

CHAMBER OF COMMERCE  
OF THE  
UNITED STATES OF AMERICA

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VICE PRESIDENT AND  
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September 13, 2006

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

RE: Release No. 34-54122; File No. S7-11-06

Dear Ms. Morris:

The U.S. Chamber of Commerce is the largest business federation in the world, representing the interests of some three million companies of every size and industry. We have been an advocate for the issuance of specific guidance by the U.S. Securities and Exchange Commission (the "SEC") for issuers under Section 404 of the Sarbanes-Oxley Act ("SOX"). In that regard, we very much appreciate the opportunity to provide comments in response to the SEC's Concept Release on such guidance.

The Chamber has been very supportive of most provisions of SOX and, with respect to Section 404, strongly advocates for good systems of internal control in public companies. We agree that SOX has had positive effects in causing boards, management, and external auditors to be more thorough and attentive in fulfilling their responsibilities. However, we believe that Section 404 has been implemented in such a way as to create extraordinary and unnecessary burdens that are disproportionate to identified benefits. This has had an extremely negative effect on the overall health and competitiveness of the U.S. capital markets.

Our overall comments regarding improvement in the implementation of Section 404 are set forth in our comment letters of April 12, 2005, October 24, 2005, April 3, 2006, and May 3, 2006. In addition, Chamber representatives participated in the SEC/Public Company Accounting Oversight Board (PCAOB) Roundtables on April 13, 2005, and May 10, 2006. We have been an active voice for the business community on this issue because it is critically important to a broad cross-section of domestic and foreign companies.

### *Overview*

The implementation of Section 404 has, to date, failed for several interrelated reasons:

- Auditing Standard # 2 (“AS2”) is a vague and difficult to apply standard – and, to date, there has been no formal standard for issuers.
- The auditing profession has legitimate concerns about being second guessed by the plaintiffs’ trial bar and its new regulator, the PCAOB. The long-term risks to the profession are very significant<sup>1</sup>, and there has been every incentive to apply AS2 (such as it is) in a conservative way.
- Issuers have been trapped between the uncertain demands of AS2 and their own concerns about diverting critical resources from research, development, investment, and employment.

The result has been generally bad for any public companies with securities available in the United States – as well as any foreign or domestic companies who may have hoped to list here in the future. The implementation of SOX 404 has damaged our capital markets and there is an immediate need for corrective action.

We are, therefore, hopeful about the dual undertakings of (i) the SEC to promulgate issuer guidance regarding internal controls, and (ii) the PCAOB to revise AS2. We are also encouraged that the SEC and PCAOB are seeking to align their activities to avoid unintentional confusion. There is now a real opportunity for regulatory action on SOX 404 that would obviate the need for any legislative adjustment to the Act. We trust that the SEC and PCAOB will seize the opportunity and drive real improvement in the system.

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<sup>1</sup> For further discussion of this issue, please see a U.S. Chamber of Commerce publication entitled *Auditing: A Profession at Risk*, dated January 2006. <http://www.uschamber.com/publications/reports/0601auditing.htm>

With respect to the Concept Release, our specific comments below reflect three basic themes:

- There must be a risk-based focus on those controls that are most likely to have a material impact on the financial statements. This includes an emphasis on entity-level, rather than transaction-level, controls.
- The guidance for issuers should have as much specificity and clarity as possible. Where this is not achievable, issuers should have some ready means to seek and obtain on-going guidance from the SEC.
- It should be emphasized that the design, creation, and maintenance of good internal controls is a primary obligation of management. While auditors evaluate and determine the sufficiency of controls, they should not – and should not be expected to – decide how companies best manage their operations.

### *Discussion*

#### Risk and Control Identification

As mentioned, it is critical to employ a risk-based focus on those internal controls that are most likely to have a material impact on financial statements. We agree with the SEC that the evaluation framework of internal controls will vary depending on what is reasonable for the issuer. This framework, however, must be aligned with specific guidance that alleviates the implementation issues that caused the overly conservative application of SOX 404 and AS2.

#### *Specific Responses*

- We would suggest that the SEC begin by clearly stating the goal of an appropriate examination of internal controls under SOX 404. We believe that an implicit expectation has evolved – supported by the plaintiffs’ trial bar, among others – that the purpose of SOX 404 is to prevent every fraud and, in fact, every other possible type of business risk. Until the SEC is extremely clear that the purpose is to reach an appropriate level of assurance about controls – but not obviation of all risk – then the problems with overly conservative implementation will remain.

- We would suggest that the SEC identify those entity-level controls that it will always consider relevant. Further, it should provide examples of entity and transaction-level controls that it would not consider material. While no guidance can address every possible factual circumstance, it should be possible to establish guideposts that show the limits of the analysis. We would also ask that the SEC indicate what constitutes a test failure and when requirements on additional sampling are necessary.
- The Chamber supports the idea of placing greater reliance on assuring that issuers have a proper base control structure and good entity-level controls, along with management processes that assure broadly that these controls are effective.
- We would strongly encourage the SEC to specifically address fraud controls. As noted above, one of the most fundamental problems is a popular misunderstanding about the reasonable role of SOX 404 analysis – and auditing generally – in preventing fraud. Experienced accounting professionals know that there will be companies with excellent internal controls and superb audits that will, nonetheless, fall victim to collusive fraud. While it may not be easy or pleasant, the SEC has a core obligation to educate the public about this fact and provide issuers with guidance as to the reasoned limits on control evaluation under SOX 404. We also encourage the PCAOB to quickly and thoughtfully bring closure on the procedures that should be employed by external auditors to detect fraud.
- The Chamber supports the SEC's August 9, 2006, release proposing a one-year transition period for newly public companies. We believe that this will provide relief for start-up costs incurred during the first year. We continue to urge the SEC to delay implementation for non-accelerated filers and foreign private issuers until the new and revised standards have been tested by experience and proven to have been successful in alleviating key implementation issues.

- It is important that the SEC and PCAOB address smaller public companies as they are – in terms of personnel and resources – and not apply SOX 404 in a way that requires them to radically alter their operations or business objectives. Developing “scalable” guidelines means clearly defining what is “acceptable,” even if that means something less than “perfect.” As a clear example, appropriate span of control should – as a matter of logic – have a different application at a company with \$1 million in revenues when compared to a company with \$1 billion in revenues. “Scalable” doesn’t mean two (or more) different standards or fundamental differences in levels of assurance. It does, however, mean acknowledging that what might be necessary at one type of company may not be required for assurance at another.
- We continue to believe that not all internal controls need to be evaluated annually. Appropriate analysis of entity-level controls can include (i) periodic testing, and (ii) the testing of controls that have changed from established baseline conditions. In addition, testing by external auditors should reflect the work of internal parties. This would reduce some of the unnecessary cost burdens while maintaining a structure that protects the validity of financial statements.
- One of the unintended consequences of SOX is that companies are forced to delay system implementations or business process changes planned for the second half of the year in order to obtain a clean attestation result from the audit firms. We encourage the SEC to consider solutions to avoid these unnecessary delays.
- We would encourage the PCAOB to unify the approach of its standard setters and investigators. While the standard setters are encouraging the use of judgment, the inspections appear to be far-reaching.

### Management’s Evaluation

In absence of direct guidance for issuers, management has been forced to rely on AS2 in its evaluation of internal controls. Unfortunately, AS2 was not well-designed for this purpose (nor was the PCAOB ever intended to be a regulator of issuers). Among other things, this has served to de-emphasize the importance and primacy of management’s own assessment of its internal controls.

*Specific Responses*

- Our members tell us that the application of AS2 to IT systems has been particularly problematic. Issuers do not have enough guidance to determine which systems – and which levels of systems – need to be evaluated in order to obtain a reasonable assurance as to the effectiveness of internal controls over financial reporting. As an example, excessive time, energy, and expense have been devoted to the evaluation of access controls without regard to whether the access points in question could pose a significant risk to the validity of the financial reporting of the company. This is certainly an area where SOX 404 has been presumed to be about eliminating all business risks, instead of simply assuring the reasonable validity of the financial statements. In addition, significant confusion exists on how to assign monetary exposure to IT deficiencies, especially when they have been mitigated by entity-level or business process controls. We would strongly urge the SEC to work with the issuer community and the IT industry to develop specific standards regarding the evaluation of IT systems that limit the analysis to the intent and purpose of SOX 404.
- As noted above, while no standard could comprehensively address every situation faced by every affected public company, we would encourage the SEC to provide as many illustrative examples as possible (including examples of overly conservative implementation) and also establish a system for the provision of on-going advice and guidance. It would be flatly inappropriate for the SEC to issue a standard and then make it “the issuer’s problem” to figure out what it means. This comment most particularly applies to the meaning of critical but fundamentally hard-to-define terms, such as “material weakness,” “significant deficiency,” and “more than remote.”
- We have received a number of complaints to the effect that asking for advice – from outside auditors or others – can itself be construed as a “material weakness.” In short, if you need to ask then you don’t know, and if you don’t know then there must be a material weakness. This only creates a disincentive to seek expert advice on difficult issues. The SEC must make it clear that a request for guidance should not be used as evidence as to whether a “material weakness” does or does not exist. After all, the recognition by an issuer that a problem might exist should be seen as a strength on its part – not a weakness.

- The SEC should issue guidance as to the appropriate application of the requirement that the management assessment be “as of” the year end. There is tremendous confusion about the timing of the examination of internal controls and the value – or, more appropriately – lack of value of the experience with controls that is obtained over the course of an entire year.
- There is currently an excessive number of restatements. Many are driven by “reinterpretations” of long-standing accounting treatments. Accounting is not an exact science and disagreements about appropriate application of complex accounting standards are not necessarily evidence of failure. In fact, the view that “change = failure” does a disservice to the investing public by implicitly communicating a false precision surrounding financial statements. The SEC has a basic obligation to educate investors about the limits of accounting and financial statements. In that regard, we believe that there are many circumstances when a restatement should not be construed as evidence of a “material weakness” in internal controls.

Separately, we continue to support an overall review by the SEC and the PCAOB of the current standards for restatement, including an examination of the impact on investors of restatements that do not result in a material change in the overall financial performance or prospects of an issuer. Restatements can undermine investor confidence in an otherwise sound system of accounting principles. To that end, when the SEC considers the need for a new interpretation of GAAP that has previously been generally accepted in the marketplace, it should do so prospectively as opposed to retroactively so as not to undermine investor confidence.

### Documentation to Support the Assessment

During the first two years of implementation, it is clear that accelerated filers often over-documented internal controls in absence of specific guidance. Non-accelerated filers do not have access to the same resources and therefore would be put at a significantly greater disadvantage by overzealous documentation requirements.

#### *Specific Responses*

- A lack of documentation should not be confused with poor internal controls. Smaller public companies, in particular, often have good internal controls that are simply insufficiently documented. While documentation is important in order for systems to be auditable, we would urge the SEC to closely evaluate documentation alternatives and determine whether there are “low resource cost” solutions that might be acceptable for smaller companies, even if they are not appropriate for larger companies with more complex control systems.
- We would encourage the SEC to further examine footnote level information, particularly as how to measure the materiality of a deficiency. Not all footnotes are created equally and those that merely give information on routine accounts such as the composition of inventory are demonstrably less important than others like the disclosures of off balance sheet contingencies. One solution would be to expressly rule some footnotes out of the 404 scope and develop bright lines test for inclusion/exclusion for all other footnotes.

#### *Conclusion*

In summary, the Chamber is very supportive of systems of good internal controls maintained by management. We look forward to the forthcoming guidance from the SEC and PCAOB providing clear and specific recommendations for issuers and auditors. In absence of specific guidance, we fear that the current ambiguity will continue to cause unintended consequences, including diverting management time away from valuable business operations.



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The Chamber commends your dedication to achieving a long-term solution that will benefit issuers, auditors, investors, and the health and competitiveness of our capital markets. Thank you for your consideration, and we would be happy to discuss our comments with the relevant staff.

Sincerely,



David C. Chavern

Vice President  
Capital Markets Programs

cc: Christopher Cox, Chairman, U.S. Securities and Exchange Commission  
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