Business Roundtable

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April 7, 2005

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

Henry A. McKinnell, Jr.
Pfizer
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Executive Director
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Re: Roundtable On Internal Control Over Financial Reporting – File Number 4-497

Dear Mr. Katz:

This letter is submitted on behalf of Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $4 trillion in revenues. The Business Roundtable strongly supported enactment of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), as well as the efforts of the Securities and Exchange Commission ("SEC") to implement Sarbanes-Oxley.

The Sarbanes-Oxley provision that has garnered the most attention in the past year is the implementation of Section 404, management's report on internal control over financial reporting and the auditor's attestations related thereto, including concerns expressed about the efficiency and effectiveness of its implementation. We applaud the SEC for convening a roundtable on April 13, 2005 to reflect on the Section 404 implementation process.

We appreciate the opportunity to present our views on this subject and look forward to appearing at the April 13 roundtable discussion. We have attached to this letter a statement, setting forth our observations regarding the Section 404 process and offering our recommendations for improvements.

Sincerely,

Steve Odland
Chairman & CEO
Office Depot, Inc.
Chairman
Corporate Governance Task Force

Business Roundtable

cc: Hon. William H. Donaldson, Chairman
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey J. Goldschmid, Commissioner
Mr. Alan L. Beller, Director, Division of Corporation Finance

<u>Business Roundtable Statement Submitted for</u>
<u>SEC Roundtable on Implementation of</u>
<u>Internal Control Reporting Provision</u>

<u>Introduction</u>

This statement is submitted on behalf of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $4 trillion in revenues. The Roundtable was a strong supporter of the Sarbanes-Oxley Act of 2004 and the securities markets corporate governance listing standards. We also have participated extensively in the SEC rulemaking implementing Sarbanes-Oxley and have issued a number of corporate governance best practice documents in the past several years.

We are all in agreement that, in the wake of several high-profile corporate failures, Congress needed to act to restore the integrity of financial reporting. One of the critical measures Congress enacted as part of Sarbanes-Oxley was Section 404, relating to internal controls. Roundtable companies have embraced Sarbanes-Oxley, including Section 404, and the revised listing standards and have used the opportunity to improve their corporate governance and their internal control over financial reporting. The result has been – as Congress intended – improved investor confidence in our capital markets.

Now that we have gone through the first cycle with 404, it is a good opportunity to address implementation issues. Thus, we applaud the Commission for convening this roundtable. In implementing Section 404 and its related rules, including in particular the PCAOB's Auditing Standard No. 2, it has also been clear that the benefits of 404 have not always outweighed the burdens. In this statement, we would like to outline briefly some of the challenges that 404 has presented and offer some suggestions to the SEC and PCAOB with respect to Auditing Standard No. 2.

<u>The Challenges of 404</u>

We would like to start by referencing some of the challenges of Section 404 implementation, particularly costs, for large public companies, as catalogued in several recent studies:

- A recent Business Roundtable survey found that 47% of responding companies estimated costs of more than $10 million, up from 22% in 2004.

- A Financial Executives International survey indicated that public companies with revenues over $5 billion estimate that they spent on average $4.4 million on 404 efforts this past year. The survey also noted that 94% of the respondents said the costs of 404 exceeded the benefits.

- A September 2004 report by the Roundtable on Internal Controls of the Corporate Executive Board noted that public companies with revenues greater than $8 billion anticipated they would spend $14.1 million on average for internal control compliance (exclusive of audit fees).

And, many of these costs will be on-going due to the testing and documentation requirements under Auditing Standard No. 2. The recent FEI survey noted that on-going compliance costs may decrease, but only slightly, and a survey by the Corporate Executive Board noted that fees for internal control audits are not expected to decrease significantly next year.

In addition to the absolute dollars spent on 404 efforts, public companies have had to divert substantial personnel resources to 404 efforts. On average, companies surveyed by FEI spent nearly 27,000 hours in personnel time on 404 efforts. And, as Commissioner Glassman has recently noted, numerous companies have reported they put market opportunities and innovation on hold in light of 404 concerns.

<u>Suggestions</u>

To be clear, we want to express Business Roundtable support for the underlying premise of Section 404 – effective internal control over financial reporting. There are steps, however, that we believe the SEC and PCAOB can take to make the 404 process more effective and efficient, while still preserving the benefits Congress intended.

Specifically, we suggest the following steps for the SEC's and PCAOB's consideration:

- *<u>A Change in Tone</u>* – The SEC and PCAOB could convey clearly to public company accounting firms that the exercise of professional judgment is entirely permissible under Auditing Standard No. 2. We all recognize that public company accounting firms have been under the microscope for the past several years. In this environment, it is not surprising that they have taken a very conservative approach to the implementation of Auditing Standard No. 2. This approach, however, has resulted in increasing 404 costs for public companies.

  Auditing Standard No. 2 spans almost 200 pages of detailed auditing standards. Notwithstanding this detail, numerous interpretive issues have arisen, and public company accounting firms generally have been unwilling to adopt or accept procedures that vary in any way from stringent adherence to the letter of the standard. As a result, the 404 audits have been excessively burdensome in many instances, to a degree that may not provide corresponding benefits to investors.

  Recommendation – We are encouraged by the recent comments of PCAOB Chairman McDonough and Board Member Gillan urging auditors to exercise their professional judgment and use flexibility in applying Auditing Standard No. 2. We believe that specific amendments could be made to Auditing Standard No. 2 to encourage the auditor to exercise greater professional judgment in the internal control process.

- *<u>The Definition of Significant Deficiency</u>* – Auditing Standard No. 2 establishes a threshold for identifying a "significant deficiency" that is too low. As a result, public companies and their auditors have had to expend significant resources in evaluating and debating whether deficiencies, which are in theory possible, are actually something more than remotely likely.

And, although significant deficiencies are not required to be publicly disclosed, the consequences of identifying a significant deficiency are not insignificant. They must be reported to the audit committee and because auditors have been intently focused on the contours of significant deficiencies and related remediation efforts, valuable resources of boards and management are spent analyzing numerous deficiencies that again only present an insignificant likelihood of actually giving rise to a misstatement.

Our concern is that the "significant deficiency" definition in Auditing Standard No. 2 creates an environment where public companies and their auditors are striving for absolute assurance, even though the Commission's rules provide a "reasonable assurance" standard for the design of internal control over financial reporting.

Recommendation – The definition of significant deficiency in Auditing Standard No. 2 could be modified to reflect a reasonable assurance standard under which public companies and their auditors will focus on concerns that actually may impact financial reporting and thus are of concern to the investing public.

- *Limit Walkthroughs* – Auditing Standard No. 2 requires that the auditor conduct "walkthroughs" of each major class of transaction (defined to mean any type of transaction that is significant to a company's financial statements). It then includes detailed procedures for reviewing "the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified . . . ." These procedures include, among other steps, interviewing company personnel, and scrutinizing relevant documentation, at each step of the transaction process.

  At large public companies, and in particular those that have diversified businesses, the costs associated with, and time it takes to conduct, the number of required walkthroughs is significant. Also, guidance from the PCAOB, stating that the auditor cannot use the internal auditors as direct assistance for the walkthroughs conducted by the independent auditor, has added to this burden.

  In addition, Auditing Standard No. 2 requires that most testing be done at the end of the year, which results in a logjam of walkthroughs and substantial retesting at the end of the year. Moreover, Auditing Standard No. 2 creates difficulties for significant information system and business process changes in a company's fourth quarter.

  Recommendations – Auditing Standard No. 2 could be revised so that the independent auditor may use its professional judgment to conduct walkthroughs for only a random sampling, rather than all, of the major classes of transactions in any given audit year. In addition, to remedy the problems caused by the logjam of year-end testing, the standard could be modified to allow the auditor greater flexibility in conducting interim testing, including walkthroughs.

- *Reliance by Auditors on Work of Others* – While certain portions of Auditing Standard No. 2 permit the auditor flexibility to rely on the work of others, this flexibility appears to have been diminished by the "principal evidence" standard separately set forth in Auditing Standard No. 2 and subsequent guidance issued by the PCAOB staff. Specifically, Auditing Standard No. 2 mandates that the "principal evidence" for the audit of certain controls must be evaluated directly by the independent auditor, thereby limiting the extent to which auditors can rely on procedures performed by management, internal audit and others. Additional PCAOB guidance on this point states that the independent auditor:

  > "must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. Because the auditor is not performing the testing himself or herself when internal auditors provide direct assistance, testing performed by internal auditors as direct assistance does not qualify as part of the principal evidence supporting the auditor's opinion."[1]

  As a result, the independent auditor has been unwilling as a general matter to rely on the work of others. This has driven up 404 costs, both in terms of auditor fees and the resources required of public companies.

  Recommendation – Auditing Standard No. 2 could be revised to clarify that the independent auditor is encouraged to exercise its professional judgment and rely on the work of others as principal evidence where the independent auditor has considered and reasonably tested the competence, objectivity and independence of the those on whom it seeks to rely. This is particularly true with respect to reliance on the work of a company's internal audit function in walkthroughs and control testing where in the auditor's judgment, the internal audit personnel are competent and objective.

Conclusion

The suggestions we have outlined are designed to enhance the efficiency of the Section 404 process and Auditing Standard No. 2, while retaining the most important benefit – effective internal controls.

[1] PCAOB Staff Questions and Answers, Auditing Internal Control Over Financial Reporting, at A36 (November 22, 2004).