THE SEC ROUNDTABLE ON INTERNAL CONTROL REPORTING REQUIREMENTS (404)

General Comments

- The benefits and therefore the cost/benefit trade-off of 404 implementation varies widely among companies. Cost increments were substantial for all companies, but benefits ranged across the spectrum --- from "little benefit" for companies that already had excellent controls and required mostly some additional documentation to "significant benefit" for companies and potentially for shareholders of companies that had weak controls.

- A benefit of 404 that should be noted is that there is, generally, a higher degree of understanding by various functions of companies of how their work contributes to timely and accurate financial reporting. Additionally, there is a heightened awareness by management of many companies of the critical importance of internal controls.

- The Audit Committees on which I serve have always had private meetings with internal and external auditors to encourage frank, open communications and assessments. However, 404 (and SOX generally) have led to much more frequent off-line communications with the companies' internal auditors and with the external auditors. Frequent and open contact could be beneficial in terms of early identification of issues that might require Audit Committee and Board attention.

- I have always found it to be particularly important to have frank, objective advice from outside auditors on accounting treatment and other issues surrounding financial reporting and auditing. The management and internal auditors of some companies are finding that relationships with their outside auditors have changed. They report that outside audit firms are taking the position that they can no longer help their clients in deciding how to apply accounting principles and that management must form its own independent conclusions. This has led the management of many companies to consult with their external auditors less frequently than is appropriate due to concerns that the need for consultation may be viewed as a deficiency.

  I think this is counterproductive to good financial reporting. It has always been important to me to be able to look the outside auditor in the eye and ask straight out whether an accounting treatment is duly conservative and well within the bounds of appropriate treatment. It is important that management, whose objective it is to prepare financial statements with integrity, be able to have these discussions with the audit firms.

- Implementation of 404 has been challenging for many reasons, including the fact that there has been little guidance by the SEC to management on what is expected of them regarding the control assessment process. The management of many companies have obtained guidance from their external auditors. This has resulted in the PCAOB, in effect, setting the standard for management on what is required to perform a control assessment (i.e., Audit Standard No. 2), rather than management setting the standard based on guidance from the SEC. Guidance would be very helpful for the ongoing process.

- Implementation of 404 has been very, very costly, and as mentioned, benefits to specific companies vary widely. Some changes to 404 that could help reduce costs and that are also reasonable in terms of performing a reliable audit are 1) place more emphasis on riskier areas in terms of the frequency and detail of the audit by allowing some rotation of low risk areas, particularly for companies that have good records of controls, and 2) where possible, allow the external auditors to use the work of the internal auditors to a greater degree.

Detailed Observations and Recommendations

Observation #1: Excessive time has been spent on documenting and testing low risk routine process-level controls. Recent corporate accounting scandals resulted from “tone-at-the-top” issues, outright fraud and poor corporate governance, not the lack of routine process-level controls.

Recommendation: The control assessment process should focus more on highly subjective areas and areas of high risk (as defined by management and the auditor), rather than on low risk routine process-level controls.

Observation #2: Audit Standard No. 2 requires that the testing for each year must stand on its own. Auditors are not allowed to use the concept of “rotation” of testing for lower risk areas. Auditors will likely be compelled to perform comprehensive testing of all areas every year rather than focusing their testing on high risk areas, resulting in unnecessary costs.

Recommendation: Management and the auditors should be allowed more flexibility in determining the nature and timing of tests, including considering audit results from testing in prior years. For example, if a company has demonstrated a highly effective system of internal controls for several years and there is no significant change in the design of controls or in related business processes, management and the auditors should be allowed to focus testing on high risk areas and perform tests of monitoring controls rather than process-level controls, while rotating tests of low risk routine controls (e.g., performing tests every 2-3 years).

Observation #3: A lack of definitive guidance regarding what constitutes “principal evidence” and restrictions on the use of the work of others (particularly related to walkthroughs, the control environment and information technology controls) contained in Audit Standard No. 2 has resulted in excessive/duplicative testing being performed by the external auditors. The external auditors have generally interpreted the “principal evidence” requirement to mean that they must perform more than 50% of the work in all areas, including areas of low risk.

Recommendation: Revise Audit Standard No. 2 to allow auditors to utilize the work of others (in particular internal auditors) to a greater degree, especially with regard to walkthroughs, the control environment, and information technology controls. Also allow auditors to satisfy the "principal evidence" requirement by focusing their testing on high risk areas rather than on low risk routine process-level controls.

Observation #4: Ambiguity within Audit Standard No. 2 (e.g., the use of terms such as "remote likelihood" and "more than inconsequential") coupled with the "no exceptions" test evidence required by external auditors resulted in excessive documentation and testing requirements by the external auditors. Auditors generally concluded that more documentation and testing was better, rather than considering the cost/benefit of these decisions.

The ambiguity of Audit Standard #2 and the lack of other definitive guidance regarding Section 404 also resulted in differing interpretations of the requirements among the Big 4 external audit firms. These firms have issued their own guidance to which they expect their clients to adhere. The constantly evolving guidance and external auditor requirements made for numerous false starts and a considerable amount of re-work for the management of many companies during 2004.

In addition, auditors generally concluded that if "evidence of the performance of a control was not maintained, the control did not operate". As a result, companies were required to implement procedures to create "auditable evidence" that each control is performed (e.g., sign-offs on forms/reports, checkmarks on reports, checklists). A missing signature or checkmark resulted in a testing failure even though the control/review procedure may have occurred. Alternative procedures to validate the effectiveness of the control in these cases were not generally considered by the external auditors.

Recommendation: Continue to clarify the requirements of Audit Standard No. 2. Look for ways to provide more consistency in how Audit Standard No. 2 is interpreted and implemented among the external audit firms. In particular, provide additional guidance to reduce the onerous requirements regarding documentation and audit evidence.

Observation #5: Certain external audit firms have advocated sampling approaches that provide no tolerance for human error. If one exception is found in a test of a manual control, the control is generally presumed to have "failed" and a deficiency is noted.

Recommendation: Provide additional guidance regarding testing/sampling methodologies in Audit Standard #2 on what constitutes sufficient evidence to demonstrate the effectiveness of their controls.

Observation #6: The external audit firms have taken the position that they can no longer help their clients with the application of accounting principles and management must form its own independent conclusions. This has led the management of many companies to consult with their external auditors less frequently than is appropriate due to concerns that such consultation may be viewed as an internal control deficiency.

Recommendation: Develop standards that encourage communication between management and the external auditors regarding accounting matters, which will result in improved financial reporting.

Observation #7: The costs related to Section 404 were significantly greater than anticipated and were a financial burden to many companies. Estimated Section 404 costs for 2005, including costs of the external auditors, reflect very little decrease from 2004.

Recommendation: In addition to the recommendations noted above that should help reduce the extensive costs related to the Section 404 requirements, the SEC should perform studies to determine the primary causes of these costs and take steps to reduce costs going forward.