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Ms. Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. S7-11-06
Concept Release Concerning Management's Reports on Internal Control over Financial Reporting

Ladies and Gentlemen:

This letter is submitted on behalf of the Committees on Federal Regulation of Securities and Law and Accounting (the "Committees") of the Section of Business Law of the American Bar Association in response to the request for comments by the Securities and Exchange Commission (the "Commission") in its July 11, 2006 release referenced above (the "Concept Release").

The comments expressed in this letter represent the views of the Committees only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the American Bar Association (the "ABA"). In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committees.

Summary of Comments

We recognize that Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") has imposed significant burdens on accelerated registrants that have complied with Section 404 and believe that it will impose disproportionately greater burdens on non-accelerated registrants if they must comply with the existing internal control over financial reporting requirements. We applaud the Commission's efforts in trying to find a way to reduce these burdens while still maintaining the benefits of that provision and concur with the Commission's view that it would be wholly inappropriate to proceed with the implementation of Section 404 with respect to non-accelerated registrants before completing that effort. We do not believe, however, that additional Commission guidance would be sufficient.

As the Commission noted in the Concept Release, management's implementation and assessment of internal control over financial reporting has largely been driven by Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements" ("AS 2"). Accordingly, we believe that fundamental changes in AS 2 are necessary to better accomplish the goals of easing the burdens of Section 404 compliance. We are pleased that Public Company Accounting Oversight Board (the "PCAOB") intends to propose amendments to AS 2, as Chairman Mark W. Olson announced in his testimony on September 19, 2009 before the Committee on Financial Services of the United States House of Representatives. We believe that amendments to AS 2 in the areas described by Chairman Olson will significantly enhance the understanding of auditors and registrants as to how to analyze and identify material weaknesses in internal control over financial reporting. In addition, this will enhance the quality and efficiency of audits of internal control over financial reporting.

While many of the concepts suggested in the Commission's release will help to reduce the financial burden on registrants in complying with Section 404, we believe that their cumulative effect will be insufficient. Therefore, we request that the Commission consider the following recommendations.

- Support the PCAOB's consideration of the elimination of the requirement that the registrant's independent registered public auditing firm (the "auditors") evaluate the process that management uses to reach its conclusion about the effectiveness of a registrant's internal control over financial reporting and encourage the PCAOB to consider eliminating one of the two auditor opinions on internal control over financial reporting.

- Revise the definition of material weakness to eliminate unnecessary disclosure.

- Encourage the PCAOB to amend AS 2 also as follows:

    - To explicitly articulate a risk-based approach to auditor attestations, and

    - To eliminate the assertion that "reasonable assurance", which is the standard by which management is expected to assess the effectiveness of internal control over financial reporting, requires "a high level of assurance."

- Provide further guidance on the nature of the assistance that auditors can provide to a registrant in the process of establishing, amending or otherwise changing its internal control over financial reporting so as to enable audit committees to feel comfortable not retaining separate consultants to assist management where appropriate.

- Small Registrant Issues:
    - Encourage the PCAOB to permit registrants and auditors to rely on the certifications of software manufacturers regarding the internal controls built into their software systems.
    - Provide guidance to small registrants on the extent to which formal controls are necessary where the registrant relies on day-to-day management oversight.

These recommendations are discussed more fully below.

Discussion

Support the PCAOB's Consideration of the Elimination of the Requirement for Auditors To Evaluate Management's Process for Assessing the Effectiveness of the Registrant's Internal Control over Financial Reporting and Encourage the PCAOB to Consider Eliminating One of the Separate Auditor Opinions Required by AS 2. In his September 19, 2006 testimony, Chairman Olson stated that the PCAOB plans to "consider eliminating any suggestion [in AS 2] that auditors need to evaluate the process that a company uses to reach its conclusion about the effectiveness of company controls". Thomas Ray, the Chief Auditor and Director of Professional Standards of the PCAOB, stated in Remarks at the 25th Annual SEC and Financial Reporting Institute Conference in Pasadena, California that auditors have probably done "unnecessary additional work directed to evaluating the adequacy of management's process" because of a "misunderstanding" that they must express "an opinion on management's assessment process."

We believe that Paragraphs 40 through 46 of AS 2 do more than "suggest" that a registrant's auditor evaluate management's process for assessing the effectiveness of the registrant's system of internal control over financial reporting. For example, paragraph 40 specifically requires the auditor to "obtain an understanding of, and evaluate, management's process for assessing the effectiveness of the company's internal control over financial reporting." In contrast, however, Paragraph 19 of AS 2 states that "[t]here is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting."

We agree with Mr. Ray that the confusion as to whether the auditor must audit the registrant's processes or simply management's conclusion as to the effectiveness of the registrant's internal control over financial reporting may have resulted in unnecessary work by auditors and a heightened level of concern by management of the adequacy of its process for evaluating internal control over financial reporting and its related documentation of this process. The additional testing for the auditor to assure the adequacy of management's process probably does little to provide further assurance about the effectiveness of the registrant's internal control over financial reporting. A review of management's process for evaluating internal control over financial reporting is not needed to better protect investors.

The provisions of Sarbanes-Oxley do not appear to require an evaluation by the auditor of management's process for evaluating internal control over financial reporting. Section 404(b) of the Sarbanes-Oxley Act calls for the registrant's independent auditor to render a report on management's assertions pursuant to Section 404(a) regarding the registrant's internal control over financial reporting. In addition, Section 103(a)(2)(A)(iii) of Sarbanes-Oxley requires the auditor to conduct such:

> testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report) –
>
> (I) the findings of the auditor from such testing;
>
> (II) an evaluation of whether such internal control structure and procedures –
>
> (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
>
> (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
>
> (III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.

The requirements in AS 2 for both an opinion on management's assessment of internal control over financial reporting as well as an opinion on internal control over financial reporting lead to the inescapable conclusion that the auditor's tests and other processes to render each opinion must be different in a meaningful way. Otherwise, only one opinion would be required. If the PCAOB believes that the level of audit work for each opinion is the same and, accordingly, eliminates the paragraphs in AS 2 that require an evaluation of management's processes, we suggest that the Commission encourage the PCAOB to consider eliminating one of the required opinions on internal control over financial reporting. This will eliminate the confusion that is likely created by two opinions. Moreover, one opinion of the auditor on either management's assessment of internal control over financial reporting or on a registrant's internal control over financial reporting would accomplish the goal of the Section 404 certification of forcing registrants and their auditors to understand the registrant's system of internal control over financial reporting and the potential for errors in the financial data that are generated by the registrant. Either opinion would require the auditor to assess the risks of misstatements in the registrant's financial statements so that he or she can better plan the audit of the registrant's financial statements.

Revise the Definition of Material Weakness to Eliminate Unnecessary Disclosure. In our experience, the marketplace generally does not react to disclosure about a material weakness because so many registrants have reported material weaknesses. This suggests to us that too many deficiencies meet the definition of material weakness and that the test for a material weakness should be tightened. A tightened definition would result in disclosures about material weaknesses that consistently provide material information to investors. In addition, it would have the added benefit of reducing the time and effort being expended by registrants in negotiations with their auditors on whether a given control deficiency is a "material weakness." Finally, it would reduce the time being spent on the nature of the disclosure of material weaknesses, which is often dictated by registrants' auditors. Guidance from the Commission on the extent of required disclosure about internal weakness would also be helpful.

We agree with the suggestion made by John J. Huber in footnote 6 of his May 1, 2006 letter submitted in connection with the Commission's "Roundtable on Second-Year Experiences with Implementation of Sarbanes-Oxley Internal Control Reporting and Auditing Provisions (File Number 4-511)." Mr. Huber stated as follows:

> For example, the structure of the term material weakness – probability and magnitude is appropriate, but the thresholds – more than remote likelihood based on FAS 5 and materiality based on SAB 99 – are too low. The PCAOB should raise the bar to "likely" rather than the current standard of "more than remote likelihood" and the Commission should revise SAB 99 to ensure that the definition truly reflects the standard of what as (sic) reasonable investor would need to know to make an informed investment decision.

Encourage the PCAOB to Amend AS 2 to Explicitly Articulate a Risk-based Approach to Auditor Attestations. The auditing profession long ago concluded that the sheer size and complexity of modern business enterprises make it impossible for annual audits to be conducted on the basis of substantive testing alone. Nor could the annual audit be made economically feasible by relying on the client's internal controls. As a result, the profession was forced to adopt the concept of a "risk-based audit" pursuant to which the auditor would analyze which accounts were most likely to contain a material error and concentrate his or her efforts on those accounts. While risk-based auditing is not a perfect solution (as it leaves open the possibility that material errors will escape detection), it was the best solution considering the limited amount of time and resources that could be reasonably devoted to an annual service. The Commission, in a number of its releases, has recognized the validity of this approach and has encouraged the auditing profession to adopt this approach in its Section 404(b) certifications. The problem is that auditors are required to guide their efforts using AS 2, which is a highly detailed procedural road map that does not lend itself well to a risk-based approach. Thus, if the profession is going to be able to reduce its efforts in Section 404(b) engagements by exercising greater judgment in the selection of tests which it performs, AS 2 will have to be amended to accommodate this approach.

We are pleased that Chairman Olson's September 19, 2006 testimony suggests that the PCAOB is currently considering amendments to AS 2 that will articulate a risk-based approach.

Simply providing further "guidance" without such amendments would not likely effect any substantial reductions in the costs of Section 404 engagements.

Encourage the PCAOB to Amend AS 2 to Eliminate the Assertion that "Reasonable Assurance" Requires "A High Level of Assurance". Paragraph 17 of AS 2 states as follows:

> Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditors' opinion.[footnote omitted] Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

Although the footnote in paragraph 17 refers to the Commission's "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," Securities Act Release No. 8238 (June 5, 2003), for further discussion of reasonable assurance, the Commission's release does not explain what it means by reasonable assurance. In the Concept Release, the Commission simply points out that the term "reasonable assurance" does not convey "absolute assurance."

AS 2 has clarified the meaning of reasonable assurance for purposes of an auditor's attestation under Section 404(b) by providing that it means a "high level of assurance." To be sure, there is no empirical evidence indicating what level of reporting accuracy the procedures specified in AS 2 will yield. There is no question, however, that the impact of this new standard is to prompt auditors to be exhaustive in their attestation procedures in an effort to deliver "a high level of assurance" in their reports.

We are concerned that auditors and registrants believe that "a high level of assurance" results in a different analysis than that required for purposes of internal accounting controls by Section 13(b)(7) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and we think that the existing standard in the Exchange Act should be used in AS 2. Section 13(b)(2)(B) requires that a registrant:

> Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:
>
> (i) Transactions are executed in accordance with management's general or specific authorization;
>
> (ii) Transactions are recorded as necessary: (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) Access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences;

For this purpose, Section 13(b)(7) provides that the term "reasonable assurance" means "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." We recommend that the Commission encourage the PCAOB to use that definition of reasonable assurance.

We believe that the accounting profession generally views a high level of assurance as roughly 95% assurance. Accordingly, the existing reasonable assurance standard in AS 2 is likely one of the reasons why Section 404 compliance has been costly. Moreover, we believe that it is wholly inconsistent with a risk-based approach that recognizes that the amount of testing which can be economically performed is necessarily limited. Since Section 404 does not define "reasonable assurance" and Section 13(b)(7) does, we recommend that the Commission encourage the PCAOB to use the definition already established in the Exchange Act that is applicable to internal control, that is, "the level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."

Provide Further Guidance Regarding the Nature of the Assistance that Auditors Can Provide to a Registrant in the Process of Establishing, Amending or Otherwise Changing its Internal Control over Financial Reporting Without Adversely Affecting Independence. Following the enactment of Sarbanes-Oxley, the Commission adopted new independence standards which prohibit independent auditors from designing their client's internal controls. Although this prohibition is reasonably designed to separate independent auditors from their clients, many registrants may have unnecessarily expended significant amounts engaging a separate consultant to assist them in establishing their internal control over financial reporting because of concern by their audit committees that any involvement in the process by their auditors would be inconsistent with their independence. We believe that virtually all accelerated filers were compelled to retain another auditing firm to assist them in complying with Section 404(a). This means that two auditing firms reviewed and assessed the registrant's system of internal controls with resulting increases in the cost of compliance.

The involvement of the auditors in the client's development of its system of internal controls can enable the auditor to obtain a better understanding of the client's systems, operations and personnel and thereby conduct a better risk-based audit. In addition, to the extent that this work can be performed by the registrant's independent auditors, the registrant may be able to reduce the costs of the Section 404 process.

We believe that there may be aspects of internal control work that can be performed by a registrant's independent auditors without impairing the auditor's independence, such as documenting controls that have been instituted by management. Accordingly, we recommend that the Commission consider providing further guidance in this area with a view toward minimizing the need for non-accelerated registrants to employ a second outside auditing firm to assist them in complying with Section 404(a).

In this same connection, there seems to be a great deal of misunderstanding as to what advice relating to internal controls an auditing firm can and cannot provide to its audit clients without impairing its independence. Accordingly, there is clearly a need for further guidance in this area. We urge the Commission to consider the additional costs which registrants may have to incur when it addresses this issue.

<u>Small Registrant Issues</u>

Encourage the PCAOB to Permit Registrants and Auditors to Rely On the Certifications of Software Manufacturers Regarding the Internal Controls Built into Their Software Controls. We believe that auditing firms engaged by small registrants may not always have the skills necessary to test the controls governing data processing systems and may simply "audit around" their client's computer systems. Unfortunately, this lack of expertise may therefore leave them wholly unprepared to assess the likely risks of a material misstatement in the client's financial statements. As a result, financial frauds resulting from the manipulation of data in a registrant's data processing system may be allowed to go undetected for many years.

Issuing a warning of this potential danger is not likely to be an effective way of addressing this situation as it is not particularly feasible for small auditing firms to acquire these skills. Thus, any such warnings (or even requirements) are likely to go unheeded. Fortunately, many small registrants use off-the-shelf software systems, which means that is possible for the producers of these systems to supply both the auditing firm and the client with a certification regarding the effectiveness of the controls inherent in their systems. If the PCAOB were to amend AS 2 to permit auditors to rely upon such manufacturer certifications, software producers might be encouraged to provide this vital information. It would also encourage them to create software with greater controls. In this way, a serious gap in the internal control structure of most small registrants might be minimized and the possibility of financial fraud reduced.

Provide guidance to small registrants on the extent to which formal controls are necessary where the registrant relies on day-to-day management oversight. Many non-accelerated registrants rely on management's day-to-day oversight of their company's operations and personnel as a substitute for formal controls. In some cases, this is adequate and in other cases it is not. If the Commission and/or the PCAOB is to provide further guidance, this would appear to be an appropriate subject for that guidance.

* * * * * *

Finally, based on recent reports, it appears that the PCAOB has made substantial progress in preparing draft revisions of AS 2, focusing at least in part on efforts to reduce or eliminate excessive, unnecessary and expensive audit protocols and procedures. In promulgating further rules or guidance, it seems obvious that the Commission should strive to ensure that guidance to registrants on Section 404 and a revised AS 2 complement one another. Accordingly, we believe it would be prudent for the Commission to defer the release of guidance on internal control over financial reporting, and to extend the period of time for commentary on the Concept Release to coincide with a comment period on the planned AS 2 revisions. This would permit users and practitioners simultaneously to consider and comment on both Section 404 guidance and changes to AS 2 and thereby offer more coherent and informed input.

We appreciate the opportunity to provide these comments. Members of the Committees are available to discuss them should the Commission or the staff so desire.

Respectfully submitted,

/s/ Linda L. Griggs

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