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These comments address the need for clarity in three broad aspects of management assessments of internal control over financial reporting (ICFR) effectiveness: (1) quantitatively material misstatement and reasonable assurance, (2) potential impact disclosure for "super-material" control weaknesses, and (3) minimum ICFR documentation and testing. All interpret implications of SOX section 404.

1. Quantitatively material misstatement and reasonable assurance

A financial statement audit is intended to provide *reasonable assurance* that financial statements present fairly in all *material* respects an entity's financial position, results of operations, and cash flows in conformity with GAAP. The two italicized parameters affect the cost and value of audited financial and internal control reporting.

Quantitative aspects of possible financial misstatements are reflected in the "quantitatively material amount," or the *minimum* amount of aggregate misstatement judged to be important to investors. For a typical company and a typical year, this amount is often judged to be 5% of net income. Thus, if individual and aggregate misstatements are less than 5% of net income, then the financial statements are "fairly presented in all material respects," other things equal.

When planning a financial statement audit, the auditor must consider the risk that misstatement of particular financial statement items might, individually, exceed the material amount. The auditor must also consider the risk of hypothetical and individually *immaterial* misstatement amounts that, when aggregated across the entire consolidated income statement or balance sheet, would exceed the material amount. Related judgments about known, likely, and hypothetical misstatements are required at audit completion when determining whether financial statements should be deemed free of material misstatement.

These difficult judgments about possible misstatements of various magnitudes are now required for ICFR audits under AS No. 2, and some issuers now make the same judgments for ICFR assessments. These issuers start ICFR assessment at the individual process level (a bottom-up approach) with management evaluating, for each important process, the risk of hypothetical immaterial misstatements that might aggregate to the material amount. Furthermore, these process-level judgments are made even though effective company-level controls are sufficient to detect any important misstatement that might arise at the process level.

> **Clarification needed:** Should the SEC provide guidance for issuer management that further encourages and explains the merits of a top-down approach?

Comment: A top-down approach might entail evaluating whether the issuer has effective company-level controls that provide (a) an environment that facilitates strong ICFR at the process level, (b) secure general controls over information technology, and (c) effective monitoring of both process-level controls and the resulting financial output. The top-down approach is less costly to apply because it does not necessarily require detailed analysis of hypothetical process-level misstatements. Also, it can be more effective because company-level controls are important – even when individual process-level controls are assessed as strong.

Empirically, the assurance achieved for financial statement audits has been above 99%. The PCAOB's Auditing Standards clearly indicate that investor assurance for annual financial statement audits is to be maintained even in the presence of weak ICFR. However, the level of assurance for misstatement in *unaudited quarterly* financial statements could be adversely affected by ICFR weaknesses.

Clarification needed: In the presence of material weakness in process-level ICFR, should issuer management (or the auditor) further examine the particular quarterly financial statement amounts potentially affected by the weakness?

Comment: In some contexts, it is cheaper to detect and correct misstatements than it is to prevent them. Allowing the option of after-period-end examination procedures can be an economical way to protect investors from material financial misstatement.

In addition to its role in financial statement audits, the term reasonable assurance also applies to ICFR through the Foreign Corrupt Practices Act, SOX section 404, SOX-related SEC guidance, and the PCAOB's AS No. 2. In contrast to financial statement audits, many believe that assurance that is "reasonable" for ICFR assessments is much lower than 99% (perhaps 90% or 80%) due, in part, to inherent limitations of internal control such as collusion, management override of ICFR, and management fraud.

Clarification needed: Should investors and others equate reasonable assurance as provided by financial statement audits with reasonable assurance for management's ICFR assessments and the auditor's opinion about ICFR effectiveness?

Comment: If the answer is yes, then is it both necessary and possible to achieve 99% assurance for management assessments, for ICFR audits, and for audits of financial statements produced by ICFR? If the answer is no, then additional guidance could both reduce the cost of implementing SOX section 404 and better inform investors.

2. Potential impact disclosure for "super-material" control weaknesses

At present, neither the SEC nor the PCAOB mandates differential disclosure of the misstatement magnitudes that might arise from a material weakness in ICFR. Yet the maximum potential misstatement from a company-level weakness can be several times that from a process-level weakness.

For example, a material (process-level) weakness may be deemed to exist when, due solely to an issuer's lack of accounting expertise, the issuer's financial statements provide no tax-related amounts. But the financial statements are not impaired if the appropriate tax-related amounts are, in fact, zero. On the other hand, a company-level weakness, such as weak general controls over information technology, exposes investors to *super-material* aggregate misstatement – perhaps five to ten times the material amount.

> **Clarification needed:** Should unaudited quarterly financial statements warn investors about super-material misstatements that could arise from ICFR weaknesses?
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> **Comment:** Disclosure of potential super-material misstatements is more important than hypothetical immaterial misstatements that might aggregate to the material amount. Furthermore, disclosure would require no added investigation expense.

3. Minimum ICFR documentation and testing

Present management practices for ICFR assessments are dominated by detailed description and extensive effectiveness testing of process-level controls. Auditors also conduct extensive effectiveness tests of the controls.

These extensive bottom-up approach practices would seem particularly expensive and unnecessary for the non-accelerated filer who has (a) effective management oversight, and (b) an auditor who, for financial statement audit efficiency, chooses not to rely on process-level controls, but instead conducts more financial audit procedures that also yield indirect evidence about process-level ICFR effectiveness.

As an alternative, issuers with effective company-level controls might satisfy requirements of SOX section 404 through an option for process-level control effectiveness assessment. Each key process-level control would be (a) described and the description confirmed by a walk-through and (b) evaluated as to design effectiveness but then (c) evaluated as to operating effectiveness by management analysis of exceptions noted through internal monitoring and by review of actual misstatements detected by the financial statement auditor for evidence of ineffective process-level controls.

> **Clarification needed:** Should non-accelerated filers (and perhaps others with special circumstances) be granted specific documentation and testing options that reflect their circumstances?
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> **Comment:** Requirements (a) and (b) above would reveal process control design and implementation defects and assist the financial statement auditor in audit planning. The new option (c) would substantially reduce cost of effectiveness testing by issuers and auditors while maintaining investor protection (several sources indicate that at least 80% of ICFR weaknesses of accelerated filers are detected by financial audit procedures).