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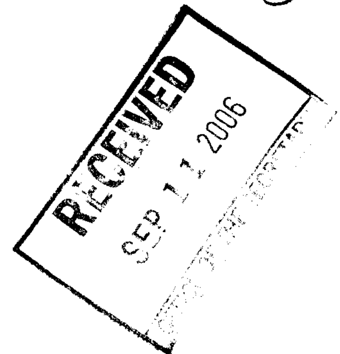

September 8, 2006

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

Re: File Number S7-11-06

Dear Ms. Morris:

Thank you for the opportunity to provide comments concerning management's reports on internal control over financial reporting. Much of the guidance previously issued has been focused on the external auditor and how they should plan, conduct, and document their audit. The absence of guidance for management has caused companies to adopt an approach similar to the auditors, even in cases where this was not the most efficient approach for the company. Guidance that explains the Securities and Exchange Commission's (the Commission) expectations and intent for the planning, testing, and documentation of management's assessment will create a strengthened and more efficient assessment by management. Our comments as follows discuss the topics included in your Concept Release under the comparable headings.

II. Introduction

Guidance for management should be issued in the form of a Commission rule rather than interpretive guidance. The guidance should be principal based; however, it should make use of detailed examples, where possible, to ensure the Commission's intent is clearly understood. Although the Commission issued guidance in the *Staff Statement on Management's Report on Internal Control over Financial Reporting* (the Staff Statement) on May 16, 2005, detailed examples would better help management implement the approach and determine the scope of testing necessary. We realize that management flexibility is necessary because of the unique differences that exist in reporting companies, but if the Commission issues the guidance in only broad principles, disagreements between management and the external auditors could arise over interpretation.

We believe that your guidance from the Staff Statement should be incorporated into the guidance for management, particularly the guidance on "Top-Down/Risk-Based Assessments" and "Scope of Assessment." Although similar guidance was issued to accounting firms by the PCAOB in a May 16, 2005 policy statement regarding implementation of AS2, we do not believe the accounting firms interpret management's assessment in a comparable way. An example of this difference in interpretation and the need for the Staff Statement guidance to be incorporated into management guidance relates to Question 53 of the *Staff Questions and Answers* also issued by the PCAOB on May 16, 2005. Question 53 addresses the topic of "sign-and-file" whereby a

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signature or other similar evidence "might become more important than the performance of the control itself." However, auditors still place an undue importance on the signature or other physical evidence and will not make proper use of other methods, such as inquiry, observation, or re-performance. Management can cite the guidance from the PCAOB and the guidance from your Staff Statement around "Scope of Assessment," but the auditors can still document a deficiency citing the sentence that regardless of the other information "the auditor must be satisfied ...that the control actually operated." In situations where management bases its assessment that the control is working through monitoring activities or other similar means that do not require a signature, how would management respond to the auditors who require a signature as evidence for their audit of operating effectiveness?

On the role of the external auditors and the current approach, a viable alternative to the two opinion approach should be considered. The auditors should not be required to opine on management's assessment. Rather, they should issue only an opinion for the operating effectiveness of the internal control over financial reporting. This would alleviate the possible scenario wherein management might perform certain procedures simply to satisfy the external audit firm even though management does not rely on that particular control. In rendering the operating effectiveness opinion, the auditors use management's work to support their opinion per AS2, just as they use management's documentation to support their opinion on the financial statements. Requiring two opinions from the external auditors on internal control is similar to requiring two opinions on the financial statements, one stating that the financial statements are not materially misstated and one stating management has appropriate documentation to support the financial statements. The second opinion (management's assessment) is inherent in the first one. However, the Commission's rule should address the inevitable disagreements over control design in cases where the auditor believes a control is necessary to meet a certain assertion and management's assessment does not include that control. For example, could this situation create a deficiency that would be cited by the auditors?

III. Risk and Control Identification

The identification of the relevant risks and controls for compliance was a difficult task for many companies. Many companies documented far too many processes and controls in the initial year and have spent the last two years reducing the number of relevant internal controls. Management often relies on segment, line of business, or other operating unit financial reviews to identify potential errors that could have a material misstatement. Yet many of the controls tested by management are still at a level that is identified as immaterial. As we discussed in the Introduction section, management continues to test those controls due to the requirement that the external auditor give an opinion on management's assessment. Companies are not willing to take the risk that a deficiency might occur and result in an adverse opinion by the external auditor relative to the company's assessment, even though the company itself does not rely on those controls to support its own assessment.

As discussed in the Introduction section, the PCAOB issued guidance in its May 16, 2005 release concerning a top-down, risk-based approach. However, that guidance focused on the external auditors and improvements for efficiencies in performing their audit. Although your Staff Statement gives guidance on this approach as well, many companies are overly cautious in their assessment and do not effectively use a top-down, risk-based approach. This is due to apprehension that the auditor may find a significant deficiency or material weakness in an area where the company performed limited testing due to low risk. The company considers the area to be low risk, but continues to perform work covering all risk exposure rather than adopt a risk-

based approach. Further guidance for management to rely on in determining the extent of work required in a risk-based approach and how to adequately document that approach is needed.

Entity-level controls can reduce the amount of low-level, transactional control testing required. Companies often have adequate entity-level controls in place and rely on these controls in a variety of areas. For example, companies can easily evaluate and document the competency of its staff relative to their level of GAAP expertise, the participation and oversight by the board of directors' audit committee, etc. However, companies still spend a vast majority of the total time related to SOX compliance on documentation of and testing transactional control activities. The reason this occurs is that companies have a difficult time taking the knowledge of the entity-level controls and understanding how these controls impact lower-level controls. For example, how does a company take its knowledge of its Code of Ethics and apply it to accounts payable transactions? The company may inherently understand the link that an ethical employee will be less tempted to fraudulently pay an invoice, but may not know how to document that link in such a manner that it will lower the amount of transactional testing required. The Commission should consider providing guidance to management on how to document this link and utilize the knowledge gained in entity-level controls to minimize detailed transactional testing where appropriate.

The Sarbanes-Oxley Act of 2002 was enacted in response to corporate frauds. However, in completing the testing of internal controls, the evaluation of fraud risk is often relegated to a section in entity-level controls. The guidance from the AICPA in *Management Antifraud Programs and Controls* (as referenced in the Concept Release), while providing useful information, does not provide any new steps management can take to evaluate fraud risk. The guidance suggests entity-wide steps to take to address fraud risk (an active audit committee, an internal audit function, a code of ethics policy, and the other various human resource type policies). However, these steps do not necessarily help management assess the risk of fraud. It would be helpful if the Commission could provide a framework that management can follow to assess and document fraud risk. Also, if the Commission wants management to address fraud in a manner consistent with the AICPA guidance, the Commission could incorporate it by reference.

IV. Management's Evaluation

The COSO framework, which most companies use as the basis for internal controls, is made up of five equal components. However, the major focus is on one section – control activities. AS2 has established requirements for the assessment and audit of internal control over financial reporting, and AS2 focuses primarily on control activities. Management has been hesitant to utilize monitoring due to this focus. For example, the May 16, 2005 guidance from the PCAOB that further explains the timing of testing and rollforward work by the auditor does not indicate how monitoring activities might be used. The Commission should provide specific guidance to management on the timing of testing and the role of monitoring activities. This could substantially reduce the number of hours spent by management on control testing while still providing a basis for management's assessment.

A problem companies have had in applying entity-level controls and monitoring activities to the lower-level transactional controls has been in determining the extent of testing needed. Guidance has been issued that says entity-level controls and monitoring activities, as well as other factors such as nature, frequency, and importance, should affect the extent of testing. However, no real link has been provided to show exactly how it affects the extent. For example, how is a control that has been tested using a selection of 25 items in the prior year with no deficiencies affected by

monitoring activities? Should that activity be tested using 5 items in the current year? Or could monitoring activities in that area mitigate the need for any item to be tested?

Further guidance on evaluating control deficiencies would be helpful, especially for items that have an indirect, but pervasive, effect on the financial statements. An example is information technology control deficiencies. Applying the "prudent official" framework to IT or other controls is vague and non-descriptive. Also, control deficiencies in entity-level controls are hard to evaluate, as their impact on the financial statements cannot reasonably be quantified. The main considerations for evaluating deficiencies currently are the potential quantitative impact on financial statements, length of time outstanding, and actual number of exceptions documented. Further guidance on how to consider qualitative aspects and mitigating entity-level controls could lead to a more accurate classification of deficiencies.

V. Documentation to Support the Assessment

Current consensus appears to be that the initial amount of documentation completed by management was in excess of what was needed to satisfy the requirements. Much of this was due to the uncertainty about the requirements of the external auditors and because management was unsure as to what was required for companies. Guidance on how to apply entity-level controls and monitoring activities to lower-level transactional controls could help avoid excessive documentation.

Despite the guidance issued by the PCAOB, external auditors still have a "sign-and-file" approach to documentation, as previously mentioned in the Introduction section. This can, and does, cause unnecessary work by management while not providing primary evidence of the control effectiveness. Further guidance on re-performance, inquiry, and observation and the related documentation could allow for strengthened evidence of operating effectiveness while reducing time spent on unnecessary documentation.

Lastly, the Commission should provide management with a guide on how long to retain the documentation to support its assessment.

Sincerely,

Daniel J. Waxenberg
Assistant Vice President, Internal Controls
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