Jordan Reed is a Managing Director in the Houston office of Protiviti specializing in the execution of Internal Audit and Financial Advisory solutions. Jordan assists both public and private organizations with internal audit planning and execution, and has been involved with all phases of internal control over financial reporting initiatives. Jordan is a frequent speaker on topics including Internal Audit, Sarbanes-Oxley, COSO, emerging technology, and spreadsheet risk.
TOXIC COMBINATIONS
TREADWAY COMMISSION

National Commission on Fraudulent Financial Reporting formed with James C. Treadway, Jr., former SEC Commissioner and General Counsel, Paine Webber as its Chairman – becoming known as the “Treadway Commission” a private-sector initiative, was formed in 1985 to inspect, analyze, and make recommendations on fraudulent corporate financial reporting.

Source: sechistorical.org
Committee Of Sponsoring Organizations of the Treadway Commission

- Formed in 1985 in response to corrupt and unethical business practices in the 1970’s and 80’s
- Voluntary private sector organization
- COSO Internal Control Integrated Framework was developed in 1992
- Used by the majority of companies to evaluate their internal control environment, particularly as it relates to internal controls over financial reporting

COSO Cube (1992 Edition)
DEFINITION OF INTERNAL CONTROL…

A process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Effectiveness and efficiency of operations
2. Reliability of financial reporting
3. Compliance with applicable laws and regulations
FINANCIAL REPORTING
OPERATIONS
COMPLIANCE
COSO 2013

Environment changes…

- Expectations for governance oversight
- Risk and risk-based approaches receive greater attention
- Globalization of markets and operations
- Increased complexity of business and organizational structures
- Use of, and reliance on, evolving technologies
- Demands and complexity in laws, rules, regulations and standards
- Large-scale governance and internal control breakdowns
- Expectations for competencies and accountabilities
- Expectations relating to preventing and detecting fraud

…have driven Framework updates

COSO Cube (2013 Edition)*

DEFINITION OF INTERNAL AUDITING

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”

– Source: The IIA

1. Supports current internal auditing practice environment
2. Fosters ERM
3. Addresses role of internal auditing in governance
KEY POINTS FROM THE CBOK STAKEHOLDER STUDY

Two in three board members believe internal audit should have a more active role in assessing and evaluating the organization’s strategic risks.

Audit committees desire that the CAE and internal audit function:

| Think more broadly and strategically, |
| Move beyond assurance to provide value-added consulting and advisory services, and |
| Continue to deliver to expectations. |

A strong majority of responding CEOs provided similar feedback. 72%
SIX IMPERATIVES FOR INTERNAL AUDIT

These six imperatives for internal audit are based on feedback from members of audit committees regarding expectations of the CAE and the internal audit function.

1. Focus more on strategic risks
2. Think beyond the scope
3. Add more value through consulting
4. Facilitate effective, high-quality communication
5. Elevate stature and perspective
6. Align stakeholder expectations

Source: 2015 CBOK Stakeholder Study
CONTRIBUTING VALUE TO THE ORGANIZATION

To address the six imperatives, we have suggested 15 ways the future auditor contributes value.

**Elevate Stature And Perspective**
14. Reports directly to the audit committee
15. Interacts with directors in relevant nontraditional board settings, as appropriate

**Facilitate Effective, High-Quality Communication**
11. Improves information for decision-making across the organization
12. Expand the emphasis on assurance through effective communication with management and the board
13. Remains vigilant with respect to fraud

**Focus More On Strategic Risks**
1. Thinks more strategically when analyzing risks and framing audit plans
2. Provides early warning on emerging risks

**Think Beyond The Scope**
3. “Connects the dots” when considering enterprise wide implications of audit findings
4. Broadens the focus on operations, compliance and nonfinancial reporting issues
5. Watches for signs of deteriorating risk culture

**Add More Value Through Consulting**
6. Strengthens the lines of defense that make risk management work
7. Collaborates effectively with other independent functions focused on managing risk and compliance
8. Leverages technology-enabled auditing
9. Improves the control structure, including the use of automated controls
10. Advises on improving and streamlining compliance

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ALIGN STAKEHOLDER EXPECTATIONS

The future auditor bears the brunt of the responsibility to bring executive management and business owners in alignment regarding internal audit’s mandate and performance.
STRIKING THE RIGHT BALANCE

Should the CAE implement all 15 of these suggestions? How does the CAE balance taking on new value-added audit initiatives with existing audit priorities?
Face the Future with Confidence
APPENDIX: PCAOB INSPECTION OVERVIEW
The Public Company Accounting Oversight Board (PCAOB) has released several reports over the past year to provide guidance to auditors, Registrants and audit committees addressing the inspection process and its results.

On July 14, the issuer-focused 2016 Staff Inspection Brief was released by the PCAOB to lift the curtain on its plan, scope and objectives for inspections of registered audit firms.

This builds upon the April 2016 Staff Inspection Brief, “Preview of Observations from 2015 Inspections of Audits of Issuers.”
PCAOB INSPECTIONS PROCESS

1. PCAOB inspects registered public accounting firms to assess compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the Securities and Exchange Commission, and professional standards, in connection with the firm’s performance of audits, issuance of audit reports, and related matters involving U.S. companies, other issuers, brokers, and dealers. This in-depth inspection covers:
   - Certain aspects of a limited number of audits performed by the audit firm.
   - Certain elements of the firm’s system of quality control over its audit processes (refer to Appendix E).

2. Nine (9) domestic firms are inspected every year.
   - Six (6) global network firms which audited 99% of total market: BDO, Deloitte, E&Y, Grant Thornton, KPMG, PwC.
   - Three (3) non-affiliate firms: Crowe Horwath, MaloneBailey, McGladrey.

3. The Board makes portions of the reports available to the public; however, certain information is restricted from public disclosure, or its disclosure is delayed.

4. PCAOB issued 219 in 2015 and in 2016 80 through 8/10/16.
2015 INSPECTIONS
DEFCIENCY AREAS HIGHLIGHTED IN THESE REPORTS

- Gaps in evaluating the control procedures performed for **appropriateness against the control objectives**, including whether they addressed GAAP requirements.
- Controls **not identified or tested**, including ITGC and application controls.
- Management Review Controls: Gaps in evaluating design and testing management review controls **precision** including understanding the nature of **review procedures**, and criteria for **follow-up investigation**.
- Testing issues:
  - Didn’t test Information Produced by Entity (IPE).
  - Coverage missed some **transaction streams**.
  - Centralized control coverage not sufficient and **presumption of homogeneous controls** across locations.
  - Failed to update testing for **yearend and Q4 coverage**.
  - Failed to evaluate **SOC gap period** between the SOC report date and company yearend (refer to **Appendix C**).
  - Failed to **sufficiently test compensating ITGC controls** where primary controls failed.
  - **Inappropriate reliance** on others.
- Deficiency analysis:
  - Failed to evaluate the effect of errors identified in substantive testing on control operating effectiveness.
  - Failed to evaluate effects of exceptions on its conclusion.
  - Refer to **Appendix A** for a summary of 2015 findings
KEY TAKEAWAYS

1. The PCAOB inspections process continues to evolve.

2. Accordingly, issuers will likely see new demands this year from their auditors as a result of the shifting of PCAOB focus areas.

3. New financial statement focus areas will generate further scrutiny on additional audit areas and will likely result in more work by management to support the attestation process.

4. It is important that preparers continue to focus on prior inspection areas, as our experience is that nothing ever seems to come off the PCAOB’s list.
KEY TAKEAWAYS

5. Seasoned issuers will have an easier time adjusting, but new public companies will find the bar moved higher on the preparation side, transitioning from an “AICPA audit preparation” mode to the more demanding “PCAOB audit preparation” mode.

6. The PCAOB and SEC continue to question why material weakness disclosures are not preceding financial restatements. It’s becoming a matter of significant concern to both regulators.

7. Expect to see rigorous analysis to source the root cause of proposed adjustments from the financial statement audit, with management being asked to explain why these exceptions, while not always material, are not the reflection of material weakness in ICFR.
2016 INSPECTIONS
2016 INSPECTION OVERVIEW

Cover 2016 audits, with inspectors concentrating on audit areas that present auditing challenges with significant audit risk, including risks of material misstatement in the financial statements, as well as areas of recurring audit deficiencies both within and across firms.

As such, these risk-based selections are not representative of the overall population of the firms’ audit portfolios.

The PCAOB plans to conduct inspections of 205 firms, including 10 U.S. firms that audited more than 100 issuers in 2015.
This year’s inspections will continue to place attention on the most frequent audit deficiencies in three broad areas:

1. Internal control over financial reporting
2. Assessing and responding to risks of material misstatement
3. Auditing accounting estimates, including fair value measurements
FOCUS AREA #1 – INTERNAL CONTROL OVER FINANCIAL REPORTING (ICFR)

PCAOB inspections will evaluate the **sufficiency of auditors’ procedures performed** to identify, test and evaluate controls that address the auditors’ assessed risk of material misstatement, and auditors’ testing of management review controls.
FOCUS AREA #2 – RISK OF MATERIAL MISSTATEMENT

Conformance to the engagement quality review standard will be assessed to **connect the dots between failures to link significant risks of material misstatement to the engagement quality review process**. Specific areas of inspections focus include:

1. **The sufficiency of testing** the design and operating effectiveness of controls to support the auditors’ planned level of control reliance, including testing the controls over the **accuracy and completeness** of system-generated data and reports;

2. Whether the **substantive procedures**, including tests of details, were specifically responsive to fraud risks and other significant risks identified;

3. The evaluation of the presentation of the financial statements, including the accuracy and completeness of the **disclosures for those focus areas** including the section (refer to **Appendix D**); and

4. The evaluation of **relevant audit evidence** that appeared to contradict certain assertions in the financial statements.
Reviews will cover auditors’ procedures performed to understand how estimates were developed, testing of data used in the estimate, and evaluation of significant assumptions.

**Fair value measurements** and other accounting estimates involve the potential for management bias and the PCAOB has raised concerns about a lack of professional skepticism by auditors when testing these estimates.

Inspection reports have historically found issues with auditors not sufficiently evaluating or considering contradictory/inconsistent information that could impact the valuation of estimates.
## Usual Focus Areas for Financial Statements Will Remain

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<thead>
<tr>
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<th>Area</th>
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<tbody>
<tr>
<td>1</td>
<td>Revenue</td>
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<td>2</td>
<td>Receivables</td>
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<td>3</td>
<td>Inventory</td>
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<tr>
<td>4</td>
<td>Allowance for Loan Losses</td>
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<tr>
<td>5</td>
<td>Non-Financial Assets (assets acquired in Business Combinations, including Goodwill and other Intangibles/Long-lived Assets)</td>
</tr>
<tr>
<td>6</td>
<td>Financial instruments</td>
</tr>
<tr>
<td>7</td>
<td>Benefit-Related Liabilities</td>
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<tr>
<td>8</td>
<td>Income Taxes</td>
</tr>
<tr>
<td>9</td>
<td>Equity Transactions</td>
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</tbody>
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# Newer Areas of Emphasis for the Inspection Work Stream

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<thead>
<tr>
<th></th>
<th>Evaluation of Segment Identification and Disclosures (including conformity with the applicable financial reporting framework)</th>
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<tbody>
<tr>
<td>2</td>
<td>Consideration of the entity’s ability to continue as a going concern</td>
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<tr>
<td>3</td>
<td>Evaluation of Income Tax Accounting and Disclosures</td>
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ASSESSMENT OF ECONOMIC TRENDS

Economic trends will be assessed during the inspection of individual audits to determine the impact on financial statement accounts and disclosures.

In particular, the following areas will be considered:

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<tbody>
<tr>
<td>1</td>
<td>Effects of strengthening U.S. dollar on multinational issuers</td>
<td>2</td>
<td>Increasing merger and acquisition activity</td>
</tr>
<tr>
<td>3</td>
<td>Search for high-yielding investment returns in a low interest rate environment</td>
<td>4</td>
<td>Effects of the continued fluctuations in oil and natural gas prices</td>
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