



## POLICY STATEMENT

Specifically, this Policy Statement expresses the Board's view that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should –

- ***integrate their audits*** of internal control with their audits of the client's financial statements, ***so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits***;
- ***exercise judgment to tailor their audit plans to the risks facing individual audit clients***, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);
- ***use a top-down approach*** that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and ***use the risk assessment required by the standard*** to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;
- take advantage of the significant flexibility that the standard allows to ***use the work of others***; and
- ***engage in direct and timely communication with audit clients*** when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

## Background

The Sarbanes-Oxley Act has had a profound effect on the integrity of financial reporting in U.S. capital markets. The Act has strengthened and reformed almost every aspect of the financial reporting process, from the composition and role of the audit committee to preparers' certifications of accuracy, covering the integrity of gatekeepers such as analysts, lawyers and auditors in between. Although some of these changes have been in place for some time, the participants in the financial reporting process are now implementing one of the most challenging – but also one of the most promising – provisions of the Act.

## **POLICY STATEMENT**

Section 404 of the Act aims to strengthen the internal controls that underpin the accuracy and reliability of a company's published financial information. That section, along with the SEC's implementing rule, requires a public company to annually report its assessment of the effectiveness of its internal control over financial reporting. The section also requires such a company to provide its auditor's attestation to, and report on, the company's assessment. Auditing Standard No. 2 governs the auditor's responsibilities under Section 404.

In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it maintains adequate internal control over the preparation of accurate financial statements. Companies have been required to have internal control over their accounting since the Congress enacted the Foreign Corrupt Practices Act in 1977. There is no doubt, however, that the Act's requirement for annual assessments, and auditor attestations to those assessments, has led to a renewed emphasis on internal control over financial reporting and significant improvements in companies' controls.

Many of the larger public companies have recently filed their first assessments of the effectiveness of their internal controls, as well as the related reports from their auditors. There is evidence that the benefits of the internal control requirements are already being realized,<sup>1/</sup> and investors have expressed strong support for the goals of Section 404, including the increased transparency that the provision provides.<sup>2/</sup> Section

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<sup>1/</sup> Seventy-nine percent of the 222 financial executives surveyed by Oversight Systems, Inc. reported that their companies have stronger internal controls after complying with Section 404. Seventy-four percent said that their companies benefited from compliance with Sarbanes-Oxley, and, of those, 33 percent said that compliance lessened the risk of financial fraud. See Oversight Systems, Inc., The 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley (December 2004).

<sup>2/</sup> See, e.g., Remarks of Mark Anson, Chief Investment Officer, California Public Employees' Retirement System, Transcript of SEC Roundtable on Implementation of Internal Control Reporting Provisions (Apr. 13, 2005) ("Roundtable Tr."); Remarks of Ann Yerger, Executive Director, Council of Institutional Investors, Roundtable Tr.; Remarks of Damon Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organizations, Roundtable Tr.; Letter from Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System, to William H. Donaldson, Chairman, SEC (Mar. 1, 2005); see also Remarks of

## **POLICY STATEMENT**

404 has, however, proven to be an enormous challenge for those involved in its implementation. Companies have found the requirements costly and demanding, and many have questioned whether the benefits are worth the cost.

We take these concerns seriously and are committed to learning from the first year's experience implementing Section 404. As part of this effort, on April 13, 2005, we participated in the Commission's Roundtable. The Roundtable was an opportunity for us and the Commission to hear directly from issuers, auditors, and investors on the front line of the Section 404 implementation process. Many participants at the Roundtable expressed their support for Section 404's purpose. One of the most valuable aspects of the Roundtable, however, has been the constructive criticism provided by many of those currently involved in the implementation process.

The cost of Section 404 compliance was the primary concern raised at the Roundtable.<sup>3/</sup> Among other reasons, commenters suggested that costs were too high because companies and their auditors did not sufficiently focus their efforts on higher risk areas of internal control over financial reporting. In addition, commenters expressed the view that auditors did not use the work of others sufficiently or fully integrate the audit of internal control with the audit of the financial statements. Some Roundtable participants also stated that auditors are often less willing than they were previously to provide guidance to clients on accounting issues for fear of compromising independence or triggering a material weakness finding.

At the conclusion of the Roundtable, the Board agreed to take several steps to promote an internal control audit process that is both effective and cost-efficient. Today, we take the first two of these steps.<sup>4/</sup> First, we are separately publishing a

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Gregory Jonas, Managing Director of Accounting Specialists Group, Moody's Investors Service, Roundtable Tr.

<sup>3/</sup> One survey found that for 217 public companies with average revenues of \$5 billion, first year Section 404 compliance cost, on average, \$4.36 million and consumed an average of nearly 27,000 hours. See Financial Executives International, FEI Special Survey on SOX Section 404 Implementation (March 2005).

<sup>4/</sup> The Board also intends to devote the agenda of the upcoming meeting of its Standing Advisory Group, scheduled for June 8 and 9, 2005, to a discussion about implementation of Auditing Standard No. 2.

## **POLICY STATEMENT**

series of additional staff questions and answers related to Auditing Standard No. 2.<sup>5/</sup> These questions and answers further explain and clarify provisions in Auditing Standard No. 2. In particular, these questions and answers seek to correct the misimpression that certain provisions of Auditing Standard No. 2 need to be applied in a rigid manner that constrains professional judgment and prevents the conduct of an audit in a manner that is both effective and cost-efficient. Second, we are also issuing today this Policy Statement, which amplifies some of the themes in those questions and answers and articulates our policy with respect to administering Auditing Standard No. 2.

Failure to apply the concepts discussed in this Policy Statement may reflect poor audit planning and result in unnecessary cost. Indeed, although we have not performed a detailed analysis, it is sufficiently clear to us that the costs to date associated with the implementation of Section 404 have been too high. For the Section 404 process to be sustainable, these costs must be reduced in future years. Some of this excess expense is attributable to first-year, start-up costs that should not recur in future years; nevertheless, we are concerned that auditors may not sufficiently be using several features of our standard, described below, that are designed to reduce costs without sacrificing quality.

### **The Integrated Audit Concept**

As auditing has evolved over the last century from a process of detailed examination of individual transactions and account balances into a process of testing samples, internal control over financial reporting has emerged as the foundation not only of the financial reporting process but also of the financial statement audit. Since 1941, the SEC's regulations have required auditors to consider a company's internal controls in planning an audit.<sup>6/</sup> In addition, if controls had been adequately designed and were operating effectively, then longstanding auditing standards permitted the

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<sup>5/</sup> The Staff Questions and Answers are available on the Board's Web site, at [http://www.pcaobus.org/Standards/Staff\\_Questions\\_and\\_Answers/index.asp](http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/index.asp).

<sup>6/</sup> Amendment of Rules 2-02 and 3-07 of Regulation S-X, Accounting Series Release No. 21, 11 Fed. Reg. 10921 (Feb. 5, 1941) (amending Regulation S-X to provide that "[i]n determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff.").

## **POLICY STATEMENT**

auditor to rely on less costly and time-consuming procedures.<sup>7/</sup> Conversely, if an auditor determined that a control was inadequate in its design or operation (or elected not to test the control), then the auditor could not rely upon that control.<sup>8/</sup> In this event, the auditor would take a considerably more detailed approach by relying almost exclusively on detailed tests of account balances and transactions.

Sections 103 and 404 of the Act, and Auditing Standard No. 2, changed that audit model. Today, auditors of companies subject to Section 404 must not only obtain an understanding of internal control, but they must also examine the design and operating effectiveness of internal control sufficient to render an opinion as to that effectiveness, as required by Section 103(a)(2)(A)(iii). To reap the most benefit from this examination, and to make the overall audit process as efficient as possible, we designed in Auditing Standard No. 2 an integrated audit model.

An integrated audit combines an audit of internal control over financial reporting with the audit of the financial statements, such that the objectives of the two audits are achieved simultaneously through a single coordinated process. In an integrated audit, the auditor's examination of internal control is validated by the findings in the audit of the financial statements. In addition, the auditor's findings and conclusions reached during the audit of internal control help the auditor better plan and conduct the auditing procedures designed to determine whether the financial statements are fairly presented. The two processes are mutually reinforcing. In this way, the integrated audit helps to improve the quality and integrity of both corporate controls over financial reporting and independent financial statement audits. We also believe that an integrated audit is more cost-effective than performing two distinct processes to audit internal control and the financial statements separately.

As a practical matter, integration of the two audits means that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits.

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<sup>7/</sup> See AU Section 319.03, *Consideration of Internal Control in a Financial Statement Audit*. Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, temporary rules that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"), including AU Section 319. These standards are reproduced on our Web site at [http://www.pcaobus.org/Standards/Interim\\_Standards/index.asp](http://www.pcaobus.org/Standards/Interim_Standards/index.asp).

<sup>8/</sup> See AU Section 319.04, *Consideration of Internal Control in a Financial Statement Audit*.

## **POLICY STATEMENT**

This kind of coordination of work requires an auditor to plan and conduct his or her work with both audits in mind. Failing to integrate these audits not only wastes resources, but it also jeopardizes the quality of the overall audit and, potentially, misses key insights that could identify and uproot a budding accounting or reporting problem.<sup>9/</sup>

Some auditors have acknowledged that, for a variety of reasons, they did not achieve fully integrated audits this year. As a result, audit costs may have been substantially higher than necessary. According to a recent survey commissioned by the largest U.S. accounting firms, auditors believe that the total costs of compliance with Section 404 will decline by 46 percent next year.<sup>10/</sup> Among the factors cited to support this prediction was auditors' expectations that integration will be improved.<sup>11/</sup> We, too, expect that auditors will better integrate their audits in the coming years. This should meaningfully affect both audit costs and audit quality.

### **The Importance of Professional Judgment**

Auditing Standard No. 2 is no different from any other auditing standard in that it does not prescribe detailed audit programs. For as long as the profession has established auditing standards, auditors have used those standards to tailor their own audit plans, in a manner that addresses the nature and complexity of the audit client.

Many participants in the Roundtable, as well as others, have noted, however, that some auditors have in fact failed to use tailored audit plans in their first year of auditing internal control over financial reporting under Section 404 of the Act and Auditing Standard No. 2. Those auditors have instead used a one-size-fits-all audit plan driven by standardized checklists that may have little to do with the unique issues and risks of the particular client's financial reporting processes. This is a disappointing development indicative of poor training and audit planning. Not only do audit fees

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<sup>9/</sup> PCAOB Staff Question and Answer No. 50 issued today provides additional guidance on integrating the audit of internal control over financial reporting with the audit of the financial statements.

<sup>10/</sup> See Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies (Apr. 2005).

<sup>11/</sup> See Letter from Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers to Jonathan G. Katz, Secretary, SEC (Apr. 11, 2005).

## **POLICY STATEMENT**

increase when, for example, an audit plan calls for less experienced auditors on the engagement team to devote endless hours to process-level control testing, but audit quality also decreases, because such a plan contributes little to the search for material weaknesses in internal control that could identify a financial reporting problem.

The overall objective of Auditing Standard No. 2 is for the auditor to obtain evidence that a company's control system reasonably assures that its financial statements do not contain material misstatements. To accomplish this, the auditor must not only exercise judgment to determine how to apply the standard to audit clients in different industries and of different sizes, but also exercise judgment to focus their work on areas that pose higher risks of misstatement, due either to errors or fraud. Reliance on standardized checklists that lead to a focus on controls in low-risk areas obviously fails to meet this objective.

### **The Top-down Approach and Role of Risk Assessment**

Auditing Standard No. 2 was designed to be applied from the top down. That is, the standard focuses the auditor first on company-level controls and then on significant accounts, which lead the auditor to significant processes and, finally, individual controls at the process, transaction, or application levels. Knowledge obtained at each step guides the auditor toward the higher risk areas within the next succeeding level of controls. By approaching the task in this way, the auditor is naturally steered toward higher risk areas and away from those with less potential to have a material impact on the financials. This approach also provides a road map through the control system to ensure that the individual controls selected for testing are, in fact, relevant to internal control over financial reporting.

An auditor who chooses another approach needlessly risks adding to the audit's cost and reducing its quality. For example, starting at the bottom increases the risk that the auditor will become bogged down in testing that may ultimately prove pointless, in light of the primary objective of preventing or detecting material misstatements of the financial statements, resulting in increased and unnecessary costs.

A risk-based approach to the auditor's testing strategy can further reduce costs while increasing audit effectiveness. The auditor should consider the overall risk related to each significant account identified to determine whether he or she should alter the nature, timing, and extent of testing of the controls over that specific account. By doing so, the auditor will be able to eliminate from further consideration accounts that have only a remote likelihood of containing a material misstatement and, in any event, devote



## **POLICY STATEMENT**

less audit attention to areas of low risk. In addition, the auditor should look to the individual control being tested and consider the nature, frequency, and importance of that specific control in order to determine whether the testing strategy should be revised further.

Finally, the auditor should consider, as part of his or her risk assessment, the strength of the company-level controls, to determine whether the result of testing these controls will alter the nature, timing, and extent of testing. Although the auditor may not rely solely on testing company-level controls,<sup>12/</sup> strong company-level controls should lead the auditor to do less work than he or she otherwise would have performed or rely to a greater degree on the work of others.

### **Using the Work of Others**

An auditor who applies Auditing Standard No. 2 from the top down and appropriately assesses risk should naturally identify areas where use of the work of others is not only appropriate but is also the most efficient way to perform the audit. Redoing work in these areas may unnecessarily increase costs without producing a corresponding increase in audit quality. Spending auditor resources in areas in which the auditor could rely on the work of others also may cause the auditor to focus too much on low-risk controls. As discussed earlier, this could be an early warning sign of poor audit planning.

Auditing Standard No. 2 provides the auditor with considerable flexibility to use the work of others, consistent with the profession's longstanding auditing standard on using the work of internal auditors in the financial statement audit.<sup>13/</sup> There is some

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<sup>12/</sup> See Auditing Standard No. 2, paragraph 54. PCAOB Staff Questions and Answers Nos. 38-43 issued today provide additional guidance on how to plan and perform an audit of internal control over financial reporting using both a top-down and a risk-based approach.

<sup>13/</sup> See AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. This standard provides that the work of competent and objective internal auditors may affect the nature, timing and extent of the audit. Specifically, if internal auditors are competent and objective, then external auditors may rely on work performed by internal auditors in the ordinary course of their duties. For example, "for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved

## **POLICY STATEMENT**

concern that auditors have been reluctant to use Auditing Standard No. 2's flexibility to rely on the work of others because the standard also requires the external auditor to obtain the principal evidence supporting his or her opinion as to whether internal control is effective overall. These provisions are not in conflict. The principal evidence provision of Auditing Standard No. 2 requires the auditor to perform sufficient auditing to reach his or her own, independent opinion as to the effectiveness of a company's internal control over financial reporting. In broad terms, it prevents auditors from merely passing on to investors the judgments and opinion of others.

As one of the questions and answers issued today explains, the principal evidence requirement is "primarily qualitative."<sup>14/</sup> Indeed, under Auditing Standard No. 2 the amount of work necessary to meet the principal evidence test "is not susceptible to precise measurement."<sup>15/</sup>

In practical terms, this means two things. First, the auditor should perform more work directly in high-risk areas and seek to use the work of others in areas of lesser risk. Second, in evaluating whether the auditor has met the principal evidence test, the auditor should ascribe more weight to the work he or she performs in high-risk areas.<sup>16/</sup>

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in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work ... performed by internal auditors ..., that ... testing of the assertions directly by the auditor may not be necessary." See id. at paragraph 22. In addition, this standard also permits auditors to request direct assistance from the internal auditors, such that internal auditors will work under the direct supervision of the external auditor. See id. at paragraph 27. PCAOB Staff Question and Answer No. 54 issued today provides additional guidance on using the work of others. See also PCAOB Staff Question and Answer No. 36 (Nov. 22, 2004) (stating that external auditors may "use internal auditors to provide direct assistance in the audit of internal control over financial reporting").

<sup>14/</sup> PCAOB Staff Question and Answer No. 54 (May 16, 2005).

<sup>15/</sup> See Auditing Standard No. 2, note to paragraph 108.

<sup>16/</sup> In other words, principal evidence is not meant to be assessed by simply adding up hours or numbers of controls tested in a mechanical fashion; rather, such an approach would likely detract from the standard's goal of allowing the auditor to use the work of others in an efficient and appropriate manner.

## **POLICY STATEMENT**

In this manner, following the risk-based principles regarding using the work of others will, in most circumstances, result in the auditor having obtained the principal evidence supporting his or her opinion.

### **The Auditor's Ability to Provide Advice to Audit Clients**

Finally, we are concerned about a misconception that, as a result of Auditing Standard No. 2, companies may no longer look to their auditors for advice on difficult accounting and internal control issues. This misconception appears to manifest itself in two particularly problematic ways. First, we have heard at the Roundtable and elsewhere that auditors have been unwilling to provide accounting advice to their audit clients; second, auditors have apparently encouraged audit clients to finish their assessments of internal control and their financial statements before the auditor begins audit work to attest to the fairness of those assessments and financial statements. Such practices are neither necessary nor advisable.

Auditing Standard No. 2 provides that an auditor's detection of a material misstatement in financial statements is a "strong indicator" of a material weakness in internal control. In addition, longstanding rules on auditor independence prohibit the auditor from preparing a client's financial statements and from making financial reporting decisions on behalf of management.<sup>17/</sup> The prospect of PCAOB inspectors examining for compliance with these independence rules seems to have led some to conclude that management and the auditor should not consult on accounting and internal control questions or that the auditor should not review draft financial statements that, because they are not finished or complete, may contain misstatements or misapplications of Generally Accepted Accounting Principles ("GAAP"). When auditors are unwilling, or believe that they are unable, to provide advice on accounting or internal control, management may be forced to retain other accounting experts, or to make accounting decisions without the benefit of access to the auditor's technical knowledge.

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<sup>17/</sup> See Rule 2-01(c)(4)(i) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(i) (stating that an auditor is not independent of an audit client if it "prepar[es] the audit client's financial statements"); Rule 2-01(c)(4)(vi) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(vi) (stating that an auditor is not independent of an audit client if it "perform[s] any decision-making, supervisory, or ongoing monitoring function for the audit client"); see also Meeting of PCAOB Standing Advisory Group, February 16, 2005, available on the Board's Web site <http://www.pcaobus.org>.

## **POLICY STATEMENT**

Nothing in Auditing Standard No. 2 requires this result. Determining when it is appropriate for the auditor to provide accounting advice requires professional judgment and common sense. Auditors may not, of course, make accounting decisions for their clients, and management may not abandon its responsibility for quality financial reporting and simply rely on auditors to catch errors. Where management makes its own informed decisions regarding how applicable accounting principles apply to its company's circumstances, however, the auditor may discuss freely with management the meaning and significance of those principles.

To help dispel confusion on this issue, our staff addressed last June the question of whether audit clients may – or should – share draft financial statements with their auditors. The answer is decidedly yes. Indeed, information-sharing on a timely basis between management and the auditor is necessary. When reviewing draft financial statements, in determining the point at which the auditor must draw the line for purposes of identifying when a deficiency exists, the auditor should be concerned primarily about instances in which the company completed its financial statements and disclosures without recognizing a potential material misstatement. If it is clear that all applicable controls have not yet operated, then a conclusion as to whether a material misstatement in draft financial statements demonstrates a control deficiency would be premature.<sup>18/</sup>

Auditors may also provide audit clients technical advice on the proper application of GAAP, including offering suggestions for management's consideration to improve disclosure and financial statement quality and giving updates on recent developments with accounting standards-setters. In addition, management may provide and discuss with the auditor preliminary drafts of accounting research memos, spreadsheets, and other working papers in order to obtain the auditor's views on the assumptions and methods selected by management. Although the auditor may determine that some of these communications need to be made in writing, timely and open communication will often be best accomplished orally.

For example, a company that is contemplating a transaction may ask the auditor for assistance in determining the proper accounting for the transaction. In this situation,

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<sup>18/</sup> See PCAOB Staff Question and Answer No. 7 (revised July 27, 2004) (explaining that Auditing Standard No. 2 requires an auditor to judge whether, once all applicable controls have operated, the company is able to prepare financial statements that are free of material misstatements).

## **POLICY STATEMENT**

the auditor may provide substantial help, including explaining how applicable accounting principles apply to the transaction, offering sample journal entries, and reviewing management's preliminary conclusions. This is very different from a situation in which the auditor identifies a potential misapplication of applicable accounting principles in connection with a transaction that the auditor learns of outside of the consultation process, such as during a quarterly review, or after management has completed its financial statements and disclosures, in which case the auditor would have to consider whether management's failure to recognize the potential misapplication of applicable accounting principles constitutes a significant deficiency or material weakness.

### **The Board's Approach to Oversight of Implementation of Auditing Standard No. 2**

We take seriously our responsibility to oversee implementation of Auditing Standard No. 2. This includes issuing additional guidance to explain or interpret the standard as necessary, as well as supervising auditors' implementation of the standard. In particular, we intend to use our upcoming inspections to evaluate how firms have conducted the first round of audits under Auditing Standard No. 2.

Our inspections should drive improvements in the effectiveness and efficiency of registered firms' audits of internal control in two ways. First, as we have described above, Auditing Standard No. 2 leaves auditors considerable flexibility to apply the standard in a manner that is appropriate to each audit. Indeed, the standard requires auditors to use professional judgment to tailor their audit plans to the specific risks facing each audit client. In our inspections, we will look for audits that suffer from poor planning and risk assessment, such as by using standardized checklists without appropriately tailoring the procedures to the circumstances or focusing the audit on areas that are unlikely to lead to the discovery of material weaknesses in internal control at the expense of adequately auditing high-risk areas. When we detect such shortcomings, we will demand improvements.

Second, we have also described above, as well as in the staff questions and answers issued today and in the past, several approaches to the audit of internal control that we believe improve both the effectiveness and the efficiency of these audits. When we review audits that do not apply the approaches described above, we will expect auditors to justify their decisions and to be able to explain how the audit plan nevertheless met the objectives of the standard.

At the Roundtable, a number of the participants focused on the role our inspections will play in shaping implementation of Auditing Standard No. 2. Some

## **POLICY STATEMENT**

suggested that our inspections should require auditors to reduce costs overall. Others suggested that, if our inspections are narrowly focused on technical compliance, they could have the perverse effect of promoting a checklist mentality and discouraging the use of judgment and tailored audit planning.

We intend for our inspections to do neither. By focusing on the conduct of a high-quality audit as described above, we believe our inspections will promote efficiency without the need for us to get involved in auditors' billing practices. And, by focusing on appropriate use of judgment and risk assessment, we are deliberately planning our inspections in a manner that promotes an audit of internal control that is both thoughtful and risk-focused. In other words, we do not intend to second-guess good faith audit judgments. If we believe, however, that an auditor has approached the audit in a way that is mechanistic and does not reflect the application of professional judgment to the specific risks associated with the audit client's financial reporting system, we will not hesitate to demand changes to the auditor's approach to implementing Auditing Standard No. 2.

### **Conclusion**

The first year's implementation of Section 404 required a tremendous effort on the part of management and auditors, as well as the commitment of substantial corporate resources. The lessons learned so far – and to be learned as we complete our first cycle of inspections of audits under Auditing Standard No. 2 – should provide a solid basis for substantial improvement in the process, including significant cost reduction in the future.