**Consumer Federation of America**
**Consumer Action**
**U.S. Public Interest Research Group**

February 27, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-24-06
Management's Report on Internal Control over Financial Reporting

Dear Secretary Morris:

We are writing on behalf of the Consumer Federation of America,[1] Consumer Action,[2] and the and U.S. Public Interest Research Group[3] in opposition to the Commission's proposed interpretative guidance for management regarding its evaluation of internal control over financial reporting and to the safe harbor the Commission proposes to provide to public companies that rely on this guidance in assessing their internal controls.

CFA, CA and U.S. PIRG support the stated intent behind the proposed guidance – to ensure that management's internal control assessments are focused on the areas that pose the greatest risk of material error or fraud, to eliminate unnecessary procedures that drive up the cost of the assessments without delivering significant benefits, and to ensure that control systems and management's assessments of those systems reflect the specific characteristics of the audited company. We also recognize that, in arriving at the approach reflected in this interpretive guidance (and in the Public Company Accounting Oversight Board's proposed revisions to the internal control audit), the Commission rejected a number of alternatives – such as a small

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[1] The Consumer Federation of America (CFA) is a non-profit association of approximately 300 consumer groups. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of more than 9,000 community based organizations.

[3] The U.S. Public Interest Research Group serves as the federation of state PIRGs, which are non-profit and non-partisan public interest advocacy organizations with one million members across the country.

company exemption, design-only internal control audits for smaller companies, or multi-year rotational testing – any of which would have effectively eviscerated the internal control requirements in Section 404 of the Sarbanes-Oxley Act (SOX 404) as a deterrent to fraud and as a means of preventing financial statement errors.

Furthermore, we believe improved guidance from the SEC on design and assessment of internal controls, particularly for smaller companies, is needed. Indeed, the absence of clear, timely guidance has, in our view, been a significant factor driving up the cost of implementation. That said, we believe the proposed guidance suffers from serious short-comings that will prevent it from accomplishing the stated goals or from providing the kind of clear direction that is needed to improve implementation.

- Although the Commission describes the approach in the guidance as principles-based, it fails to provide a clear articulation of investor protection principles to guide its implementation. As a result, the proposal has the worst characteristics of a principles-based approach, lack of clarity, without its chief benefit, a plainly articulated desired investor protection outcome that managers can be held accountable for achieving.

- The Commission has proposed a top-down, risk-based approach to the internal controls assessment without in any way addressing the short-comings that have made that approach such an abysmal failure in the audits of financial statements. Until the Commission, working with the Public Company Accounting Oversight Board, analyzes the many failed risk-based financial statement audits and determines what went wrong, it cannot in good conscience propose a risk-based approach to management's assessment of internal control with any confidence that it will provide an appropriate level of investor protection.

- The guidance is so vague as to be unenforceable. The only clear message it sends is that it is intended to drive down costs. As a result, and particularly if the SEC brings that mind-set to its enforcement, managers are likely to be able to claim compliance with the guidelines, and the safe harbor that it provides, for even the shoddiest of internal control assessments.

The Commission has made clear that its proposed guidance was developed in response to complaints from the business community about the costs of SOX 404 compliance. At no point does it acknowledge, however, that the real problem with management assessments of internal control since implementation of SOX 404 is that they have not provided either timely information to investors about weaknesses in controls or prompt correction of control deficiencies. In fact, since SOX 404 was implemented, several thousand companies have reported material weaknesses in their internal controls (more than 1,500 in 2005, and 1,105 through September 2006).[4] In the vast majority of cases, the disclosure of material weaknesses came only after an independent audit of the controls. Specifically, only one out of eight of these

[4] Glass, Lewis & Co., LLC analysis of company filings.

companies had reported a material weakness as recently as the quarter preceding the filing in which the material weakness was disclosed.[5] In other words, the certifications that many CEOs and CFOs had been making since 2002 attesting to the adequacy of their controls were unreliable.[6] Only the independent control audit forced control weaknesses into the open. Instead of sending the message that reducing costs of compliance is the top priority, the SEC should be looking for ways to improve the effectiveness of management assessments.

**The Benefits of SOX 404 Outweigh the Costs**

Moreover, we are concerned that the Commission and the PCAOB appear to be giving such uncritical credence to complaints about SOX 404 compliance. These complaints are typical of the business response to any major new regulation, particularly if it is viewed as effective in changing industry behavior. Although it is early in the process to reach a conclusion, the evidence to date overwhelmingly suggests that the benefits of SOX 404 greatly outweigh its costs. Given the constant refrain from the business community that new investor protections should be justified under a cost-benefit analysis, it seems ironic, to say the least, that the same standard is not being applied to a major roll-back of investor protections advocated by business.

Many of the complaints about compliance costs are based on the first-year experience under SOX 404. The Committee on Capital Markets Regulation, for example, bases its estimates of compliance costs on the first year of implementation, inexplicably ignoring the significant cost savings that occurred in the second year. For a variety of reasons, the first year's experience under the new standard can hardly be viewed as representative. First, no reasonable person would expect implementation of a major new requirement such as this to go off without a hitch. Beyond the problems inherent to introducing any major new standard, many public company managers were ill-prepared and slow to perform their own documentation and assessment of internal controls, without which the auditor's assessment could not go forward. This, combined with the arrival of the standard and guidance on implementation after planning and data gathering for financial statement audits had already begun, effectively prevented auditors from conducting an integrated audit of financial statements and internal controls in most cases during that first year.

We are aware of two leading surveys that attempt to assess the costs of compliance associated with Section 404 of the Sarbanes-Oxley Act – one by Financial Executives International and one by Charles River Associates. The FEI survey, which did not differentiate among companies based on size, found average second-year 404 compliance costs among its members of $3.8 million.[7] For its assessment, CRA did divide companies by size and found

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[5] "Learning from Accounting History: Will We Get It Right This Time?" by Lynn Turner, *Issues in Accounting Education*, Nov. 2006.

[6] Ibid.

[7] "FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping," Financial Executives International Press Release, April 6, 2006.

second-year costs of $4.77 million for larger companies (those with more than $700 million in market capitalization) and $0.86 million for smaller companies (those with market capitalizations between $75 and $700 million).[8]

As expected, both surveys showed a marked drop in costs between the first and second year of implementation. Specifically, FEI members reported 404 cost declines of 13 percent between 2004 and 2005. On the CRA survey, costs were found to have declined by 43 percent for larger companies and by 31 percent for smaller companies. There is every reason to believe that the smaller companies that have yet to implement the rule would experience still lower costs, even without any adjustments to the standard or additional learning from further experience implementing the internal control audits.

Moreover, substantial evidence supports the conclusion that SOX 404 brings benefits that greatly exceed its costs. That evidence takes a number of different forms. These include: statements by institutional investors that they have seen significant post-SOX improvements in the quality of financial reporting;[9] statements from senior managers of public companies that it has helped them to streamline and improve processes and make better business decisions;[10] evidence that, absent the requirement, many public companies had failed to maintain adequate internal controls or report weaknesses in those controls; and academic research on the effects of SOX 404.

One important goal of SOX 404 is to improve the accuracy of financial disclosures, which should then reduce the incidence of financial restatements.[11] These restatements result in substantial costs to investors, beyond the misallocation of capital that can result when financial disclosures are erroneous or misleading. A recent analysis by the General Accounting Office, looking at financial restatements from July 2002 through September 2005, found an average negative market impact of 1.9 percent in a three-day window around the restatement.[12] Based on its data, and using this very narrow time frame, the GAO calculated an aggregate negative

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[8] "CRA Survey: SOX Costs Falling from 2004 to 2005," *Big Four Blog*, April 2006, found at http://bigfouralumni.blogspot.com/2006_04_01_archieve.html. This information is also reported in the Interim Report of the Committee on Capital Markets Regulation, Table V.3, page 135.

[9] "Not Everyone Hates SarbOx," by David Henry, *BusinessWeek Online*, Jan. 29, 2007. Found at http://www.businessweek.com/print/magazine/content/07_05/b4019053.htm?chang=gl.

[10] "Examining Section 404, With Two Years of Hindsight," by Richard M. Steinberg, *Compliance Week,* Jan. 24, 2006.

[11] Although the long-term goal is to reduce restatements, a short-term rise in restatements is predicted as a result of the new level of scrutiny being applied to corporate disclosures and public company audits as SOX is implemented.

[12] *Interim Report*, Committee on Capital Market Regulation, Dec. 1, 2006, pg. 120.

market impact from financial restatements of $40.9 billion in 2004 alone and $63 billion for the entire period of the study, far above even the most inflated estimates of SOX 404 compliance costs.[13]

Given the significant negative effect restatements can have on share price, investors stand to benefit greatly if SOX 404 improves the reliability of financial statements and reduces the incidence of restatements. Early evidence indicates that this is occurring. First, financial restatements are up dramatically since the implementation of SOX, indicating that it has helped bring to light a number of problems that had previously gone undetected. A recent analysis by AuditAnalytics reported 1,876 restatements in 2006 by 1,591 unique filers.[14] That represents a 17 percent increase over 2005, which itself saw a 57 percent increase over 2004.

Of particular note when considering the effect of SOX 404, however, is the fact that restatements among accelerated filers (those that have implemented its requirements) are down significantly – from 16.1 percent of such companies in 2005 to 13.3 percent in 2006.[15] Meanwhile, the number of restatements among non-accelerated filers has continued to increase – from 921 in 2005 to 1,318 in 2006.[16] One clear implication of these findings is that the large companies that have already implemented SOX 404 have begun to improve their procedures and clean up their books. As one commentator noted, this appears to indicate that "the Sarbanes-Oxley law is working and investors are getting higher-quality financial statements than ever before."[17]

Several recent academic studies have also helped to document the substantial benefits of SOX 404. One study found, for example, that companies with poor internal controls have poorer quality financial reporting. When they improve their internal controls (as reflected in an auditor attestation that they have corrected a reported weakness) the quality of their financial reporting improves.[18] A separate study found that, after controlling for other risk factors, firms with internal control deficiencies "have significantly higher idiosyncratic risk, systematic risk, and

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[13] Ibid., Table V.2, page. 122. Also, footnote 138. Table V.3 on Page 135 shows estimated aggregate compliance costs of $15 to $20 million in 2004 and $11 to $13 million in 2005.

[14] *Audit Analytics Briefing Paper: 2006 Financial Restatements, A Six Year Comparison*.

[15] Ibid.

[16] Ibid.

[17] Ibid.

[18] *The effect of Internal Control Deficiencies and Their Remediation on Accrual Quality*, Ashbaugh-Skaife, H. (University of Wisconsin-Madison), Collins, D. (University of Iowa), Kinney, Jr., W., (University of Texas at Austin), and LaFond, R. (Massachusetts Institute of Technology-Sloan School of Management) May 30, 2006.

cost of equity capital."[19] Furthermore, this study found that "remediation of an internal control deficiency is followed by a significant reduction in the cost of equity capital" and that "the magnitude of the cost of equity capital effects of the internal control deficiency are economically important, ranging from 50 to 150 basis points depending on the analysis."[20] In other words, not only is SOX 404 improving the quality of financial statements, but these improvements are recognized and rewarded by the market with a lower cost of capital.

**The Global Competitiveness Argument against SOX 404 Has Been Discredited**

In making its case against SOX 404, the business community has repeatedly argued that a relaxation of the standard is needed to preserve the competitiveness of U.S. securities markets. Recent reports have thoroughly discredited this argument. For example, a study by Thomson Financial analyzing 20 years of initial public offerings (IPOs) reportedly found no noticeable ill effects from SOX.[21] Instead, it found that foreign IPOs accounted for 16 percent of IPOs in the United States last year, the highest proportion in the 20 years covered by the study. Furthermore, the $10.6 billion foreign companies raised through U.S. IPOs last year represented a 23 percent share of U.S. IPO volume, the highest level since 1994, according to the study.

To the degree that the United States has seen a decline in its share of global IPOs, a number of analyses, including recent reports by Goldman Sachs[22] and Ernst & Young,[23] have clearly documented that other factors are primarily responsible. The Goldman Sachs analysis notes that U.S. share of global equity market capitalization dropped dramatically from 1970 to 2000, long before the passage of SOX, attributes recent IPO trends to "economic and geographic factors" as well as the spread of the "U.S. capital market 'culture,'" and notes that U.S.-based but globally minded firms stand to benefit from the growth of world markets. The Ernst & Young analysis demonstrates that companies have always tended to list close to their home markets, that as a result, only a very small percentage of international listings can truly be viewed as competitive, and that the United States has done extremely well in recent years in attracting IPOs from among those that are competitive.

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[19] *The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital*, Ashbaugh-Skaife, H.; Collins, D.; Kinney, Jr., W.; LaFond, R., April 2006.

[20] Ibid.

[21] "Do Tough Rules Deter Foreign IPO Listings in U.S.?," by Yvonne Ball, *The Wall Street Journal*, Feb. 20, 2007.

[22] "Is Wall Street Doomed?," by Jim O'Neill and Sandra Lawson, *Global Economics Weekly*, Goldman Sachs Economic Research, Issue No. 07/06, Feb. 14, 2007.

[23] *Global Capital Market Trends*, by Maria Pinelli and Joseph A. Muscat, Ernst & Young, Jan. 2007.

Indeed, even those who have argued most strenuously for a relaxation of internal control audits have been forced to acknowledge that SOX 404 is, at most, a minor influence on recent IPO trends. Despite their obvious biases, both the Interim Report of the Committee on Capital Markets Regulation and the McKinsey Report commissioned by Sen. Schumer and Mayor Bloomberg clearly document that global economic and market trends, rather than the U.S. regulatory or legal environment, are the key factors behind a drop in the U.S. share of foreign IPOs. Although they continue to argue for a relaxation of U.S. regulatory standards, they offer no evidence that these measures would have any beneficial effect on the global competitiveness of U.S. markets.

Of course, SOX 404 could be shown to offer benefits that exceed its costs and still be more costly than necessary to bring about those benefits. At the very least, however, those who advocate measures to bring down those costs should have to show that their proposed approach would maintain the current level of benefits. The Commission's proposed interpretative guidance states that its proposed approach will do just that. However, there are several reasons to conclude that it will not.

**Risk-based Audits Have Not Proven Effective**

Everyone can agree in theory that audits should take a top-down, risk-based approach that focuses on those areas that present the greatest risk of a material misstatement. In analyzing the merits of this approach, however, we need not rely solely on theory. Audit firms have been conducting top-down, risk-based audits of the financial statements for several decades – with often disastrous results. In fact, many of the failed audits implicated in recent massive accounting scandals were risk-based audits.[24] Time and again – in audits of companies like Enron, WorldCom, Tyco, HealthSouth, Global Crossing, Bristol Myers, and an endless litany of others – audit firms have shown that they are unable to correctly identify high-risk issues, to appropriately design the audit to address those issues, or to stand up to high-risk clients.

If independent auditors are unable to get this right, why should we expect that managers, who have shown a great unwillingness to expose control weaknesses, will do a better job? In fact, it requires either breath-taking naiveté or a cynical disregard of reality to suggest that they will. Yet, this is exactly what the interpretive guidance does, and the entire effectiveness of the risk-based approach hinges on management's ability to get this right. Among the smallest companies, lack of financial and accounting expertise appears to be a pervasive problem. How will these managers conduct an effective risk assessment on which the top-down, risk-based approach depends? Moreover, experience tells us that the greatest fraud risk, particularly in smaller companies, is the risk of management override. Under the approach outlined here, however, those individuals who are most likely to present a fraud risk (the CEO and CFO) are responsible for making subjective judgments about the effectiveness of controls, the risks of misstatement, the risk of control failure, and the extent of testing needed. And, in the accompanying proposal from PCAOB, auditors are strongly encouraged to rely on what may be

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[24] "Behind Wave of Corporate Fraud: A Change in How Auditors Work," by Jonathan Weil, *The Wall Street Journal*, March 25, 2004.

highly questionable work performed by management in cases such as this.

The Commission makes no effort that we can see to address weaknesses in the risk-based approach. On the contrary, it actually takes steps that are likely to exacerbate those problems inherent to such an approach. Of greatest concern in this regard are the lack of clearly articulated investor protection principles managers can be held accountable for achieving and the message conveyed throughout that reducing costs, rather than improving effectiveness, is the top priority, and that nobody at the Commission is going to lose much sleep over it if managers miss a few material weaknesses here or there.

**The Proposal Lacks a Clear Articulation of Investor Protection Principles**

The Commission has touted the interpretive guidance as taking a principles-based approach. The Release identifies two "broad principles" around which the guidance is organized: 1) that management should evaluate the design of the controls that it has implemented to determine whether they adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner; and 2) that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. In fact, however, the first "principle" simply restates SOX 404's basic requirement for management. Neither provides a clear articulation of the investor protection outcome managers are responsible for attaining.

We believe the addition of clear investor protection principles is essential to ensure that managers do not use the interpretive guidance as an excuse to cut costs without regard to effectiveness. The following are among the principles that ought to be included:

# Management is responsible for maintaining a system of internal controls that is reasonably likely to prevent a material misstatement of annual and interim financial statements.

# Management's annual assessment of internal control plays a central role in that effort. Through this process, management is responsible for carefully scrutinizing internal controls at the company to determine whether they are functioning at a level that provides reasonable assurance they will detect and prevent a material misstatement and identifying weaknesses that may prevent them from doing so.

# In assessing internal controls, managers are responsible for obtaining sufficient evidence to support their conclusion about the adequacy of internal controls.

# Managers must maintain sufficient documentation to allow a third party to review the work performed and determine whether the conclusion reached by management is reasonable.

# When the assessment uncovers material weaknesses in internal control, management is responsible not only for reporting on those weaknesses in a timely fashion, but

also for acting promptly to rectify those weaknesses.

The addition of such principles in no way limits the flexibility of management in determining how best to achieve the desired results. However, it would add a measure of accountability that is sorely lacking from the proposed guidance. In fact, to call the proposed guidance principles-based without the addition of such principles is a gross misrepresentation.

**The Tone of the Interpretive Guidance Sends a Strong Anti-Investor Protection Message**

The bulk of the discussion in the proposed guidance seems designed to address what management need ***not*** do in conducting its assessment of internal control, rather than what they are responsible for doing or achieving. An early example of this can be found in the discussion of the first "broad principle" around which the proposed guidance is organized – "that management should evaluate the design of the controls that it has implemented to determine whether they adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner."[25] In discussing this requirement, the Release emphasizes that:

> "under the approach described herein, management focuses its evaluation process and the documentation supporting the assessment on those controls that it believes adequately address the risk of a material misstatement in the financial statements. For example, if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, no further evaluation of the other controls is required."

There is no counter-balancing text emphasizing management's responsibility to conduct a rigorous review, or to obtain sufficient evidence to support its conclusions, or to document its work so that a third party could assess the reasonableness of its conclusions, or even to have a reasonable basis for its conclusion that the controls in question adequately address the risk. This lack of balance is evident throughout.

Similarly, in discussing the scalability of the guidance, the Release notes that "smaller companies generally have less complex internal control systems than larger public companies" and thus should be able to "take advantage of the flexibility and scalability of this approach to conduct an efficient evaluation of internal control over financial reporting."[26] While this is true as far as it goes, there is no acknowledgment here of the factors that can make internal control at a smaller company a greater challenge. These include: lack of competent personnel performing the financial functions, lack of adequate personnel to provide checks and balances through segregation of duties, or enhanced potential for management override in a company where the CEO and CFO perform many of the financial reporting functions directly. A scalable assessment for smaller companies must take these enhanced risks into account, as well as those factors that

[25] Proposing Release, page 16.

[26] Proposing Release, page 17.

may simplify the testing obligations. But that is a message that is almost entirely missing from the Proposing Release.

Another typical example can be found at the conclusion of the Release's discussion regarding identification of controls that adequately address reporting risks. Again, the entire thrust of this discussion is to minimize the number of controls management needs to test. It also specifically suggests that, in selecting which controls to test, management can chose those that are easiest to test, rather than those, for example, that are most important to control effectiveness. In the end it states:

> "At the end of this identification process, management will have identified for testing ***only*** those controls that are needed to adequately address the risk of a material misstatement in its financial statements ..."[27] (Emphasis added.)

A pro-investor rewrite would state that management will have identified for testing ***all*** those controls that are needed to adequately address the risk of a material misstatement in its financial statements. These differences in language matter. Unlike the proposed language, the pro-investor alternative sends the message that managers should be prepared to be held accountable if they fail to test controls that are later deemed to have been important to address risks of a material misstatement. That would help to counteract a natural bias of management toward under-testing. At the very least, in instances such as this, the Commission should adopt neutral language, in this case simply that management should select for testing those controls that are needed to adequately address the risk of a material misstatement.

As noted above, we believe requiring adequate documentation of management's assessment is essential. This documentation should be sufficient to provide an audit trail that would allow a third-party to evaluate the reasonableness of management's conclusions – not only about the adequacy of controls, but also regarding the identification of risks of misstatement and the selection of controls for testing. Although the Release highlights the importance of documentation, it makes no demands in this area. Instead, it simply suggests that management "consider the need to maintain evidential matter, including documentation," and only for those "entity-wide and other pervasive elements of its ICFR that it believes address the elements of internal control that its chosen control framework prescribes as necessary."[28] Given the reliance the guidance places throughout on management judgment and assessment of various subjective issues, the very least it ought to require is that management provide documentation that shows on what basis they justify their conclusions.

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[27] Proposing Release, page 26.

[28] Proposing Release, page 29. A later more lengthy discussion of evidential matter management must maintain does not begin to provide the kind of audit trail we envision here. It appears to allow so little documentation in some areas that a complete reevaluation would be needed to determine whether management's assessment is reasonable. Even where it suggests that more evidential matter is needed, it simply suggests, it does not require.

Even a seemingly more balanced aspect of the guidance -- the discussion of how to determine the evidence needed to support the assessment[29] -- suffers from several shortcomings in this regard. For example, it notes that management will normally focus its evaluation "on those areas of ICFR that pose the ***highest*** risk to reliable financial reporting." (Emphasis added.) There is nothing to put this in context, by emphasizing the need to evaluate all those areas that pose a significant risk or a material risk. Similarly, it defers to management's assessment of the effectiveness of the control environment to determine the likelihood that a control will fail and thus the amount of evidence that needs to be collected. But how can management know with any reliability, as they are assessing the controls, how effective those controls are? And how objective are they likely to be in making that assessment? As it is currently written, this is likely to be seen by management as an excuse to do less testing. Moreover, the vagueness of the standard (combined with its lack of clear, underlying investor protection principles) is likely to protect managers from being held accountable, even when they ignore high-risk areas or do insufficient testing to determine operational effectiveness.

A particularly egregious example can be found in the section discussing the expression of an assessment of effectiveness of ICFR by management and the registered public accounting firm.[30] The guidance appropriately notes that management "should not qualify its assessment by saying that the company's ICFR is effective subject to certain qualifications or exceptions or express similar positions." It then turns around, however, and permits management to state that "controls are ineffective due solely to, and only to the extent of, the identified material weakness(es)." We fail to see how that is any different than the types of statements the Commission has expressly prohibited. Worse, it allows management to make a statement for which it has no basis, as even the best assessment can't possibly provide the absolute assurance that no other weaknesses exist, material or otherwise, as this statement clearly implies. This type of statement must be prohibited to prevent investors from being misled about the certainty provided by management's assessment, which is grossly exaggerated here.

The discussion of the impact of restatement on management's report on ICFR is similarly egregious.[31] The Commission should be sending the message that a forced restatement obligates management both to carefully reassess its decisions about risk and the design of its control assessment and its conclusions about the adequacy of controls. The presumption in such cases should be that management's original assessment was incorrect and must be revised. The burden should be on management to show why that is not the case. Instead, the Commission bends over backward to assure management that the mere fact that their internal controls failed to prevent a material misstatement should not force them to reevaluate their previous judgment that internal controls were adequate to prevent a material misstatement. It is absurd on the face of it, and will clearly undermine the quality of assessments performed by management (since there is apparently no downside to getting it wrong) and thus deny investors timely information about

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[29] Proposing Release, page 31-35.

[30] Proposing Release, page 46.

[31] Proposing Release, page 47-48.

control weaknesses.

**Conclusion**

Investor advocates have long complained about audit standards that are so vague as to be unenforceable and that are written with an eye toward protecting auditors from liability rather than promoting effective audits. This interpretive guidance for management has both those characteristics. Worse, despite overwhelming evidence that the benefits of SOX 404 outweigh its costs and that management assessments to date have been highly ineffective, it sends the message that driving down the cost of the assessment, rather than improving its quality, is the Commission's top priority. In fact, with its lack of underlying investor protection principles and its anti-investor tone, we are convinced that the risk-based approach outlined here will further erode the quality of management assessments and provide even less reliable information to investors than they already receive.

Until these shortcomings in the interpretive guidance are corrected – including the addition of strong investor protection principles, adjustments to the risk-based approach to ensure its effectiveness, and removal of language throughout that encourages shoddy assessments – under no circumstances should the Commission provide a safe harbor to companies that rely on this guidance in conducting their controls. To do so would be to permit virtually any management assessment, regardless of how poorly designed or implemented, to pass muster. This would be particularly harmful when combined with the proposed standard from the PCAOB, which if adopted would seriously weaken the independent audit as an effective method to detect and deter financial statement fraud and errors. The combined result of this joint effort would be to fatally undermine the effectiveness of SOX 404 just as it is beginning to deliver real benefits to investors.

Respectfully submitted,

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