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

File No. S7-24-06
Management's Report On
Internal Control Over Financial Reporting
Release Nos. 33-8762; 34-54976

Dear Ms. Morris:

KPMG welcomes this opportunity to respond to the Securities and Exchange Commission's (the Commission) request for comment on its proposed guidance, Management's Report on Internal Control Over Financial Reporting (Proposed Guidance). First and foremost, we wish to recognize the significant efforts of the Commission and its staff in responding to the formidable challenge of striking an appropriate balance between enhancing investor protections and the costs associated with reporting on internal control pursuant to Section 404 of Sarbanes-Oxley. We believe that the Proposed Guidance, taken together with the PCAOB's proposed auditing standards, will result in a reduction of the total section 404 compliance effort.

Fundamentally, we believe that compliance with the provisions of Section 404 of Sarbanes-Oxley provides needed protections to investors of all companies, regardless of size or complexity. We believe that internal control reporting pursuant to Section 404 has made, and will continue to make, a significant contribution toward improving financial reporting, corporate governance and audit quality, all serving to further the public interest and restore confidence in our capital markets. In addition, the benefits realized by compliance with Section 404 extend beyond improved internal control and financial reporting. Many issuers that have implemented robust management evaluation and assessment processes initially designed to support Section 404 compliance, have realized enhancements in operations, regulatory compliance, communications and documentation.

We believe that the Proposed Guidance provides sufficient flexibility to facilitate scalability and will help resolve uncertainties associated with management's approach to

evaluation and assessment of internal control over financial reporting (ICFR). In addition, we believe that the Proposed Guidance reminds issuer managements that fulfilling their responsibility to maintain effective ICFR is fundamental to satisfying their investor protection obligations – a notion critical to ensuring the viability of our capital markets system.

We fully support the following core principles evidenced in the Proposed Guidance:

- A principles-based approach to management's assessment that can be scaled to the size and complexity of the issuer;
- A top-down, risk-based approach to management's assessment that directs management to test those controls that are most important to the issuer's financial reporting; and
- The requirement that management test the operating effectiveness of controls over financial reporting each year.

We believe that subjecting management's assessment of ICFR to external audit pursuant to Section 404(b) necessitates a certain degree of documentation and formality. The benefits of ICFR reporting are due, in part, to the discipline and rigor of management's evaluation and assessment of the effectiveness of ICFR. We believe that it is important to recognize that the flexibility afforded management in the Proposed Guidance may result in similar benefits not being realized by issuers complying with the provisions of Section 404 for the first time and that the Commission should remain cognizant of this potential consequence when finalizing its management guidance.

We recognize that management may employ a variety of alternatives to assess the effectiveness of ICFR, and that management's assessment and the auditor's audit is not conducted in the same manner. However, effective interaction between management and the auditor is essential to promote the efficient execution of an integrated audit. Effective interaction between management and the auditor facilitates coordination of the combined work effort and optimum use of the work of others by the auditor. To that end, we believe that the Commission should consider including an *Interaction with the Independent Auditor* section in its final guidance that addresses the coordination and interaction necessary to comply with the provisions of Section 404 in the most effective and efficient manner.

Compliance with the provisions of Section 404 has placed important responsibilities on issuers and auditors that, in many instances, have required the dedication of significant resources. As previously noted, we believe that the Proposed Guidance, taken together with the PCAOB's proposed auditing standards, will result in a reduction of the total Section 404 compliance effort. In our comment letter to the PCAOB, we support the enhancements to its auditing standards emphasizing or providing for (i) the increased use of professional judgment, including the assessment of audit coverage; (ii) the ability to use cumulative knowledge obtained during prior audits in considering the nature, timing and

extent of current year audit procedures; (iii) elimination of the requirement to evaluate management's assessment process; and (iv) increased use of the work of others, assuming certain conditions are met.

The extent of these reductions in effort will vary significantly based on each issuer's particular facts and circumstances. The quality of an issuer's control structure and processes, the relative complexity and business risks of an issuer, and the quality of management's evaluation and assessment process, including relevant documentation, all are factors that will affect reductions to the overall Section 404 compliance effort and the relative balance of such reductions between management and the auditor.

Because of the myriad factors involved, we do not believe that reductions in the total Section 404 compliance effort can by synthesized into specific or across-the-board reductions in Section 404-related compliance costs for all issuers. While the reductions in effort will vary, a constant in the equation is the acknowledgement that the maximum benefits will be achieved when management and the auditor work in a coordinated manner, and when the auditor can make effective use of the work of others. For example, the quality of management's evaluation and assessment of internal control, including relevant documentation, directly impact the effectiveness and efficiency of the external audit.

We are committed to supporting continued improvements in the effectiveness and efficiency of Section 404 compliance and believe that the Commission's Proposed Guidance facilitates progress in that direction and upholds investor protections that are critical to the effective functioning of our capital markets. This letter is organized by first providing our principal observations on the Proposed Guidance. Less significant and editorial comments and suggestions are included in the Appendix to this letter.

Documentation and Management's Evaluation and Assessment

We do not believe that management can perform an effective evaluation and assessment of ICFR without documentation of its key processes and controls. In addition, we believe that an effective management evaluation and assessment process requires some form of documentation evidencing procedures performed and related findings. The form and extent of such documentation is a matter of management judgment and will vary depending on the size, nature and complexity of the entity.

The quality of management's documentation and its evaluation and assessment of internal control have a direct impact on the effectiveness and efficiency of the external audit. For example, to the extent that documentation of an issuer's design of controls is insufficient to enable auditors to satisfy their requirements, auditors will be required to create such documentation, thereby increasing audit effort. In addition, the quality of management's documentation of its evaluation and assessment of ICFR directly affects the auditor's ability to use the work of management and others under the direction of management in executing an effective and efficient integrated audit. Clearly, the auditors' ability to use the

work of management improves as the quality of documentation of internal control design and management's assessment and evaluation increases.

The following statements in the Proposed Guidance illustrate the degree of flexibility afforded management when complying with the provisions of Section 404 and speak to the expected quality of management's documentation and evaluation and assessment process:

- "In a small company with less complex business processes…, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks." (p. 24)
- "In smaller companies, management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR." (p. 37)
- "For example, in smaller companies, where management's daily interaction with its controls provides the basis for its assessment, management may have limited documentation created specifically for the evaluation of ICFR." (pp. 38-39)

As noted above, we believe that the Commission should consider including an *Interaction with the Independent Auditor* section in its final guidance that addresses the coordination and interaction necessary to comply with the provisions of Section 404 in the most effective and efficient manner.

Identifying Controls that Adequately Address Financial Reporting Risks

One of the stated broad principles in the Proposed Guidance (p. 16) is that "…management should evaluate the design of the controls that it has implemented to determine whether they adequately address the risk that a material misstatement in the financial statements *would* not be prevented or detected in a timely manner" [emphasis added]. The Proposed Guidance directs management to focus on those controls necessary to adequately address the risk of a material misstatement in its financial statements, and indicates that, if risks for a particular financial reporting element are adequately addressed by an entity-level control, then no further evaluation of other controls is required.

Due to the importance associated with selecting the appropriate controls, including entity-level controls, for management to rely upon to effectively address financial reporting risks, we encourage the Commission to provide additional guidance for evaluating control design effectiveness. An effectively designed control not only "*could*," but "*would*," detect a material misstatement in the financial statements. We recommend that this concept be highlighted in the Commission's guidance on identifying controls that adequately address financial reporting risks. For example, the level of precision at which controls involving evaluation of Key Performance Indicators (KPIs) are designed and operate is a key factor in assessing the effectiveness of such controls. Controls evidenced by reconciling company-level financial results with general industry and economic trends ordinarily do not operate

at a sufficient level of precision because they *could*, but not necessarily *would*, prevent or detect a material misstatement in the financial statements.

We recommend that the Commission expand its guidance on identifying controls that adequately address financial reporting risks to incorporate illustrative examples of controls, particularly entity-level or company-level controls, that would be considered effective. In addition, we believe that the Commission's guidance on determining whether such controls are designed and operating effectively should be consistent with the PCAOB's guidance on the same subject (refer to paragraphs 43 and 44 of the PCAOB's proposed auditing standard on an audit of internal control over financial reporting).

Consistency Between Proposed Guidance and PCAOB Proposed Auditing Standards

Certain provisions of the Proposed Guidance appear to be inconsistent with the PCAOB's proposed auditing standards. We support the Commission's objective to develop management guidance that is not dependent on the PCAOB's proposed auditing standards and recognize the need for management and auditors to employ different approaches. However, the use of different terms in the respective guidance could frustrate efforts to improve the effectiveness and efficiency of the process and limit the ability of the auditor to use the work of others. For example:

Strong Indicators of a Material Weakness. The description of strong indicators of a material weakness in internal control in the Proposed Guidance (pp. 44 - 46) omits one item that is in the PCAOB's proposed auditing standard's description of strong indicators - an ineffective internal audit function or risk assessment function at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies. In addition, the Proposed Guidance includes "ineffective oversight of the company's external financial reporting and ICFR by the company's audit committee" as a circumstance that may indicate an ineffective control environment, whereas the proposed auditing standard includes this control deficiency as a strong indicator of a material weakness.

We do not believe that inconsistencies should exist between the Commission and PCAOB guidance associated with the determination of severity of identified internal control deficiencies. Accordingly, we believe that the Commission's Proposed Guidance should be revised to reflect strong indicators of a material weakness in ICFR consistent with those in the PCAOB's proposed auditing standard.

Significant Accounts/Financial Reporting Element. The Proposed Guidance (p. 23) refers to potential misstatements in "financial reporting elements" and indicates that, "[t]he methods and procedures for identifying financial reporting risks will vary based on the characteristics of the company." The Proposed Guidance (p. 23, footnote 50) also states that, "the guidance in this proposed interpretive release does not prescribe a particular

methodology for the identification of risks and controls," and "[w]hile the May 2005 Staff Guidance used the term 'significant account,' which is used in AS No. 2, we are not requiring that companies use the guidance in the auditing literature to conduct their evaluation approach."

While we fully support the Commission's views that a "one size fits all" approach to management's evaluation and assessment is not appropriate, we believe that consistency in the methodology for the identification of financial reporting risks will provide a consistent basis for management and the auditor to evaluate ICFR. If the Commission elects to retain this guidance as proposed, we believe that definitions of "financial reporting element" and "financial reporting risk" would be helpful. In addition, the terminology "financial statement element, or component thereof" (p. 42) should be more clearly defined.

In summary, if key differences between management's guidance and the PCAOB's proposed auditing standards are maintained, we encourage the Commission to address these matters in the final guidance and their implications to compliance with both Sections 404(a) and 404(b) of Sarbanes-Oxley. See also, "Documentation and Management's Evaluation and Assessment".

Foreign Private Issuers

The scoping and deficiency evaluation considerations associated with foreign private issuers' reconciliation of primary financial statements to U.S. GAAP are not clear in the Proposed Guidance. The Proposed Guidance (p. 21, footnote 47) states, "[m]anagement of foreign private issuers…should plan and conduct their evaluation process based on their primary financial statements (i.e., home country GAAP or IFRS) rather than the reconciliation to U.S. GAAP." This statement could imply that the U.S. GAAP reconciliation is not within the scope of internal control reporting.

However, footnote 73 of the Proposed Guidance states, "[b]ecause of the importance to investors of the reconciliation to U.S. GAAP, when management of foreign private issuers…determine[s] the severity of an identified control deficiency, management should consider the impact of the control deficiency to the U.S. GAAP reconciliation disclosure" and "[f]or example, it would be inappropriate to determine, without further consideration, that a control deficiency associated with an item included in the reconciliation to U.S. GAAP, is not material to the primary financial statements, and therefore cannot be, by definition, a material weakness." This element of the Proposed Guidance, particularly the illustrative example, implies that reconciling items contained in the U.S. GAAP reconciliation are within the scope of ICFR.

We believe that scoping decisions associated with management's evaluation and assessment should be predicated on the issuer's primary financial statements. Additionally, we understand that the Commission staff indicated earlier in 2006 that the U.S. GAAP

reconciliation is within the scope of ICFR for purposes of reporting under Section 404. We encourage the Commission to clarify these matters in the Commission's final guidance.

The Proposed Guidance on evaluating the severity of identified internal control deficiencies for foreign private issuers that reconcile to U.S. GAAP also should be clarified in the Commission's guidance. For example, is the potential magnitude of an internal control deficiency considered relative to the foreign private issuer's primary financial statements, the individual elements of the U.S. GAAP reconciliation (if applicable), or the disclosed U.S. GAAP operating results?

Reassessments of ICFR and Disclosure Controls and Procedures

The Proposed Guidance is unclear regarding whether, or to what extent, management should reassess ICFR and/or disclosure controls and procedures in conjunction with a restatement of previously issued financial statements to correct an error. For example, the Proposed Guidance (pp. 47- 48) states that "…the restatement of financial statements does not, by itself, necessitate that management consider the effect of the restatement on the company's prior conclusion related to effectiveness of ICFR." The Proposed Guidance (p. 48) further states, "[w]hile there is no requirement for management to reassess or revise its conclusion related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement." The Proposed Guidance includes similar discussion relative to disclosure controls and procedures when an issuer restates its previously issued financial statements to correct an error.

We believe that the above-referenced guidance is confusing. In addition, we believe that the restatement of previously issued financial statements to correct an error does, in fact, necessitate that management consider the effect of the restatement on management's prior conclusions relative to ICFR and disclosure controls and procedures.

Existing and proposed PCAOB auditing standards (paragraph 197 of AS No. 2 and paragraph 108 of the proposed auditing standard) require auditors to reassess management's assessment of ICFR upon a restatement of previously issued financial statements to correct an error. Accordingly, we believe that the statements in the Proposed Guidance that management need not consider the effect of a financial statement restatement on the company's prior conclusions relative to the effectiveness of ICFR and disclosure controls and procedures introduce a variation between management and auditor responsibilities that we are unable to reconcile.

We recommend that the Commission clarify its guidance on these matters. In addition, we believe that the Commission's guidance on these matters should be aligned with the auditor's responsibilities articulated in the PCAOB's auditing standards.

Consideration of Fraud

Effective internal control over financial reporting can help companies deter fraudulent financial accounting practices or detect them earlier, and perhaps reduce the related adverse effects. The Commission's Proposed Guidance discusses management's need to evaluate financial reporting risks and consider the entity's vulnerability to fraudulent activity. However, we believe that the Commission's guidance should focus more attention on anti-fraud controls and procedures that should be considered by management to help prevent or detect fraudulent financial reporting.

As noted in footnote 49 of the Commission's Proposed Guidance, reference is made to *Management Antifraud Programs and Controls - Guidance to Help Prevent, Deter, and Detect Fraud*, which was issued jointly by seven professional organizations. We suggest that relevant concepts from this guidance be incorporated directly into the Commission's guidance to more completely articulate management's consideration of fraud risks and controls to address these risks.

Frequently Asked Questions

We recommend that the Commission retain, or incorporate into its guidance; the concepts in certain of its previously issued frequently asked questions included in Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions (FAQ). FAQs to consider for retention include:

FAQ 1 – Scope of management's report – consolidation of variable interest entities and proportionate consolidation
FAQ 2 – Scope of management's report – equity method investee
FAQ 3 – Scope of management's report – material purchase business combination
FAQ 4 – Timely and current filing status
FAQ 6 – Reportable disagreement
FAQ 7 – Accelerated filing status
FAQ 8 – Management's report in a transition filing
FAQ 12 – As-of-date for entity consolidating a subsidiary on a lag basis
FAQ 14 – SAS 70 – service organization auditor also is user organization auditor
FAQ 17 – Assistance provided to audit clients
FAQ 20 – Use of the term "material weakness" in management's assessment
FAQ 21 – Consent related to the auditor's report on management's assessment of ICFR
FAQ 22 – Annual report to shareholders
FAQ 23 – Supplementary information.

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We believe that the above FAQs continue to be applicable and provide useful guidance to management for performing an effective evaluation and assessment of ICFR and promote consistency in issuer compliance with Section 404(a) of Sarbanes-Oxley.

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We support the Commission's efforts to provide additional guidance for management to assist in its evaluation and assessment of internal control over financial reporting pursuant to Section 404 of Sarbanes-Oxley, and we appreciate the opportunity to provide comments on the Proposed Guidance. If you have any questions regarding information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

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Appendix

The following comments and other suggestions considered less significant or editorial in nature are presented for your consideration.

1. The Proposed Guidance (p. 21) states, "[m]anagement ordinarily would consider the company's entity-level controls in both its assessment of risk and in identifying which controls *adequately* address the risk" [emphasis added]. We recommend that the Commission clarify the meaning of "adequately" and whether "adequately" is intended to be synonymous with "effectively." If the terms are considered synonymous, we recommend that the Commission use "effectively" in lieu of "adequately" to avoid unnecessary confusion. If the terms are not synonymous, we believe that the Commission should clarify its definition of "adequately."

2. We recommend that the first sentence in the first full paragraph on page 28 of the Proposed Guidance be revised as follows, "Management should consider whether, and the extent to which, general IT control objectives related to program development, program changes, computer operations, and access to programs and data apply to its facts and circumstances." We believe that management always should consider whether and to what extent general IT control objectives apply to its facts and circumstances.

3. The Proposed Guidance (p. 29) states, "[m]anagement should also consider the need to maintain evidential matter, including documentation, of the entity-wide and other pervasive elements of its ICFR that it believes address the elements of internal control that its chosen control framework prescribes as necessary for an effective system of internal controls." We believe that this guidance may be interpreted that there are certain circumstances where no evidential matter, including documentation, may need to be maintained and recommend that the guidance be clarified accordingly.

4. We recommend that the last sentence on page 35 of the Proposed Guidance be revised as follows, "Further, activities performed to meet the monitoring objectives of the control framework may provide evidence to support the assessment." We believe that this change is necessary because not all monitoring activities will provide evidence to support management's assessment.

5. The Proposed Guidance (pp. 46 - 47) provides items that management should consider disclosing regarding reported material weaknesses. Such items include "management's plans, if any, for remediating the weakness" and "the root cause of the control deficiency." The proposed auditing standard and AS No. 2 appropriately require auditors to disclaim on such "additional information" if it is included within "Management's Report on Internal Control Over Financial Reporting." Accordingly, to avoid confusion, we recommend that the Proposed Guidance suggest that these types of disclosures be provided outside of "Management's Report."