CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors, & the Markets

February 16, 2007

Ms. Nancy M. Morris
Secretary
U.S. 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

Dear Ms. Morris:

The Center for Audit Quality (CAQ) is a newly formed group created by the public company auditing profession to help foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies. We welcome the opportunity to share our views on Release No. 33-8762, *Management's Report on Internal Control Over Financial Reporting.*

The CAQ supports proposals that encourage increased effectiveness and efficiency in implementing the provisions of Section 404 of the Sarbanes-Oxley Act (the Act) while maintaining the investor protections that are so fundamental to the success of the Act. Since its passage, the Act has helped enhance the integrity of the capital markets and restore investor confidence. It has done so in large part by recognizing that effective internal controls are the bedrock of reliable financial reporting. We strongly believe that any regulatory changes must not erode that foundation. As the Securities and Exchange Commission (SEC) advances its proposals in this area, we strongly believe that change should flow primarily from the desire to reinforce the significant benefits of effective internal control over financial reporting, rather than a drive to cut costs.

Investors are the lifeblood of our capital markets system, and that system cannot thrive without investors' steady, unwavering belief that legislative and regulatory safeguards are designed for their protection. Any changes must support the current level of investor protection and facilitate realistic cost efficiencies without affecting the quality of financial reporting and auditing.   We fully endorse regulatory change that supports our mutual and deep commitment to investors and the markets.

We know all too well the costs that come with the loss of investor and market confidence. In August 2002, two months after WorldCom's implosion, only 31 percent of those surveyed by Gallup had confidence in the capital markets; by October 2006, thanks at least in part to provisions of the Act, investor confidence was at 54 percent (*USA Today*/Gallup Poll, October 6 – 8, 2006). It should be a goal of all market stakeholders to continue to increase investor confidence in the markets.

We expect the proposed changes, along with the proposals by the Public Company Accounting Oversight Board (PCAOB), will result in a reduction of total Section 404 effort, due to various specific, positive changes in the proposals. These would include: (a) the ability of management to undertake or accelerate a controls rationalization process through the principles in the proposal, to better focus its assessment on those controls that impact its financial statement reporting; and (b) the ability of an auditor to increase the use of the work of others, if certain conditions are met.

We believe that the scope of these reductions in effort, and their relative balance between management effort and auditor effort, likely will vary significantly based on facts and circumstances for each particular company. Factors that will impact these reductions include: (a) the degree to which management undertakes a thoughtful, comprehensive effort to rationalize the controls that it includes in its assessment; (b) the state and quality of an issuer's control structure, as well as the degree of centralization and complexity of its operations, and the risks inherent in its business model; and (c) the quality and commitment that management demonstrates in its assessment process, including the quality of its documentation, its tone at the top, and the consideration it gives to various activities it performs, in order to maximize the degree to which these could be used by the auditor.

Because of these and other factors, it is not possible to set the expectation of a specific or across-the-board reduction that the proposals by the SEC and PCAOB will cause in Section 404-related costs for all companies. We expect that the maximum opportunities for efficiencies and cost-effectiveness in Section 404 implementation can be obtained when management and auditors work together to conduct their assessments in a complementary manner, and when the auditor can make effective use of other's work. We also believe that the benefits from the SEC and PCAOB proposals will be greatest to companies that have not yet initially implemented the requirements of Section 404, such as non-accelerated filers and new public companies. We also expect that the cost of complying with Section 404 can decline as companies and members of the auditing profession become more familiar with the legal and regulatory requirements.

The CAQ strongly supports the following core provisions of the SEC proposal:

- Applying a principles-based approach to the internal control assessment that can be scaled based on the size *and* complexity of the issuer;

- A top-down risk-based approach to management's assessment of internal control over financial reporting that requires testing of only those controls necessary to prevent or detect material misstatements in the financial statements; and

- Requirements that management test the operating effectiveness of those controls over financial reporting necessary to prevent or detect material misstatements each year.

Management may employ a variety of alternatives to assess the effectiveness of its internal control over financial reporting. Appropriate application of the principles set out in the SEC proposal will support effective and efficient management assessments and evaluations of internal control over financial reporting. These principles will support effective application among a wide range of sizes and complexities of issuers.

Although we recognize that management's assessment and evaluation of internal control over financial reporting and the auditor's audit of internal control over financial reporting are two separate activities and need not be conducted in the same manner, there is an important interaction between the two through the auditor's consideration of the work of others. If management eliminates significant steps in completing its Section 404 assessment, upon which the auditor might otherwise have relied in performing its audit, that may result in a reduced ability by the auditor to use management's work, and in a corresponding increase in the testing the auditor must perform and the amount of documentation that the auditor must complete. With respect to smaller companies, especially non-accelerated filers, the effect of this trade-off may be significant if such companies do not make investments in the internal control over financial reporting process.

To address these concerns, we suggest that the SEC guidance include a new section entitled *Interaction with the Independent Auditor* that would include the matters discussed above as well as examples of how the audit scope may be affected by the level of work that management performs and its documentation. Interaction between the auditor and management is crucial for the most efficient overall internal control reporting process. The goal is to improve effectiveness and efficiency of the process.

We also believe that the benefits realized from Section 404 extend beyond improved internal control and financial reporting. Many issuers that support robust management assessment processes as part of Section 404 compliance have realized enhancements in operations, regulatory compliance, and communications. However, similar benefits, particularly for smaller public companies, may not be realized if management's assessment process is not sufficiently robust. This challenge is most pronounced among non-accelerated filers that may not have yet upgraded their monitoring processes or remedied internal control weaknesses. In these cases, savings realized due to a less robust management assessment process may be more than offset by risks to investors from weaker controls, and lost efficiencies in other areas. In addition, auditor effort relative to internal control over financial reporting is directly affected by the quality of management's assessment process – the more comprehensive and robust management's process, the more efficient the audit process.

A more detailed discussion of our perspective is included in the appendix to this letter, and many of the public company auditing firms that are members of the CAQ will submit their own comment letters.

We appreciate the SEC's efforts to improve implementation of the provisions of Section 404, and we look forward to working with you and other market participants to identify enhancements that improve efficiency without diluting investor protection.

We appreciate the opportunity to comment on the SEC's proposal and would welcome the opportunity to meet with you to clarify any of our comments.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: SEC
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Thomas Ray, Chief Auditor and Director of Professional Standards

Appendix

The Center for Audit Quality recognizes that there were various requests for comments within the *SEC Proposed Interpretation - Management's Report on Internal Control over Financial Reporting.* However, we have limited our comments to the significant matters noted below on behalf of our member firms. Please refer to the public company auditing firm letters for additional comments.

While we are supportive of the direction of the proposal, we offer the following comments intended to improve it to meet the overall goal of making implementation of Section 404 more effective and efficient.

Consideration of Fraud

Effective internal control over financial reporting (ICFR) can help companies deter fraudulent financial accounting practices or detect them earlier and perhaps reduce their adverse effects. The SEC proposal discusses management's need to evaluate financial reporting risks and consider the entity's vulnerability to fraudulent activity. However, we believe it is prudent that the SEC guidance focuses more attention on anti-fraud controls and procedures and clearly articulates the tools and techniques that should be considered by management and may be implemented to help prevent, detect or deter fraud.

As noted in footnote 49 of the SEC proposal, reference is made to *Management Antifraud Programs and Controls - Guidance to Help Prevent, Deter, and Detect Fraud*, which was issued jointly by seven professional organizations. We suggest that certain relevant concepts from this guidance be incorporated directly into the SEC guidance to better articulate management's consideration of fraud risks and controls to address these risks.

"Financial Reporting Risks" and "Significant Accounts and Relevant Assertions"

We agree that the methods and procedures for identifying financial reporting risks will vary based on the characteristics of the issuer. The SEC proposal uses the term "financial reporting risks" as the focal point for identifying controls for assessment. To identify and describe risks of material misstatement, auditors will use the concepts "significant account" and "relevant assertion" from the PCAOB proposal (paragraphs 24 through 29) that also includes risk factors to consider in identifying significant accounts. We acknowledge that it is acceptable that management and the auditor use different terminology, but it appears that the terms essentially are describing the same thing, i.e., what can go wrong in the financial statements. While this will not necessarily affect the effectiveness of either management's assessment or the audit, it could adversely affect the overall efficiency of the internal control reporting process. Accordingly, we recommend that the SEC consider the possible implications of using different terminology and either align terminology or discuss whether the different terms are or are not intended to be synonymous.

Monitoring Activities

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) - *Internal Control Framework* states that internal control systems need to be monitored - a process that assesses the quality of the issuer's internal control performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the normal course of operations and includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures.

To be an effective source of evidence, ongoing monitoring activities (often through management's daily interactions) should be supported by documentation and evidence of the following: (1) what the ongoing monitoring activities consist of; (2) the process for communicating findings (regardless of whether there are exceptions identified); and (3) how exceptions, when identified, are evaluated and resolved. Guidance to management specifically illustrating when monitoring activities are insufficient, making direct testing necessary, would be helpful to ensure that the COSO framework for monitoring activities is appropriately considered and addressed by management. If management does not implement appropriate monitoring activities, the auditor will not be able to use such work and may determine that a control deficiency exists because monitoring is inadequate. Accordingly, it is important for the SEC guidance to be clear that it does not supplant the requirements of the chosen framework.

Documentation Requirements

Although the SEC proposal states that management must maintain "reasonable support" for its assessment, there is little guidance on the nature and extent of documentation that management should maintain. We agree that the documentation may take several forms, (e.g., paper documents, electronic, or other media), and can be presented in a number of ways (e.g., policy manuals, process models, flowcharts, job descriptions, documents, internal memoranda, forms, etc). However, if no consideration is given to whether or how the auditor may use this documentation, then the efficiency of the overall internal control reporting process may be negatively affected.

We support the goal of the SEC and the PCAOB to reduce the possibility of costly and time-consuming discussions between the auditor and management regarding the extent of documentation and testing to satisfy management's ICFR evaluation and assessment requirement. However, the auditor may have to perform more work and create additional documentation to comply with the PCAOB's auditing standards, if management's documentation is not sufficient for such purpose.

We suggest that the SEC guidance consider including the following elements for management's documentation because they may enhance the effectiveness and efficiency of the overall internal control reporting process:

- The design of controls over relevant assertions related to accounts and disclosures for which there is a reasonable possibility that the account or disclosure could contain a material misstatement. The documentation should include the five components of internal control over financial reporting, including the control environment and company-level controls;

- Information about how significant transactions are initiated, authorized, recorded, processed and reported, including sufficient information about the flow of transactions to identify the points at which material misstatements could occur; and

- Controls designed to prevent or detect fraud, including controls over the period-end financial reporting process, and over the safeguarding of assets. Such documentation should identify who performs the controls and the related segregation of duties;

- The results of management's testing and evaluation.

Entity-Level Controls (Company-Level Controls)

Precision relating to the "design" of entity-level controls is not clearly discussed in the SEC proposal, and we suggest that this discussion be included in the section, *Consideration of Entity-Level Controls* (page 27). The precision of entity-level controls related to the "evaluation" is referenced in footnote 77 of the SEC proposal; however, we believe that the SEC guidance should emphasize precision related to both the design and evaluation of entity-level controls. This emphasis is necessary to illustrate that while company-level controls may be designed to operate in a manner that would identify possible breakdowns in lower-level controls, such controls may not be designed at a level of precision that would sufficiently address the risk that material misstatements to a relevant financial statement assertion will be prevented or detected.

If management designs company-level controls to detect material misstatements in the financial statements without regard to their precision, the auditor likely would need to identify and test controls at a lower level, negatively affecting the efficiency of the overall process.

Strong Indicators of a Material Weakness

Certain items that are included in the PCAOB proposal as strong indicators of a material weakness are not identified as such in the SEC proposal. For example, the SEC proposal does not include 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), which are defined as strong indicators of a material weakness by the PCAOB.

The deficiencies noted above are strong indicators of a material weakness and should be referred to as such in the SEC proposal. Having an inconsistent description of strong indicators in the SEC and PCAOB proposals is unnecessary and will create confusion and inefficiency when management and the independent auditors are evaluating and comparing their findings. Accordingly, we strongly suggest that the SEC guidance on strong indicators of a material weakness be aligned with that of the PCAOB.