Discussion – Implications of Internal Control Over Financial Reporting

A panel of individuals discussed their compilations of data on corporate disclosures about internal control over financial reporting and the implications of these results. The two panel participants were Mark Cheffers, Audit Analytics, and Terry Baldwin, Glass Lewis & Company.

The panelists were asked to address the following matters (access [briefing paper](#)):

- The nature of identified material weaknesses, including areas of frequent occurrence and accounting implications;
- How disclosures related to internal control over financial reporting differ by the size of companies' revenue and market capitalization; and

- How audits of internal control over financial reporting have affected the auditor's ability to detect material misstatements, caused by either error or fraud, in the financial statements.

View Audit Analytics [slides](#) presented to the SAG.

View the Glass Lewis & Company Restatements Trend Alert dated March 2, 2006: [Getting it Wrong the First Time](#).

Emerging Issues – Stock Options Backdating

Mr. Ray indicated that two SAG members had requested that the group discuss the recent press on issues surrounding backdating of stock options. He noted that Section 403 of the Sarbanes-Oxley Act of 2002 changed the timing of the reporting of stock options from 45 days to 2 days and requested the group to provide feedback on whether this change has resolved the issue or whether there continues to be issues related to this matter. He also inquired for feedback on what the SAG believes auditors should be doing going forward with regard to any of those issues that may continue to exist.

The following are highlights of some of the comments made by the SAG members and observers of the group regarding this issue:

- It is very early in the process. There are a lot of analytics but not a lot of facts.
- Companies with stock options can be put into two buckets: one for companies that are in forensic mode; and one bucket for companies to ensure this is not going to happen going forward.
- Auditors review a number of legal documents in the course of an audit. Are auditors now required to question the integrity of the legal documents that are given to them? If that is the case, it should not stop with stock options.
- One of the questions being asked by the public, investors, and the press about this is where were the gatekeepers who are the lawyers and the auditors? The Board should be asking that question. There is also an issue about inspection and enforcement that the Board needs to deal with. What can we learn from the fact that this occurred, particularly, to some degree post-Sarbanes-Oxley. What does it tell us about what auditors should be looking for?
- This is not an emerging issue; it is a significant issue. The Board needs to act very timely and quickly on this to ensure that the gatekeepers (the auditors in this case) are doing what they need to do. A number of companies are filing their Form 4's late and hopefully the SEC will address. The Board needs to come out with quick guidance to the auditors similar to how the Auditing Standards Board issues practice alerts and does so on a very timely basis giving auditors direction on what they should be doing. Corporate boards also appear to have been asleep at the wheel.

- We have been hearing a lot recently that auditors are getting into the “nitty gritty too much.” This is an example of “nitty gritty” where perhaps executives and others would not want the auditors getting down into the details and perhaps the auditors haven’t gotten into the nitty gritty consistent with what people around the table (i.e., SAG) have said; “we want the auditors out of the nitty gritty.” “Here is a classic case where the “nitty gritty” and perhaps the auditors did exactly what you asked them to do and now there is a problem with that.”
- Designing internal controls to prevent this type of thing from happening is a very difficult thing to do. Unless you are willing to get into the details on these (stock options) and other examples of these kinds of things, we are going to have a problem.
- Company-level controls are not going to come close to capturing issues of this sort.
- Options at a company are very significant and are not considered “nitty gritty” items. Corporate boards, as well as the auditors, should be all over this. This is a major miss on both sides.
- It is not just stock options – it is any stock based compensation where there is a degree of judgment when the stock is granted and the agreement is signed. Some cases involve more judgment especially in situations when the agreement is not yet signed and the date is questionable. The Board should consider an audit alert for practitioners.
- There is a danger that we are lumping together all issues related to the granting of stock options. The real backdating cases of stock options are intentional lies. There are also situations where there is a true question of judgment. There is concern that some legitimate issues will get swept up in the rush to judge those who backdated. Not all questions of grant dates are created equal.
- There needs to be some accountability by the corporate boards including compensation committees as well as in house and external counsel. For the spring loading cases, it will be difficult to detect in large multi-national companies where a number of press releases are being issued.
- The SEC staff should consider whether or not there should be a self-reporting mechanism so that we do not have a “Chinese torture” situation. The SEC should also look to enforce late filings of the Form 4’s.

The SAG meeting is available via archived audio web cast and can be accessed at the following link: http://www.pcaobus.org/News_and_Events/Webcasts.aspx#37. The complete [agenda and briefing papers](#) for this SAG meeting can be accessed by clicking on the respective link.

For information regarding past SAG meetings, visit the member’s only section of the [Center for Public Company Audit Firms – PCAOB Standing Advisory Group Web Page](#) by clicking on the respective link.

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