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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 – Management's Report on Internal Control Over Financial Reporting

Dear Ms Morris:

Moody's appreciates this opportunity to comment on the Commission's proposed guidance for management on its evaluation of internal control over financial reporting.

We are writing from our perspective as users of company financial statements and internal control reports in the course of rating the credit risk of debt instruments.

We believe that over the course of the last three years, we have developed a basis for commenting on internal control reporting. Since Congress required reporting on controls, and before the first reports were issued, we developed a methodology for considering control weaknesses in our credit ratings, and we published our approach in October 2004. For the past two years, we have centrally monitored rated companies reporting material control weaknesses to ensure consistent application of our methodology and to fine tune it along the way. We have published on the impact of internal control reports on our ratings following both the first and second years of control reporting and we are now collecting data that will provide the basis for our comments on the third. Throughout this period, we have held many discussions with company management and been active in conferences, panel discussions, public hearings and roundtables about the benefits and costs of reporting on control.

We believe that reporting on internal control has helped restore confidence in U.S. financial reporting which was badly shaken after massive instances of fraudulent reporting. Our discussions with companies suggest that control reporting has promoted investment in the people, policies, processes, and systems necessary to support quality reporting. Further, Moody's has benefited from new information about control problems which has helped us assess the risk of misleading financial reporting, which is one of many elements we consider when assessing credit risk. These benefits have been significant.

By any measure, the costs of implementing reporting on internal control by management and auditors have been high, indeed a multiple of what was projected during the debate over the Sarbanes/Oxley Act. Most commentators have argued that some portion of the cost is unnecessary. Although we have no special insight into costs, we have seen nothing to suggest concerns about costs are invalid. Accordingly, we support policies that promote efficient control reviews by management and auditors, provided, of course, that this can be done without reducing the benefits of reporting on control.

While much of the commentary about control reporting has been concerned with compliance costs, evidence suggests that important goals of reporting on controls are not being fully achieved:

a) There appears to be insufficient emphasis on controls that prevent senior management from fraudulently manipulating financial reporting (cooking controls).
b) Material weaknesses too often lag rather than precede material errors in financial reporting.

In providing guidance to management on assessing controls, we encourage the SEC to adopt a strategy that both encourages efficiency in control reporting and improves performance in deficient areas. On the one hand, the proposed guidance offers important ways for management to improve the efficiency of its control assessment. On the other hand, it is unlikely to cause greater scrutiny of cooking controls and earlier reporting of material weaknesses. We discuss each area of concern below and suggest a way forward.

Controls that Prevent Senior Management from Fraudulent Reporting

The requirement to report on internal control resulted from one particular type of internal control breakdown: senior management of some major public companies overrode their control systems and intentionally issued misleading financial statements. History has shown that senior management cooking the books has been the most costly of control failures. It has caused billions in investor losses, undermined confidence in reporting affecting the liquidity and cost of capital for many companies, and triggered significant new regulation and requirements, including reporting on controls. Other forms of fraudulent reporting, such as misleading reporting by lower-level employees, have not had the same impact. Neither has control failures resulting in honest errors in financial reporting, regardless of whether they relate to insufficient accounting skills, complex reporting requirements, difficult estimates or judgments or system failures.

Because of its dominant importance, ensuring adequate controls that prevent senior management from cooking the books must be a focus of control assessment. Although other controls are important, companies, auditors and regulators should give first priority to cooking controls.

Yet, despite many hard lessons, control-related literature does not give priority to cooking controls. Control frameworks, auditor guidance on controls, and the SEC's guidance to management each treat fraud-related controls as no more important than a myriad of other control issues.

In defending that guidance, some note that the literature calls for management and auditors to use a top-down, risk-oriented approach in deciding where to spend time. Yet, we suspect that those in senior management who are inclined to cook the books will deem book cooking to be of low risk and direct subordinates to spend time on other controls management deems more important. Similarly, auditors, who decide to accept and retain clients in part based on their assessment of the integrity of senior management, are likely to deem book cooking by management they trust to be of low risk.

Internal control reports to date also suggest that audit committees, management and auditors are not giving priority to controls related to senior management fraud. For example, in the latest year of internal control reporting, of the thousands of companies that Moody's rates, only four referred to fraud-related control weaknesses, including tone at the top, and in each case the companies had discovered instances of fraudulent reporting prior to reporting fraud-related control problems.

Why haven't management, auditors, standard setters and regulators given priority to controls related to cooking the books? We speculate reasons possibly include:

- Its difficult for senior management to objectively assess its own tone
- Assessing controls that prevent senior management from cooking the books are often judgmental and its hard to obtain objective compelling evidence absent an instance of senior management fraud
- Controls over senior management are sensitive and uncomfortable for audit committees, management and auditors to address
- Control frameworks don't provide much guidance on cooking controls
- Control-related literature doesn't give priority to cooking controls; risk assessment is left to judgment.

The evidence of insufficient attention to critical cooking controls suggests the need to redouble efforts. More specifically, we suggest the SEC consider the following in its guidance to management or in follow-on activities:

- Separate the assessment of tone at the top and other controls that prevent senior management from cooking the books from senior management. It's difficult for senior management to assess its own tone. Perhaps the assessment should be under the oversight of the audit committee, and conducted by internal audit or outsiders.
- Give priority to cooking controls by <u>always</u> deeming them a high risk area.
- Request developers of control frameworks to provide more guidance on controls that prevent senior management from cooking the books.
- Study instances of senior management fraudulent reporting specifically to identify controls that would have prevented the fraud and reasons why control assessment failed to identify the material weakness. Incorporate the lessons learned in future guidance.

Material Weaknesses as Leading Indicators of Reporting Risk

Few would question that strong controls are essential to quality financial reporting. As users of control reports, we had hoped that material weaknesses flagged would provide insight into the risk of future errors in financial reporting, and provide management time to address control weaknesses before they resulted in reporting failures.

Unfortunately, reports citing material weaknesses appear to be lagging rather than leading indicators of financial reporting problems. Of the companies Moody's rates, during the last year of internal control reporting, 74 companies reported material weaknesses in internal control, but only 4 did not experience prior reporting errors (restatement or material audit adjustment) in the area related to the material weakness.

The data suggest management and auditors require evidence of error or fraud before they are willing to conclude that a control concern is a material weakness. Why are management and auditors so reluctant to cite a material weakness absent evidence of a past error? Concluding that a control issue is a material weakness involves considerable judgment, which is sure to be questioned when it involves controversial and unhappy news. We suspect that management, audit committees and auditors are asking for hard evidence to support a view that control problems are material weaknesses. We also suspect that the hardest evidence is when control breakdowns result in reporting errors.

Yet, the lagging nature of reported control weaknesses undermines their usefulness to users of financial statements. Further, failing to identify a material weakness may reduce the chance that management will take corrective action in time. Reporting control weaknesses after financial reporting problems have occurred is analogous to a medical doctor reporting high blood pressure only after the patient has suffered a heart attack.

We can find only one instance where the SEC's proposed guidance for management directly addresses the lagging nature of material weaknesses. It occurs in the section on evaluating control deficiencies and notes that "…management's evaluation should be based on whether the company's controls will fail to prevent or detect a misstatement on a timely basis, not necessarily on whether a misstatement actually has occurred."

While we agree with the SEC's point, we doubt that a single subtle reference will be enough to encourage proactive reporting of material weaknesses. We suggest that the SEC turn up the noise level on the important problem of the lagging nature of material weaknesses. A few ideas to do so are:

- Identify the problem of the lagging nature of many control weaknesses to date and call for improvement
- Be clear that a key goal of reporting on internal control is to identify material weaknesses before related reporting problems occur
- While reporting errors often suggest material weaknesses in controls, the absence of reporting problems should be irrelevant to judging whether a control deficiency is a material control weakness.

We offer one final comment, related to Section B4, "Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR." We perceive the guidance in this section to be inconsistent, and were left wondering what the SEC wants management to do. The front part of the discussion suggests that management need not revise its prior assessment of control (which, we note, hardly encourages management to proactively identify control problems). In contrast, the end of section suggests that management should modify its prior disclosures. We suggest clarification.

We thank the Commission and SEC staff for their consideration of our comments. Of course, we would be pleased to discuss our comments should they desire further information.

Sincerely,

Gregory J. Jonas (s)
Managing Director