KPMG LLP
757 Third Avenue
New York, NY 10017

Telephone 212-909-5600
Fax 212-909-5699
Internet www.us.kpmg.com

September 18, 2006

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

File No. S7-11-06
Concept Release Concerning Management's Reports On Internal Control Over Financial Reporting
Release No. 34-54122

Dear Ms. Morris:

KPMG LLP welcomes this opportunity to respond to the request of the Securities and Exchange Commission (the Commission) for comment on its Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting (the Concept Release). We recognize the Commission's substantial efforts in responding to the challenge of weighing the investor benefits of reporting on internal control over financial reporting against the costs incurred by issuers. We believe that additional guidance for management relative to reporting on internal control would be a significant step toward furthering investor protection.

Since the adoption of the initial rule in September 2002 requiring reporting on internal control over financial reporting pursuant to Section 404 of Sarbanes-Oxley (Section 404), significant improvements have been made to companies' financial reporting and disclosure processes and the effectiveness of their internal controls. At the same time, compliance with the provisions of Section 404 has placed important responsibilities on issuers that, in many instances, have required the dedication of significant resources.

Fundamentally, we believe that compliance with the provisions of Section 404 provides needed protections to investors in all public companies, regardless of size or complexity. We support the Commission's efforts to develop practical guidance for companies to further improve the reliability of financial reporting and to make compliance with Section

404 more efficient and cost effective. We believe that additional guidance for management on how best to evaluate the effectiveness of a company's internal control over financial reporting would be useful, and that any guidance developed should be scalable to companies of all sizes and complexities.

We believe that additional guidance for management relative to reporting on internal control over financial reporting should be expressed as broad principles, with illustrative examples evidencing the application of those principles. In addition, we believe that additional guidance for management should be in the form of interpretive guidance rather than a Commission Rule, similar to the Commission's guidance on preparation of Management's Discussion and Analysis.[1] This approach would provide flexibility to management in performing its evaluation of internal control and is consistent with the Commission's long-standing belief, reiterated in the Concept Release, that the methods of conducting assessments of internal control over financial reporting will, and should, vary from company to company. In addition, substantial investments have been made by accelerated filers in developing their assessment processes over the past three plus years. The Commission can obtain valuable input from these issuers in developing its interpretive guidance, and a principles-based approach will allow these issuers to consider their existing assessment process relative to such principles, without the need to "reinvent the wheel."

Excessively detailed guidance ordinarily is counter to the notion of scalability. On the other hand, guidance should be specific enough to be meaningful to issuers. We caution the Commission to remain mindful of this balance in the development of any additional guidance for management. We also believe that any such guidance issued by the Commission should build on the existing definition of internal control over financial reporting and the fundamental principles underlying that definition.

Our comments in this letter are based on an assessment of the additional guidance contemplated in the Concept Release and its effect on our ability to fulfill our professional responsibilities under the standards of the Public Company Accounting Oversight Board (PCAOB). The extent to which auditors are affected is largely dependent on how additional management guidance issued by the Commission impacts performance of integrated audits pursuant to PCAOB professional standards.

---

[1] Release Nos. 33-8350, 34-48960, FR-72, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*.

I. Role of the External Auditor

We do not support the proposal of a lower level of assurance on internal control effectiveness provided by the external auditor than currently is required by PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*. In our April 3, 2006 comment letter to the Commission, we did not agree with the Advisory Committee on Smaller Public Companies' recommendation regarding the development of a standard providing for an audit only of the design and implementation of internal control. While clear disclosure that a company has not undergone an audit of internal control over financial reporting is understandable to investors, those same investors cannot be expected to assess the relative gradations of assurance provided by this distinction in reporting on internal control.

An alternative providing for an auditors' report only on design and implementation of internal control, at a time when much attention has been directed toward reporting on the operating effectiveness of internal control, undoubtedly would result in users' misunderstanding the level of assurance provided by the auditor. It is important to note that a well-designed system of internal control, while vital, does not equate to the generation of reliable financial information in the absence of effective operation of internal control. Accordingly, we continue to believe that such an alternative would serve only to widen the current expectation gap relative to auditor assurances at a time when emphasis should be directed toward narrowing that gap.

In addition, we do not support an alternative providing for an auditors' report on the effectiveness of internal control over financial reporting predicated on less than "reasonable assurance" (i.e., less than a high level of assurance), or on a less than annual frequency, for many of the same reasons noted above. Effective implementation of the provisions of Section 404 contemplates auditor attestation on the effectiveness of internal control over financial reporting. We believe that any dilution of existing Section 404 (b) requirements runs counter to the stated objective of the Sarbanes-Oxley Act to protect investors by improving the accuracy and reliability of corporate disclosures.

II. Documentation to Support Management's Assessment

The nature and extent of documentation that management must maintain has been the subject of much deliberation over the past few years. Additional guidance to management on this subject would be very helpful, to both management and auditors. Fundamentally, we believe that subjecting management's assessment of internal control effectiveness to external audit pursuant to Section 404(b) necessitates a certain degree of documentation formality.

We believe that management should maintain some level of documentation of the design of its internal control over financial reporting for all business units/locations, including those considered insignificant individually and when aggregated with other business units/locations. We believe that this position is consistent with an issuer's obligation to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."[2]

Documentation of the design of controls is evidence that controls related to management's assessment of the effectiveness of internal control over financial reporting, including changes to those controls, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. Such documentation also provides the foundation for appropriate communication concerning responsibilities for performing control activities, and for the company's evaluation and monitoring of the effective operation of controls.

We do not believe that it is realistic to expect that management can perform an effective evaluation and assessment of an entity's internal control over financial reporting without some form of documentation evidencing procedures performed and related findings. We acknowledge that documentation of the design of processes and controls may take many forms, including paper, electronic files, or other media, and can include a variety of information, including policy manuals, process models, job descriptions, documents, and forms. The form and extent of such documentation is a matter of management judgment and will vary depending on the size, nature, and complexity of an individual business unit or location.

The auditor's use of the work of management and others in an integrated audit continues to be an area of focus in the cost/benefit debate. The formality of management's documentation directly affects the auditor's ability to use the work of management in executing an effective and efficient integrated audit. Clearly, the auditor's ability to use the work of management improves as the formality of documentation of internal control design and management's assessment and evaluation increases.

---

[2] Required pursuant to Section 13(b)(2)(A) of the Securities Exchange Act of 1934.

Our comments on management's documentation are intended to address all areas of management's assessment, including information technology controls. In addition, we believe that the Commission should recognize that many issuers have made substantial investments in identifying and documenting risks and controls, including those related to information technology, when proposing additional management guidance in this area.

In summary, we believe that the Commission needs to provide principles-based interpretive guidance relative to the extent of management's documentation supporting both the design of its internal control system and its assessment process. A principles-based approach will allow management to apply its judgment in satisfying the objectives, and will allow such guidance to be scalable.

III. Top-Down Approach and Company-Level (Entity-Level) Controls

We believe that additional guidance to management on executing a top-down approach to internal control evaluation and assessment would be very helpful. One objective of a top-down approach is to avoid the assessment of redundant or excessive controls in completing an evaluation of operating effectiveness. Critical to effective execution of a top-down approach is an appropriate consideration of company-level or entity-level controls.

The subject of company-level controls does not, on its surface, appear to embody difficult or controversial concepts. However, application of the company-level controls concept has presented difficulties in practice, for both management and auditors, during the first two years of internal control reporting. These practice difficulties revolve around two threshold questions:

> *If deficient company-level controls lead management to perform more extensive procedures, do effective company-level controls allow management to perform less extensive procedures than otherwise would have been necessary in the circumstances?*
>
> *If management is to "take credit" for effective company-level controls, how does that "credit" translate into a reduction in the performance of management's procedures?*

In response to these questions, it is important to acknowledge that not all company-level controls are created equal. For example, a well-designed and robust period-end financial reporting process that includes meaningful analyses of financial information generated by a company's financial reporting system may demonstrate a clear link to financial statement amounts and the assertions to which they relate. In this instance, concluding that controls associated with the period-end financial reporting process are operating effectively may allow management to determine that a reduction in process- or transaction-level testing relative to certain financial statement assertions associated with some financial statement amounts may be appropriate.

On the other hand, while an appropriate "tone at the top" is critical to a well-controlled organization and undoubtedly permeates the entire system of internal control, the process of linking the positive implications of a control that operates at that level to specific financial statement amounts and their related risk of misstatement is neither clear nor intuitive. Furthermore, it is difficult to determine the precision at which many company-level controls operate, and in many cases such controls do not operate at a level of precision sufficient to prevent or detect a material misstatement of the financial statements. As a result, a very real risk exists that management may place too much reliance on company-level controls and not sufficiently evaluate process- or transaction-level controls in performing its assessment.

We believe that effective company-level controls should not serve as justification for management to alternate or rotate its evaluation of process- and transaction-level controls associated with significant accounts. As cited in the background and basis for conclusions of AS 2, this approach is comparable to an auditor testing accounts receivable only once every few years in a financial statement audit. We believe that management faces similar risks in the performance of its assessment of internal control over financial reporting pursuant to Section 404(a). For example, even if there were no changes in the company – to its business model, employees, organizational structure, etc. – controls that were effective in prior years may not be effective in the current year due to error, complacency, distraction, and other human conditions that define the inherent limitations in internal control over financial reporting. Allowing management to alternate or rotate its evaluation of controls would increase the risk that inappropriate conclusions on the operating effectiveness of a company's internal controls would be reached, thereby increasing the risk of material misstatements in a company's financial statements going undetected and uncorrected.

However, we do believe that management should explore opportunities to alter the nature, timing and/or extent of its evaluation and assessment procedures performed from year to year. Effective company-level controls clearly contribute to the ability of management to alter its procedures from year to year, and additional guidance provided by the Commission in the area of company-level controls should focus on this aspect of management's assessment.

IV. Evaluating Deficiencies

In response to the Commission's question regarding the need for management guidance on evaluating deficiencies, we believe that guidance in the document, *A Framework for Evaluating Control Exceptions and Deficiencies* (the Framework), developed by representatives of nine public accounting firms, including KPMG LLP, and a professor from Georgia State University, is appropriate for management's use. The Framework, released in late 2004,[3] was designed for use by both issuers and auditors when evaluating control exceptions and deficiencies identified during an evaluation of a company's internal control over financial reporting.

Feedback we have received from various constituents indicates that the use of the Framework is widespread amongst auditors and issuers alike. The Framework also has been made available for issuers' use by groups representing a number of issuer constituencies. If the Commission feels compelled to issue further guidance for management on evaluating deficiencies, we believe that such guidance should be consistent with the Framework.

We also believe that the terms "material weakness" and "significant deficiency" are clearly defined in the Commission's Rules and in AS 2, and properly incorporate the concepts outlined in the Commission's guidance on materiality. AS 2 identifies strong indicators of material weaknesses and significant deficiencies. We believe that further guidance for both management and auditors would be helpful with respect to how these presumptions might be overcome, beyond the limited and infrequent circumstances cited in the basis for conclusions of AS 2.

We believe that guidance on factors that management should consider in determining whether a strong indicator of a material weakness can be overcome would be useful. Clearly, such guidance should be consistent with the relevant auditor guidance. We believe, however, that the concept of strong indicators of a material weakness should be

---

[3] The nine firms include: KPMG LLP, BDO Seidman LLP, Crowe Chizek and Company LLC, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton LLP, Harbinger PLC, McGladrey & Pullen LLP, and PricewaterhouseCooopers LLP; William F. Messier, Jr., Professor, Georgia State University, also contributed to the development of the Framework.

retained. We agree with the view expressed by the PCAOB in paragraph E97 of AS 2, that a list of strong indicators "promote[s] consistency in auditors' and managements' evaluations of deficiencies consistent with the definitions of significant deficiency and material weakness." The same paragraph of AS 2 also indicates that the "'strong indicator' construct allows the auditor to factor extenuating or unique circumstances into the evaluation, and possibly to conclude that the situation does not represent a material weakness."

We believe that there is, and should continue to be, a high hurdle for overcoming a strong indicator of a material weakness. Factors that we believe appropriate to consider in determining whether a strong indicator related to a material error in accounting (including a restatement of financial statements to correct an error) can be overcome include:

- whether the subject accounting is complex,
- whether management identified the respective accounting issue at the inception of the accounting or related transaction(s),
- whether management considered the accounting alternatives prior to the initial adoption of the relevant accounting,
- whether management prepared documentation of its considerations and conclusions contemporaneous with the initial adoption of the accounting, and
- whether management should have implemented or modified controls that would have prevented or detected the error.

V. Foreign Private Issuers

Foreign private issuers (FPIs) that are required to implement Section 404 have benefited from the experiences of domestic accelerated filers over the last two years. However, there are a number of issues that are unique to FPIs, and we believe that guidance in the following areas would be helpful:

- *Interim Reporting* – The Commission should consider publishing guidance on the extent to which FPIs should assess the impact of internal control deficiencies on interim financial reporting. This guidance should specifically address those instances where FPIs voluntarily furnish Forms 10-Q on a schedule consistent with that of a domestic issuer.

- *Scoping* – The Commission should consider publishing guidance to assist management in determining the basis of accounting to use for Section 404 scoping purposes. For example, if the FPI's primary financial statements are prepared in accordance with the FPI's local GAAP, resulting in the consolidation of certain entities that would not be consolidated under U.S. GAAP, we believe that guidance on whether those entities should be included in the scope of management's Section 404 assessment would be helpful.

- *Proportionate Consolidation* – In some countries, local GAAP requires proportionate consolidation of an entity that otherwise may not be consolidated under US GAAP. For example, Canadian GAAP requires many issuers in the oil and gas industry to proportionately consolidate investments in joint ventures, where US GAAP provides that issuers account for these investments under the equity method. We believe that the Commission should consider publishing guidance on whether FPIs may analogize to existing guidance on scoping when the investing entity is not able to assess the internal control over the entity proportionately consolidated.

VI. PCAOB Coordination

A number of the matters addressed in the Concept Release indirectly impact auditor performance in an integrated audit. Accordingly, we recommend that the Commission coordinate its efforts relative to the development of additional management guidance with the PCAOB. It is critically important that the PCAOB consider and address how additional management guidance provided by the Commission may affect additional guidance developed for use by auditors, including amendments to AS 2. The coordination of efforts and the PCAOB's development of guidance relative to auditor performance consistent with the Commission's interpretative guidance will facilitate the achievement of our mutual objective to comply with the provisions of Section 404 in the most efficient and cost effective manner.

****

We support the Commission's efforts to provide additional guidance for management to assist in reporting on internal control over financial reporting, and we appreciate the opportunity to provide comments on the matters raised in the Concept Release. If you have any questions about our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5366, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: SEC Commissioners

Mr. Christopher Cox, Chairman
Mr. Paul S. Atkins
Mr. Roel C. Campos
Ms. Annette L. Nazareth
Ms. Kathleen L. Casey

PCAOB Members

Mr. Mark W. Olson, Chairman
Ms. Kayla L. Gillan
Mr. Daniel L. Goelzer
Mr. Willis D. Gradison
Mr. Charles D. Niemeier

Mr. Conrad Hewitt, Chief Accountant - SEC
Mr. Thomas Ray, Chief Auditor and Director of Professional Standards - PCAOB