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Update From the PCAOB

2007 NATIONAL DIRECTORS INSTITUTE

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At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "Update from the PCAOB" was a featured breakout session focusing on a number of issues relating to the public company audit process. The discussion focused on items that might be of interest to audit committee members and directors of public companies. The panel prefaced the presentation with the disclaimer that the views expressed by the panel members are solely their own and not necessarily those of the Public Company Accounting Oversight Board (PCAOB), its members or its staff. Daniel L. Goelzer, PCAOB board member, and Jarett Decker, Deputy Director, Chief Trial Counsel, served on the panel.

Section 404 of the Sarbanes Oxley Act

The panel noted that although Section 404 of the Sarbanes Oxley Act (SOX) is a rather brief portion of the Act, when measured by the number of words, the requirements flowing from Section 404 have generated a tremendous amount of controversy. The direct average costs for compliance with Section 404 vary by the size of company, but the panel noted that, according to a survey of CRA International, on average, large public companies spent $8.5 million dollars and smaller public companies spent $1.2 million dollars in 2005. Costs fell substantially in 2006. However, the panel also noted that two recent reports analyzing the competitiveness of the U.S. capital markets have not recommended the repeal of Section 404. In addition, the panel cited the facts that one in twelve public companies restated certain of their financial results in 2005 with that number increasing to one in ten in 2006 as evidence of the need for a thorough review and certification of internal control systems at U.S. public companies.

Although many argue that there are significant benefits of Section 404, the Board has moved to improve auditors' implementation of Section 404. Among the PCAOB initiatives to improve Section 404 implementation is the proposed revision of Auditing Standard No. 2. The proposed revisions are designed to focus the audit of internal controls on the most important matters, by emphasizing a risk-based, top-down approach. The proposal is also intended to eliminate procedures unnecessary to achieve the intended benefits, such as removing the requirement that the auditor evaluate management's process. In addition, under the proposal, auditors would be given more flexibility to rely on the work of a public company's internal audit function. The proposal also provides direction on how to scale the audit process to the size and complexity of a particular company. Finally, the panel pointed out that the proposed standard would simplify the text of Auditing Standard No. 2, by, among other things, revising the definition of key terms, such as material weakness and significant deficiency. In particular, "more than remote" would be replaced by "reasonably possible."

Since the proposal of the revisions, the PCAOB has received approximately 160 comments. Some of the comments expressed concerns with the concept of risk-based auditing and the likelihood that such a revision would lead to a less thorough evaluation of accounting processes than the methods which are currently in place. Among the other comments were suggestions for a quantitative measure of materiality, critiques noting the inconsistencies between the PCAOB proposal and the SEC's proposal on management guidance, and requests for a discussion of processes or methods that should not be used by auditors in addition to descriptions of what auditors should be doing. The panel noted that the PCAOB is working toward finalizing a new standard in the late spring or early summer of 2007.

Competitiveness of the U.S. Capital Markets

The panel next focused on the concerns that the U.S. capital markets may be losing a certain degree of their competitiveness due to the increase in capital market regulation. In response to these concerns, the panel noted that the decrease in the number of initial public offerings, which has been cited by some critics of the Sarbanes-Oxley Act (SOX) as evidence of the its negative effects on the U.S. capital markets, began prior to the passage of the Act. The panel also noted that the rise of free capitalist markets in other countries has given local companies seeking to raise capital additional options when choosing where to raise funds. Finally, the panel noted that underwriter fees in the United States are approximately twice as high as similar fees charged to issuers in Europe.

Role of the PCAOB Relative to the SEC

Commonly, the SEC Enforcement Division becomes involved in reviewing auditing practices after a serious financial fraud or misstatement has taken place. The PCAOB, in contrast, may be involved in audit evaluations even absent a financial misstatement or fraud. The PCAOB employs several hundred inspectors who evaluate the methods and processes used by auditors who conduct public company audits. These inspections are done once every year for audit firms that audit more than 100 public companies per year, and at least once every three years for firms auditing 100 or fewer public companies per year. In the inspection process, the PCAOB intends to focus its efforts on the audits that pose the greatest risk of failing to uncover material financial misstatements. Under the "supervisory model of regulation," most deficiencies in audit practices that are uncovered are handled through the process of inspections and remediation.

However, the PCAOB Division of Enforcement and Investigations need not limit its investigations to instances where a serious financial fraud or misstatement has taken place. Rather, the Division has authority to investigate instances where, although the financial statements may have been fairly presented, the auditors have seriously departed from auditing standards in testing the information contained in those financial statements. Primarily through its Inspections program, but also through the Division of Enforcement and Investigations, the PCAOB has important tools to address breakdowns in the audit process, regardless of whether they resulted in the kind of fraud or misstatement that in the past have commonly been the backdrop for SEC enforcement actions against auditors.

PCAOB Inspections and the Audit Committee

The panel then discussed what actions the audit committee of a public company might wish to take with respect to PCAOB inspections. Most audit committees want to be informed by the audit firm whether their audit has been selected by the PCAOB for review. If so, the audit committee may want to have the auditors identify and describe any issues raised in comments which may have been issued by PCAOB with respect to their review of the audit.

The panel also discussed the significance of the reports issued by the PCAOB. The listing standards of the New York Stock Exchange require that listed companies be informed by their auditors of the results of any peer review or other professional inspection related to the company's audit. In this respect, audit committees should ascertain whether any of the information contained in the non-public portions of the particular audit firm's inspection reports affected any engagements with the company. The public portions of the reports are not intended to provide a means for evaluating a firm's audit work quality.

PCAOB Enforcement

In leading off the discussion on fraud detection, the panel discussed the differences in enforcement authority that exist between the PCAOB and the SEC. In particular, the SEC may bring an enforcement action against an auditor or audit firm for intentional misconduct, recklessness or instances of multiple acts of negligence in the performance of their professional duties. In contrast, the PCAOB may bring a disciplinary action whenever there is a violation of the PCAOB standards or a violation of any federal securities laws by auditors.

In a public report issued in January of 2007, the PCAOB described some significant deficiencies in audit practices for uncovering fraud that have been noted by PCAOB inspectors, including the following:

- *A "check the box" mentality.* The PCAOB has cautioned auditors not to rely too heavily on generic audit procedures when a more tailored approach may be required for a particular client. Auditing standards require that a multi-person audit team meet at the outset of the audit to "brainstorm" as to company-specific risks and vulnerabilities with respect to financial errors or fraud. PCAOB inspectors have found instances where such brainstorming sessions were not held, or were held too late to inform the planning and execution of audit procedures.
- *Lack of unpredictability.* PCAOB inspectors have noted failures to incorporate an element of unpredictability in audits from year to year, which can be important for catching problems in financial reporting.
- *Red flag areas.* PCAOB inspectors have found instances where some auditors have failed to focus adequately on related party transactions and other instances where management has displayed unwillingness in correcting known misstatements.

Audit Committees and Outside Auditors

The panel noted that, under SOX, outside auditors' primary relationship should be with the audit committee rather than management, and PCAOB inspections may review auditor conduct to assure that outside auditors are conducting all required communications to enable the audit committee to fulfill its role. One area where communication between an auditor and the audit committee is specifically required is under Section 2.07 of Regulation S-X. Section 2.07 requires that certain matters – e.g., significant alternative accounting treatments and their effects on the financials, unadjusted differences and misstatements – be communicated to the audit committee before an audit report is signed.

Areas for Audit Committee Consideration

The panel flagged three additional areas for audit committee awareness in the upcoming year.

Audit Committee Role in Internal Control Audits. The PCAOB intends to use its inspection program this year to look at whether auditors have done internal control audits in an efficient and effective way. The panel suggested that audit committees may want to discuss this area with their auditors; in particular, audit committees may wish to discuss what is being done to integrate the financial statement and the internal control audits, the extent to which the company is relying for financial statement purposes on the conclusions reached about controls, and the extent to which the auditor concludes it is able to rely on testing performed as part of management's assessment of controls.

Options Backdating. In July 2006, the PCAOB issued Audit Alert No. 1 on how auditors should deal with the risk of options backdating from prior periods. Although the alert does not call for an automatic audit of prior periods in every situation, it provides some guidance to auditors on "red flags" that should be considered and questions that should be asked currently to determine whether additional examination of prior periods is appropriate.

Impact of Auditor Tax Services. In 2005, the PCAOB adopted rules on the impact of tax services provided by auditors, one of which prohibits auditors from performing tax services for executives during the period of engagement or the period being audited. As a result of concerns that this provision may pose an obstacle to a company's ability to change auditors, the PCAOB has suspended application of the portion of this rule that related to the audit period (as opposed to the engagement period) until at least April 30, 2007 and is soliciting comments.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.