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

Concept Release Concerning Management's Reports on
Internal Control Over Financial Reporting
Commission File No. S7-11-06

Dear Ms. Morris:

Ernst & Young LLP is pleased to comment on the Concept Release of the Securities and Exchange Commission (the "Commission" or the "SEC") regarding management's reports on internal control over financial reporting. We strongly support development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting, and believe it is important for the SEC to be at the forefront of efforts to develop such guidance for issuers.

In previous comment letters to the Commission (see April 3, 2006 letter on the Draft Final Report of the SEC Advisory Committee on Smaller Public Companies and May 1, 2006 letter in connection with the 2006 Roundtable on Second-year Experiences with Internal Control Reporting and Auditing Provisions), we have emphasized the need for practical implementation guidance, particularly for smaller, less complex public companies, that provides management with a useful "roadmap" to approach its evaluation and assessment of internal control over financial reporting. We commend the Commission for considering additional actions to develop such guidance and stand ready to assist in any way.

It is critically important to focus on, understand, and appreciate the significant benefits resulting from the implementation of the provisions of Section 404. We believe that the effective implementation of Section 404 benefits the investing public in the form of more reliable and transparent financial reports, increased investor confidence, lower cost of capital for issuers, and a reduced risk of corporate fraud. We also believe that issuers have benefited from the discipline, rigor, and focus on financial reporting and the associated evaluation and reporting on internal control. We have observed improved corporate cultures with a stronger control consciousness and better identification and management of specific risks that should help companies in the long run.

We support the Commission's goal of reducing unnecessary costs and work associated with the implementation of Section 404, while providing the same benefits and protections to investors. As we have previously commented, the second-year experience with Section 404 implementation was markedly improved over the difficult first year and the third-year experience promises further benefits in effectiveness and efficiency. Because experience shows that internal issuer costs were the largest component of total Section 404 costs for issuers not only in the initial year of implementation but also in succeeding years, providing additional guidance to management on how to perform its assessment should contribute to a more effective and efficient initial implementation by non-accelerated filers that have not yet implemented Section 404. Such additional guidance also may help accelerated filers that already have been through the most challenging aspects of initial Section 404 implementation to further improve their processes and reduce their costs. Accordingly, while we believe that the additional guidance will be particularly helpful to those issuers that have not yet implemented Section 404 and should in many respects be focused on the unique considerations in the smaller, less complex public company environment, we also believe that the additional guidance should be directed at all reporting companies subject to the Section 404 requirements.

It is our view that the additional guidance should articulate principles and objectives for management's assessment that illustrate the key elements of the assessment process. At the same time, we believe the guidance should be sufficiently robust so that the requirements and expectations of the Commission for management's assessment are clearly articulated. For example, the additional guidance should make clear the flexibility that management has in approaching its assessment, including the ability to incorporate both a top-down and risk-based approach that reflects how management has designed its internal control and how management has assessed the risks of material misstatement of its financial statements. However, the guidance also should state management's responsibility to evaluate and test internal controls and gather sufficient evidence so that it may conclude, with reasonable assurance, on the overall effectiveness of the system of internal control over financial reporting.

We believe that additional guidance in the form of principles and objectives will need to be supplemented with practical illustrations and examples. For example, one of the broad principles in the guidance might refer to the need for management of a multi-location entity to consider which locations to include in the assessment, and the nature and extent of procedures necessary at each location included. This could be supplemented with illustrations and examples about the specific factors to consider in determining the locations to be included in the scope of management's assessment, and the types of procedures to consider in obtaining evidence to support the operating effectiveness of controls at those locations. While higher-level guidance can be expected to address a wider array of facts and circumstances and thus can be applied by most or all reporting companies subject to the Section 404 requirements, it may fall short of providing the implementation assistance sought by smaller, less complex issuers. We believe management of these entities in particular is seeking more specific guidance and practical illustrations and examples.

We fully support providing management with a significant amount of flexibility in how the internal control evaluation and assessment is conducted. We also believe, however, that the guidance should acknowledge that the manner in which management completes its assessment directly affects the work the independent auditor must do to perform an audit that complies with PCAOB standards. It has been our experience that management is interested in determining both how to complete its assessment and how the independent auditor completes its related attestation in an overall effective and cost-efficient manner. We frequently observe that where, in conducting its assessment, management has performed a more extensive level of planning, risk assessment, and testing, including gathering and retaining robust documentation, the independent auditor has been able to use more of management's work in discharging its responsibilities under PCAOB Auditing Standard No. 2 ("AS 2"). We suggest that the additional guidance convey these practical considerations and that it align with the requirements for independent auditors in AS 2.

We believe the recently issued COSO Guidance for Smaller Public Companies ("COSO Guidance") will provide companies of all sizes, and particularly smaller companies, cost-beneficial considerations and approaches to implementing a control structure that achieves the objectives of reliable financial reporting. However, the COSO Guidance does not provide management with sufficient guidance for conducting a Section 404 assessment of internal controls over financial reporting. Rather, the additional guidance the Commission intends to issue to management will be complementary to the COSO Guidance. Please refer to our responses to Questions 13 and 14 for additional discussion regarding our views with respect to the COSO Guidance.

We also have included our responses to each of the Commission's 35 discussion questions.

We would be pleased to discuss our comments with the Commission or its staff at your convenience.

Very truly yours,

Ernst + Young LLP

Introduction

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 fully support the issuance of additional guidance for management on its assessment of the effectiveness of internal control over financial reporting, and agree that such guidance in each of the areas of risk and control identification, management's evaluation, and documentation requirements would be useful. When accelerated filers first implemented Section 404, the time, effort and expense required of management on average comprised up to 75% of an issuer's total Section 404 first-year costs. Accordingly, we believe the effort to provide additional guidance to management holds considerable promise for clarifying how issuers that are conducting their initial assessments of internal control can discharge their responsibilities under the Commission's rules and regulations in an effective and efficient manner.

   We believe additional guidance issued to management would be useful for, and should be directed at, all reporting companies subject to the Section 404 requirements. We believe that guidance in the form of principles and objectives that illustrate the key elements of the assessment process could be applied by most or all reporting companies. In our view, the primary limitation to developing such guidance is that broader principles and objectives may not provide the detailed guidance that would facilitate the implementation of Section 404 by those issuers that have not yet done so, particularly smaller issuers. Therefore, we believe that robust examples to illustrate the application of the additional management guidance would be beneficial in addressing the needs of such companies.

   Finally, we have observed in practice an inverse relationship between the quality and sufficiency of the various aspects of management's assessment and the time and cost incurred by the independent auditing firm in discharging its responsibilities under PCAOB Auditing Standard No. 2 ("AS 2"). Simply put, often times in areas where management's assessment process involves more extensive planning, testing and related documentation, the independent auditing firm can use more of management's work and therefore perform less work of its own, reducing audit costs. While we acknowledge that the additional guidance issued to management should allow for considerable flexibility in the manner in which management conducts its control assessment, we also believe the additional guidance should suggest that management consider the consequent effects on the auditor's assessment as part of an overall cost-benefit trade-off.

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 there are a number of technical matters that the Commission could address in the additional guidance that would significantly aid management of all foreign private issuers in scoping and conducting their assessments of internal control over financial reporting. We summarize them by general category below. Although we are aware of the Staff's views on some of these matters, we believe the Commission should address them in a Staff Q&A or through other formal means.

   - Scoping management's assessment—for example, the use of primary GAAP (e.g., local country GAAP or IFRS) or U.S. GAAP, including whether any exclusions from scope will be permitted for entities for which management does not have the ability, in practice, to assess controls; and whether to include or exclude interim period reporting, U.S. GAAP reconciliation, or other disclosures required pursuant to their primary GAAP for which there is no corresponding requirement under U.S. GAAP
   - Evaluating deficiencies—for example, whether or not to evaluate effect on interim periods; and whether to use materiality measures established under the issuer's primary GAAP, U.S. GAAP, or both

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

   We believe that many companies of various sizes are seeking fairly specific guidance as to the Commission's performance and documentation expectations of them in the implementation of Section 404. Where it is necessary for the Commission to convey guidance through broad principles, we believe such guidance needs to be supplemented with illustrations and practical examples that demonstrate efficient and effective ways in which the guidance can be implemented in practice.

   The Commission and PCAOB both advocate a top-down, risk-based approach to evaluating the effectiveness of internal control over financial reporting. We strongly support this approach and believe that for the most part, detailed, objectives-based guidance consistent with the performance of a top-down, risk-based approach would be most useful to management. Further, we have observed in practice that significant efficiencies have been achieved by issuers after the initial year of their Section 404 adoption through the leveraging of first-year knowledge and experience in the planning process, and the "maintenance" rather than the "building" of critical documentation. Many different effective and efficient approaches to management's assessment under Section 404 are currently working.

Accordingly, we strongly support the Commission's stated intent in developing the additional guidance to be sensitive to the fact that many companies have already invested substantial resources to establish and document processes and controls to perform their assessments, and rework should not be required in these situations.

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?

In our experience, as management teams begin to implement self-assessment programs, they strive to incorporate the annual assessment of internal control over financial reporting into other existing business processes. Accordingly, we encourage the Commission to provide considerations for such self-assessment programs in its guidance. We recommend the Commission address the following:

- Identification of the areas of the company's internal control that are most suitable for self-assessment
- Consideration of the competence and objectivity of the persons performing the self-assessment
- Monitoring of the quality of the self-assessment programs over time

We believe that focusing management's attention on the consideration of these points will greatly enhance the quality and sustainability of self-assessment programs and will contribute to the ability of the independent auditor to use some of this work in performing the integrated audit.

We also have indicated in other responses herein other topics we believe the Commission should consider with respect to the additional guidance to be issued to management.

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

We do not offer an opinion as to whether a Commission rule is preferable to interpretive guidance. However, we believe the guidance should articulate principles and objectives for management's assessment that are authoritative and thus compel issuers to incorporate consideration of the principles and objectives into their assessments 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 that management was both more effective and efficient when its approach included elements of a top-down, risk-based approach rather than approaches that started at either the detail process or business location level. We also have observed the difficulties experienced by management of both larger and smaller companies that operate with multiple reporting units in scoping their assessments and determining which reporting units to test. We have found that companies that focused prematurely on controls and processes at individual locations without an understanding of what controls are important to the consolidated financial statements, and the nature and strength of entity-level controls, generally were less efficient because they tended to identify and test a number of controls that were not critical to management's overall assessment. We also have observed that in performing its first assessment management tended to identify and test more controls than was ultimately necessary. Such scoping frequently resulted from management desiring to mitigate the possibility of a material weakness by being able to point to redundant compensating controls should it encounter deficiencies in primary controls.

Although management should utilize a top-down, risk-based approach, the SEC staff's May 16, 2005 statement acknowledges that management and external auditors need to keep the reasonable assurance standard in mind. We encourage the SEC to illustrate for management the nature and extent of evidential matter necessary to support its assessment of the effectiveness of internal control over financial reporting, including documentation, so that the resulting assessment provides reasonable assurance regarding the reliability of financial reporting.

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?***

We recommend that the additional guidance not establish standards or guidelines that have the potential to impugn alternative, yet acceptable, approaches to management's assessment. We observe that numerous smaller public companies have been using the additional time provided by the delayed implementation of the internal control reporting requirements to refine their approaches to their assessments using existing guidance and drawing on the initial implementation experiences of others, including their external auditors. We recommend that the additional guidance illustrate acceptable, but not exclusive, approaches to management's assessment.

For example, the recent COSO Guidance illustrates one approach to evaluating internal control over financial reporting. We recommend that the additional SEC guidance indicate that management can adopt a variety of approaches, including the recent COSO Guidance for conducting its assessment; however, we do not believe the guidance should express or imply a preference for a particular approach.

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 a lack of awareness, knowledge, training, pressure from auditors, or some other reason? Would companies benefit from the development of additional frameworks?***

   The COSO framework was developed by the private sector as an effort to establish a common ground for understanding internal control and to provide established criteria that entities could use to assess their internal control. It is widely recognized and has been referred to in U.S. Auditing Standards since December 1995 with the adoption of Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit—An Amendment to SAS No. 55*. In its release of AS 2 (PCAOB Release 2004-001), the PCAOB states, "The directions in Auditing Standard No. 2 are based on the internal control framework established by COSO because of the frequency with which management of public companies are expected to use that framework for their assessments." We also observe that when adopting its definition of internal control over financial reporting in June 2003, the SEC stated that its definition "encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives." We believe these factors, combined with the fact that only U.S. accelerated filers have thus far been required to perform an assessment of internal control over financial reporting, have resulted in widespread use of the COSO framework.

   We do not believe companies would benefit from development of additional frameworks as we do not believe additional frameworks would afford any further flexibility to management that is not already present within existing frameworks. Additional frameworks might very well appear over time as other regulatory bodies adopt internal control reporting requirements. However, the promotion of alternatives to the COSO framework would have the added cost of time spent by both management and their auditors to understand and implement new requirements.

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's 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 the additional guidance should incorporate the May 16, 2005 SEC Staff statement. The concepts of reasonable assurance, a top-down, risk-based approach, and scope and timing of management's assessment are important to effective management assessments. However, we recommend that the additional guidance clarify Staff statements under the sub-heading "Scope of Assessment" that reads, "The use of a percentage as a minimum threshold may provide a reasonable starting point for evaluating the significance of an account or process; however, judgment, including a review of qualitative factors, must be exercised to determine if amounts above or below the threshold must be evaluated." While we agree that accounts may be significant based on quantitative or qualitative factors, in our view, an account that is significant for purposes of financial reporting in the financial statements should also be significant for internal control over financial reporting, and accounts that are quantitatively material should always be considered significant accounts. For significant accounts that are determined to be lower risk, this should be reflected in the nature, timing, and extent of the procedures applied by management rather than by exclusion from the assessment process.

We also recommend that the additional guidance incorporate all the guidance from the SEC Staff's Frequently Asked Questions document (revised October 6, 2004). We observe that several of the Q&A deal with the scope of management's assessment and discussion of these and other scoping matters are important elements of guidance for management's assessment. Finally, we noted in our response to Question 2 that there are certain issues relating to the scope of management's assessment for foreign private issuers that also could be addressed in the additional 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?***

Fundamentally, we believe the role of the external auditor in connection with management's assessment required by Section 404(a), and the manner in which external auditors provide the attestation required by Section 404(b), is appropriate. We do not believe weakened standards, or audits that attest to the appropriateness of the design and implementation of internal controls but skirt the question of their actual effectiveness, are appropriate policy considerations in response to concern over the application of Section 404. Such proposals would, in our view, undermine significant gains in financial reporting, corporate accountability and investor protection.

With respect to the role of the external auditor in connection with the management assessment required by Section 404(a), we are aware that the issuance of a separate opinion on management's assessment has been incorrectly interpreted by some parties as the expression of an opinion on management's assessment process rather than its intended purpose of acknowledging whether or not the auditor is in agreement with management's assertion about the effectiveness of the company's internal control over financial reporting. To the extent there is wide perception that expressing an opinion on management's assessment is tantamount to an audit of the assessment process, we believe such opinion is not providing useful information to investors. Accordingly, we would support efforts to have a single auditor's report that contains an opinion on the effectiveness of internal control over financial reporting. However, while potentially less confusing, we do not believe that eliminating one of the two auditor opinions would have a measurable reduction of audit effort. External auditors still will need to gain a sufficient understanding of management's process to determine that management has a basis for its assertion and to properly plan the integrated audit using a top-down, risk based approach.

The suggestion has been made by some parties that auditors might have spent too much time evaluating management's assessment process, which may have caused companies to perform more work than they would have otherwise determined to be necessary. While we are not aware of many instances where we spent significant incremental time and effort evaluating management's assessment process, generally we spent less time in the second year of Section 404 reporting than in the initial year. We believe this is related to an increased understanding of Section 404 and its requirements and familiarity with management's documentation. In most cases in the second year, management needed only to update its documentation rather than develop it.

Risk and Control Identification

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 management could benefit from explicit objectives-based implementation guidance related to applying a top-down, risk-based approach in identifying risks to reliable financial reporting and the related internal controls that address those risks. As to the specific objectives, we believe that the discussion and guidance included in AS 2 and the May 16, 2005 PCAOB and SEC Releases effectively state the overall objectives in applying a top-down, risk-based approach to identifying risks to reliable financial reporting and the related internal controls that address those risks. We believe that management would find additional, actionable implementation guidance, especially illustrative examples where possible, related to these core objectives useful and such guidance would significantly contribute to the continued effectiveness and efficiency of management's assessment process.

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?

We assume that "existing guidance" is comprised of AS 2, the May 16, 2005 guidance provided by the SEC and PCAOB, other interpretive guidance such as "questions and answers" issued by the staff, and the recent COSO Guidance for Smaller Public Companies. These materials are a useful starting point for identifying controls. However, because controls necessarily vary based on the facts and circumstances of a particular situation, we do not believe the SEC should develop additional guidance for identifying controls.

In our response to Question 11, we express our belief that additional guidance for management regarding the objectives inherent in applying a top-down risk-based approach to identifying risks to reliable financial reporting, and the related internal controls that address those risks, would be useful. As we discuss elsewhere in this document, we observe in practice that those issuers that did not use a top-down, risk-based approach as a basis for management's assessment process often identified and tested more controls than was otherwise necessary, which resulted in increased costs.

In addition to guidance that more fully describes a top-down and risk-based approach, we highlight throughout this document several areas where additional guidance could aid management. In our responses to Questions 15, 19, and 21, we discuss the role and importance of entity-level controls in a top-down approach to management's assessment, including their ability to influence the ongoing effectiveness of other controls. We also discuss the need to link specific entity-level controls to specific control objectives (assertions) related to significant accounts and disclosures to aid management in identifying opportunities to evaluate and test entity-level controls and reduce or eliminate other control testing. We also discuss the importance of considering both the composition and combination of controls that address the achievement of multiple objectives of the control criteria. In our response to Question 18 we describe some of the areas where additional guidance for management regarding multi-location environments would be helpful.

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?***

The recently issued COSO Guidance for Smaller Public Companies (the "COSO Guidance") had the stated intention of neither replacing nor modifying the original COSO internal control framework, but rather seeks to provide guidance on how to apply the framework in designing and implementing cost-effective internal control over financial reporting. We believe the COSO Guidance will provide companies of all sizes, and particularly smaller companies, cost-beneficial considerations and approaches to implementing a system of control that achieves the objectives of reliable financial reporting. We hope the COSO Guidance will be complementary to the additional guidance that the Commission intends to issue to management, and vice versa. However, we do not believe the COSO Guidance was designed to provide, nor do we believe it will provide, management with sufficient guidance on performing a risk assessment, identifying controls that address those risks, and conducting an assessment of internal controls under Section 404.

Accordingly, we believe that explicit objectives-based guidance supplemented by a broad array of illustrative examples would be useful for management, would go significantly beyond the scope of the COSO Guidance, and would enhance the COSO Guidance's usefulness. With respect to risk assessment and control identification, we believe the additional management guidance should include, among other things, a discussion regarding (a) materiality, including quantitative and qualitative considerations, (b) the identification of significant accounts and relevant assertions, (c) considerations of the types of errors that could occur, (d) the definition of a control, the various types of controls, and considerations with respect to control identification, and (e) assessing internal controls in a multi-location environment. We believe a discussion of these topics, which are consistent with the efficient and effective performance of a top-down, risk-based approach, and which are generally not discussed within the COSO Guidance, would be useful as part of the Commission's additional guidance to management.

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?***

As stated above in our response to Question 13, we believe the COSO Guidance was not designed to provide, nor do we believe it will provide, management with sufficient guidance on performing a risk assessment, identifying controls that address those risks, and conducting an assessment of internal controls under Section 404. With respect to areas where companies identified significant start-up efforts in the first year, we believe the COSO Guidance can be of assistance to companies that have not yet complied with Section 404. For example, the COSO Guidance does provide a detailed focus on efficient documentation strategies, including the entirety of Volume III: Evaluation Tools, which should be useful for management in conducting its assessment of internal controls.

While we believe the COSO Guidance does not alleviate the need for additional guidance to management on conducting an assessment of internal controls under Section 404, we also believe that the issuance by the Commission of additional assessment guidance to management will enhance the usefulness and applicability of the COSO Guidance. For example, we have found it almost universally recognized that one of the most challenging aspects of performing a top-down, risk-based approach to an assessment of internal control over financial reporting is the identification and evaluation of entity-level controls, including more pervasive "monitoring" controls. See our responses to Questions 15 and 19 for further discussion of considerations related to entity-level controls. These controls are discussed throughout the COSO Guidance, and we believe that additional guidance to management with respect to the consideration of these controls would be helpful.

With respect to the COSO Guidance, we do believe that certain areas need further emphasis. These areas include (a) the role of the 20 principles, (b) the interrelationship between the five components of internal control, and (c) the emphasis on control activities.

First, we are concerned that certain statements in the COSO Guidance suggest that the 20 principles are in fact required elements of the original COSO framework. If viewed in this manner, this could have the practical effect of creating a new framework of 20 essential control principles as compared to the original COSO framework consisting of five components. For example, we note that the COSO Guidance states that the 20 principles are "essential to good internal control and cannot be compromised," that "all principles are relevant to effective internal control, regardless of company size," and "when a principle is not achieved, an internal control deficiency exists." We believe that these statements have the potential to cause confusion for issuers and auditors as to how the COSO Guidance should be used along with the existing COSO framework. Without further clarification, we believe these statements may lead companies, regardless of size, and their auditors to structure their documentation and evaluation approaches to specifically address each of the 20 principles rather than the five components. Lack of clarification also will leave unanswered the question as to how deficiencies in one or more of the 20 principles should be evaluated within the entirety of internal control, and as to their severity, and whether auditors would need to communicate such deficiencies under AS 2. Accordingly, we believe the SEC should either encourage COSO to clarify these statements or address these considerations to the fullest extent possible in its guidance for management.

We believe that management and audit committees need to clearly understand that the COSO Guidance is simply a means to an end, or a way of applying the original COSO framework. Companies can choose to use the COSO Guidance or can elect to use a different approach. Along these lines, it would be helpful if COSO or the SEC would clarify that the COSO criteria continue to consist of five components, and that noncompliance with one or more of the 20 principles does not automatically constitute a material departure from the COSO framework. Said differently, issuers should know whether it is possible for a company's system of internal control to be effective based on the COSO framework even though one or more of the 20 principles is not met. In addition, we believe it would be helpful for the SEC to clearly acknowledge and articulate the point that the COSO Guidance does not constitute a new framework or a separate set of criteria.

With respect to the interrelationship between the five components of internal control, the COSO Guidance states that the original COSO framework's five components should be viewed as an integrated system working together and that some trade-offs may exist with controls in one component serving to compensate for deficiencies in controls in another component. We agree with this concept and believe management of smaller public companies could significantly benefit from further emphasis and additional practical examples of its application.

Finally, we believe the COSO Guidance appropriately recognizes the unique characteristics of smaller organizations by emphasizing the importance of the control environment and monitoring components of the original COSO framework. However, we believe that the unique characteristics of smaller companies also require an equal, if not greater, emphasis on controls within the control activities and information systems (both accounting and IT) components of the original COSO framework. The traditional prevent and detect controls within these components, such as account-level reconciliations and authorization of transactions, are often some of the most important controls within a smaller business. In addition, the accounting system itself for many smaller businesses can become a critical part of internal control as various accounting modules within the system provide a roadmap for the processing of transactions and include built-in controls such as edit checks and exception reporting. While we do not believe that the COSO Guidance meant to downplay the importance of controls at the account or transaction level, with the emphasis of the COSO Guidance on controls within the control environment and monitoring components, we are concerned that management of smaller issuers may infer that control environment and monitoring controls can be relied upon almost exclusively. While we believe that control environment and monitoring controls play a critical role in internal control over financial reporting in all businesses, and in particular for smaller companies, we continue to expect in practice a far greater number of controls at the account or transaction level will be identified and evaluated by smaller and larger businesses alike. As the COSO Guidance gives less emphasis and practical illustration to the principles, attributes, approaches and examples of an efficient and effective assessment of account or transaction level controls of a routine nature, we believe further emphasis and additional examples within the SEC's management guidance in this area would be useful.

15. ***What guidance is needed about the role of entity-level controls in evaluating 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?***

With appropriate guidance (including examples), the SEC could significantly aid the understanding among issuers of the role of entity-level controls in the assessment of a company's overall system of internal control over financial reporting. We urge the SEC in developing guidance for management's assessment to reiterate and, where necessary, expand upon the description of the role of entity-level controls provided in paragraphs 50-54 of AS 2. Most importantly, we believe the new guidance should point out that in designing and tailoring a system of internal control for a particular company (1) an effective system of internal control is comprised of a combination of entity-level and other controls and both need to be evaluated and tested to some extent to conclude on the overall effectiveness of internal control over financial reporting, (2) entity-level controls must function at the control objective (assertion) level if they are to serve in place of other controls, and (3) entity-level controls comprise more than the control environment component of internal control. Each of these aspects of the suggested guidance is described in the following paragraphs.

Test a Combination of Entity-Level and Other Controls
Paragraph 50 of AS 2 puts forth the concept that some of the controls that comprise the overall system of internal control implemented by management might have a pervasive effect on the achievement of many overall objectives of the control criteria, while numerous other controls that are a part of the same overall system of internal control are designed to achieve specific objectives of the control criteria. AS 2 describes the former as company-level controls. Company-level controls are referred to in the SEC Concept Release and our comment letter as entity-level controls. In practice, controls that achieve specific objectives of the control criteria relating to a class of transactions have been described as transaction-level controls.

The composition and combination of entity-level and transaction-level controls that achieve the overall objectives of the control criteria are influenced both by the nature of the company's business and by the preferences of management. Therefore, management's assessment needs to evaluate that combination of controls in order to conclude on the overall effectiveness of internal control — it is not appropriate to evaluate and test only the entity-level or transaction-level controls to the exclusion of the other.

In our view, AS 2 neither states a preference for testing either entity-level or transaction-level controls, nor implies that it is possible to test entity-level controls to the exclusion of other controls. Instead, paragraph 52 of AS 2 states that because entity-level controls often have a pervasive effect on transaction-level controls "as a practical consideration, it may be appropriate for the auditor to test and evaluate the design effectiveness of [entity-level] controls first, because the results of that work might affect the way the auditor evaluates the other aspects of internal control over financial reporting." This is an important concept to guide management in its assessment. When management has designed and implemented entity-level controls that potentially address aspects of numerous control objectives, for practical reasons management should consider the design and efficacy of those entity-level controls first. This is not because the presence of entity-level controls obviates the need to evaluate and test other controls. Rather, it is because the pervasive nature of the entity-level controls can influence management's conclusions regarding the nature and extent of the evidence of operating effectiveness needed for the other controls to conclude that each of the specific control objectives is achieved.

Evaluate Entity-Level Controls at the Control Objective (Assertion) Level
PCAOB Staff Question and Answer No. 43 states that, "Although testing [entity-level] controls alone is not sufficient, pervasive [entity-level] controls can have significant effect on the auditor's testing of other controls, particularly when strong [entity-level] controls that have a direct relationship with lower-level controls result in the auditor decreasing the testing he or she otherwise would have performed." Notwithstanding that Question and Answer No. 43 states that testing [entity-level] controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting, we are of the view that when focusing on specific control objectives, it is possible

that one or more entity-level controls can achieve the control objectives (i.e., assertion) if the entity-level controls function at a sufficient level of precision. We find that this might be the case, for example, where there is a low volume of transactions affecting a significant account and material errors in the account balance can reasonably be expected to be identified through management's ongoing monitoring activities. This concept may be beneficial to management of smaller public companies as they perform their assessments, and we encourage the SEC to make this clarification in its guidance. In these situations, management might be able to conclude that the entity-level controls address the objectives of the specific control criteria and that testing other controls is not necessary. Please refer to the example of this concept in our response to Question 19.

<u>Entity-Level Controls Comprise More than the Control Environment</u>
It has been our experience that one reason entity-level controls were under-represented in initial assessments of internal control is because management and auditors focused principally on those entity-level controls that comprise the control environment component of internal control. Other aspects of entity-level controls that comprise the other four components of internal control (risk assessment, control activities, information and communication, and monitoring) were not always explored for their potential pervasive effect on transaction-level controls. In our view, guidance for management's assessment should provide examples of entity-level controls outside of the control environment and demonstrate how they can be linked to specific control objectives. Please refer to our response to Question 19 for a further discussion of how entity-level controls associated with other components of internal control can potentially reduce the need to test certain transaction-level controls that address specific control criteria.

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?***

AS 2 requires that if an account is considered significant for the audit of the financial statements, it should be considered significant for the audit of internal control over financial reporting, and vice versa. We have observed that management of issuers have been using both quantitative and qualitative factors in identifying significant accounts that fall within the scope of their assessment. Our experience has not indicated that the current process of making such assessments has resulted in accounts unnecessarily being identified as significant.

However, as we previously stated in our response to Question 9 above, we believe it would be useful for the SEC to provide additional guidance regarding the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of a material error or material weakness, should be used when assessing risks at the significant account level and when identifying controls that mitigate such risks. In this regard, we believe the lack of specific authoritative guidance for management has contributed in some circumstances to significant variability from company to company in the nature and number of controls identified and tested.

To maximize its usefulness, we suggest that additional management guidance include the following: (a) emphasis that accounts that are quantitatively material should always be considered significant accounts for purposes of both financial reporting in the financial statements and internal control over financial reporting, (b) example qualitative factors to consider in the identification of significant accounts, (c) further guidance and illustrative examples of quantitative and qualitative considerations with respect to the identification of relevant assertions related to accounts determined to be significant, and (d) further guidance and illustrative examples of how the assessment of the risk of material misstatement in a significant account or assertion, or qualitative factors, can affect the identification of controls and the nature, timing and extent of control testing.

We believe that additional guidance within this area would be useful for companies of all sizes and should not be addressed specifically to smaller public companies. However, we do believe that some illustrative examples that include considerations of the special characteristics and needs of smaller public companies would be useful.

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?***

In practice, management may be devoting more time and attention than in the past to better understanding anti-fraud programs and controls; however, we believe many companies are relying upon the entirety of their internal controls over financial reporting as an integrated approach to preventing, deterring and detecting material misstatement due to fraud. Some private sector guidance, including the 2002 guidance issued by the AICPA Fraud Task Force, provides illustrative considerations with respect to anti-fraud programs and controls. Fundamentally however, we believe that the best deterrent to fraud is an effective system of internal control over financial reporting. In this regard, we believe that additional guidance to management as to the appropriate consideration of fraud risk factors when identifying significant accounts, assertions and related controls would be useful. Further, we believe that illustrative examples of common controls consistent with the prevention and detection of fraud, and their relationship within an effective system of internal control over financial reporting, would be useful.

We also believe that additional guidance relating to fraud controls should dispel the notion that a separate universe of fraud programs and controls must exist, and be identified and tested. Rather, we would support the reinforcement that anti-fraud programs and controls are an integral part of effective internal control, such programs and controls may work in tandem with other controls, and such programs and controls often meet other control objectives outside of the prevention or detection of fraud.

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?

We have observed difficulties for management of both larger and smaller companies that operate with multiple reporting units in scoping their assessments and determining which reporting units to include in the assessment. We also observe that the subject of multiple reporting units highlights several fundamental issues about the intended scope of management's assessment, particularly when considering management's daily interaction with these reporting units and its reliance on entity-level controls and other monitoring activities, which we discuss below. We believe additional guidance in this area would be welcome. In the absence of guidance, many companies relied heavily on the advice and experience of their advisors or auditors, or applied the guidance provided to auditors in Appendix B of AS 2.

We believe the guidance should aid management of a company with multiple reporting units in understanding how to approach its assessment with the objective of controlling the *risk* of a material weakness and, accordingly, an incorrect assessment (e.g., concluding internal control is effective when there are one or more material weaknesses present) rather than focusing on *coverage*. It has been our experience that management sometimes proposed to exclude material reporting units from its assessment in the belief that it already had "sufficient coverage" of key financial measures (e.g., assets, revenues, income). The guidance should emphasize that management should apply a risk-based approach to the scoping of reporting units and that significant reporting units that can cause or significantly contribute to an overall material weakness should, in some fashion, be addressed in management's assessment.

Some companies have concluded that it is only necessary to formally document internal controls at reporting units that are the subject of management's assessment and other companies have concluded that it is necessary to document internal controls at all reporting units. We also observe differing views as to whether the scope of management's assessment, in terms of the number of reporting units for which procedures to support the operating effectiveness of controls are performed, should include a greater number of reporting units than the number of reporting units the external auditor believes it is necessary to test when applying AS 2.

We believe the guidance should aid management in understanding and evaluating the composition of its reporting units and how this and other factors affect its risk assessment and control identification strategies. Growth through acquisition and the resulting divergence in information and accounting systems, processes, and controls significantly complicated the scoping of management's assessment for a great many companies. In these cases, while management often expressed confidence in the financial information it receives from reporting units, frequently it felt compelled to test a great number of similar controls at a significant number of reporting units in order to gather evidence that internal controls over the disparate information and accounting systems that process core business transactions function effectively.

We also believe the guidance should address from management's perspective the statement in paragraph B11 of AS 2, "Testing [entity-level] controls is not a substitute for the auditor's testing of controls over a large portion of the company's operations or financial condition." Auditors have interpreted this to mean that the strategy described in paragraph B7 of AS 2 of testing entity-level controls to address the risks posed by individually insignificant reporting units, in lieu of testing transaction-level controls at these reporting units, is valid barring over-reliance. It is not clear whether management should hold itself to the same "large portion" threshold or whether management's daily interaction with the system of internal control and the totality of its ongoing monitoring activities provide it the opportunity to more heavily weight entity-level controls in its assessment.

Management Evaluation

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.

In our response to question 15 above, we summarize the guidance we believe is needed to clarify the role of entity-level controls in evaluating and assessing the effectiveness of internal control over financial reporting. As stated above, we believe management's assessment should focus on the composition and combination of entity-level and transaction-level controls that achieve the overall objectives of the control criteria. Further, we believe it is not appropriate to evaluate and test only the entity-level or transaction-level controls to the exclusion of the other. Due to their potential pervasive effect on other controls, management ordinarily should consider the potential effects of relevant entity-level controls early in its assessment because relevant entity-level controls might affect the way management evaluates the other aspects of internal control over financial reporting.

It has been our experience that in evaluating entity-level controls, few companies were able to easily link specific entity-level controls to specific control objectives (or assertions) related to significant accounts and disclosures. In some situations, it was because management had not considered the effect of entity-level controls early on in its assessment and in some other situations it was because management's evaluation of entity-level controls focused principally on "tone-setting" controls typically associated with the control environment component of entity-level controls.

We believe guidance that aids management in identifying a broader array of entity-level controls other than controls that comprise the control environment component would be useful. We are finding situations where management has implemented a pervasive set of entity-level controls that demonstrate elements of risk assessment, monitoring, control activities, and gathering and dissemination of information. Together these controls address several specific control objectives and provide opportunities to reduce the need to test other controls that address specific control objectives. We illustrate an example of this below.

> Over time, Company A has prepared and disseminated accounting policies and procedures to its reporting units and developed quarterly reporting packages that include a variety of reporting unit information and analysis in addition to needed information to include in the consolidated financial statements. Each quarter, senior management holds a conference call with management of each reporting unit where the integrity of the financial reporting of the reporting unit is carefully reviewed. In addition to discussing the accounting for new or unusual transactions, the review includes discussion of the key estimates and judgments that were made in closing the books for the quarter (reserves, deferrals, accruals, etc.).
>
> In addition to setting the tone as to the importance management places on the integrity of its financial reporting, over time these reviews have proven effective in identifying potential errors or misstatements in several of the significant accounts of the reporting unit, such as certain accruals and estimates. Management concludes that these reviews combined with periodic on-site reviews, including periodic internal audits, and other monitoring activities performed by the central accounting group achieve the control objectives for these accounts. Management therefore does not perform any additional tests of the controls over these accounts as part of its assessment.
>
> Management also concludes that, while effective, the quarterly management reviews are not sufficiently sensitive to address each of the control criteria related to significant financial statement accounts such as revenues and accounts receivable, inventory and cost of goods sold, manufacturing and general expense, payroll, etc. As part of its overall assessment, management performs tests of key controls for these accounts and related processes. The nature and extent of these tests of controls is influenced by management’s evaluation of the entity-level controls. Together, the tests of transaction-level controls and the evaluation of entity-level controls satisfy the control criteria for these core business accounts.

The example illustrates how elements of each of the five components of internal control interact to provide effective entity-level controls over the financial reporting by individual reporting units. The example also illustrates how, in certain situations, the entity-level controls reduce or eliminate the need to test other controls for certain accounts, while in other situations they work in combination with other controls to address the objectives of the control criteria.

We also believe that examples that help illustrate how management might go about linking specific entity-level controls to specific control objectives (assertions) related to significant accounts and disclosures would aid management in identifying opportunities to evaluate and test entity-level controls and reduce or eliminate other control testing. For each of the accounts described in the example above, it was necessary for management to evaluate how the various aspects of the accounting policies and procedures, reporting packages, and management reviews addressed the specific control objectives. This also entailed understanding the nature and complexity of the accounts, including their overall materiality to the consolidated financial statements. For certain accruals and estimates, management determined that due to their noncomplex nature, their relative transparency, and the low volume of associated transactions, the entity-level controls addressed all of the specific control criteria. For the core business accounts, management determined that due to their magnitude, associated volume and range of transactions, and the complexity of the related accounting (e.g., revenue recognition, valuation of inventories), additional transaction-level controls that address specific control objectives of the accounts needed to be tested in order to conclude that all the associated control criteria had been achieved.

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?

The concepts of separate evaluations and ongoing monitoring are rooted in COSO. Accordingly, we do not believe additional guidance is necessary to articulate the nature and use of separate evaluations or ongoing monitoring activities. However, additional guidance as to whether and to what extent it is expected that management will carry out some aspects of its assessment through separate evaluation would be helpful. Additionally, it would be beneficial if the guidance were to address the nature and amount of documentation that management should gather and retain to support its assessment, including evidence obtained either through formal self-assessment programs or less formal forms of monitoring.

It has been our experience that more clarification is needed as to the difference between (1) ongoing monitoring activities that monitor the effective functioning of controls and (2) those controls that address specific control objectives. We also believe that additional guidance should help differentiate monitoring activities that monitor the effective functioning of controls from monitoring activities that monitor the entity's operating performance.

Clarification of these control concepts would greatly aid management in understanding how it might design and embed more efficient ongoing monitoring activities and reduce its dependence on separate evaluations.

The example provided in our response to Question 19 illustrates a form of effective ongoing monitoring in a company with multiple reporting units that incorporates elements of all five components of internal control. We believe other less formal forms of ongoing monitoring by management often occur in smaller organizations. In our experience, controllers, chief financial officers, chief accounting officers, and financial analysts at smaller organizations or individual reporting units of larger organizations frequently perform similar ongoing monitoring activities. Guidance on how management should document and evaluate these less formal ongoing monitoring activities as part of its assessment would be helpful.

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?***

We believe the guidance should describe several other important concepts of entity-level controls that we have observed in practice and which we believe would be important to management's assessment at smaller public companies.

<u>Ongoing Effectiveness of Other Controls</u>
We observe that effective entity-level controls are equally important to management's assessment of internal control at smaller companies as at larger companies. Effective entity-level controls ordinarily result in a higher likelihood that other controls will continue to function over time with the most direct benefit being the ability for management to test controls throughout the year yet make its assessment at the company's fiscal year end.

Effective entity-level controls also may provide management of a smaller company similar opportunities to streamline other aspects of its assessment, including the ability to alter the nature, timing, and extent of its testing of other controls. When there are effective entity-level controls in a multi-location environment, these controls may provide management the opportunity to test controls at fewer locations or vary the nature of the testing across locations.

<u>Link Entity-Level Controls to Specific Control Objectives</u>
We have found it difficult in practice to leverage the effectiveness of entity-level controls to directly affect the amount of testing of other controls without linking entity-level controls to specific control objectives for significant accounts and disclosures. We have found that broad assessments of effectiveness without linking that effectiveness to the achievement of specific control objectives only provides indirect benefit and may not reduce the overall extent of management's evaluation and testing. We also observe that making broad assessments of the effectiveness of entity-level controls without making appropriate linkages may lead to

management placing inappropriate reliance on entity-level controls. We recommend that the guidance make this important observation so that management of smaller public companies are encouraged to make those linkages early in their assessment and appropriately reflect the effect of entity-level controls in achieving specific control objectives.

Entity Level Controls Comprise More than the Control Environment

We illustrate in our response to Question 19 that entity-level controls are comprised of more than the controls related to the control environment component of internal control. We find this important to management of smaller companies because management ordinarily has more direct involvement in all aspects of the company's operations and operates with a narrower span of control. In our experience entity-level controls are less formal and frequently involve more direct monitoring and control activities.

We believe the guidance should encourage management to focus broadly as it evaluates entity-level controls and consider whether there are combinations of controls that address, at least in part, several objectives of the control criteria. We also have found that some of the monitoring and control activities that management initially identifies may require some amount of remediation. While this may involve some investment, not only are controls improved but also the pervasive nature of the entity-level controls ordinarily results in quick recovery of the initial investment through reduced need to identify and test other controls.

Entity-Level Controls May Exist beyond the Corporate Headquarters

Many smaller public companies also operate from multiple locations. We believe the guidance should convey that entity-level controls need not reside only at the corporate headquarters and need not operate on an enterprise-wide basis, even in smaller companies.

We have found in practice several instances where effective entity-level controls had been implemented at a segment, division, or group level. In these situations the pervasive nature of the entity-level controls influenced management's conclusions regarding the nature and extent of the evidence of operating effectiveness needed for the other controls at a segment, division, or group level to conclude that each of the specific control objectives was achieved.

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?***

We believe that decisions with respect to varying the nature and extent of the evaluation procedures supporting an assessment of internal controls are largely dependent upon considerations with respect to the risk of a material weakness in the controls relating to a significant account or class of transactions. Such risk depends, at least to a certain extent, on both the "inherent reliability" of the controls (that is, factors indicating a lower risk that the control would fail to prevent or detect a material misstatement) and the likelihood that the transactions or balances subject to the controls would result in a material misstatement. Accordingly, to assess the risk of a material weakness, management should consider the following factors:

- Inherent risk of the transactions subject to the control—the relative importance of the possible errors that could result if the control is not functioning, including consideration of the pervasiveness of the control—the volume of transactions subject to the control and how often the control is performed
- Complexity of the control
- The effectiveness of internal control at the entity-level
- Experience gained from past assessments, i.e., history of errors or deficiencies in the control or related controls
- The competency of the person who performs the control
- Whether the control is manual or automated (i.e., an automated control generally would be expected to have a higher inherent reliability if IT general controls are effective)
- Standardization of policies, procedures, and controls across multiple reporting units

The persuasiveness of evidence that management needs to obtain depends on the nature of the control being tested and the degree of significance of the aforementioned risk factors, as well as the nature of the test of that control. For auditors, paragraphs 93-97 of AS 2 describe the nature of tests of controls to include inquiry, observation, inspection, and reperformance, with inquiry providing less persuasive evidence and reperformance providing more persuasive evidence. Notwithstanding that the nature of the control often influences the nature of the tests of controls that can be performed, management might have additional flexibility to alter its testing strategy for one or more of the controls. We believe additional guidance to management in assessing the risk of a material weakness and varying its testing strategies for different controls would be useful.

We do not believe that management flexibility with respect to varying the nature and extent of control testing would mean that management could completely eliminate control testing for a particular significant account, class of transactions, or assertion. Paragraph 95 of AS 2 states, "Because inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control, the auditor should perform additional tests of controls." We believe this concept also would hold true for management; however, in developing its testing strategy, management should consider and incorporate any other evidence that exists about the functioning of the controls.

Varying the persuasiveness of the evidence in response to the risk of a material weakness can provide significant benefit for a control that is designed to operate in the same way across multiple locations (i.e., pursuant to a standard corporate policy or process, but executed by different people at each location). Management might adopt a strategy to reperform that control at some locations, but limit its testing to inquiry, observation and, where appropriate, inspection at other locations. Accordingly, we believe additional guidance to management in varying its testing strategies for controls across multiple locations would also be useful. However, it is our experience that this flexibility has limited applicability for companies with a single or few locations.

With respect to the use of separate evaluations versus ongoing monitoring activities, we have observed that to date separate evaluations generally have been used to assess the effectiveness of internal controls. Separate evaluations have been used predominantly for various reasons, including a general lack of understanding of the types of ongoing monitoring activities that could be relied upon, uncertainty with respect to the persuasiveness of such monitoring controls or the nature, timing and extent to which they are required to be tested, and a general preference for management alignment with the traditional testing strategies employed by the external auditor. We believe management's preference for using separate evaluations has contributed to management having less flexibility in the manner in which it designs its assessment of internal controls. Accordingly, we strongly believe that additional guidance to management with respect to factors influencing management's judgment as to whether to use separate evaluations or rely on ongoing monitoring activities, and factors to consider when deciding to test ongoing monitoring activities instead of performing separate evaluations, would be useful.

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 believe it is important that the guidance point out that while management may evaluate controls throughout the year, its assessment as to the overall effectiveness of internal control is as of the year-end assessment date. Therefore, management's assessment should address the risk that the effectiveness of controls may have changed in the period of time that has elapsed since the controls were tested. We believe the guidance should describe how management might assess the risk that individual controls or their effectiveness might change over the intervening period from the date they are tested to the year-end assessment date and how management might effectively consider this risk when developing its overall evaluation strategy. For example, management might test controls that appear stable and not likely to change earlier in the year, especially where there are effective entity-level controls. Conversely, management might test controls that are less stable, subject to change, or more subjective in nature closer to the year-end assessment date. In either case management, as part of its assessment, should determine the nature and extent of procedures necessary under the given conditions to update its conclusions about the effectiveness of controls to the year-end assessment date.

In our response to Question 21, we make the observation that when an organization implements effective entity-level controls, particularly controls that monitor the ongoing effectiveness of other controls, this ordinarily results in a higher likelihood that other controls will continue to function over time. In our experience this is because effective entity-level controls raise the control consciousness of the organization and the various monitoring and control activities that comprise the entity-level controls alert management on a timely basis to potential breakdowns in controls that can be addressed before becoming more serious deficiencies. Therefore, the most direct benefit is the ability for management to test controls throughout the year, yet make its assessment at the company's fiscal year end.

While in our view effective entity-level controls do not obviate the need to address the risk that control effectiveness may have degraded since the internal controls were evaluated, their presence lessens the risk, and the procedures that management may need to perform to update its assessment as of the year end assessment date may be less extensive. In the absence of effective entity-level controls, there is a heightened risk that internal controls may no longer function effectively. That risk further increases as the period of time since the controls were originally tested expands.

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 an indirect relationship to a specific financial statement account or disclosure? If so, what are some of the key considerations currently being used when evaluating the control deficiency?

It has been our experience that both issuers and auditors found that the evaluation of certain types of deficiencies required considerable judgment and careful consideration of both qualitative and quantitative factors. While management for companies dealing with large numbers of deficiencies often tried to apply strict quantitative measures in their evaluation, we frequently found that careful consideration of qualitative factors was often the key to drawing appropriate conclusions. We recommend the additional guidance emphasize the need to consider both qualitative and quantitative factors and demonstrate this through examples.

Absent guidance for management's assessment, most companies looked to the provisions of AS 2. We and many of our clients found the guidance in *A Framework for Evaluating*

Control Exceptions and Deficiencies (Version 3, December 20, 2004) to be helpful in applying the provisions of AS 2, especially in evaluating the indirect effect of deficiencies in IT general controls. We believe it is important that management and auditors evaluate deficiencies using the same criteria and recommend that the additional guidance remain consistent with AS 2 and any revisions thereto.

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 recommend the additional guidance clarify that the term "more than remote" used in both the definition of a significant deficiency and a material weakness means there is at least a "reasonably possible" likelihood that misstatements could occur. We believe the term "reasonably possible" as defined in FASB Statement No. 5 as being more than a remote likelihood of occurrence, more directly describes the threshold range of likelihood that would trigger either a significant deficiency or a material weakness.

In our experience, the two primary difficulties companies face in applying the definitions of the terms "material weakness" and "significant deficiency" have been (1) the requirement to evaluate the likelihood of misstatement to interim as well as annual financial statements and (2) the requirement to evaluate the possible future consequences of the deficiency as required in paragraph 133 of AS 2. If these concepts are retained, we recommend that the additional guidance clarify through examples of how management should apply these two considerations when evaluating the severity of identified deficiencies.

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 recommend that the additional guidance clarify that an error identified and corrected in the financial statement close process, whether discovered by management or the auditors, should be evaluated in light of the facts and circumstances considering both qualitative and quantitative factors. We recommend the additional guidance or examples illustrate how management might evaluate relevant quantitative and qualitative factors in drawing a conclusion as to whether a material weakness exists.

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 believe guidance for management that addresses the circumstances under which a restatement of previously reported financial information would or would not lead to a conclusion that a material weakness exists in the company's internal control over financial reporting would be useful.

We believe guidance on restatement considerations would be most helpful by including descriptions and examples of the types of situations involving restatements that might lead to a conclusion that no material weakness existed.

We also believe guidance on restatement considerations should address whether the restatement of prior year financial statements and the conclusion that a material weakness exists also necessitates management rescinding and restating its prior conclusion as to the effectiveness of internal control over financial reporting or whether disclosure of the material weakness need only be disclosed on current filings with the SEC. Paragraph 197 of AS 2 states, "if previously issued financial statements and the auditor's report have been recalled and reissued to reflect the correction of a misstatement, the auditor should presume that his or her report on the company's internal control over financial reporting as of same specified date also should be recalled and reissued to reflect the material weakness that existed at that date." These provisions of AS 2 suggest that management ordinarily should file a revised assessment of internal control over financial reporting; however, we are not aware of any SEC requirement for management to file a revised report. In the situations of which we are aware, management concluded that it should file a revised report on its assessment. We recommend the guidance address the circumstances where management should file a revised report on its assessment.

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)?***

During the Panel 2 discussion of management's evaluation at the May 10, 2006 SEC and PCAOB Roundtable, panelists observed that companies made significant progress in the second year in testing IT general and application controls. However, some panelists also observed there was further room for improvement in leveraging IT controls in the assessment of internal control, especially in optimizing the configuration of previously installed ERP systems and expanding their use across all relevant areas of the company's system of internal control. In our Fourth Survey on Emerging Trends in Internal Controls, we observed that for 63% of companies surveyed, less than 30% of internal controls evaluated as part of management's assessment were IT-based. We believe that management generally should develop a controls rationalization approach to increase the mix of automated controls to 50% or more of all documented and tested controls, which will provide a greater opportunity to gain efficiency via automated testing tools or benchmarking strategies.

We observe in practice that benchmarking is not being utilized to a significant extent. We believe there are a number of contributing factors. For benchmarking to be effective, there must be effective IT general controls and limited changes in the automated application controls. Most IT environments are dynamic and program changes occur frequently.

Additionally, we observe that many companies find the potential efficiencies to be gained from benchmarking often are not cost effective compared to the relatively low level of effort required to test automated controls each year when there are effective IT general controls.

In certain instances, companies have been able to use technology to gain efficiency by utilizing various forms of Sarbanes-Oxley compliance software that have emerged, as well as other automated tools. The compliance software has helped companies organize their information on scoping, risks, internal controls and testing strategies, track issues, and monitor progress in completing management's assessment. Although not automated testing software per se, identity access management systems have been implemented by some companies to help manage logical security, both within and across applications. Implementation of these systems has required large up-front investments; however, the automation has delivered efficiency and enhanced effectiveness in ongoing user access management and has simplified the testing of logical security access.

Some companies are utilizing automated tools to monitor the effectiveness of logical access controls on significant operating system platforms (e.g., evaluating password controls across multiple servers). Certain companies also have automated the effectiveness testing of automated controls through closely linking internal control assessment considerations into the system development life cycle ("SDLC"), requiring key automated controls to be included in test plans when changes are made to related programs as a standard part of the SDLC.

One area of automated testing that has not been leveraged significantly is continuous controls monitoring/continuous controls measurement. While this area is generating some interest, there is a shortage of general-purpose tools and software to effectively implement the concept. As this type of software matures, it likely will create opportunities to further automate testing of IT and other related controls.

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?

Paragraphs 40 and 50 of AS 2 indicate that information technology general controls that encompass controls over program development, program changes, computer operations, and access to programs and data might have a pervasive effect on the achievement of many overall objectives of the control criteria. In our experience, management has had difficulty identifying the specific IT general controls to test and determining how to test them. Additional guidance would be helpful that describes how management should determine which IT general controls to test by first identifying the controls at the process or transaction level that are IT dependent (i.e., automated or IT-dependent manual controls over the processing of transactions that address risks of material misstatement for significant financial statement accounts and assertions). Once those controls are identified, management can then identify the relevant IT general controls that support their continued functioning and effectiveness. We have observed that following this approach resulted in more efficient and effective assessments.

Many companies have relied upon the IT Governance Institute's ("ITGI") publication "IT Control Objectives for Sarbanes-Oxley" to determine which controls they should test. While companies that are currently making annual assessments of their internal control over financial reporting generally have determined those IT platforms/controls that are important and need to be tested, in many cases they continue to struggle with how many controls to test, and the extent of testing required. Therefore, one approach might be to encourage and work with the ITGI to expand the guidance currently provided in the publication.

Documentation

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?

As noted in our response to Question 29, many companies have used the ITGI's publication "IT Control Objectives for Sarbanes-Oxley" as a guide to determine the IT-related controls to test in an assessment of internal control over financial reporting. The ITGI's publication identifies those aspects of the ITGI's broad framework, *Control Objectives for Information and Related Technologies* ("COBIT") that are applicable to internal control over financial reporting, and we believe it has proven useful in practice in driving consistency in how companies approach their assessment of the IT-related aspects of internal control. The appendices to the document are particularly useful as they include: (1) a map of the COBIT control objectives to the COSO components, (2) an illustrative company-level control environment questionnaire and (3) illustrative IT general controls and tests.

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?

First-year documentation clearly entailed very significant time and effort by management. A major reason for the level of effort often was the absence of existing documentation of systems of internal control.

Our experience indicated that many public companies started their Section 404 process without the benefit of narrative descriptions or flowcharts documenting the flow of transactions in major processes. Accordingly, in order to conduct and document a risk assessment, management needed to develop descriptive process documentation giving an overview of the flow of transactions for the purpose of effectively identifying risks of material misstatement and controls within such processes that mitigated those risks. This documentation also was often utilized by management to address perceived weaknesses in the sufficiency and clarity of policies and procedures. To the extent some companies did not use a top-down, risk-based approach, additional documentation inefficiencies also occurred as more controls may have been identified than otherwise would have been necessary.

We believe that specific guidance for companies related to documentation created and retained by management as part of a top-down, risk-based assessment process would be useful. However, we recommend that, in addition to addressing minimum expected requirements for compliance with Section 404, the guidance also should discuss practical considerations such as how internal control documentation supports management's ongoing risk assessment processes, evaluation of possible process efficiencies, and the auditor's ability to increase their reliance on the work of management.

32. What guidance is needed about the form, nature, and extent of documentation that management must maintain 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?

We believe that management's appropriate documentation of its risk assessment and control identification is a required component of its overall assessment. The form, nature and extent of such documentation can also increase auditor efficiency, and is currently doing so for most companies already reporting under Section 404.

With respect to the nature and extent of management's documentation related to its assessment of risks to financial reporting and control identification, we believe a variety of formats (e.g., process narratives, flowcharts, matrices, etc.) are being used effectively in practice. We strongly believe that any guidance to management be objectives-based, should retain the notion of flexibility regarding its nature and extent, and should illustrate best practices — all of which would avoid the potential consequence of undoing what is currently working in practice.

As a matter of general principle, we do believe there are several factors to consider in making judgments about the nature and extent of documentation. Our experience as auditors is analogous in that we generally will retain more robust audit documentation in areas of higher significance and risk, as compared to areas of lower significance and risk.

We believe that further guidance for management as to the various considerations involved in documenting its assessment of risks to financial reporting and control identification would be useful. Such guidance could include, where applicable, illustrative examples of considerations being made for both higher and lower areas of risk, as well as considerations related to the risk assessment and control identification procedures being performed among different COSO components (e.g., control environment, control activities, etc.).

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?

We believe that considerations with respect to the extent of management's documentation related to its evaluation procedures supporting its annual assessment of internal control over financial reporting mirror the considerations discussed above in our response to Question 32. Similar to Question 32, we support additional guidance for management as to the various considerations involved in documenting its evaluation procedures that support its annual assessment of internal control over financial reporting, including illustrative examples where possible. However, we strongly believe that any such guidance be objectives-based, preserving the option for companies to continue to utilize what is currently working well in practice.

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

In general, we believe that guidance issued to management with respect to the form, nature and extent of documentation related to its assessment of risks to financial reporting, control identification, and evaluation procedures supporting its annual assessment of controls can be applied generally to both IT and non-IT controls, and therefore separate guidance related specifically to IT controls may be unnecessary.

However, there are certain specific aspects related to the testing of IT controls for which additional guidance for management would be useful. In particular, in situations whereby management has concluded that IT general controls are effective, and testing of such controls has confirmed this effectiveness, certain IT application controls, including the IT component of IT-dependent manual controls, can be tested and benchmarked in future periods. We believe that additional guidance to management related to the form, nature and extent of documentation with respect to the benchmarking of certain IT application controls, including the IT component of IT-dependent manual controls, would be useful. However, we strongly believe that such guidance be objectives-based, preserving the option for companies to continue to utilize what is currently working well in practice.

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?***

We believe that the COSO Guidance provides meaningful evaluation tools for management's documentation of the various aspects of conducting an appropriate assessment of risks to financial reporting and control identification. Such tools can be used by smaller public companies to standardize in an efficient manner the form, nature and extent of process, risk assessment and control identification documentation.

We believe further guidance would be helpful with respect to similar evaluation tools that could be used by smaller public companies in documenting the evaluation procedures that support its annual assessment of internal control over financial reporting, including illustrative examples where possible. However, we strongly believe that such guidance should be objectives-based, and be provided for example purposes only, so as to preserve the option for companies to continue to utilize what is currently working well in practice.