Regulation

Serving the investing public through transparent information resulting from high-quality financial reporting standards, developed in an independent, private-sector, open due process.
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- TEXAS STATE BOARD OF PUBLIC ACCOUNTANCY
  - CPA
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Sarbanes-Oxley
Public Company Accounting Reform and Investor Protection Act
Sarbanes-Oxley Impact on Business Environment

- Law applies to public companies
  - Effect is much broader (marketplace adjustment)
- Provisions of Sarbanes-Oxley are seen by many to be “best practices”
- For example:
  - Some insurers are adopting the Act’s corporate governance and auditing requirements as minimum standards for underwriting directors and officers liability coverage even in non-public environment
Sarbanes-Oxley and the States

Section 209 of Sarbanes-Oxley--Considerations by Appropriate State Regulatory Authorities

- PCAOB-approved standards “should not be presumed to be applicable... for small and medium sized unregistered public accounting firms.”

- “State regulatory authorities should make an independent determination of the proper standards applicable....”
States Respond

- **2003** – 25 bills introduced in 14 states
- **2004** – 18 bills introduced in 5 states
- Most activity in California and New York
- 3 states have pending legislation to extend to non-profit sector
- **Texas** – legislature mandated report from TSBPA, December 31, 2004 due date
**Sarbanes-Oxley Act of 2002**

- Currently only applicable to public companies
- Legislation seeks to:
  - Increase investor and shareholder confidence in public reporting and reduce aggressive financial reporting
  - Ensure effective internal controls surrounding financial reporting
  - Reduce fraud and increase accountability for expenses
  - Ensure the board of directors is independent from the company
  - Increase accountability of the executive team for financial reporting and information disclosed
- Effective internal controls, competent governance and auditor independence is healthy for all businesses
SOX Matrix
## Sarbanes-Oxley Act Provisions

<table>
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<td><strong>General Provisions:</strong></td>
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<td>(1) auditing, quality control, independence and ethics</td>
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<td>(2) Registration and inspection of public accounting firms</td>
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<td>202</td>
<td>Audit committee (or its equivalent) pre-approval or non-prohibited outside auditor services</td>
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<td>Application Description</td>
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<td>302</td>
<td>CEO &amp; CFO must certify their primary Responsibility for:</td>
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<td>(1) review of the financial statements</td>
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<td>(2) no known misrepresentations</td>
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<td>(3) materially correct financial statements</td>
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<td>(4) establishment and maintenance of internal controls</td>
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<td>(5) Required financial statement disclosures</td>
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<td>303</td>
<td>Unlawful for officer or director to fraudulently influence, coerce, manipulate, or mislead outside auditor</td>
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<td>304</td>
<td><strong>Forfeiture of bonus and profits:</strong> If a material misstatement occurs as a result of their misconduct, CEO and CEO must reimburse bonuses and incentive pay from prior 12 months.</td>
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<td>401</td>
<td>Enhanced financial disclosures</td>
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<td>402</td>
<td>Prohibition against personal loans to director, CEO and CFO (or equivalent)</td>
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<td>404</td>
<td><strong>Internal Controls (I/C):</strong></td>
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<td>(1) annual report contains I/C report detailing responsibility of management for establishing and maintaining adequate I/C and procedures for financial reports</td>
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<td>(2) Independent auditor attests to and reports on I/C assessment by management</td>
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<td>(a) requirements for outside auditors</td>
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<td>(b) requirements for audited entity</td>
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<td>Requirement of disclosure of company code of ethics for senior management</td>
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<td>407</td>
<td>Requirement of at least one “financial expert” on audit committee</td>
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<td>802</td>
<td>Criminal penalties for altering documents and 5-year retention of audit work papers</td>
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<td>806</td>
<td>Whistleblower protection</td>
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<td>901-905</td>
<td>Strengthens criminal penalties for acts regarding financial statement</td>
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<td>906</td>
<td>Corporate responsibility for financial reports</td>
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<td>1001</td>
<td>CEO, in addition to preparer of income tax returns, signs the corporate income tax or information returns</td>
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<td>1102</td>
<td>Criminal penalties for altering documents</td>
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<td>1105</td>
<td>Prohibition from serving as officers and directors</td>
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<td>1107</td>
<td>Whistleblower protection</td>
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Introduction

- 1999 Blue Ribbon Committee issues recommendations
- Sarbanes-Oxley Act of 2002 adds new guidelines for public companies
- Public confidence in financial reporting process declines
- Constituency groups demand more accountability
- Audit committee’s roles and responsibilities increase
Objectives

- Help audit committees understand their roles
- Discuss audit committee oversight responsibilities
- Provide resources and best practice ideas
- Encourage not-for-profit organizations to establish effective audit committees
Historical and Regulatory Perspective

- Responsible to constituency groups
  - Debt holders
  - Resource providers
- Not-for-profit organizations not historically motivated by profits
  - Beneficiaries
  - Members
  - The public
- Increased state and federal funding and public scrutiny require more oversight
- Audit committee roles and responsibilities become more diverse
The Audit Committee Charter

- Well written charter provides understanding of roles and responsibilities
- Serves as a planning guide
- Provides framework for reporting to governing board
- Assigns responsibilities
Audit Committee Responsibilities

- Understanding organization’s operations and programs
- Assessing adequacy of internal controls and risk management
- Overseeing financial and compliance reporting process
- Overseeing audit process
- Selecting independent auditor
Assessing the Adequacy of Internal Controls

- Five main elements (COSO)
  - Control environment
  - Risk assessment
  - Control activities
  - Information and communication
  - Monitoring
Control Environment

- Provides key element of internal control system
- Establishes tone at the top
- Includes
  - Organizational structure
  - Management philosophy and operating style
  - Employee integrity
  - Corporate culture
  - Organizational values
Risk Management Systems

- Must stay informed
  - Risks that impact financial and compliance reporting process
  - Controls established to respond to risks

- Risks can arise or change because of:
  - Changes in operating environment
  - New personnel
  - New or revamped information systems
  - Rapid growth
  - New technology, operating model, program or activity
  - Restructuring
  - New accounting standards or changes in accounting principles
Monitoring

- Assess quality of internal control system’s performance over time
- Take corrective action when necessary
- Activities include:
  - Comparison of actual results to prior periods, budgets or forecasts
  - Internal audit testing of process controls
  - Independent auditor evaluation
  - Information from external parties
  - Communication from regulators and major funding sources
Fraud Risk

- Identify and understand factors that can lead to fraudulent financial reporting
- Assess risk of fraudulent financial reporting
- Design and implement internal controls for prevention or detection
- Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*, establishes and provides guidance to auditors to assess that the financial statements are not materially misstated due to fraud
- Management is responsible for implementing systems that prevent fraud
Budget Considerations

- Many audit committees are asked to assess and approve the annual budget before presentation to board.

- Areas to review:
  - Quality and accuracy of previous budgets
  - Process used to develop budget
  - Methodology used to project the significant cost items
  - Difficult estimates in the budget and how were they derived
  - Benchmark information
Budget Considerations, cont.

- Areas to review, cont.:
  - Key objectives, new initiatives and programs
  - Planned efficiencies and cost cuts
  - Major changes between last year’s actual results and proposed budget
  - Capital budget items
  - Management’s monitoring process
  - Regulatory or contractual requirements
Financing Considerations

- Does the organization have a short- and long-term cash flow forecast that demonstrates the adequacy of current debt financing?
- Does the organization understand its current cost of debt?
- Does the organization have a strategic plan and related 3-5 year forecast that identifies their financing needs?
Understanding the Financial Reporting Process

- Audit committee should understand:
  - Clarity and completeness of financial statements and financial and compliance disclosures
  - Management’s selection and application of significant accounting principles
  - Critical accounting policies
  - Significant or unusual transactions and accounting judgments and estimates
Audit committee should understand, cont.:

- SAS No. 61, *Communications with Audit Committees*
- Whether financial statements present a complete and accurate picture of the financial results
- Whether the financial statements, footnotes and related management discussion provide the reader with a clear understanding
- The impact of management’s assertion on the controls over financial and compliance reporting and disclosure
Overseeing the Financial Reporting Process

- Your review enhances the quality of communication from management to third parties
- Explore what is not there
  - Disclosures omitted because of immateriality or because they are not required by GAAP
- Pay attention to items that are unclear or subjective
- Exhibit healthy skepticism accompanied by due diligence
Compliance Reporting Process

- Not-for-profits that depend on funding from federal, state or other agencies are often required to submit compliance audit reports
  - Ranging from simple tests of specific transactions to single audits which encompass the entire operation
- Audit committees need to consider
  - What specific compliance audit requirements exist and who is responsible for meeting them
  - Ensuring timely completion and submission of compliance audit reports
  - Requesting internal administrative control reportable conditions from external auditor
  - Reviewing management’s corrective action plan before it is submitted to applicable oversight agencies
Internal Audit Process

- Monitors processes and controls
- Focuses on compliance with established policy statements and procedures and regulatory guidelines
- Provides a broad range of audit coverage and feedback on risk assessment, operations and internal control processes
- Reports the following issues to the audit committee:
Independent Audit Process

- Independent auditor provides:
  - An opinion on the fairness of the financial statements and compliance with laws and regulations which gives:
    - Stakeholders an understanding of the financial results
    - Regulatory agencies a level of assurance
  - Audit committees with a neutral access to:
    - Emerging accounting issues, industry trends and risks
    - Tax and regulatory issues
    - General business advice
Independent Audit Process, cont.

Audit committee should expect the independent auditor to:

- Recognize their client is the audit committee
- Maintain open communication providing timely, open and candid discussions
- Understand the committee’s expectations
- Meet privately periodically
- Discuss concerns promptly
- Advise about areas that need special attention
- Inform about time pressures exerted by management and degree of cooperation
- Meet for an “exit” conference regarding audit requests and to discuss auditor’s formal letter, aka SAS 61 communication
ETHICS
College Required Ethics Course

- Beginning July 1, 2005 - TSBPA requires all Exam candidates to have 3 hours of a Board approved Business Ethics course
- Taught by qualified faculty
- Covers recognized ethics materials & subjects
- Supported by a detailed syllabus describing teaching methodology, class materials, lecture-by-lecture assignments and basis of student evaluation
Sample Student Comments

- Ethics class does not teach you what to think, but molds an individual to determine how to think.

- We all knew what ethics were, but we didn’t consciously know how to reason through situations and now we do.
Student Comments (Cont.)

- I’ve learned that while there may be no easy answer, there are good ways to handle ethical problems and I don’t have to do it on my own.
CPE Ethics Course

For January birth month –
If completed 2 hour ethics course in

- **2002** –
  Report 2 hours in January 2005, 4 hours in January 2007, 2009

- **2003** –
  Report 4 hours in January 2006, 2008

- **2004** –
  Report 4 hours in January 2007, 2009
Texas Licenses Issued From 1980 to 2005
If you get a letter from the Board

- Respond timely
- Provide complete information
- Show up to an informal conference
- If a violation – acknowledge your responsibility, make restitution, take steps to avoid a reoccurrence
- Remember that most complaints are dismissed
Texas CPA Candidates
CPA Exam Passing Rates

April 2004 through December 2005

AUD 46.69%
BEC 47.46%
FAR 46.28%
RE 44.88%
CPA ‘S

- **ECTOR COUNTY** – 145
- **DALLAS COUNTY** – 10,672
- **HARRIS** – 15,417
- **MIDLAND** - 446
Questions or Comments