May 15, 2006

CPCAF Summary of the SEC and PCAOB Roundtable on Second-Year Experiences with Internal Control Provisions

The Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) hosted a roundtable discussion on May 10, 2006, to discuss second-year experiences with the reporting and auditing requirements of the Sarbanes-Oxley Act of 2002 (SOX) related to companies' internal control over financial reporting. Roundtable panelists consisted of issuers, auditors, investors and other interested parties.

This publication summarizes the roundtable discussion, which primarily focused on five key topics, into the following sections:

Opening Remarks

Christopher Cox, Chairman – SEC

Mr. Cox welcomed all of the participants and thanked the panelists for agreeing to take part in discussing a topic of great importance to the nation's public companies. He said SOX, and especially its provision on internal control reporting under Section 404 (Section 404), has great potential to enhance financial reporting – and has already done so. Adding that this potential may only be realized if implemented properly and consistent with the Act's intent, he noted that in practice this has not always been the case. He also stated that the SEC and the PCAOB are committed to strong internal controls, which were introduced into federal law with the Foreign Corrupt Practices Act in 1977. He shared some statistics, illustrating a significant drop in material weaknesses reported by companies in years 1 and 2 of Section 404 reporting (from 1,500 to 400), and a change in the percentage of companies reporting that their internal controls were not effective (from 16 percent to 7 percent during the same period).

Mr. Cox stated that the SEC and PCAOB would like feedback about whether the process has worked in year 2, for example, any impediments encountered and suggestions to improve Section 404 documentation, assessment, reporting and auditing processes. He indicated that the SEC and PCAOB would also consider all of the written submissions, the GAO report, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, and recommendations of the SEC's Advisory Committee on Smaller Public Companies. Hopefully, he indicated, all of the information and feedback would help them get Section 404 right – sooner rather than later.

Bill Gradison, Acting Chairman – PCAOB

Mr. Gradison remarked that the roundtable format, which seeks to get to the 'nitty gritty' of Section 404 issues is much like congressional testimony. He reiterated Mr. Cox's statement about the PCAOB's willingness to revisit Auditing Standard No. 2 (AS 2) or issue additional guidance on how to implement the standard, if necessary. He stated that AS 2 protects investors' interests and that public companies have a special responsibility to comply with it. Concerned about small companies' ability to implement that standard, he believes the standard is flexible and scalable enough to accommodate them. Due to concerns about Section 404 inefficiencies and costs, inspections (which began last week) will focus on audit effectiveness. Specifically, inspectors will look for integration between the financial statement and internal control audits, and whether auditors are using a top down, risk-based approach and the work of others (such as internal auditors). He said the PCAOB welcomes comments on their inspection approach and ways to scale the requirements of Section 404 to smaller companies.

Panel 1 – *Overview of the Second Year*

SEC Moderators

Nancy L. Salisbury
Office of the Chief Accountant

John W. White
Division of Corporation Finance

PCAOB Moderator

Thomas Ray
Office of the Chief Auditor

Panelists

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

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?

Highlights of Panelists' Views

Panelists generally agreed that second year implementation was much improved over the first year; it was more efficient because auditors and companies leveraged their experiences from year one. Some noted that it was difficult to quantify the benefits of Section 404 but that there were definite benefits. They generally agreed that the May 2005 guidance

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 Engines

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

issued by the SEC was very helpful but more was needed. Most panelists thought that second year's Section 404 costs fell but were still too high and that requirements for smaller companies were still needed.

Philip D. Ameen said GE management and the board were favorably impressed by progress made in the second year of Section 404 implementation. As for benefits of Section 404, he cited the company's increased focus on internal controls (helpful in operations and acquisitions), the ability to do more targeted assessment and analyses of controls that are important to the financial reporting process, and the establishment of a common vocabulary around internal controls throughout the organization.

Mary K. Bush saw a positive development from year 1 to year 2 in ways the companies and external auditors interacted and management assumed responsibility for internal controls. One key benefit she noted was the integration of controls in work processes, which helps companies operationally. Overall, she observed a cultural change in companies with a greater emphasis on controls and better utilization of internal audit departments to design controls that prevent problems, which greatly enhances companies' financial reporting and safeguarding of assets. Another issue noted was auditors' over-reliance on checklists and emphasis on lower level controls (vs. more risky areas). She saw these as areas needing further guidance. On the subject of audit costs, Ms. Bush added that anecdotally she understands outside audit costs in year 2 are much lower, as are internal costs, which have decreased even more since documentation was completed in year 1.

H. Rodgin Cohen believes that significant benefits have been derived from Section 404, in that companies can detect problems earlier than before, investor confidence has risen, and companies consolidating are provided a major benefit when they can rely on internal controls of a target company. He stated there is more work to do to balance costs and benefits. In terms of cost, he thought that year 1 experience and last year's SEC guidance eased the burden on companies. He added that the qualitative cost of Section 404 was still high due to auditor conservatism. He believes that additional guidance will help drive costs down further.

Colleen Cunningham cited an FEI survey of public companies which noted several benefits of Section 404 including greater investor confidence, reliability and accuracy of company financial results, and an enhanced ability of companies to prevent and detect fraud. Ms. Cunningham stated that according to the survey audit fees are on average 13 percent lower in year 2 than in year 1. While many anticipated a larger decrease, supply/demand, liability costs, and other issues kept costs high. She also noted that when using an integrated audit approach it is hard to differentiate costs related to each component of the audit (i.e., Section 404 vs. financial statements) and that according to the survey results it appears that overall audit fees were flat. Concerned about management being constrained by new AS 2 requirements, Ms. Cunningham hopes that any additional guidance will be principles-based and not a “new” standard.

Robert W. Davis agreed that the May 2005 guidance was helpful and that investor confidence has increased but that costs were still too high. He thought an amendment to AS 2 might be appropriate and further guidance from the SEC was needed. He sees a lot of variety in practice. Mr. Davis also noted his concern about ‘soft costs’ of Section 404, e.g., time spent by boards and senior managements across companies.

Samuel A. DiPiazza, Jr. thought that Section 404 had a positive effect on company behavior. He considered the May 2005 guidance helpful and would welcome further guidance to define certain terms in the standard. He believes the accounting profession can be more efficient and predicted that the learning curve, which is underway, would continue at the current rate. Responding to a question raised for the panel’s auditors that a substantial decrease in audit fees was offset by other costs, Mr. DiPiazza attributed offsetting costs to:scope increases on the integrated audit, new and revised standards, increased emphasis on fraud and forensics, system changes and process adjustments needed as a result of implementing Section 404, and increased M&A activities. This was another year of changes, he said. Mr. DiPiazza doesn’t believe AS 2 needs to be re-opened for wholesale changes but that if the standard is re-opened, previously issued guidance should be incorporated into the standard.

Barbara Hackman Franklin was favorably impressed with her second year experiences as an audit committee chair and member in several organizations; the process was smoother, control systems better, and there was greater reliability in internal controls. However, she was concerned somewhat about the ongoing costs of Section 404 and that a balance between costs and benefits had not been struck. She said the improved “mindset” and understanding of internal controls throughout organizations and management’s ownership of the controls system were also positive. She indicated that small companies will need guidance to help them implement the standard. Ms. Franklin also stated that auditors were more confident and performed better in year 2. She attributed year 1 ‘nervousness’ to litigation concerns and uncertainty in applying the new standard, which caused auditors to apply the rules too literally. Ms. Franklin believes that audit committees have become more engaged in the Section 404 process with the auditors – from planning and scoping to the issuance of a final opinion, and providing oversight throughout. She indicated that costs have fallen but not enough. Ms. Franklin agreed with other panelists by stating that the fundamentals of AS 2 should not change. She thought that the SEC should provide clarification on materiality and that the May 2005 guidance should be incorporated into the standard, which would empower auditors.

Joseph A. Grundfest commented on the effect of the PCAOB inspection process has had on Section 404 compliance by stating that there is great concern among auditors in terms of whether they audit too much or too little. He believes the auditors have taken a defensive stance and generally over-audited to protect themselves from aggressive enforcement of the rule by PCAOB and litigation. He likened this to physicians who over-test patients to avoid costly litigation – in both instances the patient (client) does not benefit and in fact is harmed since they bear the unnecessary cost. Professor Grundfest believes that the terms “material weakness” and “significant deficiency,” as defined in AS 2, contribute to the situation in that they cause the auditor to look at items that have a minute (.05%) chance of occurring (the auditors on the panel did not agree with Professor Grundfest’s analysis). He also questioned whether Section 404 had gone too far, noting that the vast majority of negative Section 404 reports were not followed by a stock market response.

Dennis A. Johnson believes that audit committees are better qualified and more engaged in planning but that auditor costs are still too high. He cautioned about the opportunities that may be lost due to Section 404 and cited a *Wall Street Journal* article, which reported that 90% of the top initial public offerings (IPOs) (in terms of capital raised) last year were made outside the US. Mr. Johnson still believed that the benefits exceeded the costs and that Section 404 was vitally important to CALPERS.

Edward E. Nusbaum indicated that year 2 documentation of controls was much improved and the process had become much more efficient. He added that the May 2005 guidance on integrated audits and the risk-based approach was very helpful. He believed that the underlying principles in AS 2 should be kept but that more guidance is needed. He suggested that the guidance provide illustrations on how to apply the principles via case studies and examples. He also suggested that the guidance be developed by a consortium of investors, preparers, auditors, regulators and others. Mr. Nussbaum believes the guidance would be particularly helpful to small companies. He also thinks the guidance should distinguish management’s and the auditor’s roles in Section 404, which could help bring costs down by eliminating duplicated efforts. Firms would benefit by being informed about best practices that the PCAOB identifies in their inspections as well.

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Panel 2 – *Management's Evaluation and Assessment*

SEC Moderators

Scott A. Taub
Office of the Chief Accountant

John W. White
Division of Corporation Finance

PCAOB Moderator

Laura J. Phillips
Office of the Chief Auditor

Panelists

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, CBS, 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, KPMG LLP

Stephen A. Sherwin, M.D.,

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 riskfocused 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

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

might make the process more efficient and effective? Are particular modifications desirable or necessary for smaller and less complex companies?

Highlights of Panelists' Views

Panelists agreed that a top-down approach to risk assessment in scoping the Section 404 audit is important as this should reduce much of the detail work that is being done (for example, some panelists thought detailed testing of IT application controls was excessive). There was also general agreement that the SEC should provide guidance to companies, particularly smaller companies.

William J. Brunner believes guidance aimed at management would be helpful and open the gates to more cooperation with the auditors. He sees opportunities for improvement, e.g., removing some of the silos among different types of controls, and stepping back to evaluate the environment as a whole. Mr. Brunner said that a greater focus on entity level controls, more inquiry and observation, and a backing away from excessive documentation and testing is needed. He also believes that smaller companies may need different guidance than larger ones. On entity level controls, Mr. Brunner suggested greater focus on the business model and environment, including for example management's involvement in financial reporting, executive tone, and ethics. He added that an environment in which the fear of 20/20 hindsight trumping one's judgment drives people to "paper everything up."

Kimberly Parker Gavaletz agreed that guidance geared toward management would be helpful to companies that have experienced Section 404 and those who will begin complying with Section 404 in the future. She believes the top-down approach is being used more and more although there is still too much testing taking place. She cautioned against over-regulating, stating that companies and auditors need time to adjust. Ms. Gavaletz believes that any additional guidance should emphasize entity level controls and be as simple and flexible as possible. She suggested that small companies may need additional guidance.

Susan C. Gordon did not believe her company would do anything different if their internal control assertion were not subject to external audit. Noting some debate in year 1 with their auditor regarding the testing of certain controls, Ms. Gordon said that debate diminished by year 2. She also believes that there has been a shift in mindset throughout management regarding internal controls, which she attributes to SOX. Ms. Gordon acknowledged the difficulties smaller companies face in becoming public and supports some relief from Section 404 for small companies. She attributed some of the frustrations regarding IT inefficiencies to the fact that IT specialists were not knowledgeable about internal controls and internal control personnel were not knowledgeable about IT; in addition, these professionals did not always communicate with each other. She believes this situation is self-correcting.

Keith E. Holmberg noted that foreign filers have gone from being amused by SOX Section 404 to being very concerned about their impending requirement to comply with it. He says in year 2, his organization wrestled with questions, but in year 1 may have benefited from a lack of prescriptive guidance. He thinks Section 404 makes good business sense and does not see Section 404 solely as a compliance exercise, which Mr. Holmberg says is key in obtaining buy-in from his foreign counterparts.

Lee Level stated that if his company's assertion about internal controls were not subject to audit, he would put more resources into assessing entity level controls. He said that management's assessment is driven by the auditor's opinion, thus companies determine the auditor's focus early in the process to ensure that the auditor will agree with their assessment. He urged the SEC to consider merging the three opinions into one. Guidance was helpful (though late). Mr. Lee agreed that IT testing was overdone and that the SEC should consider developing criteria that would allow firms to use a benchmark, and offered his company's assistance to develop the criteria.

Peter F. Minan believes the May 2005 guidance was helpful. He stated that there has been a steep learning curve regarding risk assessments and documentation. He also saw opportunities to migrate from detection controls to preventive controls in the IT area.

Stephen A. Sherwin cautioned against stifling innovation by burdening small companies (particularly those in areas such as biotechnology) with Section 404. Dr. Sherwin voiced his concern that Section 404 costs would make it impossible for small emerging companies to participate in US public markets. He also stressed that this could cause the US to lose its lead position in the world financial markets as smaller companies consider their options in non-US markets. Dr. Sherwin added that the real cost of small company personnel time that would be spent on Section 404 is grossly underestimated; because of lean staffs and a lack of expertise, small companies are generally forced to buy assistance from audit firms. Opportunity costs to these companies – especially biotechnology – are difficult to measure and he emphasized that time spent on Section 404 is time not spent on important research efforts (e.g., cancer cures).

Dr. Albert M. Teplin thought guidance would help make the process more efficient. He had hoped costs would decrease more than they did but believes improvements since the outset of Section 404 implementation have been significant. He attributed that to management, auditors and audit committees working more efficiently, adding that there is still room for improvement (e.g., having external auditors leverage internal auditor work). Dr. Templin also suggested that controls in less risky areas may not need to be tested each year and this would alleviate some of the cost burden.

James S. Turley thinks many companies would act differently if there were no auditor involvement in Section 404 and that his firm has had to push some clients hard. He recommended that May 2005 guidance be aligned with AS 2 and that further guidance be provided to companies, especially to smaller companies. In particular, guidance should address ways to think through the Section 404 process, appropriate levels of documentation, and how to evaluate entity level controls. He believes AS 2 is scalable and that there should be more focus on entity level controls to help determine the amount of testing needed on lower level controls.

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Panel 3 – *The Audit of Internal Control Over Financial Reporting*

SEC Moderator

Nancy L. Salisbury
Office of the Chief Accountant

PCAOB Moderators

Laura J. Phillips
Office of the Chief Auditor

Thomas Ray
Office of the Chief Auditor

Panelists

Frank H. Brod, Corporate Vice President Finance and Administration and Chief Accounting Officer, Microsoft Corporation

Lisa A. Flavin, Vice President - Audit, Emerson Electric Co.

Timothy P. Flynn, Chairman and Chief Executive, KPMG LLP

Jay Howell, Associate Director of Assurance, Northwest region, BDO Seidman LLP

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

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 riskbased 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?

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

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

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?

Highlights of Panelists' Views

There was general agreement that 2005 guidance was helpful and more is needed and that it may not be necessary to test the same controls every year. Several panelists also thought that auditors should focus more of their efforts on evaluating company level controls as a proper analysis at the company level may allow the auditor to substantially decrease the testing of lower level controls.

Frank H. Brod says last year's guidance was helpful. He noted a sea change in terms of cooperation between management and the external auditor although timing did not allow for full implementation of the guidance in 2005. Leverage from prior year experiences should allow less testing at appropriate (lesser) level. He believes that inspections drive management and auditor behavior and that inspection feedback has to be timely. In response to Commissioner Glassman's question about whether auditors should serve in a different role under Section 404 (i.e., not require separate testing of controls by auditors), Mr. Brod stated there is redundancy in the testing process and that greater efficiencies could be achieved by gaining a better understanding of what should be tested. He also believes in rotational testing of controls. The PCAOB inspection process is an enhancement over peer review but unfortunately has been very slow and this is not helpful. Mr. Brod also remarked that the PCAOB has not yet taken an integrated approach to its inspection process.

Lisa A. Flavin stated that her company has had good experiences with her company's auditors and that they have generally agreed with the scope of the Section 404 audit. At times she indicated, an account which is not significant (e.g., accrued vacation) met a quantitative measure that under the auditor's policies, required the auditor to test controls underlying the account. This created significant work for the company with little corresponding benefit; Ms. Flavin attributed auditor conservatism to fears of litigation and uncertainty about the inspection process. She also believes it would be more efficient if auditors could test and rely on monitoring controls. Also, due to confusion around the word, 'pervasive' in the standard, auditors tested more IT controls than were necessary in her opinion. Ms. Flavin suggested that the risk-based approach would help rectify this.

Timothy P. Flynn believes that PCAOB inspections have helped improve audit quality in terms of enhancing efforts put into documentation, judgments made and conclusions reached. It has also helped audit committees and boards become more engaged in the audit process. Mr. Flynn thinks there are additional opportunities to gain insight and share those insights with the profession by encouraging meaningful debate. He was pleased to hear that members of the PCAOB standards group will participate in inspections. Mr. Flynn also suggested that a group of registrants, regulators, and auditors be formed to build a repository of AS 2 best practices.

Jay Howell stated that BDO has focused on the use of professional judgment in applying Section 404 and that such training / development takes time. He stated the need for consistency in practice and that the communication of inspection findings would help everyone do a better job. He thought that testing should be done on all controls related to significant accounts by either management or the auditor and that the risks inherent to each account would need to be considered. Guidance is needed on evaluating entity level controls, including how to document and test the controls for both auditors and companies. As for relying on the work of others, Mr. Howell pointed out that AS 2 standard states that where internal audit does not report directly to the audit committee, the auditors are limited in their reliance on internal audit work. Mr. Howell stated that more timely feedback from PCAOB inspections (throughout the process and not only at issuance of the final report) would help auditors apply AS 2 with greater confidence.

Leo L. Kessel emphasized the importance of gaining Section 404 efficiencies by turning what was initially a project into an ongoing process. Ways to do this include discussions with client managements on possible improvements (particularly where there are multiple locations) and gaining greater reliance on the work of others. A risk-based assessment results in testing of higher level controls, which is prudent and benefits all. The PCAOB inspection does not reveal what was done right by the auditors; rather inspectors are there to challenge the work and judgments made. Mr. Kessel believes that opportunities are lost if best practices and positive feedback in the inspection process are not gathered and provided to the auditors.

Bruce A. Renihan says year 2 was more effective than year 1 – it has been a learning process for the external auditors and management. He has some concerns about scoping this year's audit and believes a risk-based approach must be applied. Examples would be welcome. He finds that auditors are driven largely by quantitative measures in Section 404 and in the current environment, err on the side of caution as they have a lot at stake. As for PCAOB inspections, it would be very helpful to hear what auditors are doing right and to share this information with the profession.

Garrett L. Stauffer says PwC made significant changes to its audit approach in year 2 to incorporate the May 2005 guidance, e.g., a risk-based approach and use of others' work. There are still benefits to be gained. He believes AS 2 is scalable to small companies and that additional practical guidance is very important. The standard however should not change since the fundamentals apply to both small and large companies alike. Mr. Stauffer disagreed with the notion of changing the auditor's role in Section 404 (i.e., only auditing management's assessment and not the effectiveness of internal controls over financial reporting), stating that by not auditing the effectiveness of internal controls over financial reporting you will not gain the same reliability and public confidence as you do by auditing the effectiveness of internal controls over financial reporting.

Shelley S. Stein believes that the auditor must test management's assertion but there should be an appropriate balance. She asked that AS 2 not be changed but that guidance be provided. With regard to the inspection process, Ms. Stein indicated that a few years ago, the audit profession was characterized as not auditing enough; now the profession is being criticized for auditing too much and in between all of that, Section 404 came along. As a result, she expressed the need that more guidance and real life examples be developed by all (the issuers, auditors, regulators, academics, etc.). She continued to say that the PCAOB has indicated that auditors need to use judgment in carrying out their audits, however, during the inspection process, auditors are questioned on their judgment. Ms. Stein used a baseball analogy as a basis for her point of what is frustrating to the profession: you have two teams playing (i.e., the auditors who are exercising their best judgment and the PCAOB inspectors who are also exercising their best judgment) but one of the teams is also the umpire putting the auditors in a very difficult position. Hence, auditors have become very conservative because their CPA licenses (or registration to practice) are at risk. Lastly, she stated that she is looking forward to the efficiency comments from the PCAOB in the coming year.

Tom Szlosek replied to Commissioner Glassman's question on a different role for the auditor , noting a blurring of the lines between controls testing performed by the auditor and management. He believes once there is agreement on scope, the effort should be cooperative and not two separate processes. Mr. Szlosek agreed that a rotational approach to testing would be appropriate since companies are always evolving. He also indicated that in the coming year the auditors have discussed with the company that they plan to use the work of others (i.e., internal audit) much more in year 3.

Richard G. Ueltschy indicated that companies struggled at first with the project management aspects of Section 404, which is critically important to implementing Section 404. He also indicated that in year 3, he expects audit teams to be able to place more reliance on certain controls or increase the work of others in lower risk areas than in year 2 to make the process more efficient.

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Panel 4 – *The Effect on the Market*

SEC Moderators
Carol A. Stacey Division of Corporation Finance John W. White Division of Corporation Finance
PCAOB Moderator
Thomas Ray Office of the Chief Auditor
Panelists
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

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 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?

Highlights of Panelists' Views

Most panelists agreed that Section 404 provides benefits to investors

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

although attribution is difficult given other possibly contributing factors. A few commented that SOX sections 302 (management certifications) and Section 404 worked well together. Other panelists thought that the perceived positive effect of Section 404 on the marketplace was overstated and that investors have not shown particular interest in internal control attestations – other than the costs they represent to the investor. There was acknowledgement among some panelists that non US public listings have grown enormously popular in the last year and there is concern that Section 404 costs may have been a significant driver.

Charles A. Bowsher sees a big positive effect on the markets from Section 404 and believes SOX has made great strides. Through his service on boards and audit committees, Mr. Bowsher believes auditors can eliminate duplicated efforts and rely on work performed by internal auditors to increase efficiencies. In his fifty years of working with companies all over the world he said he has found that his non-US counterparts have consistently complained that US regulatory reforms went too far – similar to what is occurring today with SOX. He believes these other countries will ultimately have their own SOX type reform, which will impact their business communities. Lastly, Mr. Bowsher believes that Section 302 works hand in hand as a complete package with Section 404 and it is important to have the audit piece in there but he believes that the audit piece must be much more cost effective.

Noreen M. Culhane said that Section 404 is an important (but not the only) component of SOX but that it has helped improve investor confidence. The reaction to Section 404 results has been extremely calm though and that may be indicative of what is material to investors. She shared several statistics that showed the proportion of IPO activity that took place outside the US in 2005 (i.e., 23 out of the 24 IPOS over $1B). Ms. Culhane indicated that investors are using the US private markets but appear to be avoiding the public markets, which can at least in part be attributed to strict US governance standards. The sea change, she said, is irrefutable adding that while the benefits are many, the costs of Section 404 need to be aligned. Ms. Culhane also remarked that two of the panelists (both sophisticated investors) said they have subject matter experts explaining Section 404 disclosures to them. She urged everyone to consider the unfortunate retail investors who do not have an expert on hand in an effort to improve the understandability of disclosures.

Gregory J. Jonas believes that credit spread data shows that investors are benefiting from Section 404, i.e., corporate investment grade debt was 2.5 percentage points over the treasury rate in 2002; the spread has narrowed to .85 percentage points over the treasury rate, a dramatic reduction. He acknowledged that all of the effect cannot be attributed to Section 404 but even 10 percent attribution to Section 404 represents a huge benefit to investors. Mr. Jonas also thinks that investors' risk of making a poor investment has decreased as a result of better quality and reliability of financial statements. He believes that investors generally understand what a material weakness in internal controls is. Mr. Jonas also reported on three tests to see to what degree Section 302 can stand on its own or whether auditor involvement is needed with Section 404 to supplement it. The first test was to how many Section 302 material weaknesses were reported before Section 404 was required for those companies and the results were that not many were reported. A second test was for all companies that reported a Section 404 weakness, how much before that did a Section 302 material weakness get reported and the answer was not much. And the third test related to smaller companies. They compared Section 302 material weaknesses flagged by not yet subject to Section 404 versus small companies that are subject to Section 404 and the answer was that a whole lot more material weaknesses were surfaced in the Section 404 process. This test tells us that problems surface when auditors are involved which makes this a healthy process. Mr. Jonas reminded everyone that the primary reason SOX legislation came about in the first place was the result of massive corporate fraud and that controls aimed at detecting fraud should be a primary focus as it is a critical area. He also suggested that Section 404 disclosures should be forward-looking as this provides the most value to investors because it is preventive and it flags a potential problem *before* rather than after fraud or other issue has already been reported.

Peter D. Lyons says two things have driven behavioral changes in corporations: first, SOX 906 and 302 certifications and second, board and audit committee activity and interaction with top management; a very positive effect and far more substantial than Section 404. He also noted that since Section 404 implementation began companies began to list their securities in London and Hong Kong and do more private placements in the US.

Michael J. McConnell says SOX is working and has enhanced the quality of financial reporting as well as corporate governance, measurement and decision-making. He based this belief on the following: market multiples increased showing a decreased cost of capital, data about stock performance in relation to Section 404 (e.g., Lord & Benoit study), an increase in IPO and M&A activity since 2001 and 2002, and academic research that can point to data that the cost of capital has decreased. Mr. McConnell also believes that Section 404 disclosures may be improved.

Robert C. Pozen says there is a cost associated with management's time being devoted to Section 404, and he is hesitant to attribute benefits to Section 404 when other variables (such as corporate earnings growth and post 9/ll recovery) may be responsible. Mr. Pozen also pointed out that analysts and accountants view materiality somewhat differently; reports of material weaknesses relating to an account balance are not relevant to analysts but restatements generally are because they relate to the entity as a whole. He added that Section 404 disclosures should provide better explanations of material weaknesses (i.e., a technical accounting or other issue) and be more forward-looking.

Monte N. Redman speaks with many investors and the only SOX related question he fields relate to the cost of compliance. Investors do not ask about controls. He acknowledged that the lack of investor interest could be attributable to the heavy regulation banks historically have been under, and particularly since FIDICIA was implemented in 1993.

Kurt N. Schacht says that embedding Section 404 thinking into the psyches of companies, benefits investors by providing managements with the tools they need to detect and repair a material weakness before it becomes a problem. This is a significant deterrent to large scale accounting frauds. Mr. Schacht believes that Section 404 costs have come down and will decrease further.

David Warren says he speaks to many investors and that while he agrees with panelists' comments about the benefits of Section 404, he is not convinced that investors reward or penalize companies for having good internal controls. He doesn't think that investors understand the auditor's Section 404 attestation and that some of the benefits being cited may be the result of work done pre-Section 404 implementation. Overall, he believes that investors think that the costs of Section 404 outweigh its benefits – particularly for small companies. Mr. Warren said that investors are not focused on SOX and that during his interaction with investors (probably 150 people) he never once received a question on Sarbanes-Oxley regarding whether it is good, bad or indifferent.

Karen Hastie Williams believes investor confidence has increased because companies and their auditors took SOX very seriously. There has been a steep learning curve from year 1 as companies invested in the systems and tools they needed to comply with Section 404 but year 2 costs are lower, both internally and externally.

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Panel 5 – *Next Steps*

SEC Moderators

Scott A. Taub
Office of the Chief Accountant

John W. White
Division of Corporation Finance

PCAOB Moderator

Thomas Ray
Office of the Chief Auditor

Panelists

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

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?

Highlights of Panelists' Views

Many panelists believe that investors benefit from Section 404 and also believe an improved cost/benefit balance will be achieved over time. Several panelists believe that only minor changes and clarifications should be made to AS 2 (specifically to incorporate the May 2005 guidance). Timing of information was also discussed with some panelists indicating that to be useful Section 404 reporting should precede company events (e.g., restatements or reports of management fraud) and that PCAOB inspection feedback needs to be more timely

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

and should include best practice reporting.

J. Michael Cook suggests that the SEC and PCAOB change as little of AS 2 as possible as consistency is important and it would be very difficult for companies and auditors to shift gears again. He says the small company issues must be resolved as soon as possible. As next steps, he also suggests that Section 404 be put in perspective, i.e. it is important but is obscuring other financial reporting efforts such as global convergence, nontraditional financial information, and forward-looking information. In the meantime, he thinks regulators should have a cooling off period and not issue any additional guidance – rather, let the audit firms and larger companies use the existing guidance.

Nick S. Cyprus cautioned against wholesale changes to AS 2 since auditors and companies have been on a learning curve and now understand the guidance. He believes costs will be driven lower and that only specific, clear changes should be made. Mr. Cyprus believes all public companies should be subject to Section 404; if costs are an issue, a company should not seek capital in the public markets. He says CFOs are focused on decreasing Section 404 related costs while maintaining benefits and over time costs will decrease.

Alex Davern expressed his disappointment at the tenor of the panel discussions, which he said was too polite. He gave the SEC, who estimated that Section 404 implementation costs to registrants of all sizes would be approximately $90,000, a failing grade. The SEC had also estimated that costs, which according to proxies of external audit fees remained flat from year 1 to year 2, would decrease 40 percent. Mr. Davern stated that investors he has spoken with never asked about Section 404 – apart from the cost of complying with the rule. He also cited a NASDAQ committee survey, which found that 86 percent of buy side institutional investors think costs of Section 404 outweigh the benefits. Eighty percent of institutional investors clearly support the recommendations of the SEC Advisory Committee of Smaller Public Companies; that there be scaled regulations and that we practically recognize the realities of the world. He believes that the reason we are in the situation we are today is because of “the elephant in the room” – that the Big Four are an oligopoly with a significant amount of anti-competitive market power. He believes that there will be a very strong political backlash if small companies are forced to comply with Section 404. He believes that AS 2 must be amended but for application in 2007 for the following: (a) change the definition of material weakness to include a qualitative assessment; (b) change the assessment of a material weakness from quarterly to annually; and (c) rotational testing should be permitted. He also believes that we need to restore competition.

Michele J. Hooper has heard from many people about the importance of feedback from the inspection process but says that “real world” experiences and assessments will only be useful if the feedback from PCAOB is timely. There is a nature of conservatism centered on liability. Case study-type guidance to auditors will alleviate some of this. In the case of company boards and management, there appears to be a certain level of conservatism due to the lack of guidance. There is a very vague approach to safe harbors in the rules for management and she requested a clarification of how boards and management should be executing their responsibility.

John J. Huber thinks the costs of restatements, litigation, defaults and de-listings are much greater than the cost of Section 404 compliance. Mr. Huber suggests re-evaluating AS 2, in particular the process, in light of the first 2 years of experience. Probabilities (i.e., more than remote) and magnitude (i.e., materiality/SAB 99) need to be reconsidered. For Section 404 information to benefit investors it must precede restatements; otherwise, it is too late. He also recommended that the May 2005 guidance should be included in AS 2 but that more importantly, the “nine-firm framework” on evaluating significant deficiencies and material weaknesses, should also be included. There also needs to be guidance on the question of the zone of reasonableness because judgment is a critical underpinning to getting this system to work from a management standpoint as well as from the auditors’. He also believes that an auditors’ reasonably based judgment should not be penalized and that AS 2 should have that built into the standard. Mr. Huber recommends the SEC and PCAOB form an “EITF” (i.e., emerging issues task force) to get guidance out for small companies. Finally, it is imperative that the US work with the European Union to get an international internal control over financial reporting process in place.

Robert J. Kueppers believes there has been an inordinate amount of attention placed on auditors and Section 404 costs and has heard during the roundtable that most agree that costs have gone down (although there have been differences in opinion about how much costs have gone down). He also acknowledged that the reliance on the work of others by the auditors has doubled this year from last year but that he is hearing that management will do less work in the coming years. Further, Mr. Kueppers believes that if management does less, then auditors can not rely. As a result, he recommends that guidance would be helpful to assist management assess their responsibilities (e.g., responsibility for walkthroughs, etc.). In addition, he believes that there needs to be guidance for materiality (not so much within the definitions of AS 2) but instead in the overall assessment of a deficiency in the context of whether it would have a material impact on the financial statements. There really does not appear to be a good metric for quarters versus years and segments versus quarters, etc. He is ambivalent about re-opening AS 2 to incorporate the May 2005 guidance but also believes there is a certain level of risk when things are re-opened since he believes that the basic building blocks should not be “fiddled with.” Lastly, he believes small companies can learn from the experiences of large companies’ Section 404 implementation. He believes this can be done through a pilot program where draft guidance could be developed for both auditors and management for 2006. From that it could be determined whether further consideration is needed before the SEC requires the rest of the companies to go live in 2007.

Damon A. Silvers believes that we should all start by recognizing that there is a statute which requires that all managements of all public companies assess internal controls and that those assessments be attested to by an outside auditor annually. Mr. Silvers does not believe it is appropriate for auditors to rely on managements’ work or base their testing solely on entity level evaluations. An annual audit of the controls is important. However, costs should be lower and Mr. Silvers suggested the SEC issue additional guidance to issuers, continue to encourage integrated audits, and resolve small company issues.

David M. Walker expressed strong support for Section 404 stating that while year 1 presented challenges, after year 2 it is clear that the benefits exceed the costs. He believes that AS 2 could be made clearer and incorporate concepts and objectives of the May 2005 guidance so that all the guidance has the same authority. Mr. Walker supports rotational testing and the risk-based approach and thinks that the PCAOB should take steps to incorporate this in their standards. He thinks small company issues related to Section 404 must be resolved by the SEC. Mr. Walker recommends that the SEC support the work of COSO and continue to work with them. He added that the inspection process could provide valuable information on implementation and be used as the basis for additional guidance. He also believes the profession has an obligation to share best practices to get the job done in an efficient and cost effective manner. Lastly, Mr. Walker reminded everyone that there used to be eight international public accounting firms and now there are four. Mr. Walker indicated that there are a lot of reasons for that but part of it was because of the government. The government essentially opposed going from six to five and the government *caused* it to go from five to four because they indicted the firm instead of responsible individuals.

Ann Yerger says internal controls are critically important to financial reporting. Costs are important too and there needs to be a balance between the two. She also believes that Section 404 should be risk-based and right-sized. Time is of the essence for the SEC and PCAOB to address the small company issues; Ms. Yerger is concerned that congress will intercede if this is not done. She agrees with the recommendation that there be practical “plain English” guidance particularly for smaller public companies. Ms. Yerger also very much supports a pilot program to test the effectiveness of the guidance that is issued. With regard to deadlines – the Council can live with one modest final extension, however opposes a multi-staged phase in process. With regard to PCAOB, she recommends that they expand or clarify AS 2 to incorporate the May 2005 guidance since it does not appear that it is being followed in the field by auditors. In addition, Ms. Yerger very much supports the issuance of guidance to small company auditors. Finally, she recommends that the SEC and PCAOB work together and also work with COSO to ensure that the Section 404 framework is risk-based and right-sized and the all the guidance is coordinated and complimentary.

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Concluding Remarks

Christopher Cox, Chairman – SEC

Chairman Cox thanked everyone including his fellow commissioners, PCAOB board members, and particularly the PCAOB and SEC staff. He also thanked the panelists for their participation and willingness to share their experiences which is extremely valuable. Chairman Cox then summarized what they heard during the roundtable which included that Section 404 has produced significant benefits and costs; and actions the SEC and PCAOB could take to make the Section 404 process more efficient and effective. The SEC and the PCAOB will evaluate the comments they heard today and received in writing in deciding what next steps to take to improve the efficiency and effectiveness of the process. Finally, while the focus today was on the accelerated filers they also heard the special challenges that small companies face in undertaking the process and will consider those as well as the recommendations made by the Advisory Committee on Smaller Public Companies.

For more information on the roundtable, including access to the archived Web cast, please Web casts section on the SEC's Web site at http://www.sec.gov/spotlight/soxcomp.htm.

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