fei financial executives international

committee on corporate reporting

April 1, 2005

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0609

Reference: File Number 4-497

Dear Mr. Katz,

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") is pleased to provide feedback regarding the implementation of Section 404 ("Section 404") of the Sarbanes-Oxley Act (the "Act") relating to internal control over financial reporting. Now that we have gone through the first run of this compliance effort, we agree that it's time to review what we have learned and identify ways to improve the annual process going forward. We are encouraged by the Commission's willingness to solicit such feedback.

FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily those of FEI.

FEI was one of the first business associations that supported the Act. We believe that many aspects of the Act, including Section 404, have enhanced investor confidence in our financial reporting and disclosure practices, corporate governance and auditor independence. As one of the sponsoring organizations of COSO, FEI has long supported the notion that having effective internal controls over financial reporting is vital to the integrity of financial reporting. We do not see the need for an overhaul of the legislation, just greater balance in implementing the regulations and guidance.

While this was a useful exercise in many respects, it cost much more than originally projected. In a March 2005 survey of 217 companies, FEI found member companies spent an average of $4.3 million for added internal costs and additional fees spent on auditors and other consultants and software associated with complying with Section 404. Companies over $25 billion in revenue spent more, $14.7 million on average. According to the survey, employees logged an average of 26,758 hours to comply with the regulation, some dramatically more. Additionally, 94 percent of the respondents to our survey indicated that the costs far outweighed the benefits.

Many point to the downfall of Enron, WorldCom, and others, and the resulting loss in investor confidence in the markets as justification for companies to invest this level of time and money to ensure that similar failures won't happen again. However, most frauds are uncovered by insider tip-offs and the work of internal audit staff. The problems at companies like Enron and WorldCom were related to ethical lapses, collusion and override of existing controls at the very highest level of the company. Even though procedures can be documented and tested, most intent on committing financial fraud will devise ways around the safeguards. The very detailed documentation and testing of routine transaction processing that was the bulk of the implementation effort for Section 404 will do little in preventing the types of frauds that the Act was meant to address. Better fraud prevention and detection can come from the expanded whistle-blower protections and increased accountability for wrongdoing that were also part of the Act. We believe that the recent conviction of Bernard Ebbers, former CEO of WorldCom, will do more to combat fraud than the implementation of Section 404.

CCR has also observed several unintended consequences associated with implementing the Act. The Act appropriately precluded audit firms from providing consulting services and from developing the internal control structure. Unfortunately, in an over-interpretation of the rules seeking to preserve auditor independence, many of our members experienced hesitation by their audit firms to provide guidance to their audit clients on complex accounting issues. Given that recent accounting standards have become increasingly complex, it is a challenge to stay on top of every detail related to new accounting pronouncements. In the past, companies were easily able to access and utilize the subject matter expertise of their auditor's national technical experts to obtain appropriate guidance. Many are concerned now that if the audit firm disagrees with the company's preliminary assessment of complex accounting transactions, this can be considered a control deficiency or a material weakness. This view is not helpful to shareholders and may explain why a high percentage of the material weaknesses publicly reported thus far relate to not having personnel with the appropriate skill sets in place (as recently reported by Compliance Week).

Another unintended consequence was less timely communication to shareholders. We are aware of companies that issued their year end earnings release up to three weeks later than in previous years to ensure that the Section 404 work was completed prior to any external communication.

Additionally, the implementation efforts of Section 404 have had the unintended consequence of causing companies to delay installing new IT systems by six months or more. The current rules make it impractical to add a new IT system late in the year, since many new software systems simply cannot be installed, tested, and potential control issues remediated before year-end. The compliance burden will be a drag on future corporate productivity and profitability. In fact, many member companies have put restrictions on any new systems implementations and upgrades during the third and fourth quarter of the year. It is simply impractical to implement, document, test and remediate potential control issues with a new system installed in the latter part of the year.

We believe that the following suggestions for refining the existing guidance and implementation practices will significantly reduce the current burden to comply with Section 404 of the Act, without diminishing the value.

1. Allow for a more risk-based approach to documentation/testing/aggregation

The Public Company Accounting Oversight Board ("PCAOB") issued "Auditing Standard No. 2: An Audit of Internal Control over Financial Reporting conducted in Conjunction with an Audit of Financial Statements" ("AS2") which sets out the requirements of the auditor for providing an attestation of management's assessment of internal control.

While we believe that AS2 appropriately allows for auditor judgment in many areas, the prescriptive nature of several requirements calls for the auditor to perform specific tests without considering a more risk-based approach.

We suggest that AS2 be revised to consider the following:

a) Allow reliance on cumulative knowledge

AS2 requires that each year's audit must stand on its own; therefore, the auditor is not currently permitted to rely on cumulative knowledge or to consider the rotation of testing of key controls year to year. The standard fails to recognize the value of cumulative knowledge in assessing potential risk. We believe that management and the auditors should be permitted to rotate the testing of key controls based on a risk assessment related to each material account. This would allow for modulation of the frequency and scope of testing based on the risk and the underlying control environment. The requirement to start over each year ignores the fact that many controls, IT controls in particular, do not necessarily change from year to year.

Additionally, AS2 does not require the high level of "coverage ratios" that many of the audit firms adopted in the first year of implementation. CCR recommends that the SEC and/ or PCAOB offer guidance for subsequent year implementation that "coverage ratios" of 80 - 90% (audit firm practice in year one) are only required for companies with "high risk" control environments and that lower "coverage ratios" i.e. 50% should be sufficient in companies with lower risk control environments.

b) Allow for more utilization/reliance on management/internal audit

The scope of the auditor's work under AS2 mandates that the auditor must rely on its own work to provide the "principal evidence" for its conclusions. As a result, the extent of reliance the auditor may place on procedures performed by management and internal audit is limited. This creates added duplicative costs, as the auditors are put in the position of testing an unreasonable number of controls without assistance of the company's internal audit or other personnel. In 2004 this caused a severe shortage of appropriately trained staff at the audit firm. This situation is also causing the rate per hour charged by the audit firm to increase (basic supply and demand function).

The auditor should be able to place greater reliance on the work of others after considering their competence, objectivity and independence. Testing should be performed to corroborate the results.

c) Allow flexibility to test throughout the year based on risk

Current regulations require management to assess and the auditor to attest to the internal controls of a company "as of" the end of the most recent fiscal year. We realize that this "as of" assessment and attestation is legislatively mandated, however, we believe that the implementing guidance could address some of the challenges this presents. This point-in-time assertion requires controls to be tested as of that day or throughout the year with roll-forward tests applied on the assertion date. We suggest permitting management and auditors more flexibility to rotate test of controls and consider a risk-based approach to testing throughout the year. There is a long history in the audit profession which supports such interim testing.

d) Consider a more principles-based approach to AS2

In addition, in this first year of implementation, the auditors, in a defensive strategy to avoid being second-guessed, appeared to be striving for absolute assurance rather than reasonable assurance. In CCR's experience, the auditors spent an inordinate amount of time on routine transactions without considering risk appropriately in the design of their audit process. We note that the excessive amount of documentation and testing being performed is not explicitly required by AS2. This was exacerbated by AS2's use of low-threshold terms such as "remote likelihood", "more than inconsequential" and "significant deficiency".

We have also noted that the rules and implementation guidance place an inordinate amount of emphasis on documentation of control performance, classifying inadequate documentation as at least a deficiency and potentially a significant deficiency. This has caused the audit firms to take the position that in the absence of documentation, controls should be presumed to be ineffective. We note the following guidance provided in the COSO framework, Executive Summary, Chapter 6 (Monitoring):

> "Many controls are informal and undocumented, yet are regularly performed and highly effective. These controls may be tested in the same ways documented controls are. The fact that controls are not documented does not mean that an internal control system is not effective, or that it cannot be evaluated."

We suggest that the SEC and PCAOB consider a more principles-based approach to this standard and allow management and the audit firms to use greater judgment in determining an appropriate risk-based approach to documentation, testing and aggregation of deficiencies going forward. Perhaps the PCAOB inspectors should look at the efficiency of the audit process in addition to the effectiveness.

2. IT systems changes/integration should have option to exclude from scope for one year (similar to the acquisitions exception)

In answer to Question 3 of the SEC's Frequently Asked Questions regarding "Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Reports", the SEC provides guidance that allows for a transition period of at least one year for processes related to material acquisitions that could not be fully integrated by year end to test the processes for Section 404 compliance. This exception was provided to ensure that companies could make appropriate business decisions associated with acquisitions and integrate such acquisitions in a thoughtful manner. We believe that there are other circumstances which might require similar treatment. As noted above, many companies are putting off systems implementation efforts as a result of Section 404. We suggest allowing for a one year exception from the scope of Section 404 for major IT systems changes and new implementations, similar to the current one year scope exception for acquisitions. This would enable companies to ensure that the new processes were appropriately integrated, documented, monitored and tested in accordance with Section 404. Similar to the current requirement for appropriate disclosure of scope exceptions for acquisitions, we suggest that companies appropriately disclose the system that is not covered by their assessment including the details of the specific functions that the systems serve. CCR would be interested in helping determine the definition of a "major" IT system change and when it would be appropriate to exclude these changes from the year's Section 404 analysis.

3. Materiality

Based on the implementation effort in year one, the concept of materiality for all practical purposes seemed to be gone. The audit firms appeared to be striving for absolute assurance rather than reasonable assurance in their documentation, testing and aggregation of control deficiencies.

Additionally, the materiality guidance that the auditors have provided in their "Framework for Evaluating Control Exceptions and Deficiencies" issued in December 2004 indicates that it should be considered based on a quarterly assessment, even though the attestation is done on an annual basis. This inconsistency in applying the concept of materiality is baffling and unnecessary. We suggest that materiality be determined on an annual basis consistent with the annual assessment and attestation requirement.

4. Enhance the ability to communicate with auditors

We believe that more guidance is needed in the area of communication between management and the audit firms. Certain companies have experienced what we perceive as overly conservative interpretations to auditor independence, stifling valuable communication on the application of complex accounting standards. Additionally, many companies have stopped providing auditors with drafts of their financial statements prior to internal finalization. This rigid communication approach is unduly cumbersome and not helpful. We do not believe that the current interpretation of these rules is in line with the Act's objective of improved financial reporting. We note that the PCAOB did attempt to address this issue in its Staff Q&A 7, however, we do not believe it has sufficiently curtailed the problem. Instead of providing a detailed approach to communication, we suggest that the SEC and PCAOB issue guidance that actively promotes the ultimate objective of improving the accuracy and timeliness of financial reporting.

5. Make inspection reports and auditor financial statements publicly transparent

Much has been written regarding the role of the audit firms in the "crisis of confidence" in our financial markets as a result of the failures of the past few years. Much has also been written regarding transfer of wealth from shareholders to audit firms as a result of the fees charged for implementation of Section 404. We believe that the audit firms should be subject to similar reporting requirements that the companies they audit are subject to. It seems appropriate that companies and their shareholders should have access to the inspection reports that the PCAOB prepares for their audit firm. Additionally, to address the transfer of wealth issue, we suggest that the audit firms' financial statements be publicly available to constituents.

Conclusion

In summary, we'd like to reinforce that CCR fully supports the spirit of the Act and believe that the recommendations noted above will significantly decrease the current burden of implementing Section 404, without diminishing its value.

Thank you for considering our views. CCR members would be happy to discuss at your convenience any of the observations and recommendations noted above and look forward to participating in the April 13, 2005 roundtable discussion.

Sincerely,

Frank H Brod

Frank Brod
Chair, Committee on Corporate Reporting
Financial Executives International