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January 3, 2007

Rep. Nancy Pelosi
Speaker Elect
House of Representatives
2371 Rayburn HOB
Washington, DC 20515-0508

Rep. Charles B. Rangel
Chairman Designate
Committee on Ways and Means
1106 Longworth HOB
Washington. DC 20515

Rep. Barney Frank
Chairman Designate
House Financial Services Committee
B-301C Rayburn HOB
Washington, DC 20515

Senator Chris Dodd
Chairman Designate
Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen SOB
Washington, DC 20510

CC: Nancy M. Morris
Secretary, SEC
100 F Street, NE
Washington, DC 20549-1090
Re: SEC File Number S7-24-06

Office of the Secretary
PCAOB
1666 K Street NW
Washington, D.C. 20006-2803
Re: Rulemaking Docket No. 021

Honorable Members of Congress:

On December 19, 2006 the Public Company Accounting Oversight Board (PCAOB) issued Release 2006-007 proposing changes to rules governing external auditor responsibilities under the Sarbanes-Oxley Act of 2002 Section 404 (SOX 404)[1]. At the same time the Securities and Exchange Commission (SEC) proposed Release 33-8762 to clarify responsibilities for the related management assessment of internal control[2]. These proposals have been exposed to public comment through February 26, 2007 after which they may be adopted by the PCAOB, approved by SEC and supersede present requirements.

The PCAOB/SEC proposals perpetuate the existing requirement for a full-blown external 'audit of internal control,' which in our experience has been the single largest contributor to the extraordinarily high expense associated with SOX 404 compliance. Over the past three years this requirement has resulted or contributed to huge audit fees, a massive transfer of wealth, a continuing erosion of shareholder value, a substantial shift to private from public financing and possible loss of U.S. global competitiveness.

We urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007. **Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act that would either better define or limit requirements presently imposed on public accounting firms under the Act.** Such amendments should reinforce the notion that the maintenance of a system of internal control, its assessment, and reporting on that assessment is primarily a <u>management</u> responsibility that <u>management</u> must satisfy as <u>management</u> considers necessary and appropriate to protect and enhance shareholder value.

January 3, 2007

The PCAOB's external 'audit of internal control' is *not* required by SOX 404 and represents an approach to protecting the interests of investors that has been specifically considered *and rejected* in the UK, Canada and perhaps other international jurisdictions, yet the PCAOB has never encouraged any serious public debate about the need for or value of an external 'audit of internal control' in the United States. The PCAOB's proposed Release 2006-007 perpetuates this trend by providing 131 pages of redefinition and redirection on *how auditor's should perform* an external 'audit of internal control' without ever addressing *the need for and value of the service itself*.

The manner in which this matter has been handled causes serious concern about the independence and objectivity of the PCAOB, its focus on protecting the public interest and the controls surrounding the standards-setting process itself. After three years of waiting, it no longer appears the PCAOB alone is capable of the innovative thinking and bold action needed to address the serious problems the American business community has experienced with SOX 404. **We need assistance from Congress and revisions to the Sarbanes-Oxley Act itself.**

This might be accomplished by relatively minor amendments limited to Section 103(a)(2)(A) and Section 404(b) of the Sarbanes-Oxley Act of 2002. After these amendments are in place, both the PCAOB and the SEC can develop and propose revised requirements. Further detail on amendments and requirements that might be considered is provided in the following pages.

Should the changes we suggest be made, we believe public accounting firms will be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection <u>or more</u>, than is provided in other international jurisdictions. Costly and unnecessary redundancy in the internal control assessment process would be removed for <u>all</u> registrant's, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical approach to satisfying the requirements of SOX 404. We believe that with assistance from Congress, management teams, Boards of Directors and public accounting firms can and will work together much more efficiently to design, implement, assess and report on internal control systems as needed to protect the interests of shareholders and investors.

Again, we urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007. **Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act** that would either better define or limit requirements presently imposed on public accounting firms under the Act while reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a *management* responsibility that *management* must satisfy as *management* considers necessary and appropriate to protect and enhance shareholder value.

Thank your for your consideration.

Respectfully submitted,

Dennis M. Stevens
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Alamo Group

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Background

In March 2003 the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued a proposal to have an external 'audit of internal control' performed to comply with SOX 404[3]. The full-blown external 'audit of internal control' proposed by the AICPA appeared to be a far broader scope of service than the more focused report on management's assessment contemplated in SOX 404(b). Subsequent to the ASB proposal, the PCAOB was organized and assumed responsibility for setting auditing standards. Nevertheless one year later, in March 2004, the PCAOB issued their Auditing Standard 2 (AS2), which adopted the AICPA's proposal requiring a full-blown external 'audit of internal control'[4]. The estimated aggregate annual cost of implementation was $1.24 billion or $91,000 per registrant.[5]

The Alamo Group, with operations in five countries and roughly $360 million in annual sales, was defined as an "accelerated filer" to whom the provisions of SOX and AS2 have been applied for the past three years. During those three years Alamo had **18** internal control reviews, assessments and audits performed, consisting of:

- management's review and update of approximately 1,000 control procedures each quarter (12 reviews as required by SOX Section 302),
- management's annual assessment, inspection and test of these controls (3 assessments as required by SOX Section 404), and
- the external 'audit of internal control' performed each year (3 audits as required by AS2).

Additionally, our external auditors have reviewed and reported on management's assessment each year, also as required by SOX 404. In total **21** internal control related projects have been managed and performed at Alamo in the past three years. Our costs have been substantial. External audit fees associated with Section 404 work represent about 40% of those costs, with the majority of those fees related to the full-blown external 'audit of internal control' required by AS2. We believe only a small portion of those fees relate specifically to the external auditor's report on management's assessment as required by SOX 404.

Every accelerated filer in the United States has been subjected to essentially this same level of scrutiny for the past three years, resulting or contributing to huge audit fees, a massive transfer of wealth, a continuing erosion of shareholder value, a substantial shift to private from public financing and possible loss of U.S. global competitiveness[6]. In contrast to the original estimate of $91,000, the Committee on Capital Markets Regulation recently estimated the average first-year cost for companies to comply at $4.36 million[7]. Venture capitalists suggest the average compliance cost for smaller portfolio companies is in the area of $1 million to $3 million[8].

There have been benefits. Through an array of comment letters and roundtable discussions sponsored by the SEC and PCAOB, many report a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls. Corporate board members note an improvement in audit committee oversight, while investors suggest public company financial reporting is of higher quality and transparency.

The PCAOB Proposal

The benefits noted above are among those cited by the PCAOB in the introduction to its proposed Release 2006-007, which SEC Chairman Christopher Cox recently characterized as a "proposal to repeal the unduly expensive and inefficient auditing standard under Section 404 of Sarbanes-

Oxley"[9]. The unduly expensive and inefficient auditing standard to which Chairman Cox refers is the PCAOB's AS2 issued in March, 2004 which adopted the AICPA's earlier proposal to have a full-blown external 'audit of internal control' as a means of satisfying the requirements of SOX 404.

Incredulously, in it's Release 2006-007 the PCAOB attributes <u>all</u> benefits noted above <u>solely</u> to the external 'audit of internal control' required by the PCAOB's unduly expensive and inefficient AS2. The PCAOB suggests the work of others is irrelevant - neither the Congress nor management teams nor Boards of Directors throughout the United States contributed to these benefits. This arrogant presentation is symptomatic of a much more significant problem – **the PCAOB has never encouraged any serious public debate about the need for or value of an external 'audit of internal control'**.

Of the **21** internal control related projects that Alamo has been subjected to in the past three years, the PCAOB proposal would eliminate those three that have had the **least** impact on our SOX 404 related expenses. In its Release 2006-007 the PCAOB proposes to maintain and clarify requirements for the external 'audit of internal control' while eliminating an existing requirement for the external auditor's evaluation of management's assessment process. The external auditor would continue to report on management's assessment as required under SOX 404(b), but that report would apparently be based on written representations from management and a comparison of results from the external audit and the management assessment of internal control.

In our experience, the requirement for an external 'audit of internal control' promulgated by the PCAOB in AS2 has been the single largest contributor to SOX 404 compliance expense. It is significant to note that an external 'audit of internal control' was **NOT** required by the elected members of Congress through SOX 404; it is solely an invention of the appointed members of the PCAOB. **Further, the external "audits of internal control" we have experienced have been <u>entirely redundant</u> with our own management assessments**, which WERE required by Congress through SOX 404(a). In each of the past three years we have had a management team doing an assessment and external auditors performing an audit of internal control – essentially two teams doing the same thing at the same time. Again, **due to the requirements of the PCAOB's unduly expensive and inefficient AS2, every accelerated filer in the United States has been subjected to essentially this same redundant exercise**.

Under the terms of the PCAOB and related SEC proposals, every accelerated filer in the United States <u>*will continue*</u> to be subjected to redundant management assessments and external "audits of internal control" each year. Smaller firms, who have not yet had to comply with SOX 404, are to perform a management assessment in their first year of compliance efforts, and then enjoy redundant management assessments and full-blown external "audits of internal control" in all subsequent years.

<u>Justification</u>

Title I of the Sarbanes-Oxley Act established the PCAOB in part to protect the interests of investors and further the public interest. Nevertheless there is not now, nor has there ever been, any indication of how or why an external 'audit of internal control', when performed in addition to the verifiable management assessment of internal control contemplated in the SOX 404(a), better protects those investors or their interests.

Further there is not now, nor has there ever been, a cost-benefit justification for this redundancy provided by the PCAOB. "AS2 is a big, vague document that requires a lot of interpretation," said

David Chavern, Vice President of the Capital Markets Program at the U.S. Chamber of Commerce. "Here we are, tens of billions of dollars later, and I have not heard an argument that the benefit even comes close to a small portion of the cost," Chavern said.[10]

The historical record however does provide some insight as to why the PCAOB continues to require an external 'audit of internal control' in addition to the management assessment required by SOX. In a Financial Times article titled "Auditors In Fight with Regulators" dated August 3, 2003, Adrian Michaels in New York reported as follows:

> US businesses and the large accountancy firms are fiercely lobbying regulators in a dispute over corporate governance reform that has millions of dollars in fees at stake.
>
> The two sides are arguing about the reach of a crucial part of last year's Sarbanes-Oxley Act, sweeping legislation passed in the wake of corporate scandals.
>
> The Act says that a company's auditor has to sign off on management's assessment of internal controls - the mechanisms by which financial statements are assembled, fraud is detected and other monitoring operations are carried out.
>
> But the audit firms argue they need to go further. If investors see they have signed off on the controls, they will believe that the auditors have tested them.
>
> This expectation gap could harm the profession's already battered reputation if companies have to restate earnings. Partners at KPMG and Deloitte Touche Tohmatsu were last week lobbying regulators on the issue.

As this article suggests, the external 'audit of internal control' is focused less on direct concern about the public interest and more on alleviation of the audit firms' concerns about their potential liability. The external audit community has long held the view that any public assurance they provide on internal control could carry with it enormous potential liability, since virtually any subsequently discovered problem could be attributed to a failure of internal control.

This is a valid concern. In November 2006 the CEOs of the six leading global audit networks provided a paper[11] which in part described in painful detail the problems caused by the U.S. litigation environment and their concomitant risk of liability. The Committee on Capital Markets Regulation recently reported that the nearly "open-ended responsibility of auditors in complying with Section 404 has made an already consolidation-shriveled profession virtually uninsurable for this work".[12] Public accounting firms have an important function in the global economy and clearly the interests of investors would not be better protected by letting them sink under the weight of extensive litigation.

The proposed PCAOB Release 2006-007 however will NOT resolve the audit firm's valid concerns about potential liability. The PCAOB indicates their proposal is designed, among other things, to clarify requirements for the external 'audit of internal control' by "directing the auditor's testing to the most important controls, emphasizing the importance of risk assessment", revising an array of definitions, "directing the auditor to tailor the audit to reflect the attributes of smaller, less complex companies", and "reducing detail and specificity". These may be laudable objectives, but if achieved they **will NOT change the U.S. litigation environment** and they will NOT reduce the audit firm's valid concerns about their concomitant risk of liability.

Effects

The PCAOB and SEC proposals will however result in some changes, and not all will be desirable. The proposals give both the external auditor and management considerable latitude in determining what each will do to satisfy their respective responsibilities. When considered together and projected over time along with the audit firm's continuing concerns about potential liability, we might reasonably expect the effects of these proposals to be as follows:

- Management of accelerated filers may determine that they can, in the absence of other considerations, reduce the amount of documentation and testing that supports their assessment. They may also find that the firm performing the external 'audit of internal control' can rely upon management's work if that work is performed and documented to the level of detail required by the external auditor. In an effort to reduce the combined expense of management's assessment and the external 'audit of internal control', management will perform and document their assessment to the level of detail required by the external auditor. **This is essentially the same situation that has existed for the past three years.** The principal difference is a de-emphasis on the need for a management assessment that is independent of the external 'audit of internal control'. In time the work may be combined into one project performed to the level of detail dictated by the external audit firm, thus resulting in a subtle shift of responsibility from management to the external auditor.

- Management of smaller firms, who have not yet had to comply with SOX 404, will turn to their external auditors for advice. They will undoubtedly be advised to implement, document and test control procedures to the level of detail required by the audit firm. In time the external auditor becomes responsible for the review and test of a system of internal accounting control that the external auditor has designed or influenced to a significant degree, thereby compromising the external auditor's independence and objectivity and reducing the value of both the external 'audit of internal control' and the financial audit itself.

The PCAOB recognizes the potential effect of its proposals on auditor independence and on page 33 of Release 2006-007 appears to address these concerns in a novel way:

> (The existing AS2) includes discussion of the application of principles of independence to internal control-related services and specifically notes that designing or implementing an issuer's controls would place the auditor in a management role and result in the auditor auditing his or her own work. The Board proposes to not repeat this independence guidance in the auditing standard or in a separate independence rule. . . . (Instead the) Board proposes to add a Note to this portion of the pre-approval rule …

Standards-Setting

Those responsible for developing and setting *new* auditing standards may reasonably be expected to abide by *existing* standards in executing their responsibilities. Among the existing standards is the need to maintain independence in fact and appearance, which in this case would serve to encourage the independent, objective evaluation of alternatives to the unduly expensive and inefficient full-blown external 'audit of internal control.'

The PCAOB's appearance of independence however appears compromised with regard to this matter. The PCAOB's present Chief Auditor and Director of Professional Standards was the Deputy Chief Auditor when the PCAOB's unduly expensive and inefficient AS2 was developed. Prior to joining the PCAOB he was a partner with a major public accounting firm that was reported to be lobbying regulators on the issue. Prior to joining that firm, he was the senior technical advisor to the AICPA's Auditing Standards Board[13], the group that initially proposed the full-blown external 'audit of internal control' as a means of addressing the requirements of SOX 404. In fact it appears he served on the Internal Control Reporting Task Force of the Auditing Standards Board – the group that in 2003 wrote the original proposal.[14]

Further, the original cost estimate of $91,000 per registrant has proven to be so grossly in error that it raises questions about whether those who prepared the estimate had the necessary training and proficiency to do so. While the original estimated annual aggregate cost was $1.24 billion, AMR Research estimates that companies will spend $6 billion on complying with Sarbanes-Oxley Act (SOX) requirements in 2006, on par with the $6.1 billion spent in 2005.[15] If the experience of other accelerated filers is similar to our own, some 40% of those dollars can be attributed to the PCAOB's unduly expensive and inefficient AS2 and its insistence on a full-blown external 'audit of internal control'.

After the first year of compliance efforts the PCAOB knew of this error and was repeatedly advised that the costs of SOX 404 compliance appeared to far exceed related benefits. As stated on page 3 of PCAOB Release 2006-007, "Over the last two years, the Board has heard a consistent message that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs than expected." Nevertheless, during those two years the PCAOB response was more verbiage and further "guidance" – their response did not appear to include reexamination of the fundamental need for and value of their full-blown external 'audit of internal control'. As other international jurisdictions considered *and rejected* the PCAOB approach they did not waiver, and now propose in their Release 2006-007 that still more verbiage will resolve significant concerns about redundant work, high costs, the erosion of shareholder value, a substantial shift to private from public financing and the competitive disadvantage of U.S. companies.

These matters would appear to suggest a need for reconsideration of the composition, internal procedures and supervision of the PCAOB itself.

Comments

The international business community does *not* universally see value in the full-blown external 'audit of internal control' required by the PCAOB. Such services have been considered by regulatory authorities in Canada, the UK and perhaps other international jurisdictions. None mandated them.

Canadian Securities Administrators Notice 52-313, Status Of Proposed Multilateral Instrument 52-111 - Reporting On Internal Control Over Financial Reporting, dated March 10, 2006

> On February 4, 2005, the securities regulatory authorities in every Canadian jurisdiction, other than British Columbia, published for comment Proposed MI 52-111 . . . (which) was substantially similar to the requirements of the SOX 404 Rules.
>
> After extensive review and consultation . . . we have determined not to proceed with proposed Multilateral Instrument 52-111. . .

> (Instead) The CEO and CFO of a reporting issuer, or persons performing similar functions, will be required to certify in their annual certificates that they have evaluated the effectiveness of the issuer's internal control over financial reporting as of the end of the financial year. They will also be required to certify that, based on their evaluation, they have caused the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year. . . .
>
> The issuer will not be required to obtain from its auditor an internal control audit opinion . . .
>
> This will contribute towards achieving our objectives while balancing the costs and benefits associated with the internal control reporting requirements.

Chris Hodge, Corporate Governance Unit, Financial Reporting Council, the independent regulator responsible for promoting confidence in corporate reporting and governance in the United Kingdom, in comments to the SEC/PCAOB dated April 28, 2006:

> In the UK external auditors of listed companies are required under the Listing Rules to review the board's compliance statement relating to its review of the internal control system, and to add an additional paragraph to their audit report if they believe that the board's internal control statement is inconsistent with the auditors' knowledge. . . . There is no requirement on the auditor to express a view publicly on the effectiveness of the company's internal control system.
>
> There was virtually no demand from investors or companies for an increased role for external auditors. The existing powers and remit of the external auditors were considered sufficient; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls.

David L. Shedlarz, Executive Vice President & CFO, Pfizer Inc., writing as Chairman - Principle Financial Officers Subcommittee, Corporate Governance Coordinating Committee of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues, in comments to the SEC/PCAOB dated November 26, 2003:

> . . . the Proposed Standard appears to expand the scope of the auditor's responsibility beyond that contemplated under Section 404. By proposing at the outset that the auditor's attestation required under Section 404 be characterized as "an integrated audit of the financial statements and internal control over financial reporting," we believe that the Proposed Standard proceeds from an incorrect premise. . . .
>
> by proposing that the auditor conduct an audit of the internal control over financial reporting, the Proposed Standard embraces a level of testing that is more extensive than that contemplated under the statute. . . . Accordingly, we urge the Board to revisit the scope of the Proposed Standard.

Richard M. Whiting, Executive Director and General Counsel of The Financial Services Roundtable, representing 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer, in comments to the SEC/PCAOB dated May 1, 2006:

> Section 103 (of the Sarbanes-Oxley Act) does not require an audit of a company's internal control structure.
>
> Section 404, likewise, does not require an independent audit of management's assessment of internal controls. The statute only requires the external auditor to "attest to and report on the assessment made by management of the issuer." Nonetheless, the PCAOB has interpreted the statute to call for a "full-blown" audit. The elimination of the separate audit would significantly lessen the compliance burdens imposed by Section 404, without impairing the integrity of the Section 404 process as envisioned by Congress and set out in Section 103 of Sarbanes-Oxley.

Paul A. Sharman, ACMA, president and CEO of the Institute of Management Accountants (IMA®), writing on behalf of their worldwide network of nearly 65,000 professionals in response to the Committee on Capital Markets Regulation interim report released on November 30, 2006, stating in part:

> IMA believes the way the PCAOB has interpreted Section 404 Part B (the external auditor attestation) must be significantly changed to align with what Congress asked for – a report on management's risk and control assessment process.
>
> Current PCAOB rules require auditors to arrive at the subjective pass-fail opinion on "how much control is enough". This regulatory interpretation is at the root of an inordinately high burden on management and litigation-wary auditors, leading to excessive testing and record audit fees. . . .
>
> It is time that audit firms cooperated in this endeavor in a serious and thoughtful manner for the benefit of investors, corporations and the U.S. economy.

David A. Richards, CIA, CPA, President, The Institute of Internal Auditors, representing more than 124,000 members across the globe, in comments to the SEC/PCAOB dated September 18, 2006:

> The IIA continues to recommend a fundamental change be considered to legislation and PCAOB's Auditing Standards Number 2 be modified accordingly. Currently three attestations are being produced to provide assurance on internal controls over financial reporting . . . We believe the intent and the benefit of the Sarbanes-Oxley Act are met with only two attestations . . .
>
> This approach (two attestations) is prevalent in other securities trading markets and would provide for international consistency, harmonization, and fair treatment for corporations in a global economy. Requiring all three attestations creates a competitive disadvantage for U.S. companies, especially for those doing business abroad.

> We further believe that the third attestation – the auditors own report on internal control over financial reporting – represents a fundamentally unrealistic and unfair expectation on the part of the auditors, which in turn leads to operating inefficiencies and costs. . . . Making statements about operations status, financials, internal controls accomplishments, tone at the top, and strategy, is the sole responsibility of management and are duties that solely management has capacity to fulfill. For the auditors, the best auditing methodologies and techniques cannot compete nor make up for
>
> • Management position in an organization
> • Management responsibility over operations and processes
> • Management accountability

Arguments

There is however a wide range of opinion as to the need for and value of a full-blown external 'audit of internal control'. One extreme might be represented by the CFO of a $76 million company: "This has turned into a check-the-box process. The work is being done by individuals – often only 22 to 26 years old – with very little business knowledge. They just don't know where to begin."[16] Here the feeling is that the external 'audit of internal control' as performed for the past three years provides little value to shareholders and has little to do with the problems inherent in the corporate accounting scandals that gave rise to Sarbanes-Oxley.

On the other hand, groups that represent consumers and large institutional investors see any attempt to water down the SOX provisions as shortsighted. These groups might argue that a full-blown external 'audit of internal control' is critical to restoring and maintaining investor confidence. Without it, management is free to use what the proxy research firm Glass, Lewis & Co., characterized as "a rubber stamp to certify the effectiveness of internal controls".[17]

It is significant to note that the SEC's currently proposed Release 33-8762 is the first guidance provided directly to management since the Sarbanes-Oxley Act itself became effective. For the past three years there has been no guidance whatsoever as to the depth and scope of procedures to be included in management's annual assessment as required under SOX 404. In the interim much has been learned, and an entire industry appears to have developed around SOX 404 and the provision of assistance when needed. Any management team that finds it necessary to get assistance in performing their management assessment will surely find that assistance readily available.

While there may be wide-ranging arguments about *how* to satisfy the requirements of SOX 404, there is no argument about the importance of restoring and maintaining investor confidence. To date, efforts to restore and maintain investor confidence have proven to be unduly expensive and inefficient. The PCAOB proposes to maintain the fundamental approach inherent in those efforts. **Bold action is needed to develop a better way of providing management with the ability to assess and report on internal controls while also providing investors with reasonable assurance that results have substance and are not in fact a "rubber stamp".**

Amendments

The concerns of public accounting firms appear to center on existing requirements for them to provide public reports that suggest they have tested or "signed off " on controls. In their experience, doing so evidently gives rise to an "expectation gap" and substantial potential liability.

Thus they attempt to protect themselves by performing a full-blown external ‘audit of internal control’ at great expense to all registrants.

The external auditor’s report on management’s assessment of internal control is required by Section 404(b) of the Sarbanes-Oxley Act. Section 103(a)(2)(A)(iii) of the Act provides specific requirements for that report. Those requirements in part include a description of “the scope of the auditor’s testing of the internal control structure and procedures of the issuer” as well as other references to external auditor testing.

It would seem that the concerns of the public accounting firms can be effectively addressed by focusing on just these two sections of the Sarbanes-Oxley Act. The external auditor’s participation in the annual internal control assessment process could for example be eliminated entirely by deleting the two sections of the Act referenced above. While expedient, this would be an extreme measure that would not inure to the benefit of investors.

Investors benefit by receiving independent assurance that management’s annual assessment has substance. This we believe was the original intent of Congress. **We would hope that the public accounting firms can find a way to provide such assurance at a more reasonable cost by making a determination as to whether management’s assessment meets standards established be the SEC.** This should be a much more focused service compared to the broad, all inclusive, full-blown external ‘audit of internal control’ that is currently required.

To facilitate a determination as to whether SEC standards were met, it would be incumbent upon the SEC to establish certain benchmarks that management must meet. These benchmarks must be verifiable to permit public accounting firms to objectively determine if they have been met. Should this approach be pursued, the existing Section 103(a)(2)(A)(iii) of the Act might be deleted in its entirety and replaced with new wording as follows:

> (iii) provide in each audit report their conclusion as to whether management’s assessment of internal control for financial reporting performed as required under Section 404(a) met standards established by the Securities and Exchange Commission.

Section 404(b) of the Act could be reworded to read as follows:

> With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall report on the assessment made by the management of the issuer. Any such report shall not be the subject of a separate engagement.

As stated on page 38 of the SEC’s proposed Release 33-8762, “Management’s assessment must be supported by evidential matter that provides reasonable support for its assessment.” The SEC should expand its proposal to establish benchmarks that reasonably define that evidential matter and represent the minimum level of verifiable support that management of all registrants must provide. These benchmarks might include for example:

1) A written plan that is submitted to and approved by the registrant’s Board of Directors or its Audit Committee at least annually, describing in reasonable detail:

    a) the risks to reliable financial reporting that management has identified,

b) the degree to which those risks are affected by multiple locations of the registrant, if any,
c) management's evaluation as to whether the design of the controls that address each of those risks is such that there is a reasonable possibility that a material misstatement in the financial statements would be prevented or detected in a timely manner,
d) the methods and procedures management plans to utilize to gather and evaluate evidence as to the effectiveness of those controls as well as any entity-wide or other pervasive elements of internal control that management considers applicable in the circumstances.

2) Reports provided by management to the registrant's Board of Directors or its Audit Committee, on a schedule that is acceptable to the Board of Directors or its Audit Committee, describing in reasonable detail progress against managements plans to gather and evaluate evidence as described above,

3) A written description and evaluation, provided to the registrant's Board of Directors or its Audit Committee in a timely manner, of any control failings or weaknesses that management considers significant, including the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission,

4) A written description and evaluation, provided to the registrant's Board of Directors or its Audit Committee in a timely manner, of any control failings or weaknesses that management considers to be material, including their root cause, the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission, as well as management's plans to rectify and report upon each such control failing or weakness.

Should these relatively simple amendments be made and benchmarks provided, public accounting firms should be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection <u>or more</u>, than is provided in other international jurisdictions. Redundancy in the internal control assessment process would be removed for <u>all</u> registrant's, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical approach to satisfying the requirements of SOX 404. We believe that with assistance from Congress, management teams, Boards of Directors and public accounting firms can and will work together much more efficiently to design, implement, assess and report on internal control systems as needed to protect the interests of shareholders and investors.

Again, the proposed PCAOB Release 2006-007 and SEC Release 33-8762 have been exposed to public comment through February 26, 2007, after which they may be adopted by the PCAOB, approved by SEC and supersede present requirements. **We urge you to use the power of your office on or before February 26, 2007 to halt adoption of PCAOB Release 2006-007**. **Further, we urge the Congress to consider amendments to the Sarbanes-Oxley Act** that would either better define or limit requirements presently imposed on public accounting firms under the Act while reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a *management* responsibility that *management* must satisfy as *management* considers necessary and appropriate to protect and enhance shareholder value.

[1] For full text of Release 2006-007 see http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf

[2] For full text of Release 33-8762 see http://www.sec.gov/rules/proposed/2006/33-8762.pdf

[3] AICPA Auditing Standards Board, Proposed Statements on Auditing Standards, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, March 18, 2003

[4] For full text of AS2, see http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_2.pdf

[5] American Electronics Association, *Sarbanes-Oxley Section 404: The Section of Unintended Consequences and its Impact on Small Business*, February 2005, page 6

[6] The *Summary of the Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, reports on page 2 as follows:

- 5% of the value of global initial public offerings was raised in the U.S. last year, compared to 50% in 2000.
- The U.S. share of total equity capital raised in the world's 10 top countries has declined to 27.9% so far this year from 41% in 1995.
- The decrease in U.S. listing premiums erodes the traditional edge maintained by the U.S. on cheaper cost of capital.
- Private equity firms, almost non-existent in 1980, sponsored more than $200 billion of capital commitments last year alone.
- Since 2003, private equity fundraising in the U.S. has even exceeded net cash flows into mutual funds and going private transactions have accounted for more than a quarter of publicly announced takeovers. The increased use of private markets disadvantages the average investor, who typically cannot participate in such markets.
- The dramatic increase in the use of private U.S. markets is important evidence that regulation and litigation are keeping them out of the public market.

[7] *Interim Report of the Committee on Capital Markets Regulation, November 30, 2006, page 5*

[8] Sean Wolfe, "SEC Shifts SOX Strategy–Can SOX really be scalable?," *Red Herring The Business of Technology*, December 14, 2006

[9] U.S. Securities and Exchange Commission, Press Release 2006-213, *Statements of SEC Chairman Christopher Cox and Chief Accountant Conrad Hewitt Regarding PCAOB's Proposed Section 404 Auditing Standard*, December 19, 2006

[10] David Raths, "Backlash Against Sarbanes-Oxley - Is the cost of compliance too high?," *The CRO* , 2006

[11] *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks*, November 2006

[12] *Summary of the Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, page 3

[13] PCAOB News, *Board Names Thomas Ray as PCAOB Chief Auditor, Succeeding Douglas R. Carmichael*, December 16, 2005

[14] AICPA Auditing Standards Board, Explanatory Memorandum to Proposed Statements on Auditing Standards, *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, March 18, 2003, page 4 of 10, lists the following members of the Internal Control Reporting Task Force: Garrett L. Stauffer, Chair, Robert Dohrer, John A. Fogarty, Lynford Graham, William F. Messier, Jr., Keith O. Newton, Thomas J. Ray, George H. Tucker, Michael T. Umscheid

[15] Kevin Reilly, "AMR Research Estimates Sarbanes-Oxley Spending Will Exceed $6 Billion in 2006," *AMR Research Press*, November 29, 2005

[16] American Electronics Association, *Sarbanes-Oxley Section 404: The Section of Unintended Consequences and its Impact on Small Business*, February 2005, page 5

[17] Melissa Klein Aguilar, "SOX 404 Deficiencies Preceded By "Effective" 302 Reports", *Compliance Week*, July 26, 2005