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Ms. Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

File Number S7-11-06

Dear Ms. Morris:

We are pleased to submit comments on the Securities and Exchange Commission's (SEC) Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting (Concept Release).

*1. Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?*

Yes, additional guidance to management on how to evaluate the effectiveness of a company's system of internal control over financial reporting (ICFR) would be useful.

To indicate some of the reasons we believe additional guidance would be useful, we wish to provide a brief discussion of the current environment surrounding evaluation of ICFR. Prior to the statutory mandate of the Sarbanes-Oxley Act, most evaluations of the effectiveness of internal controls were narrow, being focused on a specific control or risk at a time, and were to varying degrees concerned with operating efficiencies and the cost of controls, rather than just whether the amounts in the financial statements ran the risk of being materially misstated. As a result, there was little knowledge in place at reporting companies regarding either the

conceptual underpinnings or the practical implementation of an evaluation effort over ICFR.

Currently there is no specific management guidance that has been promulgated. What was available for the first year's evaluation cycle involving ICFR was the recently issued Auditing Standard No. 2 (AS 2), which was largely focused on the testing that needed to be performed by the auditor, and the "Internal Control - Integrated Framework" (COSO Framework) guidance issued in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Therefore company managements have defaulted to the use of AS2 and COSO Framework as the standards by which they perform and evaluate the effectiveness of their internal control over financial reporting.

AS 2 required the auditor to assess management's documentation of controls over all relevant assertions related to all significant accounts and disclosures, and including at least five components of control (paragraph 42 of AS 2). AS 2 specifically instructed the auditor that "inadequate documentation" by management was at least a deficiency and perhaps was a scope limitation (paragraphs 45 and 46 of AS 2) in reporting on ICFR. Early implementation efforts by management naturally focused on the extensive documentation requirements of AS 2. We note also that AS 2 also requires testing of controls in areas where there is little risk, simply because the area is material in dollar amount (paragraph 66 of AS 2), even though that requirement may have been softened by later interpretive releases.

The COSO Framework is intended to help companies assess and enhance internal control, and defines internal control to include "effectiveness and efficiency of operations, reliability of financial reporting, (and) compliance with applicable laws and regulations" (Framework, page 1). The COSO Framework thus has a broader scope than ICFR, but has nevertheless proved useful in ICFR evaluations. However, it is general and does not provide documentation requirements nor much assistance in making testing decisions.

The new evaluation and reporting requirements in the Sarbanes-Oxley Act created an unknown degree of potential added liability exposure to both managements and auditors, which may have led in varying degrees to more management and auditor work than otherwise might have been necessary, just as some allege litigation concerns may lead to unnecessary testing by physicians in the health care field. Under today's litigation environment, it is not surprising that, with no safe harbor for ICFR reports during the initial years, the level of work was substantial.

Additionally, the Public Company Accounting Oversight Board (PCAOB) indicated their inspections of registered accounting firms would be “rigorous”, which no doubt is the correct position, but which nevertheless is yet one more factor leading to pressures for very extensive documentation and assessment by both managements and auditors.

In light of all the above, additional guidance for management about evaluating ICFR should be helpful to all companies. We suggest that any such guidance issued should present a variety of different examples as to how it could be implemented, to illustrate that many different approaches, not one checklist, are desired and are workable.

In providing this guidance, it should include a focus on the activities companies already use to manage their business operations. Most companies have many day-to-day operating processes in place that provide assurance to those within the company that assets are safeguarded and transactions are recorded correctly, even if those might not be the primary objectives of these operating processes.

To date there has been little discussion of how such activities can be used in management’s assessment. Prior Commission or PCAOB guidance has largely emphasized an incremental testing and evaluation structure, rather than the process of evaluating the effectiveness of controls over ICFR within the company’s routine management and operating activities. We believe guidance focused on how routine management activities can provide evidence of the effectiveness of ICFR would help companies design lower cost approaches to the evaluation.

We do believe there are potential limitations to any guidance. The wide range of business activities undertaken by reporting companies makes it very difficult to provide guidance for all eventualities.

*2. Are there special issues applicable to foreign private issuers that the Commission should consider in developing guidance to management on how to evaluate the effectiveness of a company’s internal control over financial reporting? If so, what are these? Are such considerations applicable to all foreign private issuers or only to a sub-group of these filers?*

We see no significant differences in the evaluation of controls over financial reporting in a foreign private issuer versus a domestic US company. However, the Commission should consider how any rules and or regulations within the foreign private issuer’s home country may conflict with the requirements to report on ICFR. The Commission should consider broad relief to address any such issues that are identified from time to time.

*3. Should additional guidance be limited to articulation of broad principles or should it be more detailed?*

We believe the guidance should be focused on principles, but at the same time it should provide detailed examples that are meant to be illustrative of how different approaches may be taken that meet the principles. The examples should be quite specific, with the intent to clearly illustrate how the concepts may be met in many differing ways, but not with the intent to provide specific detailed implementation guidance that would apply across all fact patterns.

The detailed, rules based approach of AS 2 may have been a key factor in driving the company and auditor behaviors that have been much criticized by observers of the first two years of ICFR evaluation. Criticisms such as “mindless testing of low risk areas,” “lack of a risk-based approach,” “a one size fits all mentality,” and “a checklist approach,” among others, arise from behaviors undertaken in response to detailed requirements such as those in paragraph 42 of AS 2. Thus, interpretive guidance that illustrates different approaches would be much more effective in encouraging companies to tailor solutions to their particular circumstances.

*4. Are there additional topics, beyond what is addressed in this Concept Release, that the Commission should consider issuing guidance on? If so, what are those topics?*

This may continue to be an evolving issue. We believe that guidance on the nature of the “top down” evaluation should be considered, as to how a top down evaluation specifically should be performed so as to assist management in increasing the efficiency of the overall evaluation.

Guidance should be provided to deal with testing. To date management has largely relied upon the guidance of the external auditors to determine sample sizes, sampling methods, reaction to sampling errors, etc. Guidance should discuss sampling size considerations, sampling methods, ways to combine separate tests, confidence levels, the treatment of errors found in a sample, and so on.

*5. Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?*

Interpretive guidance would be preferable to a rule. Practice is likely to be more receptive and adaptive to the different environments among public companies if the guidance on evaluating and reporting is more flexible. We envision it would be easier to provide flexibility via interpretive guidance rather than by a rule.

*6. What types of evaluation approaches have managements of accelerated filers found most effective and efficient in assessing internal control over financial reporting? What approaches have not worked, and why?*

Experience indicates that the approaches utilized by management of accelerated filers have varied and while some can be considered to have “worked,” no one approach is appropriate for all filers. Since accelerated filers are inherently different from smaller non accelerated filers or foreign filers, an analysis of their approaches may not result in a conclusion of what is “correct” for the latter type of filers.

Our experience has shown that what generally is effective and efficient in managements’ approach is when two approaches are used.

The first approach is to establish a centralized project management office that takes ownership of the planning and coordination of the ICFR project as a whole. This centralized office would identify the assessment tools to be used, identify key business cycles to be documented, specify how to compile the risk assessment, coordinate between process owners and other appropriate parties including external auditors, identify materiality levels, determine material locations, and identify timing needs.

The second approach is to take a true top down approach, where risk is assessed within each business cycle and key business processes identified. Next, an entity level and IT general control documentation and evaluation are performed. Continuing to use the top down approach, at this point the scope, extent and timing of documentation and testing at the transactional level can be defined. Our experience also has indicated that the continued involvement of the external auditor in providing feedback on the qualitative nature of the evaluation is vital in order to limit “surprises”. Typically, a pilot program focusing on one business area leads to effectiveness and efficiency of the overall project by reviewing the results of the pilot so as to establish suitable guidance for documentation, the testing approach and identification of remediation issues during the evaluation of the remaining business processes.

Generally, approaches that have not been effective lack a centralized oversight of the project. This has resulted in individual process owners developing their own approaches that, lacking communication and consistency with others, results in a disjointed and non-uniform evaluation.

*7. Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? If so, what are they? How might those drawbacks or other concerns best be mitigated? Would more detailed*

*Commission guidance hamper future efforts by others in this area?*

A potential drawback would exist if the Commission's guidance is too rules-based such that it creates a checklist of what needs to be done. We also suggest that whatever guidance the Commission issues contain a clear suggestion that other entities be encouraged to develop other forms of guidance, rather than implying that the Commission has "spoken" and that's it.

One drawback of issuing additional guidance is that any guidance is likely, in the initial year it is implemented, to create additional cost for companies that have already developed their approach to ICFR evaluation, merely by the need to rethink or redocument or refine their existing approach. This can best be mitigated by ensuring the guidance issued provides sufficient flexibility in its application from company to company. A second drawback is that as more guidance is issued, the risk of the internal control evaluation process evolving into a rule-based, one size fits all approach increases. This too can be best mitigated by ensuring the guidance provides sufficient flexibility in its approach and follows a principles-based, scalable approach. A third drawback is that some companies are now in their third year of evaluation, and rules based guidance could result in the addition of procedures of limited value or require the substitution of a new method to replace what the company had already developed.

We believe there are few drawbacks to the release of interpretive guidance designed to encourage management to build tailored assessment processes embedded within their companies. Such an approach should stimulate creative thinking, including academic study. Release of more detailed, rules-based, guidance might serve to constrain original thinking and cause companies to focus on rules compliance rather than on an effective assessment process.

*8. Why have the majority of companies who have completed an assessment, domestic and foreign, selected the COSO framework rather than one of the other frameworks available, such as the Turnbull Report? Is it due to a lack of awareness, knowledge, training, pressure from auditors, or some other reason? Would companies benefit from the development of additional frameworks?*

Most companies selected COSO because they were not, and likely are still not, equipped to undertake a comparative evaluation of the alternative frameworks and did not, due to the short implementation period available, have the time to undertake such an analysis. Absent the time and ability to conduct such an analysis, COSO became the default standard because of several reasons. The COSO guidance was the most widely known and widely used framework in the United States, it was specifically mentioned in the Commission's earlier guidance and is

almost always the “named example” when describing a comprehensive approach to describing internal control, the consultant community developed their implementation processes and tools around COSO, and the auditor community built their procedures and tools assuming a COSO implementation. These factors were all self-reinforcing.

We think it would be very useful to develop an additional framework that focuses on what we believe may be one of the significant areas of effort and cost, which is the tests needed at the detailed account and assertion level. Much that is contained in the various frameworks focuses on the control environment, monitoring, and other activities that are of a more overall nature. However, much of the assessment and evaluation work involved in ICFR involves the assessment of controls at the AS 2-driven level of relevant assertion within significant account (paragraph 83 of AS 2), which is a very detailed level and which likely involves the largest portion of the cost of the assessment.

It would be very useful for a future framework to provide a clear way of relating entity-wide control matters, such as human resource policies and the like, to the assessment of assertion-level controls. One of the difficulties in using a framework such as COSO is how an entity-wide assessment of, say, monitoring, is to be used in determining how much to affect testing scopes for individual transactions that are recorded in a significant account.

We also suggest that the COSO guidance be made available for free, although still with retention of copyright. We note that the Turnbull report is available for free download, whereas both the COSO Framework and recent COSO Guidance for Smaller Public Companies require significant purchase costs to obtain multiple copies of that guidance. Perhaps the SEC could license the COSO guidance and make it available on the SEC’s website.

*9. Should the guidance incorporate the May 16, 2005 “Staff Statement on Management’s Report on Internal Control Over Financial Reporting”? Should any portions of the May 16, 2005 guidance be modified or eliminated? Are there additional topics that the guidance should address that were not addressed by that statement? For example, are there any topics in the staff’s “Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004)” that should be incorporated into any guidance the Commission might issue?*

The guidance should include the May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting". The guidance should also include the “Frequently Asked Questions” guidance revised October 6, 2004, so that

as much of the Commission's guidance will be located in one place as possible and thus make it simpler to locate and understand all the Commission's guidance. This codification effort will likely need periodic updates as further guidance is issued from time to time.

*10. We also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b). Should possible alternatives to the current approach be considered and if so, what? Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?*

We generally believe that the auditor involvement brings to bear a discipline that makes management's assessment more effective, preventing it from turning into a middle management compliance exercise rather than a real assessment of the effectiveness of ICFR. There is little doubt that the auditor's involvement has provided the necessary conceptual guidance and procedural discipline in the initial years to ensure that an effective management assessment process has been undertaken at many companies. In most cases, management's process was performed better because they knew that the auditor would be reviewing and assessing that process. Also, the auditor's need to conclude on management's assessment provides an incentive for the auditor to thoroughly understand management's process, which leads (when the work is done well) to the auditor relying on management's work to a greater extent when forming their own conclusions. This results in a more effective integrated audit at a lower cost. These factors will be even more important as management at non-accelerated filers begin their assessments of ICFR.

An alternative approach, although short-range, to auditor involvement has already been proposed by the Commission for non-accelerated filers. This proposal is essentially a one-year delay in auditor reporting when non-accelerated filers first start reporting on ICFR. Another alternative approach might be more of a focus on selected control areas, such as revenue recognition, which have historically been found by various studies to be riskier areas, with less effort and reporting applied to various other control areas.

It is also possible that as thinking regarding how management should undertake an evaluation of the effectiveness of ICFR evolves, the approach taken by management and the approach taken by auditors may begin to diverge. Once this happens, the value of the auditor's conclusion regarding management's assessment may diminish. Depending on the degree of divergence, it is possible that concluding on management's approach may become a significant incremental cost (it is not today,



given the parallel nature of management and auditor assessment processes) which may not provide sufficient benefit.

*11. What guidance is needed to help management implement a “top-down, risk-based” approach to identifying risks to reliable financial reporting and the related internal controls?*

One of the challenges companies face is how best to make use of evaluations of entity-level, company-level, and other pervasive-type controls as part of an overall top-down risk based approach, when assessing controls at the assertion level – where a financial statement misstatement would occur. There is nothing reported in the financial statements called “monitoring”, or “control environment”, but instead the financial statements report “this asset exists”, “this asset is valued appropriately”, etc. The overall controls are often difficult to associate directly with an individual financial statement line item, financial statement assertion, or process. For example, assume a company evaluates that it has an effective human resources function. How is this to “be given credit for” when evaluating controls over an assertion for a specific account, such as the controls over recording depreciation expense or valuing an investment?

Accordingly, companies have been challenged with how much weight to give to these controls as part of their overall internal control evaluation process and how the relative strength or weakness of these controls affects the assessment and evaluation of process-level and transaction-level controls.

This may be especially challenging for smaller companies who typically have a greater relative reliance on pervasive controls in their overall internal control environment. Additional guidance from the Commission on how companies can consider entity-level and company-level controls to impact the evaluation process of process-level and transaction-controls would prove meaningful.

*12. Does the existing guidance, which has been used by management of accelerated filers, provide sufficient information regarding the identification of controls that address the risks of material misstatement? Would additional guidance on identifying controls that address these risks be helpful?*

More guidance in this area, especially at the assertion level, would be useful. Registrants would benefit from guidance that discusses each of the primary financial statement assertions and the types of controls often used to ensure that such assertions are properly supported. What types of controls frequently help with assertions related to existence? Accuracy? Valuation? Completeness? Presentation and disclosure?

Guidance regarding different ways to develop a cost-effective testing strategy would also be helpful. Registrants often have many controls in a significant account processing stream. Some controls may be in place to ensure timely error detection, while others might be controls of last resort—intentionally redundant back-end controls meant to compensate for potential failure of earlier controls. These latter controls tend to have broader impact, addressing multiple assertions.

If history has shown that the controls work well, a strategy which calls for specific testing of all the relevant controls would likely be effective but inefficient. Lower cost testing strategies might be undertaken. One approach might be specific testing of just the final, back-end controls, given their more powerful nature, with the understanding and assessment of earlier, process controls (via walkthroughs) being less important or even redundant.

Another approach might be to evaluate the preventive controls by reviewing documentation of the disposition and correction of errors detected, and evaluate the back-end controls through review of detail control documentation. Combining these reviews with the results of a detail test of a strong entity-level analytical control procedure might provide sufficient evidence for management to assess ICFR.

In any event, we believe examples of alternative acceptable testing strategies would be helpful for management to determine suitable cost-effective approaches.

*13. In light of the forthcoming COSO guidance for smaller public companies, what additional guidance is necessary on risk assessment or the identification of controls that address the risks?*

This new COSO guidance for smaller public companies has now been issued. We believe this guidance may be useful but we also believe this guidance should more appropriately be viewed as applying to the “middle-sized” public companies rather than to smaller public companies. For example the COSO guidance for smaller businesses discusses the effect of “new stock exchange listing standards” (page 8, Volume II), but most smaller public companies are not listed on a stock exchange. The COSO guidance has many instances where it describes internal audit functions (page 6, volume II), but many smaller public companies may not have an internal audit function available.

Additionally, this new COSO guidance may run the risk of requiring more work. For example, COSO has determined that are twenty basic principles that, if any one is not met, there is a control deficiency that may be a significant deficiency (page 17,

Volume II). This may require a more detailed look at controls than would be the case if the assessment of control deficiencies was at the level of the five COSO elements (control environment, risk assessment, control activities, information and communications, and monitoring) rather than at the more detailed list of 20 “basic principles” in the new COSO guidance.

We think guidance from the Commission would be useful on how to combine the twenty basic principles in the new COSO guidance into a more workable number for smaller businesses. For example, the “organizational structure” and “authority and responsibilities” separate principles may be combined into one principle for evaluation and assessment. Also, the “financial reporting competencies” and “human resources” separate principles may be combined for evaluation and assessment into one principle. The “ongoing and separate evaluations” and “reporting deficiencies” separate principles may similarly be combined into one principle. Thus, the twenty basic principles may more realistically, and simply, be presented as thirteen or so basic principles, which would simplify the application of these by smaller public companies.

Further, we think it very important that the Commission indicate that the new COSO guidance is only one of many ways in which ICFR may be assessed. It would be unfortunate if practice for companies were to solidify on the new COSO guidance for small businesses without more alternatives being considered and used. Without suitable recognition of alternatives, the new COSO guidance may become the de facto standard for smaller companies. It also may, by extension, be a minimum for the “larger” public company, since if the smaller company needs 20 principles, the larger company may need at least that many and maybe more.

Finally, the COSO guidance for small businesses appears directed more to the overall organizational controls than to assertion-level controls. While part of assessing ICFR is the entity-wide matters (control environment, monitoring, etc.), most of the assessment of ICFR is at the detailed assertion level (assertions such as: receivables exist, receivables are properly valued, receivables are complete, etc.). It is this assertion part of the ICFR assessment where the COSO guidance may not be as extensive or as helpful as many had hoped for. For example, the COSO guidance does not provide an effective mechanism for the clear identification of a “key” control at the assertion level. Several examples might be provided in guidance that take accounts at the financial statement level, identify the relevant assertions, highlight the risks associated with those assertions, and then discuss the types of controls that frequently mitigate those risks in a cost effective way.

In smaller companies there may not be as large a proportion of total ICFR evaluation time spent in evaluating entity level of controls, since there are fewer complex entity controls, and hence the assertion-level controls are the biggest area to consider cost savings through better guidance.

*14. In areas where companies identified significant start-up efforts in the first year (e.g., documentation of the design of controls and remediation of deficiencies) will the COSO guidance for smaller public companies adequately assist companies that have not yet complied with Section 404 to efficiently and effectively conduct a risk assessment and identify controls that address the risks? Are there areas that have not yet been addressed or need further emphasis?*

We do believe the guidance will be of some help to companies undertaking their initial assessment. It is our observation that the primary differences between a good and bad first year experience was the knowledge management developed regarding COSO and the evaluation process, and the strength of the project management processes put in place over first year activities. Further, the COSO document provides some linkage between the concepts and the start of an implementation plan. We believe more guidance on IT controls and the linkage of entity level controls to the account level would be helpful.

*15. What guidance is needed about the role of entity-level controls in evaluating and assessing the effectiveness of internal control over financial reporting? What specific entity-level control issues should be addressed (e.g., GAAP expertise, the role of the audit committee, using entity-level controls rather than low-level account and transactional controls)? Should these issues be addressed differently for larger companies and smaller companies?*

Smaller companies may have numerous disadvantages, perhaps involving difficulties in attracting qualified board members with financial expertise, difficulties in segregation of duties, and difficulties due to limited GAAP expertise. It may be useful to provide examples of how the Commission views that compensating controls may overcome some of these weaknesses. For smaller companies, guidance is also needed that would enable management to link entity level controls to risks at the specific transaction level and assertion level.

The inherent nature of smaller companies dictates that controls will be more centralized and occur at a higher level in the organization. Therefore, for example, a smaller company may not have specific controls at the transaction level to ensure proper revenue recognition. Instead, they may rely more heavily on CEO, CFO and board review, although these reviews may be at too high a level to be able to detect errors. Smaller companies characteristically do not often have an extensive

budgeting process, job descriptions and formal performance evaluations. Smaller companies are also disadvantaged in their ability to cost effectively support an internal audit infrastructure, which is a double difficulty since not only is there no internal audit group available to perform tests but also internal audit testing often yields a higher level of objectivity than other forms of management assessment.

Strategies to overcome these disadvantages can include strong centralized controls which address operating control level objectives, as well as identification of operating controls which also contribute to effective ICFR. Guidance on implementation of both of these strategies would be particularly valuable to smaller companies.

*16. Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of an error, should be used when assessing risks and identifying controls for the entity? If so, what factors should be addressed in the guidance? If so, how should that guidance reflect the special characteristics and needs of smaller public companies?*

Guidance regarding the use of quantitative and qualitative factors in assessing risk and identifying appropriate controls to mitigate such risk would be helpful. We again support the style of general concepts followed by a variety of illustrative examples for this area.

*17. Should the Commission provide management with guidance about fraud controls? If so, what type of guidance? Is there existing private sector guidance that companies have found useful in this area? For example, have companies found the 2002 guidance issued by the AICPA Fraud Task Force entitled "Management Antifraud Programs and Controls" useful in assessing these risks and controls?*

It would be helpful to have guidance on the level of fraud analysis, with examples, expected of management. We generally believe that concepts surrounding fraud controls have not been a particularly difficult area for smaller companies. The AICPA guidance referred to in the question is useful guidance.

*18. Should guidance be issued to help companies with multiple locations or business units to understand how those affect their risk assessment and control identification activities? How are companies currently determining which locations or units to test?*

It would be helpful to have guidance on how to handle the situation when there are many locations and risk assessments cannot be limited to a few locations making up the majority of the company's business.

*19. What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at the individual account or transaction level? If applicable, please provide specific examples of types of entity-level controls that have been useful in reducing testing elsewhere.*

While the documentation of entity level controls will not eliminate the need to assess other key business processes, guidance on how such controls are tied into the mitigation of risk in the key business processes areas would potentially assist in limiting extensive testing in other areas. The Commission should give consideration to issuing guidance that provides the mechanism to do that. In our experience the following are examples of entity level controls that have been used to effectively reduce testing at the transaction level:

- monthly budget to actual reconciliations that are performed and reviewed at a sufficiently high enough organizational level so that appropriate issues are factored into the analysis
- certification of business units' monthly financial results by the applicable business unit controller or department manager(s)
- quarterly questionnaires that require the CEO/CFO to examine changes in the internal control environment and accounting policies

The documentation and testing of entity level controls have, in our experience, been treated by some as a separate business process rather than as a set of controls that mitigate risks at the individual or transaction level, largely perhaps due to the difficulty in documenting how "this" entity level control specifically has an affect on the risk in "that" transaction level or assertion level area. This has resulted in two effects. First, there has been an overreaching in assessing the impact of deficiencies within entity level controls by forcing an allocation of a quantitative amount of risk to the deficiency. Second, there has been an identification of too many controls and therefore excessive testing at the transaction level rather than placing reliance on the entity level control(s) to mitigate risk within the applicable business cycle.

Additionally the Commission should issue guidance that is specific in that it allows for the reduction of testing, due to adequate entity level controls, in those process that are determined to be of low risk.

*20. Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of controls, such as on-going monitoring activities, be useful? What are some of the sources of evidence that companies find most useful in ongoing monitoring of control effectiveness? Would guidance be useful about how management's daily interaction with controls can be used to support its assessment?*

This guidance would be useful. To the extent that account balances and business cycles take place over a period of time, on-going monitoring of the controls in place would provide greater reliance on the control environment as whole. Realistically management has in place checks and balances that are continuous. Evidence that such checks and balances, i.e. controls are in place and working properly is vital to ensuring reliance on such controls. Guidance in this area should specifically cover how on-going monitoring may be performed, what should be considered when an error is detected, etc. Further if evidence exists that controls have not changed during the period of time of the evaluation then this may eliminate or limit the need for a separate evaluation-type testing, and perhaps also less external auditor testing in this area. This approach may reasonably be expected to impact the reliance that external auditors place on management's assessment. For account balances that are subject to a high degree of judgment or possibly cycle activity occurring nearer to the as of date this is understandable. However for account balances that are not subject to a high degree of judgment, comprised of transactions occurring over the course of the year, are not high risk, etc., allowing for on going monitoring to be relied upon by the external auditors would seem to be a practical approach.

Our experience has led us to the conclusion that effective on-going monitoring controls consist of some or all of the following within a given organization:

- Internal Audit activities (that are tailored towards financial reporting)
- Control Self Assessment
- Whistleblower programs
- Enterprise Risk Management programs
- Establishment of the Department of Chief Risk Officer
- Analysis of key metrics
- Review of Key Performance Indicators
- Financial Statement Review
- Budget to Actual Analysis

This list is not meant to be all inclusion as no two organizations are exactly alike and the needs, structure, industry, etc. of an organization may determine the nature and extent of on going monitoring.

Our comments for other questions, such as numbers 1 and 10, are also relevant here.

*21. What considerations are appropriate to ensure that the guidance is responsive to the special characteristics of entity-level controls and management at smaller public companies? What type of guidance would be useful to small public companies with regard to those areas?*

Entity-level controls are often not as elaborate or as well documented in smaller companies than in larger companies. Some entity-level controls may not exist at all in smaller companies in their traditional fashion, because smaller companies seem to operate in a more informal environment. Thus, the control objectives of entity-level controls may be achieved in other ways, such as through informal management meetings, more communication, and the sharing of more information. If something does go wrong within a smaller company, the short lines of communication may detect it, if not prevent it in the first place. This may lead to efficiency through a more detailed knowledge by those at the top of the company in what to expect in financial reporting.

Such guidance should also discuss how a control can be relied upon when documentary evidence of its existence may not readily exist.

Due to the inherent nature of smaller companies, limited segregation of duties may likely exist, such that controls that depend more on separation of tasks (one person handles the cash, another keeps the records of what cash should be present, etc.) may not be present in some or many cases. Also, small companies may have a greater possibility of override of otherwise-effective control elements, and we note that in many recent large financial reporting cases there may be override or disregard of well-designed controls. To overcome this, guidance should consider how management can look to implement certain protocols. For example, management override may not be permitted without certain Board approval. Management will need to consider what level of override they can tolerate and stratify the need for board approval, e.g. all management override of controls with a financial impact of equal to or greater than \$5,000 require Board approval.

*22. In situations where management determines that separate evaluation-type testing is necessary, what type of additional guidance to assist management in varying the nature and extent of the evaluation procedures supporting its assessment would be helpful? Would guidance be useful on how risk, materiality, attributes of the controls themselves, and other factors play a role in the judgments about when to use separate evaluations versus relying on ongoing monitoring activities?*

Guidance as to varying the nature and extent of evaluation-type testing would be useful. It is a bit easier to envision variations in the nature and extent of testing when a company has multiple locations and thus variations between years in the number and specific locations tested can occur simply by varying the number of locations at which tests are performed and varying the specific locations tested. It is more difficult to determine how the nature and extent of the evaluation procedures over entity-level controls, such as effectiveness of the audit committee, may be



varied or even if they should be varied at all, and we believe guidance should cover the various types of entity-level control evaluations.

It would be helpful for the Commission to issue guidance about how ongoing monitoring controls should be supplemented by specific evaluation-type testing. We believe a significant factor in determining whether evaluation-type testing is needed is the extent and nature of the documentation provided as to the operation and effectiveness of ongoing monitoring controls. It's easy to say ongoing monitoring is taking place, but is it really? Has the ongoing monitoring kept on or has it dwindled, even though others may believe that ongoing monitoring is as robust as it once may have been.

How the top down and risk assessment approaches are tied into the controls evaluation now lacks sufficient guidance to assist management in making this a cost-effective process. We note that AS 2 specifically states that if an area is material, then controls must be tested even if a risk assessment indicates low inherent risk (paragraph 66 of AS 2).

*23. Would guidance be useful on the timing of management testing of controls and the need to update evidence and conclusions from prior testing to the assessment "as of" date?*

Such guidance as to timing of management testing and updating would be useful. The timing of management testing is an area where we would expect gradual divergence in approaches between management and the auditor. Management is in place--a first-hand witness to changes and processes as they occur. The ability to participate in changes in procedures, or the introduction of new procedures, or to observe that there have been no changes in procedures, provides significant eye-witness evidence that an auditor simply does not have. Guidance regarding the utilization of this first-hand, "eye-witness" knowledge in assessing the ability to roll-forward conclusions formed earlier in the year would be of significant value to companies. Also, testing performed closer to the "as of" date is of more use than testing performed earlier in the year, but not everything can realistically be tested near the "as of" date, so suggestions as to how to roll forward interim testing would be useful.

It also would be helpful to discuss how much evidence/testing needs to occur in the current year versus rollforwards of evidence/testing that was performed in a prior year.

*24. What type of guidance would be appropriate regarding the evaluation of identified internal control deficiencies? Are there particular issues in evaluating deficient*

*controls that have only an indirect relationship to a specific financial statement account or disclosure? If so, what are some of the key considerations currently being used when evaluating the control deficiency?*

Numerous approaches have been taken to evaluate deficiencies. The deficiencies assessment framework that exists and was issued by the larger accounting firms represents a useful starting point to assess deficiencies, especially from a quantitative aspect. More guidance as to qualitative evaluations would be useful. As an example, an error rate may have a different implication as to potential error depending on the nature and frequency of transactions that occur. It is more difficult to assess a deficiency, especially in entity-level controls, when the control involved has, at best, only an indirect relationship to an account where there might be a financial statement misstatement.

Auditors typically have more training in making these assessments, and having the Commission provide guidance for managements would be useful. This guidance could also discuss how to evaluate the relationship of multiple deficiencies within a given process and how any mitigating controls can reduce or eliminate the deficiency or deficiencies.

*25. Would guidance be helpful regarding the definitions of the terms "material weakness" and "significant deficiency"? If so, please explain any issues that should be addressed in the guidance.*

Yes. It would be helpful if the SEC would adopt for management use the same definitions the PCAOB has adopted for auditor evaluation. However, the Commission should consider changing certain elements of AS 2's guidance that certain matters are strong indicators of a material weakness before issuing its own guidance.

For example, PCAOB guidance defines fraud (AU 316.06) as "...an intentional act that results in a material misstatement in financial statements..." and notes the general concern about the difficulty that sometimes exists in determining intent. AS 2 indicates that "fraud of any magnitude" by senior management would be a strong indicator of a material weakness. It may be useful to reconcile the definition of fraud as necessarily involving a material matter with the definition of fraud as applying to any amount. Also, if considered to apply to immaterial matters, there may need to be a common sense approach such that if an item is recorded based on a preliminary estimate of \$10 and the item is later determined to be \$11 but the change is not directed to be recorded (likely due to cost-benefit issues involving recording a \$1 item), is this an intentional misstatement although clearly not material that constitutes "fraud on the part of senior management". It may be better

to use the guidance of “prudent officials in the conduct of their own affairs” as contained in Staff Accounting Bulletin Topic 1-M.

Also, AS 2 notes that that a significant deficiency can become a material weakness after some period of time. Especially in smaller companies, there may be significant deficiencies due to their inherent nature, such as perhaps lack of segregation of duties. We are unclear if the Commission similarly believes that a significant deficiency always escalates if, with due consideration by management and the audit committee, it isn’t easily correctible.

See also our comments under question 27.

*26. Would guidance be useful on factors that management should consider in determining whether management could conclude that no material weakness in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the financial statement close process? If so, please explain.*

Yes. It would be helpful for the SEC to address the significance of front-end financial statement preparation control failures identified through financial statement closing controls. It may very well be that financial statement closing controls should be presumed to be given a fair chance to be applied and evaluated before there is deemed to be an “error” in the financial statement preparation and completion process. This guidance could include how to evaluate the error discovery process. For example, was the error identified in the normal course of the review by the individual responsible for the control operation, or was that person made aware of an error that was discovered by another party? It would be helpful for the Commission to issue guidance on the various considerations with examples.

*27. Would guidance be useful in addressing the circumstances under which a restatement of previously reported financial information would not lead to the conclusion that a material weakness exists in the company’s internal control over financial reporting?*

Yes, such guidance would be useful. It appears somewhat illogical to presume that a restatement of previously reported financial information would lead to a conclusion that there is a material weakness in ICFR as of a current date. A restatement may mean there was a material weakness at the earlier date, but a current report on ICFR is not a report as of that earlier date but as on now.

For example, a company may have made changes or remediation in its system of ICFR so that it is “perfect” as of the current date, and thus an evaluation of ICFR “as of” the current date would logically be expected to say the system of ICFR “as of”

the current date contains no material weaknesses. However, the financial reporting of several years ago may now be realized or found to be in error, and thus prior information is restated. It is difficult to see how a restatement of information as of December 31, 2003 implies there is a material weakness in ICFR as of December 31, 2006. For example, how would the ICFR system as of December 31, 2006 be remediated to remove the material weakness “as of” December 31, 2006 when no control weakness exists “as of” December 31, 2006 but which control weakness instead may have existed three years earlier and have resulted in incorrect financial reporting at that earlier date?

In fact, it may well be that the “perfect” ICFR system as of December 31, 2006 is what detected a prior year misstatement, so that far from having a material weakness as of December 31, 2006, the December 31, 2006 status may truly be “effective.” The Commission should issue some guidance discussing how a restatement due to a material weakness existing at a prior period results in a conclusion that a material weakness exists as of the end of the current period.

Additionally, we believe that it is important to clearly define “what management should have known” in making this determination. Certain restatements take place because of the evolution of thinking regarding the application of a standard on the part of the SEC staff, the FASB staff, or the technical leadership of the largest firms. The results of such thinking are often made known through speeches or letters by Commission staff members, individual interpretations provided by the SEC or FASB staff, SEC comment letters, or technical publications of the largest firms. Often the new thinking is applied to transactions that were structured and documented before the new thinking took place. However, companies cannot be expected to monitor speeches or all of the other sources discussed above. We believe that guidance should be provided as to whether a restatement due to changes in how standards are applied is a material weakness in internal control.

*28. How have companies been able to use technology to gain efficiency in evaluating the effectiveness of internal controls (e.g., by automating the effectiveness testing of automated controls or through benchmarking strategies)?*

Companies have been able to obtain some efficiencies through the use of technology such as the use of computer assisted audit techniques (CAAT) to quickly analyze transaction populations for control exceptions or recalculate amounts or reprocess the application of system logic. Benchmarking is similarly useful to help determine if system logic may be relied on or whether program changes may have affected system outputs.

Understanding the changes to the control environment at quarter end and year-end is being facilitated at some organizations via on-line surveys. Each control is assigned to a process owner, and the process owner is required to assess the software at quarter-ends and year-end. They are asked a series of questions designed to identify potential changes in the performance on controls. Examples would include turnover statistics, system changes, third party processing changes, etc. The results can then be quickly and centrally evaluated for the impact on ICFR.

However, many of these uses of technology may not be readily available to smaller companies due to their limited IT resources.

*29. Is guidance needed to help companies determine which IT general controls should be tested? How are companies determining which IT general controls could impact IT application controls directly related to the preparation of financial statements?*

Yes, guidance should be issued on what IT general control areas should be tested and what may not need testing, especially in a smaller company. It would be useful to have an indication of various ways in which IT general controls do, or do not, affect more specific IT or non-IT controls for a specific assertion. Often, application program change control is considered an important IT general control, although often smaller companies used canned software and do not make any program changes.

Guidance would also be useful on many areas of IT general controls that do not directly pertain to ICFR but are more focused on operational recovery, etc. , and thus where evaluation and testing should be limited in an evaluation of ICFR if done at all. Some areas in IT general controls which do not normally relate to ICFR would include tape back-up, off-site data storage, fire suppression systems, emergency alternative processing facilities, and so on. These matters are generally not considered crucial in the "paper" portion of systems and likely would not lead to a material weakness in the accuracy of financial statements. Said another way, it is unlikely that a material weakness in ICFR should be determined to exist as of a balance sheet date because a back-up tape was missing or a fire suppression system in the server room was not working.

*30. Has management generally been utilizing proprietary IT frameworks as a guide in conducting the IT portion of their assessments? If so, which frameworks? Which components of those frameworks have been particularly useful? Which components of those frameworks go beyond the objectives of reliable financial reporting?*

The most commonly published IT framework used with our clients is the Information Systems Audit and Control Association's (ISACA) Control Objectives

for Information and Related Technology (CobiT) model. CobiT serves as a reference standard especially when examples are needed for illustrative control techniques and objectives. What CobiT lacks is a discussion of adequate process control when there are differing levels of execution frequency (example daily, weekly, and monthly, etc.). In some cases, CobiT maybe be more difficult to implement as it is drawn on an end-to-end process flow, in which multiple IT functions may be involved on a particular process. It is not drawn up along typical IT functional lines thus making it more challenging to deploy by IT functional department, such as what the IT security department should have in place, what the application programming department should have in place, etc.

*31. Were the levels of documentation performed by management in the initial years of completing the assessment beyond what was needed to identify controls for testing? If so, why (e.g., business reasons, auditor required, or unsure about "key" controls)? Would specific guidance help companies avoid this issue in the future? If so, what factors should be considered?*

In the initial years of compliance, the amount of documentation created may have gone beyond what was necessary to identify key controls for testing. This additional documentation resulted for the following reasons.

1. The general orientation of AS2 was a significant contributor to this problem. This orientation is one of documenting the entire process and all of the controls (paragraph 80, for example). Then, once having understood all the controls, the auditor is to determine the relevant assertions and related controls and design testing (paragraph 83). As a result of this required approach, a lot of irrelevant processes and controls were documented, studied, understood and discarded. In most transaction streams, management and auditors know the key points in the process, the relevant assertions and the most powerful controls. Rather than the comprehensive documentation of everything, it would be more efficient for management (and auditors) to focus on the controls are relied upon for reliable ICFR.
2. Excess documentation was mainly created due to the lack of compliance guidance provided by regulatory bodies – this affected both the auditor and management. This created situations where management would start and then revise the evaluation and documentation process as new guidance or interpretations would come out from auditors or others. In addition auditors were not clear as to the standards they would be held to, and public comments from the PCAOB indicated they would be rigorous in their inspections, resulting in a very conservative approach to the auditor's extent of assessment.

3. An additional driver for increased documentation in some cases was the auditor driving management to have their documentation conform to either the auditor's documentation format or to add in controls that the auditor deemed important to document. This created cases where management created documentation twice – once for the internal assessment and then recreating it in the auditor's format.
4. Even when a robust entity level environment was in place and controls were identified, testable and operating, management and auditors still extensively documented and tested transactional level controls because of concerns as to how overall entity level controls, such as tone at the top and codes of conduct (paragraph 53 of AS 2) could be related to control assessments on specific assertions such as valuation of inventory.

*32. What guidance is needed about the form, nature, and extent of documentation that management must maintain as evidence for its assessment of risks to financial reporting and control identification? Are there certain factors to consider in making judgments about the nature and extent of documentation (e.g., entity factors, process, or account complexity factors)? If so, what are they?*

The documentation needed should outline how management determined where the highest risks of material misstatements are and the approximate level of those risks. It would be most useful if this documentation would relate the financial statement assertions by account (existence, completeness, valuation, rights and obligations, and presentation and disclosure) to the risk of material misstatement. In question 33, management would then relate these risks to the control procedures to prevent or detect misstatements.

Guidance should be provided as to differing ways in which the results of the risk assessment procedures link to entity-level controls, which by nature have a less direct relationship to specific risks of misstatement.

AS 2 may still be driving an inefficient approach where amounts that are quantitatively material are still being documented and evaluated and tested, due to AS 2's insistence (paragraph 66) that material areas be evaluated as to ICFR even if risks are low. If the Commission believes that low-risk areas, even though material, need less documentation and evaluation and testing, that would be useful guidance to provide. In such low-risk areas, this may be a good place for the Commission to discuss how risk-based evaluation should proceed.

*33. What guidance is needed about the extent of documentation that management must*

*maintain about its evaluation procedures that support its annual assessment of internal control over financial reporting?*

Guidance as to the extent of documentation required to support management assessment should be clear. One matter that should be stressed is that the evaluation needs to relate the risks (discussed in question 32 above) to the financial statement assertions, so as to avoid documenting and testing risks that do not relate in a meaningful manner to what appears or should appear in the financial statements.

*34. Is guidance needed about documentation for information technology controls? If so, is guidance needed for both documentation of the controls and documentation of the testing for the assessment?*

Guidance would be more useful in terms of what would constitute sufficient levels of testing of operating effectiveness for the various typical IT general controls. It would be useful to indicate the types of IT general controls that might not be particularly relevant for evaluation of ICFR, especially in smaller companies, such as back-up procedures, off-site storage, fire suppression devices, and the like, that typically are not considered control procedures when paper systems are involved. Further, since many smaller companies use canned software systems and do not make changes to the software, guidance should indicate that inapplicable IT general controls, such as controls over program changes, do not need documentation in such cases.

*35. How might guidance be helpful in addressing the flexibility and cost containment needs of smaller public companies? What guidance is appropriate for smaller public companies with regard to documentation?*

Guidance would be helpful if it could be used to eliminate some of the practices set into use by AS 2. We believe the objective is determining whether there are material weaknesses in ICFR, and that often it is most efficient to “work back” for each significant assertion to determine the key control or controls that prevents a material misstatement of the assertion from making it into the financial statements, and then documenting, evaluating, and testing this key control. This is more efficient than documenting, evaluating, and testing the complete process from origination to inclusion in the financial statements. It eliminates the need for extensive documentation of the portions of the financial reporting process that, for the given assertion, do not provide the key control(s) over the assertion or that are redundant with other controls.



This is especially relevant to smaller companies, that have simpler types of transactions, fewer transactions, and shorter processing streams than do larger companies. For example, in a smaller company all sales transactions may be processed in one location or by one system, and often by a small number of people. Thus, the control points throughout the process may be more readily identified.

This is not inconsistent with the top-down and risk-based approaches. Top-down and risk-based approaches would yield the assertions that are significant to be tested. Then, in testing those assertions, working back from the assertion to determine the key controls(s) to be tested ensures that the tests performed will be tests that directly provide assurance about ICFR.

Guidance as to documentation that would be appropriate to smaller companies would include:

- a) How simpler forms of process documentation, such as narratives, might be prepared
- b) A description of the overall entity-level controls that might be considered to be controls, such as monthly management meetings or informal forms of direction on various matters, and such controls should be documented and evaluated as to effectiveness
- c) How to link the overall entity-level controls to specific risks of material misstatement at the assertion level

In conclusion, we encourage the Commission to develop guidance that would allow public companies of various sizes to prepare an assessment of ICFR in differing ways, while at the same time cautioning public companies that they need to have a robust analysis of ICFR, they need to prepare and maintain documentation of their ICFR, and they need to link their internal controls to the assertions they present in their financial statements.

We also encourage COSO to develop guidance for smaller companies that is more appropriate for them than the recently issued guidance that may be viewed as more appropriate for middle-sized companies, and to remove its direction that each of the 20 principles it stated needs to be met to avoid a control deficiency.

We encourage managements to work with their consultants and their auditors to determine what cost-effective analyses may best be prepared.

We encourage the SEC to remove the threat of unknown liability for management reports on ICFR and auditor attestations thereto for a period of 3 to 4 years while best practices can be worked out without the fear of second-guessing or the fear, as

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now expressed in the medical arena involving concerns about unnecessary tests being conducted merely to avoid liability issues, that tests will be more than what is truly needed. In this mutual process of learning and responding to investor needs, a period of exploration to determine best practices should be provided rather than a period of unknown litigation exposure.

We encourage our fellow auditors to experiment to determine what the best approaches are to attesting to ICFR, and to share their accumulated wisdom widely.

We also note that to date that individual PCAOB inspection comments have focused on wanting more testing done and more documentation to be provided, especially in the IT area, which appears inconsistent with guidance issued by the PCAOB that has urged focusing on more top-down evaluation, risk assessment, and avoidance of checklist-driven needless work,

Should there be any clarification needed, please contact Jim Brown.

Very truly yours,

*Crowe Chizek and Company LLC*