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Via E-mail

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

Re: File Number S7-11-06
Release No. 34-54122
CONCEPT RELEASE CONCERNING MANAGEMENT'S REPORTS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Dear Ms. Morris:

BDO Seidman, LLP appreciates this opportunity to comment on the Securities and Exchange Commission's (the "Commission") Concept Release concerning management's reports on internal control over financial reporting. To date, management's evaluation and assessment have been driven largely by the audit requirements contained in the PCAOB Auditing Standard ("AS") No. 2. The lack of guidance at a similar level of detail for management has resulted in some inconsistent use of this audit standard as the de facto guidance for management. This situation has resulted in confusion and occasional disagreement between companies and auditors about how management should document, evaluate and assess internal control over financial reporting. Accordingly, we support the Commission's efforts to understand the extent of public interest in the development of additional guidance for management and what form any additional guidance should take. We agree with the Commission that any additional guidance should be scalable and responsive to the size and unique characteristics of each public company.

Our responses to each question posed by the Commission are presented within the same categories set forth in the Concept Release.

Introductory Questions

1. **Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the section 404 requirements or only to a sub-group of companies?**

What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the section 404 requirements?

We believe that the issuance of additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting would be helpful to management of public companies of all sizes. The issuance of guidance by the Commission would provide all interested parties with a common set of expectations about the extent and depth of the evaluation to be performed by management. Additionally, the development of such guidance, aimed directly to management's evaluation and assessment process, would help management and auditors communicate more effectively by clarifying management's responsibilities in the evaluation of a company's internal control over financial reporting.

We believe that the additional guidance provided to management should be principles based and apply to all companies, not just a subgroup of public companies. The fundamental internal control concepts, set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in their 1992 publication, *Internal Control – Integrated Framework* and now reemphasized in their most recent publication, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies,* are fundamental to all internal control systems. There has been extensive discussion during the roundtable discussions promoted by the Commission and the Public Company Accounting Oversight Board ("PCAOB") and in other venues, about how non-accelerated filers could best perform an evaluation and assessment of internal control, and we believe that the issuance of additional guidance that is principles based, supported by practical illustrative examples relevant to smaller public companies would be instrumental in achieving an effective and efficient evaluation process by management.

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

The fundamental concepts of internal control are the same regardless of whether a company is a domestic public company or a foreign private issuer. And while we believe that there should be a single principle based set of guidance, we realize that foreign private issuers face some unique challenges in evaluating internal control over financial reporting. For example, foreign private issuers have additional considerations related to reporting under foreign GAAP and U.S. GAAP, and audits are similarly often conducted under local GAAS as well as PCAOB standards. Materiality could also be significantly different under the different accounting standards, and this could affect both scoping decisions and evaluation of deficiencies. In recognition of these challenges, we recommend that specific examples that are unique to foreign private issuers be developed.

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

While we support the concept of additional guidance that is scalable, to accommodate the differing nature of the entire population of public companies, in order for the guidance to be meaningful, the broad principles which we recommend would need to be supplemented with examples containing sufficient detail to demonstrate how the broad principles would generally be expected to be implemented. Without such specificity, any additional broad based guidance would not be as effective in clarifying management's responsibility, particularly with respect to scoping, identifying significant risks and appropriate controls that mitigate those risks, including those controls that operate at the company level, and documenting the evaluation of internal control. However, it should be clear that the examples are for illustrative purposes only, and do not constitute part of the guidance itself.

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?**

We believe the objective of management's annual evaluation of internal control over financial reporting should be to provide a high level of assurance that effective internal control was maintained, regardless of whether or not there is concurrent auditor reporting on internal control. We believe the Commission's guidance should clearly communicate this objective and help management perform evaluations that are sufficiently rigorous to achieve it.

We also believe the guidance should explain how the objective of management's annual evaluation of internal control over financial reporting differs from the objective of its quarterly evaluation of internal controls which are elements of a company's disclosure controls and procedures. An effective way to accomplish this might be to provide guidance regarding evaluating disclosure controls and procedures, and we believe it would be helpful if the Commission did so.

Exchange Act Rules 13a-15(b) and (c) both require the management of each issuer to "evaluate … the effectiveness" of the issuer's disclosure controls and procedures and internal control over financial reporting, respectively. The evaluations of disclosure controls and procedures must be performed at the end of each fiscal quarter, and the evaluations of internal control over financial reporting must be performed at the end of each fiscal year. Management evaluations and reporting on disclosure controls and procedures have been required since 2002. Reporting on internal control over financial reporting began over two years later. A substantial portion of the controls that comprise a company's internal control over financial reporting are also part of its disclosure controls and procedures. Presumably these controls were often evaluated in some manner in connection with issuers' evaluations of their disclosure controls and procedures.[1] Nevertheless, in many cases, material weaknesses in these controls were not identified until later, when evaluations pursuant to Rule 13a-15(c) were performed for purposes of providing audited reports on internal control over financial reporting.

Issuers were required to "evaluate" disclosure controls and procedures before they were required to "evaluate" internal control over financial reporting, and evaluations of disclosure controls and procedures must be performed each quarter. Therefore, even though the words used in the rules are identical, it appears to us that the procedures issuers have applied in evaluating internal controls as part of disclosure controls and procedures evaluations have been less rigorous than the procedures they have applied when evaluating such controls in connection with internal control evaluations pursuant to Rule 13a-15(c). Accordingly, the level of assurance provided by issuers' disclosure controls and procedures reports has often been lower than that provided when issuers performed more rigorous evaluations of internal control that were subject to audit.

In view of the ambiguity in the rules (i.e., identical words in Rules 13a-15(b) and (c) apparently result in different levels of rigor) and, particularly, the fact that certain reports on internal control will not be audited for a time,[2] in order to achieve an appropriate and consistent level of rigor, we believe it is important for the Commission's guidance to help management perform evaluations that are sufficiently rigorous to provide a high level of assurance that effective internal control was maintained, regardless of whether there is concurrent auditor reporting.

We also believe the Commission would improve the consistency of the rigor with which issuers perform quarterly evaluations of disclosure controls and procedures if it provided guidance for performing those evaluations as well.

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[1] The Commission staff's frequently asked questions document covering the Sarbanes-Oxley Act of 2002 (http://www.sec.gov/divisions/corpfin/faqs/soxact2002.htm) states, "Some elements of internal controls are included in the definition of disclosure controls and procedures. There is a current evaluation requirement involving the CEO and the CFO of that portion of internal controls that is included within disclosure controls and procedures as part of the required evaluation of disclosure controls and procedures. We expect that issuers generally also would engage in an evaluation of internal controls. We believe that issuers generally currently evaluate internal controls, for example, in connection with reviewing compliance with Section 13(b) of the Exchange Act or in connection with the preparation or audit of financial statements."

[2] Reports by foreign private issuers that are accelerated filers will not be audited until years ending on or after July 15, 2007 and the Commission has proposed that reports by non-accelerated filers not be audited until years ending on or after December 15, 2008.

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

We believe that it is important that the guidance carries sufficient weight so that it is followed consistently and not seen as optional. Therefore, while illustrative guidance could easily meet the same objectives in assisting companies, we think that there will be less confusion about its intention if the guidance is issued as a rule.

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?**

Since the implementation of AS No. 2, both auditors and managements have developed approaches to meeting the requirements contained in Section 404(a) of the Sarbanes-Oxley Act. Some observations that we as auditors believe will lead to an effective and efficient process in assessing internal control over financial reporting include performing an effective top-down, risk-based approach and maintaining an open line of communication between the auditor and management. In the first year of implementing AS No. 2 there was confusion surrounding the extent and nature of communication that was permitted between the auditor and management. This confusion has often hindered the efficient implementation of AS No. 2 and resulted in many assessments not being completed by management until very late in the year. Now that we are in the third year of implementation of the standard and the extent and nature of communication between an auditor and a company has been clarified, we believe that the implementation of AS No. 2 will continue to improve. Companies now performing an initial assessment and preparing for an audit under AS No. 2 will be able to draw on the cumulative experience that auditors have already derived in the first two years.

The concept of the top-down, risk-based approach is a cornerstone of management's assessment and the audit process and is therefore essential for an efficient and effective approach to the implementation of section 404. The primary focus of this approach is the assessment of risk, which should be performed in the early stages of the process. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's controls and the identification of key controls, and the extent of testing to be performed on those controls. The extent of testing is also dependent upon the relationship to and the strength of certain entity level controls, and therefore these need to be established early in the process.

In our experience, companies that failed to evaluate their entity level controls and perform a rigorous risk assessment early in their process were inefficient in the process and typically did not allocate resources appropriately to the higher risk areas. Further, companies that failed to communicate early and frequently with the auditors often experienced tension and inefficiencies when auditors started to focus on areas not already assessed by management. Such communication with the auditors should also address what needs to be done in order to satisfy the auditors as to the competence and objectivity of the testing, and therefore permit the auditors to maximize reliance on management's testing.

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?**

In providing additional guidance to management, the Commission should ensure an adequate comment period to ensure all ramifications have been identified and that sufficient flexibility in the implementation of the guidance is provided to allow companies that have previously implemented AS No. 2, to make an orderly transition in the event that modifications to existing management assessments are necessary as a result of any new guidance. Also, since establishment and assessment of internal control over financial reporting is an evolving area, guidance should allow for ongoing flexibility.

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 Turnball 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?**

In 1992, COSO issued the *Internal Control – Integrated Framework* (the "COSO Framework") to address the needs of management in carrying out their responsibility for establishing, monitoring, evaluating and reporting on internal control. Since that time, auditors and management have both utilized this framework to design and assess internal control, and as a result, the framework has become the most widely used framework relating to internal control. In fact, AS No. 2 requires that the assessment of the effectiveness of internal control be based on a "…suitable, recognized control framework established by a body of experts that followed due-process procedures including the broad distribution of the framework for public comment" and has referred to the COSO Framework as a suitable and available framework for management's assessment.

Since the implementation of AS No. 2, we are not aware of any other framework in the U.S. that has been used to evaluate internal controls for the purpose of complying with the provisions of AS No. 2. The COSO Framework to assessing internal control is now familiar to all interested parties within the financial reporting community, including management, investors, auditors and regulators. The continued use of the COSO Framework will in our opinion ensure the ongoing improvement in the effectiveness and efficiency of both management's assessment of internal control and the auditors' opinion on internal control over financial reporting.

The use of other internal control frameworks, while feasible, would in our opinion not result in any additional benefits but would most likely result in additional costs as management (and their auditors) re-learn how to evaluate internal control against a new framework.

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 support the incorporation of the May 16, 2005 *Staff Statement on Management's Report on Internal Control over Financial Reporting* into any guidance issued by the Commission. The May 16, 2005 guidance issued by the Commission reemphasized the importance of the top-down, risk-based approach to assessing internal control and to identifying deficiencies in internal control that have more than a remote likelihood of leading to a material misstatement in the financial statements.

Based on our experience in implementing AS No. 2 we have provided some suggestions in areas where additional guidance to management may be helpful.

First, the concepts of reasonable assurance and a risk-based approach are fundamental to the efficient and effective assessment of internal control and should be emphasized and clarified for management. These concepts are crucial in performing an assessment of internal control over financial reporting in the most efficient and effective manner, however these concepts, while generally better understood by auditors, may be entirely new to management of some companies and those within the entity who will be responsible for assessing the effectiveness of internal control. Accordingly, management may benefit from more extensive guidance in the application of these concepts than is currently available.

Second, guidance in terms of the identification and determination of significant risks may also be helpful to management in focusing their attention on the areas of the greatest risk of material misstatement taking into consideration the likely magnitude of the potential misstatement, including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring.

Another area where additional guidance may helpful is in the implementation of the top-down approach and how the strength of company level controls can reduce the amount of testing in low risk areas. Because company level controls may have a bearing on the evaluation of risk associated with the controls operating at more detailed application level, the evaluation of company level controls can result in increasing or decreasing the testing that otherwise would have been performed on controls at the process, transaction, or application levels.

Additionally, we believe that clarification on project scoping and the determination of which accounts and locations should be included within management's assessment process would be beneficial.

In that regard, the SEC guidance should eliminate the inconsistency between paragraph 66 of AS No. 2 and Q&A 41 of the PCAOB Questions and Answers issued May 16, 2005. Paragraph 66 provides an example of an account (the fixed assets), which would be considered significant purely based on its materiality to the financial statements, even though the account may have a low volume of transactions and inherent risk is assessed as low. In contrast, the response to Question 41 states that "paragraph 66 of AS 2 should not be understood to require that the fixed asset account be identified as a significant account for the audit of internal control over financial reporting simply because it is quantitatively large and without regard to the risk that the account could be materially misstated." We are concerned with this conflicting guidance and believe that an account should be considered significant when it is quantitatively material, and that the risk associated with the account should then be considered when determining the nature, timing and extent of procedures to be performed relative to that significant account.

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?**

With respect to the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, we believe that the auditor's role should only be to report on the effectiveness of internal control and not to opine on management's assessment process. We believe that the current reporting structure, that requires auditors to opine on both management's assessment and the effectiveness of internal control over financial reporting, should be eliminated and that the auditor should only opine on the effectiveness of internal control. The elimination of the auditor's opinion on management's assessment would remove any confusion about the extent of work required to support such an opinion and the degree of assurance provided.

With respect to a possible alternative to the current reporting approach for smaller public companies, we suggest that the Commission consider the appropriateness of permitting smaller public companies with a pervasive material weakness, such as inadequate segregation of duties, to stop its assessment process early and have this fact reported on by the auditors. This alternative would effectively limit the cost of complying with AS No. 2 for this group of filers while also protecting the public by reporting the known pervasive material weaknesses to the investing public.

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 that incorporation of the May 16, 2005 Guidance, along with illustrative examples that clarify the concepts presented in the guidance, would go a long way in helping management understand and then implement the top-down, risk-based approach.

As stated in our response to question 6, the concept of the top-down, risk-based approach, is a cornerstone of the audit process and is essential for an efficient and effective approach to the implementation of section 404 for management's process. As such, it is essential that examples be provided, that illustrate the implementation of each step of the top-down, risk-based approach. While we are sensitive to the fact that any guidance must avoid the appearance of a check-the-box, cookie-cutter format, we believe that without appropriate examples that demonstrate the application of the principles, it will be difficult for management of differing enterprises to apply the guidance in an efficient and effective manner.

In particular, the guidance should focus on selection of significant accounts and identification of key controls for testing, as well as the interaction of entity level controls with those at the process level.

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

The COSO publication, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies,* provides extensive guidance that can be used by management of all size companies to identify control objectives and the risks to achieving those objectives that may result in material misstatements over major business processes.

While we believe this existing guidance is appropriate, we also believe that additional guidance that defines the term "key" control would be helpful. This term is used widely by companies to determine which controls to test and we feel that additional guidance should discuss the factors companies should consider in assessing whether a control is a key control. One interaction that should be considered is the interaction of risk and magnitude. For example, should key controls be identified for low inherent risk but high magnitude areas such as fixed assets or deposits? Additionally, we believe it would be helpful for the Commission to reaffirm the role and importance of entity level controls and provide guidance on identification, documentation and assessment of key entity level controls.

If, after consideration of the comments received, the Commission decides to issue additional guidance, care should be taken to ensure the recommended methodology is consistent with and validates the approach already taken by accelerated filers in their identification of controls that address the risks of material misstatement.

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 has provided some good examples of how those companies can implement an effective system of internal control by illustrating how the totality of internal control needs to be assessed and how different components work together to achieve an objective. This guidance has emphasized that all five components of internal control; the control environment, risk assessment, control activities, information and communication, and monitoring, each contribute to achieving the objective of reliable financial reporting, and how a weakness in one component can be mitigated by related controls in another component.

However, while the examples included in the COSO guidance have clarified how some smaller public companies can achieve effective internal control, there is still concern that the smallest of the group of smaller public companies, may have difficulty in applying some of the examples offered in the guidance, such as examples that refer to the use of internal audit departments, and that smaller public companies will need additional guidance about how to effectively implement separate evaluations. As referred to in our letter to the SEC on April 3, 2006 regarding the *Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies*, File 265-23, we believe that additional guidance and tools for smaller public companies should be developed by a task force of appropriate parties to guide the implementation and assessment of effective internal control.

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?

The COSO guidance for smaller public companies provides extensive information and examples about the risks of material misstatements and the types of controls management should consider in implementing an efficient and effective system of internal control in a small company environment. This guidance will hopefully help the smaller public companies that have not yet implemented section 404 avoid some of the initial start up costs incurred by accelerated filers when they first complied with section 404. However, some first year start-up costs may be hard to avoid, because the COSO guidance does not provide information to management about the nature of documentation management should prepare and retain to evidence the operation of controls and the assessment of those controls. It would be useful for the Commission to provide this type of guidance to management.

Another area where significant start-up costs were incurred in the first year of implementation, and where the smaller public companies may be able to benefit from the experience of the accelerated filers, is in the identification and testing of key controls. In the initial year of section 404 implementation, many controls were identified and tested. However, not all of those controls were key controls and possibly need not have been tested. Further, scoping decisions may not have adequately considered entity level controls. Additional guidance on the definition of a key control and how to identify controls for testing would benefit companies who have not yet complied with section 404.

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?

We have learned from experience that many companies address the entity-level control components of the COSO framework late in their implementation process, often do not place as much importance on these controls in their assessment process, and are often not clear on the importance of and how to go about testing these controls. Also, since the linkage between entity level controls and financial statement risk is more subjective in nature, when deficiencies in entity level controls are identified, both companies and auditors often have more difficulty evaluating the potential impact. Additional guidance to help companies address these issues would be useful.

There has been much discussion about placing greater reliance on entity level controls since Thomas Ray, Chief Auditor and Director of Professional Standards, Public Company Accounting Oversight Board, in his speech of June 8, 2006, stated that "Company management may also have increased attention to strengthening company level controls, in particular, monitoring controls – those controls that are designed to monitor the effectiveness of other company controls." Entity level controls, by their nature, operate at a lower level of precision than do transaction-level controls. They are typically pervasive and impact the environment in which business process transactions operate. Accordingly, the strength of entity level controls may impact the nature, timing and extent of testing necessary to assess the effectiveness of detailed key control activities, and may serve to mitigate the effect of general risks that impact an entity; but entity level controls rarely operate at the level of precision necessary to support the effective operation of controls at the assertion level. If the Commission believes that entity level controls can play a greater role to support the effective operation of controls at the assertion level, then additional guidance would be useful to demonstrate how entity-level controls might be expected to operate at this level of precision.

We acknowledge that larger companies have differing operating characteristics from smaller companies, and that will impact how they document, implement and assess internal control over financial reporting; however the framework within which the assessment takes place should be the same for both. The COSO guidance for smaller public companies supports this view when it states:

> "This document neither replaces nor modifies the *Framework*, but rather provides guidance on how to apply it in designing and implementing cost effective internal control over financial reporting."

As such, we propose that the Commission develop examples relevant for all sizes of companies of how entity-level controls, used in conjunction with detailed control activities can efficiently and effectively satisfy the control objectives at the relevant assertion level.

16. **Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of an error, should be used when assessing risks and identifying controls for the entity? If so, what**

factors should be addressed in the guidance? If so, how should that guidance reflect the special characteristics and needs of smaller public companies?

We believe that guidance about the appropriateness and extent to which quantitative and qualitative factors, such as the likelihood of an error, in assessing risk and identifying key controls, are necessary for management to perform a risk assessment process that appropriately identifies risks relevant to the financial reporting objectives. The recently issued Statement on Auditing Standards ("SAS") No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, sets forth factors for auditors to consider when assessing risks and identifying controls that address the risks of material misstatement. Many of the concepts presented in that standard, such as matters to be considered in determining the nature of risks, including the complexity of transactions, the risk of fraud, and significant developments in the economic or accounting environment, may also be helpful to management in assessing risks and identifying controls for purposes of their section 404 responsibilities. Additionally, Appendix B of SAS No. 109 directly refers to the entity's risk assessment process. However, we believe that assessing risks related to the operation of controls goes further than assessing inherent risk related to the financial statement area to which the control relates. Such assessment would include consideration of such items as the complexity of the control being performed and the competence of the person performing the control activity. Further, we believe that prior experience and history should be appropriate factors to consider in assessing risk.

We believe that the basic concepts of the risk assessment process do not change based on the size of the entity. Accordingly, we do not think that the guidance related to risk assessment should be different for a large versus a small company.

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?**

The identification of the risk of material misstatement due to fraud and the entity's programs and controls that address those fraud risks are part of the entity's system of internal control and as such are not considered separate and apart from the entity's system of internal control. However some controls may be designed to mitigate specific risks of fraud, for example, controls to address specific assets susceptible to misappropriation and broader company level controls such as tone at the top that promote ethical behavior. Therefore, we believe some guidance should be provided related to these items. We note that guidance regarding fraud risks and responses to this risk are available through various sources, including the AICPA guidance referenced above in addition to the AICPA publication, *Management Override of Internal Controls: The Achilles Heel of Fraud Prevention.* We recommend that the SEC review these and other appropriate publications in the development of appropriate guidance for management in assessing these risks and controls.

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 believe that companies with multiple locations do face additional challenges in performing their risk assessment and identification of controls to test. Based on our experience to date, we believe that accelerated filers have scoped their engagements based on the guidance provided in AS No. 2, (that provides extensive guidance to auditors with respect to scoping for both documentation and testing purposes), that begins with a determination of materiality from which significant locations and business units are selected for full documentation and testing. However, the determination of which locations and business units are significant should encompass both quantitative and qualitative considerations, taking into account such factors as entity level controls, the level of activity at each location, complexity of transactions, the likelihood of a material misstatement and contribution to overall consolidated results. We believe that specific guidance that focuses on management's risk assessment would be extremely helpful to management to assist them in this complex assessment.

Management's 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 general, our experience has indicated that in most cases, entity-level controls do not operate at a sufficiently robust level to address relevant assertions related to significant accounts without some additional testing at the detail control level. However, we believe that the assessment of entity level controls should affect the risk assessment and therefore the nature, timing and extent of testing at the detail control level. This could serve to either increase or decrease testing in any particular area. In our experience, the entity level controls that have the most impact on the extent of testing are the monitoring controls (i.e., controls that monitor other controls). If the company has robust monitoring procedures (and by this we mean monitoring of the effectiveness of controls in operation at the lower level, not merely high level analytical review processes performed at the entity level,) then this has the greatest impact on the ability to reduce the extent of testing at the detail level.

We therefore believe that guidance to management as to how to implement and document effective monitoring controls would be valuable. This guidance should include examples for both large and small companies, as we believe the methods will likely differ depending on the size of the company.

Please see also our response to question 15 in this regard.

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?

Management has a unique vantage point from which to evaluate the effectiveness of controls. As stated in this SEC Concept Release, "…management's daily interactions with its internal controls may provide it with an enhanced ability to make informed judgments regarding the areas that present the greatest risk." This allows management to use ongoing monitoring as a means of assessing internal control effectiveness rather requiring separate evaluations. We support the development of additional guidance that offers examples on how management's assessment can be based on such ongoing monitoring activities so that this process becomes a self-sustaining and efficient process rather than a one time effort to satisfy regulatory requirements. However, such guidance should clearly indicate how such monitoring activities should be evidenced so as to provide support for management's assessment as well as permit maximum reliance thereon by the auditors.

To assist management in the use of ongoing monitoring in their assessment of internal control, we also recommend that clarification be developed to reduce the confusion that surrounds the term "monitoring." Monitoring activities such as financial analysis and review are generally more appropriately considered a control activity rather than a monitoring control, depending on whether the primary purpose is to perform an initial check on processing accounting information or whether it provides assurance over the operating effectiveness of the control over time. A monitoring control that directly tests the operation of another control (such as a CFO randomly checking that bank reconciliations are effectively reviewed at a lower level) have a greater impact on affecting the level of detail testing needed than a monitoring control that merely reviews the financial information, (such as monitoring bank balances against prior periods or operating budgets).

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?

Smaller public companies share some basic characteristics that distinguish them from their larger counterparts. The COSO guidance for smaller public companies described smaller public companies as companies that have the following characteristics:

- Fewer lines of business and fewer products within lines
- Concentration of marketing focus, by channel or geography
- Leadership by management with significant ownership interest or rights
- Fewer levels of management, with wider spans of control
- Less complex transaction processing systems
- Fewer personnel, many having a wider range of duties
- Limited ability to maintain deep resources in line as well as support staff positions such as legal, human resources, accounting and internal auditing.

As a result of these unique characteristics, smaller public companies also face unique challenges, two of which, segregation of duties and the risk of management override, may be difficult to overcome. We therefore believe that additional guidance about how smaller public companies can effectively overcome these challenges or mitigate the related risks and still attain a cost effective internal control system would be extremely valuable. .

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?**

Ongoing monitoring and separate evaluations are two ways that management assesses the effectiveness of internal control. The extent to which ongoing monitoring should be used versus separate evaluations in assessing internal control is a matter of judgment for management. We believe that the focus here should be on how effective each approach is in assisting management in their assessment. We would presume that an effective and efficient assessment process would be comprised of both types of evaluations. Guidance, directed at the appropriate use of monitoring in management's assessment given various scenarios, would assist management in determining when one approach over the other is preferable in terms of effectiveness and cost.

Please see also our response to question 20 in this regard.

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 that additional guidance for management that clearly sets forth circumstances when testing at year end, or close to year end (and what that term means), is necessary and when it would be appropriate to perform testing at an interim period. Further, guidance as to the nature and extent of procedures, and documentation thereof, that would be required to update that interim testing would be helpful. This guidance should indicate that certain factors, including items such as the strength of the control environment and whether there were any changes in the external environment or organizational structure, would impact the nature and extent of any updating procedures.

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?

A Framework for Evaluating Control Exceptions and Deficiencies, Version 3, (the "Evaluation Framework") was issued in December 2004 by representatives of 9 firms and a professor from Georgia State University, as a suggested framework for evaluating exceptions and deficiencies resulting from the evaluation of a company's internal control over financial reporting. The framework recognized the requirements in AS No. 2 to consider both likelihood and magnitude in evaluating deficiencies and the importance of the use of judgment in the application of the framework.

Since its issuance, this framework has been used widely by both management and auditors as a method to consistently evaluate deficiencies in accordance with AS No. 2. We believe it is extremely important that management and auditors use the same framework for evaluating deficiencies, so this guidance should be strongly emphasized.

One area where we have seen confusion, however, is in the evaluation of whether the likelihood of a material misstatement of both annual and interim financial statements is remote. We recommend that the guidance regarding the likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure, be clarified from the current guidance contained in AS No. 2.

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 do not believe any additional guidance is necessary regarding the definitions of a "material weakness" or "significant deficiency". However, additional examples of when a deficiency rises to the level of a significant deficiency and when a significant deficiency rises to the level of a material weakness may be helpful to management and provide for greater consistency between management's evaluation and that of the auditors.

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.

Paragraph 140 of AS No. 2 lists the circumstances that should be regarded as at least a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists. One of the circumstances described is the identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.) This statement was clarified by the PCAOB's response to question 7, included in their Staff Questions and Answers dated June 23, 2004 (Revised July 27, 2004). The response clarified that management could share draft information with their auditors without risk of auditors determining that a material weakness exists, as long as management communicates, in writing or orally, the following three items; that the financial statements are in draft form, the extent that controls had operated, and the purpose for which management was giving the draft financial statements to the auditors.

We believe that guidance should be issued to management that is consistent with the guidance referred to above. We believe that such guidance should clarify for management how the above factors are to be evaluated and provide examples as to which circumstances would or would not cause a deficiency in the financial statement close process to be considered a material weakness.

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?

According to AS No. 2, the restatement of previously issued financial statements to reflect the correction of an error is a strong indicator of a material weakness. In our experience, generally, restatements have resulted in the conclusion that a material weakness existed as a control had failed to operate effectively. However in some circumstances, a restatement has not resulted in the identification of a material weakness if it is concluded that the company had a well reasoned position, and that no control in particular failed. We believe that there may have been inconsistency in approach in this regard, and therefore additional guidance for management to follow would be valuable.

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.

We believe that additional guidance about how IT general controls should be tested and the determination of which IT general controls impact the automated application controls that impact the preparation of the financial statements would be helpful. We believe that the additional guidance should incorporate information about how IT general controls impact the effective operation of other transaction level controls and the appropriate testing.

<u>Documentation to Support the Assessment</u>

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?

In our experience, during the initial years of implementing section 404, it was not uncommon to find that documentation and the related testing of controls started from the bottom up. This occurred as a result of many different factors including the challenges inherent in the implementation of a new standard and the related learning curve, in addition to the timing of the issuance of the guidance in the initial year of implementation. We believe that companies were uncertain as to the extent of documentation and testing necessary, and many companies left their entity level assessment to the end, which precluded a top-down approach. But after the initial start up efforts and the issuance of the May 16, 2005 guidance, documentation and testing efforts have now become more appropriately focused on the top-down, risk-based approach, and we believe this will be more effectively implemented as companies and auditors alike become more experienced in this methodology. Accordingly, at this time we do not see the need for additional guidance other than as described in our answers to various specific aspects above.

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?

Currently paragraphs 20 to 21 and 40 through 46 in AS No. 2 describe management's responsibility in an audit of internal control over financial reporting and also describe management's assessment process, respectively. These two sections in AS No. 2 describe management's responsibilities within the context of the work the auditor is required to perform as part of the audit of internal control over financial reporting. Now that guidance is to be developed that is aligned directly with management's responsibilities, guidance equivalent to these sections in AS No. 2 should appropriately be included within management's requirements.

In the development of guidance specifically for management it is important to recognize that documentation is an important part of any assessment of internal control, regardless of the size of the entity. We do not believe that effective assessments can occur without documentation. The assessment cannot be effectively performed purely in the minds of management. Therefore, documentation is not required only to support an audit. However, we believe it is important to note that the level of documentation could directly impact the extent of auditor effort, as a well documented assessment is more likely to result in increased reliance by auditors on management's assessment. Therefore, we believe additional guidance on how to effectively document an assessment should be provided. We believe that examples pertinent to both large and small companies would be valuable in this regard, as the extent of documentation could differ based on the size and complexity of the company. As a starting point, the COSO guidance for smaller public companies has described some factors that may be helpful in the development of guidance about the form, nature and extent of documentation.

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

Please see our response to question 32 above.

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?

Please see our response to question 32 above.

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We would be pleased to answer any questions you may have about our comments and look forward to continued dialogue and participation in the standard setting process. If you have any questions, please contact Wayne Kolins, National Director of Assurance, at (212) 885-8595 or via electronic mail at wkolins@bdo.com, or Lee Graul, National SEC Director, at (312) 616-4667 or via electronic mail at lgraul@bdo.com.

Very truly yours,

/s/ BDO Seidman, LLP