

September 18, 2006

Ms. Nancy Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-9303

RE: File Number S7-11-06, *Concept Release Concerning Management's Reports on Internal Control over Financial Reporting*

Dear Ms. Morris:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC) *Concept Release Concerning Management's Reports on Internal Control over Financial Reporting* (Concept Release) and support the SEC's objective to improve the effectiveness and efficiency of Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404). We believe additional guidance for management will contribute toward that objective. We also note that an effective and efficient management process will impact positively the effectiveness and efficiency of an integrated audit.

The Public Company Accounting Oversight Board (PCAOB) issued PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2) to provide guidance to the independent auditor in performing an audit of internal control over financial reporting. To date, the SEC has issued limited guidance for use by management. As a result, AS 2 became a *de facto* standard for management despite not having been written for that purpose. We support the development of guidance for management's assessment of internal control over financial reporting that is responsive to the specific needs of management.

The PCAOB is currently working on proposed amendments to AS 2. While understanding the need for guidance specific for management, we believe it is important that the SEC's guidance be closely aligned and compatible with any amendments to AS 2 in order to facilitate the important interaction and coordination that must occur between management, audit committees and auditors to maximize the effectiveness and efficiency of both management's assessment and the audit.

Because of the importance of this coordinated approach, we have also included recommended improvements to AS 2 in addition to our views on the need for additional guidance for management. We believe that our recommendations for additional guidance for management, along with our proposed amendments to AS 2, will result in the

improvements to effectiveness and efficiency demanded by the stakeholders of the capital markets, without reducing the value delivered by Section 404.

Appendix A includes our specific responses to the questions included in the Concept Release.

Guidance for Management

We support the overarching principle that judgment should take precedence over a prescriptive approach to management assessing the effectiveness of internal control over financial reporting. Guidance that is too prescriptive, detailed, or voluminous may limit management's ability to apply reasoned judgment and may foster a compliance-oriented approach. Accordingly, the guidance should be articulated in clear objectives and fundamental principles and concepts without setting rigid requirements. However, sufficient context and examples should also be provided in order to drive reasonably consistent interpretation and application. We believe that high-level principles alone, without context and examples, will likely not be sufficient to accomplish the objective of producing meaningful improvements to the current process.

Areas of Emphasis

In providing this guidance, it would be helpful if the SEC guidance encouraged open communication between management and external auditors in determining the most effective and efficient approach for a particular company recognizing that the approach will likely vary from company to company. We believe it would also be important to highlight that the decisions that management makes with regard to the nature, timing, and extent of testing may impact the extent to which the external auditor may be able to rely on management's work.

We believe that management will benefit most from guidance in the following areas where practice has illustrated the need for clarity to facilitate management's understanding and improve efficiency.

- *Top-down, risk based approach.* The guidance should explain the importance and benefit of implementing a top-down, risk-based approach and provide illustrative examples of how to apply the judgment necessary to successfully implement such an approach. While we acknowledge that progress has been made, in our experience, many companies have not fully implemented a top-down, risk based approach.

We believe an effective “top-down, risk-based” approach first considers the impact of an effective risk assessment and entity-level controls, which includes tone at the top and controls over the period-end financial reporting process, on the scope and coverage of management’s assessment as well as the nature, timing, and extent of testing management should perform to obtain the evidence necessary to complete the assessment.

We believe the inclusion of examples of different techniques management might use to vary the nature, timing and extent of their testing based on the risk of an account and the complexity of the related controls would be useful. The guidance should make clear that a properly applied "top-down, risk-based" approach means that management may need to obtain less evidence about the effectiveness of controls for lower risk accounts or processes and more evidence about the effectiveness of controls for higher risk accounts or processes. We also believe that applying a "top-down, risk-based" approach requires a certain degree of judgment and that any guidance in this area should not constrain management's ability to exercise such judgment.

- *Effective entity-level controls.* We believe that strong, comprehensive and substantive entity-level controls significantly reduce the risk of a material misstatement of the financial statements and, as such, should be strongly encouraged by the SEC. We believe, however, that there have been significant inconsistencies in practice and management would benefit from guidance regarding the range of impact that reliance on entity-level controls can have on the nature, timing, and extent of testing of transaction-level controls.

Management guidance should discuss and clearly illustrate the benefit that can be derived from reliance on effective direct or indirect entity-level controls. An example of an entity-level control that may allow management to reduce or eliminate the testing of certain underlying transaction-level controls would be a disaggregated analytical procedure or business performance review performed by management at a level of precision sufficient to prevent or detect on a timely basis a misstatement due to error or fraud that could result in a material misstatement of the financial statements.

- *Identification of key controls.* An appropriate identification of "key" controls is central to performing an effective and efficient assessment of internal control over financial reporting. We believe the guidance should help management understand the characteristics that make a control "key". We consider a "key control" to be the control(s) that provides the most effective or efficient evidence of achieving the objectives underlying one or more relevant financial statement assertions for one or more significant accounts or disclosures. While significant progress was made in Year 2 of Section 404, we believe there are additional opportunities for many companies to improve efficiency by reducing the number of controls tested based on a thoughtful selection and testing of those controls that are considered "key".
- *Scoping considerations.* There is a strong consensus that the use of judgment in assessing risk is an indispensable element to improving the process of assessing internal control over financial reporting. What is needed, however, is workable guidance on how that judgment is to be exercised. We believe the guidance should provide the opportunity to balance quantitative and qualitative factors in determining the scope of management's assessment (e.g., the identification of

significant accounts and level of coverage to be obtained in management's assessment) and the nature, timing, and extent of testing internal control over financial reporting.

- *Evaluating the significance of control deficiencies.* We believe guidance on the circumstances of when a restatement was not caused by a material weakness would be useful. For example, there may be circumstances where a company has a robust and effective process in place, performed by qualified personnel, to determine the appropriate accounting for complex issues, and has historically reached the appropriate accounting conclusion on such issues. After appropriately applying its process, the company may reach a position on a complex accounting issue that is later determined to have been incorrect; resulting in a restatement of the financial statements.

In situations like this, it may not be clear that a control has failed. Effective internal control is intended to provide reasonable, but not absolute, assurance and the nature of the control is influenced by many factors, including the fallibility of individuals. We question whether this example, which highlights a single failure in judgment in a complex area that has otherwise proven to be an effective environment, should necessarily be interpreted as an indication of the existence of a material weakness.

Perspectives on AS 2

The PCAOB announced a four-point plan intended to improve the implementation of internal control reporting requirements including the intent to amend AS 2. We believe improvements in auditor efficiency can be achieved through enhancements to AS 2 while still preserving the core tenets of the standard. As discussed above, we are recommending improvements to AS 2 that we believe will align management guidance with AS 2, improve auditor efficiency, increase the use of judgment, and improve the clarity of information reported to the capital markets.

We believe these proposed amendments to AS 2, along with the additional SEC guidance for management, will significantly improve the effectiveness and efficiency of Section 404.

Increase the use of judgment in determining the scope of the audit.

AS 2 requires that controls be tested over a "large portion" of a company's operations or financial position. Specifically, Appendix B to AS 2, *Additional Performance Requirements and Directions; Extent-of-Testing Examples*, expands on this terminology by requiring the auditor to perform tests of controls over *all* relevant assertions related to significant accounts and disclosures at *each* financially significant location or business unit. In many cases, the application of such a mechanical process has resulted in coverage well in excess of the level we believe required to satisfy the "large portion" intended by the standard. We believe that the requirement should be modified to allow the auditor to use

more judgment in making a risk-based assessment. For example, when a "large portion" of coverage of a company's operations or financial position, as well as over all significant accounts, has already been obtained, we do not believe the auditor should be required to continue to add additional financially significant locations or business units of lesser significance to their audit scope when prior experience combined with effective entity-level controls or other evidence support that controls are effective at those locations. This revision would result in a scoping process more in line with the risk-based principles and yield noticeable cost savings.

Changes to Walkthrough Requirements

We believe that there are several ways in which the existing walkthrough requirements could be amended to achieve greater efficiency. Currently, AS 2 requires that a walkthrough be conducted by the auditor for each major class of transactions every year. After the initial audit of internal control over financial reporting, we believe that in low risk areas, auditors should be allowed to rely on management walkthroughs when performed by competent and objective personnel. Alternatively, in low risk areas, auditors should be permitted to use walkthroughs as the only evidence of operating effectiveness when there has been no significant change in controls. In the spirit of the auditor varying the nature, timing and extent of work, we believe over some reasonable period of time the auditor should perform walkthroughs for each major class of transactions, including the low risk areas. Changes of this nature are consistent with our desire to increase the opportunities for auditors to apply reasoned judgment to better align the level of risk with the level of effort.

Other Proposed Changes

The following proposals, while not expected to have as significant an impact on cost and efficiency as the recommendations above, would, however, improve the clarity and quality of the information about the effectiveness of internal control over financial reporting that is reported to investors and other stakeholders in the capital markets.

- Permit "except for" opinions on the effectiveness of internal control over financial reporting. The SEC's final rules on Section 404 and AS 2 require a conclusion that internal control over financial reporting is ineffective when one or more material weaknesses exist at the end of the reporting period. In limited cases, where the material weakness is not pervasive, we believe it would be appropriate to conclude that internal control over financial reporting was effective, in all material respects, "except for" the stated material weakness. We believe the SEC's final rules on Section 404 and AS 2 should be amended to require an overall assessment of "ineffective" only for instances in which a determination was reached that internal control over financial reporting was ineffective as a whole.
- Eliminate the auditor's opinion on management's assertion. AS 2 requires two auditor opinions on internal control over financial reporting. The first opinion relates to whether management has reached the appropriate conclusion as to

whether internal control over financial reporting is effective and whether all material weaknesses have been appropriately disclosed by management. The second opinion relates to the effectiveness of internal control over financial reporting. Because of the requirement for the auditor to issue this second opinion, the substance of the objectives of Section 404 are met. The first opinion therefore provides little incremental value and, for the sake of clarity to the marketplace, could be eliminated. The auditor, however, will need to review and understand management's assessment in order to properly conduct their integrated audit and to determine how much reliance can be placed on management's work on internal control over financial reporting

- Reword the assessment of the likelihood of a material weakness to be "at least reasonably possible" as opposed to "more than remote". While we believe that these terms are synonymous, there seems to be a perceived difference in the marketplace.
- Eliminate the requirement to evaluate the significance of all control deficiencies against interim materiality, unless the deficiency is associated with a known error.

In summary, we believe appropriate guidance for management will improve the effectiveness and efficiency of Section 404. We also believe that the principles included in management guidance and the auditing standards should be aligned and complementary. Toward this end, concurrent comment periods on the SEC's guidance for management and amendments to AS 2 would provide issuers, investors and auditors the opportunity to provide valuable input that would contribute to achieving the necessary alignment and consistency.

We believe that the above recommendations will contribute positively to the quality, transparency and reliability of financial reporting that compliance with Section 404 has brought to the capital markets.

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We would be pleased to discuss our comments and to answer any questions that the SEC staff or the Commission may have. Please do not hesitate to contact Vincent Colman (973-236-5390), Jim Lee (973-236-4478), or Raymond Beier (973-236-7440) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

**Concept Release Concerning Management's
Reports on Internal Control over Financial Reporting**

1. **Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?**

We believe additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting will be useful for all companies. However, as discussed in the cover letter, we believe the guidance should not be overly detailed or voluminous and should focus on the areas of highest complexity and the opportunities to improve efficiency.

We believe additional guidance to management should focus on key principles in order to allow for the guidance to be effectively scaled to companies of all sizes. It is important that the guidance not limit management's ability to apply reasoned judgment. We believe the following overarching principles should be observed when developing additional guidance to management:

- We believe the guidance to management should be closely aligned with the provisions of AS 2 and believe that the final guidance should clearly state such intent.
- To avoid confusion, the SEC should clearly highlight any areas in which the intent is to provide management with guidance representing a substantive difference from AS 2.
- The SEC should not issue additional guidance for management that could be interpreted as *requiring* change for accelerated filers who may have already developed a practical approach over the last three years of assessing the effectiveness of internal control over financial reporting. To do so, would require these registrants to expend unnecessary cost and effort to modify an existing process.
- Management may expect the additional guidance to reduce the costs of Section 404 compliance. However, the focus of the guidance should be on performing an effective assessment of internal control over financial reporting. Adoption of the principles in the guidance may not always reduce costs, and in fact, in some cases, may increase costs. The SEC should be cognizant of expectations surrounding additional guidance and clearly explain the primary purpose of the development of the additional guidance to management.

- 2. Are there special issues applicable to foreign private issuers that the Commission should consider in developing guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting? If so, what are these? Are such considerations applicable to all foreign private issuers or only to a sub-group of these filers?**

We believe the guidance for domestic registrants will be equally applicable to foreign private issuers (FPIs). However, we support supplemental guidance for FPIs in the following areas:

- The appropriate GAAP basis for purposes of determining the scope of management's assessment. We support the current practice of making scoping decisions based on financial measures determined using the base GAAP of the primary financial statements.
- Clarification that the requirement to assess the significance of control deficiencies against quarterly or interim measures of materiality would not apply to FPIs since FPIs are not required to file interim financial statements with the SEC.

- 3. Should additional guidance be limited to articulation of broad principles or should it be more detailed?**

As discussed in the cover letter, the use of judgment is an indispensable element to improving the process of assessing internal control over financial reporting. As a result, we support the overarching principle that judgment should take precedence over a prescriptive approach.

- 4. Are there additional topics, beyond what is addressed in this Concept Release, that the Commission should consider issuing guidance on? If so, what are those topics?**

Although the topics addressed in the SEC's Concept Release are comprehensive, we believe management may also benefit from guidance in the following areas, stressing their importance due to high relative risk:

- Sufficiency of controls over the period-end financial reporting process and financial statement preparation, including related disclosures;
- Controls over critical accounting estimates and judgments.

- 5. Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?**

Based on its nature, we believe that the SEC should provide interpretive guidance and not necessarily a Commission rule. We believe that interpretive guidance is more consistent with the high degree of judgment that is applied to registrant-specific facts and circumstances. We also believe that interpretive guidance provides flexibility to registrants that have spent several years developing and refining an effective and

acceptable process to assess the effectiveness of internal control over financial reporting.

6. What types of evaluation approaches have managements of accelerated filers found most effective and efficient in assessing internal control over financial reporting? What approaches have not worked, and why?

We have observed the following:

- Companies with the most efficient and effective processes incorporated the evaluation and testing of the effectiveness of internal control over financial reporting into their every day operations.
- The most effective evaluation process has involved a “top-down, risk based” approach and appropriate identification and testing of “key” controls. In our experience, some companies believed that prior communications regarding a “top-down, risk-based” approach were directed at auditors. While we acknowledge that progress has been made, in our experience, many companies have not fully implemented a top-down, risk based approach due to (1) a lack of understanding or experience in applying the necessary judgment such an approach requires and/or (2) an acquired familiarity with their already-established, workable approach.
- Standardization of processes, controls, and related documentation contributes to an effective and efficient process.
- Management walkthroughs improve management’s understanding of the risks, controls, and processes and ensures the corresponding documentation is accurate. Furthermore, walkthroughs are a very effective method to assess the design of internal controls.
- An engaged audit committee with strong oversight and accountability facilitates an effective and efficient process.

7. Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? If so, what are they? How might those drawbacks or other concerns best be mitigated? Would more detailed Commission guidance hamper future efforts by others in this area?

Refer to our response to Question 1, above.

- 8. Why have the majority of companies who have completed an assessment, domestic and foreign, selected the COSO framework rather than one of the other frameworks available, such as the Turnbull Report? Is it due to lack of awareness, knowledge, training, pressure from auditors, or some other reason? Would companies benefit from development of additional frameworks?**

The decision on which framework to select has always been management's prerogative. We believe many companies have selected the COSO Framework because it is comprehensive, well-known, and widely accepted by the capital markets as an effective framework for establishing internal control over financial reporting. In addition, due to the significant number of companies selecting the COSO Framework and the corresponding practical and experiential guidance available at the time, it is easy to understand why many companies selected the COSO Framework.

We believe that the original COSO Framework, in conjunction with the Enterprise Risk Management (ERM)—Integrated Framework, provides an effective framework for establishing effective internal control over financial reporting.

As time passes and systems and companies continue to gain complexity, we believe it would be appropriate to have a process whereby COSO, and any other frameworks, are periodically evaluated. This process of continuous improvement will ensure that the principles remain relevant and applicable to dynamic organizations of all sizes.

- 9. Should the guidance incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting"? Should any portions of the May 16, 2005 guidance be modified or eliminated? Are there additional topics that the guidance should address that were not addressed by that statement? For example, are there any topics in the staff's "Management Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004)" that should be incorporated into any guidance the Commission might issue?**

We believe that the SEC should reaffirm the principles of the May 16, 2005, "Staff Statement on Management's Report on Internal Control over Financial Reporting" and the "Management Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004)" (collectively the "May 16th Guidance") by incorporating them into the new guidance.

10. We also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b). Should possible alternatives to the current approach be considered and if so, what? Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?

As discussed in the cover letter, we would support the elimination of the auditor's opinion on whether management has reached the appropriate conclusion as to whether internal control over financial reporting is effective because we do not believe it provides incremental value. It is important to note that in order to properly plan their audit, the auditor will need to review and understand management's assessment to determine how much reliance can be placed on management's work on internal control over financial reporting.

11. What guidance is needed to help management implement a "top-down, risk-based" approach to identifying risks to reliable financial reporting and the related internal controls?

We believe the implementation of a "top-down, risk-based" approach is paramount to effectively and efficiently assessing internal control over financial reporting. These concepts are equally useful to management and external auditors.

We anticipate that effective guidance in this area would include:

- Impact of the risk assessment on the scope and coverage of management's assessment as well as the nature, timing, and extent of testing.
- Identification of direct company-level controls and the extent to which reliance may impact scoping or testing decisions.
- Identification of "key" controls.
- Application of a risk-based approach as it relates to testing information technology general controls (ITGCs).
- Benefits of management walkthroughs on assessing the design and operating effectiveness of internal controls.

12. Does the existing guidance, which has been used by management of accelerated filers, provide sufficient information regarding the identification of controls that address the risks of material misstatement? Would additional guidance on identifying controls that address these risks be helpful?

The identification of the "key" controls that address the risks of material misstatement is critical to efficiently and effectively assessing the design and operating effectiveness of internal control over financial reporting. As mentioned in the cover letter, while significant progress was made in Year 2 of Section 404, we believe there

are additional opportunities for many companies to reduce the number of controls tested based on a re-evaluation of which controls have been assessed as key. We believe significant efficiencies will be achieved by thoughtful selection and testing of "key" controls. Accordingly, we believe guidance in this area would be useful.

We believe a "key control" is a control that provides the most effective evidence of achieving the objectives underlying one or more relevant financial statement assertions for one or more significant accounts or disclosures and may be detective or preventative in nature. They operate at the level of precision that would prevent or detect a material misstatement to annual or interim financial statements.

In addition, appropriate consideration of key controls includes reliance on automated controls. In our experience, automated controls are not identified as frequently as manual controls as being "key". Reliance on automated controls may increase efficiency and improve reliability.

13. In light of the forthcoming COSO guidance for smaller public companies, what additional guidance is necessary on risk assessment or the identification of controls that address the risks?

We believe the COSO guidance for smaller public companies, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*, provides practical approaches and illustrative examples that improve the understanding of the risk assessment and control identification process for companies of all sizes. As noted in our response to Question 8, we believe that all frameworks should be subject to review for continuous improvement to ensure that the needs of its users continue to be met.

14. In areas where companies identified significant start-up efforts in the first year (e.g., documentation of the design of controls and remediation of deficiencies) will the COSO guidance for smaller public companies adequately assist companies that have not yet complied with Section 404 to efficiently and effectively conduct a risk assessment and identify controls that address the risks? Are there areas that have not yet been addressed or need further emphasis?

We acknowledge that the implementation of a new rule will always require some level of non-recurring start-up costs. Deferred maintenance of documentation of internal control over financial reporting contributed, in part, to the significant start-up efforts in the first year. However, the best practices, lessons learned, existing guidance and the experiences of accelerated filers should result in comparatively lower start-up costs for non-accelerated filers than those experienced by the accelerated filers.

It is important to clarify that the primary purpose of the COSO guidance for smaller public companies was unrelated to the assessment of the effectiveness of internal control over financial reporting required by Section 404. The COSO guidance was

intended to assist management in demonstrating the effectiveness of internal control given the informal nature and lack of segregation of duties common among the systems and processes at many smaller public companies.

15. What guidance is needed about the role of entity-level controls in evaluation and assessing the effectiveness of internal control over financial reporting? What specific entity-level control issues should be addressed (e.g., GAAP expertise, the role of the audit committee, using entity-level controls rather than low-level account and transactional controls)? Should these issues be addressed differently for larger companies and smaller companies?

We believe that strong, comprehensive and substantive entity-level controls significantly reduce the risk of a material misstatement of the financial statements and, as such, should be strongly encouraged by the SEC staff. We believe, however, that there is diversity in practice regarding the impact reliance on entity-level controls can have on the nature, timing, and extent of testing of transaction level controls.

Management guidance should discuss and clearly illustrate the benefit that can be derived from reliance on effective entity-level controls—both direct and indirect entity-level controls. Direct entity-level controls are controls designed to prevent or detect on a timely basis a misstatement due to error or fraud of a significant account or disclosure that could result in material misstatement of the financial statements. Indirect entity-level controls are critical to the effectiveness of the overall control environment, but are not designed to prevent or detect a material misstatement at a significant account or disclosure level.

To the extent that management determines that reliance on entity-level controls is appropriate, we believe the guidance should emphasize the need to document the basis for their conclusion.

16. Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of an error, should be used when assessing risks and identifying controls for the entity? If so, what factors should be addressed in the guidance? If so, how should that guidance reflect the special characteristics and needs of smaller public companies?

We believe quantitative and qualitative factors are important in assessing risks and identifying “key” controls for companies. Additional guidance would be useful specific to the consideration of qualitative factors. We support management's ability to make reasoned judgments. As such, management should be allowed to consider qualitative factors not just to increase the scope of testing, as currently observed in practice, but under the right circumstances, management should be able to consider qualitative factors to reduce the scope otherwise indicated by a quantitative assessment.

We believe that qualitative factors to be considered should include (a) complexity of the process, (b) nature, size and volume of individual transactions, (c) effectiveness of company-level controls, and (d) the history of errors.

17. Should the Commission provide management with guidance about fraud controls? If so, what type of guidance? Is there existing private sector guidance that companies have found useful in this area? For example, have companies found the 2002 guidance issued by the AICPA Fraud Task Force entitled "Management Antifraud Programs and Controls" useful in assessing these risks and controls?

We believe the capital markets benefit from greater emphasis on fraud controls and management's assessment of the risks of fraud. We consider fraud controls an important component of effective internal control over financial reporting. Any guidance should be consistent with the principles prescribed by Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (SAS 99).

18. Should guidance be issued to help companies with multiple locations or business units to understand how those affect their risk assessment and control identification activities? How are companies currently determining which locations or units to test?

Many companies have multiple locations and business units, which increase the complexity of management's assessment. As discussed above, we believe guidance for management should support the application of reasoned judgment and consideration of risk in determining the scope of management's assessment.

Similar to our perspectives on the auditor scoping process as discussed in the cover letter, when a "large portion" of coverage of a company's operations or financial position, as well as over all significant accounts, has already been obtained, we do not believe management should be required to continue to add additional financially significant locations or business units of lesser significance to their scope each year when prior experience combined with effective entity-level controls or other evidence supports that controls are effective at those locations. This revision would result in a scoping process more in line with the risk-based principles and allow increased opportunity to consider the appropriate balance of quantitative and qualitative factors.

In addition, part of the complexity of a multiple location company is the identification of a "location". In practice, we have seen some companies struggle with determining what qualifies as a separate location, particularly when significant transactions are handled by a shared-service center, but some level of input-output exists at geographically distant facilities (e.g. sales offices, manufacturing plants, etc...). Further guidance on the identification of a location and the consideration of entity-level controls in shared-service environment would be helpful.

In the absence of guidance from the SEC, we have observed a significant majority of companies apply the scoping guidance outlined in AS 2 in determining which locations or units to test.

19. What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at the individual account or transaction level? If applicable, please provide specific examples of types of entity-level controls that have been useful in reducing testing elsewhere.

As discussed in our response to Question 15, we believe effective entity-level controls can impact the nature, timing and extent of testing at the individual account or transaction level.

20. Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of controls, such as on-going monitoring activities, be useful? What are some of the sources of evidence that companies find most useful in ongoing monitoring of control effectiveness? Would guidance be useful about how management's daily interaction with controls can be used to support its assessment?

We believe that the guidance should encourage judgment in determining the nature, timing, and extent of testing. To the extent that the guidance will encourage reliance on evidence other than that derived from separate evaluation-type testing of controls, we believe that guidance in the form of practical examples would be effective to demonstrate to management how such controls may be considered. In our experience, many companies have not taken full advantage of the various alternatives available to them in obtaining evidence of the operating effectiveness of internal control over financial reporting (e.g., self assessments, ongoing monitoring activities, etc...). We believe additional guidance should both reinforce and illustrate the various alternatives available to management.

We believe that any guidance in this area should be careful not to promote over-reliance on controls without obtaining the appropriate level of evidence of operating effectiveness.

21. What considerations are appropriate to ensure that the guidance is responsive to the special characteristics of entity-level controls and management at smaller public companies? What type of guidance would be useful to small public companies with regard to those areas?

As mentioned in our responses to Questions 15 and 19, we believe entity-level controls are an important component of effective internal control over financial reporting. We believe the characteristics of effective, entity-level controls are not unique to companies of a particular size. Accordingly, the aforementioned considerations regarding the use of and reliance on entity-level controls are scalable

to smaller public companies, but smaller public companies may find it difficult to demonstrate the requisite characteristics.

In addition, the COSO guidance for smaller public companies provides appropriate considerations regarding entity-level controls that will benefit not only smaller public companies but also companies of all sizes.

22. In situations where management determines that separate evaluation-type testing is necessary, what type of additional guidance to assist management in varying the nature and extent of the evaluation procedures supporting its assessment would be helpful? Would guidance be useful on how risk, materiality, attributes of the controls themselves, and other factors play a role in the judgments about when to use separate evaluations versus relying on ongoing monitoring activities?

Additional guidance and flexibility regarding the appropriate use of a “top-down, risk-based” approach will help determine when separate, evaluation-type testing or ongoing monitoring activities are appropriate. As mentioned previously, we believe some level of separate evaluation-type testing is necessary to conclude internal control over financial reporting is effective. Additional guidance addressing the consideration of risk, materiality, attributes of the control, and other factors in determining when to use separate evaluations versus relying on ongoing monitoring activities would be useful. Toward that end, we believe the guidance should address the impact of the following factors on the nature, timing, and extent of testing:

- inherent risk and complexity of the control;
- overall assessment of the control environment;
- changes in the operation or design of the control;
- consideration of direct and indirect company-level controls;
- frequency of the control;
- history of control deficiencies and financial statement misstatements.

We support a principles-based framework for determining the appropriate approach for management to obtain evidence of operating effectiveness based upon the aforementioned factors.

23. Would guidance be useful on the timing of management testing of controls and the need to update evidence and conclusions from prior testing to the assessment "as of" date?

We have observed that performing testing as of an “interim” date may significantly increase the efficiency and effectiveness of management’s assessment. Guidance regarding the timing of management’s testing of controls and the need to obtain updated evidence would be helpful. In conducting the update testing, the guidance should also address alternative approaches management has to obtain evidence during

the update period, including the use of inquiry, observation, self-assessment, re-performance, or walkthroughs.

We believe update testing should generally be performed near and within a reasonable period of the “as of” date. How close the testing should occur is directly related to the importance and complexity of the control. The greater the complexity, the closer the testing should be completed to the “as of” date. If the initial testing of a control occurs within this timeframe, it typically would not be necessary to perform update testing unless a significant change in the control had occurred.

The guidance should also address period-end financial reporting controls that do not operate until after the “as of” date but pertain to management’s assertion of the effectiveness of internal control over financial reporting at the “as of” date.

24. What type of guidance would be appropriate regarding the evaluation of identified internal control deficiencies? Are there particular issues in evaluating deficient controls that have only indirect relationship to a specific financial statement account or disclosure? If so, where are some key considerations currently being used when evaluating the control deficiency?

We believe there has been consistent application of the framework that was developed by the auditing firms for evaluating control exceptions and deficiencies. We support the continued use of this framework which requires the use of significant judgment, considers both likelihood and magnitude, and quantitative and qualitative factors. We encourage the SEC to acknowledge and endorse the use of this Framework by management.

As discussed in the cover letter, we support the elimination of the requirement to evaluate the significance of all control deficiencies against interim materiality, unless the deficiency is associated with a known error.

25. Would guidance be helpful regarding the definitions of the terms "material weakness" and "significant deficiency"? If so, please explain any issues that should be addressed in the guidance.

We have not observed diversity in practice in the application of the definitions of the terms “material weakness” or “significant deficiency”. We support the current requirements to identify and report to the audit committee significant deficiencies, which are an early warning of and may serve to prevent future material weaknesses.

We believe additional guidance to clarify the “magnitude” and “likelihood” that a control deficiency, or a combination of control deficiencies, could result in a misstatement of an account balance or disclosure would be useful. However, as discussed in our cover letter, we believe the SEC at a minimum should clarify the definition of “likelihood” from “more than remote” to “at least reasonably possible”.

- 26. Would guidance be useful on factors that management should consider in determining whether management could conclude that no material weakness in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the financial statement close process? If so, please explain.**

We believe Question #7 of the PCAOB's Staff Questions and Answers: Auditing Internal Control Over Financial Reporting (Questions 1 - 26) (Revised July 27, 2004) provides adequate guidance on useful factors management should consider in determining whether management could conclude that no material weakness in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the financial statement close process.

- 27. Would guidance be useful in addressing the circumstances under which a restatement of previously reported financial information would not lead to the conclusion that a material weakness exists in the company's internal control over financial reporting?**

We have observed that the determination that no material weakness in internal control over financial reporting exists despite the discovery of a need to restate previously reported financial information has contributed to significant debate and tension among interested constituents.

We believe that the restatement is a "strong indicator" that a material weakness in internal control over financial reporting exists. While in the event of a restatement it is not uncommon to conclude that a material weakness exists, it should not be considered a presumption. For example, there may be circumstances where a company has a robust and effective process in place, performed by qualified personnel, to determine the appropriate accounting for complex issues, and has historically reached the appropriate accounting conclusion on these issues. After appropriately applying its process, the company may reach a position on a complex accounting issue that is later determined to have been incorrect; resulting in a restatement of the financial statements.

In this example, it is not clear that a control has failed. Effective internal control is intended to provide reasonable, but not absolute, assurance and the nature of the control is influenced by the fallibility of individuals. We question whether this example, which highlights a single failure in judgment in a complex area that has otherwise proven to be an effective environment, should necessarily be interpreted as an indication of the existence of a material weakness.

- 28. How have companies been able to use technology to gain efficiency in evaluating the effectiveness of internal controls (e.g., by automating the effectiveness testing of automated controls or through benchmarking strategies)?**

Companies are early in the learning curve of automating the effectiveness testing of automated controls. They are beginning to leverage technology to gain efficiencies

within the evaluation process, through the use of tools like ACL, change management audit trail programs and user access administration systems. However, many of these programs and systems are first-generation tools, with limited integration into a company's evaluation process.

We continue to believe that companies can leverage the use of automated controls to reduce the volume of manual control testing performed. Increased reliance on automated controls would better support the use of the benchmarking testing strategy. Companies have struggled to effectively use the benchmarking strategy, due to the difficulty in efficiently gathering and maintaining the evidence necessary to support the completeness of the change process supporting the automated controls. In many cases, companies have found it more efficient and cost effective to retest automated controls annually rather than utilize a benchmarking strategy. The efficiencies gained by the use of the benchmarking strategy are directly related to the volume of automated controls and the quality of the ITGCs surrounding the automated environment.

29. Is guidance needed to help companies determine which IT general controls should be tested? How are companies determining which IT general controls could impact IT application controls directly related to the preparation of financial statements?

In developing guidance, we believe it is important to recognize that there is minimal empirical evidence where IT general controls have directly contributed to a material weakness. Accordingly, while IT general controls are critical to maintaining effective internal control over financial reporting, the SEC should be judicious in providing additional guidance to avoid increasing the level of work in this area.

Many of the areas that warrant guidance in the non-IT areas would be equally helpful relative to IT, namely the identification of "key" IT general controls and application controls and how to apply a "top-down, risk-based" approach to an IT environment.

The guidance should address the benefits of better alignment between finance and IT functions. The design and evaluation of an effective system of control is the collaborative responsibility of both teams.

We believe that the guidance should highlight that certain IT related testing can significantly impact the effectiveness of management's process. For example:

- The use of automated application controls to reduce testing of manual controls
- Better leverage of the change management process to gain efficiencies in process walkthroughs and update testing
- Appropriate consideration of IT-dependent manual controls that incorporate system-generated reports or end user computing tools (e.g., spreadsheets or report writers) into the control activity

- Direct linkage of IT applications to the processes that support the financial statement assertions, where understanding this linkage may increase the use of automated application controls.

30. Has management generally been utilizing proprietary IT frameworks as a guide in conducting the IT portion of their assessments? If so, which frameworks? Which components of those frameworks have been particularly useful? Which components of those frameworks go beyond the objectives of reliable financial reporting?

We observed that in Year 1, the default approach was to use Control Objectives for Information and related Technology (COBIT). However, many companies realized that COBIT was too detailed and migrated away from the use of COBIT primarily to reduce costs. In addition, since COSO does not comprehensively address IT general controls, many companies have logically gravitated to an AS 2 based assessment as described in paragraph 50 of AS 2, which focuses on program development, program changes, computer operations, and access to programs and data to help ensure that specific controls over the processing of transactions are operating effectively.

31. Were the levels of documentation performed by management in the initial years of completing the assessment beyond what was needed to identify controls for testing? If so, why (e.g., business reasons, auditor required, or unsure about "key" controls)? Would specific guidance help companies avoid this issue in the future? If so, what factors should be considered?

We acknowledge that the level of documentation performed by management in the initial year of completing an assessment may have been more than what was needed to identify key controls for testing. However, in many cases, the early documentation lacked clarity and precision. The level of documentation was partially attributed to an incomplete understanding of a company's internal processes due, in part, to deferred maintenance of management's documentation of internal control over financial reporting as well as an inability to identify key controls. In addition, the levels of documentation in the initial years were partially attributed to management's documentation of processes from the bottom-up as opposed to the top-down. We believe guidance regarding identification of key controls may help with the level of documentation.

We also believe the guidance should discuss the use of management walkthroughs as a best practice in streamlining and reducing management documentation. The completion of management walkthroughs would also contribute to an efficient and effective process for management and independent auditors. We also support the use of a combination of flowcharts and narratives as a best practice for effective documentation.

Finally, many companies found significant operational value and sustainable benefit in documenting controls, which contributed to the formalization of processes.

32. What guidance is needed about the form, nature, and extent of documentation that management must retain as evidence for its assessment of risks to financial reporting and control identification? Are there certain factors to consider in making judgments about the nature and extent of documentation (e.g., entity factors, process, or account complexity factors)? If so, what are they?

An assessment of the effectiveness of internal control over financial reporting should be supported by evidential matter, including written documentation, regarding both the design of internal controls and the testing performed. Guidance regarding the form, nature, and extent of documentation that management should prepare would be useful. However, because the form, nature, and extent of documentation will vary from company to company, we support general guidelines regarding the documentation needed to support management's assessment as opposed to prescriptive, detailed guidance.

It is also important to note that the sufficiency of management's documentation may impact the auditor's ability to rely on the work of others. We suggest that it would be helpful for the SEC guidance to clarify the appropriate period of retention for management's documentation.

33. What guidance is needed about the extent of documentation that management must maintain about its evaluation procedures that support its annual assessment of internal control over financial reporting?

Refer to our response to Question 32, above.

34. Is guidance needed about documentations for information technology controls? If so, is guidance needed for both documentation of the controls and documentation of the testing for the assessment?

We believe guidance regarding documentation of IT controls and the IT risk assessment process would be helpful. Our general views regarding documentation for information technology controls are consistent with our response to Question 32, above.

35. How might guidance be helpful in addressing the flexibility and cost containment needs of smaller public companies? What guidance is appropriate for smaller public companies with regard to documentation?

The primary criticism against Section 404 is not that it fails to deliver value, but the high cost of compliance. Additional guidance for management will increase clarity and improve efficiency while reducing redundancy in performing management's assessment, which addresses the flexibility and cost containment needs of companies of all sizes.

We believe the documentation requirements as discussed in our response to Question 32, above, are scalable to companies of all sizes.