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STANDING ADVISORY GROUP MEETING

PANEL DISCUSSION – IMPLEMENTATION OF SECTION 404 AND AS NO. 2

JUNE 12-13, 2006

Introduction

As announced on May 17, 2006, the Board is considering certain amendments to Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2"), as part of an overall plan to improve the efficiency and effectiveness of the implementation of the internal control reporting provisions of the Sarbanes-Oxley Act of 2002. Accordingly, the Board's Standing Advisory Group ("SAG") will discuss various potential amendments to AS No. 2. This paper outlines two significant topics for possible amendment—the function of company-level controls in the auditor's evaluation of internal control over financial reporting and the role of the auditor in evaluating the process that management uses to reach its own conclusion about the effectiveness of the company's controls. Panelists will provide brief prepared remarks that address these two topics to facilitate the SAG's consideration of these matters. SAG members will have the opportunity to ask additional questions of the panelists and then provide follow-up comments.

Company-Level Controls

AS No. 2 was designed to encourage the auditor to take a top-down approach to an audit of internal control over financial reporting. In taking a top-down approach, the auditor performs procedures to gain the necessary understanding of internal control over financial reporting in a sequential manner, starting with the company-level controls. Company-level controls include, among other things, the overall tone at the top of the organization, management's risk assessment process, and the controls covering the period-end financial reporting process.

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Company-level controls function within all five COSO internal control components[1/] and often have a pervasive effect on the controls at the process, transaction or application level. By following a top-down approach and focusing on company-level controls early in the process, the auditor should use his or her evaluation and conclusion on these controls in building a strategy for identifying and testing controls at lower levels.

Company-level controls have a bearing on the auditor's evaluation of risk associated with the controls operating at more detailed levels. Therefore, the auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on lower-level controls. Although AS No. 2 states that the testing of company-level controls alone is not sufficient for the purposes of expressing an audit opinion on the effectiveness of internal control over financial reporting, the auditor's evaluation of the effectiveness of company-level controls can have a significant effect on the nature, timing, and extent of his or her testing of other controls.

Discussion Topics

The panel will address:

- How auditors and companies have linked company-level controls to the underlying processes and transactions and the resulting changes to the testing that otherwise would have been performed on lower-level controls

- Whether additional guidance would encourage auditors to rely more on company-level controls, when appropriate

- Whether a more precise definition of company-level controls might assist auditors and management in their duties

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[1/] The Committee of Sponsoring Organizations ("COSO") of the Treadway Commission identified five internal control components within *Internal Control – Integrated Framework*: Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring.

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- Whether the principle in AS No. 2 that the testing of company-level controls alone is not sufficient for the purposes of expressing an audit opinion on the effectiveness of internal control over financial reporting is sound

- Whether (and, if so, how) the auditor's evaluation of company-level controls should affect the auditor's ability to alternate testing of process and transaction level controls.

Auditor's Involvement in Management's Assessment Process

Conditions for Engagement Performance

Under AS No. 2, before the auditor can complete his or her audit, company management must evaluate the effectiveness of internal control over financial reporting. The standard states that for the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:[2/]

- 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.

[2/] See Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* ("AS No. 2"), paragraphs 20 and 21. Management is required to fulfill these responsibilities under the SEC's implementing rules. See Items 308(a) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 229.308 (a), respectively.

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In the event that the auditor concludes that management has failed to fulfill these responsibilities, AS No. 2 currently directs the auditor to communicate to management and the audit committee that the audit cannot be completed and that he or she cannot render an opinion.

Evaluating Management's Assessment Process

Currently, AS No. 2 contains specific requirements related to the auditor's evaluation of management's assessment process. For example, an auditor should determine, in accordance with the standard, whether management has properly identified which controls should be tested. In addition, according to AS No. 2, management may test the effectiveness of controls through a variety of means, including the use of internal audit, testing of controls by others under the direction of management, using a service organization's reports, or testing by means of a self-assessment process, some of which might occur as part of management's ongoing monitoring activities.

The auditor's evaluation of management's assessment process has a natural place in a top-down approach to an audit of internal control since the auditor would use that evaluation to help him or her obtain an understanding of the company's internal control over financial reporting overall, inform the auditor's preliminary risk assessments, and decide how best to use the work of others. To aid in this evaluation, the standard lists controls that generally should be included in management's testing, such as controls over the selection and application of accounting policies, antifraud programs and controls, information technology controls, company-level controls, and controls over significant estimates and judgments.[3/]

Management's Documentation of its Assessment Process

As part of evaluating whether management has reasonable support for its assessment, AS No. 2 currently directs the auditor to evaluate whether management's documentation contains certain specified elements.[4/] The standard also acknowledges

[3/] See AS No. 2, paragraphs 40 and 41.

[4/] See AS No. 2, paragraph 42.

that the form and extent of documentation will vary depending on the size, nature, and complexity of the company.[5/]

The standard classifies both inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control as control deficiencies.[6/] Also, the standard states that inadequate documentation could cause the auditor to conclude that there is a limitation on the scope of the engagement.[7/]

Discussion Topics

The panel will address:

- To what extent the auditor needs to understand management's assessment process to make decisions about the following:
  - Whether management, as required by the SEC's rules, has a basis for its conclusion[8/]
  - How to best make use of the work of others
  - How to make preliminary risk assessments
- The auditor's role in determining whether management's documentation of the company's assessment of internal control over financial reporting is adequate

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5/ See AS No. 2, paragraph 43.

6/ See AS No. 2, paragraph 138.

7/ See AS No. 2, paragraph 46.

8/ See Instruction 1 to Item 308 of Regulation S-K, 17 C.F.R. § 229.308 ("The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting.").

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- Whether the adequacy of management's assessment process should continue to be a necessary condition for the auditor to be able to form an opinion on the effectiveness of internal control over financial reporting

- Whether the auditor can obtain sufficient evidence to form an opinion about the effectiveness of internal control over financial reporting without regard to the adequacy of management's assessment process

- Whether the auditor's opinion on management's assessment provides investors with additional useful information, beyond the information contained in the auditor's opinion on the effectiveness of internal control

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