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Comments on File No. S7-24-06, Management's Report on Internal Control Over Financial Reporting

Submitted Electronically on February 26, 2007

The Silicon Valley Leadership Group appreciates the opportunity to submit comments in respect to the Securities and Exchange Commission's Release No. 33-8762 and 34-54976 regarding Management's Report on Internal Control Over Financial Reporting (File No.: S7-24-06, the "Release").

This Release is largely concerned with Section 404(a) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), while the Leadership Group's attached Section 404 Reform Recommendations focus principally on Section 404 (b) requiring auditor attestation regarding financial controls; in particular the adverse impact on smaller public companies, and the competitiveness of U.S. capital markets, of its burdensome and costly requirements.

The Leadership Group has separately offered comments on the companion PCAOB Release Number 2006-007, "An Audit of Internal Control Over Financial Reporting that is Integrated with a Audit of Financial Statements" ("PCAOB Release"), which follows.

Our comments will therefore first address the change proposed in the Release to the Commission's current rule implementing Section 404(b). We commend the proposed modifications to Rules 1-02(a) and 2.02(f) of Regulation S-X, eliminating the separate auditor's attestation as to management's assessment of internal controls, which has created significant confusion, inconsistency and duplication of effort, all of which have been especially burdensome for smaller public companies.

We agree with the Commission's focus on a direct opinion on the effectiveness of internal controls. Moreover, we believe that the foundation and framework for such opinion is included in preexisting auditing requirements, specifically under AU Section 319, and hence, does not require duplication or supplementation, under Section 404(b) of the Sarbanes-Oxley Act or otherwise. As the Commission itself has stated, the "establishment and maintenance of internal controls has been required of public companies since enactment of the Foreign Corrupt Practices Act of 1977", which was implemented by AU Section 319.

Accordingly, in specific response to the Commissions question as to whether this proposed rule revision effectively communicates the auditor's responsibility or whether "another alternative would better convey the auditor's role with respect to management's assessment and the auditor's reporting obligations," we believe that further clarification is required. This will prevent unnecessary cost, duplication of effort and confusion on the part of auditors and companies in connection with the preparation and audit of financial statements and the assessment and reporting on internal controls. Fortunately, we believe the clarification is apparent and leverages current practices. The preexisting requirements of AU Section 319 mandate an auditor to assess a Company's internal controls in connection with its standard audit and audit opinion process.

It is our belief that these requirements are sufficient, in and of themselves, to support and satisfy the auditor attestation/opinion requirements of Section 404(b). Moreover, it is our belief that conformance of Section 404(b) with AU Section 319 will significantly achieve the Commission's current objectives to reduce confusion, work duplication and inconsistency. Accordingly, we respectfully suggest that the following alternative language would be more properly aligned with the clear legislative intent of Sarbanes-Oxley that the auditor's assessment of internal controls should be considered an integral part of the audit report "and not the subject of a separate engagement."

Specifically, we propose that the Commission simply confirm by rule that:

A. "Compliance with the requirements of AU section 319 constitutes compliance with Section 404(b);"
B. "The requirements of related Section 103 (a)(2)(A)(iii) of the Act are deemed satisfied by a description of the standard processes used by the relevant auditor to comply with AU section 319;" and
C. "Nothing in Section 404(b), or elsewhere in the Sarbanes-Oxley Act of 2002, shall be deemed to modify AU section 319 in any manner or to impose additional requirements or procedures with respect to the compliance therewith."

The Leadership Group's further comments and responses to the Commission's questions at pages 49-51 and 53-54 of the Release are limited to the provisions of the Release which address the concerns raised in our adopted position.

Our position relative to Section 404 (a) suggested modification of the timeframe for management's testing of internal controls to a three-year cycle based on a risk assessment model. We also urged clarification of the Commission's and PCAOB's guidance concerning the meaning of terms such as "significant deficiency," "remote likelihood" and "material weakness".

Accordingly, we are pleased that the Commission has provided specific guidance to management to adopt what our position termed a "top-down, risk-based approach" to determine whether internal controls adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner, and further that management's "evaluation should be based on its assessment of risk". We believe that such an assessment model would indeed allow for the rotational approach to testing controls that the Leadership Group has suggested.

We also support the effort by the Commission, as well as the PCAOB in its parallel Release No. 2006-07 (the "PCAOB Release") to clarify definitional issues and thereby address the lack of clarity and agreement between auditors and their regulators which is resulting in undue burdens on all public compliances.

We note that the Commission's definition of "smaller" companies in the Release with specific reference to the existing definition of "large accelerated filers" is a helpful clarifying step.

The Commission's useful new definition of material weakness provided at page 13 of the Release, however, begs the question whether the PCAOB "re-articulation" of its definition of the same term will be understood the same way. It is essential that the current lack of clarity between <u>auditors</u> and the PCAOB not be replaced and exacerbated by lack of consistency between the <u>Commission</u> and the PCAOB. We will address such apparent inconsistencies in our separate letter of comments on the PCAOB Release.

In terms of the specific questions raised at pages 53-54 of the Release concerning the Commission's interpretive guidance for management's assessment of the effectiveness of internal controls, we believe that such guidance should be:(i) voluntary in terms of issuer choice, since many have adopted their own processes while waiting five years for specific guidance from the Commission; (ii) implemented by rule, to provide maximum clarity going forward; and (iii) deemed a <u>non-exclusive</u> safe harbor for demonstrating compliance with Section 404(a).

This new specific guidance is clearly preferable to the current state of affairs, which the Commission itself acknowledges has led management to misapply the PCAOB's Auditing Standard No. 2 regarding audit firms' internal control attestation to the management assessment process. Auditing Standard No. 2 was never intended to serve this purpose, and has in fact been so ineffective in serving the purpose for which it was intended that the PCAOB Release abandons it altogether in favor of a wholly new formulation of standards for the auditor's attestation. This new standard is "integrated with" the audit of the company's financial reports: we are pleased that this recasting at least of the title of the Auditing Standard for Section 404 (b) is consistent with the core recommendations of the Leadership Group.

Finally, we address the Commission's question at pg. 53 of the Release as to whether it should "consider change to other definitions or rules". In light of our belief (now apparently shared by the PCAOB) that the nature of the internal controls audit under Section 404 (b) must be truly integrated with the financial report audit and no longer a separate opinion "in conjunction with" such audit, we return to our central concern: the extraordinarily adverse effect of the Section 404(b) regulatory framework on smaller public companies.

Although the Commission argues that its new "top-down, risk-based approach should enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances," it is really not yet clear that the PCAOB Release will result in an equivalently scaleable approach to the auditing of internal controls.

The PCAOB Release does assert that the auditor should evaluate the "size and complexity" of the company when planning and performing such audits, and lists six specific attributes where the audit of a smaller company "might vary from the audit of a larger and more complex company" (PCAOB Release, Paragraphs 9-12). However, the PCAOB also indicated that these six attributes would provide the foundation for planned guidance on auditing internal controls in smaller companies "to be issued next year". Thus, it appears there will not be any truly comprehensive PCAOB guidance on Section 404(b) in respect to smaller companies until 2008 at the earliest.

We therefore reiterate our earlier view that, in light of the potential for continuing confusion and significant cost, smaller companies should be exempted by the Commission from Section 404 (b) compliance, at least until both the Commission and the PCAOB promulgate specific and internally consistent guidance for both management and auditors in respect of internal control attestation. Smaller public companies cannot afford to "wait till next year".

In conclusion, we note that an alternate approach to relieve the duplicative, burdensome and costly impact of 404 (b) compliance requirements would be to remove the requirement for auditor attestation of the financial controls themselves and instead require solely an attestation of management's assessment of such controls. This is, of course, the opposite of the current proposal but offered in the same spirit. We believe this approach is worthy of serious consideration on the parts of both the SEC and the PCAOB because it would appear to have a more far-reaching and salutary impact on the issues of complexity and excessive costs. Furthermore, it may be the best way in a regulatory context to emphasize the primacy of management's responsibility over internal controls over financial reporting. We would be pleased to provide additional comment should the SEC and PCAOB choose to explore this alternative further.

Sincerely,

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Sarbanes-Oxley Section 404 Reform Recommendations

Adopted December, 2006

The Sarbanes-Oxley Act of 2002, commonly known as SOX, is a set of accounting and auditing rules applicable to publicly-traded US companies which has resulted in significant costs to those corporations – particularly for compliance with Section 404.

SOX compliance brings with it a heavy burden that strains resources that could otherwise be used for critical research and development or other corporate initiatives to improve company management, expand into new markets and increase investor value.

While we are heartened by recent developments at the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) to address the challenges identified by the business community, we support significant regulatory and/or legislative relief from the burdens imposed by Section 404(b) by exemption of smaller public companies and other means.

The Leadership Group and its member companies categorically support the objectives of the Sarbanes-Oxley Act of 2002; namely, to achieve increased management accountability for establishing and maintaining disclosure controls and procedures and enhanced internal control over financial reporting and detection of fraud and malfeasance.

However, the Leadership Group does not support the application of Section 404(b) to smaller companies – that is, companies that do not meet the definition of an accelerated filer. Due to lower staffing levels and insufficient earnings, smaller and micro-cap companies can not support the burdensome administrative overhead required to successfully comply with Section 404(b).

We feel that Section 404(b) is damaging the competitiveness of U.S. capital markets as it has been applied. We are already noting a trend of an increasing number of private companies seeking initial public offerings on foreign stock markets to avoid the costly requirements of Section 404(b) compliance.

The member companies also feel that a lack of clarity and agreement between the auditors and their regulators regarding Section 404(b) has resulted in undue burdens on all public companies. We therefore recommend a thorough review of 404(b), implementation of clearer guidance, and greater conformance with pre-existing audit standards - within six (6) months - for accelerated filers.

In light of such confusion and significant costs, the Leadership Group recommends that smaller companies be exempt from SOX Section 404(b), and that the SEC and the PCAOB quickly move to establish clearer guidance regarding its implementation for accelerated filers. We hope this can be achieved largely by confirming that compliance with existed, well-established standards, such as AU section 319, constitutes compliance with Section 404(b).

Short of the above recommendations, there are alternative means to modify Section 404 and the applicable audit standard to effectively achieve the objectives of SOX internal control assessments than under current practice – to whit:

- Move to a performance-based system of ***conducting external SOX audits on a rotating basis*** (as described in the attached matrix) for those companies who have achieved an annual audit with no material weaknesses. While we agree that detailed internal controls documentation is essential for all complex and high volume transaction processes, we encourage ***more widespread use of the integrated audit***, whereby substantive audit procedures supplemented with summary controls documentation will suffice for certain non-complex and low volume transaction processes.

- ***Modify the timeframe for management testing*** of internal controls to span a longer period, ***e.g. three year cycle***, ***based on a risk assessment model***. With this approach, ***higher risk processes/controls are tested annually***, and lower risk processes/controls are tested on a rotating basis. A risk-based approach to testing permits more time and emphasis to be placed on higher risk areas and internal control enhancements. While this model will ***require close coordination between auditors and their clients,*** we do not believe it would result in any notable incremental effort over the amount currently expended to coordinate management and external auditor testing.

- ***Encourage regulators to develop more detailed guidance for auditors*** to counter-balance the incentive for audit firms to interpret SOX conservatively. While understandable, a healthy counter-balance to this conservatism is required to prevent bloated, ineffective audit regimes. ***The PCAOB needs to clarify and codify risks, definitions, and scope*** – both quantitative and qualitative. We also recommend that PCAOB and SEC guidance surrounding key definitions relied upon in Section 404 compliance, including “significant deficiency”, “remote likelihood” and “material weakness”, be revisited.

We intend to actively engage in reform efforts at the PCAOB and SEC. In addition, if a proposal to amend SOX is introduced in the new Congress, such as the COMPETE Act of the previous session, we would consider that an excellent starting place for the reforms sought here.

Status	Events & Triggers	Audit Type	
		External	**Internal**
Year 1	Clean Opinion.	Full Scope Audit.	Full Scope Audit.
Year 2		Full Scope Audit for 1/3 of Companies, Based on a Rotating Schedule; Attestation and Management Certifications to Correspond.	Rotation of key control testing based on risk assessment.*
Year 3		Full Scope Audit for 1/3 of Companies, Based on a Rotating Schedule; Attestation and Management Certifications to Correspond.	Rotation of key control testing based on risk assessment.
Year 4 +		Cycle continues.	
Any Year - Isolated Material Weakness	*Isolated Material Weakness:* Limited to a single functional area or financial statement line item. (e.g., tax process or A/R financial statement line item).	Limited Scope Audit.	Full examination audit of key controls related to process or financial statement line item where material deficiency occurred. Rotation of key control testing based on risk assessment.
Any Year - Pervasive Material Weakness	*Pervasive Material Weakness:* More than one material weakness or multiple significant deficiencies involving a pervasive break-down in controls (e.g., personnel hiring / staffing deficiencies or pervasive lack of appropriate reconciliations or management reviews).	Full Scope Audit.	Full Scope Audit.
Plus - 1 Year	Clean Opinion.	Full Scope Audit.	Full Scope Audit.
(repeat cycle above)			
Any Year - Material change in entity-wide controls over financial reporting	For example, major changes in key company personnel or an ERP implementation.	*Full or Limited Scope Audit,* based on risk assessment. If change or factors could have a pervasive impact on processes and/or financial statement accounts, then full examination is called for.	*Full or Limited Scope Audit,* based on risk assessment.

* Risk assessment to include quantitative and qualitative considerations. With this approach, higher risk processes/ controls are tested annually, and lower risk processes/controls are tested on a rotating basis. A risk-based approach to testing permits more time and emphasis to be placed on higher risk areas and internal control enhancements.

Comments on Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

Submitted Electronically on February 26, 2007

The Silicon Valley Leadership Group (Leadership Group) appreciates the opportunity to comment on the PCAOB's recent Release Number 2006-007, "An Audit of Internal Control Over Financial Reporting that is Integrated with a Audit of Financial Statements" ("PCAOB Release").

Please find attached the Leadership Group's Section 404 Reform Recommendations, focused principally on Section 404 (b). Our comments in respect to the PCAOB Release will be focused primarily on the issues we raised in our adopted position.

The Leadership Group has separately offered comments on the companion Release Numbers 33-8762 and 34-54975 of the Securities and Exchange Commission (the "SEC"), "Management's Report on Internal Control Over Financial Reporting" (the "SEC Release"), which follows.

Given our concerns with the burdensome and duplicative expense associated with regulatory implementation of Section 404 (b) of Sarbanes-Oxley, we are pleased that the PCAOB has determined to replace current Accounting Standard No. 2 with an entirely new standard for internal control audits, and has also reframed the new standard for such audits at least as nominally "integrated with", rather than "in conjunction with", the annual audit of the issuer's financial reports.

We believe this is wholly consistent with the original Congressional intent of Sarbanes-Oxley that the audit of financial controls not be the subject of a "separate" audit engagement but rather be truly integrated with the financial statement audit. We believe, however, that the PCAOB could go further in offering specific guidance on how to ensure effective "integration" of the Section 404 and financial statement audits. We offer responses to the questions in this release to suggest how the PCAOB should provide additional guidance.

It is also essential that the confusion between the accounting profession and the PCAOB regarding Section 404 (b) implementation not be replaced or even exacerbated by inconsistencies between the PCAOB Release and the SEC Release in relation to key terms of reference for Section 404(b) implementation.

Below are our responses to Questions 1-27 posed in the Release.

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?

A top down approach is the most effective and efficient approach to assess the quality of a company's internal controls over financial reporting. However, the proposed standard does not provide the level of specificity required by auditors and their client companies to ensure that a consistent, defined standard is applied to all public companies. We believe the audit standard should provide examples of best practices in entity levels controls, which are common to most public companies. The standard should then prescribe the effect of a strong, moderate or weak control environment should have on follow on test work. For instance, if a Compensation sub-committee of the Board of Directors approves an employee incentive program from the outset and then approves or rejects the results of the program, what impact should that have on testing of management's detailed controls over the program, as compared to an employee incentive program with no Board of Director Oversight?

2. Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?

The Standard should be enhanced to provide more details on how an auditor should implement the top down approach, particularly as it pertains to assessing the entity level controls and risk of fraud. Again, if the Standard provided insight into deemed best corporate governance practices, an auditor can assess whether the client company has adopted such best practices and thus make a quantitative judgment regarding risk of fraud.

3. Will the top-down approach better focus the auditor's attention on the most important controls?

It could, but only if the Standard provides a better definition of corporate governance best practices which minimize the risk of fraud.

4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?

Not in its current form. The Standard should provide a better definition of corporate governance best practices which minimize the risk of fraud.

5. Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?

No. The standard should provide some specific examples. For example, the standard could provide that for lower risk processes, allowable evidence could include: self assessments and management reviews (e.g., evidence of balance sheet review), whereas areas that are deemed to be higher risk (e.g., revenue cut-off, or complex tax or stock option calculations) would require more specific objective evidence.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

Yes, and the standard should specifically allow the auditor to rely on walkthroughs performed in previous years – even for higher risk processes. The auditor could do an inquiry and consider the following factors: the process and people performing the process haven't changed, no additional risk factors have been introduced into the process, the process is low risk and/or the auditor will be perform substantive audit procedures of process anyway as part of the audit.

7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

No, the term 'significant' as a replacement of 'more than remote' is not helpful to companies or their auditors, as this middle tier of control deficiency unnecessarily increases the level of judgment and debate surrounding categorization of deficiencies. We propose that the middle tier known as significant deficiencies be eliminated and that all deficiencies be assessed in terms of 'control deficiencies' or 'material weaknesses'. The notion of a middle ground is the subject of unproductive debate.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor? How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?

No, it would appear to the casual observer that most material weaknesses materialize immediately subsequent to either an announcement of a company's restatement of its financials, or due to uncovering an accounting issue during the substantive audit. It does not appear that test work related to the internal control environment uncovers material weaknesses. The standard should focus auditors on the top ten material weakness areas such as quality and sufficiency of accounting staff, income taxes, revenue recognition, derivatives/fair value accounting, compensation, etc.

9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?

Yes, it is reasonable to expect that the use of a term that has been historically used in the accounting vernacular will decrease the assessment effort.

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present? Will this change improve practice by allowing the use of greater judgment? Will this change lead to inconsistency in the evaluation of deficiencies?

The assessment of deficiencies in an internal control environment is predicated on the professional judgment of both the Company's management and its auditors, the two parties most familiar with the facts and circumstances. Therefore, we agree that is makes sense that no particular deficiencies be prescribed as either significant or as a strong indicator or a material weakness. The company's management and its auditor are the only parties in a position to make this assessment and we should rely on their judgment, subject to regulatory oversight.

11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?

Move to a performance-based system of conducting external SOX audits on a rotating basis for those companies who have achieved an annual audit with no material weaknesses. While we agree that detailed internal controls documentation is essential for all complex and high volume transaction processes, we encourage more widespread use of the integrated audit, whereby substantive audit procedures supplemented with summary controls documentation will suffice for certain non-complex and low volume transaction processes.

12. Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what would be the effect on the scope of the audit?

The reference has previously been incorrectly interpreted by auditors to be a scoping reference. Codifying into the guidance itself that this relates solely to the assessment of deficiencies and not to provide additional scoping guidance should address the issue without having to remove the reference from the definitions.

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?

This change is positive, as there should be one opinion on the effectiveness of a company's internal controls over financial reporting. It could reduce management's work by not requiring management to meet the same audit standards that their auditors are required to meet, but if management plans to have auditors rely on their work (less direct testing by the auditor) then this change won't reduce management's effort - as reduced management effort would mean increased effort by auditors. It could help companies that don't have the resources internally to conduct extensive "formal" internal testing requirements, by allowing their auditors to perform that work.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

Yes - by directly testing the controls; but as pointed out in the guidance, if the auditor is going to rely on management work (work performed by others), then the auditor will still need to evaluate management's process.

15. Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

Yes, and investors need to understand if controls are effective and financials are not materially misstated.

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?

Yes. We believe good examples were provided to allow reduced direct testing for processes deemed to be lower risk and that have tested effectively in previous years' audits.

17. What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?

When the auditor has already performed a walkthrough of the process in the previous year and the process, and people performing the process, have not changed; where the testing has shown that the controls have repeatedly been effective; where no new risk factors have been introduced into the process; where the process is low risk, and/or the auditor will be performing substantive audit procedures for the process as part of the audit.

18. Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

This should help reduce the testing requirements for multi-location audits, but the proposed language could provide more specific examples (e.g., for testing processes that are the same in multi-locations, the auditor should not impose a separate requirement to achieve the maximum sample sizes in all locations unless there was a specific risk to a location).

19. Is the proposed standard's single framework for using the work of others appropriate for both an integrated audit and an audit of only financial statements?

Yes.

(19., cont.)If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

N/A

20. Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?

Yes.

21. Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

It depends. In theory, if the company has a strong monitoring function (i.e., Internal Audit) that evaluated processes regularly and identifies control deficiencies, fraud or financial misstatements, then the auditors should be able to rely on that information to reduce their own direct evaluation of the processes. In practice, usually auditors will dive more deeply in their evaluation of areas that the company has identified weaknesses. This proposed language will probably not change the auditor’s practice.

22. Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

No. It’s not necessary and the proposal to remove the principal evidence provision from AS No. 2 is an improvement. If the auditor concludes that they can rely on the work of others, then they should place reliance on the evidence produced by the work of others. The process to conclude that they should be to rely on the work of others includes a process to evaluate that work, including examining the objectivity and competence of the people performing the work.

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing?

For the most part, the proposed framework is appropriate. It is very positive that the framework as proposed does not arbitrarily limit the use of the work of others in specific areas but allows judgment to be used. It is also positive that the framework explicit states the areas that the auditor might use the work performed by others. This should expand the auditors’ willingness to rely on the work of others where appropriate. What is noticeably absent from the framework presented, however, are illustrative examples as previously provided in the guidance of AS No. 2. Given the level of judgment permitted in this framework, a variety of illustrative examples will be critical to the successful dialogue between management and auditors.

(23., cont.) Will this framework be sufficient to protect against inappropriate use of the work of others?

Yes. The emphasis on the "Responsibilities of the Auditor" and the direct reminder that the responsibility rests solely with the auditor, in conjunction with the rest of the framework, will act sufficiently to protect against inappropriate use of the work of others.

(23., cont.) Will it be too restrictive?

It is difficult to determine at this time, but possibly.

24. Has the Board identified the right factors for assessing competence and objectivity?

Yes.

(24., cont.) Are there other factors the auditor should consider?

Not at this time.

25. What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

This is a positive factor as it will result in management evaluating if it is compensating individuals performing the work in a way that would compromise objectivity. Again, to avoid inaccurate interpretation of this element and lengthy unproductive debates, illustrative examples of the intent of this factor should be provided.

26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

Yes, and even for significant processes, walkthroughs should not be required every year. If the auditor has already performed a walkthrough of the process in the previous year, the auditor should be specifically allowed (by the audit standard) to consider the following factors: whether the process, and the people performing the process, are stable and haven't changed, whether additional risk factors could be introduced into the process, whether the process is lower risk, and even if it's higher risk, whether the auditor substantive audit procedures will be sufficient to conclude that the process is effective and that it would not be reasonable possible that a material misstatement could occur.

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs?

Yes, but we believe it's appropriate for the people who are performing critical tasks to be responsible to participate in the walkthrough at least once so that the company and the auditor can conclude that the people performing the tasks understand their roles in performing critical controls.

(27., cont.) Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

Yes, and this would especially be appropriate if the auditor had already performed a walkthrough of the process in a previous year and if the people performing the walkthroughs are competent and independent.

Finally, we choose to address via narrative questions 28-32 of the PCAOB Release as to whether its new proposed standard appropriately describes how auditors should "scale" the audit for the size and complexity of the company; what other attributes or differences with respect to smaller companies the PCAOB should address; whether the discussion of complexity in the standard limits flexibility as to scaling; and whether the market capitalization and revenue thresholds in the standard are meaningful in terms of company size for the purpose scaling the audits of internal controls.

First, we are satisfied with the measures of company size used as benchmarks in the standard. As to the prior questions on scalability, we return to the central concern of the Leadership Group's position: the extraordinarily adverse financial and operational effect of the Section 404(b) regulatory framework on smaller public companies.

Although the SEC argues in its Release that its new "top-down, risk-based approach should enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances," it is not clear that the companion PCAOB Release will, by its terms, result in establishing a scalable model for audits of internal controls.

The PCAOB Release asserts that the auditor should evaluate the "size and complexity" of the company when planning and performing such audits, and lists specific attributes where the audit of a smaller company "might vary from the audit of a larger and more complex company" (PCAOB Release, Paragraphs 9-12). But the list is hardly exhaustive; it does not include, for example, an acknowledgement of the more limited financial resources available in smaller companies to pay for any audit services not fully integrated with the audit of financial reports, or the degree of sophistication and robustness of the IT systems supporting the financial controls in smaller companies.

Moreover, the PCAOB also indicated that even the six areas of the internal controls audit affected by these attributes of smaller companies would merely provide "the foundation for planned guidance on auditing internal controls in smaller companies to <u>be issued next year</u>" (emphasis supplied). Thus, it appears there will not be any truly comprehensive PCAOB guidance on Section 404(b) audits in respect to smaller company financial control audits <u>until 2008 at the earliest.</u>

We therefore reiterate our view that, in light of the potential for continuing confusion and significant cost, smaller companies should be exempted from Section 404 (b) compliance, at least until both the SEC and the PCAOB promulgate specific and internally consistent guidance for both management and auditors in respect of internal control attestation. Smaller public companies cannot afford to "wait till next year" for standards that are fully thought through by the regulators.

In conclusion, we note that an alternate approach to relieve the duplicative, burdensome and costly impact of 404 (b) compliance requirements would be to remove the requirement for auditor attestation of the financial controls themselves and instead require solely an attestation of management's assessment of such controls. This is, of course, the opposite of the current proposal but offered in the same spirit. We believe this approach is worthy of serious consideration on the parts of both the SEC and the PCAOB because it would appear to have a more far-reaching and salutary impact on the issues of complexity and excessive costs. Furthermore, it may be the best way in a regulatory context to emphasize the primacy of management's responsibility over internal controls over financial reporting. We would be pleased to provide additional comment should the SEC and PCAOB choose to explore this alternative further.

Sincerely,

Carl Guardino
President & CEO, Silicon Valley Leadership Group