The Changing SOX Landscape
How PCAOB Inspections Will Change SOX During 2013
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PRESENTERS

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WHY IS THIS WEBCAST IMPORTANT?

The Public Company Accounting Oversight Board’s (PCAOB) observations and deficiencies may drive changes in both management and external auditors’ assessment of internal controls over financial reporting (ICFR).
LEARNING OBJECTIVES

• Understand observations and deficiencies identified by the PCAOB from its 2010 inspections

• Understand impact of PCAOB’s report to the SOX 404 compliance program

• Help management develop strategies in addressing the PCAOB’s observations and deficiencies
AGENDA

• Overview of PCAOB ICFR Deficiency Report
• Scoping and Risk Assessment
• Control Assessment
• ICFR Evaluation
• Summary and Questions
PCAOB RELEASE NO. 2012-006

- Issued December 10, 2012
- Provided results of 2010 inspection of eight firms
- Discussed ICFR audit deficiencies
- Inspected 309 integrated audits for 2009 fiscal year
OVERVIEW: PCAOB ICFR ISSUES

Scoping & Risk Assessment
- Account Analysis
- Assertion ID
- Risk ID

Control Assessment
- Design
- Audit Adjustment Impact
- Risk Factors
- Magnitude Determination
- Compensating Controls
- Substantive Audit Procedures

Evaluation
- Operating Effectiveness
- Evidence
- W/T Purpose
- Prior Year Knowledge
- Management Review Controls
- Rollforward Testing
- Key Report Testing
- Work of Others

Management
- Operating
- Risk
- Effectiveness
- Audit
- Adjustment
- Impact
- Risk Factors
- Magnitude Determination
- Compensating Controls
- Substantive Audit Procedures

Moss-Adams LLP
SCOPING AND RISK ASSESSMENT: ACCOUNT ANALYSIS
SCOPING AND RISK ASSESSMENT: ACCOUNT ANALYSIS (CONT.)

SEC Report

Trial Balance

XYZ Corporation

Trial Balance

December 31, 2012

<table>
<thead>
<tr>
<th>Account No.</th>
<th>Account Description</th>
<th>Balance</th>
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</thead>
<tbody>
<tr>
<td>3010</td>
<td>Raw Materials</td>
<td>2,375.00</td>
</tr>
<tr>
<td>3020</td>
<td>Work in Process</td>
<td>$1,036.00</td>
</tr>
<tr>
<td>3030</td>
<td>Finished Goods</td>
<td>6,181.00</td>
</tr>
</tbody>
</table>

Financial Statements

<table>
<thead>
<tr>
<th>December 31, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>Cash and investment</td>
</tr>
<tr>
<td>Accounts receivable</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
<tr>
<td>Prepaid and other current assets</td>
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</table>
SCOPING AND RISK ASSESSMENT: ASSERTION IDENTIFICATION

- Scoping & Risk Assessment
- Assertion Identification
- Evaluation
- Control Assessment
- Audit Adjustment Impact
- Risk Factors
- Magnitude Determination
- Compensating Controls
- Substantive Audit Procedures
- Evidence
- W/T Purpose
- Prior Year Knowledge
- Management Review Controls
- Rollforward Testing
- Key Report Testing
- Work of Others
- Design
- Operating Effectiveness

Account Analysis
Risk ID
**DOCUMENTATION:**

**ASSERTION IDENTIFICATION**

### Significant Accounts

<table>
<thead>
<tr>
<th>Account No.</th>
<th>Account Description</th>
<th>Balance</th>
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<tbody>
<tr>
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<tr>
<td>3030</td>
<td>Finished Goods</td>
<td>$6,181.00</td>
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### Financial Statement Assertions

<table>
<thead>
<tr>
<th>Assertions</th>
<th>Classes of Transactions</th>
<th>Account Balances</th>
<th>Presentation &amp; Disclosure</th>
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<tr>
<td>Occurrence/Existence</td>
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<td>✔</td>
<td></td>
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<tr>
<td>Completeness</td>
<td>✔</td>
<td></td>
<td></td>
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<tr>
<td>Accuracy/Valuation &amp; Allocation</td>
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<td>✔</td>
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<tr>
<td>Rights &amp; Obligations</td>
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<tr>
<td>Cut-Off</td>
<td>✔</td>
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<tr>
<td>Classification &amp; Understandability</td>
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<td>✔</td>
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</tbody>
</table>
SCOPING AND RISK ASSESSMENT: RISK IDENTIFICATION

Scoping & Risk Assessment

Risk Identification

Control Assessment

Evaluation

Account Analysis
Assertion ID

Design
Evidence

W/T Purpose
Prior Year Knowledge

Management Review Controls
Rollforward Testing
Key Report Testing
Work of Others

Audit Adjustment Impact
Risk Factors
Magnitude Determination
Compensating Controls
Substantive Audit Procedures

Operating Effectiveness

Operating Effectiveness

Evaluation
SCOPING AND RISK ASSESSMENT: RISK IDENTIFICATION

Risk Identification

Financial Statement Risks

<table>
<thead>
<tr>
<th>Process</th>
<th>Subprocess</th>
<th>Risk</th>
<th>Materiality of the control (Adequately designed and operating)</th>
<th>Fraud Risk?</th>
<th>Impact on FVS</th>
<th>Probability of Misstatement</th>
<th>Mitigating Controls</th>
<th>Re-Groups</th>
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<tbody>
<tr>
<td>Inventory and Merchandise Tracking</td>
<td>Inventory Counting</td>
<td>Reliance on information from non-concurrent audit procedures</td>
<td>No</td>
<td>H</td>
<td>H</td>
<td>N</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Inventory and Merchandise Tracking</td>
<td>Inventory Counting</td>
<td>Adequate internal controls and related procedures</td>
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<td>H</td>
<td>H</td>
<td>N</td>
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<td>Yes</td>
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<tr>
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<td>Inventory Counting</td>
<td>Reasonable to reduce the risk to an acceptable level</td>
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<td>H</td>
<td>N</td>
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<td>Yes</td>
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<td>Inventory Counting</td>
<td>Use of alternative sources of evidence and related procedures</td>
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<td>M</td>
<td>M</td>
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<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
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<td>Inventory Counting</td>
<td>Preliminary review results, reconciliations of adjustments, and related procedures</td>
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<td>M</td>
<td>M</td>
<td>N</td>
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<td>Yes</td>
</tr>
<tr>
<td>Inventory and Merchandise Tracking</td>
<td>Inventory Counting</td>
<td>Adequate internal controls that are not included in the audit plan</td>
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<td>H</td>
<td>H</td>
<td>N</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Inventory and Merchandise Tracking</td>
<td>Inventory Counting</td>
<td>Preliminary results of the reconciliation procedures and related procedures</td>
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<td>M</td>
<td>M</td>
<td>N</td>
<td>Yes</td>
<td>Yes</td>
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</tbody>
</table>
DESIGN: EVIDENCE

Scoping & Risk Assessment
- Account Analysis
- Assertion ID
- Risk ID

Control Assessment

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- Work of Others

Operating Effectiveness

Design
DESIGN: EVIDENCE (CONT.)

• Auditor’s tests of design were inadequate due to inappropriate reliance on inquiry.

<table>
<thead>
<tr>
<th>Level of Evidence</th>
<th>Nature of Test</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Reperformance</td>
</tr>
<tr>
<td>Medium</td>
<td>Examination</td>
</tr>
<tr>
<td>Low</td>
<td>Observation</td>
</tr>
<tr>
<td>None</td>
<td>Inquiry</td>
</tr>
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DESIGN: EVIDENCE (CONT.)

• Auditor’s tests of design were inadequate due to inappropriate reliance on inquiry.

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Auditor’s tests of design were inadequate due to inappropriate reliance on inquiry.

Walkthroughs are generally the best way to test design.
**DESIGN: EVIDENCE**

- **Auditor’s tests**

  **Management Actions**
  
  - Be prepared to experience more rigorous and in-depth walkthrough procedures
  
  - Ensure your auditor (or your internal audit function, if working on behalf of your auditor) have documented procedures that include a mix of test procedures

  **Walkthroughs are generally the best way to test design**

  We perform walkthroughs to:
  - Confirm that our understanding of the SCOTs or significant disclosure process is as we have documented
  - Confirm the points where data is, or should be captured, transferred or modified as these are the points where misstatements are most likely to occur
  - Verify that we have identified the appropriate “what can go wrongs” (WCGWs) that have the potential to materially affect relevant financial statement assertions related to significant accounts and disclosures within each significant class of transactions.
  
  Additionally, for significant risks, highly automated SCOTs, controls over journal entries and when we plan to use a controls reliance strategy, we perform walkthroughs to confirm our understanding:
  - The relevant prevent and/or detect and correct controls over the SCOT or significant disclosure process.
  - Whether the controls have been designed effectively to prevent or detect and correct material misstatements on a timely basis.
  - Whether the controls have been implemented.
DESIGN: WALKTHROUGH

Scoping & Risk Assessment
- Account Analysis
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Control Assessment
- Audit Adjustment Impact
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Design
- Operating Effectiveness

Walkthrough Purpose
- Evidence
- Prior Year Knowledge
- Management Review Controls
- Rollforward Testing
- Key Report Testing
- Work of Others

Evaluation
- Operating Effectiveness
DESIGN: WALKTHROUGH PROCEDURES

- Design procedures were focused only on identified controls
- There are two aspects to design effectiveness:
  - Is a given control adequate in mitigating the relevant risk(s)?
  - Have all relevant controls been identified?
DESIGN: WALKTHROUGH PROCEDURES

Risk/Control

Risk/Control

Risk/Control

Risk/Control
DESIGN: WALKTHROUGH PROCEDURES

Initiate

Authorize

Record

Process

Report

Risk/Gap

Risk/Gap

Risk/Control

Risk/Gap

Risk/Control

Risk/Control

Risk/Control
Management Actions

• Be prepared to experience more rigorous and in-depth walkthrough procedures

• Focus on a clear and robust risk assessment as this will help focus your auditors' walkthrough procedures

• Similarly, the better your process documentation, the less onerous the walkthrough procedures will be as external audit staff can quickly understand your process and not expend effort “getting up to speed”
DESIGN: PRIOR YEAR KNOWLEDGE

Scoping & Risk Assessment
- Account Analysis
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Control Assessment

Evaluation
- Audit Adjustment Impact
- Risk Factors
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- Substantive Audit Procedures

Design
- Evidence
- Walkthrough Purpose

Prior Year Knowledge
- Management Review Controls
- Rollforward Testing
- Key Report Testing
- Work of Others

Operating Effectiveness
Firms inappropriately:

- Reduced testing solely on the basis that the relevant control had been tested in the prior year
- Assumed no changes in the people, processes or controls from the prior year
Firms inappropriately:

- Reduced testing solely on the basis that the relevant control had been tested in the prior year
- Assumed no changes in the people, processes or controls from the prior year

**Management Actions**

- Depending on your external auditor’s previous approach, be prepared for more rigorous walkthrough and design assessment procedures
CONTROL ASSESSMENT: OPERATING EFFECTIVENESS

Scoping & Risk Assessment
- Account Analysis
- Assertion ID
- Risk ID

Design
- Evidence
- W/T Purpose
- Prior Year Knowledge

Prior Year Knowledge
- Management Review Controls
- Rollforward Testing
- Key Report Testing
- Work of Others

Management Review Controls
- Control Assessment

Control Assessment
- Operating Effectiveness
- Evaluation
- Audit Adjustment Impact
- Risk Factors
- Magnitude Determination
- Compensating Controls
- Substantive Audit Procedures
OPERATING EFFECTIVENESS: MANAGEMENT REVIEW CONTROLS

- **Scoping & Risk Assessment**
  - Account Analysis
  - Assertion ID
  - Risk ID

- **Control Assessment**
  - Design
  - W/T Purpose
  - Prior Year Knowledge

- **Evaluation**
  - Audit Adjustment Impact
  - Risk Factors
  - Magnitude Determination
  - Compensating Controls
  - Substantive Audit Procedures

- **Operating Effectiveness**
  - Evidence

- **Management Review Controls**
  - Rollforward Testing
  - Key Report Testing
  - Work of Others
OPERATING EFFECTIVENESS: MANAGEMENT REVIEW CONTROLS

• PCAOB noted design and operating effectiveness testing issues with respect to management review controls (MRC) such as:
  o Monthly comparisons of budget and actual results to forecasts revenues and expenses
  o Comparisons of other metrics, such as profit margins and certain expenses as a percentage of sales
  o Quarterly balance sheet reviews
Management Review Control Issues

• Testing was limited to inquiries or inspection of review evidence (i.e., sign-off or meeting minutes)
• Lack of understanding of criteria used to identify items for investigation and resolution
• Controls were not tested at an appropriate level of precision (i.e., thresholds)
• Failure to obtain corroboration of management’s explanation of the variances from other evidential matter
OPERATING EFFECTIVENESS: MANAGEMENT REVIEW CONTROLS

Management Review Control Issues

• Lack of understanding of how information used in the control was generated to assess design and gain understanding of the output

• Failure to test controls over accuracy and completeness of the report and embedded calculations (more to come on this)
Management Actions

- Inventory your controls and identify Management Review controls

- Review control descriptions to ensure they include:
  - Specific investigation criteria such as dollar ($) or percent (%) variance or other qualitative considerations
  - Clear precision thresholds (for quantifiable criteria)
  - Evidence of control performance can be tested through re-performance (not just through review of signatures) including evidence of issue follow-up and disposition

- With respect to Management Assessment of review controls:
  - Be aware of embedded reliance on key reports and system configuration and ensure testing occurs where appropriate
  - Use a similar approach to testing Management Review Controls
OPERATING EFFECTIVENESS: ROLLFORWARD TESTING

Scoping & Risk Assessment
- Account Analysis
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Control Assessment

Evaluation
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Operating Effectiveness

Rollforward Testing
- Evidence
- W/T Purpose
- Prior Year Knowledge
- Management Review Controls
- Key Report Testing
- Work of Others
OPERATING EFFECTIVENESS: ROLLFORWARD TESTING

Rollforward Testing

• Interim test results not updated
• Rollforward test procedures limited to inquiry
OPERATING EFFECTIVENESS: ROLLFORWARD TESTING

Management Actions

- Review test plans, including rollforward testing strategy, with external auditor to ensure the nature, timing and extent of testing is sufficient for their use.

- Ensure rollforward test procedures includes observation, examination of evidence or re-performance as test procedures.
OPERATING EFFECTIVENESS: KEY REPORT TESTING

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Operating Effectiveness

Key Report Testing
- Work of Others
Operating Effectiveness: Key Report Testing

Testing System-Generated Data and Reports

Failure to:

- Test logic of queries or parameters used
- Test related Information Technology General Controls (ITGCs)
- Address related ITGC deficiencies
## OPERATING EFFECTIVENESS: KEY REPORT TESTING

**Key Report Analysis**

<table>
<thead>
<tr>
<th></th>
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<td>X</td>
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<td>High</td>
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</table>

**Reason Code**
1. Report is self-validating and compared to an independent source document and therefore errors in the report cannot be identified by existing reconciliation and reconciliation controls.
2. Transactions and balances in the reports are considered immaterial for financial reporting.
3. Subject to GAAP test criteria.
4. Errors in the report, if any, can be identified through other key secondary controls.
OPERATING EFFECTIVENESS: KEY REPORT TESTING

Parameters Testing

1. For the period under review, haphazardly select 2 months for testing. For the selected months, obtain the Journal Entry Report.
2. Using the documents obtained, perform the following procedures:
   a. Verify that the Journal Entry Report was reviewed by the Accounting Manager.
   b. Verify that the Journal Entry Report was reviewed prior to 10Q/10K filing.

3. Using the Journal Entry report, select sample of 25 journal entries and obtain the journal entry package for testing. For the samples selected, perform the following procedures:
   a. Verify that the journal entry is adequately supported by appropriate documentation.
   b. Verify that the journal entry agrees to the supporting documentation.
   c. Verify the reasonableness of the GL coding used in the journal entry.
   d. Verify that the journal entry was reviewed by the preparer’s supervisor.

Key Report Testing:

1. Verify that the Journal Entry Report captured all the journals posted in the selected period by independently obtaining the journal entry report for sample 1 month and reconciling against the reviewed Journal Entry Report.
2. For the period under review, perform the following procedures:
   a. Obtain a screenshot of the parameters used in generating the Journal Entry Report. Review the screenshot to verify that the parameters used do not exclude any type of manual journal entry transaction.
OPERATING EFFECTIVENESS: KEY REPORT TESTING

Parameters Testing

Management Actions

• Ensure periodic communication between the business process and IT audit teams

• Inventory your system generated data and reports

• Perform a risk assessment and scoping of system data and reports to identify key items for testing

• Communicate and confirm testing strategy with external auditors to ensure that testing is sufficient for their use

• Update test strategy to include system data and report testing
OPERATING EFFECTIVENESS: WORK OF OTHERS

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- Magnitude Determination
- Compensating Controls
- Substantive Audit Procedures

Operating Effectiveness

Work of Others
OPERATING EFFECTIVENESS: WORK OF OTHERS

Using Work of Others

• Failure to establish sufficient basis for using work of others
• Inappropriate use of internal audit’s work in higher risk areas
• Failure to evaluate design of internal audit’s test procedures, scoping and control identification
• Failure to re-perform test of controls
• Nature, extent and timing of control testing not documented
OPERATING EFFECTIVENESS: WORK OF OTHERS

Management Actions

• Proactively provide to the external auditors management assessment team’s resumes

• Develop a reliance plan delineating areas where the external auditors plans to place reliance on management assessment procedures

• Review test plans with external auditor to ensure the nature, timing and extent of testing and related deliverables are sufficient for their use

• Ensure test workpapers are well-designed, documented and supported to allow for easy use and reperformance

not documented
DEFICIENCY EVALUATION: AUDIT ADJUSTMENT IMPACT

Sources of Deficiencies
1. Management testing
2. External auditor’s testing
   - Test of controls
   - Substantive testing
DEFICIENCY EVALUATION: AUDIT ADJUSTMENT IMPACT

Management Actions

• Proactively ask the external auditors to provide a list of control deficiencies potential deficiencies early and often (at the quarters, during interim and throughout final fieldwork)

• Aggregate a complete deficiency list from the external auditors’ substantive and ICFR audits along with Internal Audit and Management’s findings

• Maintain a running issues log of open items, near misses, etc. during the course of the year
EVALUATION: RISK FACTORS

Scoping & Risk Assessment
- Account Analysis
- Assertion ID
- Risk ID

Control Assessment
- Design
- Operating Effectiveness
- Audit Adjustment Impact

Evaluation
- Risk Factors
  - Magnitude Determination
  - Compensating Controls
  - Substantive Audit Procedures

Risk Factors
- Evidence
- W/T Purpose
- Prior Year Knowledge
- Management Review Controls
- Rollforward Testing
- Key Report Testing
- Work of Others
EVALUATION: MAGNITUDE DETERMINATION

Scoping & Risk Assessment
- Account Analysis
- Assertion ID
- Risk ID

Control Assessment
- Design
- Operating Effectiveness
- Audit Adjustment Impact
- Risk Factors

Evaluation

Magnitude Determination
- Evidence
- W/T Purpose
- Prior Year Knowledge
- Management Review Controls
- Rollforward Testing
- Key Report Testing
- Work of Others

Compensating Controls
Substantive Audit Procedures
EVALUATION: RISK FACTORS AND MAGNITUDE DETERMINATION

- Nature of Accounts, Disclosures & Assertions
- Susceptibility to Loss or Fraud
- Interdependency or redundancy of control
- Subjectivity, complexity or extent of judgment
- Future consequences of deficiencies
- Interaction of deficiencies
- Cause and frequency of exceptions

XYZ Corporation

Trial Balance

December 31, 2012

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<thead>
<tr>
<th>Account No.</th>
<th>Account Description</th>
<th>Balance</th>
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</tr>
<tr>
<td>3030</td>
<td>Finished Goods</td>
<td>6,181.00</td>
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</tbody>
</table>
Management Actions

• Take the first pass at evaluating the likelihood and magnitude of identified control deficiencies

• Evaluate these deficiencies on your own and provide to the external auditor as draft

• Meet to discuss your preliminary evaluation with the external audit team, including the external audit Partner
EVALUATION: COMPENSATING CONTROLS

Deficiency Evaluation

Compensating Controls
SUMMARY

- The PCAOB’s December report on ICFR audit deficiencies signals an increase in focus on SOX compliance
- The increased focused will impact your SOX compliance (directly or indirectly)
- Ensure your risk assessment and scoping is thorough and links to specific risks
- Be prepared for increased auditor activity, particularly with respect to walkthroughs and Management Review Controls (MRC)
- Reassess your MRC to ensure they are well-defined and documented
- Improve coordination with auditor regarding the nature, timing and extent of operating effectiveness tests
- Ensure that your overall assessment includes all sources of control deficiencies and appropriately considers compensating controls
BEFORE YOU GO...

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