

CHAMBER OF COMMERCE  
OF THE  
UNITED STATES OF AMERICA

DAVID CHAVERN  
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April 12, 2005

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Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

RE: File Number 4-497

Dear Mr. Katz:

The U.S. Chamber of Commerce is the largest business federation in the world, representing the interests of some three million U.S. companies. We are committed to promoting responsible corporate governance and have supported legislative and regulatory efforts in this regard, including many aspects of the Sarbanes-Oxley Act of 2002 (the "Act"). As a result of the Act, boards are more independent, they meet more often, and they've improved communications with shareholders.

A large cross-section of our membership, however, has expressed concerns about the rules issued by the Securities and Exchange Commission (the "SEC") pursuant to Section 404 of the Act, "Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," and the standards issued by the Public Company Accounting Oversight Board (the "PCAOB") as Audit Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements" ("AS 2"). The most common general concern of our members is that Section 404 has been implemented in such a manner as to damage the long-term competitiveness of U.S. companies and the U.S. capital markets and to create burdens on these companies and their management well beyond what Congress intended and what is needed to remedy acknowledged abuses.

Our members strongly support responsible standards for internal controls over financial reporting and the presentation of meaningful information to the public about compliance with those standards. We agree that effective internal controls help to increase value for investors, employees and management. However, despite the recent tremendous efforts by U.S. public companies and their independent auditors to achieve compliance, it is evident that the system of internal control review imposed by the SEC and the PCAOB pursuant to Section 404 needs to be reexamined. We believe that, following the experience of the first round of compliance and reporting under Section 404, now is the time to address these concerns so that modification of the process can be considered in a timely fashion for both companies that have compliance issues ahead of them and for companies that have recently gone through the process.

As Section 404 has been implemented, companies are currently required to commit extraordinary resources (in time, management and staff resources and money) to collect, review and analyze data. While the SEC has tried to provide relief through extending compliance dates, these extensions only postpone the inevitable burden. We applaud the establishment of the SEC Advisory Committee on Smaller Public Companies but believe the issues discussed below go beyond the impact of the Section 404 regime on small business. Consequently, we believe it is necessary for the SEC and the PCAOB to reexamine the manner in which the implementation of Section 404 has occurred and to make changes that fulfill the statutory and regulatory role more efficiently and that provides better information to companies' stakeholders and the investing public generally.

### *Summary of Key Points*

We received a large number of comments from our members regarding AS 2 and the implementation of Section 404. We have attempted to capture the range of these comments in this letter, however, we believe that it is important to highlight several points in particular:

- We do not believe that the current system for setting and implementing standards provides sufficient input for issuers – or sufficient accountability on the part of the SEC and PCAOB. It is important that the SEC and PCAOB take some direct responsibility for ensuring that Section 404 is not implemented in a way that ultimately damages the U.S. economy.
- To date, the implementation of Section 404 has not provided a good cost/benefit balance.
- Specifically, we urge the SEC and the PCAOB to set and announce a clear timetable to act on constructive recommendations to improve Section 404 implementation so that these changes are in place well in advance of the next 404 cycle.
- The relationship between issuer and independent auditor has been changed in a fundamental way, to the ultimate detriment of the investing public.
- As applied, terms such as “material” and “reasonable” have no meaning under AS 2. This is because of the lack of clarity in the standard and litigation risk faced by the auditing firms. The SEC and PCAOB can take steps to give real meaning to such words.
- As currently applied, AS 2 can be an impediment to desirable business operations, including IT investments and mergers and acquisitions. We don't believe that Congress ever intended for Section 404 to impede normal business activities.

### ***Setting Standards***

In this reexamination and on an ongoing basis, we believe that the PCAOB and SEC should each revisit the process for setting applicable standards and guidelines. The PCAOB should provide greater opportunities for the managers of public companies, who are responsible for the design and implementation of internal controls and who are ultimately subject to the audit process under AS 2, to have input in the development of PCAOB standards and guidelines in a manner similar to the working model of the Financial Accounting Standards Board. The process needs to be more open with expanded opportunities for businesses to meet directly with PCAOB members and talk to them about practical problems. We would also suggest that the PCAOB examine the FASB Emerging Issues Task Force as a possible model for obtaining additional information on implementation issues.

Further, interpretive guidance should not be left to the auditing firms. We believe that business managers will provide constructive insight, and our members are willing to devote time and effort in this working group approach. Also, in fulfilling its statutory roles under Section 404 and Section 107 of the Act, the SEC should develop guidelines for reporting companies in the implementation of AS 2 and the assessment of internal controls in coordination with parallel activities by the PCAOB. Overall, an enhanced dialogue among all affected parties will lead, we believe, to a process that better reflects the goals of the Act without unduly impeding effective, efficient management.

As importantly, it is critical for the SEC and the PCAOB to take more responsibility for ensuring that established standards are balanced and provide good cost/benefit value for the U.S. economy. While we understand that impetus behind the drive to set high standards, it is also clear that “more” is not always “better.” We would suggest that the SEC and PCAOB both more explicitly incorporate the need for this balance into their goals for the implementation of Section 404.

### ***Cost/Benefit Balance***

Implementation of Section 404 has imposed extraordinary costs on U.S. businesses. These costs have included not only direct out-of-pocket costs, but also the opportunity cost of attention being taken away from other important issues. Large costs can be expected upon adoption and implementation of such significant legislation and regulation. However, many of our members do not expect (i) that these costs will drop significantly over time or (ii) that the incurrence of costs at present levels will result in the creation of commensurate value for investors.

In its implementing release,<sup>1</sup> the SEC estimated that the aggregate cost for implementing Section 404(a) of the Act would be approximately \$1.24 billion, or \$91,000 per reporting company. This was a gross underestimation. Financial Executives

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<sup>1</sup> SEC Release Nos. 33-8238; 34-47986.

International (FEI) has conducted a survey of a broad range of U.S. public companies regarding the implementation costs of Section 404. In its letter to the SEC, dated April 1, 2005, FEI noted that member companies spent an average of \$4.3 million for added internal costs and additional fees spent on auditors and other consultants and software in connection with Section 404. Companies over \$25 billion in revenue spent more than \$14.7 million on average. These results are consistent with surveys conducted by other parties<sup>2</sup> and by anecdotal information.

Our members do not believe that these costs are likely to decline significantly as the excessive testing regimes adopted and augmented by public accounting firms have locked in large ongoing costs for compliance. Given the dynamic nature of business operations, these ongoing costs will increase as companies implement improvements to IT systems, implement business reorganizations, make other significant operational changes or engage in mergers, acquisitions and divestitures, since each instance will require control assessments to determine the impact of the change.

While benefits have clearly been gained from improved internal control regimes, it is not clear whether these have been commensurate with the time and money costs. In order to reduce costs, we urge the SEC and the PCAOB to pursue the reforms noted in this letter, to respond to comments from a broad range of parties who are participating in the Roundtable, and to otherwise adopt a more flexible regulatory approach that would allow companies to meet the objectives of Section 404 in more rational and cost-effective ways.

### ***Impact on Auditor-Client Relationship***

One particularly unfortunate result of the new rules under Section 404 has been the chilling effect on the communication channels between companies and their independent auditors that we believe is harmful to companies and their investors. Even though auditing costs have risen tremendously, one unintended consequence of Section 404 is that U.S. companies are receiving substantially less support and advice from their independent auditors. Auditors are hesitant to give companies any advice that could be perceived as impacting internal controls due to an apparent lack of clarity in the application of the standards themselves as well as from fear of appearing to compromise their independence. For example, accounting firms are increasingly reluctant to provide any advance advice to their auditing clients with respect to the proper application of GAAP. Although we recognize that auditor independence is critical, companies need to be able to call on their independent auditors for their expertise and resources, including for prospective advice on technical interpretation issues. If this resource is not available,

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<sup>2</sup> Other studies include a March 2005 survey released by the Independent Community Bankers of American, available at <http://www.icba.org/files/PDFs/SarboxSurveyResults.pdf>, and the report by the American Electronics Association, "Sarbanes-Oxley Section 404: The 'Section' of Unintended Consequences and its Impact on Small Business," February 2005, available at <http://www.aeanet.org/governmentalaffairs/AeASoxPaperFinal021005.asp>.

companies, especially companies with limited internal technical capacity, may be forced to engage multiple firms to address the same sets of issues, imposing unnecessary costs, reducing the overall quality of accounting advice provided and subjecting companies to potential conflicting interpretations from outside experts. The SEC and the PCAOB should provide explicit guidance in support of the provision of reasonable GAAP accounting and internal control advice by independent auditors.

Section 404 has also had a significant effect on the relationship between companies and their independent auditors. All stakeholders benefit when companies and auditors are able to productively work together to identify and solve real problems. In the current environment, however, independent auditors feel compelled to focus more on noting flaws and weaknesses than in assisting with the investigation or resolution of those issues. We do not believe that the Act intended this effect on the collaborative nature of the relationship between company and independent auditor (indeed, certain provisions of the Act are specifically designed to increase the communications between the audit committee and the company's independent auditors). The SEC and the PCAOB should provide explicit guidance to help resolve the tensions in this area.

#### *Clarification of the Standards*

We believe that while Section 404 and AS 2 suggest that judgment is called for in assessing terms such as "reasonable" and "material," this judgment has not been applied in the assessment process. It appears that external auditors have been unwilling or unable to bring their professional judgment to bear due to the lack of clarity that is present in such terminology and the potential risk to the auditor – with respect to both future PCAOB review and potential litigation – that is inherent in the application of judgment. Audit firms have interpreted standards very conservatively, requiring excessive documentation and the testing of a large number of controls, even those with low risk of preventing or detecting a material error. They felt the need to insist on extensive documentation and testing even where there is a long history of consistently accurate and reliable financial reporting and highly effective management systems. We understand that mathematical or other definitional certainty is not a solution, but we believe that structural elements can be added to these terms.

For example, management could provide a definition of materiality that is disclosed as a reference point, or could identify those systems or processes that are low risk and thus excluded from testing or from annual testing. If a baseline control environment were established that is crafted to the individual company, critical system testing could be directed toward higher risk areas and areas where change has occurred, instead of having control testing with universal applicability. Further, we believe that materiality should generally be framed in the context of the full year primary financial statements. We are aware of instances where materiality has been established in the context of quarterly segment information, however, we would suggest that the circumstances where this is appropriate should be very limited. SEC and PCAOB guidance should also include explicit recognition that the independent auditor can rely on

the testing procedures of internal auditors and management if the quality of these procedures is established, rather than duplicate the internal work.

Further, we believe that the benefit achieved from disclosure of material weaknesses is not clear in many instances. One result of the lack of definition in the process that has been implemented is that many disclosures of a "material weakness" may in effect exaggerate the nature of the reported control weakness through the use of a single term applicable to items that do not pose the same level of risk. We believe that the market may have difficulty discerning the level of risk attached to potential problems from a material weakness because of the wide range of items that fall within the definition of material weakness.

Chairman William J. McDonough reflected our concern in his comments on March 31, 2005, at the public meeting of the PCAOB for the purpose of introducing the Proposed Auditing Standard on Corrections of Material Weaknesses in Internal Control over Financial Reporting when he said:

Auditors should apply AS 2 in a manner that is proportional to the quality of management's monitoring of controls as well as the complexity of the company. Untailored checklists, to me, are an early sign of poor quality judgments, which can lead to poor quality auditing.

We agree that this philosophy needs to be applied to the PCAOB's forthcoming review of the quality of registered auditing firms' implementation of AS 2, but we also believe that PCAOB and SEC guidance needs to be revisited, with this philosophy in mind, to provide better guidance to auditing firms and their corporate clients.

### ***Impact on Business Operations***

Companies are dynamic entities that grow, invest funds, restructure their organization and implement new systems. These are all healthy business activities but can also have significant effects on a company's internal control system. Unfortunately, the uncertainty surrounding the implementation of Section 404 has given a number of companies an incentive to remain as static as possible in order to ensure that internal controls are not affected prior to the assessment date. Although the SEC has indicated that it will provide a grace period (with conditions) to Section 404 compliance with respect to certain acquisitions, other more routine corporate changes, such as significant personnel changes or IT system acquisitions, are not granted this flexibility. This has led a number of companies to delay important business decisions to avoid dealing with the potential consequences under Section 404. We do not believe that Congress intended that legitimate business decisions should be impeded by a fear of Section 404 or that this serves the best interests of investors. We urge the SEC and the PCAOB to focus on the need to facilitate business activity by implementing compliance grace periods with respect to a wider scope of activities and by simplifying and streamlining testing regimes under AS 2.

### ***Integration of Audits***

The SEC and PCAOB should provide explicit guidance and encouragement to the external auditing firms to ensure that the audits of the financial statements and internal controls are integrated to the greatest extent possible. Many companies feel that they are now subject to two separate – and often duplicative – audits.

### ***Third Party Relationships***

The SEC and PCAOB should provide additional guidance with respect to the types of third party relationships that are “in” or “out” of the 404 assessment process. A lack of clarity has resulted in over-testing with respect to certain attenuated corporate relationships.

Further, consideration should be given to establishing standards that would allow registrants that are subsidiaries of other registrants to be subject to less extensive control testing where the relevant systems have already been tested at the parent company level.

### ***IT Assessment***

The SEC and PCAOB need to examine the approach taken in the review of IT systems and provide specific guidance to companies and independent auditors. We believe that (i) IT systems have been examined with different standards than are applied to other business processes, (ii) critical and noncritical IT systems have not been distinguished, (iii) testing and documentation by auditors have been excessive, and (iv) auditing firms have applied inconsistent standards to IT systems. Therefore, we would first recommend that a single, clear standard be established for IT systems that is consistent with the standards applied to other business systems and also provides for differentiated treatment between critical and noncritical systems.

As a particular matter, we do not understand the rationale of the ad hoc requirement of the auditing firms that imposes a three-month testing cycle on IT systems of certain companies. IT systems typically are well-planned, with extensive troubleshooting in the planning and installation stages, but even well-planned and executed roll-outs encounter bugs and other implementation problems. By imposing a three-month testing cycle the auditors have effectively required that the IT system changes of many companies must occur in the first six months of the year so that the internal debugging can occur, followed by the three-month test cycle prior to the end of the year. This is clearly inefficient and extraordinarily disruptive to orderly business planning. In the absence of this Section 404 testing protocol, this process/business decision would be driven by the business cycle, not by the audit cycle.

We also believe that any new IT system that has been properly vetted by management should be presumed to be functioning correctly for some period of time. In that regard, assuming that a company properly discloses that it has implemented a new IT

system, we would recommend that such systems not be required to be specifically tested under 404 until the fiscal year following their start of regular operation.

### *Attorney-Client Privilege*

Under Section 404, independent auditors require broad access to the corporate decision-making process and documentation of that process, including tax and litigation reserve analyses. It is common for a company's legal counsel (both in-house and external counsel) to attend meetings to discuss the legal aspects of various issues and decisions and to provide written work product. Such discussions and analyses are protected by the attorney-client privilege. However, the presence of the independent auditors at the meetings where privileged communications occur or the access by the independent auditors to the records of such meetings and legal analyses jeopardizes the privileged status of these attorney-client communications. Auditors have asserted the need to review such records as part of their internal control assessment. The SEC and the PCAOB should consider ways to address the scope of participation and review by the independent auditors in the context of privileged communications, keeping in mind the substantial changes effected with respect to "reporting up" by attorneys under Section 307 of the Act and the SEC's rules in Part 205 and the carefully crafted resolution of similar issues set forth in the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information.

### *Proving a Negative*

The excessive standards that companies are required to meet directly contribute to the compliance difficulties that companies are encountering, both in terms of practical implementation as well as burdens of time and expense. These standards require companies to demonstrate to their independent auditors that there are no weaknesses or defects in internal control, effectively requiring them to prove a negative as opposed to establishing and demonstrating effectiveness. This applies to both AS 2 and the PCAOB's recently announced Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness.<sup>3</sup> The SEC and the PCAOB should address what constitutes primary evidence and the point at which "certainty" can be reached with respect to the demonstration of the lack of weaknesses or defects so that companies can focus more on effective business operations and less on testing beyond an accepted "certainty" point. One potential method for addressing this concern is to move away from the binary "effective/noneffective" test to one which has gradations or is more clearly tied to the ability of the auditor to render a clean opinion on the company's financial statements.

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<sup>3</sup> PCAOB Release No. 2005-002, March 31, 2005, PCAOB Rulemaking Docket Matter No. 018.



### ***Testing and Year-End Assessments***

Testing pursuant to Section 404 occurs throughout the fiscal year. Assessment of internal control that relies on this testing, however, is presented as of a single point in time, generally the end of the fiscal year. Greater flexibility needs to be provided in the design and execution of testing. For example, certain testing done at the beginning of the year may not have to be repeated if certain described standards are met. Further, entire areas of control should be examined to determine if, in fact, they need to be assessed annually as opposed to less frequently – in particular if they have been demonstrated to be effective through prior testing and have not significantly changed. Annual retesting could be based on identified risk factors, such as system changes, significant turnover, previous control deficiencies and the nature of controls. Consideration should also be given to addressing these circumstances on a basis other than “pass/fail” that would contemplate reliance on earlier work product.

### ***PCAOB Inspections***

We understand from Chairman McDonough’s comments on March 31, 2005, that the PCAOB “will use our inspections ... to assess the effectiveness of registered firms’ implementation of AS 2, *including the quality of their judgments about planning audit programs appropriate to the nature of their clients.*” (Emphasis added). We know that accounting firms will be criticized by the PCAOB for various things they did not do. However, we would also strongly suggest that the PCAOB note when auditing firms did *more* than was required under the applicable standard so that excesses can be eliminated in the future. Without such guidance, auditing firms may well feel subject to risk if ever questioned about adjustments to their audit programs.

### ***Conclusion***

We believe it is imperative that the SEC and the PCAOB move decisively and promptly to address the problems that have been identified in the implementation of Section 404. In the absence of change, U.S. companies will continue to be saddled with an excessive regulatory regime that (i) makes them less competitive than their foreign counterparts, (ii) causes U.S. capital markets to be less attractive to growing U.S. companies and overseas firms, and (iii) ultimately damages the long-term interests of investors.

The U.S. Chamber of Commerce strongly supports the core ideas behind Section 404, in terms of increasing management accountability, strengthening internal control over financial reporting and facilitating accurate and fair disclosure for investors. However, as an unintended result of rules implementing Section 404, businesses have incurred excessive and unnecessary auditing and related costs that damage their competitiveness and, ultimately, the interests of investors. The dilution of focus of our business managers from creating value for shareholders will show up as an unmeasured opportunity cost. These costs are also a strong deterrent to any company that may be

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interested in accessing the U.S. capital markets. Further, the information produced and disclosed pursuant to the current implementation of Section 404 actually does a disservice to investors and the public by failing to distinguish high-risk gaps in internal control systems from relatively insignificant ones, by forcing companies to spend substantial sums of money and resources evaluating nonmaterial processes, and by inappropriately creating negative perceptions of company internal control mechanisms through use of the excessively blunt “no weaknesses or defects” standard.

We strongly urge both the SEC and the PCAOB to reexamine the means by which they have implemented the requirements of Section 404 and to tailor these requirements to achieve more cost-effective ways for U.S. companies to meet the goals and objectives of the Act.

Sincerely,

David C. Chavern

Director  
Corporate Governance Initiative

cc: Hon. William H. Donaldson  
Hon. Cynthia A. Glassman  
Hon. Harvey J. Goldschmid  
Hon. Paul S. Atkins  
Hon. Roel C. Campos  
Hon. William J. McDonough  
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