National Retail Federation
The Voice of Retail Worldwide

March 31, 2005

Mr. William H. Donaldson, Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

RE: File No. 4-497

Dear Mr. Chairman:

The National Retail Federation (NRF), on behalf of its members, is pleased to submit comments on the impact of Sarbanes-Oxley (SOX) Section 404, Management Assessment of Internal Controls on the retail industry, as solicited in your February 7 call for written feedback from registrants, auditors, and others.

NRF is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet and independent stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees - about one in five American workers - and 2004 sales of $4.1 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

NRF and its members firmly believe in the fundamental objectives of the Sarbanes-Oxley Act of 2002 (the Act). We support the principles of sound and transparent financial reporting and the underlying importance of effective internal controls. We have concerns, however, that confusion about and inconsistent application of the Act have undermined its objectives and effectiveness. We further question whether the initial intent of this Act--to restore investor confidence--has been balanced against the cost of its implementation. We are encouraged by the SEC's request for feedback on how the Act has affected corporate America and are hopeful that our recommendations will lead to better clarity and effectiveness of the Act.

Our comments and recommendations focus on two areas: (1) PCAOB rules that pose the greatest challenge and (2) areas where the independent auditors could strengthen their performance for the benefit of all constituencies. We address the

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following items: (i) the need for risk-based assessment in determining materiality, (ii) the need for clearer, timely guidance and consistency of application, (iii) the need for greater reliance on historical and interim testing, (iv) the challenge of independent auditor resources, (v) significant documentation and testing requirements, (vi) the substantial cost of compliance, and (vii) lessons learned and Year Two implications. We trust that working together, the SEC, the PCAOB, and the independent auditors will develop guidelines and practices that improve the aforementioned areas.

The Need for Risk-Based Assessment in Determining Materiality

Auditors have long used risk-based assessment to determine the scope of a financial statement audit. The practice allows the auditor to focus on areas that have the greatest potential for misstatement, error, or abuse. This tool was also used as part of the Section 404 internal control assessment to determine high, medium, and low risk controls. Our members believe that independent auditors did not use this tool as effectively as possible in their compliance testing. Rather than focusing on the areas that posed the greatest level of risk—such as the ethical culture of the company, entity-wide controls, non-routine transactions, new markets, areas of rapid growth, or new technology implementation—auditors seemed to treat the entire business as a more risky venture and insisted on testing an inordinate number of medium and low risk controls. The independent auditors tested routine transactions at multiple locations with the same rigor and resources as those transactions or judgments that posed substantial financial statement risks.

We do not believe this was the intention of the Act. Section 404 of the Act was put in place to ensure that a control environment existed to prevent material fraud or misstatement; it was not intended as a mechanism to identify and prevent every single error that could occur. The result of the excessive testing was costly efforts and strains on resources with questionable added value to shareholders.

We fully expect and desire material, key controls to be documented and tested. However, the cost/benefit must be considered when requiring the same documentation and testing for immaterial (non-key) items. We recommend that guidance be provided to auditors and public companies to ensure that materiality is applied in the most meaningful way. This guidance will help ensure that scarce resources are not carelessly wasted.

The Need for Clearer, Timely Guidance and Consistency of Application

While our members fully support the spirit of Section 404, its implementation has been particularly onerous and costly because of the lack of clear and timely guidance from the PCAOB. The PCAOB's guidance evolved throughout the year, making planning and implementing the internal control requirements challenging. Uncertainties existed over how many controls needed to be tested, the timing of testing, and materiality expectations.

As Year One of compliance testing comes to an end, variations of interpretation can be seen between the public accounting firms, as well as between audit partners within the same firm. Areas of inconsistency include: the level of reliance on internal auditors' work, the level of testing and documentation required, and the attestation approach taken by independent auditors. Our members note that disparities in interpretation could create an advantage for some companies as different levels of testing and reliance cause increased fees and/or variances in what may or may not constitute a material weakness. Our members request that clearer guidance be issued by the PCAOB to ensure consistent compliance and practices in the industry.

The Need for Greater Reliance on Historical and Interim Testing

Section 404 calls for auditors to perform internal control tests at the end of the fiscal year. Most companies run tests throughout the year but, under the current rules, tests that are performed earlier than a specified date must be refreshed for year-end. There is little guidance from the PCAOB on what the appropriate window of testing should be. This fact has resulted in duplicative and costly testing for companies. It has also strained the already limited resources of the public accounting firms as they struggle to simultaneously perform the detailed testing for multiple clients. This will be even more of an issue for Year Two audits because companies will have less time to complete the audit and file the 10K than they did for Year One. We question what value is added by the requirement to reinforce successful tests of controls at year-end.

The internal auditors at our member companies are both competent and independent in the work they perform. We recommend that provisions of Section 404 be modified to allow for greater reliance on work completed by internal auditors including the areas of financial reporting, disclosure, and general computer controls. In Year Two, reliance should incorporate cumulative knowledge gained from prior years' testing. Efficiencies could be realized by retesting areas that showed deficiencies in Year One and cyclical testing of control areas that passed all tests in prior years.

The Challenge of Independent Auditor Resources

The presence and oversight of experienced professionals during the course of the internal controls assessment is critical to its overall quality. Unfortunately, many of our members have expressed discord with their independent auditors, citing the lack of resources as a substantial problem. We have heard complaints of tax professionals performing the SOX work, of auditors arriving in the field unsure of what to do, and of independent auditors starting the entire Section 404 assessment too late in the year. All of these factors lead to inefficient work and higher auditing fees. It is essential that an adequate number of individuals be trained to perform internal control assessment work.

In Year Two and beyond, the combination of greater reliance on internal audit departments and historical testing (as recommended above), as well as the experience gained by the independent auditors during Year One will alleviate this problem.

Significant Documentation and Testing Requirements

Our members feel that the volume of internal control testing and the level of detail required by the PCAOB under Section 404 go significantly beyond the point of diminishing returns. For example, the method used to determine sample size was ineffective and led to more testing and documentation than was necessary. Often, the sample size used by the independent auditor to determine the number of tests to be performed on a control was driven solely by the frequency that the control occurred in the business cycle. The risk of the control failure was not taken into consideration. Our members believe that the sample size should incorporate both the risk and frequency of the control.

In order to prevent an unreasonable volume of testing under SOX 404, we recommend that the PCAOB issue more specific direction to public companies and public accounting firms on the definition of key controls.

The Substantial Cost of Compliance

According to a March 21, 2005 survey by the Financial Executives International (FEI), "Companies' total costs for year one Section 404 compliance averaged $4.36 million, up 39 percent from the $3.14 million they expected to pay, based on FEI's earlier July 2004 cost survey." 217 public companies with average revenues of $5 billion were surveyed. Perhaps more telling, "94% of all respondents said the costs of compliance exceed the benefits." These costs stem from the complications listed above. Unclear guidance leads to overly sensitive and costly audit plans for the internal controls opinion. This is exaggerated by independent auditors' conservative, costly and confused interpretation of existing guidance.

Another issue, according to our members, is that independent auditors have failed to integrate the audit plan for the financial audit with the internal controls assessment. By integrating the two plans, the audit fees could be significantly reduced. The Sarbanes-Oxley Act was put into place to protect shareholders; our members do not act in their best interest by paying excessive audit fees for duplicative work.

Lessons Learned and Year Two Implications

Now that all the groups involved in SOX implementation (SEC, PCAOB, Corporate America, and the Independent Accounting Firms) have the benefit of hindsight following Year One, we ask all parties to consider the lessons learned.

We ask the PCAOB to increase the amount of reliance that independent auditors can place on internal audit and management. We believe once the independent auditors have a high level of confidence in management, as supported by management's demonstrated commitment to the spirit of the Act, the independent auditor should be allowed to place more reliance on their work products.

We ask all parties to identify areas where companies are performing too much testing relative to the risk and value received and ask the PCAOB to support a reduction in testing requirements as a result.

The cost of compliance with Section 404 can be reduced in Year Two if the PCAOB were to issue additional guidance. Such guidance would help eliminate unnecessary and redundant work, ensure consistent application among the accounting firms and within the accounting firms, and improve understanding of the PCAOB's expectations.

The National Retail Federation is wholly supportive of a transparent and efficient financial marketplace. We understand the risks involved with poor internal controls and value the legislation to improve the process. However, with Year One of implementation ending, the methods and inefficiencies must be addressed so as to ensure we are not harming those individuals, the shareholders, for whom this legislation is aiming to protect.

We welcome any further discussion on this topic.

Sincerely,

Tracy Mullin

Tracy Mullin
President and CEO
National Retail Federation

cc: Mr. William J. McDonough, Chairman, Public Company Accounting Oversight Board