ERNST & YOUNG

Office of the Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

6 December 2010

Re: File No. S7-29-10: Study Required by Section 989G(b) of the Dodd-Frank Act Regarding Compliance with Section 404(b) of the Sarbanes-Oxley Act

Dear Office of the Secretary:

Ernst & Young LLP (Ernst & Young) is pleased to submit comments on the Securities and Exchange Commission's (SEC or the Commission) request for comment regarding how the Commission could reduce the burden of complying with the auditor attestation requirement of Section 404(b) of the Sarbanes-Oxley Act (the Act) for companies whose public float is between $75 million and $250 million, while maintaining investor protections for such companies, pursuant to Section 989G(b) of the Dodd-Frank Act. We believe that reporting under Section 404 provides investors with meaningful information regarding a company's internal control over financial reporting (ICFR), and that the required independent audit of management's assessment of the effectiveness of ICFR has been integral to the achievement of the intended objectives of ICFR reporting under the Act. This letter provides perspective on certain aspects of the SEC's request for comment, including:

- Cost trends associated with the auditor attestation requirement,
- The benefits engendered by the ICFR audit requirement to both issuers and users of the financial statements,
- Concern with any expansion of the current exemption from the requirements of Section 404(b), and
- Recommendations for SEC activities that have the potential to enhance the effectiveness and the efficiency of the auditor attestation requirement.

<u>Costs of Implementation</u>

Perspectives related to the relationship of the costs and benefits of the implementation of the internal control reporting provisions pursuant to Section 404(b) of the Act – particularly for smaller public companies - have been a subject of discussion since the initial implementation of the requirements by larger public companies in 2004. In response to concerns that the costs of Section 404 implementation, including the auditor attestation requirement, were higher than anticipated, the SEC and the Public Company Accounting Oversight Board (PCAOB) undertook a number of steps to enhance both the effectiveness and efficiency of the evaluations of ICFR, including the following:

- In 2007, the SEC released management guidance for companies to utilize when conducting their assessment of ICFR.

- In 2007, the PCAOB released Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of the Financial Statements* (AS No. 5), which replaced the original ICFR auditing standard.

- In 2009, the PCAOB published staff guidance on AS No. 5 for audits of smaller public companies.

All of these efforts were undertaken with the overarching objective of providing frameworks for conducting evaluations of ICFR that were considerate of the internal control environments at smaller public companies. For example, the SEC's guidance for management, which provided a framework for companies to utilize when performing their assessments, empowered management to focus its compliance efforts on the areas of the financial statements that posed the greatest risk to financial reporting, while at the same time allowed management to tailor the nature, timing and extent of its efforts to the company's individual facts and circumstances. We believe providing such a framework for management to leverage in its assessment has contributed to effective, yet more efficient, management evaluations of ICFR, which has also had a positive impact on the independent audit of ICFR. Similarly, AS No. 5 brought improvements to the audit of ICFR by better enabling auditors to focus their efforts on those areas that were critical to a company's ICFR, utilize their judgment in the design and performance of audit procedures, and tailor the procedures necessary to conduct the audit to a company's particular facts and circumstances. In addition, the PCAOB staff provided further guidance and illustrations related to how auditors can scale their procedures in audits of smaller public companies.

In addition to the above activities, other organizations have developed resources that have contributed to improvements in the efficiency of the ICFR audit. For example, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued guidance related to the application of its internal control framework in smaller public companies, as well as guidance related to the monitoring component of its internal control framework. In addition, the Center for Audit Quality issued a practice aid in 2009 for public companies that provided lessons learned from audits of ICFR. We believe that these efforts, along with those of the PCAOB and SEC, have provided auditors with the tools necessary to conduct efficient and effective evaluations of ICFR, which has had a significant impact on both the initial implementation costs as well as the recurring costs associated with the ICFR audit.

For example, with respect to costs associated with the initial implementation of the ICFR requirements, the SEC's SOX study noted that for companies that had to comply with Section 404(b) for the first time after 2007 (i.e., after the issuance of the SEC's management guidance and the PCAOB's AS No. 5), costs declined approximately 21% compared to companies who were initially subject to the ICFR audit requirement before 2007. In addition, a recent academic study[1] noted that the audit costs for issuers who were required to comply with Section 404(b) for the

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[1] See Table 3, William R. Kinney, Jr., Marcy L. Shepardson: "Do Control Effectiveness Disclosures Require Internal Control Audits? A Natural Experiment with Small U.S. Public Companies." Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1533527

first time in 2008 had declined over 50% compared to issuers who had to comply in 2004, and over 30% for issuers that had to comply for the first time in 2007 (the year the SEC and PCAOB reforms went into effect). With respect to trends associated with recurring audits, the SEC SOX study noted that estimated 404(b) audit costs for smaller public companies (i.e., companies with less than $75 million in public float that were required to obtain an audit of ICFR) declined approximately 42% from 2006 - 2008.

We believe the above studies illustrate that the normal learning curve since the introduction of the Section 404 requirements, along with the reforms undertaken by the SEC and the PCAOB and the activities of other organizations, such as COSO and the Center for Audit Quality, have had a significant impact on the effort associated with the ICFR audit, particularly at smaller public companies. While we note that there is limited data with respect to the particular subset of companies subject to the SEC's study, as well as for periods subsequent to 2007, we believe that additional experience by both management and auditors with the SEC's management guidance, the requirements of AS No. 5 and the other tools available continue to drive improvements in the efficiency and effectiveness of the ICFR audit.

Benefits of Section 404(b)

While we recognize that there is a cost to conducting an audit of a company's ICFR, we believe both issuers and investors have benefited from the auditor's involvement in ICFR reporting. For example, the SEC's SOX study noted the following:

- The auditor's evaluation of a company's ICFR results in a more disciplined management's assessment process, which includes enhancing a company's assessment of financial reporting risks, its implementation of controls to address those risks and facilitates timelier remediation of control issues.
- The independent auditor's expertise can provide management with an additional perspective on the quality of a public company's ICFR, which can facilitate improvements in internal control that have a positive impact on the quality of a company's financial reporting.
- The independent audit of management's assessment increases investors' confidence in the quality and reliability of a company's financial reports and ICFR assessment.

In addition to the above, we believe that the ICFR audit has fostered additional improvements to corporate governance. For example, AS No. 5 requires auditors to communicate to the audit committee all significant deficiencies and material weaknesses in ICFR that have been identified during the audit. This communications fosters meaningful discussions about ICFR among management, the audit committee and the auditor, which enhances the audit committee's oversight of the ICFR assessment process. All of these benefits have a positive impact on the quality of a company's financial reporting, which is integral to providing investors with reliable information on which to base investment decisions. Recent studies related to restatements illustrate the impact of the auditor's evaluation of a company's ICFR on the quality of a company's financial reporting. For example, a 2010 study conducted by Albert L. Nagy, a professor at John Carroll University, found that companies subject to Section 404(b) are less likely to issue materially misstated financial statements than companies not subject to the auditor attestation requirements. In addition, a 2009 study conducted by Audit Analytics noted that companies that disclosed ICFR was effective and were not subject to auditor attestation of ICFR had a 46% higher restatement rate than those companies that disclosed the ICFR was effective and had auditor attestation of ICFR. We believe these studies emphasize the significant contribution an auditor's involvement in the evaluation of ICFR has in the quality of a company's financial reporting to investors.

Concern with the Expansion of the Exemption from Section 404(b)

Investors have benefited from the auditor's involvement at companies with market capitalization between $75 and $250 million, which is particularly meaningful given that smaller public companies are typically more susceptible to financial reporting fraud.[2] In addition, such companies have been subject to the requirement to obtain an ICFR audit since 2004 and have benefited, and continue to benefit, from the activities noted above to enhance the efficiency and effectiveness of the ICFR audits. Given the considerable protections and significant benefits to investors outlined above and further considering the significant efficiencies that already have been gained from the natural maturation of the audit process with the benefit of additional guidance and tools, we do not believe exemption of the ICFR audit requirement for these companies is needed or appropriate.

Potential SEC Activities for Improving Effectiveness and Efficiency of the Section 404(b) Process

As stated above, we believe the initiatives undertaken by the SEC and the PCAOB, as well as activities undertaken by other organizations, have facilitated improvements in the effectiveness and efficiency of the audit of ICFR. However, we have the following recommendations that we believe would contribute to further improvements to the ICFR audit.

Update of COSO's Internal Control Framework

Recently, COSO announced that it will undertake a project to review and update its internal control framework. The framework, which was originally issued in 1992, serves as the basis by which a significant majority of issuers implement and evaluate their systems of internal control over financial reporting. Based on the announcement, COSO intends to refine the guidance to "reflect the evolution of the operating environment [and] changed expectations of regulators and other stakeholders." In addition, COSO notes that an objective of the project is to further explain the interconnections of the internal control framework with its previously issued guidance for smaller public companies and guidance on monitoring internal control systems. We expect that COSO's efforts will further enhance all stakeholders understanding of internal control, which should benefit both the effectiveness and efficiency of the ICFR evaluations required by Section 404. As

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[2] For example, in 2010 COSO released a study, *Fraudulent Financial Reporting: 1998 - 2007*, which noted that the median assets of companies experiencing fraudulent events was approximately $100 million. Study available at http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf.

such, we encourage the SEC to actively participate and monitor the work of COSO, and to consider the impact of COSO's efforts in the SEC's study.

Implementation of AS No. 5

While the issuance of AS No. 5 in 2007 was intended to engender a number of improvements in both the effectiveness and efficiency of audits of ICFR, both the SEC and the PCAOB noted that PCAOB inspections would have a significant impact on the manner in which AS No. 5 was implemented and would play a significant role in monitoring whether audit firms were implementing AS No. 5 as intended. To that end, the PCAOB announced that its inspections would be focused on whether firms were sufficiently challenging their methodologies to take advantage of the provisions of AS No. 5. In addition, the SEC noted that, as part of its oversight capacity, it would be monitoring the effectiveness of the PCAOB's inspections in facilitating the implementation of AS No. 5 by auditors as intended.

As a result of its inspections of 2007 audits, the PCAOB issued a report in 2009 related to its observations on the first year implementation of AS No. 5. As that report was focused only on the first year of implementation of AS No.5, we believe the PCAOB should consider publishing observations on how the implementation in 2008 and 2009 has progressed relative to its expectations when AS No. 5 was issued. Such information might enable auditors to continue to adjust their ICFR procedures to further improve the effectiveness and efficiency of the ICFR audit.

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We would be pleased to discuss our comments with members of the Securities and Exchange Commission or its staff.

Sincerely,

Ernst + Young LLP