

Emerging Trends in Internal Controls

May 10, 2006 SEC and PCAOB Roundtable

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SEC and PCAOB Roundtable Discussion on Implementation of Internal Control Reporting Provisions: Year Two

Introduction

On Wednesday, May 10, 2006, the Securities and Exchange Commission and the Public Company Accounting Oversight Board held a roundtable discussion on second-year experiences with the internal control reporting and independent auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act"). The purpose of the roundtable discussion was to obtain feedback from those who have experience with the internal control reporting requirements to allow the Commission and the Board to further assess the implementation of those requirements and continue to develop policies that improve the accuracy and reliability of financial statements for the benefit of investors in a way that is both efficient and effective.

The roundtable consisted of five separate panels with each including representatives from public companies, auditing firms, investor groups, the legal community, and government agencies. The panelists were asked to provide their views about second-year implementation experiences with respect to various aspects of the Section 404 reporting requirements. Many of the panelists also participated in the previous SEC roundtable in April 2005 that discussed first-year experiences with the implementation of the internal control reporting provisions.

This publication summarizes the views and comments of the five panels and includes our insights on these matters. Consistent with the views of many other roundtable participants, we believe that the second year experience of Section 404 indicated significant improvements over Year 1 for both auditors and issuers, resulting in tangible benefits for issuers and investors with process efficiencies that led to a reduction in overall implementation costs.

Moderators

Thomas Ray, Office of the Chief Auditor, PCAOB

Nancy L. Salisbury, Office of the Chief Accountant, SEC

John W. White, Division of Corporation Finance, SEC

Participants

Philip D. Ameen, Vice President and Comptroller, General Electric Company

The Honorable Mary K. Bush, President, Bush International, Inc.; Chairman and Audit Committee Member, Mortgage Guaranty Insurance Corporation; Chairman and Policy and Administration Member, Pioneer Family of Mutual Funds; Director, Briggs and Stratton and Brady Corporation

H. Rodgin Cohen, Chairman, Sullivan & Cromwell LLP

Colleen Cunningham, President and Chief Executive Officer, Financial Executives International

Robert W. Davis, Chief Financial Officer, CA, Inc.; Representative of U.S. Chamber of Commerce

Samuel A. DiPiazza, Jr., Global Chief Executive Officer, PricewaterhouseCoopers International Limited

The Honorable Barbara Hackman Franklin, President and CEO, Barbara Franklin Enterprises; former U.S. Secretary of Commerce; Audit Committee Chair, MedImmune, Inc.; Director, Aetna, The Dow Chemical Company, and GenVec, Inc.; Director, National Association of Corporate Directors (NACD)

The Honorable Joseph A. Grundfest, The William A. Franke Professor of Law and Business and co-Director of the Rock Center on Corporate Governance at Stanford University; former Commissioner of the U.S. Securities and Exchange Commission; Director and Audit Committee Member, Oracle and Financial Executives

Dennis A. Johnson, Senior Portfolio Manager, Corporate Governance Office, California Public Employees' Retirement System

Edward E. Nusbaum, Chief Executive Officer and Executive Partner, Grant Thornton LLP

Panel One—Overview of the Second Year

Discussion Questions

1. Do you believe that the requirements of Section 404 have helped improve the quality of companies' annual and quarterly financial statements or resulted in other benefits? If so, what is the primary source of that improvement? What are the countervailing costs of Section 404 compliance?
2. Please provide your overall perspectives regarding your experiences with the second year of assessing, reporting, and auditing internal control over financial reporting. What was different about the process in the second year? Were substantial modifications made in management's and the auditor's approach to the assessment? If so, what were they?
3. What are your thoughts about the efforts and costs incurred this year as compared with the first year? What portion of these efforts and costs related to work by the outside auditor versus other efforts and costs to companies? Did you realize expected cost savings in the second year? If so, what is the primary source of cost savings (e.g. increased efficiency, reduced documentation, etc.)? What are your views regarding efforts and costs to be incurred in future years?
4. What implementation and/or ongoing issues have arisen or continued in the second year of assessing, reporting, and auditing internal control over financial reporting? How should such issues be addressed?
5. Was the level of effort required to complete the assessment in the second year substantially greater or less than in the first year? Are further modifications to management's assessment and the auditor's process anticipated in future years? Will the same level of effort expended in the second year be necessary or even increase in the third year and beyond?

Summary of Panelists' Views

The panelists generally agreed that the requirements of Section 404 have helped improve the quality of companies' financial reporting. The benefits cited by panelists include: better and more transparent disclosure, increased awareness and ownership of controls by company personnel, and more engaged audit committees and boards of directors. Some panelists described the improvements as a cultural change where emphasis on internal controls is being incorporated into management's vocabulary and day-to-day work processes.

In Year 2, companies focused on controls key to the integrity of their financial reporting, looked for opportunities to standardize their Section 404 processes, and focused on eliminating redundancy. As a result, companies generally identified and tested fewer controls. Panelists also observed that improvements in management's assessment process provided additional opportunities for auditors to use more of management's work. While the panelists observed overall improvement in Year 2, there was strong belief that further improvements by management and auditors can be achieved over time as they continue to examine and challenge the appropriate mix of controls to test. Several panelists also noted that the benefits of the additional guidance provided by the SEC and PCAOB in May 2005 were not fully achieved in Year 2.

Panelists generally observed that companies experienced lower overall costs in Year 2 with a significant portion of the savings coming from lower costs to document controls and less effort to remediate control deficiencies. A number of panelists expressed the view that the costs of Section 404 compliance outweigh the benefits, especially for smaller issuers. A few of them stated the view that costs can be brought in line with benefits by focusing the scope of the assessment on areas of higher risk to the integrity of financial reporting and limiting testing in areas of lower risk.

While accelerated filers have now developed their assessment processes, a general view of the panelists was that additional guidance would be helpful to distinguish the roles and responsibilities of management and auditors and to acknowledge the greater flexibility available to management in performing its assessment. Panelists felt this would be especially helpful for those public companies that have not yet performed their initial assessment. However, panelists cautioned against making any new guidance too prescriptive such that it added to management's assessment burden or created conflict with PCAOB Auditing Standard No. 2 ("AS2").

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Comparison of Year 2 to Year 1

We have previously commented that no party — management, auditors, or regulators — was perfect in that first year of execution. Clearly, the second year experience was markedly improved, and the third year experience promises further benefits in effectiveness and efficiency. Few argue that the benefits of Section 404 are not significant. The challenge has been rationalizing the costs, which are immediate and measurable, against the benefits, which are longer term and more difficult to quantify. With Year 2 of Section 404 recently completed for most accelerated filers, experience continues to show that there have been improvements in both management and auditor processes. All parties continue to strive for more efficient and effective approaches to the requirements of Section 404.

The favorable Section 404 cost trend observed in the CRA International survey that was published April 17, 2006, and submitted to the SEC and PCAOB by Ernst & Young and other major accounting firms, generally has been supported by a variety of other reports and surveys, including estimates by groups that have been critical of Section 404. Because of differences in methodology, the various surveys provide somewhat differing estimates of the magnitude of the declines, but there is wide acknowledgement that total Section 404 costs fell in the second

year for the vast majority of issuers. We believe this downward trend should be recognized as policymakers consider proposals to adjust the requirements of Section 404. We also believe further enhancements in implementation are achievable and additional, practical issuer guidance that recognizes the difference between larger and smaller issuers could support continued efficiency improvements in Section 404 implementation.

The need for regulatory guidance regarding management's assessment is underscored by the CRA survey. The survey examined both larger and smaller accelerated filer experience in the second year of internal control reporting. The survey found issuers' total costs associated with Section 404 implementation, on average, fell nearly 44 percent for larger companies (above \$700 million in market capitalization) and nearly 31 percent for smaller companies (\$75 million to \$700 million in market capitalization).

Such overall issuer cost reductions are noteworthy. Even more instructive is the breakdown of issuers' total Section 404 costs. The study examined three components of an issuer's total Section 404 costs: two related to management's performance requirements, either internal costs for efforts performed directly by management or third party costs for assistance to management, and the third component for costs resulting from Section 404 external audit fees.

The study found that Year 2 Section 404 external audit fees accounted for 33% of the total Section 404 costs of larger companies and 39% of total Section 404 costs of smaller companies. While larger and smaller issuers achieved similar percentage cost reductions relative to Section 404 external audit fees, there was a significant disparity between larger and smaller companies relative to cost reductions associated with management's performance requirements. While larger companies achieved cost reductions of 51% for such costs, smaller companies achieved a 36% reduction. Thus, focusing additional guidance on the performance requirements of management has the potential for considerable positive effects. Not only do the performance requirements of management comprise the largest portion of issuers' costs, but also it appears to be an area of disparity between larger and smaller companies in terms of achieved efficiencies.

Notwithstanding the improvements brought on by time, experience and previously issued regulatory guidance, we believe that additional steps should be taken to provide practical implementation guidance for smaller issuers to further benefit their first year implementation experience.

Moderators

Laura J. Phillips, Office of the Chief Auditor, PCAOB

Scott A. Taub, Office of the Chief Accountant, SEC

John W. White, Division of Corporation Finance, SEC

Participants

William J. Brunner, Chief Financial Officer, Vice President, and Treasurer, First Indiana Corporation; Chairman, American Banker's Association Accounting Committee

Kimberly Parker Gavaletz, Vice President and Deputy, Global Sustainment, Lockheed Martin Corporation

Susan C. Gordon, Senior Vice President, Corporate Controller and Chief Accounting Officer, CBS Corporation

Keith E. Holmberg, Vice President of Financial Control Processes, British Petroleum

Lee Level, Corporate Vice President and Board Member; Computer Sciences Corporation; Audit Committee Chair, Levi Strauss & Co. and UTi Worldwide Inc.

Peter F. Minan, National Managing Partner, Audit, KPMG LLP

Stephen A. Sherwin, M.D., Chairman and Chief Executive Officer, Cell Genesys, Inc., Audit Committee Member, Rigel Pharmaceuticals, Inc. and Ceregene, Inc.

Dr. Albert M. Teplin, Audit Committee Chair, Viad Corp., Audit Committee Member, MoneyGram International

James S. Turley, Chairman and Chief Executive Officer, Ernst & Young

Panel Two—Management's Evaluation and Assessment

Discussion Questions

1. Was the guidance issued on May 16, 2005, by the SEC and PCAOB helpful in improving management's process in the second year? Were processes for evaluating controls more risk-focused in the second year? What are the biggest challenges in implementing a risk-based approach? Would further guidance be helpful in any area?
2. How, if at all, would management have approached its assessment differently if it did not know that it would be the subject of an independent audit? Were there instances where management believed that it had taken an appropriate, risk-based approach to assessing internal control over financial reporting, but modified that approach based on auditor demands? Were these changes beneficial to the company's system of internal control over financial reporting or to the effectiveness and efficiency of management's assessment?
3. Is there sufficient information available to management concerning the appropriate internal control framework? Is there sufficient information available concerning how management should conduct an internal control assessment?
4. Did management's evaluation process consider company-level controls in determining the scope and extent of testing of accounts and processes? What types of company-level controls have the greatest impact on the scope and extent of testing?
5. Are there issues or challenges that are specific to smaller accelerated filers in completing their assessments that might not apply to all accelerated filers? If so, what are those issues and challenges and how can they be addressed?
6. How did your evaluation of information technology general controls differ in the second year? Do you see additional areas for improvement? Were you able to implement a benchmarking strategy for computer application controls? If not, why not? Would additional guidance be useful?
7. Many companies indicated at last year's roundtable that they incurred significant effort and cost documenting internal controls. What drove the level of documentation? How did the second year compare to the first year in terms of effort and cost spent on documentation? What modifications to existing requirements might make the process more efficient and effective? Are particular modifications desirable or necessary for smaller and less complex companies?

Summary of Panelists' Views

Panelists indicated the additional guidance provided by the SEC and PCAOB in May 2005 was very helpful. While both issuers and auditors appreciated the many areas of additional guidance, several panelists highlighted as a chief benefit the clarification that auditors can provide advice and assistance to management regarding accounting, financial reporting, and internal control matters. Another cited benefit of the additional guidance was recognition of the flexibility in management's approach to its assessment. However, some panelists observed that in too many cases management's approach to its assessment was driven by what the audit firm might need to issue its opinion on internal control over financial reporting. Some panelists also suggested that auditors may still be testing too many low level controls. Other panelists observed that Section 404 is an evolving process and it will take some time for auditors to drive consistency in their execution.

When questioned about management's approach to evaluating and testing entity-level controls, several panelists noted that in addition to evaluating the tone at the top, companies are beginning to recognize efficiency in evaluating and testing the company's monitoring controls. In evaluating monitoring controls, management is focusing on the depth and efficacy of business reviews and the alignment of those reviews with the key business drivers and performance metrics that can indicate potential financial reporting issues. Panelists observed that some companies are making changes to their monitoring controls in order to enhance their effectiveness in monitoring the functioning of other controls or achievement of specific financial reporting objectives.

When questioned about IT controls, panelists observed that companies made significant progress in Year 2 in testing IT general controls and application controls. Yet some panelists noted there is still a long way to go with leveraging IT controls in the Section 404 process. Other panelists commented that the Section 404 process has identified opportunities for management to improve IT controls. One panelist commented there needs to be a balance of prevent controls, detect controls and entity-level controls—some automated and some manual controls. Panelists also observed that companies with a highly automated IT environment could benefit significantly by leveraging effective IT general controls to better utilize benchmarking in their Section 404 assessment.

Several panelists suggested there is too much emphasis on documentation and a general unwillingness on the part of auditors to acknowledge that lack of documentation of a control does not necessarily mean that the control does not exist or is not functioning. One panelist observed that use of inquiry and observation should be an available way of determining whether the control is functioning as designed.

The panelists noted that sound internal controls are relevant to both small and large companies. Yet smaller companies need guidance to help them determine "how to" think about risk, and "how to" apply the requirements of Section 404 and thus to determine what evidence is needed for management to make its assessment, how they should think through the intersection of work required versus risk, and determine the level of documentation needed.

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Guidance for Management's Assessment

The first year experiences of accelerated filers made apparent the need for implementation guidance designed specifically for management. As we compile and assess Year 2 observations and experiences, we believe the need remains for additional issuer implementation guidance of a practical nature that particularly recognizes the uniqueness of the small public company environment. This need continues despite the COSO undertakings to provide guidance for smaller public companies in applying the COSO criteria.

The guidance on performing the assessment should complement other guidance for applying the COSO criteria to smaller public companies. It should address how management of smaller public companies can implement comprehensive programs to enhance the company's internal control, perform periodic assessments of internal control, and report on its effectiveness. Additionally, we recognize the PCAOB may have to align the performance requirements for management's assessment in AS2 with this new guidance.

While the May 2005 guidance provided by the SEC and PCAOB has been helpful in clarifying certain aspects of the rules and standards and in providing interpretation for auditors in performing an audit of internal control over financial reporting, the additional guidance does not provide a roadmap for management of smaller public companies to conduct their own assessments. Such guidance will be particularly beneficial in making the initial implementation of Section 404 by nonaccelerated filers as effective and efficient as possible.

Moderators

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Thomas Ray, Office of the Chief Auditor, PCAOB

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Participants

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Leo L. Kessel, Senior Client Partner, Deloitte & Touche LLP

Bruce A. Renihan, Executive Vice-President and Controller, Canadian Imperial Bank of Commerce

Garrett L. Stauffer, Senior Partner, National Risk & Quality Practice, PricewaterhouseCoopers LLP

Shelley S. Stein, Chief Operating Officer, Grant Thornton LLP

Tom Szlosek, Vice-President and Controller, Honeywell International Inc.

Richard G. Ueltschy, Executive in Charge of Financial Institution audit practice, Crowe Chizek & Company LLP

Panel Three—The Audit of Internal Control Over Financial Reporting

Discussion Questions

1. Did auditors use any strategies to ensure that they appropriately altered the nature, timing, and extent of their testing in response to the assessed level of risk? If so, what were they? Are there additional improvements that could be made in the auditor's performance of a risk-based audit?
2. What impact did the Board's inspections of firms' first year internal control audits have on the audit process? What effect did the Board's November 30, 2005, report have on the second-year process? What impact did the Board's inspection program generally have on the auditor's approach to implementing the AS No. 2 audit process? How should the Board ensure that its inspection program is both rigorous and consistent with Board guidance concerning the implementation of AS No. 2?
3. Were fully integrated audits performed in the second year? If not, what barriers existed in the second year to prevent integration, and what can be done to reduce those barriers in the future? In what other ways could auditors increase the efficiency and effectiveness of the audit process without compromising the Act's goals?
4. How do auditors gather and use evidence about company-level controls? Were there changes to the auditors' approach to evaluating these controls, including control environment, in the second year? How do auditors evaluate the impact of compensating controls on control deficiencies? Do management's and the auditor's views differ in this area?
5. Did the process of identifying significant accounts, significant processes, and major classes of transactions worsen or improve in the second year? If not, what is the primary difficulty in this area? Do management's and the auditor's views differ in these areas?
6. Did auditors increase or decrease the degree to which the work of others was relied on in the second year? Was the May 16, 2005, guidance issued by the SEC and the PCAOB helpful in determining the extent to which the work of others could be used in the second-year assessment? Are there specific barriers that prevent auditors from using the work of internal auditors and others performing management's assessment to the fullest extent appropriate?
7. Are auditors tailoring the internal control audit to the complexity of the company? Is there appropriate recognition from auditors that control objectives may be achieved via many different methods? Are auditors reluctant to scale their work in less complex environments? Would modification to AS No. 2, or to the auditors requirements as a whole, make the process more effective and efficient? Are particular modifications necessary for smaller and less complex companies?

Summary of Panelists' Views

The panelists generally agreed there was significant improvement in the approach to determining scope and establishing testing strategies in Year 2. Management and auditors benefited from the significant knowledge of the company's internal controls gained from the first year assessment and both were more comfortable with their respective roles and responsibilities. Panelists also indicated that the additional guidance provided by the PCAOB and SEC in May 2005 was helpful in spurring many of the improvements and believe that additional experience will result in more consistent application by auditors and also will enhance their use of professional judgment in determining audit scope and developing efficient and effective testing strategies.

While acknowledging significant improvements in Year 2, most panelists expect further improvements in Year 3 and expressed the view that internal control reporting is an evolutionary process that will take additional time to reach a steady state. In particular, management would like to see additional reductions in auditor testing in low risk areas through more reliance on management's assessment processes. Panelists also believe there are additional opportunities to leverage effective entity-level controls that either monitor the functioning of transaction-level controls, or that are themselves sufficiently sensitive to prevent or detect errors. Some panelists observed an overall lack of guidance to aid in identifying and testing entity-level monitoring controls.

The panelists generally agreed that auditors used the work of internal audit and management more effectively in Year 2. However, they also observed there continues to be broad diversity in views among auditors as to the extent it is permissible to use the work of others. Other panelists observed that while there likely are additional opportunities to use the work of others, not every company has an internal audit function and AS2 states that auditors should use the work of management to a "lesser extent" than they otherwise would use the work of internal auditors.

Panelists also expressed the general view that the PCAOB inspection process has improved the quality of audits, but the inspections need to be completed timelier and reporting of the results needs to be accelerated. The panelists expressed their view that the PCAOB inspections provide a significant opportunity to identify best practices that can be leveraged by companies and auditors.

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In the PCAOB Report on Initial Implementation of Auditing Standard No. 2 (November 30, 2005), the Board acknowledged that, due largely to externally imposed timing constraints, most auditors were unable to integrate their first-year audits under AS2. We observed that significant audit efficiencies were achieved in Year 2 because, in most cases, we were able to better leverage our top-down, risk-based audit approach and start the Year 2 audit with both a detailed knowledge of a company's internal controls and, based on 2004 results, an expectation that internal controls were operating effectively. Additionally, because the number of internal control deficiencies declined in Year 2, we experienced more opportunities to fully rely on controls for assertions in the financial statement audit.

Following a Risk-Based Approach

A risk-based approach to the audit of internal control is consistent with our existing audit methodologies. In response to the additional PCAOB guidance, we made certain revisions to our internal guidance to better illustrate that the persuasiveness of the evidence that we need to obtain, and therefore the nature of our transaction-level control testing, should be commensurate with our determination of the degree of risk. Therefore, when our audit engagement teams conclude there is a lower risk of a material weakness, they may alter the nature of the control testing such that the persuasiveness of the evidence they obtain is commensurate with the lower risk.

Some have suggested that a risk-based approach means that auditors could perform testing only in areas that were deemed to be higher risk. However, AS2 requires management and auditors to test controls related to all relevant assertions for all significant accounts each year, so some testing would need to be performed in areas of lower risk.

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Moderators

Thomas Ray, Office of the Chief Auditor, PCAOB

Carol A. Stacey, Division of Corporation Finance, SEC

John W. White, Division of Corporation Finance, SEC

Participants

The Honorable Charles A. Bowsher, Former Comptroller General, U.S. Government Accountability Office

Noreen M. Culhane, Executive Vice President, Global Corporate Client Group, New York Stock Exchange

Gregory J. Jonas, Managing Director of Accounting Specialists Group, Moody's Investors Service

Peter D. Lyons, Partner, Shearman & Sterling LLP

Michael J. McConnell, Managing Director, Shamrock Capital Advisors

Robert C. Pozen, Chairman, MFS Investment Management

Monte N. Redman, Executive Vice President and Chief Financial Officer, Astoria Financial Corporation and Astoria Federal Savings and Loan Association

Kurt N. Schacht, Managing Director, Centre for Financial Market Integrity of CFA Institute

David Warren, Chief Financial Officer, The Nasdaq Stock Market, Inc.

Karen Hastie Williams, Director, Chubb Corporation and SunTrust Bank; Finance Committee Chair, Continental Airlines, Inc.; Audit Committee Chair, Gannett Company, Inc., Washington Gas Holdings Company, and the Federal National Mortgage Association Foundation

Panel Four—The Effect on the Market

Discussion Questions

1. Do you believe that the goals of the Act are being met? If not, why not? If so, were the goals being met chiefly by management's assessment, the independent audit, or both? Are these goals being met at a cost that is justified by the benefits delivered to shareholders? Is your view impacted by the size and/or complexity of the company?
2. Do investors benefit from internal control reporting? What is the source of any benefits? What are the countervailing costs? How could the internal control requirements be improved from an investor's perspective?
3. How is the competitiveness of U.S. public companies impacted by the internal control requirements? How might the cost of capital for U.S. companies change as a result? What will be the effect on U.S. securities markets and, therefore, U.S. investors? Will companies seeking to go public be influenced by the costs associated with the internal control reporting and auditing requirements? If so, how?
4. Do investors and other market participants generally understand the existing definition of the term "material weakness"? Do companies' public disclosures about the existence of material weaknesses adequately inform investors and the market about the material weaknesses in internal control over financial reporting and the effect of those material weaknesses on financial reporting? Does the market react to material weakness disclosures?
5. In your opinion, have disclosures related to material weaknesses in companies' internal control over financial reporting been helpful to investors? If so, how? Did such disclosure improve in the second year? If so, how?
6. Should other reporting and/or assessment options that are consistent with the goals of the Act be considered for management or the auditor? If so, how would these reporting options achieve the goals of the Act?

Summary of Panelists' Views

The panelists generally view the provisions of the Act as having had a significant positive effect on the U.S. capital markets by restoring investor confidence through improved corporate governance and integrity of financial reporting, increased transparency, and management certifying their responsibility for the company's internal controls. Panelists cited lower cost of capital and higher stock price multiples as tangible proof of the benefits afforded issuers and their shareholders. While panelists indicated difficulty in quantifying the specific benefits of internal control reporting provisions of the Act, they viewed it as an important component of the regulations. As evidence of its importance, panelists cited the numerous disclosures by companies of material weaknesses in internal control resulting from the internal control reporting process and that otherwise were not identified through management's certification process. Several panelists also cited the cultural shift taking place in many companies that has resulted in management taking more responsibility for internal controls, management having an improved knowledge of risks, and lower risk of corporate fraud.

Panelists generally were satisfied with disclosures about internal control matters and observed that market reaction to those disclosures demonstrates an ability to assess their overall importance. However, some panelists observed that in too many cases disclosures about material weaknesses in internal controls were being made at the same time that errors and restatements were being announced and thus providing backward, rather than forward-looking, information. Several panelists also expressed the sentiment that the material weakness threshold was resulting in a number of "technical" material weaknesses that detract from the focus on internal control matters that are important to investors.

Panelist views were mixed as to the long-term effect that the internal control reporting requirements will have on the global competitiveness of the U.S. capital markets. However, panelists cited recent studies that indicate a significant trend by foreign companies to list in foreign markets and access the U.S. capital market through secondary, private placement offerings and thus avoiding registration in the U.S.

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Benefits of Section 404 Requirements

We believe it is critically important to focus on, understand and appreciate the significant benefits resulting from implementation of the requirements of Section 404 of the Act. We believe that the effective implementation of Section 404 benefits the investing public in the form of more reliable and transparent financial reports, increased investor confidence, lower cost of capital for issuers, and a reduced risk of corporate fraud.

While the benefits and protections afforded to investors from the Section 404 process are generally recognized, less discussed are the direct benefits to companies that have implemented Section 404. The discipline, rigor, and focus on financial reporting and the associated evaluation and reporting on internal controls helps management and boards of directors, including their audit committees, better identify and manage the specific risks they face. Implementing the requirements of Section 404, along with other requirements of the Act, has promoted significant improvements in the culture in which many public companies now operate. We have witnessed this first-hand. Many members of management and directors have benefited, not just investors, and in the long run the successful implementation of Section 404 should help every company compete for talent and capital.

Meeting the Goals of the Act

It is critical to preserve the investor protection and other benefits of Section 404. In this regard, recent surveys indicate a growing recognition, even among those who have expressed deep concern about Section 404 costs, that Section 404 is providing a range of important benefits. For example, a recent report by Financial Executives International (FEI) shows that 56 percent of executives surveyed said Section 404 has increased investor confidence. Forty-four percent said that financial reports are more reliable because of Section 404, almost 39 percent said financial reports are more accurate, and almost 33 percent said Section 404 has helped prevent or detect fraud. And, Section 404 has resulted in the identification and remediation of a substantial number of material weakness and other control deficiencies. Fortunately, the number of material weaknesses and significant deficiencies appears to have declined in Year 2—an outcome we believe is a tangible benefit of Section 404.

Moderators

Thomas Ray, Office of the Chief Auditor, PCAOB

Scott A. Taub, Office of the Chief Accountant, SEC

John W. White, Division of Corporation Finance, SEC

Participants

J. Michael Cook, Audit Committee Chairman, Burt's Bees Inc., Comcast Corporation, Eli Lilly and Company, and International Flavors & Fragrances; Board Member, The Dow Chemical Company

Nick S. Cyprus, Former Vice President, Controller and Chief Accounting Officer, The Interpublic Group of Companies and AT&T, Member of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Board

Alex Davern, Chief Financial Officer and Senior Vice President of Manufacturing and IT Operations, National Instruments; Chairman, American Electronics Association (AeA) committee on reform of Sarbanes-Oxley 404

Michele J. Hooper, Co-founder and Managing Partner, The Directors' Council; Audit Committee Chair, PPG Industries, Inc.; Board Member, AstraZeneca, PLC and Warner Music Group

John J. Huber, Partner, Latham & Watkins LLP

Robert J. Kueppers, Deputy CEO, Deloitte & Touche USA LLP

Damon A. Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)

The Honorable David M. Walker, Comptroller General of the United States

Ann Yerger, Executive Director, Council of Institutional Investors

Panel Five—Next Steps

Discussion Questions

1. What remaining concerns about the implementation of internal control over financial reporting should be addressed? Do you believe management could obtain a reasonable basis for its assessment with less work and cost in subsequent years? Could the auditor issue his or her opinion with less work? If so, what work could be reduced or eliminated? Should management or the auditor be permitted to rotate the controls tested in subsequent years?
2. Are there specific amendments that could be made to either the Commission's rules or the PCAOB's standards to improve the efficiency and effectiveness of management's assessment and the auditor's role?
3. Is there specific additional guidance regarding internal control over financial reporting that the Commission should provide to companies, including guidance with respect to management's assessment? Is there specific additional guidance that the Board should provide to auditors regarding the audit of internal control?
4. Did costs related to internal control over financial reporting decrease as much as expected in the second year? Did total audit fees for the integrated audit decrease in the second year? Are costs expected to come down significantly in the third and subsequent years?
5. What other actions should the Commission and the Board consider to improve the process? What actions could other interested parties take to improve the process?

Summary of Panelists' Views

There was a general sentiment among the panelists that, in light of the recommendations of the SEC Advisory Committee on Smaller Public Companies ("Advisory Committee") to provide smaller companies broad exemption from the internal control reporting requirements, the SEC should act in a timely manner to address the applicability of internal control reporting for smaller public companies. The panelists also recommended that the SEC continue to support the efforts of COSO to clarify what is effective internal control over financial reporting for smaller public companies. Panelists also recommend that the SEC spearhead efforts to develop practical guidance for smaller public companies to aid in their initial and ongoing annual assessment of internal control over financial reporting.

While panelists generally were not opposed to the PCAOB revising AS2 to incorporate the Board's May 2005 guidance and to make other revisions to clarify certain aspects of the standard that are of continuing concern, several panelists expressed the view that the fundamentals of AS2 are sound and that any revisions should be made judiciously. Panelists recommended that the PCAOB leverage the inspection process to identify best practices and communicate them timely. Some panelists offered specific suggestions for revising AS2 including: eliminating the reference to interim financial reporting, emphasizing the qualitative nature of the assessment of a material weakness, and allowing for rotation of testing of transaction-level controls in lower risk areas.

Panelists also recommended that the auditing profession participate in improving the application of internal control reporting by developing and sharing best practices.

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Proposed Amendments to the Commission’s Rules or the PCAOB’s Standards

We are opposed to both large-scale permanent exemptions from Section 404 requirements and “watered down” issuer and auditor standards for smaller public companies. Therefore, we disagree with the Advisory Committee’s Primary Recommendations in Section III of the Report. In our view, it would be a disservice to investors and not in the best interests of smaller public companies to, after nearly three years, provide broad exemption to internal control reporting and, in effect, abandon the efforts of COSO to develop additional guidance for the application to smaller public companies. Further, we believe the Advisory Committee’s suggestions do little to preserve the benefits of Section 404 and appear to us to be more reactive to symptoms than responsive to the true drivers of cost and effort that concern smaller companies. The benefits of Section 404 are manifest. Therefore, measures to effectively manage effort for smaller public companies must leave those benefits largely intact. We believe the Advisory Committee’s recommendations fail that very important test. Finally, we do not believe that it would make sense to now exempt or apply “watered down” standards to many public companies that have already completed their second year of assessing and reporting on internal control over financial reporting.

It makes little sense to us to introduce an alternative to Section 404 assessment and reporting that does nothing meaningful to increase the reliability of financial statements. Therefore, we believe that design and implementation-only evaluations, such as those suggested by the Advisory Committee for some group of smaller public companies, would increase the likelihood of some material weaknesses going undetected. In addition, we believe the introduction of such an approach or a second standard applicable only to a portion of smaller public companies would lead to investor confusion and widen the current expectation gap around audits.

Improving the Process for Reporting on Internal Control

We recommend that the SEC take immediate steps to (1) coordinate completion of the COSO guidance for applying the COSO criteria to smaller public companies, and (2) establish a process for developing practical “how to” guidance and examples for smaller public companies in making their internal control assessments through identification, evaluation, and testing of key controls. We support efforts to complete the COSO undertaking, but we believe the COSO guidance on criteria alone will not sufficiently address the needs of smaller public companies in complying with the internal control reporting requirements. There is a need for practical performance guidance to provide management of a small, less complex public company with a useful “roadmap” to approach performing its assessment. There are a number of different processes that could be undertaken to create this guidance. Whatever the process, the performance guidance crafted must be practicable and bridge the gap between improved COSO guidance and the realities facing smaller public companies.

While additional guidance is clearly needed, that is not to suggest the “standards” for effective internal control should be lowered for smaller public companies. We believe issuers of all sizes need to achieve reasonable assurance that their internal controls prevent or detect material misstatement of the financial statements. We cannot overemphasize that whatever form the additional guidance takes, active involvement by management of smaller public companies, the SEC, the PCAOB, and auditors is critical to the development of guidance that will be objective, useful and authoritative.

We believe it is important for the SEC to be at the forefront of collaborative efforts to develop practical implementation guidance for smaller public companies. Issuers will rightly want to know that their regulator, the SEC, has determined the appropriateness of any published guidance or examples on applying the criteria for effective internal control to a smaller, less complex public company, and what constitutes appropriate testing and assessment procedures in such an environment.

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Using the Work of Others

The CRA survey supports that auditors were able to use the work of others to a significantly greater degree in Year 2. In 2005, our engagement teams had more flexibility to use the work of others, and we will continue to challenge modifications to our audit strategies going forward. However, the opportunity to use the work of others is largely dependent upon management's ability to perform a timely assessment and to dedicate sufficient resources to control testing efforts, including competent and objective internal audit, management personnel, or third parties. We believe it is important that management closely coordinate its assessment efforts with the external auditor to help maximize the ability of the auditor to use the work of others to the fullest extent permissible under AS2 and the company's circumstances.

Effect of November 30, 2005 PCAOB Guidance on the Second-Year Process

The data in the April 2006 CRA International survey, which updates information provided in two earlier surveys, confirms an expectation of substantial declines in total costs for the surveyed companies in the second year of reporting on internal control over financial reporting. While each company's actual experience varied with its own unique circumstances, the data clearly confirms the belief that the elimination of one-time start

up costs, combined with learning curve effects and additional regulatory guidance during 2005, has resulted in a general decline in costs for both smaller and larger companies that are accelerated filers.

As a key determinant of ongoing cost, the scope of controls identified for testing is a keen area of interest. The 2005 PCAOB guidance enabled companies and auditors to refine the criteria and approach used to identify and test Section 404 controls. The Fall 2005 CRA survey, found that an expected decline in the number of key controls tested, reflecting the benefits of experience, and greater reliance on the work of others, would tend to reduce costs. The Fall 2005 survey estimated for smaller companies, the number of key controls tested by auditors declined more than 21 percent on average from 262 to 206 from year one to year two. For larger companies the average number of key controls tested by the auditors fell more than 19 percent from 669 in Year 1 to 540 in Year 2. Management for both smaller and larger companies also reduced their own testing of key controls.

In addition, auditors for smaller companies estimated they relied on the work of others for 22 percent of audit evidence in the second year, up from 11 percent in the first year. For larger companies, reliance on others' work was estimated to have risen to 25 percent from 15 percent.

For more information on the May 10, 2006 SEC and PCAOB Roundtable, please go to the SEC's website at www.sec.gov.