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SEC Advisory Committee on Small and Emerging Companies

September 13, 2017

Agenda

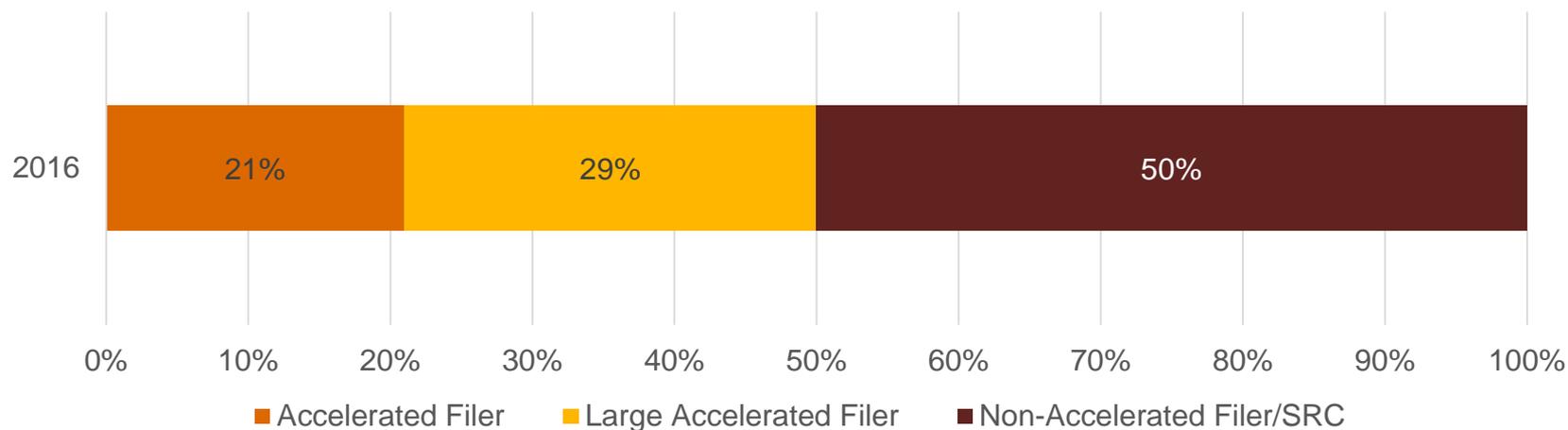
- ❑ 404(b) Exemption Background
- ❑ Evolution of the ICFR Integrated Audit Landscape
 - Key elements of the SEC and PCAOB's 2007 reforms (AS 2201)
- ❑ Integrated Audit Approach
- ❑ Key Benefits

404(b) Exemption Background

Current state

- Approximately **50%** of companies today are non-accelerated filers and as a result are exempt from 404(b)
- Emerging Growth Companies are able to forgo an ICFR audit generally for their first **5 years** as a public company (JOBS Act)

Public Filers by Filing Status*



Evolution of the ICFR Integrated Audit Landscape

- Auditors and management have gained significant experience over time and refined approaches
- Control audit closely aligned with financial statement audit
- Auditing standards are aligned with Commission guidance for management
 - Focus is on risk and materiality; top-down, **risk based** approach **integrated** with the audit of financial statements
 - ELCs can reduce the need for testing of process-level controls
- Significant regulatory reforms (AS 2201 /AS 5) and COSO guidance for smaller public companies aimed at cost effectiveness

Ongoing incremental effort to audit ICFR is a fraction rather than double the cost of the financial statement audit

Key elements of the SEC and PCAOB's 2007 reforms (AS 2201)

- Expanded options to use work of others (company personnel, 3rd parties)
- Removed requirement for auditors to perform transaction-level controls tests for a “large portion” of company’s operations
- Auditor’s ability to scale the audit based on company’s size and complexity
- *Paragraph 13: “A smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.”*
- Examples relevant to smaller, less complex companies:
 - Acceptance of alternative controls when segregation of duties is limited
 - Acceptance of alternative forms of evidence when control documentation is limited
Ability to scale IT testing
 - Use of knowledge from prior years
 - Satisfy requirement to understand process without a full walkthrough of transactions

*For issuers with public float between \$75 and \$250 million, the average declines in audit fees and outside vendor costs resulting from the reforms were 13% and 21%, respectively**

Integrated Audit Approach

- **Plan the audit**
- Establish materiality for planning and performing the audit (AS 2015/AS 11)
Materiality is the same for both integrated and financial statement only audits
- Perform risk assessment procedures (AS 2110/AS 12)
 - Obtain an understanding of the company and its environment
 - Obtain an understanding of business processes and controls
 - Perform analytical procedures and conduct inquiries
 - Consider the potential for material misstatement due to error or fraud*Risk assessment procedures are substantially the same for both integrated and financial statement only audits*
- Identify significant accounts and disclosures and determine the likely sources of potential misstatement
Significant accounts are the same for both integrated and financial statement only audits

Integrated Audit Approach (cont'd)

- Perform an audit of ICFR (AS 2201/AS 5, and AS 2301/AS 13)
 - Identify controls that respond to the risks identified
 - Select controls to test using a top-down approach
 - Determine the nature, timing and extent of work, including use of others
 - Evaluate deficiencies identified
 - Consider impact on ICFR opinion (integrated audit only)
 - Consider impact on financial statement audit

Unless we plan to take a fully substantive approach over a particular account, we test the design and operating effectiveness of controls even for a financial statement only audit

Integrated Audit Approach (cont'd)

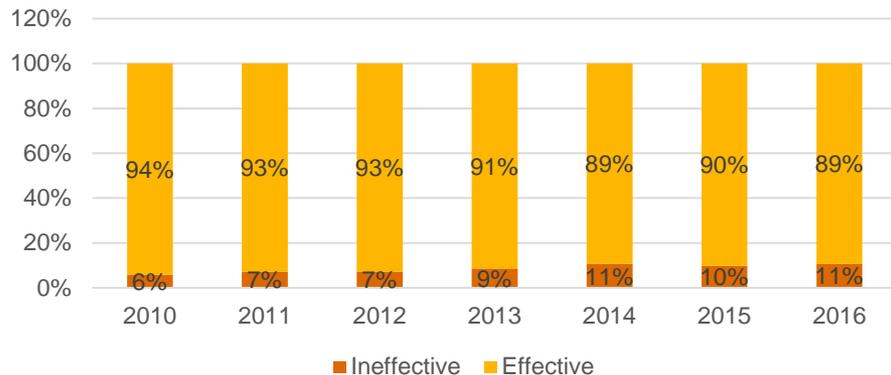
- Perform substantive audit procedures for each financial statement account (AS 2300)
 - Determine the nature, timing and extent of substantive work
 - Vary based on planned reliance on controls and evidence obtained regarding design and operating effectiveness
- Evaluate the results of work performed (AS 2810/AS 14) and evidence obtained (AS 1105/AS 15)
- Perform concluding audit procedures (AS 2800)
- Form opinions on ICFR and financial statements

Key Benefits

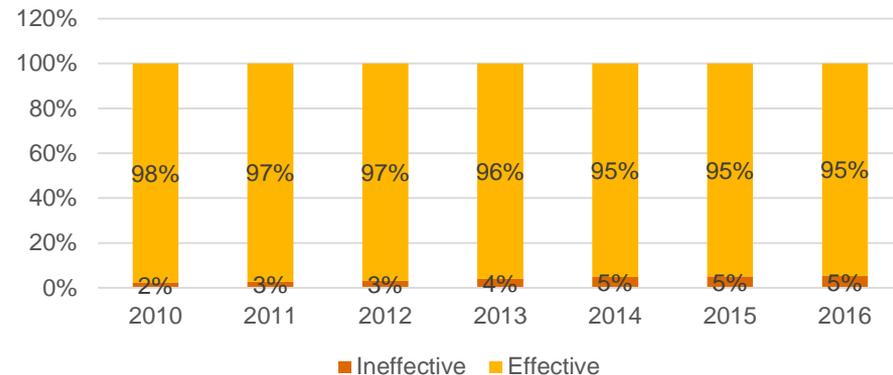
- Investors continue to support management and auditor reporting on control effectiveness
- Reductions in cost of ICFR assessments/audits have occurred over time
- More reliable financial reporting
- **Restatement rates of non-accelerated filers are noticeably higher than those of accelerated filers***
- **Rates at which companies report ineffective ICFR continue to be noticeably higher for companies with smaller market capitalization***

**Source: GAO Study – July 2013*

**% Ineffective ICFR
\$75m-\$250m Market Cap****



**% Ineffective ICFR
> \$250m Market Cap****



***Source: Audit Analytics*

Key Benefits (cont'd)

SEC and GAO studies regarding 404(b) audits have generally shown reductions in the cost of 404(b) audits over time as well as other benefits:

- 2011 SEC Staff study* found:
 - 404(b) costs have declined since implementation, particularly with the 2007 reforms
 - Investors generally view the auditor's attestation on ICFR as beneficial
 - Financial reporting more reliable when auditor is involved with ICFR assessments
- 2013 GAO study** found:
 - Companies exempt from 404(b) have had more restatements, and percentage of exempt companies restating generally has exceeded that of non-exempt companies
 - Costs associated with 404(b) have declined since 2004
 - Companies and others reported benefits of compliance, including improved reliability of financial reports

** **Source:** SEC Study: Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million (April 2011)*

*** **Source:** GAO Study: Internal Controls – SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation (July 2013)*

Key Benefits (cont'd)

- A number of studies have shown economic benefits of Section 404(b)
- One 2014 study* that evaluated the costs and benefits of Section 404(b) found results that suggested:
 - Section 404(b) decreases filers' cost of debt while increasing compliance costs modestly
 - Companies subject to 404(b) on average experienced higher valuation premiums and higher credit ratings, which decreases the cost of debt

** **Source:** An Analysis of the Costs and Benefits of Auditor Attestation of Internal Control over Financial Reporting (October 2014); Hongmei Jia, Louisiana Tech University; Hong Xie, University of Kentucky; David A. Ziebart, University of Kentucky*