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

Re: File No. 4-511 -- **Comments and Feedback on Implementation of the Sarbanes-Oxley Internal Control Provisions**

We respectfully submit our comments and feedback on our experiences in the role of advisor to our clients as they evaluated the effectiveness of their internal control over financial reporting (ICFR) and formulated an assertion with respect to such ICFR in accordance with The Sarbanes-Oxley Act of 2002 (SOA), 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 in achieving their initial year compliance with SOA and/or determining how to improve their compliance processes in subsequent years. In conjunction with these experiences, we have been exposed to all of the major accounting firms.

We support the overall SOA objective to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. We continue to believe that, as with other significant undertakings, there are opportunities to learn from experiences to date. Lessons learned provide the impetus for identifying best practices and improving the efficiency and effectiveness of the Section 404 compliance process to ensure that it is risk-driven, truly top-down and value-added. To that end, we offer the following commentary and recommendations for the Securities and Exchange Commission (SEC or Commission) and Public Company Accounting Oversight Board (PCAOB) to consider.

According to Table 8 included in Appendix I to *The Final Report of the Advisory Committee on Smaller Public Companies* to the Commission, the audit and audit-related fees increased for accelerated filers in 2004 by approximately 50 percent over the prior year. A study by AMR Research (AMR) points out that costs incurred by companies, inclusive of external audit costs, increased by over 100 percent during the same period. Therefore, it is to no surprise that many companies have focused on making their compliance approach more cost-effective during 2005 and in subsequent years. This priority was one of the major themes during the joint SEC/PCAOB roundtable conducted last year.

However, despite this focus, costs remain high. During 2005, we observed that most of the emphasis on cost reduction was concentrated on the “controls filtering” exercise to significantly reduce or eliminate independent testing of insignificant controls and in low risk areas. In addition, testing scopes were modified somewhat in moderate risk areas. In large part, this activity did not achieve the anticipated results. A more recent AMR study of larger companies noted that only 19 percent of financial executives report their companies realized the cost savings they expected during 2005. This conclusion is reinforced by a recent Financial Executives International (FEI) study which also indicated cost reductions in 2005 fell below expectations. Thus many companies have expressed, and continue to express, the view that Section 404 compliance costs need to be reduced by making the compliance process more cost-effective.

We see some challenges with respect to achieving this objective. We have organized them into two groups below:

Assertion and Attestation Process

- Audit scopes and approaches did not change significantly in 2005 following last year's roundtable because the PCAOB examiners were still in the field as inspections were underway. Auditors were understandably reluctant to modify their firm's audit methodology while that methodology was being reviewed by the PCAOB inspection division.
- To date, there has been limited modification of audit scopes because such scopes continue to driven largely by an assessment of quantitative factors. Therefore, audit work continues to be conducted in areas where, in the view of management, the risk of material errors, omissions and fraud are relatively low. It is our experience that management often considers qualitative as well as quantitative factors when assessing risk. An effectively coordinated company-wide risk assessment process offers an opportunity to reconcile management's perception of risk with that of the auditors, and vice versa, and should be encouraged as an approach to initiate constructive dialogue between the parties.
- On May 16, 2005, the PCAOB staff issued the following guidance to auditors: "Management's day-to-day involvement with processes and the underlying controls provide a broader array of procedures to achieve reasonable assurance for purposes of its assessment of internal control over financial reporting than the auditor has available." The nuances of this guidance are not widely understood. Auditors don't always acknowledge it and management of many companies continue to operate under the constraint that they must have the same body of evidence as the auditor, i.e., they must always independently test in areas in which the auditor concludes such testing is necessary.
- Companies are largely focused on reducing external audit costs, placing them in a reactive mode in dealing with their external auditors. They are often reluctant to modify their compliance process because their auditors either cannot audit the enhancement or conclude they must increase their audit scope if independent testing by management is reduced in low to moderate risk areas. As a result, management's assessment process remains substantially auditor-directed.
- A top-down approach has still not been applied to reduce the extent and/or alter the timing of independent testing in routine processes with alternative sources of evidence. Everyone agrees that audit committee oversight, "tone at the top" and other company-level aspects of the control environment are vital to reducing the more significant financial reporting risks. However, these are controls that are difficult to "touch." The point was

made during last year's roundtable that management fraud was most often perpetrated at the company level and in the period-end financial reporting process, and not within the upstream routine processes. Therefore, there needs to be more emphasis on evaluating company-level controls and less emphasis on independent testing of controls within routine processes.

More Reliable Financial Reporting Process

- Many companies have been slow to recognize the significant upside to improving the quality of upstream financial reporting processes, and the underlying controls embedded within those processes. As noted earlier, most of the cost increases are internally driven. As companies begin to understand that high compliance costs are largely a result of high-cost transaction processes, they see opportunities for: eliminating redundant activities, platforms and other nonessentials; simplifying and standardizing processes; centralizing common and similar activities; improving the mix of automated and manual controls; and transforming inefficient "detect and correct" controls to preventive controls that "build in" versus "inspect in" quality. Our clients who are embracing SOA compliance as a way to improve the quality of their financial processes, and institutionalize the compliance process around high quality financial reporting processes, are experiencing further reductions in their compliance costs.

The message is that the strategy for optimizing compliance costs through improved "filtering" of the controls population has just about run its course for many accelerated filers who have completed their second year. If there isn't a strong focus on improving the capability, transparency and operational effectiveness of financial reporting processes and on strengthening company-level controls and monitoring processes, companies will end up wrapping their Section 404 compliance activity around a high-cost internal control structure. This compliance activity will continue to emphasize heavily the minutia of detailed manual testing of routine process-level controls in moderate and low risk areas. If that happens, the SEC and PCAOB are likely to hear the same concerns regarding the high cost of Section 404 compliance during future roundtables they decide to conduct.

Our recommendations are as follows:

- Use the May 10 roundtable and other appropriate forums to frame dialogue around strategies for improving the cost-effectiveness of the compliance process. Specifically, we see five fruitful areas for discussion:

  (1) Deploy a top-down approach to the internal control assessment to reduce the extent and/or alter the timing of independent testing of process-level controls with alternative sources of evidence. A truly top-down approach remains illusive in practice. Companies attempting to use a top-down approach to reduce the extent and/or alter the timing of independent testing of process-level controls, often get discouraged when the external auditor states that he or she plans to increase the scope of his or her work as a result of management's plan. For example, if management decides to rely solely on self assessment in low risk areas, the external auditor may conclude that he or she

needs to perform additional testing in those areas because they fall within the auditor's quantitative scoping threshold. If management decides to rely on company- and/or process-level monitoring in lieu of detailed independent testing in selected moderate to low risk areas, the external auditor may decide to perform additional testing in those areas as well. This disparity is inevitable as management evaluates over time relevant qualitative factors the external auditor often chooses to ignore in deference to a quantitatively-focused scoping approach. Such disparity should have no impact on the auditor's evaluation of management's assessment process, so long as (a) management is able to articulate an effective rationale supporting the company's approach to determining the nature, timing and extent of independent testing in high, moderate and low risk areas and (b) management and the auditor have reasonably consistent points of view as to the high risk areas.

If the external auditor decides to test areas not independently tested by the company, management can still decide to perform that testing to support the attestation process. The result is that executive management and the audit committee will better understand who is driving the cost of compliance and by how much. In addition, the testing by the external auditor in areas regarded as low risk by management can be monitored over time to ascertain whether it surfaces meaningful results. If it does not, questions will likely arise over time as to whether the lack of benefit from performing such testing merits the cost.

(2) Revisit the prior year risk assessment. Many companies applied a conservative approach in the initial year of compliance and may have been overly inclusive of areas to evaluate and test. Because of the limited time available in the second year and the cost reductions made possible by the significant first year documentation and remediation costs, many companies only updated their risk assessment for changes in the business but did not take a hard enough look at the areas noted in the prior year as "high" or "moderate" risks to ascertain whether those determinations were still appropriate.

(3) Optimize IT controls to increase the cost-effectiveness of the controls portfolio. Use of automated IT controls remains an area of "mystery" to many management teams and sometimes to auditors as well. The cost of relying extensively on manual controls in sophisticated financial reporting processes has never been as evident as it today. Not only do manual tests of controls by companies and their auditors require much time and effort, they are not always reliable in sophisticated environments. The costs inherent in this compliance approach are incurred each year until management re-evaluates the controls portfolio with an eye towards balancing the mix of automated and manual controls. Because an automated control takes substantially less time to test than a manual control, the savings can quickly add up. For example, manual controls require an inspection of each sample occurrence, often embedded in reams of documents, whereas an automated control only requires a one-time observation of a configuration setting provided it is designed, maintained and secured effectively.

Testing of a remediated manual control requires additional sampling versus the real-time resolution and retesting of an online control.

(4) Continuously apply automated testing techniques with a focus on analytics. For data-intensive, high-volume transaction processes, management can deploy automated monitoring tools and data analytics to evaluate processing results on a more comprehensive and reliable basis than sample-driven manual testing. In fact, use of these tools can eliminate the need for performing labor-intensive manual tests of controls. For data-intensive and high volume processes like accounts payable, cash applications or payroll, management should replace manual testing with continuous monitoring. This shift in emphasis should also reduce substantially the need for periodic auditing. Finally, the comprehensive coverage of continuous process-level monitoring also makes the testing process value-added because it can lead to operational improvements.

(5) Improve the operating efficiency and effectiveness of upstream financial reporting processes. A significant portion of the total cost of financial reporting lies within the upstream processes that initiate, authorize, record, process and report routine transactions. These processes include procure to pay, conversion, order to cash, capital expenditure and treasury, among others. There is significant opportunity for improving the quality, time and cost performance in these upstream processes while simultaneously reducing financial reporting risk. For example:

- As organizations eliminate nonessentials within their processes, they will examine the need for redundant controls.
- As companies simplify, standardize and automate their processes, they can expect greater emphasis on preventive controls (versus the detective controls that institutionalize costly and non-value-added rework into processes), as well as increased emphasis on systems-based controls (versus the more costly people-based controls). The improved mix of controls will lead to more efficient controls testing for both the company and the external auditor.
- As companies eliminate rework and build quality into their processes, they will reduce the number of manual journal entries required to close the books, streamline account reconciliation activity, deploy available configurable controls and reduce the number of spreadsheets by transferring spreadsheet functionality into the organization's ERP system.
- By improving and taking time out of the financial reporting process, large accelerated filer organizations will facilitate continuing compliance with increasingly stringent SEC accelerated filing requirements.

In summary, we do not believe that organizations with the most effective internal controls need to be the ones who spend the most money to get them. Companies using a truly top-down approach, applying an effective risk assessment process, optimizing their IT controls, deploying continuous monitoring techniques and improving the operational effectiveness and efficiency of their upstream financial reporting processes are the ones most likely to have in place a high quality and sustainable internal control structure. As they achieve superior quality, time and cost performance, these companies will unlock the value in Section 404 compliance and demonstrate consistently the most cost-effective compliance process.

- Provide guidance to management as to what constitutes "reasonable assurance" when conducting an annual assessment of ICFR. We continue to believe that further clarification is needed as to what constitutes a sufficient effort in the assessment process. Notwithstanding last year's May 16, 2005, guidance issued by the Commission, the management assessment process largely remains auditor-directed. Managers of many companies continue to believe they must have the same level of detailed testing as the external auditor. For example, many companies believe that because their auditors won't rely on self-assessment results, the self-assessment process[1] is non-value-added.

  There is limited guidance regarding when companies have "complied" in achieving "reasonable assurance" regarding (a) the reliability of financial reporting and (b) the adequacy of the body of evidence supporting management's assertion in the annual internal control report. Absent such guidance, companies continue to be effectively subject to standards written for the auditors and to their auditor's interpretation of those standards. Without a framework or tool, management is unable to effectively gauge the effort and control the related costs.

- Institute benchmarking initiatives to identify best practices for management and for auditors. Companies need more transparency in understanding how they can achieve a risk-based, top-down and cost-effective approach. Benchmarking to achieve this transparency would help more companies get started on the right path that leads to proven results.

- Reconsider the "each year stands on its own" premise of Auditing Standard No. 2 (AS2). Auditors generally believe that this requirement precludes them from applying judgment with respect to rotating testing in areas where inherent risks are relatively low, internal controls are considered strong and conditions are generally stable over time.

- Consider issuing additional guidance on the auditor's use of the work of others. We continue to note disparity in practice in applying the "competence" and "objectivity" criteria articulated in AS2. This area continues to require attention to foster increased consistency in practice.

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[1] A self assessment process is a pre-determined approach whereby managers and process owners self-review or self-audit the key controls for which they are responsible and communicate the results to management. Important characteristics of a self assessment process include: predetermined questions approved by management, criteria for supporting responses, rigorous deployment throughout the organization, timely follow-up and resolution of issues, and periodic internal audit testing of results.

In conclusion, while we agree that the conversation around scoping of the compliance process is important, we also believe that this conversation can only go so far in gaining traction as to improving cost-effectiveness. It is time for the Section 404 conversation to focus more broadly on "process capability." By directing attention to improving the upstream financial reporting processes, including the underlying internal controls embedded within those processes, management focuses on getting the company's internal control structure in order. By taking that approach, companies not only drive down internal processing and management assessment costs, they also are able to reasonably expect external auditors to align their audit approaches with the more effective controls design. 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.

We appreciate the opportunity to submit our comments and feedback. 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.

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