



February 21, 2007

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Securities and Exchange Commission  
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Office of the Secretary  
PCAOB  
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Re:     **SEC**                    **File Number S7-24-06**  
       **PCAOB**                **Rulemaking Docket Matter No. 021**

The Association for Financial Professionals (AFP) appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC) *Interpretive Guidance for Management regarding its Evaluation of Internal Control over Financial Reporting* and the Public Company Accounting Oversight Board's (PCAOB) *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements (AS 5)*. AFP represents 15,000 finance and treasury professionals employed by over 5,000 corporations and other organizations.

Secure, transparent and efficient capital markets is a goal shared by AFP members and regulators. AFP members are concerned that current regulations have become a barrier to efficient capital markets. Increased oversight of the capital markets was necessary as a response to the corporate scandals from the early part of the 21<sup>st</sup> Century and AFP appreciates much of the work done by the SEC and the PCAOB in implementing the Sarbanes-Oxley Act (SOX). However, our concern is that regulations are being interpreted and implemented in a way that imposes excessive cost on companies and serves as a barrier that locks out companies from the capital markets. The increasing complexity of many accounting standards, combined with the concerns about Sarbanes-Oxley compliance and expectations by investors, is causing many corporations to employ suboptimal financial and risk management strategies.

Corporations and their shareholders have been responsible for the administrative and financial burden of SOX 404. As a consequence, AFP members have expressed a keen interest in the modification of SOX 404 internal control regulations. We have previously filed comments (dated 5/1/2006 in response to file #4-511 and 9/14/2006 in response to S7-11-06) with the SEC and the PCAOB expressing our views and suggestions.

AFP offers the following comments on the recent SEC and PCAOB proposals:

**Improve the Alignment Between the SEC Document and the PCAOB Document**

The SEC's proposed guidance and the PCAOB's audit proposal (AS 5) are presented in significantly different formats. The SEC guidance is a conceptual document while the PCAOB AS 5 proposal is a technical paper. Corporate management seeks guidance in resolving issues related to SOX 404 compliance work which also includes resolving issues with their auditor. There should be a greater

alignment between the two documents in order to resolve any interpretation differences between company and auditor.

### **Increase the Clarity of the SEC Document and make it More Direct and Specific**

The SEC proposed guidance attempts to address several issues that exist with SOX 404 and how management can more effectively and efficiently comply. However, the proposal in its present form lacks clarity. The SEC should specifically identify what the difficulties are and what the SEC will require of corporate management in the future.

As the draft is currently written, only those who have been significantly engaged in the SOX 404 work of the SEC over the last two years will understand what the document suggests on guidance. The SEC's proposal is a response to the issues presented by the various participants at the SEC's roundtable discussions. Unfortunately, the SEC's proposed guidance does not go far enough in explaining the issues.

The bigger concern is related to the expectations from auditors during the corporate annual audit. Management may be able to understand and interpret the proposed SEC guidance, but without clearer guidance, compliance will still be subject to the interpretation by the auditor. The current language is not strong enough to use as supporting or authoritative evidence to present to the auditor during the audit. Because of the lack of direction in the SEC document, management will remain subject to the auditor and will be required to rely on the PCAOB document (proposed AS 5) for specific guidance when communicating with the auditor.

AFP recommends improving the draft document in one of two possible ways. First, the SEC staff should rework the document and include direct and explicit explanations of what is and is not required. Second, the SEC could include some type of appendix or addendum with specific guidelines to follow. For example, the appendix could include flow charts that illustrate when evidence gathered satisfies Internal Control Financial Reporting (ICFR).

### **Reconsider Testing By Exception for Years After a Clean 404 Report**

It should not be necessary for companies that have completed and provided a clean SOX 404 report to repeat the entire process each financial reporting year. Once a company attains a clean 404 report, the next three-to-four-year reporting cycle should not require another 404 report except to report on any significant changes during the year. Further, the document should explain what events would require a report on changes. Examples of changes might include corporate reorganizations, mergers, purchases and downsizing or unusual staff turnover which impact corporate controls on financial reporting. To require a full SOX 404 compliance report every year for a company that has not experienced material changes in its internal controls does not increase transparency, and unnecessarily increases costs.

We do not support the concept of a complete exemption from ICFR. A company should still be obligated to comply with ICFR at some scaled level if the company intends to participate in the capital markets. A periodic inspection and reporting process is not the same as requesting an exemption from 404 reporting. An annual SOX 404 reporting cycle is not necessary for a company that is practicing good corporate governance. However, a company that fails a compliance threshold should be obligated to perform another annual audit of internal control until there is reasonable assurance that the company's controls are adequate.

### **Policy and Practical Issues of Management and Auditor Within the SEC Draft**

The SEC proposal details examples of where identification of risk and certain controls over financial reporting should be sufficient within a corporation. However, without more explicit guidance it is highly unlikely that the external auditor performing the evaluation of internal controls would consider these controls adequate. We are concerned that the auditor will continue to rely heavily on the concept of “separation of duties” and the “documentation” mentality.

For example, the SEC draft addresses *Identifying Financial Reporting Risks*. The SEC report presents an example of a small company with less complex business processes in which the company “operates on a centralized basis and with little change in the risks or processes, management’s daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks.”

In the current environment, it is likely that an auditor complying with AS 2 or proposed AS 5 will require additional controls, which are fully documented in order to protect the audit firm from any PCAOB inspection problems even though the company “operates on a centralized basis and with little change in the risks or processes, with management’s daily involvement.”

Further, the SEC proposal states that “for purposes of the evaluation of ICFR, the controls are not adequate when their design is such that there is a reasonable possibility that a misstatement in the related financial reporting element could result in a material misstatement of the financial statements will not be prevented or detected on a timely basis.”

Such a statement is confusing and causes both auditor and management to require excessive controls and documentation. The statement could simply state that controls are adequate if they have been designed to reasonably detect a material misstatement in the financial statements on a timely basis.

### **Establish an Informal Committee to Define Controls that Adequately Addresses Financial Reporting Risks**

The SEC and PCAOB should form a joint committee which includes corporate representatives, including finance and treasury professionals, to better define a “*Control that Adequately Addresses Financial Reporting Risks*.” Regulatory documents promote the concept of a top-down, risk-based approach to internal controls. However, at this time there have been no high level discussions to develop guidance which will add clarity and definition to that concept.

SEC Commissioners have made public statements about how they have seen an unrealistic number of ‘key’ corporate controls identified by auditors when making a determination of the extent of required documentation and testing. Both the SEC document and the PCAOB proposals stress the importance of focusing on the key corporate controls. There is no discussion or information from a practical view of what are ‘key’ controls. Guidelines on the definition of key controls should be developed by the SEC, PCAOB and corporate representatives.

While it would be impossible to cover all possible corporate structures, examples based on a common conceptual understanding would be useful. The theoretical discussions will continue to result in divergent interpretations.

While the draft documents discuss the issue of materiality, added clarification is needed to improve the conceptual understanding between company, auditor and regulator. This committee could also provide added clarification on the definition of “materiality” which represents another area of divergence between management and auditor.

#### **Specific Comments on PCAOB AS 5 Draft**

Overall, we view the PCAOB document as helpful, and AFP endorses the provisions of AS 5. However, we strongly urge the PCAOB to make compliance with this revised document, mandatory for the audit firms. AFP is concerned that excessive internal control testing procedures and practices put in place during the last two years by the audit firms may be continued, unless compliance with AS 5 is made mandatory.

The requirements to remove the evaluation of management's process and the “stand alone guideline” are good revisions. These changes will prevent additional costs from being incurred by companies.

The “walkthrough” is an effective way for an auditor to gain knowledge and understanding of the company and its controls. We agree with the proposed standard that the walkthrough should only be for significant processes and not for each major class of transactions. We also agree with the proposed standard that the auditor should be able to use others for direct assistance with the walkthrough. However, it is important to stress that the auditor is to perform this task, not the client.

#### **PCAOB Perpetuation of Excessive Auditor Costs Through the Inspection Process**

When reviewing publicly available PCAOB inspection reports, it appears that the inspectors may be performing excessive searches for auditor deficiencies and may be exacerbating the high and unreasonable costs to companies.

An auditor that is fearful of missing something in the audit of the company because of the PCAOB is going to spend time, energy and resources performing unnecessary audit procedures. Furthermore, the high degree of criticism expressed by the PCAOB Inspection Team for failure to document everything results in wasteful and duplicative work. The PCAOB should foster an environment that translates into reasonable testing and documentation within reasonable costs.

#### **The Issue of Auditor Liability Needs to be Addressed**

On September 18, 2006, the auditing profession held a roundtable meeting in Chicago. The topic was the *Future Viability of the Audit Profession*. The meeting focused on the challenges facing the largest audit firms after the Andersen and Enron collapse and the risks associated with auditing the largest global companies.

The auditors who participated at the roundtable discussed the risks and fear of working with any company that might represent a risk to the audit firm. The result is that companies in need of an audit are finding it more difficult to retain these services. Smaller, newer companies are having a particularly hard time working with audit firms.

A serious problem is the inability of the largest audit firms to obtain malpractice insurance. With a lack of insurance coverage, audit firms have no other choice but to self-insure against claims.

In light of these problems, auditors are going to great lengths to investigate and to insulate themselves against the risks of any potential corporate misrepresentation. The result is excessive audit work and inordinate audit documentation. Auditors perform whatever work is necessary to be protected against the risk of litigation. This means that some percentage of the audit work and the costs associated with the audit are not for the purpose of assuring the fair presentation of the financial statements, but are to document and insulate the auditor against potential litigation. As a result, corporations are paying significantly higher fees to auditors and other outside consultants in order to participate in the capital markets. For some companies, economics has made it more practical to delay going public or to finance the company through alternative sources.

Some reports have indicated that many companies are increasingly looking overseas to obtain needed capital. It is worth noting that the European Union has been discussing the introduction of liability caps for auditors. Some EU states already have liability caps in place. If the EU does introduce some type of cap on auditor liability, it will further encourage U.S. companies and foreign companies to search outside of the U.S. for capital.

#### **Comment on Accounting Standards**

Complex U.S. accounting standards are also contributing to the difficulty in complying with SOX 404. Corporate management is often criticized and flagged by their auditors and the SEC for deficiencies that are, in part, due to complex and unclear accounting standards.

Robert Herz, Chairman of the Financial Accounting Standards Board (FASB) has made public how complex the standards are and has stated his intent to simplify standards when possible. At the same time an increasing number of FASB standards are being prepared which require fair value presentations that rely more on professional opinion and judgment and less on actual transaction-based documentation.

#### **Summary**

As we stated at the outset, “secure, transparent and efficient capital markets is a goal shared by AFP members and regulators.” There must be a regulatory system that protects the investor and the public and allows companies to operate efficiently and effectively. Unfortunately, the SEC, PCAOB and auditors are not currently acting in cooperation to facilitate efficient capital markets, but rather as separate and distinct pieces of the process.

Regulators, standard setters and auditors appear to have forgotten that they are all an integral part of the entire process. The independent reviews by the auditor and the regulatory oversight and authority of the SEC is part of the total system. By working together we can reduce material misrepresentations and improve financial reporting. More accurate reporting allows investors to make better decisions and generally increases the efficiency and transparency of our capital markets.

AFP and its membership appreciate the opportunity to comment on these matters before the SEC. If you have any questions, please contact John Rieger, AFP Director of Accounting and Reporting at [jrieger@afponline.org](mailto:jrieger@afponline.org) 301-961-8844.



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