711 Louisiana St.   General   713.314.4900
Suite 1200   www.protiviti.com
Houston, Texas 77002

February 26, 2007

Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 Fifth Street, NE
Washington, DC   20549-1090

Re: File No. S7-24-06 -- **Comments on Proposed Interpretive Guidance on
      Management's Report on Internal Control Over Financial Reporting**

We respectfully submit our comments on the Securities and Exchange Commission's (SEC or
Commission) proposed interpretive guidance for management regarding an issuer's
evaluation of internal control over financial reporting (ICFR). Our comments are based on our
experiences in the role of advisor to our clients as they evaluated the effectiveness of their
ICFR and formulated an assertion with respect to such ICFR in accordance with The
Sarbanes-Oxley Act of 2002, and specifically with Section 404 of the Act. While we are
neither a registrant nor an accounting firm, we are offering insight arising from a multitude of
experiences as an advisor to hundreds of companies (domestic and foreign filers as well as
large and small companies) in achieving compliance with Section 404 and/or determining how
to improve their compliance processes. In conjunction with these experiences, we have been
exposed to all of the major accounting firms.

Overall, we applaud the Commission's efforts in issuing guidance to management. We have
long advocated separate guidance from the SEC that clarifies what constitutes a sufficient
effort in the assessment process. We believe that the Commission has taken a step in the
right direction with its proposed interpretive guidance coupled with its proposed rule
amendments stating that a company choosing to perform an evaluation of ICFR in accordance
with the interpretive guidance would satisfy the annual Section 404 evaluation required by
those rules. Without a framework of this kind, management is unable to effectively gauge the
effort and control the related costs.

We also support the SEC's efforts to better align costs with the benefits of Sarbanes-Oxley
compliance. We continue to believe that the Sarbanes-Oxley objective to protect investors by
improving the transparency, accuracy and reliability of corporate disclosures made pursuant to
the securities laws, and for other purposes, is vitally important to our capital markets. We also
believe that there are opportunities for the Commission to further clarify and increase the
impact of its proposed guidance in specific areas. To that end, we offer the following
recommendations for the Commission to consider.

Clarify the Top-Down Approach as It Applies to Both Evaluating Design Effectiveness and Testing Operational Effectiveness

Issue: We agree with the top down approach suggested by the SEC as a means of focusing
companies on the most important risks and controls to reduce the cost as well as improve the
effectiveness of the Section 404 compliance effort. Having said that, in reading the proposed
guidance, we are concerned with how the top down approach could be interpreted as
companies apply it to evaluate the effectiveness of their ICFR. For example, some companies

might interpret the guidance as permitting them to take a top down approach to identifying their key controls without also gaining an overall understanding of their control environment and the flow of major transactions. It has been our experience that companies must start with a base line of understanding of the key business processes and financial reporting controls and the flow of major transactions as a foundation for assessing account level risks and evaluating the effectiveness of entity-level controls in reducing those risks to an acceptable level. Therefore, applying the SEC's guidance, some companies may decide they can:

(1) Select the significant accounts and relevant assertion risks based on a risk assessment that isn't grounded by an understanding of the underlying processes and systems

(2) Identify the entity-level controls that directly (versus indirectly) address the perceived account assertion risks and provide reasonable assurance that the risks are appropriately mitigated

(3) Stop and proceed no further in understanding the control environment

Our experience is that this approach is generally not sufficient when applied to financial reporting elements (FREs) with high or moderate assertion risks. It is impractical for scoping decisions to be determined in a vacuum at the entity-level for high-to-moderate risk areas at the level of precision envisioned by the SEC's proposed guidance. As a result, there needs to be an adequate understanding of the control environment at the process level to formulate the scoping decisions in high to moderate risk areas.

Recommendation: The SEC guidance should differentiate the application of (a) the top-down approach to documenting and evaluating controls design effectiveness from (b) the top-down approach to testing controls operational effectiveness. The guidance should address the following four points:

(1) Clarify that implementation of a top-down approach requires an understanding of the flow of transactions affecting the significant FREs and the critical systems that support those transaction flows. (Note: The process by which that understanding is obtained is not "bottom-up", but is accomplished as described further in (3)(a) below.)

(2) Explain that an assessment of design effectiveness for controls which mitigate relevant assertion risks for high to moderate risk FREs would generally not be sufficient without an understanding of the control environment at the process-level (as described in (3)(a) below), because that understanding enables management to properly source risk and determine whether the selected key controls are properly designed to mitigate the risk of material error or fraud occurring and not being detected on a timely basis.

(3) Articulate the impact of the top-down approach on compliance costs, as follows:

   (a) With respect to obtaining an understanding of the flow of transactions, that understanding can be gained through walkthroughs and discussions with, and involvement of, process owners who are sufficiently knowledgeable of the

processes and systems underlying the critical FREs; however, if company personnel are not sufficiently knowledgeable of the control environment or lack a sufficient fact base supporting their input to the top-down approach, then the company must document the control environment sufficiently to obtain the requisite understanding for applying the top-down approach.

(b) With respect to selecting the vital few controls on which management will rely for purposes of complying with Section 404, if management's understanding of the control environment is sufficient and that understanding is documented in reasonable detail, then it is more likely that the application of the top-down approach will result in selecting the control set that is the most effective in mitigating financial reporting assertion risks. A deficient understanding of the control environment will lead to a lack of transparency that will likely result in failure to select a reduced number of controls.

(c) With respect to the evaluation of design effectiveness, it is the reduced number of controls that will reduce the cost – not the documentation itself.

(d) With respect to tests of operating effectiveness, management has multiple ways to evaluate controls operating effectiveness, not all of which demand the same level of written evidence as the evaluation of design effectiveness. Both the reduced number of controls and the nature of evidence gathering to support a conclusion on operational effectiveness have the potential to reduce the cost of testing.

(4) Clarify that the Commission's intent to reduce the level of process documentation is solely for purposes of complying with Section 404 and is not intended to suggest that documentation of the underlying processes and systems as well as other controls is inappropriate for other business purposes.

We recommend that the SEC's proposed guidance address these points. While we have never advocated the "bottom up" approach, we have always believed that a reasonable level of process and systems documentation is appropriate for FREs of high to moderate risk and complexity. The nature and extent of this documentation is a separate question from the nature and extent of management testing. While we have observed that low risk processes have been over-documented in the past, we believe it is important that initial adopters of Section 404 compliance understand that it is an efficient controls design and a cost-effective test plan – not the initial documentation – which will have the greatest impact on the cost of Section 404 compliance on an ongoing basis. Furthermore, the approach suggested in (3)(a) above is quite different from the "bottom up" practices so prevalent today.

Discussion: We believe that the top-down approach is easier to apply when there is a fact base that facilitates an understanding of the flow of critical processes affecting the significant FREs and the interface of such processes with key systems. The nature and extent of the documentation providing this fact base should be a function of the risk and complexity of the accounts. For some accounts, walkthroughs and discussions with knowledgeable process owners may be all that is required to source risk and identify key controls. The issuer's

existing process documentation may be adequate to support this exercise. For example, centralized processes and shared services environments may have more extensive documentation than decentralized processes. That all said, in our experience, we have worked with process owners who needed to map their process to position themselves to confidently advise management during the risk sourcing and controls identification exercise required by a top-down approach.

The objective of a top-down approach is to undertake a thoughtful process involving knowledgeable people who have a fact base around the underlying processes and systems enabling them to address relevant factors such as those pointed out by the Commission on page 33 of the proposed guidance. For example, as pointed out in the proposed guidance, factors pertaining to the risk of control failure include the type of control, the complexity of the control, the risk of management override, the judgment required to operate the control, the nature and materiality of misstatements the control is designed to prevent or detect and the degree to which the control relies on the effectiveness of other controls. Some of these factors are impacted by the underlying processes and systems that define the environment in which the controls operate. These factors may differ from process to process and from unit to unit. It may be impractical to address some of these factors at the entity level without a sufficient understanding of the relevant transaction flows. Without that understanding, evaluators may have a tendency to place a high level of reliance in a dynamic operating environment on the historical experience of no reported issues.

We support the top-down, risk-based approach and believe that its rigorous application will reduce the control set to the fewer critical controls on which management should rely for purposes of reaching a conclusion as to the effectiveness of ICFR. We believe the SEC's proposed guidance articulates well management's responsibility for testing operating effectiveness. With respect to the evaluation of design effectiveness, we believe the proposed guidance should clarify that the top-down approach it describes is only effective to the extent that an appropriate understanding of the underlying key business processes and controls exists. We further believe, as described above, that the requisite understanding need not be documented as extensively as in the past.

Once the critical controls are identified, we believe that the documentation of the design effectiveness should be rigorous and written. Therefore, with respect to the evaluation of design effectiveness, it is the reduced number of controls that will reduce the cost – not the documentation itself. The test of operating effectiveness is different. Management's role as an insider can have a significant impact on the determination of the nature, timing and extent of tests of operating effectiveness, and that impact will translate into different forms of written evidence. It is here where the greatest reductions in cost and effort are likely to occur, particularly in low risk areas. The assessment of design effectiveness, however, requires a certain level of robust and written documentation in the first year that can be carried over and updated in future years. For newly public companies and non-accelerated filers, we expect some level of first year investment to complete this documentation. This level of investment need not be as extensive as experienced by most accelerated filers in the past, because

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under the SEC's proposed guidance the compliance process will be better aligned with the inherent risk of material error and fraud.

It is a longstanding point of view that an understanding of the flow of major transactions provides the foundation for sourcing risk. For certain types of financial reporting assertions and risks, the assessment of design effectiveness often cannot be accomplished at the entity level without a level of understanding of the controls functioning within business processes. For example, risks relating to the completeness and accuracy of processing often require a process view. Further, the flow of transactions through business processes and accounting systems and the interfaces between systems are often very important in identifying risks related to authorization, segregation of duties, unauthorized access and potential fraud, in addition to the completeness and accuracy assertions. It is within these processes where significant errors, omissions or fraud might occur. The sourcing of risk in turn enables management to choose the key controls on which to rely and provides the context for evaluating the design effectiveness of the selected controls, including monitoring controls and monitoring activities.

In summary, risk-driven investments in process documentation in the initial year of Section 404 compliance provide the transparency needed to select the vital few controls that reduce financial reporting risk to an acceptable level. These controls provide the context for rationalizing cost-effective test plans. In future years, it is the reduced number of controls and the optimum test plan that will drive the reduction of compliance costs – not the documentation created in the first-year. If the first year documentation is cut short to reduce costs, the resulting lack of transparency will lead to less rigorous identification of the most critical controls. That can translate to higher controls testing costs in subsequent years as well as non-value-added revisits to the underlying controls documentation to further refine it.

Consider the Implications of Auditing
in a "Walk-Around" Environment

Issue: High expectations have been raised with respect to the scalable audit. However, it is unclear as to how an auditor can audit the operating effectiveness of internal controls in a "walk-around" environment.

Recommendation: Because the application of the scalable audit could inevitably place auditors in the position of being unable to test the operating effectiveness of key controls, the SEC's guidance should present a balanced view concerning the scalability of the compliance process to small companies so that management of these companies will have reasonable expectations when dealing with their auditors.

Discussion: We understand the direction the SEC and Public Company Accounting Oversight Board (PCAOB) are headed in terms of requiring a scalable audit for small companies without multiple layers of management and multiple business units. We understand the points of view regarding management's daily interaction with the business and the implications of such interaction on the level of controls documentation available in a small

company environment. However, we have two concerns that are not addressed by the guidance:

- First, if management controls are to be relied upon based upon the daily interaction and "walk around" by management, how will this activity be effectively supported by management and independently validated by the auditor?

- Second, the SEC has clearly stated that more emphasis needs to be placed on controls to prevent fraud – particularly the risk of management override of established processes and controls leading to material financial reporting fraud. It is reasonable to assume that the risk of management override increases in environments where management has more hands-on oversight, responsibility and direct influence. This is the environment in which the SEC is suggesting it would be appropriate to rely upon the undocumented review and "walk around" of management as a reliable entity-level control. While the Commission's point reflects the reality of a small company environment, it nevertheless seems incongruent with the emphasis on sufficient controls to prevent management override and fraud.

In these environments, most auditors would likely expand the scope of the financial statement audit to include extensive substantive tests of account balances with little or no reliance on internal controls. The auditor would probably not rely on the control environment, regardless of management's assessment of that environment. Auditors could be placed in a dilemma of issuing the opinion on ICFR based primarily upon either (a) the lack of evidence that material errors or fraud exist based on a largely substantive testing-based audit of the financial statements or (b) the application of inquiry and observation procedures. We do not believe that inquiry and observation procedures provide a sufficient basis for an opinion on ICFR. We also are concerned that a default conclusion on the effectiveness of the control environment on the basis of a substantive financial statement audit would be potentially misleading. Notwithstanding these concerns, the irony is that a scalable audit of ICFR in a "walk around" environment could very likely involve a combination of inquiry and observation procedures PLUS extensive substantive audit tests as part of the integrated audit. The default nature of the resulting conclusion on ICFR could give rise to a differently articulated opinion than the one currently required by the PCAOB.

We realize that there are initiatives underway by the Committee of Sponsoring Organizations (COSO) and the PCAOB that may shed light on the practical application of a scalable audit. Therefore, it would be premature to suggest actions to address the above points until those efforts are completed. However, the guidance set forth to support the scalability of the compliance process to small companies needs to be sufficiently balanced so that management of these companies will have reasonable expectations when dealing with their auditors.

Encourage Management to Reduce the
Risk of Disconnects with the Auditor

Issue: In theory, with the proposed changes, management is free to exercise judgment during the risk assessment and scoping process and take into consideration what is known about the business based on management's insider knowledge. However, management should avoid, as much as possible, disconnects between the company's assessment and the auditor's assessment, because such disconnects will drive up costs, present problems if issues should arise and potentially spawn increased litigation risk for companies.

Recommendation: To fully optimize Section 404 compliance costs, the SEC's guidance should assert that management needs to take the necessary steps to ensure that the auditor fully understands management's thought process during the controls evaluation process. The Commission should:

- Include guidance that encourages management to understand the results of the auditor's risk assessment (and vice versa).

- Encourage management to review with the auditor key decisions at critical points along the controls evaluation process.

Discussion: We have found that none of our clients have appetite for disconnects between management's assessment and the auditor's assessment. If management applies the SEC's guidance in its entirety and then subjects the results to audit by an auditor who applies the PCAOB's proposed auditing standard, we do not believe the interaction between management and auditor will lead to cost-effective results. A sufficient level of communication between management and the auditor is required to ensure that the compliance process works in a cost effective manner. Because the auditor's second opinion is being eliminated, management must take the initiative to involve the auditor in dialogue at appropriate checkpoints.

The risk of disconnects increases if:

- The auditor doesn't obtain an understanding of management's assessment process

- Management doesn't involve the auditor at specific checkpoints as management applies the top-down, risk-based approach

- Management does not document the rationale for its decisions when applying the top-down, risk-based approach

Our experience in the past is that it is best practice for management to engage the auditor in dialogue as the company works through the compliance process. Since the new guidance does not change this dynamic, it should clarify explicitly its importance. This especially applies to the application of the top-down risk based approach. For example, during the process, management should engage the auditor in dialogue with respect to the following decisions:

(1)   Identifying relevant financial reporting assertions

(2)   Selecting significant accounts and disclosures (FREs)

(3)   Determining the relative ICFR risk levels of (2) and (1)

(4)   Deciding the documentation standards at different levels of FRE risk

(5)   Selecting the key controls, including the effectiveness of their design

(6)   Determining the multi-location scoping considerations

(7)   Understanding the competency and objectivity standards driving the auditor's use of the work of others

(8)   Establishing the assessment methodology for evaluating the severity of control deficiencies at the conclusion of the process

We believe, and the PCAOB asserts in the introduction to the proposed AS5, that the auditor's application of a top-down, risk-based approach is greatly augmented by, and reaches the highest level of efficiency when the auditor understands, a well-documented management application of the top-down, risk-based approach. A well-documented assessment includes the supporting rationale for management's decisions.

In summary, to fully optimize Section 404 compliance costs, the SEC's guidance should assert that management should take the necessary steps to communicate with the auditor to ensure that the auditor fully understands management's thought process. This communication is critical to a cost-effective approach and reduces the risk of costly disconnects leading to increased audit fees and the auditor discovering one or more material weaknesses that management didn't find. Therefore, we recommend the following:

- The Commission should include guidance that encourages management to understand the results of the auditors' risk assessment (and vice versa). There may be valid reasons why management's risk assessment would be lower in certain areas than the auditor's assessment since management is generally in a better position to evaluate risk. However, it would be helpful for management and the auditors to at least compare their risk assessments, and discuss the reasons for any differences.

- The Commission should also encourage management to review with the auditor key decisions at critical points along the controls evaluation process. This is an established best practice that many accelerated filers have honed over the last three years and it is a practice that should be shared with the companies that must comply with Section 404 for the first time. The eight items listed above provide examples of key decision points.

Emphasize Quality as Well as Cost

Issue: Much of the proposed guidance appears to be focused on increasing cost-effectiveness. While we agree with this objective, we believe the SEC should take this opportunity to encourage companies to improve the quality of their internal controls in addition to increase the cost-effectiveness of the compliance process. If companies do not improve the quality of their controls, they risk wrapping their compliance process around a high-cost internal control structure.

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Recommendation: The Commission should consider listing appropriate "have you thought about…" questions to encourage companies to move beyond the narrow "pass/fail" focus to a broader focus on "process capability."

Discussion: A higher quality internal control structure will ensure that compliance will be sustainable and cost-effective in the future. A high quality internal control structure will also lead to lower compliance cost. A study conducted last year by the Information Technology Process Institute supported this conclusion in the IT general control environment and we have seen evidence supporting this conclusion in business process controls as well.

If the SEC were to balance the discussion around the "value" of what the Commission is asking for to include the value to the company as well as the value to the markets, the guidance would encourage management to do things that lead to internal value-creating activities that improve quality, time and cost performance. For example, the Commission should consider listing appropriate "have you thought about…" questions to encourage companies to move beyond "pass/fail" to "process capability." For example, such questions might include the following:

Have you thought about:

- Investigating the reasons for the length of time to close the books and process transactions versus other companies, with the objective of focusing and automating manual tasks and reducing cycle times?
- The root cause of high exception rates identified and corrected in processing accounts payable, cash application and other high volume transactions?
- Standardizing processes across locations?
- Eliminating nonessential and redundant control activities?
- Simplifying complex manual procedures and work flows?
- Minimizing the number of manual and non-standard journal entries?
- Optimizing the controls embedded within your ERP system, and eliminating manual tasks which duplicate ERP functionality?
- Reducing dependency on spreadsheets?
- Evaluating the effectiveness of decentralized business units with duplicate functions?
- Evaluating costs and benefits associated with complicated segregation of duties issues?

Reference to the above matters would not position the Commission outside the role of regulator. Long-term, the above (as well as other) questions can be just as important to the cost-effectiveness of the Section 404 compliance process as direct questions pertaining to the compliance process itself. As we have stated in a prior letter to the Commission: "The current emphasis on 'pass/fail' and on managing external audit costs, while important, will not lead to optimum results from an operational efficiency standpoint." If companies do not understand that improvements in the quality of their up-stream business processes affecting financial

reporting will facilitate many of the things articulated in the SEC's guidance, e.g., monitoring activities, monitoring controls, automated controls, KPI's, etc, an opportunity will be lost. The consequences of this lost opportunity will be to wrap the compliance process around a high-cost internal control structure dominated by manual, detective controls.

Other Comments

Following are additional observations:

- **Consider whether the inclusion of more detailed guidance in specific areas in the proposed auditing standard than in the proposed management guidance will lead to unintended circumstances**. There are several examples where the proposed auditing standard provides more guidance than the proposed management guidance. For example, the auditing literature includes a list of specific factors to consider when selecting significant FREs that the SEC guidance does not. In addition, the auditing standard lists factors affecting the risk associated with a control that has some different elements than the factors in the SEC guidance regarding control failure risk. There are also other examples, and we will not list them all here.

    Footnote 50 on page 23 of the proposed guidance states the following:

    > [W]e are not requiring that companies use the guidance in the auditing literature to conduct their evaluation approach.

    While we do not disagree with the Commission's intent, it is our experience that most managers seek to manage the cost of the entire Section 404 compliance process, including the cost of the attestation process. They know that the key to making this approach successful is auditor agreement on key decision points so that the auditor will conclude that management's assessment provides a basis for the auditor to use the work of others. To accomplish that end in the past, management has had to read and understand the auditor's guidance. If management desires to work with the auditor and gain agreement from the auditor on the risk assessment, the significant FREs, the key controls and other matters which drive the scope of the evaluation process, they will need to understand the criteria the auditor must consider as well. If the auditor is applying more granular guidance on a similar topic, management may be incented to review the auditor's guidance to understand the auditor's criteria for making assessments, even though management is not required to rely on that guidance. Therefore, we suggest that the Commission and the PCAOB align their guidance providing criteria regarding the common decision points along the Section 404 evaluation process where both management and the auditor must make similar decisions.

- **Consider providing more examples of how entity-level controls can affect tests of process-level controls.** It has been our experience that many companies have not been able to demonstrate a clear linkage showing how entity-level controls reduce the risk of material error at the account level. Now that the Commission has differentiated between entity-level controls having a direct impact and an indirect impact on FREs, it would be

helpful to provide examples, particularly for the so-called "direct" controls. We understand that the COSO Monitoring Project was organized to provide such examples at some time in the future. Some examples would be helpful to companies in understanding better how their entity-level controls can affect the nature, timing and extent of tests of process-level controls.

- **Consider evaluating the nomenclature around entity-level controls, monitoring activities and monitoring controls.** The proposed guidance differentiates between monitoring controls and monitoring activities as well as two categories of entity-level controls with a direct effect and an indirect effect on FREs. We have been told by several clients that they find these terms confusing. Because the COSO Monitoring Project is also considering these same issues, the Commission may want to acknowledge that COSO may offer updated terminology to reduce the potential for confusion. In addition, the Commission should encourage companies to apply the principles it articulates in the proposed guidance using the selected controls evaluation framework. In the end, labels are not important. What's important is identifying the controls in place that reduce risk to an acceptable level.

  One option is to relate "monitoring activities' and "monitoring controls" to the COSO Framework. For example, "monitoring activities" represent the monitoring component of the COSO framework whereas "monitoring controls" are the control activities component within the framework.

- **Provide more guidance on reviewing SAS 70 reports.** Our experience has been that SAS 70 reports sometimes contain testing exceptions that do not result in a report qualification. In addition, these reports do not always address all required control objectives. As a result, management will sometimes accept a SAS 70 report without understanding how it should relate to their assessment process. We believe additional guidance should be provided to management on the consideration of SAS 70 reports provided by third party organizations. Service organizations merely execute the directions issued by user organizations, consistent with the view that under most outsourcing arrangements the user is buying expertise and competence and not transferring process risk. Therefore, the user organization's input and output controls will need to be evaluated and tested along with ensuring that the service organization's controls are adequately covered by the SAS 70 report.

- **Consider incorporating appropriate guidance with respect to Section 302 compliance.** We realize that the SEC has focused its guidance on compliance with Section 404. That said, we believe there is an opportunity to improve the connection between the Section 404 and Section 302 Sarbanes-Oxley compliance efforts. The disclosure controls and procedures disclosures required by Section 302 suggest that there should be effective controls over the fair reporting of public disclosures outside of the financial statements. The process for evaluating disclosure controls and procedures have never been defined and no standard exists – yet these controls and procedures can be as important as the ICFR. In fact, many of the control features that will now be relied upon for

purposes of Section 404 compliance – entity-level controls, monitoring controls and monitoring activities, for example – are similar for purposes of Section 404 compliance and Section 302 compliance.

- **Consider incorporating guidance with respect to reporting significant deficiencies.** The proposed guidance for management does not address the treatment of significant deficiencies, and yet the proposed guidance for auditors does. If management isn't given guidance on classifying significant deficiencies, will that lead to potential disagreements with auditors? If the SEC incorporated the definition of a significant deficiency into its guidance, the following additional points could be made, among other things:

  – The point could be reinforced that the objective of the Section 404 evaluation is to identify the existence of material weaknesses, not significant deficiencies.

  – When significant deficiencies are identified, whether through the evaluation of deficiencies discovered through the Section 404 compliance process or through other means, management must report them to the auditors and audit committee.

  – The primary distinction between a significant deficiency and a control deficiency is that the severity of a significant deficiency is "significant" (which has been defined in the PCAOB's proposed guidance for auditors).

  – The interrelationships between Section 404 and Section 302 compliance, as it relates to significant deficiencies, should be discussed.

  It is important that management have guidance on how to classify a significant deficiency as well as how to report on them.

- **Clarify the extent to which external auditors can be used by management in assessing new developments in generally accepted accounting principles (GAAP).** In practice, management frequently turns to the external auditors to assist them in understanding complex accounting matters. In addition, management frequently asks their external auditor to make them aware of new or emerging issues related to the application of GAAP. We continue to see some examples where management has questions regarding the extent to which they can rely on their external auditors in these areas? For instance, one of our clients was told by its auditor that GAAP was changing in relation to certain lease accounting issues. While there was nothing in writing, discussions had been occurring between the audit firm and the SEC. The auditor assessed this matter as a significant deficiency because management was not aware of these discussions. Our client was quite frustrated with this development, because they did not have any other way of knowing about the audit firm's discussions with the SEC until the audit firm told them. If these issues continue to arise, they will present a significant concern for smaller companies.

- **Reconsider the application controls example:** The discussion on pages 27 and 28 of the proposed interpretive guidance provides an example of an application control as "controls that update accounts in the general ledger for sub-ledger activity." This example

covers an interface or functionality control, as opposed to an automated control (such as a three-way match or a verification or validation routine). To explain further:

– Application controls are controls designed into the processing of transactions to prevent and detect errors or appropriately authorize individuals to initiate, approve and review transactions. These controls include computerized matching, error checking, edit checking, automated balancing, etc. They are in essence specifically designed into a system.

– IT functionality refers to consistently applying a formula or performing a calculation, posting the correct balance between a sub-ledger and general ledger, with the reports being complete, accurate and displaying all and only in the intended and appropriate amounts.

– Interfaces exist somewhere between applications controls and IT functionality. For example, there are some interfaces without appropriate automated controls being "designed and built" into them and therefore fit the definition of "functionality." There are other interfaces that include automated controls around them to prevent or detect errors.

In the case of IT functionality, companies rely upon the continued, consistent and appropriate operation of the system and application processing. In other words, management inherently relies upon the functionality of the program and a control does not always exist in the application that tells a process owner that the processing results are correct and consistent. If there was such a control, it would be an application control. In situations involving application controls, interfaces and IT functionality, companies rely upon "general IT controls" to assure management that the application controls, IT functionality and the related data continues to have integrity.

Given the above, the Commission may want to revisit its example of an application control.

We appreciate the opportunity to submit our comments on the Commission's proposed interpretive guidance. We hope they are helpful to the Commission and to its staff. If the staff would like to discuss any of the points made in this letter, please contact Jim DeLoach at (713) 314-4981.

Very truly yours,

Protiviti Inc.

By: James W. DeLoach, Jr.
      Managing Director