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

Re: File Number S7-24-06 Proposed Interpretive Guidance – Management's Report on Internal Control Over Financial Reporting and Proposed Rule Amendments

Dear Ms. Morris:

BDO Seidman, LLP welcomes this opportunity to provide comments on the proposed interpretive guidance – *Management's Report on Internal Control Over Financial Reporting* and the proposed rule amendments.

Overall, we support the proposed guidance and believe that it will help companies of all sizes assess the effectiveness of internal control over financial reporting ("ICFR"). The flexibility and scalability provided for in the guidance support an evaluation process that will vary based on the unique characteristics of each company and its internal control system. As a result, the balance between management and auditor effort will vary based on the quality of management's assessment and the extent to which the auditor can rely on the work of management. In addition, while it is not possible to set an expectation of across the board reductions in Section 404 compliance costs, we believe that the proposed guidance offers an efficient approach to assessing the effectiveness of internal control, especially for those companies that have not yet implemented the requirements of Section 404.

To facilitate the most efficient approach to assessing the effectiveness of ICFR, we believe that early and frequent communication between auditors and management needs to occur. Although we agree that management's assessment of ICFR is separate and distinct from that of the auditor, there is an important interaction between the two through the auditor's consideration of the work of others. When management performs a robust assessment, the auditor will generally be better able to use this work as part of the audit, which results in the most efficient process, while preserving audit effectiveness. We believe that the proposed guidance should encourage this early and frequent communication. We have additional comments on this matter included in response to specific questions below.

While we support the proposed guidance and related rule amendments, we have provided suggestions that we believe will improve their implementation. We have included comments for only those questions posed by the Commission where we had specific suggestions for improvement or clarification.

PROPOSED INTERPRETIVE GUIDANCE

Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process?

We believe that the proposed guidance will help management complete its annual evaluation process in an efficient and effective manner. However, we have some suggestions about how the guidance can be further clarified and we have included our suggestions within our responses to the questions below.

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

We offer the following suggestions about specific areas where further clarification may be appropriate.

Monitoring

While we understand that the purpose of the proposed guidance is to provide management with an efficient and effective manner in which to evaluate ICFR as of the end of the fiscal year, we believe that the guidance should state that monitoring activities and the assessment of ICFR should not be considered solely as an annual compliance exercise. Rather, these activities should be incorporated into a company's ongoing evaluation process to ensure reliable financial reporting and the effective operation of controls.

Additionally, more guidance would be useful regarding the nature and extent of the underlying documentation that is appropriate to evidence the effective operation of management's daily interaction as a monitoring procedure. Further, since management may also use its daily interaction as a primary control, we believe the proposed guidance should distinguish the use of daily interaction as a primary control from use as part of management's assessment process. When used as a primary control, guidance should be provided about how this control would be assessed to be operating effectively.

Documentation

Documentation of business processes and procedures serves many purposes and the level and nature of documentation will vary by company based on their circumstances. While the extent of documentation management prepares in support of its assessment of the effectiveness of ICFR is a matter of judgment, a certain level of documentation is necessary to (1) provide evidence that a control is operating as designed and (2) enable auditors to evaluate the work of management when reliance on such work is anticipated. We recommend that the proposed guidance emphasize these matters.

Sampling

Since sampling often plays a significant role in gathering evidence as to the operating effectiveness of controls, consideration should be given to providing issuers with guidance on the following: (1) when the use of sampling is appropriate; (2) different types of commonly used sampling methods; and (3) how sampling is affected by considerations regarding the nature and timing of testing, and by management's risk assessment, including the potential for fraud. Examples demonstrating the application of sampling would also be useful.

Consideration of fraud risk

The proposed guidance discusses management's consideration of fraud and points out that management's evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity and whether any of those exposures could result in a material misstatement of the financial misstatements (see page 23 of the proposed guidance). We suggest that the proposed guidance should more strongly emphasize the importance of fraud risk assessments and state that these assessments are critical and must be considered (rather than "should" be considered).

Since fraud risk may be difficult to identify and it may even be more difficult to design effective controls to protect against fraud, additional guidance regarding management's consideration of fraud and examples of controls that may address identified fraud risks would be helpful.

Coordination and communication with the auditor

We recognize that the proposed guidance is intended to help management design and conduct its own evaluation and assessment of ICFR, independent of the auditor's evaluation. As such, we believe it is appropriate that management be permitted to use an assessment methodology that has no direct link to the manner or methodology that the auditor uses. However, in order to achieve maximum efficiencies, it is desirable for auditors to place reliance on the work of others. While we agree that the auditors should not be driving management's assessment process, the greater the coordination between management's approach and that of the auditors, the more the auditors will be able to use management's work to reduce their own work. This is similar to a financial statement audit where company personnel prepare schedules and analyses in the manner that would best facilitate an efficient audit. There is significant emphasis in the proposals on management's judgment on the work done and the extent of documentation to be prepared. We believe that to provide better balance, the guidance should also remind companies of the potential benefits from coordinating with the auditors in order to achieve the greatest efficiencies.

Comparable terms

We believe it would be helpful if the auditing guidance and management guidance used the same terms when referring to the same concept. This should reduce any confusion and facilitate the auditors' use of the work of management when appropriate. Accordingly, we suggest the following for your consideration:

- The PCAOB's proposed auditing standard uses the term "relevant assertion" to direct audit procedures to only those controls related to relevant assertions for significant accounts that have the greatest risk of material misstatement. To help management focus attention on those controls that apply to those relevant assertions, we suggest that this term be included within management's guidance. Currently the proposed guidance states that, "The controls that management identifies as adequately addressing the financial reporting risks are then subject to procedures to evaluate evidence to the operating effectiveness…" (see page 21). It is unclear whether the concept of "financial reporting risks" is comparable to the concept of relevant assertion as used in the auditing literature. If the "financial reporting risks" are not identified at the "relevant assertion" level, this may limit the extent to which the auditors can use and potentially rely on management's work.

- With respect to the evaluation of control deficiencies, the proposed guidance provides that, "…management should evaluate individual control deficiencies that affect the same account balance, disclosure, *relevant assertion*, or component of internal control, to determine whether they collectively result in a material weakness." (See page 42). However, this term, *relevant assertion*, is not defined or presented anywhere else in the document. We suggest that this term be defined and included as part of the discussion of risk assessment.

- An assessment of the operating effectiveness of a control under the proposed auditing literature for internal control is to be performed for "significant accounts" at the "relevant assertion" level. Clarification of these terms and the differences between them will assist management and the auditors in their understanding of the extent to which the work of others may be used in the audit.

Are there aspects of management's annual evaluation process that have not been addressed by 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 believe that when management's assessment process is not sufficiently robust, the auditor's ability to rely on the work of others is likely to be reduced and therefore cost efficiencies will not be realized. It is not clear whether management will understand that while they may have complied with the spirit of the proposed guidance, and therefore fulfilled their obligations under the statute, this does not necessarily mean their work will provide maximum benefit to the auditors. To avoid any misunderstandings, we suggest that the SEC include guidance to management that would discuss how the audit scope may be affected by the level of work that management performs, including how that work is documented.

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?

We believe that much of the May 2005 Staff Guidance and many of the Frequently Asked Questions (revised October 6, 2004) continue to be relevant and, to the extent not already done, should be integrated into the proposed guidance. For example, the FAQs that clarify the scope of management's assessment, such as (1) when the exclusion of acquisitions from the scope of the assessment is appropriate, and (2) clarification that the required Supplementary Information is within scope, continue to be relevant.

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

We do not believe that the proposed guidance will <u>require</u> unnecessary changes to already established evaluation processes. The proposed guidance is sufficiently flexible to accommodate various methods of conducting evaluations of ICFR and companies will have the choice as to whether or not to make changes as appropriate in the circumstances.

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?

As stated earlier, the use of differing terms for seemingly similar concepts may cause confusion, especially in situations where management expects that the auditor will be able to place reliance on its work to reduce the nature, timing and extent of testing that the auditor would otherwise need to perform. If terms such as "financial reporting risks," "financial reporting elements," and "areas of financial reporting," which are used in management's guidance, were to be reconciled with the corresponding terminology used by the PCAOB in its proposed auditing standard, efficiencies would more easily be achieved.

Further, items included as strong indicators of a material weakness within management's proposed guidance differ from those presented in the PCAOB's proposed standard. Specifically, the PCAOB's proposed standard includes a discussion of deficiencies associated with an ineffective internal audit or risk assessment function (where such functions are needed for an effective monitoring or risk assessment process), and this item is not included as a strong indicator of a material weakness in the SEC's proposed guidance. We suggest that the SEC and PCAOB align their respective guidance as to strong indicators of a material weakness to avoid inconsistent evaluations by management and auditors of the same control deficiency.

Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?

Please see our comments above.

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

The proposed guidance requires management to disclose a clear expression of its assessment of ICFR and as a result prohibits management from qualifying its assessment. For example, management is not permitted to say that "the company's controls and procedures are effective *except to the extent* that certain material weakness(es) have been identified." However, management is permitted to state that "controls are ineffective due solely to, and only to the extent of, the identified material weakness(es)." This seems to imply that management is concluding that the company's internal control is effective except for the disclosed material weakness. We suggest that this apparent inconsistency be eliminated.

Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance? If yes, what are they?

We agree with the inclusion of guidance for foreign private issuers that allows for planning and conducting an evaluation based on the primary financial statements of the foreign private issuer (see footnote 47) and then performing an evaluation of the severity of any identified control deficiency in relation to both the primary financial statements and the U.S. GAAP reconciliation (see footnote 73).

PROPOSED RULE AMENDMENTS

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?

We believe that the proposed revisions are sufficiently clear in this regard.

Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?

We believe that this reference and the requirement for the auditor to attest to and report on management's assessment could still be confusing to auditors and investors, particularly since the auditor's opinion states "we have audited management's assessment, included in the accompanying *[title of management's report]*, that W Company maintained effective internal control over financial reporting…." We therefore suggest that the rule be amended to allow the audit opinion to refer to management's *conclusions* on the effectiveness of internal control, and not their assessment.

Further, it is at least theoretically possible that management could design and maintain an effective system of internal control but test them in an inadequate manner (particularly in years after initial compliance with Section 404). In such a situation, if the auditors' testing revealed no deficiencies, the auditors would be required to express an unqualified opinion on internal control. We therefore suggest that guidance be provided as to the auditors' responsibilities in situations where we become aware that management does not have an adequate basis for its assessment.

The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?

Rule 2-02(f) of Regulation S-X (17 CFR part 210) describes the types of audit reports (either unqualified or adverse) that can be filed with the Commission, including the "rare circumstance" when a disclaimer would be appropriate. However, we believe that the circumstances under which a disclaimer may be appropriate can vary and are subject to auditor judgment given the specific facts and circumstances. This decision should be governed by auditing literature and interpreted by each auditing firm's own policies.

We realize that acceptability of an auditor's opinion to the SEC is governed by the Commission's rules, and as such we believe it is important that the PCAOB and SEC provide consistent guidance that discusses the issuer's responsibilities when informed by the auditor that they plan to disclaim an opinion. In this regard, we suggest that the SEC consider providing guidance about whether the issuer should instruct the auditor to continue testing controls (in areas where testing can be performed) or to stop all control testing after it becomes informed that the auditor will disclaim an opinion.

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We appreciate your consideration of our comments and suggestions and we would be pleased to discuss these with you at your convenience. Please direct any questions to Wayne Kolins, National Director of Assurance at 212-885-8595 (wkolins@bdo.com).

Very truly yours,

/s/ BDO Seidman, LLP

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