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February 26, 2007

BY ELECTRONIC MAIL

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

Re: Management's Report on Internal Control over Financial Reporting (File No. S7-24-06)

Dear Ms. Morris:

We are submitting this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comment regarding the Commission's proposed interpretive guidance for management regarding its evaluation of internal control over financial reporting (the "Proposed Guidance") and related proposed amendments to the Commission's rules.[1]

We welcome the concurrent efforts of the Commission and the Public Company Accounting Oversight Board[2] to improve the process of evaluating and auditing internal control over financial reporting ("ICFR"). If properly implemented, we believe these proposals will help management and auditors make their evaluation and audit of ICFR more efficient and cost-effective. We believe the Commission's proposals would be enhanced by the changes suggested below.

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1 SEC Release No. 33-8762; 34-54976 (December 13, 2006) (the "Proposing Release").

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

1. The Commission should adopt a "reasonable likelihood" threshold for the definitions of material weakness and significant deficiency.

We agree with the observation in the PCAOB Release that the current probability threshold used in the definitions of material weakness and significant deficiency too often has led issuers and auditors to calibrate their testing of controls and evaluation of control deficiencies at an unduly low level.

We disagree, however, with the proposed solution set forth in the PCAOB Release and endorsed by the Commission in the Proposed Guidance. It is difficult to see how replacing the term "more than remote likelihood" with its synonym under SFAS No. 5 -- "reasonable possibility" – will have a meaningful impact on issuer or auditor behavior.

The problem with the current probability threshold is not that it has been misunderstood – the problem is that the threshold is too low. The current definition too often results in the identification of material weaknesses that are not viewed by investors as matters of concern. By setting the threshold too low, the current standard leads issuers and their auditors to expend resources to achieve a confidence level that is higher than investors expect or need, particularly in light of the considerable protection already afforded by the audit of the financial statements. Moreover, by multiplying the number of material weaknesses triggered by low-probability risks, the existing definition makes it more difficult for investors to identify the higher-probability material weaknesses that are better deserving of attention.

To address these concerns, we recommend that the Commission and the PCAOB adopt the "reasonably likely" threshold the Commission has used in connection with management's discussion and analysis of financial condition and results of operations. We believe adopting this standard would have several advantages.

- First, like the SFAS No. 5 standard that underlies the current definition, the "reasonably likely" standard is well understood by both issuers and auditors. This should help make the standard easy to understand and apply.

- Second, because it is meaningfully higher than the "more than remote" standard, a "reasonably likely" threshold will have a better chance of focusing the evaluation and audit on the deficiencies that are likely to be of greatest concern to investors.

- Third, by reducing the incidence of reports of material weaknesses involving low-probability risks, the proposed definition will help ensure that more important disclosures concerning high-probability risks receive the attention they deserve.[3]

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[3] Similar concerns led the Commission to adopt a "reasonably likely" standard when adopting Item 303(a)(4) of Regulation S-K concerning disclosure of off-balance sheet arrangements. There, the Commission initially proposed a standard equivalent to "more than remote" but in response to comments changed it to "reasonably likely" to reduce "the possibility that investors will be overwhelmed by voluminous disclosure of

2. The Commission should clarify the standards by which methods of evaluating ICFR will be judged.

Although we support the Commission's efforts to reduce uncertainty about what constitutes a reasonable evaluation, and believe the interpretive guidance will advance this goal, we are concerned that in the absence of clear guidance regarding the factors to be considered in determining whether alternative methods satisfy the standard, the approach outlined in the Proposed Guidance will become the *de facto* standard approach. This may require companies that have already developed reasonable procedures for carrying out the evaluation to incur additional costs to revise and retrofit their procedures to track more closely the approach outlined in the Proposed Guidance.

We also believe the proposed safe harbor, as currently drafted, will prove difficult to use. The principles-based nature of the Proposed Guidance provides few objective criteria or elements an issuer can rely on to demonstrate with certainty that its evaluation falls within the safe harbor.

To address these concerns, we suggest that the Commission replace the proposed last sentence of proposed Rules 13a-15 and 15d-15 with the following language:

> "Management must implement and conduct an evaluation that is sufficient to provide it with a reasonable basis for its annual assessment. Although an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-XXXX will satisfy the evaluation requirements of this paragraph, there are many other ways to conduct a reasonable evaluation that would meet the requirements of this paragraph. Management should use its experience and informed judgment to design a risk-based evaluation process that is reasonable in light of management's understanding of its business, organization, operations and processes. An evaluation provides a reasonable basis for management's annual assessment if it includes (i) identification of the risks that are reasonably likely to result in a material misstatement of the registrant's financial statements; (ii) an evaluation of whether the registrant has placed controls in operation that are designed to address those risks; and (iii) a risk-based process for gathering and evaluating evidence regarding the effective operation of those controls."

We believe the proposed language would have several benefits.

- First, by providing a basis on which to evaluate assessments performed using methodologies that differ from the approach set forth in the Proposed Guidance, the language helps make alternative approaches viable. This is particularly important, because many issuers have already developed detailed and reasonable procedures for evaluating ICFR that may differ in

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insignificant and possibly unnecessarily speculative information." See SEC Release No. 33-8182 (January 28, 2003).

significant respects from the approach described in the Proposed Guidance.

- Second, because it provides objective criteria for determining whether an evaluation provides a reasonable basis for management's assessment, the language would reduce uncertainty about what constitutes a reasonable evaluation and would give meaning to the safe harbor by making it easier to use.

- Third, while setting broad parameters for a reasonable investigation, the language appropriately provides management with discretion to develop a risk-based process tailored to the particular circumstances of the issuer.

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

Like the PCAOB Release and Auditing Standard No. 2 ("AS No. 2), the Proposed Guidance lists several factors that are considered strong indicators of a material weakness. We believe the experience under AS No. 2 has demonstrated the difficulties that arise from this approach, and we urge the Commission to avoid perpetuating them in the interpretive guidance. Although each of the factors on the Commission's list should be taken into account by management when evaluating ICFR, we believe management will do so in any event as it evaluates the effectiveness of its ICFR, and are concerned that singling these matters out as presumptive material weaknesses unnecessarily and unwisely ignores the facts and circumstances nature of the evaluation process. On balance, we believe the best course of action would be to eliminate the list of strong indicators of a material weakness altogether.

If the list is retained, we suggest that the Commission revise the introductory clause to state that the listed items "may" indicate the presence of a material weakness, but that management should evaluate the specific facts and circumstances relating thereto and may conclude that no material weakness exists. We also suggest that to the extent the two are inconsistent, the PCAOB's list of strong indicators should be conformed to the shorter list in the Proposed Guidance. We further suggest that the listed items be accompanied by appropriate language to highlight factors relevant to each item on the list that may suggest that a material weakness is not present. In particular:

- *Fraud on the part of senior management.* Although the identification of fraud of any magnitude on the part of senior management is a possible indicator of an ineffective control environment, the Proposed Guidance should expressly remind management to evaluate the particular facts and circumstances and should acknowledge that not every fraud involving senior management will result in a material weakness. For example, if the fraud was detected or prevented by the issuer's internal controls and the matter was dealt with appropriately, the facts and circumstances may suggest strong controls rather than a material weakness. Other factors that may be relevant, particularly where the amounts in question are immaterial, include the nature of any disciplinary action taken by the issuer.

- *Restatements.* The indicator relating to restatements of previously-issued financial statements should be revised to note that not all restatements indicate a weakness in internal controls. In particular, the note to this provision should indicate that a restatement that results from a change in interpretation of existing accounting standards by the auditing profession or an applicable standard-setter should be not be considered a restatement that gives rise to a presumptive material weakness.

- *Identification of Material Misstatements by the Auditor.* An explanatory note should be added to the indicator relating to identification by the auditor of material misstatements in the financial statements in circumstances that indicate that the misstatement would not have been detected by the company's ICFR. In light of the chilling effect the parallel provision in AS No. 2 has had on communications between auditors and their clients in the past, the Commission should either include a cross-reference to past guidance from the SEC and the PCAOB regarding such communications or include the relevant language in the Proposed Guidance itself.[4]

- *Audit Committee Oversight.* The indicator relating to ineffective oversight by the audit committee requires management to pass judgment on the effectiveness of the audit committee's oversight of management. We believe this is unnecessary and inappropriate, and suggest that the indicator be eliminated from the list. If it is retained, language should be added to the explanatory note to indicate that the auditor should consider the importance of the audit committee's effectiveness in light of the overall control environment implemented by the company. For example, if a company has a strong culture of compliance and a robust overall system of internal control, the relative importance of the audit committee in detecting or preventing material weaknesses may be less significant than it would be in companies that lack such attributes. Under such facts and circumstances, it may be reasonable to conclude no material weakness exists.

- *Regulatory Compliance Function.* If the indicator relating to an ineffective compliance function is retained, we suggest that the Proposed Guidance include an explanatory note that explains the relevant considerations to be considered in determining whether such function is necessary and whether it is effective.

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[4] See, e.g., SEC Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005); PCAOB Policy Statement Regarding Implementation of Auditing Standard No. 2 (May 16, 2005).

4. The Commission should revise the terminology in Rules 1-02 and 2-02 of Regulation S-X to better reflect the auditor's role and provide greater clarity regarding the circumstances in which a disclaimed opinion is permitted.

As proposed, Rules 1-02 and 2-02 of Regulation S-X would continue to refer to the audit report on ICFR as an "attestation report on management's assessment of internal control over financial reporting." In light of the revisions removing the need for an auditor to pass upon management's assessment, we suggest that the Commission revise the references in Rules 1-02 and 2-02 of Regulation S-X to refer to the auditor's audit report as an "attestation report on internal control over financial reporting" rather than an "attestation report on management's assessment of internal control over financial reporting."

We also suggest that the Commission provide more guidance in the adopting release regarding the circumstances in which a disclaimed opinion is permitted by including a non-exclusive list of potential examples of the "rare situations" that would permit such a disclaimer.

5. The Commission should state clearly that the U.S. GAAP reconciliation is beyond the scope of ICFR evaluation and reporting.

We welcome the guidance in footnote 47 of the Proposing Release that management's evaluation process should focus on the primary financial statements. The U.S. GAAP reconciliation already imposes a significant burden on foreign private issuers and provides a disincentive to accessing the U.S. capital markets. Requiring the U.S. GAAP reconciliation to be included in the ICFR assessment process would further compound this burden and impose additional costs that would not be justified by the marginal benefits achieved for investors, particularly in light of the considerable protection already afforded by the inclusion of the U.S. GAAP reconciliation footnote in the audit of the primary financial statements.

In view of these considerations, we urge the Commission to state clearly that the U.S. GAAP reconciliation falls outside the scope of the ICFR reporting process. In particular, we recommend that the Commission revise footnote 73 of the Proposing Release to eliminate the requirement that management consider the impact of a control deficiency on the U.S. GAAP reconciliation when evaluating the deficiency's severity.

6. The Commission should make clear that the scope limitations permitted by the Commission staff's FAQs continue to be applicable.

The Proposed Guidance includes a sentence that states that the Commission's disclosure requirements "do not permit management to issue a report on ICFR with a scope limitation." On its face, this statement would appear to run counter to the relief afforded by the Commission staff's October 2004 "Frequently Asked Questions" regarding management's report on ICFR (the "FAQs"). In particular, the FAQs describe circumstances under which management may omit from the scope of its evaluation the controls of (i) variable-interest entities formed prior to December 15, 2003 and consolidated by virtue of FIN 46; (ii) entities accounted for via proportionate consolidation in accordance with EITF 00-1; and (iii) certain acquired businesses during the year following the acquisition. We believe each of these exceptions to the general rule continues to be important and urge the Commission to reaffirm these principles either through a reference to the FAQs in the interpretive guidance or by building these matters directly into the interpretive guidance.

More generally, the Proposing Release requests comment on whether the topics in the existing staff guidance and Frequently Asked Questions continue to be relevant and whether they should be retracted. We believe the bulk of the staff guidance and FAQs continues to be relevant and these matters should either be incorporated into the Proposed Guidance or expressly reaffirmed.

7. The Commission should exclude risks that fall below the "reasonably likely" threshold from the definition of "financial reporting risks."

We agree with the Commission that in identifying financial reporting risks, management should draw upon its understanding of both the potential sources and potential likelihood of material misstatements. As drafted, however, the definition of "financial reporting risks" appears to capture all risks that "could" result in a material weakness, including risks that fall below the "reasonable likelihood" standard we propose above as the applicable probability standard for the definition of material weakness. This could create unnecessary work for management in the later stages of the evaluation approach proposed in the interpretive guidance because it would increase the risks for which the existence of controls would need to be assessed and could require potential testing of those controls. Management should not be required to design or test controls for risks that fall below the applicable reporting threshold.

To address these issues, we recommend that the sentence in the interpretive guidance containing the definition of financial reporting risks be revised as follows:

> "Management uses its knowledge and understanding of the business, its organization, operations and processes to consider the sources and potential likelihood of misstatements in financial reporting elements. Management identifies as "financial reporting risks" those risks that have a reasonable likelihood of resulting in a material misstatement of the financial statements."

We believe the above language will improve the interpretive guidance for several reasons. First, by eliminating from the financial reporting risk identification process risks that fall below the reporting threshold, the language will help make the risk identification process more efficient. Second, the definition should help reduce unnecessary procedures by eliminating the need to assess the existence and operating effectiveness of controls to address risks that fall below the reporting threshold.

8. The Commission should further clarify the relationship of ICFR Risk to the amount of evidence required to demonstrate operating effectiveness of controls.

We welcome the Commission's acknowledgment that ongoing monitoring and daily interaction with controls can be a persuasive source of evidence of the operating effectiveness of controls. We also share the Commission's view that controls that present both a high risk of a material misstatement and a high risk of control failure should be tested more extensively than those for which material misstatement risk and control failure risk are low.

We note, however, that the Commission has provided no guidance for situations involving (i) high material misstatement risk and low control failure risk or (ii) low material misstatement risk and high control failure risk. We suggest that the Commission clarify how these risk quadrants should be analyzed for purposes of determining the extent of testing. In our view, when there is a high material misstatement risk but a low risk of control failure, direct testing should be performed but can be performed on a less frequent basis (e.g., it could be tested on a rotation basis less frequently than every year). When the risk of material misstatement is low and the control failure risk is high, we have two suggestions. First, as noted above, if the risk of a material misstatement is less than the reporting threshold, no testing should be required. If the risk is above the reporting threshold, and the risk of control failure is high, we believe direct testing should be performed to confirm the control is functioning properly.

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We appreciate this opportunity to provide you with our thoughts on the Proposed Guidance. We would be pleased to respond to any inquires regarding this letter or our views on the Proposed Guidance more generally. Please contact Leslie N. Silverman, Nicolas Grabar or Mark A. Adams at (212) 225-2000.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

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>
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