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Via e-mail

rule-comments@sec.gov
Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street
Washington, D.C. 20549

Re: File No. S7-24-06—Management's Report on Internal Control Over Financial Reporting

Ladies and Gentlemen:

This letter is submitted on behalf of the Financial Reporting Committee of the Association of the Bar of the City of New York (the "Committee") in response to Release Nos. 33-8762, 34-54976, Management's Report on Internal Control Over Financial Reporting (December 20, 2006) (the "Proposing Release"). The Proposing Release proposes interpretive guidance and rule amendments concerning the evaluation of internal control over financial reporting ("ICFR") that a registrant's management is required to conduct pursuant to Rules 13a-15(c) and 15d-15(c).

The Committee is composed of lawyers with diverse perspectives on financial reporting matters, including members of law firms and counsel to major corporations, investment banks, public accounting firms and institutional investors. A list of members of the Committee is attached as Annex A to this letter.[1]

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1 This letter does not necessarily reflect the individual views of each member of the Committee or of the institutions with which they are affiliated.

The Committee welcomes the concurrent initiatives of the Commission and the Public Company Accounting Oversight Board[2] to improve reporting on ICFR under Section 404 of the Sarbanes-Oxley Act of 2002. The Committee believes that the value of the Commission's proposal would be enhanced by the changes described below.

1. Interpretive guidance is the appropriate approach, but the Commission should clarify its applicability

The Committee supports the Commission's proposed strategy of adopting extensive interpretive guidance, which it agrees is the best approach to the difficult challenge of moderating the burdens of ICFR reporting. The Committee does not believe it would be preferable for all or part of the guidance to be mandatory or to be codified as part of the Commission's rules.

The Committee believes, however, that the proposed safe harbor will prove difficult to use. The interpretive guidance is appropriately broad, reflective and thorough, but as a result it does not contain specific criteria or elements on which a registrant could rely to demonstrate that its evaluation falls within the safe harbor. We do not anticipate that many registrants will take the trouble to claim the benefit of the safe harbor, particularly larger issuers that have already conducted several evaluations without it. In practice, a safe harbor would only be truly useful if a registrant could use it as a shield against a challenge to its evaluation, and the principles-based nature of the guidance will, we believe, make that very difficult to achieve with any certainty.

There is always a danger with any safe harbor that it will end up being viewed as an exclusive standard. Eventually, management may feel that it must demonstrate that its evaluation complies with the safe harbor (just as, for example, open market purchase programs routinely comply with Rule 10b-18 and resales of control or restricted securities routinely comply with Rule 144). Such a pseudo-requirement might emerge, for example, in connection with audit committee oversight of ICFR reporting, or management representations to auditors. This would run counter to the Commission's purposes in providing principles-based guidance.

We also believe there is a risk that, when the safe harbor is not relied on, the guidance will be overlooked by users who misunderstand it to be relevant only in the context of the safe harbor.

On balance, the Committee recommends that the Commission consider addressing these problems by eliminating the safe harbor. If, however, the Commission retains the safe harbor, it should protect the value of the interpretive guidance by making three changes to prevent the safe harbor from evolving into a presumption, and to ensure that the guidance is recognized as applicable whether or not a registrant relies on the safe harbor.

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2 PCAOB Release No. 2006-07 (December 19, 2006) (the "PCAOB Proposal").

First, the guidance should include a preface clearly stating its scope and application. The preface could be adapted from the section of the Proposing Release titled "Introduction" (which in the Proposing Release appears to be separate from the guidance). In particular, this preface would state that the guidance is applicable *any time* a registrant conducts or reports on its evaluation of ICFR pursuant to Rules 13a-15(c) or 15d-15(c), *whether or not* the registrant is relying on the safe harbor. It would also (1) identify the statutory and regulatory context, (2) discuss key terms used in the guidance (including "material weakness" and "reasonable assurance"), (3) state the Commission's broad principles of risk-based assessment, and (4) address the continuing viability of the May 2005 guidance and especially the staff FAQs (see point 9 below).

Second, the Commission should strengthen the language in Rules 13a-15(c) and 15d-15(c) that surrounds the safe harbor. Language like the following would be helpful.

> The foregoing sentence provides a non-exclusive safe harbor for an evaluation of the effectiveness of internal control over financial reporting. Management may elect not to rely on the safe harbor.

Third, the Commission should provide an instruction to Rules 13a-15(c) and 15d-15(c) specifically referring to the guidance. This will make it easier for users of the Commission's rules to locate the guidance and to understand its application. The instruction might read as follows:

> Please refer to the interpretive guidance issued by the Commission in Release No. 34—XXXXX, which applies to the evaluation of the effectiveness of internal control over financial reporting required by paragraph (c) whether or not the issuer relies on the safe harbor provided by the last sentence of paragraph (c).

2. The Commission should use the words "reasonably likely" to define the threshold for a material weakness

The Committee urges the Commission to reconsider the probability standard it uses in defining "material weakness" in the Proposing Release. That discussion uses the term "reasonable possibility" and refers in note 32 to the use of that term in SFAS No. 5. In the familiar three-step hierarchy of SFAS No. 5—remote, reasonably possible, probable—"reasonably possible" is essentially equivalent to the "more than remote" standard currently used in defining material weakness in PCAOB Auditing Standard No. 2.

Apparently the Commission agrees with the PCAOB that the problem with the definition of material weakness is that "some auditors and issuers have misunderstood the term 'more than remote' to mean something significantly less likely than a reasonable possibility."[3] If so, we believe the Commission (and the PCAOB) have mischaracterized

[3] PCAOB Proposal, at page 9. The Commission is less clear about its analysis, saying only that the standard "is intended to more clearly communicate the likelihood element."

the problem and proposed a solution that will perpetuate it. The problem is clear: auditors and issuers are applying too low a threshold in determining whether a material weakness exists. The solution is not to adapt terminology from SFAS No. 5, which serves a different purpose, but to use language that will produce a higher threshold and identify weaknesses that are significantly more likely to result in a material misstatement than the "more than remote" standard.

The Committee recommends that the Commission, without referring to SFAS No. 5, adopt the expression "reasonably likely" that it has generally used in connection with management's discussion and analysis of financial condition and results of operation.[4] We believe that consistency in this respect between ICFR reporting and MD&A requirements would benefit investors. This approach would also be similar to the approach the Commission took in Item 303(a)(4) of Regulation S-K, implementing the requirements of Section 401(a) of the Sarbanes-Oxley Act concerning disclosure of off-balance sheet arrangements. The Commission initially proposed a standard equivalent to "more than remote" and in response to comments changed it to "reasonably likely" to reduce "the possibility that investors will be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information."[5] The Committee believes that the problem in ICFR reporting is similar and that the same solution could usefully be implemented.

3. The Commission should eliminate or revise its list of "strong indicators" of material weakness

The interpretive guidance lists several circumstances that are "strong indicators that a material weakness in ICFR exists." The inclusion of these strong indicators in Auditing Standard No. 2 was ill advised, and we are urging the PCAOB to delete them in amending the standard. Whether or not the PCAOB does so, there is no reason for the Commission to adopt them in its guidance for management. That these factors should be taken into account is perfectly obvious, as is true of many other factors as well, but selecting these and attaching a presumption to them fosters the kind of rigid, one-size-fits-all analysis that the Commission is commendably trying to discourage.

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4 *E.g.*, Item 303(a)(2) of Regulation S-K ("Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."). Most recently, in its December 2003 release on MD&A, the Commission used the "reasonably likely" standard repeatedly in a variety of contexts to describe the disclosure threshold applicable to MD&A, citing prior releases on the subject. Release No. 33-8350 (December 19, 2003) at, *e.g.*, text accompanying note 37 ("disclosure of a trend, demand, commitment, event or uncertainty is required unless a company is able to conclude either that it is not reasonably likely that the trend, uncertainty or other event will occur or come to fruition, or that a material effect on the company's liquidity, capital resources or results of operations is not reasonably likely to occur.")

5 Release No. 33-8182 (January 28, 2003), text accompanying notes 38-45 (explaining the change from the proposed standard) and notes 98-101 (describing the application of the standard as adopted).

Three items on this list, each currently included in paragraph 140 of Auditing Standard No. 2, are particularly inappropriate. Each, for different reasons, has had undesirable effects on the evaluation process and will continue to do so.

- *Ineffective audit committee oversight.* The inclusion of this item requires management to pass judgment on the effectiveness of the audit committee's oversight of management. This is unnecessary and inappropriate. The inappropriateness is compounded when the auditors, who are themselves subject to audit committee oversight, subsequently review the determination.

- *Restatement.* An error in prior financial statements may or may not have been related to a weakness in ICFR at that time, and the weakness may or may not persist. Obviously these matters merit inquiry. Establishing a presumption triggered by restatement, however, leads to a burdensome, formalistic exercise that runs counter to the risk-based, context-sensitive process the guidance otherwise encourages. It also undermines, and arguably contradicts, the eminently sensible discussion in the interpretive guidance concerning whether a restatement requires reassessment of management's prior conclusions concerning ICFR.[6]

- *Identification of material misstatement by the auditor.* Again, it is obvious that the identification of errors in the reporting process might implicate ICFR. The inclusion of this item, however, fosters a counterproductive, adversarial dynamic between a company and its auditors and reduces the open exchange that is itself an important element in accurate financial reporting.

The Committee also notes that the Commission's language differs from that proposed by the PCAOB on a number of points. If the "strong indicators" are retained, these differences can only cause confusion and should be eliminated.[7]

4. The Commission should change the terminology in Regulation S-X to clarify that the attestation report is on ICFR

The PCAOB proposes to change the content of the auditor's report on ICFR to eliminate the requirement to report on management's evaluation process, and the

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6 Proposing Release, Part III.B.4. The Division of Corporation Finance previously made similar points in its May 2005 interpretive guidance. Staff Statement on Management's Report on Internal Control over Financial Reporting (May 16, 2005), at D, page 9.

7 For example, (a) the PCAOB defines senior management when discussing fraud, and the Commission does not, (b) the PCAOB refers to "uncorrected" deficiencies, and the Commission uses "unaddressed," (c) the PCAOB does not use the word "material" in describing misstatements, as the Commission does and (c) the PCAOB has an additional indicator for ineffective internal audit function.

Committee concurs with its conclusion that reporting directly on the effectiveness of ICFR is consistent with the requirements of Section 404 of the Sarbanes-Oxley Act.[8] The Commission should revise Rule 2-02 of Regulation S-X, and the related definition in Rule 1-02(a)(2), to reflect this change and to correspond to the content of the report the PCAOB will in fact prescribe.

The following language implements this comment and comment 5 below.

> Rule 1-02(a)(2): *Attestation report on internal control over financial reporting.* The term *attestation report on internal control over financial reporting* means a report in which a registered public accounting firm expresses an opinion, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting (as defined in § 240.13a-15(f) or 240-15d-15(f)). In the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm, the accounting firm may disclaim an opinion.
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> Rule 2-02(f): *Attestation report on internal control over financial reporting.* Every registered public accounting firm that issues or prepares an accountant's report for a registrant, other than an investment company registered under section 8 of the Investment Company Act of 1940, that is included in an annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting must provide an attestation report on internal control over financial reporting. The attestation report on internal control over financial reporting shall be dated, signed manually, identify the period covered by the report, indicate that the accountant has audited the registrant's internal control over financial reporting, and clearly state the opinion of the accountant, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting. In the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm, the accounting firm may disclaim an opinion. The attestation report on internal control over financial reporting may be separate from the accountant's report.

5. The proposed rule amendment concerning disclaimed opinions should be revised for greater clarity

The Committee supports the Commission's proposal to amend Rules 1-02(a)(2) and 2-02 of Regulation S-X to clarify the consequences of a disclaimed opinion on ICFR. The new language could, however, be improved to eliminate possible misreadings concerning what the "except" clause refers to, what the subsequent "which" clause refers to, and especially whether or not a report falling within the "except" clause complies with the rule. We would suggest breaking the sentence in question into two sentences, as shown in the proposed language included under point 4 above.

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8 PCAOB Proposal, at 14-18.

6. The Commission should address the specific circumstances of foreign private issuers

The Proposing Release asks for comment on whether there are considerations unique to the evaluation of ICFR by a foreign private issuer that the Commission should address. The Committee believes that the reconciliation to U.S. GAAP, which is required under Items 17 and 18 of Form 20-F where an issuer presents its primary financial statements under another GAAP, presents just such considerations. The Commission should make special accommodations in this area, particularly in view of the progress currently being made toward convergence of accounting principles, the prospect of possible elimination of the reconciliation requirement for IFRS reporting registrants, and the skepticism of foreign issuers and regulators about whether the Commission recognizes the impact of the Sarbanes-Oxley Act on foreign private issuers.

Specifically, the Commission should exempt the U.S. GAAP reconciliation from ICFR reporting. The reconciliation is often not integrated with the financial reporting systems on which the primary financial statements rely. The balance between issuer burdens and investor protection is also significantly different for the U.S. GAAP reconciliation than for the primary financial statements. By applying ICFR reporting to the U.S. GAAP reconciliation, the Commission has compounded the double burdens its rules impose on foreign private issuers.

If the Commission does not provide an exemption, it should specifically address in the adopting release the situation of a registrant that has material weaknesses only with respect to the U.S. GAAP reconciliation. According to Part III.B.2 of the Proposing Release, "management may state that controls are ineffective due solely to, and only to the extent of," specified material weaknesses. The Commission should add a footnote to this guidance reading as follows:

> In the case of a foreign private issuer that provides primary financial statements prepared under a comprehensive body of accounting principles other than those generally accepted in the United States, management may express separately its conclusions on the effectiveness of ICFR with respect to the primary financial statements and with respect to the reconciliation required by Item 17(c)(2) of Form 20-F. Management may conclude that ICFR is effective except with respect to the reconciliation, and ineffective with respect to the reconciliation.

We welcome the guidance in note 47 of the Proposing Release, to the effect that management's evaluation process should be based in the primary financial statements. The Commission should also revise note 73 in the Proposing Release to (a) clarify that note 73 is consistent with note 47, (b) eliminate the middle sentence, which is unnecessary and could be misunderstood, and (c) edit the language slightly. The Committee's proposed revision is as follows.

> Because of the importance of the reconciliation to U.S. GAAP, when management of a foreign private issuer that files in home country GAAP or IFRS determines

the severity of a control deficiency identified consistent with the guidance provided in note [47] above, management should consider the impact of the control deficiency on the U.S. GAAP reconciliation disclosure. It would be inappropriate to determine, without further consideration, that a control deficiency affecting the U.S. GAAP reconciliation cannot by definition be a material weakness if it is not material to the primary financial statements.

7. The Commission should expressly permit certain evaluation techniques consistent with a top-down, risk-based approach

The Committee has recommended that the PCAOB should not only permit, but encourage, auditors to rotate their performance of certain procedures, based on the auditor's risk assessment. We encourage the Commission to provide parallel guidance to management. We also encourage the Commission to confirm that its guidance to registrants with multiple locations is based not only on its risk assessment, but on the same materiality standard as contained in the PCAOB Proposal at B12-B18. We also suggest that the Commission expand its guidance on company-level controls to include the areas of assessment contained in the PCAOB Proposal at 17-23.

8. The Commission should grant exemptive relief to smaller public companies

The Committee believes that smaller public companies should be granted exemptive relief from the requirements of Section 404, unless and until an appropriate framework for assessing their IFCR is developed. As noted by the Commission's Advisory Committee on Smaller Public Companies in its Final Report, issued on April 23, 2006,[9] smaller public companies achieve their control objectives through the daily interaction of senior management with company personnel rather than through formal policies and procedures. Compliance with more formal policies and procedures is difficult for smaller companies where flexibility is critical and often a primary competitive factor.

We urge the Commission to encourage the prompt adoption of an appropriate assessment framework for smaller companies. Until then, the Committee believes that compliance with the existing ICFR requirements will cause significant damage to smaller public companies due to decreased flexibility and increased costs, and will place smaller public companies at a competitive disadvantage without significantly improving investor protection.

9. Effectiveness

We urge the Commission to adopt the interpretive guidance as soon as possible, consistent with the need to coordinate with the PCAOB. We recognize that the

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[9] Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (April 23, 2006), at 35-39.

PCAOB's changes to Auditing Standard No. 2 may not take effect immediately, and that parts of the Commission's guidance depend on the PCAOB amendments. On the other hand, much in the Commission's guidance will be valuable immediately upon adoption. When the Commission addresses the effectiveness of the interpretive guidance, it should encourage immediate reliance insofar as the guidance is applicable.

We also urge the Commission not to withdraw the staff's FAQs on ICFR reporting. Some of the FAQs will continue to be necessary unless they are incorporated into the guidance. Of particular practical importance are those relating to equity-method subsidiaries and recent acquisitions. Alternatively, the Commission should consider incorporating the substance of the FAQs into the guidance.

Conclusion

We commend the Commission for the Proposing Release and are grateful for this opportunity to comment. Members of the Committee would be pleased to answer any questions you may have regarding our comments.

Respectfully submitted,

Norman D. Slonaker, Chair
Committee on Financial Reporting
Association of the Bar of the City of New York

cc: <u>Securities and Exchange Commission</u>
Hon. Christopher Cox, Chairman
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Annette L. Nazareth, Commissioner
Hon. Kathleen L. Casey, Commissioner

<u>Securities and Exchange Commission – Division of Corporation Finance</u>
Mr. John W. White
Ms. Carol A. Stacey

<u>Securities and Exchange Commission – Office of Chief Accountant</u>
Mr. Conrad Hewitt

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ANNEX A

Financial Reporting Committee Member List

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