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April 12, 2005

Mr. Jonathan Katz
Secretary
Securities and Exchange Commission
450 Fifth Street
Washington, DC 20549

RE: File No. 4-497

Dear Mr. Katz:

I am very pleased to participate in the Securities and Exchange Commission's Roundtable on Implementation of Internal Control Reporting Provisions and to submit these comments in response to the Commission's request for written feedback.

As background, I have been a director of 14 public companies and am currently a director of 5. I chair the audit committee of Aetna, Inc., am acting chair of the audit committee of MedImmune, Inc., and serve on the audit committee of GenVec, Inc. Until a year ago, I chaired the audit committee of the Dow Chemical Company. My experience includes 25 years of service on the audit committees of both very large and very small companies.

AUDIT FIRMS RUNNING SCARED

I believe the thrust of Sarbanes-Oxley Section 404 is sound. Good internal controls should be a key underpinning of accurate financial reporting. However, there are concerns about Audit Standard No. 2, issued by the Public Company Accounting Oversight Board (PCAOB), as well as its implementation.

Some of the complaints about implementation, such as "one size fits all" and "audit firms have a checklist approach" must be viewed in the context of the times. After the indictment and demise of Arthur Anderson, I believe the remaining audit firms became fearful for their own survival if they should be caught in a similar scandal. The creation of the PCAOB, as the new regulatory body, added another layer of concern and uncertainty. Lead engagement partners began to consult with their national offices far more often and were, in many cases, slower to provide answers to clients about accounting treatment issues. That, in turn, created new tensions with some CFOs and financial managements. In other words, auditors became more cautious and conservative as a result of the Anderson demise and the new regulatory climate. (As an audit committee member, I would observe that a bit of conservatism isn't a bad thing.)

Into this environment came the requirements of SOX 404. I believe the PCAOB wrote Auditing Standard No. 2 in such a way as to allow the auditors to make some judgments

about what their attestation should entail – at least that is what the Board thought they had done. However, in this uncertain climate, auditors have not been willing to take chances and so they have stuck to what they perceived to be the letter of the standard. Making judgments seemed simply too risky. And this is a dilemma facing regulators today: how can the PCAOB and the SEC, in this climate, encourage audit firms to make judgments – and therefore take risks – to allow the flexibility that matches each client's situation? This question has no easy answer.

BENEFITS AND COSTS

The enormous efforts that have gone into 404 compliance have been documented in a number of ways, and I have seen that first hand.

There are current and future benefits. Managements have documented and tested their internal control structures and remedied significant deficiencies and material weaknesses. They have wrestled through the learning curve phase of compliance and this has caused much higher awareness throughout the organization about the need for controls and how they function. All of this activity should mean that financial statements and the process that produces them are more reliable.

However, the costs – both internal and external – for this first time around have been great, and there has been ample documentation by various groups of what they are.

I want to highlight some other not-so-obvious costs.

- First, internal audit staffs in many cases postponed some of their audit plans to work on 404 compliance. The result is that some operational audits, which can improve performance, were postponed. Hopefully normalcy will return this year.
- Second, and perhaps most profound, was the diversion of too much time and energy by senior management towards compliance and away from strategic and other business activities.
- Third, is the rupture in relationships between management and auditors. In some companies, tensions ran much too high. Management thought auditors were unreasonable, that their identification of some significant deficiencies and material weaknesses came too late in the process, and that their fees were too high. Some auditors felt that management's work in documenting and testing was neither adequate nor timely enough. And everyone engaged in this work was feeling the stress, and in some cases, working relationships suffered. These relationships must be repaired. The audit committee going forward can play a sensitive role as arbiter in bringing the relationships back into equilibrium of constructive – rather than overheated – tension.

Clearly, one objective going forward should be a better alignment of costs and benefits surrounding 404 compliance. The second time will be easier and the immediate challenge is to institutionalize the process of keeping internal controls current and active. But there are some things that could be done to make the process work more smoothly, have a good result, and be less costly. It is important that we get this right.

The U.S. system of entrepreneurial capitalism is unique in the world and has always been an American competitive edge. We must preserve this system -- and its risk-taking culture – while we enhance the reliability of financial reporting. I truly believe this can be done, and my specific recommendations are below.

RECOMMENDATIONS

1. **Give a break to small and midcap companies.** Provide more time, as much as a year for newly public companies, and lighten the requirements. The SEC's extension of the deadline for reporting this year was a good thing. The small and midcap companies are the ones I worry about most as we think about preserving our unique capitalistic system.

   One example: a fledgling biotechnology company, with no products yet on the market, has spent 4-5% of its annual cash burn on 404 compliance. The company performed its compliance quite well and on time, but the costs were, in my opinion, too great. That example could have been replicated throughout much of the biotechnology sector and any universe of small, growing companies.

   Another example: a small cap company in a different industry, survived a tough business year and spent a too-high percentage of its operating cash flow on 404 compliance. That expenditure diverted cash from necessary product development.

2. **Focus compliance on the areas of greatest risk to financial statement misstatement.** Prudent companies are doing risk assessment and enterprise risk management, an exercise that identifies the areas of greatest risk – both in magnitude of impact and probability of occurrence. I suggest using such a risk assessment to pinpoint the areas of greatest concern where fraud or misstatement could occur. Then, apply it to the documentation, testing, and aggregation of significant deficiencies, and tie it to each item on the financial statement.

   Such a risk-based approach has not been in evidence. So, when the audit committee received reports of significant deficiencies from management and the auditor, we could not always easily isolate the potentially troublesome ones from the routine or even rather insignificant ones. This was especially true as the deadline drew near and all significant deficiencies seemed more or less equal. We found ourselves counting deficiencies and asking about remediation, without enough understanding of which ones were truly important.

   The definition of terms in the standard is part of the problem. The wordy definitions of "significant deficiency" and "material weakness" are not beacons of clarity. And it is not clear how they relate to other terms of accounting art. What is "more than a remote likelihood" that a misstatement might occur? A term like this could be used to include all sorts of things. Another unclear area concerns how to aggregate significant deficiencies into a material weakness.

My preference is for clearer definitions, with quantitative and qualitative guidelines. The auditing firms developed quantitative guidelines and applied them in determining significant deficiencies and material weaknesses. However, these guidelines seemed not to be applied consistently across that firm's client base. To add even more confusion, the firms' guidelines were not consistent with each other, resulting in a lack of consistency across corporate America. If we cannot count on some semblance of consistency, then clients of one audit firm – which has tougher standards – could have more material weaknesses than clients of another audit firm. For this, they could be penalized by the investment community. That would be unfair. I recommend that the PCAOB consider issuing guidance to the audit firms regarding the guidelines to be used, and I encourage the firms to ensure consistency in the treatment of their audit clients.

3. **Bring materiality back.** This concept seems to have gotten lost this year in the plethora of deficiencies, significant deficiencies, and material weaknesses. It seemed that we were seeking perfection instead of *reasonable assurance*. The materiality question was often asked in audit committee deliberations and the answers were in many cases too fuzzy.

4. **Be clearer about when and where auditors can rely on the work of others, such as internal audit and management, and allow reliance on the cumulative knowledge gained from earlier work.** The PCAOB can do this and it would naturally flow from an approach based on risk.

5. **Make clear to audit firms that, while they cannot tell the company how to do processes which the firm must then audit, the firm can certainly be part of a consultative process that keeps all parties informed.** The PCAOB can issue guidance to promote auditor-client communications throughout the year and can clarify any independence issues that send a contrary message.

6. **Consider including in the auditor's report the concept that a risk-based approach was used to provide "reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects".** The PCAOB can do this.

Thank you for the opportunity to express these views. It is my hope that additional guidance will be forthcoming soon so that it can be incorporated into the planning for the 2005 compliance year.

Sincerely,

Barbara Hackman Franklin
President and CEO
Former US Secretary of Commerce