February 26, 2007

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

Re: File Number S7-24-06

Dear Ms. Morris:

Financial Executives International ("FEI") appreciates the opportunity to provide its views on the U.S. Securities and Exchange Commission's ("SEC") proposed interpretive guidance ("proposed guidance") for management regarding its evaluation of internal control over financial reporting and related rule amendments.

FEI responds to such requests through its technical committees. As a result, I have attached two letters from FEI's Committee on Corporate Reporting ("CCR") and FEI's Small Public Company Task Force ("SPCTF") in response to the SEC's proposed interpretive guidance.

Thank you again for the opportunity to provide our comments.

Sincerely,

Grace L. Hinchman
Senior Vice President
Financial Executives International

financial executives international

committee on corporate reporting

February 26, 2007

Nancy M. Morris
Secretary
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100 F Street, NE
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Re: File Number S7-24-06

Dear Ms. Morris:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to provide their views on the U.S. Securities and Exchange Commission's ("SEC") proposed interpretive guidance ("proposed guidance") for management regarding its evaluation of internal control over financial reporting ("ICFR") and related rule amendments. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR, and not necessarily those of FEI or its members individually. We are also submitting a comment letter to the Public Company Accounting Oversight Board ("PCAOB") in response to its proposed auditing standards, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and *Considering and Using the Work of Others in an Audit* ("proposed standards").

We agree that the proposed guidance has the potential to assist companies in making their evaluation process more efficient and cost-effective, as the SEC intended. We appreciate the thought and effort put into developing the proposed guidance. We also appreciate the fact that the SEC has listened to comments expressed at the two Roundtables and in other forums about the need for balance between costs and benefits of Sarbanes-Oxley compliance. The proposed guidance opens the door for productive dialogue with our auditors about how to make our assessments and their audits much more efficient. We especially appreciate that the proposed guidance has moved to a more principles-based approach. It allows for a high level of judgment in applying the principles to individual company situations, moving away from the one-size-fits-all approach that many companies and their external auditors have been following. In particular, we support the top-down, risk-based approach. In the Appendix we have included additional comments about the benefits that we expect to derive from a more focused internal controls assessment and also specific responses to several of the questions posed in the proposed guidance. We support the approach of issuing interpretive guidance rather than a SEC rule to allow for flexibility in adopting the guidance.

In addition to our support for the proposed guidance, we have two critical concerns. First, management guidance and external audit standards must be aligned. We believe that the proposed standards, although improved from the existing PCAOB Audit Standard No. 2 (“AS2”), are still more detailed and prescriptive than the proposed guidance. These differences could result in external audits that are more conservative than management assessments, which will cause companies to incur unnecessary costs to remain aligned with their external auditors.

Second, for companies to implement the proposed guidance successfully in alignment with their external auditors, the auditors must be assured that the inspection practices of the PCAOB will align with the proposed auditing standards. If the auditors do not receive that assurance, they will be reluctant to change their approach until after an inspection cycle, which can be more than a year from the time of the audit. If auditors do not change their approach, companies will continue to incur additional costs and fail to achieve the objective of more efficient and effective assessments. We discuss several alternatives to help achieve this objective in the paragraphs that follow.

We also have several suggestions for clarifications or enhancements to the proposed guidance itself. All suggestions are described more fully below, but the top priority items in terms of improving efficiency and effectiveness are:

- Focus on change in controls for testing, allowing for rotational testing of controls that have operated effectively in the past and have not changed
- Increased reliance on entity-level controls to reduce process-level testing
- Elimination of the “interim” financial statement component from the definition of material weakness

We believe these suggestions are critically important to have a meaningful impact in striking the right balance between costs and benefits of internal controls assessments. We have also included these suggestions in our letter to the PCAOB. As noted above, it is essential to maintain alignment between the proposed guidance and proposed standards.

ALIGNMENT BETWEEN MANAGEMENT AND EXTERNAL AUDITORS

Companies represented by CCR are ready to take advantage of the efficiencies that the proposed guidance enables. To date our Sarbanes-Oxley compliance approaches have been largely driven by the audit firms. In the absence of management guidance, companies have had to follow AS2 to satisfy the requirements of the external auditors.

We expect that to change with the introduction of the proposed guidance. With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we anticipate that companies will drive to narrow their focus to the truly high risk areas, achieving a better tradeoff between the quality of controls assurance and the cost of compliance. Companies are certainly motivated to become more efficient in their compliance processes. It stands to reason that the external auditors, under the proposed standards, would be able to mirror management’s efficiencies.

We want to emphasize how critical it is that the audit standards are aligned with management guidance. The external auditors must be comfortable with management’s assessment approach to optimize reliance and achieve overall cost savings. Although the requirement for an opinion on management's assessment process has been recommended for elimination, the opinion on the controls themselves remains. A more detailed or conservative approach on the part of the auditors will drive companies to continue to document and assess lower-risk controls, thereby continuing to incur unnecessary costs and failing to achieve the objective of more effective and efficient assessments.

We hope that external auditors are preparing to change their approach to the same extent as management. We have heard some comments from auditors to the effect that they do not view the proposed standards as driving much of a change in their current practice as they believe that they have already been implementing a more top-down risk based approach with the issuance of May 2005 PCAOB guidance. We believe auditors have understandable concerns about the impact of PCAOB inspections, since the inspection reports issued to date have not focused on the risk of over-auditing. Some auditors seem to be taking a wait-and-see approach, anticipating guidance from the firms' national offices. Their hesitation to embrace the idea of big change is perhaps understandable. Certain auditors may actually disagree with the changes, feeling that we might be losing ground that has been gained since the passage of the Sarbanes-Oxley Act. Others could be legitimately concerned about the impact on the audit firms' revenue profile, which has been significantly enhanced by the addition of the internal controls audits in the past 2-3 years.

Barriers to change for the external auditors could manifest themselves in individual engagement teams being unwilling to make changes without support from the firm's national office, in national office guidance that interprets the standards more restrictively than intended, and/or in firms collaborating to create de facto guidance that reverts to more prescriptive language and mutes the positive changes in the proposed standards.

We believe that the PCAOB needs to be proactive in encouraging external auditors to embrace the level of significant change that the companies expect to make in their assessments, and we are including the following suggestions in our comment letter to the PCAOB in response to the proposed standards. We believe these suggestions will aid in aligning implementation of the proposed guidance and standards.

- Additional language in the proposed standards or in the introduction to the proposed standards, giving more concrete guidance regarding the extent of change that is expected
- Educational forums to clearly instruct the auditors in the intent of the new proposed standards and how the inspection process will also change in the same spirit.
- PCAOB inspections that support the drive for efficiency by including inspection criteria that evaluate conformance to the new proposed standards and resulting efficiencies. Those criteria should be communicated to the auditors as soon as possible to support efficiencies in the calendar year 2007 internal control audits.
- PCAOB monitoring of any multi-firm initiatives from external auditors to create supplemental guidance to the proposed standards. The PCAOB should also monitor guidance from the national offices of the firms regarding implementation of the proposed standards to make sure that firm guidance does not countermand the intent of the new standards. Any supplemental guidance that is developed should be the result of due process which involves input from industry as well as the external audit firms.
- Change in the definitions of "significant deficiency" and "material weakness" in the proposed standard to remove the reference to interim financial statements. We believe that the deficiency evaluation should be based upon annual materiality

thresholds since the assessment of internal controls is an annual assessment with a focus on internal control weaknesses as leading indicators of potential future misstatements.

- Modification of certain detailed or prescriptive provisions of the proposed standards, such as the requirement for walkthroughs, evaluation of all deficiencies even if clearly not material, and the continued expectation that each control will be fully tested each year.

CLARIFICATIONS AND ENHANCEMENTS

Focus on changes in controls
The proposed guidance encourages the use of prior knowledge and assessment results to guide the risk assessment and testing approach. After the initial assessment, subsequent reviews of risk and design can be focused on changes in risks and controls. Prior testing results can be used to guide the risk assessment of both the significant accounts and the controls.

We support the focus on changes in controls and believe that it could lead to the logical conclusion that a control would not need to be tested or assessed each year. In spite of the discussion about incorporating prior year information and results to guide the extent of testing, the proposed guidance does not address the current practice of requiring some type of assessment of each control each year. By contrast, the PCAOB proposed standards specifically provide for benchmarking of automated controls. We suggest that the SEC consider where and how management might be encouraged to benchmark or rotate testing of controls in all areas. If management could confirm that the control design had not changed and that the control had been operating effectively in prior assessments, we should have the freedom to forego annual testing of that control in favor of a rotational testing plan, particularly for lower risk controls.

Entity-level controls
Companies have put much thought and effort into identifying and enhancing entity-level controls. Although we are confident that entity-level controls are the key to preventing future Enron-type failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect entity-level controls such as ethics programs and Board of Directors oversight. Specific examples of potential linkage included in the proposed guidance would be very helpful in building the case for leveraging these higher level controls.

Linking entity-level controls to significant account risks is more clear in the case of direct entity-level controls, such as analytic reviews and budget-to-actual comparisons. One issue here has been establishing the precision at which these controls operate. With the new focus on detecting material misstatements, the precision should be less of an issue. The proposed guidance does address the need to establish that entity-level controls adequately prevent material misstatements but again, specific examples would be helpful to reinforce that the precision can be at a fairly high level.

One illustration that we would suggest is in the area of General IT controls. Typically management and external auditors have performed extensive testing of these controls even though the likelihood of an undetected material misstatement is not reasonably possible. When issues do arise, companies typically find that their downstream compensating controls, such as account reconciliations, supervisory reviews, and external reporting controls, mitigate the reasonable possibility of a material misstatement. It would take an issue at the overall IT control environment (entity level) for a material financial reporting issue to manifest itself.

This is an area where it would be appropriate for companies to focus their efforts at the IT (indirect) entity level. The entity-level testing combined with individual control level testing on a rotational or focused basis (i.e., looking at points of change or high-risk areas) would be an effective risk mitigation strategy in this area.

Other entity-level controls that can be leveraged to reduce testing of process level controls are variance analyses and senior level reviews. CCR would be willing to work with the SEC in developing other examples.

Annual vs. interim financial statements considered in evaluating deficiencies
The definition of "material weakness" in the proposed guidance (page 13) includes a deficiency in ICFR such that there is a reasonable possibility that a misstatement of the company's **annual or interim** financial statements would not be prevented or detected. This language implies that a control deficiency discovered during the year would be evaluated based upon a lower materiality threshold, some fraction of annual materiality. We believe that the deficiency evaluation should be based upon the impact on annual financial statements since the management assessment of internal controls is an annual assessment of whether controls are operating effectively as of the end of the year. Deficiencies discovered during the year should be evaluated in the context of a potential error on the annual financial statements, a forward-looking analysis with a focus on internal control weaknesses as leading indicators of potential misstatements. The proposed guidance states that, "As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year." For these reasons, we suggest that the reference to interim financial statements should be removed from the definition in the proposed guidance.

Detection of fraud
The proposed guidance states on paragraph 23 that, along with other factors, management should consider the risk of material misstatement due to fraud in its risk assessment. This clarification is helpful as it has been unclear whether companies should be identifying and assessing controls that would detect ANY fraud committed by a senior executive. Contradicting that point, however, is the language on page 45 which says that fraud of any magnitude on the part of senior management is an indicator of a material weakness. It may be appropriate to define the specific types of fraud that should be considered to be an indicator of a material weakness (e.g., intentional manipulation of financial statements, versus misappropriation of assets).

Amendment of regulations
Section 210.1-02 is entitled "Attestation report on management's assessment of internal control over financial reporting" and includes the language that the accountant has audited management's assessment. With the proposed elimination of the requirement for a separate opinion on management's assessment process, this language seems to be potentially misleading or confusing, even in light of the fact that the direct audit of the internal controls gives indirect assurance about management's assessment process.

OTHER OBSERVATIONS

Removal of opinion on management's assessment

We support the elimination of the opinion on management's assessment process. Although we do not expect to see substantial efficiencies result from the change, we believe that the opinion on the management assessment is superfluous and should be eliminated. If companies want to optimize auditor reliance on management testing, they will still need to mirror the external auditors' standards of testing and documentation. However, the elimination of the opinion will give companies the leeway to make that decision, as opposed to the current environment where all companies are compelled to conform their assessments to AS2 standards.

Multiple-location changes

Changes in the multiple-location guidance are important to CCR, especially for companies that are very decentralized and complex. We believe that the shift to a risk-based approach will allow companies to vary testing in locations based more on risk than on coverage and will certainly improve efficiency, significantly in some cases.

Deficiency evaluation

The change in the likelihood component of the material weakness definition from "more than remote" to "reasonable possibility" should reduce the time spent on evaluating deficiencies. Although the proposed guidance includes indicators of material weaknesses and a description of typical significant deficiencies (footnote 74), it does not address quantitative guidelines for determining materiality thresholds. The guidance could be clarified by specifying that materiality for deficiency evaluation should be aligned with financial statement materiality.

The proposed guidance includes factors to consider in evaluating the likelihood and magnitude of a control deficiency or combination of deficiencies. Many companies have been using a deficiency evaluation framework that was created by the larger audit firms. This framework focuses on a quantitative and mechanical approach that is counter to the concept of a risk-based evaluation approach. We believe that the factors in the proposed guidance can be used in lieu of the framework and recommend that the guidance include a statement that discourages the use of the existing framework.

Cost/benefits

The proposed guidance document requests comments about how the proposed guidance will affect the expenditure of effort and division of labor between the managers and employees of public companies and their audit firms. We believe that the changes suggested in the proposed guidance along with the modifications proposed in this letter should result in a more meaningful reduction in the effort and related costs of the management assessments and the external audits. But if the external audit standards and practices are more conservative than management assessments, we will not achieve this reduction.

One benefit cited in the proposed guidance is that there is a greater likelihood that management will more effectively detect material weaknesses. We believe that this is true, and suggest that the language in the proposed guidance be expanded to explain why that benefit will occur, i.e., that an increased focus on material financial reporting risks will be enabled by a decreased focus on low risk areas. If implemented effectively, the proposed guidance should result not only in cost reductions but in a real strengthening of companies' control environments.

We expect that the SEC will continually monitor and reassess the costs and benefits of the Sarbanes-Oxley legislation as it has done in the past and will be particularly focused on the impact of the proposed guidance.

Effective date

We hope that we have clearly communicated our support for the proposed guidance. To allow companies to realize the expected benefits in the near future, we suggest that the proposed guidance and the proposed standards should be implemented as soon as possible. For the benefit of calendar year companies the effective date should be as early as possible in calendar year 2007. To minimize disruption and inefficiency, the proposed guidance needs to be effective before design evaluations begin for calendar year companies, which would typically begin in the second quarter.

In addition to the above comments, the Appendix to this letter includes responses to several of the specific questions raised by the SEC in the proposed guidance.

Thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience.

Lawrence J Salva

Lawrence J. Salva
Chair, Committee on Corporate Reporting
Financial Executives International

Appendix – Responses to Specific Questions

• Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?

We believe that the primary driver of efficiency will be the focus on a top-down, risk-based assessment approach. The focus on key critical controls that would detect a material misstatement, rather than a significant deficiency, creates the possibility that companies can significantly reduce the number of key controls to be assessed. This reduction will allow for a lower assessment effort overall and more attention and focus on the critical controls, which should increase the likelihood that any existing material weakness would be discovered and remediated.

The proposed guidance includes a clear and pragmatic approach to risk assessment, starting with financial statement elements that could contain a material misstatement and moving on to considering significant accounts, relevant assertions and mitigating control activities. The proposed guidance also includes a useful list of relevant risk factors for significant accounts and also for the controls themselves. Improving the risk assessment process should improve the quality of the control assessment by providing an appropriate focus on controls that mitigate the highest financial statement risks. By separating the discussion of risk factors between significant accounts and control activities, the proposed guidance raises the possibility to vary the extent of testing of controls based upon their own risk characteristics. Thus, a low risk control activity could have limited testing even though it mitigates a high risk account. Being able to differentiate the type, timing and extent of testing will be very helpful in improving efficiency.

The helpfulness of the proposed guidance to management will be contingent upon whether it is consistent with the PCAOB proposed standards for auditors. As stated in the letter, the proposed standards are more detailed than the proposed guidance. Unless the two are aligned, the scope and level of testing will be subject to interpretation by the external audit firms, which could result in audits that are more conservative and more costly.

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

Companies have put much thought and effort into identifying and enhancing entity-level controls. Although we are confident that entity-level controls are the key to preventing future Enron-type failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect entity-level controls such as ethics programs and Board of Directors oversight. Specific examples of potential linkage included in the proposed guidance would be very helpful in building the case for leveraging these higher level controls.

Linking entity-level controls to significant account risks is more clear in the case of direct entity-level controls, such as analytic reviews and budget-to-actual comparisons. One issue here has been establishing the precision at which these controls operate. With the new focus on detecting material misstatements, the precision should be less of an issue. The proposed guidance does address the need to establish that entity-level controls adequately prevent material misstatements but again, specific examples would be helpful to reinforce that the precision can be at a fairly high level.

One illustration that we would suggest is in the area of General IT controls. Typically management and external auditors have performed extensive testing of these controls even though the likelihood of an undetected material misstatement is not reasonably possible. When issues do arise companies typically find that their downstream compensating controls, such as account reconciliations, supervisory reviews, and external reporting controls, mitigate the reasonable possibility of a material misstatement. It would take an issue at the overall IT control environment (entity level) for a material financial reporting issue to manifest itself.

This is an area where it would be appropriate for companies to focus their efforts at the IT (indirect) entity level. The entity-level testing combined with individual control level testing on a rotational or focused basis (i.e., looking at points of change or high-risk areas) would be an effective risk mitigation strategy in this area.

Other entity-level controls that can be leveraged to reduce testing of process level controls are variance analyses and senior level reviews. CCR would be willing to work with the SEC in developing other examples.

On another topic, we welcome the shift from a coverage-based approach to a more risk-based approach regarding multi-location scoping, as it implies the potential for more efficient and focused multi-location testing. However, we would appreciate more specific guidance showing how to apply a risk-based, top-down approach for companies in a decentralized and diversified environment.

• Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?

We want to emphasize how critical it is that the audit standards are aligned with management guidance. The external auditors must be comfortable with management's assessment approach to optimize reliance and achieve overall cost savings. And although the requirement for an opinion on management's assessment process has been recommended for elimination, the opinion on the controls themselves remains. A more detailed or conservative approach on the part of the external auditors will drive the companies to continue to document and assess lower-risk controls, thereby continuing to incur unnecessary costs and failing to achieve the objective of more effective and efficient assessments.

• Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?

The previous guidance should not be retracted although the following differences should be considered to determine if the new guidance should include information regarding the following:

1) *The IT information in the former guidance is more extensive than the current guidance and includes more guidance around IT (including IT upgrades). Perhaps this information should be merged in the new guidance document.*
2) *The Communications with the Auditors section from the previous guidance does not exist in the current guidance and it should be retained or incorporated in the*

new guidance as it lays out some good examples of how management and the external auditors should interact. This is important information for management.

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

The guidance states that it is not required so it is not necessary to make any changes if a company chooses not to.

• Considering the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

We believe that the PCAOB needs to be proactive in encouraging external auditors to embrace the level of significant change that the companies expect to make in their assessments, and we are including the following suggestions in our comment letter in response to the proposed standards.

- *Additional language in the proposed standards or in the introduction to the proposed standards, giving more concrete guidance regarding the extent of change that is expected.*
- *Educational forums to clearly instruct the auditors in the intent of the new proposed standards and how the inspection process will also change in the same spirit.*
- *PCAOB inspections that support the drive for efficiency by including inspection criteria that evaluate conformance to the new proposed standards and resulting efficiencies. Those criteria should be communicated to the auditors as soon as possible to support efficiencies in the calendar year 2007 internal control audits.*
- *PCAOB monitoring of any multi-firm initiatives from external auditors to create supplemental guidance to the proposed standards. The PCAOB should also monitor guidance from the national offices of the firms regarding implementation of the proposed standards to make sure that firm guidance does not countermand the intent of the new standards. Any supplemental guidance that is developed should be the result of due process which involves input from industry as well as the external audit firms.*
- *Change in the definitions of "significant deficiency" and "material weakness" in the proposed standard to remove the reference to interim financial statements. We believe that the deficiency evaluation should be based upon annual materiality thresholds since the assessment of internal controls is an annual assessment with a focus on internal control weaknesses as leading indicators of potential future misstatements.*
- *Modification of certain detailed or prescriptive provisions of the proposed standards, such as the requirement for walkthroughs, evaluation of all deficiencies even if clearly not material, and the continued expectation that each control will be fully tested each year.*

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

The proposed guidance uses the term "entity-level controls" to include direct and indirect controls other than process level controls. The PCAOB proposed standard uses the *term “company-level controls” in a similar way. Aligning the terms between the two documents could help eliminate some of the confusion that already exists about the definitions.*

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

Appears to be sufficient.

• Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?

Not necessary to codify it as a Commission rule.

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

We believe that foreign private issuers have, with a certain delay, experienced the same obstacles and challenges as US filers in implementing Sarbanes-Oxley Section 404. However, for multi-national companies with operations in most regions of the world, it becomes increasingly difficult and cumbersome to manage the different corporate governance rules in each region.

We would appreciate additional care and attention to be paid to evaluate potential conflicts and/or redundancies resulting from different legislative provisions. Where it may not be possible to harmonize the basic principles of the respective rules, at least there should be more flexibility allowed.

• Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?

It should be voluntary.

• Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?

Proposed rule revisions seem appropriate.

• Should the rules be amended in a different manner in view of the proposed interpretive guidance?

Proposed rule revisions seem appropriate.

• Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?

Yes, we believe that is appropriate.

• Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?

Neither

• Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?

Yes

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

This rule is confusing as a separate report over management's assessment is not required from the external auditors.

• Should we consider changes to other definitions or rules in light of these proposed revisions?

Yes. This is not clear.

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

Appears appropriate and adequate.

financial executives international

small public company task force

February 26, 2007

Nancy M. Morris, Secretary
Securities & Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Reference: File Number S7-24-06

Dear Ms. Morris,

Financial Executives International's ("FEI's") Small Public Company Task Force ("FEI SPCTF") appreciates the opportunity to provide its views on the U.S. Securities and Exchange Commission's ("SEC's") proposed interpretive guidance and proposed rule on Management Reporting on Internal Control [Release No. 33-8762] ("the proposal").

FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. FEI SPCTF is a task force of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations, from the perspective of small public companies. This document represents the views of FEI SPCTF, and not necessarily those of FEI or its members individually.

FEI's SPCTF notes that a separate comment letter was filed by FEI's Committee on Corporate Reporting ("CCR"). We join with CCR in commending the SEC for its role in proposing guidance for management to make its internal control assessment more efficient and effective. Like CCR, SPCTF greatly appreciates the SEC's efforts to make implementation of internal control reporting more efficient and effective, by focusing on a top-down, risk-based approach directed at items that would be material to the financial statements.

As detailed in the Attachment, we strongly support the revised definition of a material weakness – with additional improvements to the definition of materiality. We also support the SEC's proposal to make this interpretive guidance optional, and to require only one auditor opinion on internal control, removing the opinion on management's assessment. We believe these changes will benefit companies of all sizes.

With respect to small companies in particular, FEI's SPCTF strongly supports the assertions of the SEC's proposal that methods and procedures vary based on characteristics of the company, including size and complexity, as well as the proposal's statement that documentation can take many forms, and that ongoing monitoring and management's daily interaction with the business be considered.

Alignment between PCAOB, SEC Critical to Align Auditors and Management

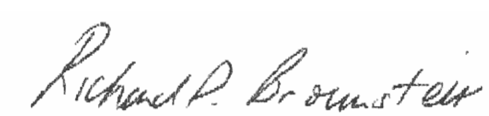
To achieve the full benefit of the SEC's proposal, it is critical that the auditors' implementation of the internal control reporting rules under Sarbanes-Oxley Section 404 be aligned with that of management. This alignment requires at the outset a consistent approach in rulemaking, followed by implementation by auditors and management consistent with the regulatory framework, and inspected and enforced accordingly by PCAOB inspectors and in reviews of filings by the SEC and PCAOB staff.

Although the SEC's proposal is very principles-based, we believe the PCAOB's proposal has elements that may result in that guidance being more prescriptive than intended. For example, although the PCAOB permits the auditor to use the work of others, the guidelines for determining which "others" are sufficiently competent and objective are still too prescriptive. There are other points in the PCAOB proposal which we believe could be improved to more closely align with SEC's guidance as well, and without those improvements, we believe the benefit of SEC's proposed guidance will be limited.

Our detailed comments specifically focused to this SEC proposal are attached.

FEI's SPCTF commends the SEC's efforts to make reporting under Sarbanes-Oxley Section 404 more efficient and effective, and we thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience. Please feel free to contact Serena Dávila, sdavila@fei.org, Director, Technical Activities, in FEI's Washington DC office, if you have any questions or wish to discuss.

Sincerely,



Richard D. Brounstein, Chairman
Small Public Company Task Force
Financial Executives International

FEI Small Public Company Task Force
ATTACHMENT: DETAILED COMMENTS

Proposed SEC Guidance Will Benefit Companies of All Sizes – but timing is still an issue

FEI's Small Public Company Task Force (SPCTF) strongly supports the SEC's interpretive guidance overall, which has many recommendations that will benefit companies of all sizes. This guidance as it pertains to small public companies, including non-accelerated filers preparing to issue their first reports under Section 404, should enable them to more cost effectively and efficiently implement Section 404 reporting. In addition, it will enable them to capture the lessons learned from larger public companies from the past two years of implementation, with additional considerations directed at small public companies. Small public companies, with a smaller bottom line to absorb costs of compliance, should benefit from such improved and cost-effective guidance.

As SEC reviews all proposals and moves this guidance forward, we would also suggest that the implementation date be extended one additional year for the non-accelerated filer – and that the determination of size category be based on the valuation at the beginning of the fiscal year. It takes a full year to manage the first year reporting process cost effectively under Section 404, and without the delay, many of these companies will need to spend significant monies – that they cannot afford – on consultants that still have only the old 404 model to safely apply.

The following aspects of SEC's proposed guidance have the potential to greatly assist in making management's assessment of internal control more efficient and effective, for companies of all sizes, thereby also benefiting small public companies: the fact that this proposed interpretive guidance will be optional, the proposal that there be only one auditor opinion on internal control (removing the requirement for the auditors's opinion on management's assessment), the SEC's explicit note that reasonable assurance does not mean absolute assurance, the fact that SEC's proposal stresses the guidance is top-down and risk-based, and SEC's statement that "it is impractical to prescribe a single methodology that meets the needs of every company."

Proposal Can Be Of Great Assistance to Smaller Public Companies

A smaller public company can greatly benefit by the flexibility provided in the SEC's proposed guidance which says companies can "Vary methods and procedures … based on characteristics of the company… includ[ing] among others, the size, complexity and organizational structure of the company … its processes and financial reporting environment…"

FEI's SPCTF also strongly supports the proposal's recommendation that subsequent evaluations be focused more on changes in risks and controls, than on identifying all financial reporting risks and controls. This concept, combined with the SEC proposal's explicit recognition of use of ongoing monitoring by management, can go a long way in blending 404 compliance in with the way companies do business.

Also on the subject of monitoring, FEI as a founding member of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is actively involved in COSO's project to develop guidance on monitoring. We encourage the SEC staff observer to be proactive with COSO, so that the project is, as intended, a principles-based, flexible, risk-based approach to monitoring that is in keeping with the SEC's and PCAOB's principles based approach. In this way, COSO's guidance would support, and not detract, from the SEC's and PCAOB's intended approach – to provide flexibility, scalability, and judgment, and more reasonable expectations as to evidence generated from management's daily interaction within their business.

We also strongly support the SEC's proposal that evidence required be linked to the degree of risk of misstatement and risk of control failure.

Additionally, we strongly support the SEC's proposal that documentation can take various forms, and the form and extent will vary based on the size, nature and complexity of the company. We also believe it is very helpful SEC states documentation can be presented in a number of ways (e.g. policy manuals, flowcharts, job descriptions, documents, internal memorandums, forms, etc.), and that documentation does not have to include all controls that exist within a process. We recommend the SEC make an explicit statement that auditors' documentation needs should not dictate managements' documentation needs, as noted under "suggested improvements" further below.

Also, we believe it will be particularly helpful to small public companies if the SEC affirms in its guidance that ongoing monitoring, including management's daily interaction with the business, can be used as part of the evaluation of the effectiveness of internal control.

SUGGESTIONS FOR IMPROVEMENT

FEI's SPCTF reiterates our appreciation for the SEC's proposal as outlined on the previous pages. We believe the SEC's proposal, in concert with the PCAOB's proposed standard will help companies and auditors significantly reduce costs, while significantly increasing benefits, of reporting under Sarbanes-Oxley Section 404 – if PCAOB aligns its proposal with the SEC's proposal as noted below. Quite simply, for the SEC benefits to be achieved, the SEC and PCAOB must work together to ensure alignment of their two proposals.

As detailed below, PCAOB's proposal is, in our opinion, still overly prescriptive, and will limit the effectiveness of SEC's proposal.

Also, certain other improvements to the SEC's proposal are recommended below, to avoid unintended consequences and maximize benefit at reasonable cost.

Definition of Material Weakness Has Improved, But SEC and PCAOB Need to Delete Reference to "And Interim" from Definition

FEI SPCTF appreciates the progress made by the SEC and PCAOB in changing the definition of material weakness from an event which has "more than a remote" possibility of causing a material error to the financial statements, to a control deficiency that poses a "reasonable possibility" of causing a material error. This change will contribute greatly to removing the extreme granularity of the initial implementation approach; although the intent of the former definition was to match GAAP, it was clearly interpreted as more severe by the auditors.

We believe the SEC should go further and fully eliminate the confusion with continued inclusion of "and interim" in the definition of material weakness (and by extension significant deficiency); by removing the reference to "and interim" from this definition. There are two reasons why we recommend "and interim" be removed:

1. As a practical matter, it is not clear how “and interim” would be interpreted, resulting in a likely diversity in practice with a great deal of resources spent in debates among preparers, auditors, regulators, shareholders and the plaintiff’s bar, as to whether something that would be material to a quarter would also be material to the annual period – particularly if the company remedies the matters before the year-end report is issued.

2. Including “and interim” will continue to drive the inefficiencies present in first and second year implementation. Using just a year-end reference point, which we believe was the point intended by Congress in the Sarbanes-Oxley Act, would encourage more use of judgment as well, including issues remedied prior to the date the report is issued.

Additional support for our recommendation that SEC and PCAOB remove “and interim” from the definition of materiality for 404 is the recommended definition of material weakness in the Nov. 30 report of the Committee on Capital Markets Regulation chaired by Glenn Hubbard and John Thornton, which says the definition of material weakness should be in reference to annual financial statements.

The report of the SEC Advisory Committee on Smaller Public Companies (page 54) also recommended the SEC encourage PCAOB to amend AS2 to clarify that materiality should be with respect to annual financial statements, and that conforming treatment be given in SEC, PCAOB and COSO guidance for annual materiality.

PCAOB Must Conform to SEC Definition By Adding “In a Timely Manner”
We also note the PCAOB’s proposed standard does not include the full definition of material weakness which is present in the SEC’s proposal; the PCAOB’s proposed standard omits the phrase “in a timely manner”. That is, a material weakness is a deficiency which would not be prevented or detected “in a timely manner.” We strongly agree with the inclusion of the phrase in the SEC proposal, and request the SEC have the PCAOB conform to the SEC’s definition by including the phrase.

“Elements”
FEI’s SPCTF recommends the SEC amend the language in the proposal which currently states: “In assessing effectiveness, management evaluates whether its ICFR [Internal Control over Financial Reporting] includes policies, procedures and activities that address **all of the elements of internal control that the applicable control framework describes as necessary** for an internal control system to be effective.” This reference to “**all elements**” can lead to a checklist approach and limit use of judgment. It may also be viewed as inconsistent with the COSO framework, which, even in the most recent (July 2006) COSO small business guidance, does not use the term “elements.” Rather, as noted in COSO’s July 2006 guidance, companies must assess the effectiveness of internal control based on all five COSO components (control environment, risk assessment, control activities, information & communication, and monitoring) taken as a whole. SEC’s focus on “all the elements” encourages an “all or nothing” approach and may result in an extremely granular approach if a particular framework – or if the auditors - should in the future identify a laundry list of “elements.”

The way to resolve this is for the SEC to remove the reference to “all the elements of internal control that” and simply refer to the “applicable framework” generically. That way the new term “elements” will not be introduced.

Additionally, the SEC uses the term “elements” with respect to “financial reporting elements” and states the term is different from the PCAOB’s term “significant account.” It may be useful to conform the two terms, using whichever term is more suitable to qualitative and quantitative judgments.

Predictive ability of internal control assertions and expectation gap
FEI’s SPCTF notes there is a need to be practical in what internal control testing and assertions can and cannot due. The definition of material weakness implies a predictive element that may not really be practical, may mislead the public, and may erroneously cause companies and auditors to have enforcement action or lawsuits placed on them, due to an expectation (with hindsight) that a misstatement or restatement should have been “predicted” by a finding of an internal control weakness prior to the actual misstatement/restatement. We encourage the SEC and PCAOB to discuss this with constituents.

Segregation of Duties
FEI’s SPCTF appreciates the listing of “small company characteristics” in the SEC’s proposed rule, but we believe more explicit statements need to be made by the SEC as to the fact that these particular characteristics do not necessarily equate to a material weakness in internal control. For example, the SEC should expressly state that lack of segregation of duties is a factor to consider, in light of relevant risk factors, and materiality of an item, but that lack of segregation of duties in and of itself does not necessarily indicate a material weakness in internal control.

SEC should also explicitly state that compensating controls and various forms of monitoring can offset control deficiencies such as lack of segregation of duties.

SEC, PCAOB Should Go Farther To Explicitly Encourage Integration
FEI’s SPCTF believes language should be added to the interpretive guidance to emphasize the audit of internal control over financial reporting was intended by Congress to be integrated with the audit of financial statements, and that therefore, specified work done for the financial statement audit – and evidence relating thereto – can also be used as evidence for, and to reduce testing relating to, the audit of internal control. Similarly, work performed by management or internal audit to test controls with respect to the financial statements, operations or compliance, can also be used with respect to management’s assessment of the effectiveness of internal control.

Additionally, with micro cap and smaller public companies (as defined by the SEC Advisory Committee Report) the integrated audit offers some of the strongest evidence regarding their internal controls over financial reporting. Smaller companies by their very nature are different than larger companies and how one controls such companies to ensure proper financial reporting tends to be more of a substantive analysis of the balance sheet. Tone at the top is relied upon significantly more than detailed process controls that are necessary to pull together financial statements of larger, complex organizations.

Assessment of “competence” and “objectivity” must be principles based
To achieve the SEC’s objective of making the internal control assessment process more efficient and effective, it is critical that the SEC oversee not only the implementation of its own rule, but also the PCAOB’s rules, including the PCAOB’s proposed standard (referred to as AS5 - replacing AS2) and the PCAOB’s proposed standard on use of work of others.

FEI's SPCTF believes the language in the proposed PCAOB standard and the proposed use of work of others standard are too prescriptive in suggesting how competence may be measured, and that the PCAOB guidance should be revised, with concurring language in the SEC's proposal, to provide a more principles-based approach to judging competence.

For example, it is normal business practice at companies small and large to use employees that do not hold certifications of any kind in various parts of their financial reporting and internal control process. Lack of a certification should not hinder a judgment of competence. Also, employees working in accounting departments and in internal control, particularly at smaller companies, may not necessarily have degrees in accounting. This also should not necessarily result in a decision that a particular person lacks the competence to perform the specific job they have been assigned, taking into account training they have received and their years of experience.

Similarly, it would be easy for some auditors and others to presume a lack of objectivity by anyone employed by a company with respect to that company. As a practical matter, and in accordance with longstanding practice, companies routinely have self-assessment and self-monitoring in place, by internal audit, management and employees. It would be helpful for the SEC to provide an example where a company uses self-assessment by management and the results of that work constitute sufficient evidence for management and the auditor to rely on in a particular area, given the assessment of risk.

Documentation
It would be helpful if the SEC would include explicit guidance that the auditor's documentation needs should not dictate management's documentation needs, and that the auditor should be flexible in considering the SEC's guidance as it applies to management, when the auditor exercises his or her own judgment, in applying auditing standards such as the proposed PCAOB standard.

The Key Will be in the Implementation
Even with the principles based approach being advocated in the SEC's and PCAOB's proposals, the key will be in the implementation and interpretation, especially by the larger accounting firms, who invariably become the drivers of best practice. There appears to be a cultural predisposition for some of the accounting firms to revert to a check list and prescriptive approach as a means of implementation, even if the guidance by the SEC and the PCAOB is principles based. This could be because a checklist driven approach may be viewed by some as providing better protection for auditors against legal liability, although check-lists may be mechanically applied with limited relevance.

We believe that for a principles based system to "walk the talk" - in real-life implementation of the standards – the PCAOB inspection process will need to accept reasonable judgments of auditors, and that PCAOB and SEC inspection and enforcement actions will need to allow for a reasonable range of judgment and flexibility in accordance with the principles based standards.

To avoid the bottoms up, mechanistic approach articulated in the control framework jointly issued by nine audit firms - cited in the PCAOB's 4010 report on implementation of AS2 published in November, 2005 as containing "statistical precision suggested by … terms [that] may have driven auditors' decision making process unduly toward simplistic quantitative thresholds and away from the qualitative evaluation that may have been necessary in the circumstances," it is important that the SEC and PCAOB monitor developments that may lead to a repeat of this phenomena.

Thus, it would be helpful if the SEC and PCAOB could avoid encouraging any such private sector framework – including by audit firms, COSO or others - from being issued prematurely or in a way that undermines the principles based approach present in the SEC's and PCAOB's proposals. Ideally, any supplemental guidance that is developed should be the result of due process which involves input from industry as well as the external audit firms.