FSA

A Dexia Company

September 14, 2006

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attn: Nancy M. Morris, Secretary

VIA E-MAIL [rule-comments@sec.gov]

Re: Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers and Newly Public Companies, Release Nos. 33-8731, 34-54295 (File No. S7-06-03), and
Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, Release No. 34-54122 (File No. S7-11-6)

Ladies and Gentlemen:

This letter is submitted on behalf of Financial Security Assurance Holdings Ltd. (the "Company") in response to the Commission's request for comments on (1) Release Nos. 33-8731 and 34-54295, "Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers and Newly Public Companies," dated August 9, 2006 (the "August Release"), and (2) Release No. 34-54122, "Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting," dated July 11, 2006.Among other measures, the August Release proposes to extend the date at which non-accelerated companies must first file an auditor's attestation report on internal control over financial reporting to the annual report for a fiscal year ending on or after December 15, 2008. Pursuant to Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Connection with an Audit of Financial Statements" ("Standard No. 2"), each registered public accounting firm that prepares or issues such a report is required to provide (1) an opinion on management's assessment of the effectiveness of internal control over financial reporting (the "opinion on management's assessment") and (2) an opinion on the effectiveness of internal control over financial reporting (the "opinion on control effectiveness").

We believe that the reporting on internal controls instituted pursuant to the Sarbanes-Oxley Act of 2002 (the "Act") has helped restore investor confidence in financial reporting by registered issuers. Investors benefit from receiving information about control problems which help them assess reporting risk. We also support the

Commission's efforts to recognize and accommodate the circumstances of non-accelerated filers in implementing these controls.

However, we believe that an additional measure is needed in order to alleviate the disproportionate impact of Section 404 of the Act on non-accelerated filers. To that end, we propose that the auditor attestation report requirement for non-accelerated filers be limited to providing an opinion on management's assessment. For the reasons set forth below, the Company contends that the opinion on management's assessment is sufficient to meet the requirements of the Act and that requiring a separate, independent opinion on control effectiveness creates an unintentional and inefficient burden on non-accelerated filers.

The Company is primarily engaged in the business of providing financial guaranty insurance on municipal and asset-backed obligations in domestic and international markets. It is an indirectly held subsidiary of Dexia S.A., a Belgian corporation. Although the Company does not have registered equity securities, the Company has registered debt securities and therefore files periodic reports under the Securities Exchange Act of 1934 (as amended, the "Exchange Act") as a non-accelerated filer. The Company's debt securities are listed on the New York Stock Exchange.

1. Limiting the requirement to the opinion on management's assessment would comply with the requirements of Section 404(b) of the Act.

Section 404(b) of the Act requires that "each public accounting firm that prepares or issues the audit report for [an] issuer shall attest to, and report on, the assessment made by management of the issuer . . . in accordance with standards for attestation engagements issued or adopted by the [PCAOB]." Rather than require one opinion, however, Standard No. 2 requires that auditors provide two opinions: the opinion on management's assessment and the opinion on control effectiveness.

The PCAOB elected to require two opinions in the belief that "two opinions will most clearly communicate to report readers the nature and results of the work performed and most closely track with the requirements" of Section 404(b).[1] However, a review of the relevant requirements demonstrates that on its own the opinion on management's assessment complies with the Section 404(b) requirement for attestation to, and reporting on, management's assessment, making the independent opinion on control effectiveness unnecessary from a statutory basis. More specifically, Standard No. 2 provides that, in respect to the Auditor's opinion on management's assessment, the auditor should evaluate, among other matters, whether:

[1] PCAOB Release No. 2004-001, "An Audit of Internal Control over Financial Reporting Performed in Conjunction With an Audit of Financial Statements," March 9, 2004, at 23.

- the framework management used to conduct its evaluation is suitable;
- management's assessment of the effectiveness of internal control over financial reporting is free of material misstatement;
- whether management has expressed its assessment in an acceptable form, including by stating whether the company's internal control over financial reporting is effective; and
- material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed.[2]

In order to provide the independent opinion on control effectiveness, Standard No. 2 goes beyond the requirements of Section 404(b) by effectively requiring that an auditor duplicate management's efforts through independent walkthroughs, documentation and testing, and by allowing only limited reliance on management's own testing and evaluation of individual internal controls. The consequence is that in preparing their reports "auditors in many instances utilize an approach that is 'bottom-up' rather than 'top-down.' This results in audits that are not risk-based . . . [and] an extensive focus by auditors on detailed processes, a number of which create little or no risk to the integrity of the financial statements."[3] These "very rigid, prescriptive audits" that arose as a result of the "onerous" Standard No. 2 requirements were not the Act's intended result[4]: as noted in the Senate Committee Report on Section 404, "the Committee [did] not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees."[5]

2. Limiting the auditor opinion requirement would strike a better balance between the benefits for investors and costs for non-accelerated companies of compliance with Section 404(b).

It is well established that the cost of compliance with Section 404(b) has far exceeded expectation.[6] In addition, "the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large multinational corporations, are of less certain value for smaller public companies . . . . The result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete."[7] In this context, the Commission is faced with the task of striking a balance between benefits investors receive from auditor attestations regarding non-accelerated filers and the cost to those companies of obtaining those opinions. Our proposal would

[2] Standard No. 2, para. 133, "Auditor's Evaluation of Management's Report."

[3] Advisory Committee Report, at 32.

[4] *Ibid.*

[5] S. Rep. No. 107-205, at 31 (2002), *cited in* Advisory Committee Report, at 28.

[6] *See, e.g.*, Release, at 11, and Advisory Committee Report, at 29 ("the Commission's June 2003 release adopting internal control rules . . . estimated that the average annual internal cost of compliance . . . over the first three years would be $91,000, and that cost would be proportional to the size of the company").

[7] Report, at 23-24.

provide investors with the comfort of an opinion on management's assessment but would relieve non-accelerated companies of bearing the full cost and consequence of providing an opinion on control effectiveness, resulting in a more cost-effective method of enhancing investor protection.

Standard No. 2 is written to provide guidance on how to perform integrated audits with a goal of providing two separate auditor opinions. The text of Standard No. 2 suggests that the PCAOB believed that the incremental work, and therefore the incremental cost, of providing the opinion on control effectiveness would not be substantial. It 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. In either case, the auditor must obtain sufficient evidence to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion."[8]

We believe that, contrary to the premise stated in the Standard, significantly more work, and related costs, would be required for providing the additional opinion on control effectiveness. Obtaining sufficient evidence to provide a reasonable basis for an opinion on management's assessment does not require the duplication of management's efforts that obtaining a reasonable basis for an opinion on control effectiveness requires. Our proposal to limit the requirement to the opinion on management's assessment would, we recognize, require the issuance of additional guidance for audit firms regarding the scope of work required for an opinion on management's assessment. However, we believe that the benefits to non-accelerated filers would be material.

Relieving non-accelerated companies of the burden of the incremental cost of the opinion on the effectiveness of internal control over financial reporting would be consistent with the Commission's approach towards such companies in implementing the requirements of the Act. As noted by many public commentators, the costs for internal control reporting compliance will be disproportionately higher for smaller public companies than larger ones—and the auditor's fee represents a large percentage of those costs.[9] In addition, while some accelerated companies have reported reduced costs in the second year of compliance with the auditor attestation requirement, we cannot assume that smaller companies will see decreases at the same rate. For them, their characteristics "result in frequent documentation change and sustained review and testing for certification under 404, the cost of which is more of a sustained annual cost."[10]

It is important to note that, in the context of a smaller company, the concern is not just that the auditor will duplicate management's own efforts, thereby increasing costs,

[8] Standard No. 2, para. 19.

[9] *See* Release, at 12 (presenting "data which shows that the expected cost of . . . implementation, as a percentage of revenue, is dramatically higher for smaller public companies"), and Advisory Committee Report, at 32-35.

[10] Release, at 39.

but also that this focus on documented controls, static processes and segregation of duties may force the company to lose competitive advantages.

> Smaller companies, by their nature, need to be flexible and the environment they operate in requires them to make changes quickly in order to compete effectively with much larger and more entrenched competitors. In fact, it is this versatility and the ability to change quickly that is their single most effective competitive strength. . . . This dynamic nature requires frequent changes in process and more frequent job changes inside the company, which limits their ability to have static processes that are well documented. . . . Larger companies have more rigidly defined roles and processes that enable them to segregate duties to the extent that the internal control environment can be relied on for financial reporting. . . Simply put, well established boundaries and flexibility are incompatible and not totally possible in a smaller company. Section 404 and [Standard No. 2] can be effective in larger companies because of the boundaries inherent in those companies. Many believe that in a smaller company these requirements cause the company to lose its flexibility, and as a result put these companies at a competitive disadvantage without significantly improving investor protection.[11]

The incremental value an investor may obtain from having two audit reports should not outweigh these negative consequences on the filer.

Under our proposal, an auditor would be able to put greater reliance on internal documentation and management walkthroughs and testing. This would reduce not only the company's audit costs but also the likelihood that the company's competitive advantages would be diminished.

3. Limiting the requirement to the opinion on management's assessment would further the primary goals of the Act.

The Act was passed with the goals of "enhanc[ing] the quality of public company disclosure concerning the company's internal control over financial reporting and increas[ing] investor confidence in the financial markets."[12] However, for all the focus that has been given to auditors' responsibilities under the Act, that legislation did not place the primary burden for meeting these ends on the auditors. Rather, the Act laid the responsibility for establishing and maintaining an adequate internal control structure squarely on the companies themselves, introducing new corporate governance and disclosure requirements, ranging from company codes of conduct through management certification and audit committee requirements. It is up to the company itself to make the relevant disclosure and determine its own internal controls—and to independently determine whether its controls are adequate.

[11] Report, at 36.

[12] Release, at 29.

We recognize that having an independent auditor report might enhance investor confidence in an individual company. Providing the opinion on management's assessment would meet that goal, while avoiding the detailed, control-focused audit of internal controls that Standard No. 2 requires for preparing an opinion on control effectiveness. At the same time, based on its audit of the company's financial statements and its work for the audit committee, the auditor would be in a position not only to evaluate management's assessment, but also to participate in "frequent and frank dialogue among management, auditors and audit committees to improve internal controls and the financial reports upon which investors rely."[13]

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We hope these comments will be of use to the Commission and its staff. Should you have any questions regarding these comments or require any additional information with respect thereto, please feel free to contact me, at (212) 339-3482 or bstern@fsa.com.

Respectfully submitted,

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General Counsel
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[13] Release, at 13.