May 11, 2006

Highlights and Perspectives

SEC and PCAOB Roundtable on Second-Year Experiences with Internal Control Provisions

Additional information, tools, and resources to assist in the implementation and oversight of the internal control over financial reporting requirements are available on Deloitte & Touche's Web site for audit committee members, Audit Committee Online. For instructions on accessing Audit Committee Online, please send an email to auditcommittee@deloitte.com.

Introduction

On Wednesday, May 10, 2006, the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) held their second roundtable discussion on the implementation of the internal control reporting requirements for public companies. The SEC invited representatives of public companies, directors, auditors, investors, members of the legal community, and others to participate in the roundtable. The roundtable consisted of five panels focused on key topics related to the second year of implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. The panel topics were:

- *Panel One:* Overview of the Second Year
- *Panel Two:* Management's Evaluation and Assessment
- *Panel Three:* The Audit of Internal Control over Financial Reporting
- *Panel Four:* The Effect on the Market
- *Panel Five:* Next Steps

For a list of the moderators, panelists, and discussion questions for each panel, refer to the appendices at the end of this document.

This publication summarizes the roundtable proceedings. We have categorized highlights into the following areas, which were major topics of discussion during the panels:

- Costs and Benefits
- Effects on the Markets
- Future Improvements – Guidance for Management
- Future Improvements – Customized Guidance for Management and Auditors of Smaller Issuers
- Future Improvements – Other Opportunities

The publication also provides Deloitte & Touche LLP's (Deloitte & Touche's) perspectives on these issues.

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Summary of Deloitte & Touche Perspectives

The internal control reporting requirements under the Sarbanes-Oxley Act, which are part of a comprehensive effort to restore investor confidence and enhance financial reporting, have added substantial and measurable benefits from their implementation. Benefits have increased as costs have declined in the second year of Section 404 implementation. Investor confidence, though still fragile, has been enhanced and the existing Section 404 model should be allowed to demonstrate its full potential for improvement. The fundamental pillars of Section 404—that management should periodically assess its control structure, that it should document this assessment, and that an auditor should independently test this assessment—are reasonable, regardless of the size of a public company.

The demonstrated decline in costs of Section 404 compliance, coupled with the continuing emergence of benefits over time, makes a compelling case about the ongoing value of Section 404 to investors and companies. In that regard, we look forward to working with public companies, the SEC, and the PCAOB toward ongoing improvements in Section 404 compliance for accelerated filers and the sound implementation of Section 404 for the nonaccelerated filers next year.

Roundtable Opening Remarks

SEC Chairman Christopher Cox and PCAOB Acting Chairman Bill Gradison opened the meeting by emphasizing the special responsibilities owed to investors of public companies of all sizes and the commitment of the SEC and the PCAOB to see that Section 404 functions as intended. Chairman Cox expressed the SEC's particular interest in identifying actions that can remove impediments to effective implementation of Section 404, and he asked whether additional guidance for management would be helpful.

Mr. Gradison voiced concern over the implementation by smaller companies and the need to communicate that PCAOB Auditing Standard No. 2 (AS 2), *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,* is scalable to their circumstances. He also reiterated the recent announcement that future PCAOB inspections will focus on whether auditors have met the goals of AS 2 as efficiently as possible.

Concluding Remarks by SEC Chairman Cox

In his concluding remarks, Chairman Cox committed to evaluate the various recommendations from the panelists and determine the appropriate next steps to improve the effectiveness of the Section 404 compliance process. He also indicated that the SEC would consider implications and alternatives for smaller issuers, but did not give a specific timeframe.

Additional information regarding the roundtable is available on the SEC's Web site at http://www.sec.gov/spotlight/soxcomp.htm.

I. Costs and Benefits

Panelists' Views

There was a general consensus that costs declined in year two compared to year one, although there was some disagreement on the specific extent of the decline. Some panelists believe that overall costs remain too high. Generally, benefits also were seen to have increased, including enhanced investor confidence, greater financial statement reliability, transparency regarding controls, and expanded management understanding of internal control risks. Panelists acknowledged that the assessment process, for both management and auditors, was much smoother than in year one, driving the cost decrease. Further, almost all panelists cited the May 2005 guidance from the SEC and the PCAOB as an important contributor to improvements in year two. While panelists observed that companies have gained confidence working within the overall control environment, they also noted that both management and auditors need to continue to focus on the efficient implementation of Section 404.

Panelists anticipated that the process would continue to improve in future years as companies and auditors gain additional experience. Many panelists felt that improvements were still possible in the implementation of a top-down, risk-based approach and in increased reliance on the work of others. For example, some panelists cited anecdotal examples that auditors are testing many lower-level controls. Additionally, one panelist offered the perspective that the costs of Section 404 are minimal compared to the costs of restatements and potential litigation if controls fail.

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Decreasing Costs – Although the debate continues over the relative costs and benefits of the Section 404 requirements, recent published surveys, as well as specific company experience, corroborate the trends cited by the panelists. These surveys provide growing evidence that costs are declining and benefits are becomingly increasingly visible for both smaller and larger accelerated filers.

Surveys by CRA International, Financial Executives International, and Manufacturers Alliance/ MAPI, among others, indicate that compliance costs for both smaller and larger accelerated filers decreased in year two compared to year one, with reported reductions ranging from 15 percent to more than 40 percent. These reductions occurred in the areas of internal management costs, amounts paid to third parties to assist in readiness and testing, and external audit fees related to Section 404. Cost decreases were primarily driven by the following factors:

- Increased efficiency (learning-curve effects) in implementing and assessing controls, including significant reductions in the number of key controls tested
- Reductions in required documentation
- Reduced use of third parties to perform readiness activities or testing for management
- Increased auditor reliance on the work of others and greater application of an integrated audit approach.

All these factors are consistent with the transition of the Section 404 compliance effort from a first-year project to an ongoing, sustainable process.

Increasing Benefits – In addition to the declines in compliance costs, the recent surveys, even those critical of Section 404, reported significant increases in the benefits realized in the second year of Section 404 compliance. The CRA study found a sharp decline in the number of material weaknesses and significant deficiencies (a 75 percent decline for smaller companies and a 50 percent decline for larger companies), which confirms that Section 404 is achieving its primary objective of improving internal control and the reliability of corporate financial data. Moreover, financial executives responding to the surveys cited an increase in the accuracy of financial reports and heightened management accountability—a strong indication that Section 404 benefits are building over time and being recognized. We have also encountered numerous situations in which clients of all sizes identified important control procedures, such as account reconciliations, data integrity checks, or contract reviews, that were actually being overlooked or inadequately performed, thus creating risk for the company or reducing its profitability.

Beyond these anecdotal benefits, a recent academic study by Ashbaugh-Skaife, Collins, Kinney and laFond[1] concluded that "internal control risk matters to investors and that firms reporting strong internal controls or firms that correct prior internal control problems benefit from lower costs of equity capital (50 to 150 basis points lower) beyond that predicted by other internal control risk factors."

[1] See http:// ssrn.com/abstract=896760

II. Effects on the Markets

Panelists' Views

The panelists generally agreed that Section 404 has had a significant and positive effect in restoring investor confidence in the capital markets. In particular, it was noted that companies that had implemented Section 404 had significantly higher-price multiples than other companies. Panelists debated whether investors understood the concept of a material weakness or reacted to reported material weaknesses rather than to financial results as a whole. In any event, the market does adjust when material weaknesses lead to a reduction in a company's credit ratings.

Several panelists also emphasized that despite the requirements in Section 302 of the Sarbanes-Oxley Act for management to certify the quarterly SEC reports and make disclosures about internal controls, including material weaknesses, the auditor's assessment appears to play a critical role in instilling consistency and discipline into management's assessment process and identifying internal control problems. One panelist referenced his firm's research, which indicated that management's interim Section 302 reports tend not to identify material weaknesses as frequently as when they are performed in conjunction with an independent internal control audit. This research was similar to a recent survey by Lord & Benoit.

There was debate about the effect of Section 404 requirements on the attractiveness of the U.S. capital markets to foreign issuers. Several panelists said that there has been a significant drop in foreign listings, largely because of costs associated with Section 404 compliance, even though the U.S. markets continue to deliver a clear competitive advantage in terms of a valuation premium of approximately 30 percent for companies that can meet its listing requirements. Another panelist questioned whether any decline was only temporary while foreign companies and markets migrate toward similar strengthened requirements.

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There is little evidence to support a general decline in initial public offerings (IPOs) as a result of Sarbanes-Oxley requirements. The empirical data show that initial public offerings (IPOs) in 2006 had their best start since the year 2000, and that U.S.-based IPO activity, which had declined in the early part of the decade, rose substantially in 2004 and 2005 during the first two years of Section 404 implementation. The percentage of IPOs for consistently profitable companies has also risen markedly, as has the volume of SB-2 filings by smaller issuers.

Although there are indications that litigation concerns may deter some foreign companies from the U.S. capital markets, many of the companies newly listed on the highly publicized London alternative market do not meet U.S. listing standards. Furthermore, a recent academic study found no increase in the incidence of going-private transactions. In fact, that study revealed that companies that "go dark" (e.g., move from public trading to the over-the-counter market to avoid SEC reporting rules) tend to fall out of favor with investors, a result that reinforces the value that investors place on the SEC's disclosure requirements, including internal control reporting[2].

2 "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," Christian Leuz, Alexander Triantis and Tracy Wang, March 5, 2006, http:// papers.ssrn.com/sol3/papers.cfm?abstract_id=592421

III. Future Improvements – Guidance for Management

Panelists' Views

In his opening remarks, Chairman Cox asked a question about the need for guidance for management equivalent to the level of guidance that AS 2 provides for auditors. However, there was no consensus among the panelists on this topic. Some panelists said that guidance for management would be beneficial and emphasized the need for it to be generally consistent with the guidance under AS 2. Those who advocated guidance for management of all issuers also emphasized that guidance should be principles-based and include examples.

Others said that sufficient information was available for management of larger companies and advocated additional guidance only for smaller issuers. A number of panelists stressed the need to issue guidance only when necessary to avoid introducing unintended additional complexity. Others cautioned against standard setting through the use of case studies, which could be difficult to interpret.

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The absence of specific guidance for management to apply in discharging its responsibilities continues to create challenges for management and auditors alike. Section 404 requires management's assessment of internal control over financial reporting, followed by the auditor's evaluation of management's assessment and an independent opinion on the effectiveness of internal control over financial reporting. In the absence of direct guidance for management, the auditor guidance in AS 2 has been used as de facto management guidance, often creating confusion and questions about management's responsibilities. We strongly recommend that the SEC provide, or develop a mechanism to provide, additional clarification and guidance for management of companies of all sizes in a number of areas, such as:

- The degree of the required documentation of controls and of management's assessment
- Management's responsibilities to perform walkthroughs of major classes of transactions
- The scope and extent of management's testing of controls, with specific guidance on management's testing of controls in multilocational entities
- The nature and extent of evidence required to support quarterly certifications.

This additional guidance for management would increase the consistency in management approaches to documenting and testing controls. Moreover, it would enable the auditor to judge more readily whether management had fulfilled its responsibilities, thus facilitating the application of a top-down, risk-based audit approach and the auditor's reliance on management's testing and other procedures.

IV. Future Improvements – Customized Guidance for Management and Auditors of Smaller Issuers

Panelists' Views

There was virtually unanimous agreement that smaller public companies face special challenges in implementing Section 404. However, there was vigorous debate over the appropriate response to the different circumstances of smaller companies. In general, panelists representing management of smaller issuers advocated exemptions for smaller companies from Section 404, either in total or from the external auditor attestation requirement, as recommended in the Report of the Advisory Committee on Smaller Public Companies. Those in support of exemptions for smaller companies provided examples of perceived costs of complying with Section 404 and focused on the detrimental effects on innovation, job creation, and international competitiveness.

Other panelists, generally investor representatives, emphasized that sound internal control is equally important to investors in all public companies, whether large or small, and they recognize that it is an appropriate cost associated with acquiring public capital. These panelists opposed eliminating the independent auditor attestation for certain smaller issuers on the grounds that the management certification (required by Section 302 of the Sarbanes-Oxley Act) and auditor attestation (required by Section 404) must go hand in hand. The investor representatives argued that auditor involvement contributes to an additional level of discipline, skepticism, and consistency, and that many problems tend to surface only when auditors are involved. They urged that guidance be developed to assist management and their auditors in scaling the requirements of Section 404 and AS 2 to the unique characteristics of smaller companies.

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As indicated in our April 3, 2006, comments on the Exposure Draft of the Final Report of the Advisory Committee on Smaller Public Companies, we recognize that the implementation of Section 404 poses particular challenges for smaller public companies. Despite the strides made by the PCOAB and SEC to provide additional guidance in May 2005 and the efforts of COSO to date, smaller companies need more guidance for their unique circumstances. For many reasons, we oppose exempting smaller companies from Section 404 reporting and audit requirements, or weakening the rules and standards to effectively mandate a partial audit. Instead, there is a need for customized guidance, for both management and auditors, that considers the specific characteristics of smaller companies. To achieve the scalability that we believe is possible under Section 404 and AS 2, we propose a plan to develop such implementation guidance, along with field testing of the guidance through a pilot program, during 2006 and 2007. The guidance should include:

- Guidance for management covering its assessment process and documentation, the implementation of control enhancements, and common challenges encountered in implementation. Specific components should include simplified COSO principles with practical examples, clear standards for management, and a simple "how-to" guide for executives of smaller companies, supplemented with examples of project organization and a summary of common challenges and solutions for smaller companies.
- Complementary guidance and tools for auditors, perhaps in the form of an audit guide, to facilitate cost-effective application of AS 2 in a smaller company environment. This should address such areas as testing monitoring controls, evaluating the risk of management override, and assessing limitations on segregation of duties, all of which can be challenges in auditing smaller issuers.

It is important for this management and auditor guidance to be developed through coordinated efforts to help bridge the Section 404 requirements to smaller companies and achieve scalability for both management and auditors. We recommend that this project begin immediately in order to complete draft guidance during the summer.

V. Future Improvements – Other Opportunities

Panelists' Views

In addition to the need for guidance for management of companies of all sizes and specific customized guidance for management and auditors of smaller public companies, panelists identified several other areas for potential improvements in the implementation of Section 404:

Revisions of AS 2 – There was considerable debate over the need to clarify or revise AS 2 to facilitate compliance with Section 404. Some panelists said that AS 2 should be amended, at least to incorporate the PCAOB guidance issued in May 2005. Others saw no incremental benefit from such a change, on the basis that auditors were already following that guidance.

Certain panelists supported changes in specific areas such as rotational testing of information technology general controls and other controls in areas of lower risk, as well as heavier reliance on entity-level controls and on the work of others.

Materiality – Several panelists urged the SEC to issue additional guidance on materiality because assessment of whether a significant deficiency represents a material weakness depends on the potential effect of the deficiency on both interim and annual periods.

Best Practice Guidance – A number of panelists mentioned the need for real-life examples and the need to understand what "good" looks like for both management's and the auditor's processes. In particular, the PCAOB was challenged to accelerate the timing of its inspection reports and to leverage the inspection process as an opportunity to provide constructive feedback to auditors, as well as a source of best practices.

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Clarification of Selected Areas of AS 2 – We have consistently stated that an amendment of AS 2 is unnecessary. Rather, we have found that the issuance of guidance and clarifications has been a preferable mechanism to improve application of the standard. At the roundtable on May 10, panelists discussed the possibility of a narrow amendment that would incorporate the guidance issued on May 16, 2005, into the standard. If the PCAOB determines to propose such an amendment, we would support that approach. However, we would not expect this to have a significant impact on practice, given that the guidance already has been implemented.

With respect to the other suggestions to change the standard, any proposed revision of the standard would be subject to the PCAOB's due process. The specifics of any such proposal would need to be considered carefully, because we believe that the basic principles of the standard need to be preserved.

Materiality – We agree that the lack of guidance on materiality poses particular challenges in implementing AS 2. In 2005, the PCAOB provided some additional guidance to auditors, which was helpful. Further clarification of the guidance by the SEC staff regarding materiality and quarterly financial statements would facilitate the application of AS 2, as well as the application of accounting standards.

Inspection Process – The inspection process provides the PCAOB a unique opportunity for insight into the practices of all public company audit firms and numerous public companies. We encourage the PCAOB to share the best practices it identifies through its inspection activities and to use the inspection process as an avenue to provide constructive suggestions to auditors.

Roundtable Moderators and Panelists

Panel One: Overview of the Second Year

Moderators:

Thomas Ray, Office of the Chief Auditor, PCAOB
Nancy L. Salisbury, Office of the Chief Accountant, SEC
John W. White, Division of Corporation Finance, SEC

Panelists:

1. **Philip D. Ameen,** vice president and comptroller, General Electric Company
2. **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
3. **H. Rodgin Cohen,** chairman, Sullivan & Cromwell LLP
4. **Colleen Cunningham,** president and chief executive officer, Financial Executives International
5. **Samuel A. DiPiazza, Jr.,** global chief executive officer, PricewaterhouseCoopers International Limited
6. **The Honorable Barbara Hackman Franklin,** president and chief executive officer, Barbara Franklin Enterprises; former U.S. secretary of commerce; audit committee chair, MedImmune, Inc.; director, Aetna, The Dow Chemical Company, GenVec, Inc., and the Washington Mutual Investors Fund; director, National Association of Corporate Directors
7. **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
8. **Dennis A. Johnson,** senior portfolio manager, Corporate Governance Office, California Public Employees' Retirement System
9. **Edward E. Nusbaum,** chief executive officer and executive partner, Grant Thornton LLP

Panel Two: Management's Evaluation and Assessment

Moderators:

Laura J. Phillips, Office of the Chief Auditor, PCAOB
Scott A. Taub, Office of the Chief Accountant, SEC
John W. White, Division of Corporation Finance, SEC

Panelists:

1. **William J. Brunner,** chief financial officer, vice president, and treasurer, First Indiana Corporation; chairman, American Banker's Association Accounting Committee
2. **Kimberly Parker Gavaletz,** vice president and deputy, global sustainment, Lockheed Martin Corporation
3. **Susan C. Gordon,** senior vice president, corporate controller, and chief accounting officer, CBS
4. **Keith E. Holmberg,** vice president of financial control processes, British Petroleum
5. **Lee Level,** corporate vice president and board member, Computer Sciences Corporation; audit committee chair, Levi Strauss & Co. and UTi Worldwide Inc.
6. **Peter F. Minan,** national managing partner, audit, KPMG LLP
7. **Dr. Stephen A. Sherwin,** chairman and chief executive officer, Cell Genesys, Inc.; audit committee member, Rigel Pharmaceuticals, Inc. and Ceregene, Inc.
8. **Dr. Albert M. Teplin,** audit committee chairman, Viad Corporation; audit committee member, MoneyGram International
9. **James S. Turley,** chairman and chief executive officer, Ernst & Young

Panel Three: The Audit of Internal Control over Financial Reporting

Moderators:

Laura J. Phillips, Office of the Chief Auditor, PCAOB
Thomas Ray, Office of the Chief Auditor, PCAOB
Nancy L. Salisbury, Office of the Chief Accountant, SEC

Panelists:

1. **Frank H. Brod,** corporate vice president, finance and administration and chief accounting officer, Microsoft Corporation
2. **Lisa A. Flavin,** vice president – audit, Emerson Electric Company
3. **Timothy P. Flynn,** chairman and chief executive, KPMG LLP
4. **Jay Howell,** associate director of assurance, Northwest region, BDO Seidman LLP
5. **Leo L. Kessel,** senior client partner, Deloitte & Touche LLP
6. **Bruce A. Renihan,** executive vice president and controller, Canadian Imperial Bank of Commerce
7. **Garrett L. Stauffer,** senior partner, national risk and quality practice, PricewaterhouseCoopers LLP
8. **Shelley S. Stein,** chief operating officer, Grant Thornton LLP
9. **Tom Szlosek,** vice president and controller, Honeywell International Inc.
10. **Richard G. Ueltschy,** executive in charge of financial institution audit practice, Crowe Chizek & Company LLP

Panel Four: The Effect on the Market

Moderators:

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

Panelists:

1. **The Honorable Charles A. Bowsher,** former comptroller general, U.S. Government Accountability Office
2. **Noreen M. Culhane,** executive vice president, global corporate client group, New York Stock Exchange
3. **Gregory J. Jonas,** managing director, Accounting Specialists Group, Moody's Investors Service
4. **Peter D. Lyons,** partner, Shearman & Sterling LLP
5. **Michael J. McConnell,** managing director, Shamrock Capital Advisors
6. **Robert C. Pozen,** chairman, MFS Investment Management
7. **Monte N. Redman,** executive vice president and chief financial officer, Astoria Financial Corporation and Astoria Federal Savings and Loan Association
8. **Kurt N. Schacht,** managing director, Centre for Financial Market Integrity of CFA Institute
9. **David Warren,** chief financial officer, The Nasdaq Stock Market, Inc.
10. **Karen Hastie Williams,** director, Chubb Corporation and SunTrust Bank; finance committee chair, Continental Airlines, Inc.; audit committee chair, Gannett Company, Inc., Washington Gas Holdings Company, and the Federal National Mortgage Association Foundation

Panel Five: Next Steps

Moderators:

Thomas Ray, Office of the Chief Auditor, PCAOB
Scott A. Taub, Office of the Chief Accountant, SEC
John W. White, Division of Corporation Finance, SEC

Panelists:

1. **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
2. **Nick S. Cyprus,** senior vice president, controller, and chief accounting officer, The Interpublic Group of Companies; member, committee of Sponsoring Organizations of the Treadway Commission (COSO) Board
3. **Alex Davern,** chief financial officer and senior vice president of manufacturing and IT operations, National Instruments; chairman, American Electronics Association committee on reform of Sarbanes-Oxley Section 404
4. **Michele J. Hooper,** co-founder and managing partner, The Directors' Council; audit committee chair, PPG Industries, Inc.; board member, AstraZeneca, PLC and Warner Music Group
5. **John J. Huber,** partner, Latham & Watkins LLP
6. **Robert J. Kueppers,** deputy chief executive officer, Deloitte & Touche USA LLP
7. **Damon A. Silvers,** associate general counsel, American Federation of Labor and Congress of Industrial Organizations
8. **The Honorable David M. Walker,** comptroller general of the United States
9. **Ann Yerger,** executive director, Council of Institutional Investors

Roundtable Discussion Questions

Panel One – Overview of the Second Year

The SEC sought information regarding second-year experiences with the assessment, reporting, and auditing requirements related to companies' internal control over financial reporting. Specifically, the SEC was interested in the nature and extent of changes in the processes in the second year as companies and their auditors gained more experience; whether resources were allocated more efficiently and effectively in the second year; and whether progress has been made in improving the integrity of financial reporting. The questions posed to the panel were:

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?

Panel Two – Management's Evaluation and Assessment

The SEC solicited input on whether, and how, companies have improved the efficiency and effectiveness of their process for assessing internal control over financial reporting in the second year of compliance. In addition, the SEC asked for input about the challenges in designing a sustainable assessment process that is both effective and efficient, as follows:

1. Was the guidance issued on May 16, 2005, by the SEC and PCAOB helpful in improving management's process in the second year? Were processes for evaluating controls more risk-focused in the second year? What are the biggest challenges in implementing a risk-based approach? Would further guidance be helpful in any area?

2. How, if at all, would management have approached its assessment differently if it did not know that it would be the subject of an independent audit? Were there instances where management believed that it had taken an appropriate, risk-based approach to assessing internal control over financial reporting, but modified that approach based on auditor demands? Were these changes beneficial to the company's system of internal control over financial reporting or to the effectiveness and efficiency of management's assessment?

3. Is there sufficient information available to management concerning the appropriate internal control framework? Is there sufficient information available concerning how management should conduct an internal control assessment?

4. Did management's evaluation process consider company-level controls in determining the scope and extent of testing of accounts and processes? What types of company-level controls have the greatest impact on the scope and extent of testing?

5. Are there issues or challenges that are specific to smaller accelerated filers in completing their assessments that might not apply to all accelerated filers? If so, what are those issues and challenges and how can they be addressed?

6. How did your evaluation of information technology general controls differ in the second year? Do you see additional areas for improvement? Were you able to implement a benchmarking strategy for computer application controls? If not, why not? Would additional guidance be useful?

7. Many companies indicated at last year's roundtable that they incurred significant effort and cost documenting internal controls. What drove the level of documentation? How did the second year compare to the first year in terms of effort and cost spent on documentation? What modifications to existing requirements might make the process more efficient and effective? Are particular modifications desirable or necessary for smaller and less complex companies?

Panel Three – The Audit of Internal Control over Financial Reporting

The SEC sought input on how the auditors' process for evaluating internal control over financial reporting has changed in the second year compared to the first year. The SEC also asked for input on the challenges to achieving long-term efficiency, effectiveness, and sustainability in the internal control over financial reporting audit process, as follows:

1. Did auditors use any strategies to ensure that they appropriately altered the nature, timing, and extent of their testing in response to the assessed level of risk? If so, what were they? Are there additional improvements that could be made in the auditor's performance of a risk-based audit?

2. What impact did the Board's inspections of firms' first-year internal control audits have on the audit process? What effect did the Board's November 30, 2005, report have on the second-year process? What impact did the Board's inspection program generally have on the auditor's approach to implementing the AS No. 2 audit process? How should the Board ensure that its inspection program is both rigorous and consistent with Board guidance concerning the implementation of AS No. 2?

3. Were fully integrated audits performed in the second year? If not, what barriers existed in the second year to prevent integration, and what can be done to reduce those barriers in the future? In what other ways could auditors increase the efficiency and effectiveness of the audit process without compromising the Act's goals?

4. How do auditors gather and use evidence about company-level controls? Were there changes to the auditors' approach to evaluating these controls, including control environment, in the second year? How do auditors evaluate the impact of compensating controls on control deficiencies? Do management's and the auditor's views differ in this area?

5. Did the process of identifying significant accounts, significant processes, and major classes of transactions worsen or improve in the second year? If not, what is the primary difficulty in this area? Do management's and the auditor's views differ in these areas?

6. Did auditors increase or decrease the degree to which the work of others was relied on in the second year? Was the May 16, 2005, guidance issued by the SEC and the PCAOB helpful in determining the extent to which the work of others could be used in the second-year assessment? Are there specific barriers that prevent auditors from using the work of internal auditors and others performing management's assessment to the fullest extent appropriate?

7. Are auditors tailoring the internal control audit to the complexity of the company? Is there appropriate recognition from auditors that control objectives may be achieved via many different methods? Are auditors reluctant to scale their work in less complex environments? Would modification to AS No. 2, or to the auditor's requirements as a whole, make the process more effective and efficient? Are particular modifications necessary for smaller and less complex companies?

Panel Four – The Effect on the Market

The SEC sought input on whether management's and the auditor's reports and related disclosure have been useful to investors and other market participants who depend on the filing of accurate financial information by public companies, as well as experiences and lessons learned from the second year. The SEC also solicited suggestions regarding any changes that the SEC or PCAOB could make to improve the usefulness of the information provided as a result of the reporting requirements related to internal control over financial reporting. The questions posed to the panel were:

1. Do you believe that the goals of the Act are being met? If not, why not? If so, were the goals being met chiefly by management's assessment, the independent audit, or both? Are these goals being met at a cost that is justified by the benefits delivered to shareholders? Is your view impacted by the size and/or complexity of the company?

2. Do investors benefit from internal control reporting? What is the source of any benefits? What are the countervailing costs? How could the internal control requirements be improved from an investor's perspective?

3. How is the competitiveness of U.S. public companies impacted by the internal control requirements? How might the cost of capital for U.S. companies change as a result? What will be the effect on U.S. securities markets and, therefore, U.S. investors? Will companies seeking to go public be influenced by the costs associated with the internal control reporting and auditing requirements? If so, how?

4. Do investors and other market participants generally understand the existing definition of the term "material weakness"? Do companies' public disclosures about the existence of material weaknesses adequately inform investors and the market about the material weaknesses in internal control over financial reporting and the effect of those material weaknesses on financial reporting? Does the market react to material weakness disclosures?

5. In your opinion, have disclosures related to material weaknesses in companies' internal control over financial reporting been helpful to investors? If so, how? Did such disclosure improve in the second year? If so, how?

6. Should other reporting and/or assessment options that are consistent with the goals of the Act be considered for management or the auditor? If so, how would these reporting options achieve the goals of the Act?

Panel Five – Next Steps

Panels 1 through 4 were intended to solicit feedback on broad and specific experiences and lessons learned from the second year of implementing the internal control over financial reporting requirements. In this panel, the SEC sought feedback on any significant remaining concerns and recommendations on how the efficiency and effectiveness of the documentation, assessment, reporting, and auditing process might be improved, as follows:

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?

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