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STANDING ADVISORY GROUP MEETING

IMPLEMENTATION OF SECTION 404 AND AUDITING STANDARD NO. 2

JUNE 8-9, 2005

Introduction

Recently, as required by Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act"), many of the largest public companies filed their first assessments of their internal control over financial reporting, as well as the related reports from their auditors. While few quarrel with the goals and purpose of Section 404, those involved in its implementation have found the first year challenging. Many companies found Section 404's requirements costly and burdensome. Some auditors encountered difficulties in applying the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

As of May 15, 2005, approximately 12% of companies reporting under Section 404 have reported material weaknesses. The most frequently cited effect of the reported material weaknesses was significant year-end or auditor initiated adjustments. Tax accounting and revenue recognition were the most prevalent accounting areas cited.[1/]

With the goal of learning from the first year's experience implementing Section 404, the Board participated in the Securities and Exchange Commission's ("SEC") Roundtable on Internal Control Reporting Provisions on April 13, 2005. At the Roundtable, issuers, auditors, investors, and regulators discussed how the Section 404 process can be improved. On May 16, in response to issues raised at the Roundtable and elsewhere, the Board published additional guidance on Auditing Standard No. 2.

[1/] Source – Audit Analytics.

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The guidance, in the form of a Board policy statement and additional staff questions and answers, should foster improvements in the way that future audits of internal control over financial reporting are conducted.[2/]

The Board remains focused on promoting a Section 404 process that is effective and cost-efficient. Accordingly, the next meeting of the Board's Standing Advisory Group ("SAG") will be devoted to continuing the discussion of Section 404 implementation issues. This paper outlines the topics to be discussed at the meeting. Three panel discussions—auditors, issuers, and small business—will facilitate the SAG's consideration of these matters.

Auditor Panel – Discussion of Strategies for 2005

Section 404 requires registered public accounting firms to attest to, and report on, management's assessment of the effectiveness of the company's internal controls. The Board's Auditing Standard No. 2 governs those responsibilities. Auditing Standard No. 2 requires auditors to exercise professional judgment to tailor its provisions to the particular circumstances of each audit client.

The first year's implementation of the standard required an enormous effort on the part of the audit profession due to, among other things, the short timeframes involved and the need to train large numbers of professionals. Notwithstanding these hurdles, many auditors effectively carried out their responsibilities under the standard, and their diligence has led to greater transparency about material weaknesses in companies' internal control over financial reporting. At the same time, it appears that some auditors may not have made sufficient use of certain features of Auditing Standard No. 2 that are designed to reduce costs without sacrificing quality. The Board's May 16 policy statement seeks to remedy some of the problems that auditors experienced during the first year.

The policy statement expresses the Board's view that, to properly plan and perform an effective audit, auditors should –

- ***Integrate their audits*** of internal control with their audits of the client's financial statements, ***so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits***;

[2/] The Board's policy statement and the staff questions and answers are available on the Board's Web site at http://www.pcaobus.org.

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- ***Exercise judgment to tailor their audit plans to the risks facing individual audit clients***, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);

- ***Use a top-down approach*** that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and ***use the risk assessment required by the standard*** to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;

- Take advantage of the significant flexibility that the standard allows to ***use the work of others, particularly in low-risk areas*****;** and

- ***Engage in direct and timely communication with audit clients*** when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

The SAG will hear a discussion from a panel of auditors on their strategies to improve the effectiveness and efficiency of future audits of internal control. The SAG will then have the opportunity to ask questions of the panelists.

<u>Discussion Topics</u> –

The panel members will provide the SAG with information about:

- How the first year's experience as well as the guidance issued by the PCAOB and SEC on May 16, 2005 will affect their approaches to auditing internal control over financial reporting in the coming year.

- What aspects of the audit process they plan to change in 2005, and how those changes improve the audit process – for instance, whether any changes are anticipated in the framework for evaluating control exceptions and deficiencies, which was developed by representatives of nine firms.[3/]

- What aspects of their audit process worked well last year and, accordingly, what they plan to retain or strengthen in 2005.

- Potential strategies for better integrating the audit of internal control over financial reporting with the audit of the financial statements, including testing controls throughout the year in order to reduce substantive testing during the financial statement audit and having the same team doing all of the work.

Issuer Panel – Discussion of Strategies for 2005

Before the auditor can complete his or her audit, company management must, of course, perform its own evaluation of the effectiveness of internal control over financial reporting. Auditing Standard No. 2, thus, sets out certain conditions that must be met in order for the auditor to issue an opinion. Specifically, management must:

- Accept responsibility for the effectiveness of the company's internal control over financial reporting,

- Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria,

- Support its evaluation with sufficient evidence, including documentation, and

- Present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.[4/]

[3/] "A Framework for Evaluating Control Exceptions and Deficiencies," version 3, December 20, 2004. The framework can be found on the Web site of the American Institute of Certified Public Accountants at http://www.aicpa.org.

[4/] See Auditing Standard No. 2, paragraph 20.

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A panel of individuals associated with issuers will discuss their views on how the Section 404 process can be improved. The SAG will then have the opportunity to ask questions of the panelists.

Discussion Topics –

The panel members will provide the SAG with information about:

- How their first year's experience in implementing section 404 will affect their approaches to the process in the coming year.

- What changes should be made to the process, and how those changes will improve the process and make it more sustainable.

- What aspects of the process they believe worked well last year and, accordingly, what they plan to retain in 2005.

Audit Committee Oversight

Audit committees play a key oversight role in the Section 404 process. Under the Act, the audit committee serves as the company's point of contact in its relationship with its auditor. Specifically, Section 301 of the Act requires the audit committee of an issuer with securities listed on a national exchange or Nasdaq to be directly responsible for the appointment, compensation, and oversight of the work of an auditor employed for the purpose of issuing an audit report, and such an auditor must report directly to the audit committee. In addition, Section 202 of the Act requires the audit committee to pre-approve all services to be provided to the issuer by the auditor.

Discussion Questions –

1. What can the PCAOB do to facilitate audit committee oversight of the Section 404 process?

2. What information do audit committees need to receive from auditors in order to fulfill their responsibilities?

3. How effective are the requirements that the auditor communicate certain matters to the audit committee?

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Evaluation of Material Weaknesses

The products of an audit of internal control over financial reporting are the auditor's opinions on the effectiveness of the company's internal control over financial reporting and on management's assessment. SEC rules implementing Section 404 prohibit management from concluding that internal control over financial reporting is effective if there are one or more material weaknesses.[5/] Similarly, under Auditing Standard No. 2, internal controls are effective when no material weaknesses exist.[6/] The definitions of control deficiency, significant deficiency, and material weakness in paragraphs 8 through 10 of Auditing Standard No. 2 are used to evaluate deficiencies in a company's internal controls. These definitions are as follows:

- A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood[7/] that a misstatement of the company's

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[5/] See Item 308(a)(3) of Regulation S-K, 17 C.F.R. § 229.308(a)(3).

[6/] See Auditing Standard No. 2, paragraph 175.

[7/] The term "remote likelihood" as used in the definition of *significant deficiency* and *material weakness* has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable, reasonably possible*, and *remote* to identify three areas within that range, as follows:
>
> a. *Probable*. The future event or events are likely to occur.

annual or interim financial statements that is more than inconsequential[8/] will not be prevented or detected.

- A *material weakness* is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Auditing Standard No. 2 further provides that each of the following circumstances should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.

- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting.

- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective.

- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the

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b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.

c. *Remote*. The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable. See Auditing Standard No. 2, note to paragraph 9.

[8/] A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential.* See id.

company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

- Identification of fraud of any magnitude on the part of senior management.

- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

- An ineffective control environment.[9/]

Discussion Questions –

1. How were these definitions applied in the first round of internal control audits? Did the definitions of *significant deficiency* and *material weakness* appropriately identify matters that should be disclosed to the audit committee and the public?

2. What challenges were encountered in evaluating deficiencies?

3. How were the strong indicators of a material weakness listed in Auditing Standard No. 2 used in making evaluation decisions?

Reporting and Communication Issues

The auditor's report on management's assessment of internal control over financial reporting contains two opinions. First, Auditing Standard No. 2 requires the auditor to express an opinion on whether management's assessment of the

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[9/] See Auditing Standard No. 2, paragraph 140.

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effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. Second, the auditor must express an opinion on whether the company maintained, in all material respects, effective internal control over financial reporting.[10/] Where the auditor determines that a material weakness exists, the auditor must express an adverse opinion on the company's internal control over financial reporting. In such circumstances, the auditor's report must also include, among other things, a description of the material weakness.[11/]

In addition, the auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting, and should distinguish clearly between those matters considered to be significant deficiencies and those considered to be material weaknesses.[12/] The auditor should also communicate to management, in writing, all deficiencies in internal control over financial reporting identified during the audit and to inform the audit committee when such a communication has been made.[13/]

Discussion Questions –

1. Management and auditor disclosures about material weaknesses were often identical in this first year of implementation. Is this good, bad, or neither?

2. Did the past year's discussions in auditor's reports of material weaknesses provide sufficient information to investors? Would more information about those material weaknesses be useful? For example, should the discussion include a description of the particular unmet control objective(s) that resulted in the material weakness?

10/ See Auditing Standard No. 2, paragraph 167.

11/ See Auditing Standard No. 2, paragraphs 175-76.

12/ See Auditing Standard No. 2, paragraph 207.

13/ See Auditing Standard No. 2, paragraph 209.

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Multi-Location Issues

Auditing Standard No. 2 provides direction to auditors to help them determine the locations or business units they should select for testing when auditing internal control over financial reporting. Under the standard, testing company-level controls is not a substitute for testing of controls over a large portion of the company's operations or financial position. Accordingly, if the auditor cannot test a large portion of the company's operations and financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting.[14/] (See the appendix to this paper for additional information on multi-location issues.)

Discussion Questions –

1. How have issuers and auditors implemented the provisions in Auditing Standard No. 2 on testing of multiple locations?

2. What approaches to multiple-location testing worked well, and what approaches were not as effective?

3. How has the provision on "large portion" been implemented in practice?

Small Business Panel

Smaller public companies make up a significant segment of the issuer population. Although these companies have the same legal obligations regarding Section 404 and the same core objectives for effective internal control as large companies, they may fulfill their responsibilities differently in some respects. The Board therefore stressed in the releases accompanying the proposal and adoption of Auditing Standard No. 2 that auditors should tailor their audit programs to suit the size and complexity of the audit client.

The Board is committed to learning from those who have implemented Section 404 in order to improve the implementation process for the smaller public companies now undertaking it. Toward that end, the PCAOB serves as an observer to the SEC's Advisory Committee on Smaller Public Companies. In addition, the Board has provided a consultative delegate to the Committee of Sponsoring Organizations of the Treadway

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[14/] See Auditing Standard No. 2, paragraph B11.

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Commission's ("COSO") project to tailor its control framework to the small business environment.

The SAG will hear a panel discussion about the application of Section 404 and Auditing Standard No. 2 to small business issuers and their auditors. The SAG will then have an opportunity to ask questions of the panelists.

Discussion Topics –

The panel members will provide the SAG with information about:

- Approaches to auditing internal control over financial reporting in a small business environment.

- How experiences implementing Section 404 and the guidance issued by the PCAOB and SEC on May 16, 2005 will affect their approaches to implementation in the coming year.

- Successful documentation strategies for management of small businesses and their auditors.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

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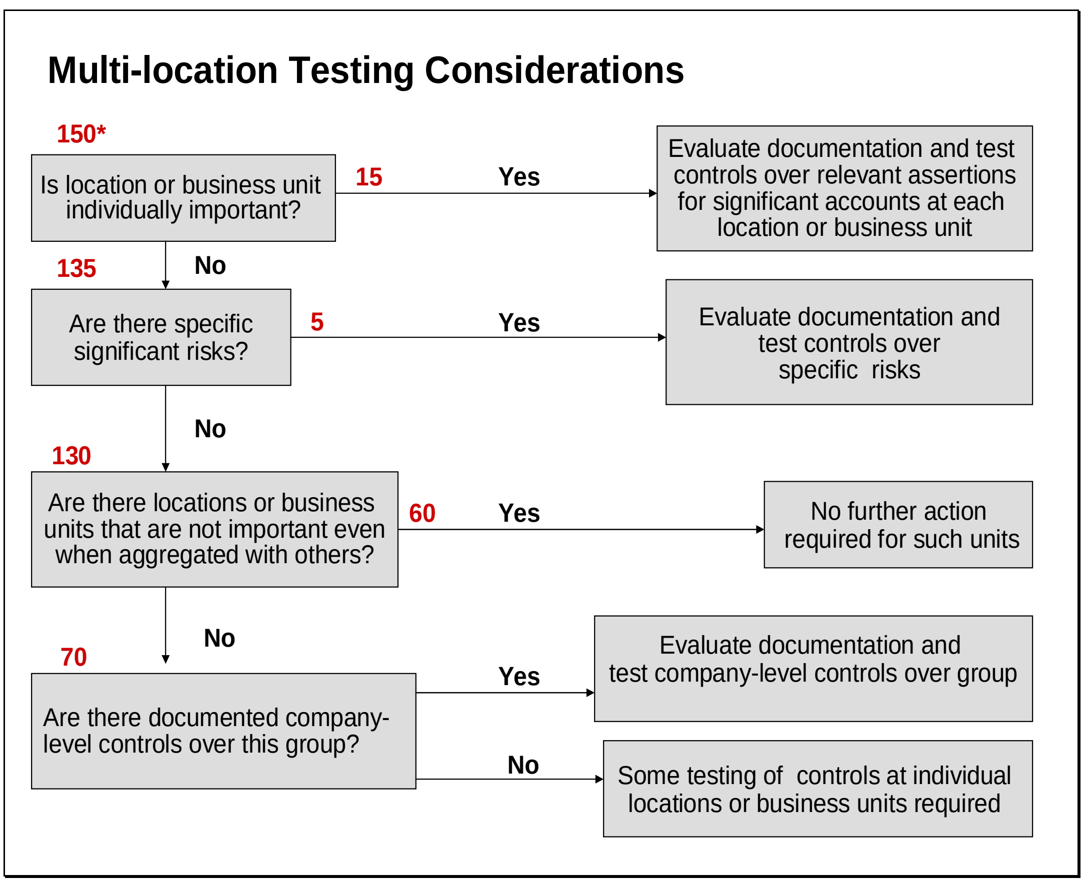
Appendix

Multi-Location Testing

Auditing Standard No. 2 provides direction to auditors to help them determine the locations or business units they should select for testing when auditing internal control over financial reporting. This instruction is specifically provided for in Appendix B paragraphs B1 – B17.

The following table, included in paragraph B13, illustrates how the directions in that section should be applied to a hypothetical company with 150 locations or business units, along with the auditors testing considerations for those locations or business units:



* Numbers represent number of locations affected.