Texas Society of
Certified Public Accountants

September 18, 2006

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

RE: Release No. 34-54122; File No. S7-11-06, *Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting*

Dear Ms. Morris:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The committee has been authorized by the Texas Society of CPAs' Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the Texas Society of CPAs' Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the Texas Society of CPAs.

We appreciate the opportunity to provide the input of the TSCPA PSC into your deliberations regarding Release No. 34-54122, *Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting*. We will begin our response to this Release with some general comments and then address those specific questions raised in the document to which we have input.

General Comments

The TSCPA PSC believes management needs additional authoritative guidance regarding its evaluation and assessment of internal control over financial reporting. In its assessment and evaluation of internal control, management seeks to develop documentation that is meaningful and relevant to its business and industry. On the other hand, the public accounting profession requires company management to focus on documentation that will satisfy PCAOB Auditing Standard No. 2.

We need to be mindful that the ultimate goal of the SEC, the public accounting profession, and corporate management is the protection of the investing community. There appears to be a lack of symmetry between the standard being applied by auditors (PCAOB Auditing Standard No. 2) and management's belief regarding its duties and responsibilities under the Sarbanes-Oxley Act. We believe the SEC is the organization best suited to coordinate the requirements of management and auditors regarding the assessment and evaluation of internal control.

We believe this Concept Release is an excellent beginning to a process that can result in a better understanding of the responsibilities of auditors and management and narrow the gap between the auditor's standards and management's standards. The end result of this exercise can be better understanding on the part of both auditors and management and a significant step in providing clear and unbiased financial reporting.

14651 Dallas Parkway, Suite 700 • Dallas, Texas 75254-7408 • 972/687-8500 • 800/428-0272 • Fax 972/687-8646

We hope the SEC will consider the development of principles-based rules for management in its approach to compliance with Sarbanes-Oxley requirements. Such guidance must be liberally supplemented with examples that can assist management in developing a thorough understanding of its responsibility. Once such rules are in place, we believe the SEC can then direct the PCAOB to reconsider the guidance in PCAOB Auditing Standard No. 2 and make it compatible with the guidance developed for management. In developing the guidance for management in this area, the SEC must remain aware of the responsibility that auditors have to audit the data generated by management. We applaud the SEC in its decision to provide clarification and guidance for management and an improved financial reporting environment for the public.

Question 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?*

Management definitely needs additional guidance in evaluating a company's internal control over financial reporting. The guidance provided to auditors is currently superior to that provided for management. Since PCAOB Auditing Standard No. 2 is the only significant guidance in effect, by default, it directs the efforts of those responsible for assessing the effectiveness of internal control over financial reporting. We believe the current situation begs for the creation of bright lines rules for management just as there are for auditors.

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

We believe the guidance should be based on sound principles that are clearly defined and thoroughly explained. These principles should not be so broad that their implementation in one entity would have little or no resemblance to their implementation in another entity. We would suggest the use of rules to the extent that such rules are designed to help management stay on track with respect to the intent of the overriding principles.

Question 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?*

The most effective approach is to tailor the testing and monitoring of controls to fit the entity, focusing on such aspects as nature of the business, risk profile, and extent of automation. COSO and the auditing literature provide guidance that identifies a number of ways to monitor and test control effectiveness in addition to attribute testing. This concept was discussed in some detail in the guidance for small businesses. Such guidance should not be isolated to small businesses. All business entities, regardless of size, could benefit from aligning their monitoring and evaluation of control effectiveness to the risk associated with the control and type of control being tested.

Question 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?*

There is a risk that standardizing the manner in which entities must control risks, or the level of risk tolerance, will suppress competitive advantage, innovation, and entity individualism. It is important for the controls to focus on the quality of reported information without restricting management's ability to take the appropriate risks to be successful in the company's business.

Question 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?*

Since auditors have the most training and experience with the COSO framework, we believe it would be easier for entities using this framework to work efficiently with their auditors. We believe COSO provides an acceptable and flexible framework that integrates well with documenting and evaluating internal controls, as well as allowing entities to further expand into Enterprise Risk Management.

Question 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 believe that both management and auditors would generally agree that improvements can be made in the integration of audits of management's assessment of internal control and the audits of financial statements. For some companies, the cost of the internal control audit far exceeds the internal cost of compliance. However, we are uncertain as to the specific alternatives that would be most effective. We realize that the primary objective of the statute is to protect investors, not reduce the efforts of management or the auditor.

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

We believe COSO's Enterprise Risk Management (ERM) framework provides acceptable guidance in the area of risk identification and assessment. Use of the ERM framework should enable an entity to document significant risks, identify the controls that will mitigate those risks, and report on the management of such risks.

Question 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?*

We believe the initial guidance that suggested an account-by-account approach to determining what the key processes and controls should be distracted some companies from focusing on the "top-down, risk-based" approach. These companies might be better served by starting at the high-level, financial statement approach and drilling down to understand how information is collected and recorded for each line, assessing risks and aligning controls.

Question 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 risks?*

The COSO guidance for smaller public companies is very good. The weakness is that it purports to address only small company environments. Many larger entities that have decentralized smaller or unique operating locations can also benefit from this guidance, along with entities that have many manual processes. However, we believe that additional guidance, especially in the form of examples, is needed. While we support and encourage a top-down, risk-based approach, we need to keep in mind that at the end of the process we must have addressed every material account and disclosure in the financial statements.

Question 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 addressed risks? Are there areas that have not yet been addressed or need further emphasis?*

We believe the COSO guidance will assist companies that have not yet complied. However, the only audit standard available, PCAOB No. 2, has been widely criticized for being overly picky, and management has not had its own standard from the SEC. We hope the SEC will encourage the PCAOB to revise PCAOB No. 2 to support the level of testing and assurance identified in the forthcoming SEC standard for management.

Question 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?*

More guidance on entity-level controls would be helpful. We believe there is incomplete understanding of this concept. Also, some discussion or clarification is needed on the concept that entity-level controls may not be designed to be as sensitive as low-level account and transaction controls. Further guidance is also needed on how companies assess and document what should be the appropriate level of sensitivity.

Question 16 *Should extra 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?*

We believe qualitative factors will always be a necessary component of risk assessment, materiality considerations, and the identification of significant control deficiencies. Additional guidance on documenting and evaluating qualitative aspects is always helpful. We further believe that additional guidance regarding what constitutes a material weakness and a significant deficiency would enhance the identification of controls to prevent or detect such items.

Question 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?*

There is considerable guidance related to fraud controls. The guidance in this area encourages management to spend time understanding and assessing the risk of fraud as one of the critical risks in its risk profile. We believe an improved mechanism is necessary to make management more aware of the guidance available on fraud controls.

Question 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?*

The materiality of a location or business unit to the financial statements seems to be a significant criterion in deciding whether to test that location or unit. We also believe better implementation and alignment with a top-down, risk-based approach would help management and auditors focus on risks and not just materiality.

Question 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.*

We believe more examples of effective entity-level controls and how to test them would be helpful. Also, additional guidance on testing or other means of documenting their effectiveness would be of benefit. Some of the most effective entry-level controls, particularly those generally known as "tone at the top," can be some of the most effective controls but also the most difficult controls to test or document effectiveness.

Question 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 would be very helpful. We believe many auditors are reluctant to recognize or rely on any testing that is not the result of a statistically valid random sample. Daily interaction is especially effective for smaller companies. Discussions regarding how small companies with inadequate segregation of duties can especially benefit from understanding the related risk and using daily interactions and reviews to mitigate those risks can be most beneficial.

Question 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?*

A small company where management is really able to monitor and understand the company's activities would be an example of very strong control. The relevance of such a belief is verified by the number of executives whose companies have experienced financial improprieties say that "they can't possibly know what's going on in such a large company." We believe it would be good to have enhanced guidance in documenting and evaluating individual interaction and monitoring.

Question 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?*

We believe guidance on the different methods of evaluating controls and when to use the various methods should be expanded. Sampling and testing of attributes and extrapolation of the results is frequently used when other testing methods might be more appropriate. A key consideration is not only providing guidance to management on when to use the testing, but also providing guidance to the auditor that he or she can rely on this type of testing.

Question 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?*

We believe most of the issues that commonly arise relate to control deficiencies that could potentially cause a financial statement error, but did not actually cause any error at all. It is those risks where there is a very slight risk that something material could go wrong, but a much greater risk that something immaterial would go wrong. The potential error is frequently a matter of professional judgment on the part of the individual performing the assessment.

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

Our committee strongly believes that enhanced guidance would be helpful in the definitions of the terms "material weakness" and "significant deficiency." Since these concepts are normally situation dependent, we suggest principles-based guidance with a variety of examples that would vary by financial area, type of company involved, and significance.

Question 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.*

One area that generates considerable debate is when the misstatement was partially due to changing accounting norms. For example, erring on the side of conservatism used to be more common and acceptable than it is today. We believe it would be beneficial to have guidance and examples on types of restatements that would not necessarily result in a material weakness.

Question 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?*

We believe it would help to have such guidance, along with examples. Also, specific guidance would be helpful on what the SEC views as management's disclosure responsibilities when it concludes that a restatement is not the result of a material weakness in internal control. Currently, there is no requirement for any disclosure, but the SEC staff has indicated in speeches that it would deem some disclosure necessary.

Question 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)?*

Automated monitoring controls have been effective, particularly those that perform exception analysis and notify management when a tolerance level has been exceeded.

Question 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?*

The guidance for which IT controls are important is improving, but we believe additional guidance would still be helpful.

Question 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 Cobit framework seems to have a substantial following. However, it provides more than required for financial reporting controls.

Question 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?

We believe the levels of documentation varied significantly from company to company. This appears to be due to a number of factors, including lack of guidance, lack of experience, and pressure from external auditors who were trying to establish acceptable documentation parameters with little or no authoritative guidance in early months. Had corporate management been provided with specific guidance, we would be better able to comment on whether the documentation was excessive in nature. We believe specific SEC guidance concerning levels of documentation would be a positive step in making the levels of documentation more understandable for management and the external auditors.

Question 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?*

We find that the main area of uncertainty is where management can set its risk tolerance. Most auditing firms appear to believe that management's risk tolerance should align with their definition of materiality. While this may be an acceptable starting point, it seems that if management can effectively communicate its risk strategy and tolerance levels it should be allowed to do so.

Question 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?*

We believe many entities are encouraged to strengthen their documentation in certain areas because those are the areas that the PCAOB focuses on when it reviews audit engagements. It would appear that the PCAOB is indirectly setting standards for management documentation when its only jurisdiction is over documentation prepared by the auditor. Management is also pressured to put its documentation into a format that is more meaningful to auditors, but less valuable to management. We believe management's documentation should serve the needs of management. The auditors should evaluate how well the documentation accomplishes that objective, not how well it meets the auditor's needs.

Question 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?*

While our general reaction to this question is to support the development of guidance for documentation of information technology controls, we recognize the difficult nature of such a task. The problems that exist in developing relevant guidance concern the variance among companies regarding their dependence on technology, purchased vs. in-house developed technology, and the vast differences in the technology environment. Members of our committee have also pointed to the use of spreadsheets as a major consideration in the development of relevant guidance in the area of information technology controls. Spreadsheets, which are used extensively in documenting information technology controls, tend to be highly flexible and unstructured. Most public accounting firms seem to use the

PricewaterhouseCoopers 2004 white paper as the bright line for assessing spreadsheets. We believe the business community needs spreadsheet guidance that goes beyond the PWC 2004 white paper.

Question 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?*

It appears to our committee that narrative discussions would be adequate and less time consuming, while at the same time more understandable than process maps or flow charts for smaller companies. Many of the processes used in smaller companies are not as complex as larger companies and could be adequately documented and evaluated by a narrative.

We appreciate the opportunity to provide our input into your deliberations concerning this important area of financial reporting.

Sincerely,

Sandra K. Johnigan

Sandra K. Johnigan, CPA, CFE
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants