Introduction

- Enron and other corporate scandals resulted in the demise of Andersen and passage of the Sarbanes-Oxley Act
- The Act establishes the Public Company Accounting Oversight Board (PCAOB) to provide oversight of auditors of public companies, including establishing auditing and quality control standards

Which of the following companies did not directly contribute to the passage of SOX?

1. Qwest Communications International
2. General Electric
3. Adelphia Communications
4. Worldcom, Inc.
5. HealthSouth Corp.
6. Tyco International

In what year did the Sarbanes Oxley Act pass into law?

1. 1999
2. 2000
3. 2001
4. 2002
5. 2003

Oxley is a representative from Ohio, what state does senator Paul Sarbanes represent?

1. Maryland
2. Ohio
3. Florida
4. Texas
5. California

SOX Act

- Established PCAOB
- Independent auditor regulation
- Audit committee rules
- Corporate governance
- Conflicts of interest
- Controls over financial reporting
- Fines and penalties
- Protection of whistleblowers
What percentage of whistleblowers are women?
1. 15%
2. 25%
3. 60%
4. 95%

Primary SOX Components (Sections)

- 301 Audit committee requirements and whistleblower protection
- 302 Corporate responsibility for Financial reporting (Quarterly reporting)
- 404 Management assessment of internal controls
- 406 Code of ethics
- 409 Real-time disclosures

Which SOX provision has received the most media attention

- 301 Audit committee requirements and whistleblower protection
- 302 Corporate responsibility for Financial reporting (Quarterly reporting)
- 404 Management assessment of internal controls
- 406 Disclose Code of ethics
- 409 Real-time disclosures

SOX Section 302

- Compliance begins after first 404 filing
- Requirements include:
  - Process for management to certify the fair presentation of the financial statements
  - Process for management to adequately identify and report internal control changes
  - Material changes to ICs disclosed to investors

What is the Public Company Accounting Oversight Board (PCAOB)?

1. A publicly-traded company
2. A private sector non-profit corporation
3. A governmental agency
4. No one is sure

PCAOB Mission

Oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.
Public Company Accounting Oversight Board

Key responsibilities of the PCAOB include:
- Registering public accounting firms that audit public company financial statements
- Establishing or adopting auditing, quality control, ethics and independence standards related to audits of public companies
- Conducting inspections of registered audit firms
- Conducting investigations and disciplinary proceedings related to registered accounting firms

PCAOB Standards

1. Auditors’ Reports
2. Audit of Internal Controls Over Financial Reporting
3. Audit Documentation
4. Reporting on Reported Material Weaknesses

SASs considered interim rules

Prohibited Non-audit Services

The Act prohibits the following services, most of which were previously prohibited by the SEC’s rule on auditor independence:

1. Bookkeeping or other services related to the accounting records or financial statements
2. Financial information systems design and implementation
3. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
4. Actuarial services
5. Internal audit outsourcing services
6. Management or human resources functions
7. Broker or dealer, investment adviser, or investment banking services
8. Legal and expert services unrelated to the audit
9. Any other service that the Public Company Accounting Oversight Board (Board) determines, by regulation, is impermissible

Rule 3520 Auditor Independence

A firm and its associated persons should be independent of the firm’s audit clients throughout the audit and professional engagement period. The period encompasses periods covered by the firms’ audit and is also ongoing, spanning from the beginning to the end of the audit relationship.

PCAOB Ethic Rules Primarily on Tax and Contingent Fees

- 3501 Definition of Terms
- 3502 Responsibility Not to Knowingly or Recklessly Contribute to Violations
- 3521 Contingent Fees
- 3522 Tax Transactions
- 3523 Tax Services for Persons in Financial Reporting Oversight Roles
- 3524 Audit Committee Pre-Approval Of Certain Tax Services
- 3526 Written communication to audit committee before initial engagement listing potential independence issues

Additional Independence Provisions

- Audit committee must pre-approve all audit and non-audit services
- Lead audit and review partners must rotate off the audit after five years
- One-year employment “cooling off” period – The audit firm cannot audit a client if its CEO, CFO, chief accounting officer, or person in a similar capacity participated in the audit during the one-year period prior to the initiation of the audit
PC Standard 1: Audit Report
- Standard Audit Report with PCAOB substituted in appropriate places
- Combined report – Financial statements and report on internal controls

SOX Sec 404/PC Standard No. 2/5
- Identify significant deficiency
  - Design or Operation
  - Reasonable possibility
  - Magnitude of potential misstatement
- Determine material weaknesses in internal control system (issue adverse opinion)
  - Fraud by senior management
  - Restatement, auditor discovered material misstatement
  - Ineffective oversight

Differences in Scope of Controls Tested in an Audit of Internal Control and an Audit of Financial Statements
- Internal Controls Over Financial Reporting
- Internal Controls Used to Assess Control Risk Below Maximum
- Controls that must be tested in an audit of internal controls
- Controls that must be tested in an audit of financial statements

PC Standard No. 5
1. Focus the Internal Control Audit on the Most Important Matters
2. Eliminate Procedures that Are Unnecessary to Achieve the Intended Benefits
3. Make the Audit Clearly Scalable to Fit the Size and the Complexity of Any Company
4. Simplify the Text of the Standard

Audit Report on Internal Control
- Auditor must report on management’s assessment of internal control
  - Report is as of the end of the company’s fiscal year
  - Auditor’s report date same as date of auditor’s report on financial statements
- Auditor’s report on internal control can be combined with financial statement audit report or issued separately

Management Certification
- CEO and CFO must certify the annual and quarterly financial statements
  - Management has reviewed the statements
  - The statements contain no untrue material facts or omit a material fact
  - Based on management’s knowledge, the statements are fairly presented
  - Management has evaluated the effectiveness of disclosure controls with 90 days of filing the report
  - Management has disclosed any deficiencies in internal control or fraud to the auditor and audit committee
  - Management has indicated any significant changes in internal controls subsequent to management’s evaluation
PC Standard No. 3: Audit Documentation

- Mandatory retention of audit documentation in sufficient detail to support the auditor’s conclusions for a period of seven years.
- Knowing and willful destruction of audit documentation is a criminal offense subject to fines and imprisonment.
- Documents generally excluded include:
  - Superseded drafts of memos and other records
  - Previous copies of working papers corrected for errors
  - Duplicates of documents
  - Voice-mail messages

Client Acceptance

- SEC final rules make the audit committee “the client”.
  - Audit committee is responsible for auditor appointment, compensation, and oversight, including pre-approval of all audit and non-audit services.
  - Audit committee responsible for resolution of any disagreements between the auditor and management over financial reporting.
- Auditors are required to report the following matters to the audit committee:
  - All critical accounting policies and practices used by management.
  - All material alternative accounting treatments of financial information within GAAP that have been discussed with management.
  - Other material written communications between the accounting firm and management.

Audit Committee Financial “Expert”

- Understands GAAP and financial statements.
- Has the ability to assess the application of principles for estimates, accruals, and reserves.
- Experience preparing, auditing, or evaluating financial statements similar in complexity to the company’s financial statements.
- Understands internal controls and procedures for financial reporting.
- Understands audit committee functions.

PC Standard No. 4

- Auditor engaged to report on previously reported material weakness in ICOFR is now corrected as of a specific date specified by management.
  - Burden on management.
  - Unqualified opinion – evidence of effectiveness of design and operation, weakness no longer exists, no scope limitations.
  - Scope limitation – disclaim or withdraw.
  - No qualified opinions allowed.
  - Still a MW – state so or do not issue a report.

MC 1

- A CPA wishes to determine how various publicly-held companies have complied with the disclosure requirements of a new financial accounting standard. Which of the following information sources would the CPA most likely consult for this information?
  1. AICPA Accounting Trends and Techniques
  2. FASB Technical Bulletins
  3. AICPA Audit and Accounting Manual
  4. FASB Statements of Financial Accounting Concepts