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April 3, 2005

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 Implementing the New Internal Control Requirements of Section 404 of the Sarbanes-Oxley Act of 2002

Dear Mr. Katz:

KPMG LLP welcomes this opportunity to comment on our experiences related to our role in implementing the Section 404 internal control reporting requirements of the Sarbanes-Oxley Act of 2002 (the Act). We commend the Commission for sponsoring this Roundtable and fully support its continuing efforts to evaluate the implementation of Section 404 and the related auditing standard issued by the PCAOB.

We believe the Act has made and will continue to make a major contribution to improving financial reporting, corporate governance, and audit quality, which will further the public interest and strengthen confidence in our capital markets. Section 404 is integral to the Act's effectiveness in achieving these goals. At the same time, we recognize that both independent auditors and issuers can improve on their first-year efforts to comply with Section 404 to make the process more effective and efficient in future years. We see this Roundtable as an important opportunity for all of us to begin the process of using the lessons learned from initial implementation of Section 404 to find the best way forward in the interest of the investing public.

Section 404 has produced significant benefits for the investing public, issuers, and independent auditors:

- Overall, the capital markets benefit through the improved integrity and transparency of financial reporting brought about by Section 404. Hundreds of companies have remediated thousands of previously unidentified control deficiencies. Investors now have a line of sight to those companies that have material weaknesses in their controls and the remedies and timetable by which these deficiencies will be remedied. This important line of sight simply did not exist prior to implementation of Section 404.

- Equipped with a controls "portfolio," management has a much more comprehensive understanding of the nature and effectiveness of their internal control over financial reporting and the related business processes—an understanding that provides management with a new "lens" through which it can evaluate and strengthen controls.

- Independent auditors, equipped with this same controls "portfolio," now have a significantly enhanced view of a company's control structure, a capability that allows them to better design, focus, and execute audits.

That said, we see a number of major opportunities for participants in the Section 404 compliance process to improve on their efforts in year two and beyond.

- What We As Auditors Can Do: Auditors can build on their year-one experiences and accomplishments by further integrating the audits of internal control and financial statements in a manner that will drive both the effectiveness and efficiencies of a truly integrated audit.

- What Issuers Can Do: Issuers should build an ongoing assessment process for Section 404 compliance by embedding internal control ownership throughout their organizations. In so doing, they will not only strengthen the integrity and value of their financial reporting, but also create a catalyst to improve the business processes impacted by such controls.

- What the Commission and PCAOB Can Do: Everyone learned a lot through year-one experiences. Sharing lessons learned and clarifying guidance in areas where uncertainties or expectation gaps remain will be crucial to future gains in quality and efficiency. Providing interpretive guidance in certain key areas, for both the issuer and independent auditor, will allow all parties to bring balanced and meaningful improvement to year-two implementation.

What We As Auditors Can Do

Implementing Section 404 in the first year was a daunting task, involving uncharted waters and demanding deadlines. At KPMG, we effectively marshaled the necessary human resources, developed the methodology and guidance, and instituted the training to fulfill our Section 404 obligations across more than 600 public company audit clients. This achievement was only possible through the dedication and professionalism of our people. We would like to acknowledge their efforts and thank them for their contributions to this historic accomplishment. All the same, we acknowledge that the first-year experience was less than perfect. The learning curve was steep and lessons learned were numerous. We stand ready to make improvements in our execution in year two and beyond.

To that end, we are planning a series of internal debriefings that will bring together partners and managers representing a comprehensive cross-section of our practice to challenge our methodologies and processes. We also are holding client debriefs, geographically and by industry. Through these efforts we intend to exchange ideas, identify best practices, and seek improvements to best leverage our year-one experience. We will pay particular attention to the key areas that require auditor judgment. In addition, we will focus on how we can better tailor our approach to unique and individual client situations.

A particular area of focus for year two and beyond involves the auditor's use of the work of others. We believe that, while the auditor's own work must provide the principal evidence for the audit opinion, better coordination of the audit effort among the auditor and others performing procedures under the direction of management will result in more effective use of the work of others in an integrated audit. We hope to identify avenues for improvement in this area as an outcome of the debriefing sessions noted above.

A major goal for us in year two is to achieve better integration of the internal control audit and the financial statement audit. We acknowledge this integration was the desired state for year one. But, the steep learning curve, the timing of rulemaking and related guidance, as well as the uncertainty as to what the findings would be, made it all but impossible to achieve the desired efficiencies in the integration of our internal control audit and financial statement audit. We are confident that in year two we will make substantial progress in truly integrating the audit. With the benefit of our clients' documentation and testing, we have a significantly enhanced view of each issuer's control structure and its overall effectiveness. Our integrated audit methodology will allow us to better leverage this knowledge in determining the nature, timing, and extent of our substantive audit procedures.

What Issuers Can Do

Management also experienced a considerable learning curve in year one. They undertook extensive discussion and debate in matters involving scoping, documentation, materiality, testing requirements, and remediation of identified deficiencies. Management also experienced considerable frustration as additional guidance and the evolving interpretation of Section 404 requirements mandated real-time modifications to the scope and nature of their work. One of the factors contributing to this frustration was the lack of guidance targeted at the issuer's assessment process. Generally, issuers had to look to an auditing standard for guidance in designing and benchmarking their implementation of Section 404's assessment process. We address this situation later in this letter.

Issuers have amassed a vast amount of documented information. As a result, they are better aware of what internal controls are in place, how they are executed, and by whom—information that provides a strong platform for sustaining compliance in year two and beyond. In year one, issuers spent a great deal of time designing and executing a consistent approach to documenting their control structure. For most issuers, this was a very extensive effort, in part due to considerable "deferred maintenance" by those issuers whose internal controls had not kept pace with changes in their business. In year two, issuers need to ensure they have a process in place to monitor and document changes to their control structure and focus on ongoing monitoring and testing. Year two should be a considerably different experience for issuers.

We have observed that many issuers have established a year-two goal of transitioning from a project orientation driven by finance or internal audit, which in many cases was necessary in the initial implementation, to a sustainable process embedded in the entity's operations. This approach will make the business leaders accountable for the control structure, rather than simply delegating such responsibility to finance or internal audit. This approach also will allow issuers to establish their own independent internal testing and monitoring process within finance or internal audit to ensure ongoing compliance with Section 404.

We encourage issuers to leverage insights gained in year-one Section 404 efforts to seek opportunities to:

- Standardize and simplify processes by eliminating redundant internal control activities
- Migrate from a detective control to a preventative control structure that will help prevent errors from occurring
- Take full advantage of available automated controls embedded in existing ERP systems to replace certain manual controls
- Embed ownership of the effective operation of internal controls into business processes, so that business process owners have greater responsibility for the accuracy of and accounting for the transactions they initiate
- Build sustainable testing plans that embrace the combination of self-assessment and independent testing, including the effective use of internal audit as an ongoing monitoring control component
- Remain vigilant over the control consciousness of their organizations by emphasizing strong corporate governance

What the Commission and PCAOB Can Do

The Commission and the PCAOB can help auditors and issuers succeed in their efforts to improve the effectiveness and efficiency of their respective roles in the Section 404 process. Additional clarification and selective interpretive guidance would be helpful in furthering the issuer's ability to comply with the provisions of Section 404, and the auditor's ability to comply with the provisions of PCAOB Auditing Standard No. 2 (AS No. 2).

Issuer Guidance

Management's evaluation and assessment – Little guidance currently exists relative to management's responsibilities in making its assessment of internal controls pursuant to the Commission's rules implementing Section 404. While AS No. 2 indicates that management must support its evaluation with sufficient evidence, including documentation, little guidance is available as to what should be considered in determining the sufficiency of such evidence. Matters to consider for additional guidance include:

- Nature and extent of management's testing;
- Timing of management's testing, including roll-forward considerations;
- Variability in management's testing from year to year; and
- Degree of detail required in management's documentation

Auditor Guidance

We believe that AS No. 2 is fundamentally sound and well suited to achieve its ultimate goal of contributing to investor confidence by enhancing the reliability of public company reporting. In particular, we believe that the "principal evidence" and "each year's audit stands on the evidence obtained that year" notions fundamental to AS No. 2 are critically important to the auditor's ability to support an opinion on the effectiveness of an issuer's internal control over financial reporting. However, we do believe that additional interpretive guidance on the following AS No. 2 concepts would enhance the effective application of the provisions of AS No. 2:

Significant accounts and disclosures – AS No. 2 states that, "the auditor should identify significant accounts and disclosures, first at the financial-statement level and then at the account or disclosure-component level." While paragraph 60 of AS No. 2 refers to the auditor's consideration of qualitative factors when identifying significant accounts, paragraph 66 appears to counter that concept by implying that inherent risk is not relevant to the determination of a significant account or disclosure. As a result, significant accounts have been determined based principally on a quantitative assessment, with the applicable threshold linked to misstatements that individually, or in the aggregate, could be material. This practice generally results in a large portion of an issuer's financial statement line items being considered significant for purposes of applying the provisions of AS No. 2. We recommend that consideration be given to providing additional interpretive guidance on qualitative considerations, including inherent risks, when identifying significant accounts and disclosures.

"Large portion" of the company's operations or financial position – paragraph B11 of AS No. 2 states that, "If the auditor cannot test a large portion of the company's operations and financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting." In practice, "large portion" has been interpreted to represent a factor of 60 to 75 percent of the applicable base. For an organization supporting a large number of individual business units under a decentralized control structure, and assuming the absence of effective company-level controls, attaining the 60- to 75- percent threshold may require the performance of procedures at locations or business units that individually, or when aggregated with others, could not result in a material misstatement to the financial statements. Appendix B of AS No. 2 provides guidance on the auditor's performance in a multi-location environment, but does not specifically address the large number of individual business units under a decentralized control structure example noted above. We recommend that consideration be given to providing additional interpretive guidance addressing auditor considerations in a multi-location environment.

Evaluation of control deficiencies – We acknowledge the existing framework developed for purposes of evaluating internal control deficiencies in an audit of internal control over financial reporting. While the framework has proved highly beneficial in clarifying certain of the requirements of AS No. 2 and in providing some consistency of evaluation, we believe that additional guidance relative to the evaluation of internal control deficiencies would be beneficial.

Specifically, additional guidance in the following areas would serve to further enhance consistency:

- Evaluation of deficiencies noted in the "softer" components of the Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (i.e., control environment, risk assessment, information and communications, and monitoring);
- Evaluation of deficiencies in the context of implications to an issuer's quarterly financial reporting process;
- Application of the concept of determining the "potential" misstatement in evaluating the significance of identified deficiencies; and

- Evaluation of those situations where an issuer has a properly designed and operating process, yet the issuer reaches an inappropriate, but well-reasoned, conclusion relative to the application of generally accepted accounting principles (often in a highly subjective or complex area of the accounting literature).

Consistency in the evaluation of deficiencies serves the public interest by providing stakeholders with some degree of assurance that similar situations will result in similar evaluations. While we acknowledge that significant judgment is required in evaluating deficiencies in general, and the situations described above require even greater use of judgment, additional guidance regarding the most significant factors to consider will enhance consistency among issuers and auditors in the evaluation of deficiencies.

Clarification of communication requirements – Paragraphs 207 through 214 address auditor communication requirements regarding internal control deficiencies, significant deficiencies, and material weaknesses identified in an audit of internal control over financial reporting. PCAOB FAQ No. 33, dated November 22, 2004, provides additional guidance on auditor communications. In practice, we have found that the auditor's navigation of AS No. 2 communication requirements is one of the more challenging aspects of compliance. Specifically, communication requirements vary depending on whether management or the auditor identified the deficiency, whether the deficiency existed at year-end or at an interim date, and the severity of the particular deficiency. We believe that effective communication of the results of our audit is critical to achieving the ultimate objective of AS No. 2. Further clarification of the intent of these communication provisions would be helpful.

Consultation between issuers and auditors – One of the unintended consequences of AS No. 2 has been a "blurring" of the boundary delineating where it is appropriate for issuers and their auditors to consult on accounting and internal control issues. While auditors must vigilantly preserve their independence in fact and appearance, issuers should be able to look to their auditors for advice on the proper application of generally accepted accounting principles. We believe these communications improve the quality of financial reporting and audits. Guidance from the Commission and the PCAOB that clarify the proper boundaries of constructive consultation between issuers and their auditors would serve the public interest. We are prepared to work with the Commission and the PCAOB in developing such clarifying guidance.

Interim testing - Consistent with our suggestion relative to issuers, we believe that additional guidance for auditors in the same area of interim testing and roll-forward considerations is warranted. Internal controls generally operate continuously; an assessment process that mirrors that reality will enhance financial reporting, the Section 302 certification process, and the quality of audits.

Finally, the interpretive guidance described above should address issues of scalability for small companies, specifically by incorporating matters arising from:

- COSO's pending study of criteria for evaluating internal control over financial reporting for smaller companies;.
- The work of the Commission's advisory committee that is examining the impact of the Act and other aspects of the federal securities laws on smaller public companies; and

- The work of an internal-control working group being formed by the PCAOB to assist in understanding implementation issues for small public companies.

Conclusion

Compliance with the provisions of Section 404 was not intended to be an insignificant exercise. Indeed, Section 404 was intended to place additional responsibilities on issuers and independent auditors, requiring substantive effort to yield substantive benefit.

A robust discussion of the proper cost-benefit balance is healthy, and we once again commend the Commission for its leadership in deliberating these issues. Nonetheless, no one can debate the fact that hundreds of companies identified and remediated thousands of control deficiencies as part of the Section 404 compliance process. We believe that this will serve to reduce the number of material misstatements to financial statements in the future. The result of that is clear: increased credibility and the strengthening of our capital markets.

Thus, the rigorous efforts we saw this year to assess internal controls must continue. We encourage all to actively support efforts to ensure ongoing reliability of financial reporting and auditing while at the same time striking an appropriate balance of meaningful improvements in year two and retaining the rigorous process from year one.

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If you have questions regarding the information included in this letter, please contact Sam Ranzilla (212) 909–5837, sranzilla@kpmg.com or Craig W. Crawford, (212) 909–5366, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP