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Re: File Number S7-24-06

Dear Ms. Morris:

The Procter & Gamble Company appreciates the opportunity to provide their views on the U.S. Securities and Exchange Commission's ("SEC") proposed interpretive guidance ("proposed guidance") for management regarding its evaluation of internal control over financial reporting and related rule amendments. We are also submitting a comment letter to the Public Company Accounting Oversight Board ("PCAOB") in response to its proposed auditing standards, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and *Considering and Using the Work of Others in an Audit* ("proposed standards").

We agree that the proposed guidance has the potential to assist companies in making their evaluation process more efficient and cost-effective, as the SEC intended. We appreciate the thought and effort put into developing the proposed guidance. We also appreciate the fact that the SEC has listened to comments expressed at the two Roundtables and in other forums about the balance between costs and benefits of Sarbanes-Oxley compliance.

We especially appreciate that the proposed guidance has moved to a more principles-based approach that will allow companies to apply the principles in assessing individual company situations. We support the top-down, risk-based approach and encourage the clear communication of the expectation that the guidance provides flexibility to support other approaches that companies may have chosen to adopt. For example, companies may choose a more detailed approach (i.e., rather than risk-based focus on detecting material weaknesses) with the intent of encompassing an internal objective of maintaining a company's robust control environment. Having flexibility to implement the most cost effective approach to balance internal and external regulatory compliance requirements can be achieved by being clear on the minimum objectives of the regulatory requirements and allowing flexibility in meeting those. Companies have adopted principles in evaluating the control framework that have been deemed effective. We are supportive of guidance that provides flexibility in the evaluation approach chosen by the company to continue to meet the objectives of the regulatory requirement.

In addition to our support for the proposed guidance, we have concerns surrounding the alignment between management guidance and external audit standards. We believe that the proposed PCAOB standards, although improved from the existing PCAOB Audit Standard No. 2 ("AS2"), are still more detailed and prescriptive than the proposed SEC guidance. These differences are likely to result in external audits that are more conservative than

management assessments and are likely to perpetuate inefficient audits by creating two distinct evaluation approaches.

Related to the ability for companies to implement the proposed guidance successfully in alignment with their external auditors, the auditors must be assured that the inspection practices of the PCAOB will align with the proposed auditing standards. If the auditors do not receive that assurance, they will be reluctant to change their approach until after an inspection cycle, which can be more than a year from the time of the audit. If auditors do not change their approach, companies will continue to incur additional costs and fail to achieve the objective of more efficient and effective assessments. We discuss alternatives in the appendix that may help achieve this objective.

We also have several suggestions for clarifications or enhancements to the proposed guidance itself. All suggestions are described more fully below, but the top priority items in terms of improving efficiency and effectiveness are:

- Focus on change in controls for testing, allowing for rotation testing of controls that have operated effectively in the past and have not changed;
- Increased reliance on entity-level controls to reduce process-level testing;
- Focus on the evaluation of control deficiency against an annual materiality definition and not an interim threshold. The complete controls evaluation is performed and reported annually; the evaluation of whether a control deficiency could result in an error to future interim or annual statements should be evaluated against an annual materiality definition.

We believe these suggestions are critically important to have a meaningful impact in striking the right balance between costs and benefits of internal controls assessments. We have also included these suggestions in our letter to the PCAOB. As noted above it is essential to maintain alignment between the proposed guidance and proposed standards.

ALIGNMENT BETWEEN MANAGEMENT AND EXTERNAL AUDITORS

Management guidance and external audit standards must be aligned. We believe that the proposed PCAOB standards, although improved from the existing PCAOB Audit Standard No. 2 ("AS2"), are still more detailed and prescriptive than the proposed SEC guidance. In the absence of management guidance, companies have had to adhere to some rules under AS2 to satisfy the requirements of the external auditors.

We expect that to change, but it will require a principles-based approach to the requirements. With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we anticipate that companies may be able to drive to a more cost-effective approach that focuses on high risk areas. However, there may be other more detailed approaches that are adopted to meet the internal objectives of maintaining and monitoring a company's control environment. Having the flexibility to implement the most cost effective approach to balancing internal and external objectives can be achieved by being clear on the minimum objectives of the regulatory requirements and allowing flexibility in meeting those. This will result in a better tradeoff between the quality of controls assurance and the cost of compliance. Companies are certainly motivated to become more efficient in their compliance processes. It stands to reason that the external auditors, under the proposed standards, would be able to mirror management's efficiencies.

We want to emphasize how critical it is that the audit standards are aligned with management guidance. The external auditors must be comfortable with management's assessment approach to optimize reliance and achieve overall cost savings. Although the requirement for an opinion on management's assessment process has been eliminated, the opinion on the controls themselves remains. A more detailed or conservative approach on the part of the auditors will drive companies to continue to document and assess lower-risk controls, thereby continuing to incur unnecessary costs and failing to achieve the objective of more effective and efficient assessments.

Further, we do not believe that additional, prescriptive guidance over management's evaluation approach is required, rather the guidance that allows judgment and principle to be used in achieving stated minimum objectives.

CLARIFICATIONS AND ENHANCEMENTS

Focus on changes in controls

The proposed guidance encourages the use of prior knowledge and assessment results to guide the risk assessment and testing approach. After the initial assessment, subsequent reviews of risk and design can be focused on changes in risks and controls. Prior testing results can be used to guide the risk assessment of both the significant accounts and the controls.

We support the focus on changes in controls and believe that it could lead to the logical conclusion that a control would not need to be tested or assessed each year. In spite of the discussion about incorporating prior year information and results to guide the extent of testing, the proposed guidance does not address the current practice of "each year standing on its own," requiring some type of assessment of each control each year. By contrast the PCAOB proposed standards specifically provide for benchmarking of automated controls. We suggest that the SEC consider where and how management might be encouraged to benchmark or rotate testing of controls in all areas. If management could confirm that the control design had not changed and that the control had been operating effectively in prior assessments, we should have the freedom to forego annual testing of that control, particularly for lower risk controls, in favor of a rotational testing plan.

Entity-level controls

Companies have put much thought and effort into identifying and enhancing entity-level controls. Although we are confident that entity-level controls are the key to preventing material future financial reporting failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect entity-level controls such as ethics programs and Board of Directors oversight. Specific examples of potential linkage included in the proposed guidance would be very helpful in building the case for leveraging these higher level controls.

Linking entity-level controls to significant account risks is clear in the case of direct entity-level controls, such as analytic reviews and budget-to-actual comparisons. One issue here has been establishing the precision at which these controls operate. With the new focus on detecting material misstatements, the precision should be less of an issue. The proposed guidance does address the need to establish that entity-level controls adequately prevent

material misstatements but again, specific examples would be helpful to reinforce that the precision can be at a fairly high level.

Annual vs. interim financial statements considered in evaluating deficiencies

The definition of “material weakness” in the proposed guidance (page 13) includes a misstatement of the company’s “annual or interim financial statements.” Management’s assessment and evaluation for deficiency is an annual assessment of the operating effectiveness as of the end of the fiscal year. We believe that reporting at fiscal year end is pragmatic...being forced to evaluate and report on an interim basis, however, leaves no room for remediation. We believe that the evaluation of whether the control deficiency could result in an error to future interim or annual statements should be evaluated against an annual materiality definition. Said another way, companies should not be held to a more demanding threshold on our interim reporting simply because our earnings (which drive materiality determination) during interim periods are a fraction of the annual amount). We believe that the deficiency evaluation should only consider the impact on annual financial statements. Basing materiality upon impact to the annual financial statements is also believed to be most consistent with the proposed guidance that also states that, “As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year.” For all of these reasons, we suggest that the reference to interim financial statements should be removed from the definition in the proposed guidance.

Detection of Fraud

The proposed guidance states on paragraph 23 that, along with other factors, management should consider the risk of material misstatement due to fraud in its risk assessment. This clarification is helpful as it has been unclear whether companies should be identifying and assessing controls that would detect ANY fraud committed by a senior executive. Contradicting that point, however, is the language on page 45 which says that fraud of any magnitude on the part of senior management is an indicator of a material weakness. It may be appropriate to define the specific types of fraud that should be considered to be an indicator of a material weakness (e.g., intentional manipulation of financial statements, versus misappropriation of assets).

OTHER OBSERVATIONS

Removal of opinion on management’s assessment

We support the elimination of the opinion on management’s assessment process. Although we do not expect to see substantial efficiencies result from the change, we believe that the opinion on the management assessment is superfluous and should be eliminated. If companies want to optimize auditor reliance on management testing, they will still need to mirror the external auditors’ standards of testing and documentation. However, the elimination of the opinion will give companies the flexibility to make that decision without being compelled to conform their assessments to AS2 standards.

Deficiency evaluation

The change in the likelihood component of the material weakness definition from “more than remote” to “reasonable possibility” should reduce the time spent on evaluating deficiencies. Although the proposed guidance includes indicators of material weaknesses and a description of typical significant deficiencies (footnote 74), it does not address quantitative

guidelines for determining materiality thresholds. The guidance could be clarified by specifying that materiality for deficiency evaluation should be aligned with financial statement materiality.

The proposed guidance includes factors to consider in evaluating the likelihood and magnitude of a control deficiency or combination of deficiencies. Many companies have been using a deficiency evaluation framework that was created by the larger audit firms. This framework focuses on a quantitative and mechanical approach that is counter to the concept of a risk-based evaluation approach. We believe that the factors in the proposed guidance can be used in lieu of the framework and recommend that the guidance include a statement that allows flexibility in using a deficiency evaluation framework and encourages judgment of factors provided in the proposed guidance.

Effective date

We hope that we have clearly communicated our support for the proposed guidance. To allow companies to realize the expected benefits in the near future, we suggest that the proposed guidance and the proposed standards should be implemented as soon as possible.

In addition to the above comments, the Appendix to this letter includes responses to several of the specific questions raised by the Commission in the proposed guidance.

Thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience.

Sincerely,

Valarie L. Sheppard
Vice President, Comptroller
The Procter & Gamble Company

Appendix – Responses to Specific Questions

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we anticipate that companies may be able to drive to a more cost-effective approach that focuses on high risk areas. However, there may be other more detailed approaches that are adopted to meet the internal objectives of maintaining and monitoring a company's control environment. Having the flexibility to implement the most cost effective approach to balancing internal and external objectives can be achieved by being clear on the minimum objectives of the regulatory requirements and allowing flexibility in meeting those. This will result in a better tradeoff between the quality of controls assurance and the cost of compliance.

Further, we do not believe that additional, prescriptive guidance over management's evaluation approach is required, rather the guidance that allows judgment and principle to be used in achieving stated minimum objectives.

- Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?

Companies have put much thought and effort into identifying and enhancing entity-level controls. Although we are confident that entity-level controls are the key to preventing future Enron-type failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect entity-level controls such as ethics programs and Board of Directors oversight. Specific examples of potential linkage included in the proposed guidance would be very helpful in building the case for leveraging these higher level controls.

Linking entity-level controls to significant account risks is clear in the case of direct entity-level controls, such as analytic reviews and budget-to-actual comparisons. One issue with this linkage has been establishing the precision at which these controls operate. With the new focus on detecting material misstatements, the precision should be less of an issue. The proposed guidance does address the need to establish that entity-level controls adequately prevent material misstatements but again, specific examples would be helpful to reinforce that the precision can be at a fairly high level.

Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?

We want to emphasize how critical it is that the audit standards are aligned with management guidance. The external auditors must be comfortable with management's assessment approach to optimize reliance and achieve overall cost savings. And although the requirement for an opinion on management's assessment process has been eliminated, the

opinion on the controls themselves remains. A more detailed or conservative approach on the part of the external auditors will drive the companies to continue to document and assess lower-risk controls, thereby continuing to incur unnecessary costs and failing to achieve the objective of more effective and efficient assessments.

- Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?

The previous guidance should not be retracted although the following differences should be considered to determine if the new guidance should include information regarding the following:

- 1) *The IT information in the former guidance is more extensive than the current guidance and includes more guidance around IT (including IT upgrades). Perhaps this information should be merged in the new guidance document.*
- 2) *The Communications with the Auditors section from the previous guidance does not exist in the current guidance and it should be retained or incorporated in the new guidance as it lays out some good examples of how management and the external auditors should interact. This is important information for management.*

- Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.

While the guidance states it does not require adoption, we believe that the guidance should be expanded to explicitly state that compliance may be achieved by either adhering to the proposed guidance or continuing with previously adopted controls approaches. Further, we believe that the guidance should be clear on the minimum objectives of the regulatory requirements and be specific in the flexibility allowed in meeting those objectives

- Considering the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

We believe that the PCAOB needs to be proactive in encouraging external auditors to embrace the level of significant change that the companies expect to make in their assessments, and we are including the following suggestions in our comment letter in response to the proposed standards.

- *Additional language in the proposed standards or in the introduction to the proposed standards, giving more concrete guidance regarding the extent of change that is expected.*
- *PCAOB inspections that support the drive for efficiency by including inspection criteria that evaluate conformance to the new proposed standards and resulting efficiencies. Those criteria should be communicated to the auditors as soon as possible to support efficiencies in the calendar year 2007 internal control audits.*

Change in the definitions of “significant deficiency” and “material weakness” in the proposed standard to remove the reference to interim financial statements. Management’s assessment and evaluation for deficiency is an annual assessment of the operating effectiveness as of the end of the fiscal year. We believe that reporting at fiscal year end is pragmatic...being forced to evaluate and report on an interim basis, however, leaves no room for remediation. We believe that the evaluation of whether the control deficiency could result in an error to future interim or annual statements should be evaluated against an annual materiality definition. Said another way, companies should not be held to a more demanding threshold on our interim reporting simply because our earnings (which drive materiality determination) during interim periods are a fraction of the annual amount). We believe that the deficiency evaluation should only consider the impact on annual financial statements. Basing materiality upon impact to the annual financial statements is also believed to be most consistent with the proposed guidance that also states that, “As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year.” For all of these reasons, we suggest that the reference to interim financial statements should be removed from the definition in the proposed guidance.

- Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?

Appears to be sufficient

- Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?

Not necessary to codify it as a Commission rule

- Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?

It should be voluntary

- Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?

Proposed rule revisions seem appropriate

- Should the rules be amended in a different manner in view of the proposed interpretive guidance?

Proposed rule revisions seem appropriate

- Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?

Yes, we believe that is appropriate.

- Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?

Neither

- Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?

Yes