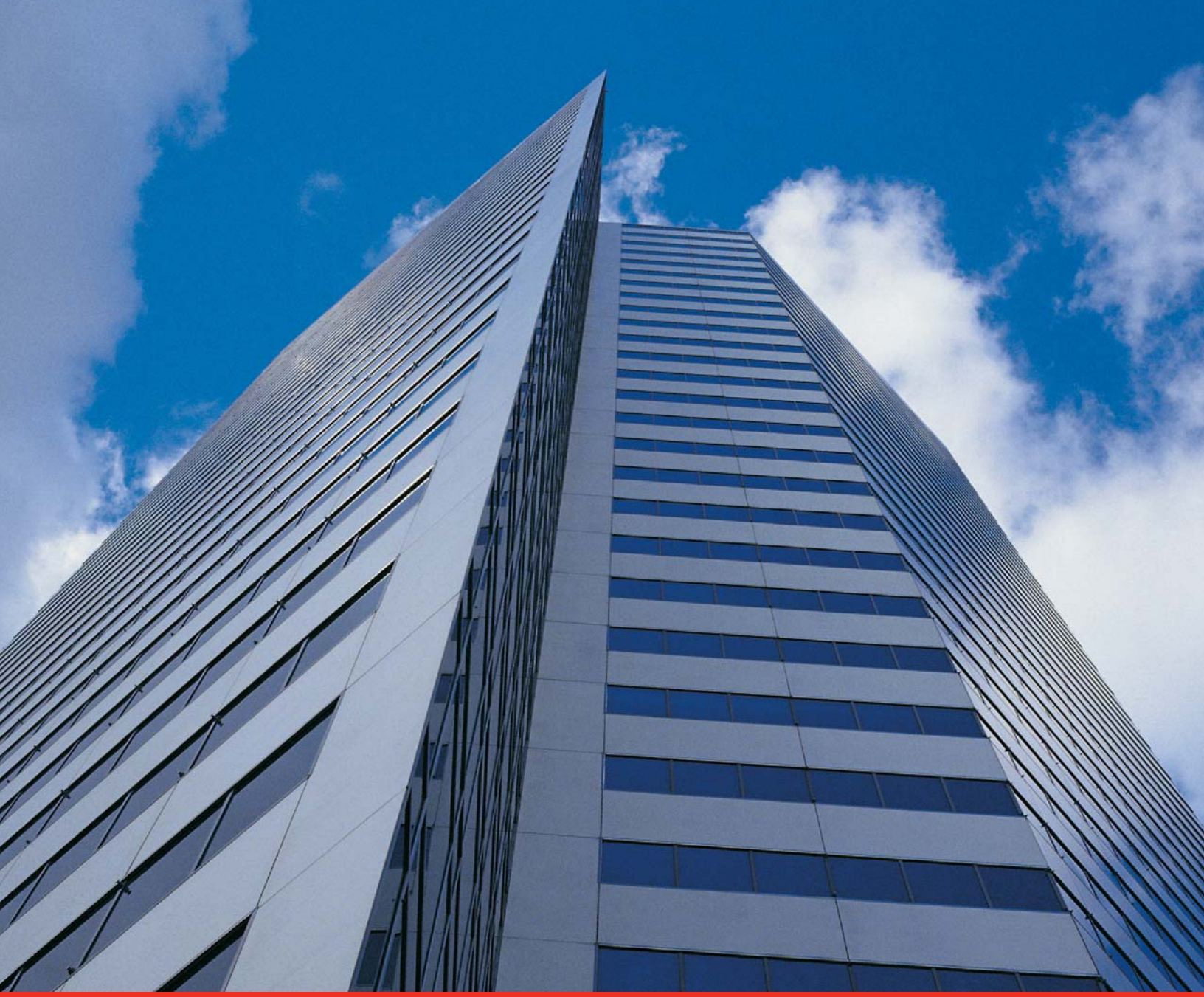

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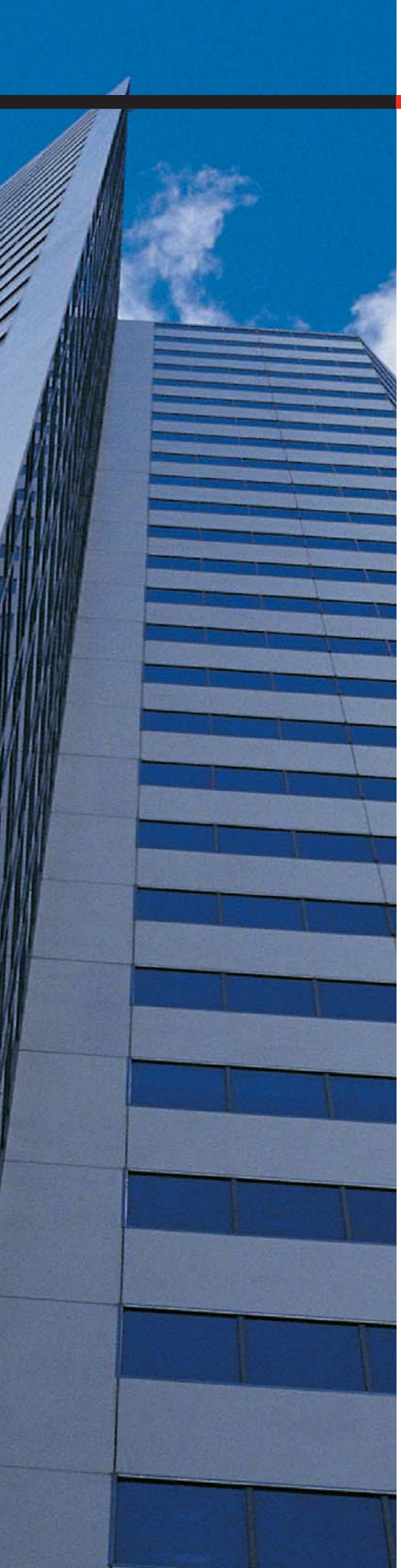
404 Perspectives

Issue No. 2
Efficient Testing Strategies for 2006



Introduction

Our first edition of *404 Perspectives: Top-Down, Risk-Based Approach* reviewed reactions to guidance issued by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) in May 2005. It highlighted how companies were beginning to use a risk-based approach and leverage entity-level controls to differentiate between those areas requiring more testing focus than those requiring less. We also discussed the basis for management to match its testing effort to the level of assessed risk and to vary the persuasiveness of evidence to improve the efficiency of the annual assessment process.

Despite the hard deadlines for accelerated filers, the way that companies have complied with the Sarbanes-Oxley Act (SOX) has been something of an evolutionary process. Clarity in the form of guidance from the PCAOB and the SEC has arrived during, rather than at the beginning of the work. Best practices have only recently begun to emerge, and the approach taken by independent auditors also has evolved. Much of the debate about balancing the cost versus value of the whole exercise was driven in the first year by what are now seen as inefficiencies in the way that both companies and their auditors approached the task. Yet as many companies move into their third year of compliance, they are, for a variety of reasons, stuck with "first year thinking." On the other hand, many Foreign Private Issuers (FPIs), with a more relaxed timetable and the benefit of learning from their U.S. peers, may be better able to implement a more efficient and often more "embedded" process for their first year.

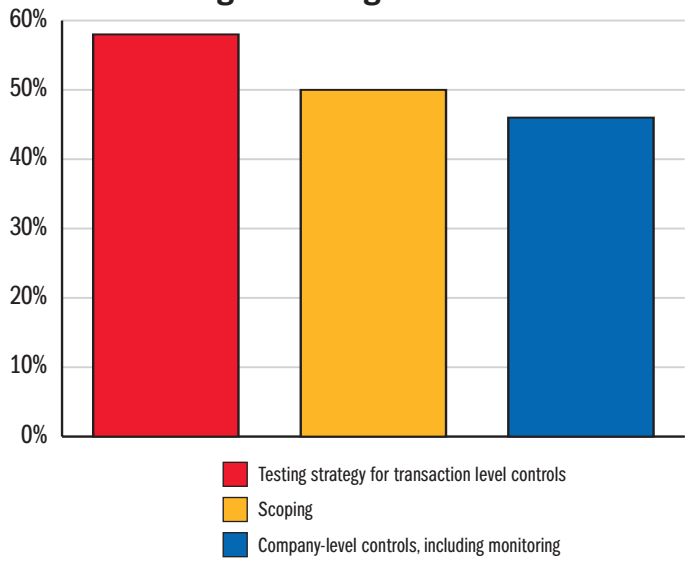
In this paper, we focus on testing. For accelerated filers, the greatest cost of ongoing compliance stems from the need to test controls each year, and many will rethink their testing strategy in Year 3. FPIs have mostly completed their documentation and are moving into their first year of testing.

Efficient Testing Strategies for 2006

The number of controls management plans to test is a strong indicator of the ongoing cost of management's annual assessment. The experience of Accelerated Filers shows that even with a "rationalized" set of controls there remain a large number to be tested each year. Management can reduce significantly the cost for the current year and the ongoing costs of its assessment process by developing efficient testing strategies.

Companies have a broader array of testing techniques available to evaluate the effectiveness of internal controls than does the independent auditor. For example, management might be able to determine that controls operate effectively through its ongoing and regular supervisory activities. The PCAOB in its guidance issued in May 2005 ("May Guidance") encouraged auditors to recognize this difference when evaluating the adequacy of management's assessment. As a result, many companies are re-thinking their testing strategy to take advantage of the flexibility.

Anticipated Changes Responsive to May Guidance
Percentage of Foreign Private Issuers



In November 2005, Ernst & Young conducted a survey of over 100 FPIs on the effect of May Guidance on their 404 assessment. More than 50% of the respondents anticipate changing their testing strategy for transaction level controls pursuant to the May Guidance.

What Are the Opportunities to Implement a More Efficient Testing Process in 2006?

In this issue of 404 Perspectives, we offer six areas of opportunity in the form of questions that a CFO, 404 program director, Audit Committee member or internal auditor should be asking themselves and their teams as they finalize their approach for 2006 testing. We hope these questions prompt thinking and action to generate real efficiencies in the process.

Key Questions to Consider for Companies

1. Have we leveraged entity-level controls sufficiently?
2. Have we leveraged supervisory activities we are already doing to the maximum extent?
3. Is our strategy for testing truly "risk-based?"
4. Do we have the right people doing testing?
5. Have we balanced the extent of our work with that done by our independent auditor?
6. Have we built process and control improvement into our plans for testing?

Placing More Emphasis on Entity-Level Controls

In its May Guidance, the PCAOB encouraged auditors to follow a top-down approach, beginning with an evaluation of entity-level controls. Consistent with the PCAOB's guidance, management can plan both its scope and level of testing of transaction controls based on an assessment of its entity-level controls. In a company with multiple locations, an effective and highly standardized set of entity-level controls can help reduce scope over locations that are not individually significant. Further, strong entity-level controls can also be leveraged to reduce the testing effort at significant locations. On the other hand, companies with entity-level controls that are ineffective, absent or that lack consistency across different locations or business units may need to increase the scope and testing plans for their annual assessment, or perhaps more importantly consider enhancing their entity-level controls.

Have we leveraged entity-level controls sufficiently?

- Have we taken full advantage of entity-level controls to reduce scope and the amount of transaction control testing in locations that are significant in the aggregate, but not individually?
- Have we considered the effect of pervasive entity-level controls when assessing the nature and extent of testing of lower-level controls?
- Does our testing plan include testing the operation of only those entity-level controls that are relevant to the assessment process?
- Have we considered testing entity-level controls that operate at the transaction level and are sensitive enough to prevent or detect an error of importance and are more efficient for us to test?

Leveraging Management's Normal Review Activities

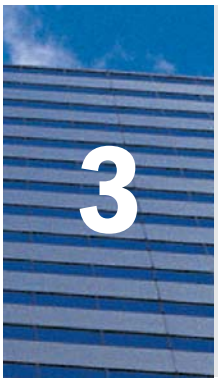
Many controls in a company may already be subject to management's review through its ongoing supervisory activities. For instance, a Treasury department supervisor may, as part of regular monitoring activities, check that key bank reconciliations have been performed properly. Such activity can represent management testing as part of a self-assessment process and clearly provides for an efficient testing strategy.

Have we leveraged supervisory activities we are already doing to the maximum extent?

- Have we included in our testing strategy management's ongoing review processes?
- Has the review been formally included as part of management's annual assessment process?
- Does this work include appropriate evidence that it was done in a manner that someone else, such as an independent auditor or internal auditor, could follow?
- Are the results of such testing evaluated properly with appropriate follow-up of any exceptions and prompt action related to any resulting deficiencies?

Using a Risk-Based Approach to Testing to Drive Efficiency

There are a number of choices management can make when planning to test controls. Control testing techniques range from a re-performance of the control to ensure it was done properly, inspecting evidence on a sample basis to see that the control was carried out, seeing the control being performed in action, or merely inquiring as to whether it was carried out properly. These techniques vary considerably as to the level of confidence and persuasiveness they provide and involve different levels of effort. Not all accounts or processes carry a level of risk that requires management to re-perform the controls, whereas some areas will require a much higher level of scrutiny than would be afforded by just inspecting evidence that the control appears to have operated. Similarly management may be able to determine how far from the year end testing is to be carried out. Controls in areas of lower risk may be tested further from the "as of date," but those in higher risk areas should be tested closer to the year end. Many companies are finding it valuable to invest time in matching the nature of testing to the degree of risk in each area.



Is our strategy for testing truly "risk-based?"

- Have we spent sufficient time considering how we plan to test controls?
- Have we reviewed test scripts to ensure the techniques we plan to use are responsive to the type of controls and the underlying risk?
- Have we considered the timing of testing so as to gain the maximum efficiency with which testing resources are employed?
- Where we are testing further from the year end, do we have effective procedures in place to identify changes in controls up to the year end?
- Have we discussed our approach with the independent auditors to avoid any surprises?

Deploying Most Efficient Testing Resources

Companies are employing a wide range of resources to meet their need to have controls tested annually. Testers include internal audit, dedicated internal controls groups reporting to local line management or a corporate controller, third-party providers, business unit personnel such as management and business process and control "owners." Many companies are exploring ways in which to embed the assessment process better into everyday business activities and are planning some form of self-assessment process to achieve this. Management "self testing" helps to ensure accountability and ownership of the process but ordinarily is not as objective as testing performed by internal audit. Evidence from a self-assessment process is less persuasive than evidence provided by other sources, making this approach more suited to areas of lower risk. Some companies plan to reap the benefits of self testing, but will enhance the persuasiveness of the evidence it generates by having both the process of self-assessment and the results validated by a more objective group, such as internal audit.

Do we have the right people doing testing?

- Have we assigned the right responsibilities for testing of internal controls?
- Is any control self-assessment process being utilized to support your annual assessment of internal controls?
- Is the level of objectivity of those performing testing acceptable given the nature of the controls and the underlying level of risk?
- Do those performing the testing have sufficient skill and experience to be able to apply judgment where required?
- Where we need increased confidence in control testing, have the results of any control self-assessment been reviewed by internal audit or other competent objective parties?
- Have we included the independent auditor in discussions about who will perform testing?

Balancing the Cost of Independent Auditor's 404 Assessment with In-House Effort

The PCAOB has indicated that the work management performs can have a significant effect on the independent auditor's testing strategy. The more extensive and reliable management's assessment is, the less extensive and costly the independent auditor's work will need to be. The independent auditor, though, is more likely to use the work of management in lower risk areas, and when it has been performed by highly competent and objective testers. In particular, independent auditors will not rely on assessments made by the same personnel who are responsible for performing the control as the basis for their assessment no matter what the level of risk.

Have we balanced the extent of our work with that done by our independent auditor?

- Have we discussed our independent auditor's strategy for reliance on work done as part of our assessment?
- Have we considered the cost effectiveness of increasing the objectivity and competence of testing in lower risk areas in order to increase auditor reliance on our work?
- Have we considered the objectivity of internal audit when planning to have them review management's assessment processes and results?

Considering Opportunities for Process Improvement Along the Way

For many companies, undertaking the SOX 404 process for the first time has generated significant benefits in terms of highlighting gaps in operating effectiveness and improving ineffective controls. Some companies plan to use their third compliance year to go one step further and seek opportunities for improvements in the underlying business processes and reduction in the overall cost of control including cost of testing. Some are carrying out specific reviews while others are including aspects of control efficiency in their testing plans.

Many large companies have multiple sites with similar business processes subject to similar inherent risks yet with different controls. Others could benefit from centralizing essentially similar business processes operated in different locations into shared service centers, not only reducing process costs but potentially improving the effectiveness of control and reducing compliance costs. Lastly, there are always opportunities to automate many of those time-intensive controls that are performed manually today.

Have we built process and control improvement into our plans for testing?

- Have we incorporated reviews of process and control efficiencies into our testing strategies and plans?
- Do we routinely evaluate control efficiency as well as effectiveness?
- Have we highlighted opportunities to benchmark and then standardize controls sets across similar processes?
- Have we identified any opportunities to centralize controls by centralizing business processes?
- Have we considered further leveraging ERP and other IT systems to automate otherwise manual controls?
- Have we considered continuous monitoring of certain risks through automated controls within ERP and other IT systems?

Efficient Testing Strategies—Key Questions to Consider

1	**Have we leveraged entity-level controls sufficiently?**	Have we taken full advantage of entity-level controls to reduce scope and the amount of transaction control testing in locations that are significant in the aggregate, but not individually?	❑
		Have we considered the effect of pervasive entity-level controls when assessing the nature and extent of testing of lower-level controls?	❑
		Does our testing plan include testing the operation of only those entity-level controls that are relevant to the assessment process?	❑
		Have we considered testing entity-level controls that operate at the transaction level and are sensitive enough to prevent or detect an error of importance and are more efficient for us to test?	❑
2	**Have we leveraged supervisory activities we are already doing to the maximum extent?**	Have we included in our testing strategy management's ongoing review processes?	❑
		Has the review been formally included as part of management's annual assessment process?	❑
		Does this work include appropriate evidence that it was done in a manner that someone else, such as an independent auditor or internal auditor, could follow?	❑
		Are the results of such testing evaluated properly with appropriate follow-up of any exceptions and prompt action related to any resulting deficiencies?	❑
3	**Is our strategy for testing truly "risk-based?"**	Have we spent sufficient time considering how we plan to test controls?	❑
		Have we reviewed test scripts to ensure the techniques we plan to use are responsive to the types of controls and the underlying risks?	❑
		Have we considered the timing of testing so as to gain the maximum efficiency with which testing resources are employed?	❑
		Where we are testing further from the year end, do we have effective procedures in place to identify changes in controls up to the year end?	❑
		Have we discussed our approach with the independent auditors to avoid any surprises?	❑
4	**Do we have the right people doing testing?**	Have we assigned the right responsibilities for annual testing of internal controls?	❑
		Is any control self-assessment process being utilized to support your annual assessment of internal controls?	❑
		Is the level of objectivity of those performing testing acceptable given the nature of the controls and the underlying level of risk?	❑
		Do those performing the testing have sufficient skill and experience to be able to apply judgment where required?	❑
		Where we need increased confidence in control testing, have the results of any control self-assessment been reviewed by internal audit or other competent objective parties?	❑
		Have we included the independent auditor in discussions about who will perform testing?	❑
5	**Have we balanced the extent of our work with that done by our independent auditor?**	Have we discussed our independent auditor's strategy for reliance on work done as part of our assessment?	❑
		Have we considered the cost effectiveness of increasing the objectivity and competence of testing in lower risk areas in order to increase auditor reliance on our work?	❑
		Have we considered the objectivity of internal audit when planning to have them review management's assessment processes and results?	❑
6	**Have we built process and control improvement into our plans for testing?**	Have we incorporated reviews of process and control efficiencies into our testing strategies and plans?	❑
		Do we routinely evaluate control efficiency as well as effectiveness?	❑
		Have we highlighted opportunities to benchmark and then standardize controls sets across similar processes?	❑
		Have we identified any opportunities to centralize controls by centralizing business processes?	❑
		Have we considered further leveraging ERP and other IT systems to automate otherwise manual controls?	❑
		Have we considered continuous monitoring of certain risks through automated controls within ERP and other IT systems?	❑

In the first edition of 404 Perspectives, we provided reactions of companies on the May Guidance and thought-provoking ideas on implementing the "top-down, risk-based" approach. In the second edition, we have highlighted key questions to consider as you develop a testing strategy that incorporates the top-down, risk-based thinking.

In the next edition, we will bring to life many of these concepts as we share some of the testing strategies of a group of companies that have applied the top-down, risk-based approach. It is our hope that these publications will help you in the journey toward an efficient and sustainable compliance process.

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