



FSA



Managing Section 404 Costs

Identifying Opportunities for Efficiencies

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Agenda

- Overview of SEC's Final Management Guidance
- Overview of AS 5 as Approved by PCAOB
- Implications of New Guidance
- Open Discussion





Where Are We Today?

- SEC approved Section 404 management guidance on May 23, 2007 and it was posted on June 20, 2007 to the SEC's website
- PCAOB approved its new auditing standard (AS 5) on May 24, 2007 and the SEC approved it in July 2007





Implications of New Guidance: What Has Not Changed

- **For management:**
 - **Requirement to assess and conclude on the effectiveness of ICFR annually**
 - **Requirement to use a framework in evaluating effectiveness of ICFR (such as COSO or another framework)**
 - **Requirement to have reasonable documentation to support assessment**
 - **However, management's determination of what is reasonable documentation could impact the level of additional documentation that the auditor must undertake**
 - **The quarterly Section 302 certification by the CEO and CFO**





Implications of New Guidance: What Has Not Changed – Cont'd

- **For auditors:**
 - **The use of a top-down, risk-based approach**
 - **One audit standard that auditors apply to all companies (although the new standard includes scalability considerations)**
 - **Continuing to identify all significant accounts and disclosures and relevant assertions**
 - **A rotation plan that shifts testing of significant processes between years is not permitted; however knowledge from prior years can be leveraged**
 - **Requirement to prepare and maintain sufficiently complete and detailed audit working papers to support conclusions**
 - **Underlying concepts regarding sufficient evidence to support opinion**





Implications of New Guidance: Areas of Opportunity for Management

- **Management's process is integral to continuous improvement**
 - **Management's approach to implementing the SEC's guidance will affect the audit process**
- **The SEC guidance affords management opportunities to improve and streamline its ICFR processes:**
 - **Risk assessment opportunities**
 - **Enhance risk assessment processes, including fraud risk assessment, to better leverage a risk-based approach**
 - **Enhance anti-fraud programs and controls**





Implications of New Guidance: Areas of Opportunity for Management (cont'd.)

- **Understanding likely sources of misstatement opportunities**
 - **Maintain documentation that the auditor can use when obtaining its understanding of the sources of likely misstatement; i.e., documentation:**
 - **Describing flows of transactions in significant processes**
 - **Noting points at which there is a risk that misstatements could occur**
 - **E.g., management's control objectives match, or are similar, to the auditors**





Implications of New Guidance: Areas of Opportunity for Management (cont'd.)

- **Design of controls opportunities**
 - **Revisit from a top-down, risk-based perspective**
 - **Focus on detective controls; e.g., appropriately designed ELCs and/or at the process level**
 - **Maintain documentation of design in a manner that the auditor can better leverage for its documentation purposes, including process flow documentation**

- **Testing strategies opportunities**
 - **Objectivity, competence, nature, extent, timing, and documentation of testing impacts the auditor's ability to efficiently leverage the use of management's work**

- **Deficiencies tracking opportunities**
 - **Managing and documenting the tracking of deficiencies and classification of unremediated deficiencies**





Key AS 5 Principles Underlying Changes to Audits

- **Allows greater flexibility and places maximum emphasis on auditor judgment**
- **The audit of ICFR is not scoped differently from the financial statements audit (i.e., same level of materiality, same locations selected for testing, etc.)**
- **ICFR opinion is no longer dependent upon assessing adequacy of management's process**
- **All sources of evidence support opinions on both the financial statements and ICFR**



Overall Impact on Audits



- **The impact of AS 5 on integrated audits will vary based on the facts and circumstances of each registrant including:**
 - **The state of ICFR at the registrant**
 - **The degree of controls rationalization the registrant has already undertaken**
 - **The manner in which management applies the SEC's guidance and modifies the design of ICFR and the manner in which management's testing is performed**
- **The impact on overall compliance costs is dependent on a number of factors**
- **As a general point, the new auditing standard provides an opportunity for a reduced auditor effort, particularly in lower risk areas**
- **PCAOB inspections could impact the application of the principles-based approach**





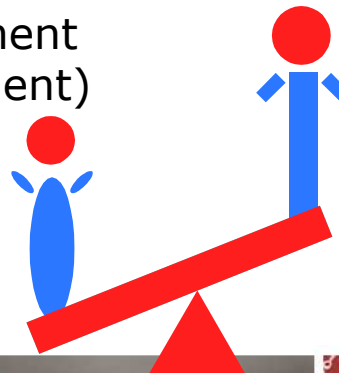
Interplay Between Management's Approach and Auditor's Approach

Management

- Maintains effective ICFR with minimal deficiencies, remediation, retesting
- Competent and objective personnel perform independent testing of all relevant controls and robust documentation of design and operating effectiveness testing is maintained
- Coordinates timing of testing throughout the year with auditor
- Performs robust risk assessment (including fraud risk assessment)

Auditor

- Leverages management's documentation to the maximum; e.g.,
 - Management's risk assessment process
 - Testing documentation
- Uses management's work and reperforms management's testing of design and operating effectiveness of all relevant controls, performed throughout the year
 - Some independent testing of controls that address specific risks



Interplay Between Management's Approach and Auditor's Approach (cont'd.)

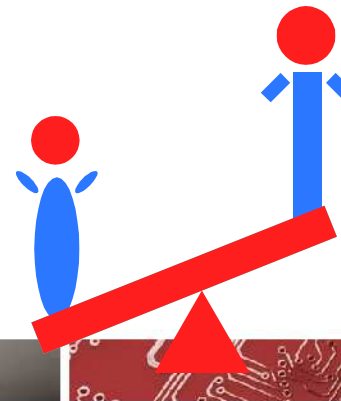
The logo for FSA (Financial Services Authority) features a red square on the left, a vertical grey bar in the middle, and the letters 'FSA' in a stylized red font on the right.

Management

- Entity level components, Financial Close and Reporting Process, General Computer Controls, Business Cycle Controls
 - Understands and identifies likely sources of misstatement due to fraud and error; i.e., identifies relevant control objectives and descriptions are clearly understood and at an appropriate level of detail
 - Identifies/implements effective entity-level detective controls (ELDCs) (i.e., those that operate at an appropriate level of precision) and links controls to relevant objectives
 - Has ELDCs that effectively monitor the results of operations in multi-location environments

Auditor

- Leverages management's documentation to the maximum; e.g.,
 - Flows of transactions and identification of relevant controls
 - Management's control objectives are similar to the auditors
- Identifies fewer low level transactions controls as relevant controls (e.g., controls that operate many times a day)
- Selects fewer locations to visit in a multi-location environment





Recommended Actions for Registrants

- **Generally speaking, Registrants should:**
 - **Read and understand final management guidance**
 - **Determine the impact that the SEC's guidance may have on documentation, testing strategy, and design of ICFR**
 - **Revisit approach from a top-down, risk-based perspective**
 - **Enhance control rationalization as necessary**
 - **Recognize that the approach does not have to mirror that of the auditor**
 - **Focus on reducing effort**
 - **Discuss any revised plans and contemplated changes with the external audit team to help assess how these changes may affect the audit process**





Open Discussion

- Potential Discussion Areas:
 - In what areas do you believe an inordinate amount of time is being incurred (e.g., either a large number controls are being tested and/or testing process is time consuming)?
 - How many locations are considered significant and require testing? Has that changed this year?
 - Are there opportunities to rely upon “Entity Level Controls”?





Thank You





Appendix 1

Overview of SEC's Final Management Guidance





Overview of SEC's Final Management Guidance

Provides Guidance in Four Areas:
1. Identification of risks to reliable financial reporting and the related controls to address those risks
2. Evaluation of the operating effectiveness of controls
3. Reporting the overall results of management's evaluation
4. Documentation

- Guidance became effective in June 2007
- SEC indicated that companies applying new guidance satisfy the Section 404 requirements, but that other effective processes may also be used
- SEC rules now include a "material weakness" definition and will include a "significant deficiency" definition
 - The SEC has proposed and is seeking comment on the significant deficiency definition





Overview of SEC's Final Management Guidance: Key Provisions

Management:

Required to use a framework (such as COSO)

Objective: To identify those controls necessary to address the risk of material misstatement

Consideration of financial reporting risks should include all locations/business units, including a determination whether risks are adequately addressed by central controls

Assessment must be supported by evidential matter that provides reasonable support for conclusions reached, but the form and extent of documentation may vary

May use a combination of direct testing and on-going monitoring activities to obtain evidence regarding effectiveness

Testing approach may differ from that used by the auditor

Should consider interaction of different controls and compensating controls in determining if a deficiency, or combination of deficiencies, is a material weakness





Appendix 2

Overview of AS 5 as Approved by PCAOB





Overview of AS 5 as Approved by PCAOB

AS 5 is Intended to Achieve Four Principles:

- 1. Focus the audit on the matters most important to ICFR**
- 2. Eliminate unnecessary procedures**
- 3. Facilitate scaling the audit for smaller companies**
- 4. Simplify the requirements**



Overview of AS 5 as Approved by PCAOB (cont'd.)



Area	Key Characteristic of AS 5 as Approved by PCAOB
Opinion	Eliminated the requirement for the auditor to report on management's ICFR assessment; report only on ICFR effectiveness
Multi-location scoping	Indicated that selection of locations for multi-location testing should be based on assessed risk, rather than "large portion" coverage
Materiality	Clarified that both the ICFR and financial statement audits should be planned and performed using the same measure of materiality
Knowledge Gained in PY Audits	Allowed for consideration of knowledge gained from previous audits in performing the current year audit



Overview of AS 5 as Approved by PCAOB (cont'd.)



Area	Key Characteristic of AS 5 as Approved by PCAOB
ELCs	Emphasized the importance of a risk-based, top-down approach and the importance of entity level controls (ELCs). Clarifies that ELCs vary in nature/precision
Walkthroughs/ Understanding Likely Sources of Misstatement	Sets forth the objectives that the auditor needs to achieve to understand the likely sources of misstatement; indicates that walkthroughs are likely the most effective way of achieving objectives, but does not explicitly require the performance of walkthroughs
Fraud risk assessment	Encourages integration of the auditor's fraud risk assessment in the evaluation of ICFR
Scalability	Includes scalability guidance throughout the standard

Overview of AS 5 as Approved by PCAOB (cont'd.)



Area	Key Characteristic of AS 5 as Approved by PCAOB
Evaluating Deficiencies	For the definition of material weakness, the term “more than remote likelihood” was replaced with “reasonable possibility”; defines a significant deficiency as “a deficiency, or combination of deficiencies, in ICFR that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting”
	Includes an abbreviated list of material weakness “indicators” with no requirement to consider these indicators as at least significant deficiencies



Overview of AS 5 as Approved by PCAOB (cont'd.)



Area	Key Characteristic of AS 5 as Approved by PCAOB
Use of Work of Others	Work done to understand likely sources of misstatement should be performed by the auditor, or by others under his/her direct supervision
	PCAOB determined that AU sec. 322 provides an appropriate framework for considering the use of the work of others; AS 5 requires auditors to apply the appropriate guidance in AU sec. 322 in the context of an integrated audit (including the evaluation of the competence and objectivity of anyone whose work the auditor plans to use)





Appendix 3

Entity Level Controls





Entity Level Controls (para 23 of AS5)

- **Level 1: Indirect; e.g. control environment, risk assessment, etc.**
 - **Important but do not directly mitigate a potential error**
- **Level 2: Direct but not precise enough alone**
 - **Transaction reviews – may provide some assurance but not at a sufficient level of precision**
 - **Flux analysis – may detect some errors but is not designed to detect all material misstatements**
 - **Comparable to our preliminary analytical procedures – negative assurance**
 - **Detective control may be an effective control but is judged to not be sufficient by itself for that particular risk**
- **Level 3: Direct and precise enough alone**
 - **Would prevent or detect misstatements at a level of precision sufficient to conclude that this control achieves one or more control objectives**
 - **Comparable to auditor’s substantive analytical procedures - positive assurance**





Level 2 or 3 Entity Level Controls

- What types of controls might they be?
 - Could be preventative or detective; e.g.:
 - Analytical reports/procedures (typically detective)
 - Automated monitoring dashboard (may be preventative or detective)
 - Others?





Level 3 Entity Level Controls

- **What form may they take?**
 - **May be very narrow in scope; e.g. a specific analysis related to a specific account/potential error**
 - **May be broad in scope; e.g. financial analysis package that shows actual trends lines, actual to budget/forecast, key performance measures, drill downs into certain accounts, commentary about unusual transactions or variances**
 - **Different parts of the package may be only Level 2 ELCs while other parts may be Level 3 ELCs; e.g.:**
 - **Level 2 examples:**
 - **Flux analysis of revenue actual to budget where budget is not a valid expectation upon which to conclude positively that there are no misstatements**
 - **Trend line of inventory as this typically would not identify misstatements if there were no significant fluctuations**





Level 3 Entity Level Controls – cont'd

- **Level 3 examples:**
 - **A flux analysis of rent expense to budget where budget is a valid expectation; e.g. based on the actual lease provisions (straight-line expense) and there have been no significant new events/changes**
 - **Detailed analysis of prepaid expenses such that the reviewer, with sufficient knowledge of the accounts and therefore a basis for an independent expectation, would identify a material misstatement**

