Center for
Public Company
AICPA Audit Firms
Committed to Audit Quality

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Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

File No.: 4-497
Feedback on Experiences with the Implementation of the Auditing and Reporting Requirements of Section 404 of the Sarbanes-Oxley Act of 2002

Dear Mr. Katz:

The Center for Public Company Audit Firms (the "Center") of the American Institute of Certified Public Accountants ("AICPA") is pleased to have the opportunity to submit feedback on experiences with the implementation of the auditing and reporting requirements under Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act" or "SOX").

The Center was established by the AICPA to, among other things, provide a focal point of commitment to the quality of public company audits and provide the Securities and Commission and the PCAOB, when appropriate, with comments on their proposals and/or feedback on the implementation of new requirements under the Act on behalf of Center member firms. There are approximately 900 firms that audit 97% of all SEC registrants. Sixty-six firms (including the largest 8 that are Center members) audited registrants that filed 404 reports with the Commission as of the date of this letter; 64 of these firms are members of the Center. All of the Center's member firms are U.S. domiciled accounting firms. The AICPA is the largest professional association of certified public accountants in the United States, with more than 340,000 members in business, industry, public practice, government and education.

The Center commends the SEC on hosting the April 13, 2005 roundtable discussion regarding registrants' and accounting firms' experiences with implementing the new internal control requirements under Section 404 of the Act. The Center member firms are appreciative of the opportunity to participate in this forum and to provide comments in advance.

Since the enactment of the Act, specifically Section 404, behaviors and requirements have changed. To name a few – increased focus on internal controls by company management, audit committees are more engaged and appropriately focused on the effectiveness of internal controls over financial reporting, companies are becoming more focused on providing reliable and transparent financial information enabling investors to be more informed; and external auditors are more engaged with audit committees, all of which contribute to more effective audits. These changes and others collectively contribute to the overall restoration of investor confidence in the capital markets.

These improvements have been discussed by many financial executives who describe the enactment of SOX as a good investment for investors. These benefits do not come without an associated cost of compliance. The cost and benefit analysis of Section 404 has been a topic of many recent surveys and articles. First year implementation costs are easier to quantify and articulate compared to the related, less transparent but potentially very significant benefits. Benefits include the thousands of control deficiencies that were remediated prior to the filing of management and external independent auditor's reports on the effectiveness of internal control over financial reporting. Benefits also include the material weaknesses that management and their external auditors are required to disclose as that information is now transparent to investors. The events that lead to the creation or the Act and the PCAOB didn't happen overnight and accordingly the process to improve investor confidence in the financial reporting process will take time.

As Chairman Donaldson stated in the announcement of the roundtable the benefits of Section 404 compliance are significant, careful and thoughtful consideration of the associated costs are necessary to achieve those benefits most efficiently. We believe that many factors contributed to the year one implementation costs including, costs incurred by both the auditors and issuers to train employees, obtaining additional resources by both hiring employees and engaging consultants, first time documentation of controls that historically were not maintained at today's standards and development of controls and systems needed to comply with Section 404. Other factors that may have driven costs include uncertainties in the application of the standard and its interpretation by both issuers and auditors. After the significant learning curve for all parties has been navigated, these situations impacting costs will have been resolved.

Consequently, we believe that costs should be lower following the first year of implementation primarily due to the fact that auditors and issuers have gained the knowledge and experience in this first year of implementation. Additionally, the PCAOB will have the opportunity through its inspection process to provide insight and clarity in the application of the internal control auditing standard to registered public accounting firms. We believe that efficiencies will be developed through this implementation experience as auditors refine the process of the integrated audit.

The members of the Center believe in open dialogue with the regulators to assist them in carrying out their public interest responsibilities. Given the depth and breadth of our membership, many firms view the Commission's actions to delay the implementation of Section 404 requirements for non-accelerated filers and foreign private issuers and the development of the Smaller Public Company Advisory Committee as their understanding of the burden these companies bear to comply with the complexities of the Act. The Center's most significant charge is to enhance audit quality for audits of public companies which will contribute towards the overall restoration and maintenance of investor confidence and trust in the capital markets. Our members' commitment is evidenced by their participation and membership in the Center and the upcoming roundtable.

While we do not believe that any revisions to the Act are needed, we do believe there may be ways for efficient and effective implementation of Section 404 and offer the following recommendations to clarify the provisions of PCAOB Auditing Standard No. 2 *Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (AS 2)*:

Testing of Controls and Evaluation of Deficiencies

How the standard has defined significant accounts and significant processes has potentially resulted in the testing of controls for accounts and processes that are not material to the financial statements and may be in areas where the risk of error and fraud are low. Research and experience have both shown that, for the most part, weaknesses at the detailed control activity level, especially in larger corporations, are not the weaknesses that are contributing to material misstatements and frauds. Frauds occur primarily when weaknesses in higher level controls or the control environment are present. Additionally, controls surrounding high risk accounts, especially accounts where estimation and subjectivity is higher or where there are non-routine transactions, are also of utmost importance.

We recommend that auditors be permitted to scope their testing at the control activity level based on a materiality and risk focus. Clearly controls over accounts and processes that are material should be tested each year. However, the auditor should be permitted to apply a risk analysis so that if an account or process is assessed as lower risk, and especially where controls have been tested by internal audit, the auditor should have flexibility with respect to the amount of testing performed in this area. Although some believe this is already permitted by the standard, it is not clear in practice and some additional guidance is helpful.

Definition of Significant Deficiency and Material Weakness

Currently, AS 2 requires substantial judgment in distinguishing between a significant deficiency and a material weakness. Our concern is that there may be inconsistency in the application. We believe additional implementation guidance would be helpful. At a minimum, we think examples should be developed for different types of deficiencies to reduce the uncertainty and inconsistency in practice.

Using the Work of Others

AS 2 permits flexibility in determining the extent to which external auditors may use the work of others (e.g., internal auditors) in their evaluation and testing. Understandably, the "principal evidence" provision is important to prevent the external auditor's over-reliance on the work of others; however, it may be possible to make greater use of the internal auditors by allowing supervision of their work to count toward the level of principal evidence provided the external auditor serves a significantly more active role in direct supervision and review. There can be more clarification in AS 2 by way of more examples of when and how the internal auditors' work can be appropriately leveraged.

In addition, further analysis showing where the external auditor can leverage the work of others when a self-assessment process is utilized may be helpful.

Lastly, in areas where there is repetitive management and auditor performing separate tests impacting cost of compliance, perhaps the notion of "joint testing" can be acceptable in limited areas, for example interviews and surveys.

Documentation

Paragraph 209 of AS 2 states that auditors should communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made. The standard further states that it is not necessary for the auditor to repeat information about such deficiencies that have been included in previously issued written communications whether those communications were made by the auditor, internal auditors, or others within the organization. We recommend that it may be appropriate to limit the requirement of communicating all deficiencies in internal control over financial reporting to management to communication of significant deficiencies and material weaknesses instead.

Reporting

An auditor is required to issue two opinions: To express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting; and to express an opinion on the effectiveness of internal control over financial reporting. We believe that dual opinions are confusing to investors. We recommend that auditors report directly on the effectiveness of the company's internal control over financial reporting. However, we do recommend that an explanatory paragraph be added for those circumstances when the auditor's and management's conclusions on material weaknesses are different.

<u>Seeking Accounting Advice from Auditors by Clients</u>

Based on the experience of our members, we observe that one unintended consequence of AS 2 is a change in the relationship between client management and auditors with respect to seeking accounting advice from the auditor. Management may be reluctant to discuss or communicate about the proper implementation of new accounting standards out of concern that such discussions or communications may be perceived to be a weakness in the entity's internal control over financial reporting. Conversely, many auditors have been reluctant to have these conversations because of concerns that such conversations would be perceived as impairing their independence.

This situation serves to undermine rather than foster the quality of financial reporting. While there are boundaries that must be maintained to preserve auditor independence, investors are not being well served, and in fact may be harmed, when management and auditor do not communicate about many of today's complex accounting issues.

As a result, the SEC and PCAOB should not only make clear that communications and discussions are permitted, within certain boundaries, but are encouraged when such communications and discussions will further enhance and improve the quality of financial reporting.

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The AICPA Center for Public Company Audit Firms appreciates the opportunity to provide the Commission with feedback. We would be pleased to discuss these comments with you at your convenience and look forward to participating on April 13.

Sincerely,

Robert J. Kueppers
Chair
Center for Public Company Audit Firms

cc: Chairman William H. Donaldson
Commissioner Cynthia A Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
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