Grant Thornton

Accountants and Business Advisors

April 6, 2005

VIA ELECTRONIC MAIL

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

Comments Re: Sarbanes-Oxley Roundtable, Panel Four – Documenting and Testing Internal Controls over Financial Reporting

Dear Mr. Katz:

Grant Thornton LLP appreciates the opportunity to comment on our experiences in observing companies as they document and test internal controls over financial reporting, and our experiences in conducting our own related audits under Auditing Standard No. 2 (AS No. 2) in connection with the public roundtable being held by the Securities and Exchange Commission (the Commission) on April 13, 2005.

Since the passage of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "the Act") public companies and their auditors have been working to keep pace with a frequently-changing landscape. In the following pages we discuss:

- primary drivers for the level of documentation and testing
- significant challenges in the initial year of implementation
- our recommendations for improvements

Primary drivers for the level of documentation and testing

For both management and auditors, the effort expended to document and test internal controls over financial reporting was the largest component of the Section 404 implementation effort.

The primary drivers in the significant amount of effort devoted to documentation and testing were:

1. Few companies had existing documentation of significant processes, risks and controls that impact financial reporting. As a result, many companies expended a

175 W. Jackson Blvd.
20th Floor
Chicago, IL 60604
T 312.856.0200
F 312.565.4719
W www.grantthornton.com

Grant Thornton LLP
US Member of Grant Thornton International

significant effort determining their documentation format (e.g., flow charts, narratives, etc.), determining the form of their repository (e.g., spreadsheets, memoranda, third-party software, etc.), and populating that repository.

2. Auditors spent time linking client documentation formats to their firm's audit documentation format or software.

3. AS No. 2 requires the auditor to identify "significant accounts" and "significant processes and major classes of transactions". The guidance provided to assist in establishing these audit scopes (i.e., AS No. 2, paragraphs 60-67 and 71-73) leaves little room for the identification of insignificant accounts, processes or classes of transactions. As recommended below, there is a need for guidance that focuses audit scopes on higher risk areas.

Clearly, the first year of implementing the requirements of Section 404 is the most difficult and time consuming. We do expect the effort to decline in subsequent years. The collaborative efforts of the issuers, auditors, investors and regulators to meet the needs of users of financial information can achieve the right balance between costs of complying with Section 404 and the resulting benefits.

Significant challenges faced in 2004

As it relates to the implementation of Section 404 of Sarbanes-Oxley, 2004 was a challenging year for auditors and public companies. Few companies had ever performed a comprehensive review of internal controls over financial reporting, and few auditors had ever audited internal controls for the purpose of issuing an opinion on an entire system of internal controls. To complicate matters, the related requirements (primarily AS No. 2) were new and not finalized until March 2004. Related interpretive guidance was continuously changing. As an example, the final framework for evaluating control exceptions and deficiencies sponsored by nine accounting firms and one accounting professor was not finalized until December 20, 2004. Even with the establishment of helpful professional guidance, its dissemination to practitioners was often inconsistent.

As a result, accelerated filers in 2004 were faced with a constantly moving target that frequently did not take into account mitigating risk factors such as their industry, size or complexity.

The Commission has taken steps to analyze the experiences with the initial implementation of Section 404 through establishment of the *Securities and Exchange*

Commission Advisory Committee on Smaller Public Companies, and the Commission's request for COSO to develop additional guidance to assist smaller companies in applying the COSO Framework. The April 13, 2005 roundtable discussions will also assist in beginning this process, but we stress that this is only a beginning. Our recommendations for improvement below highlight several areas that require the attention of both the Commission and the PCAOB.

Recommendations for improvement

Since the passage of Sarbanes-Oxley and the adoption of the related rules and auditing standards, the quality of financial reporting has improved as evidenced by the following:

1. Executive management teams at public companies are generally accepting a greater degree of responsibility for the financial reporting process; although some still see the external auditor as the party with primary responsibility for financial statement reliability.
2. Auditors and their clients are more focused on auditor independence. Consequently, many companies have hired or engaged additional resources to handle matters previously handled by the auditors, such as preparation of schedules or determination of the appropriate treatments for complex accounting areas. The benefit has been an increase in the number of qualified personnel who review complex accounting areas. Nonetheless, changes need to be made to improve, clarify and moderate the internal control documentation and testing process for both auditors and companies.

<u>Auditor independence</u> – However, there has been an unintended consequence related to the increased focus on auditor independence. Out of fear of impairing their independence, many auditors have refused to have open discussions with, or answer direct questions posed, by their clients. Likewise, companies have been reluctant to discuss, or ask questions about accounting issues. We believe this lack of auditor/client communication was never intended by Congress, the Commission or the PCAOB, and that it is detrimental to the financial reporting process.

<u>Implementation guidance for AS No. 2</u> – Both the Commission and the PCAOB have published frequently-asked-question (FAQ) documents that help companies and auditors evaluate and implement certain aspects of the Act. While these FAQs were eagerly and enthusiastically received by companies and auditors alike, they did not effectively stem

the flood of implementation issues that arose. The large accounting firms and other bodies have formed implementation groups to discuss how to implement AS No. 2 correctly, practically and consistently. However, with the exception of a whitepaper on the evaluation of control deficiencies, the work produced by these groups is not widely-available, or officially endorsed by the Commission or the PCAOB. Accordingly, there is inconsistency among firms and companies and high potential for performing work beyond that required by AS No. 2. In addition, small accounting firms, their clients and consulting firms who do not participate in these groups are at a distinct disadvantage. We recommend that the PCAOB establish an implementation group composed of auditors, regulators and issuers who will be charged with responding quickly to implementation issues and providing practical guidance that will be made available to the public at large. This single action will greatly assist issuers around the world who are just now grappling with the implementation of AS No. 2. The FASB accomplished this effectively in relation to the implementation of SFAS No. 133 with the establishment of the Derivatives Implementation Group in 1998.

<u>Need for case studies and examples</u> – The evaluation of internal controls over financial reporting is a complex process with many variables. As a result, evaluation and testing scopes set by companies and auditors have been very conservative, thus leading to a significant amount of time and effort being spent on areas that are rarely the source of financial statement problems. Companies and their audit firms should focus their resources on areas based on the degree of risk of a material financial statement misstatement. Time spent in lower risk areas naturally detracts from time that should be spent in areas of higher risk.

We encourage the PCAOB to develop guidance distinguishing between higher and lower risk areas and the related internal control documentation and testing for these areas. The guidance would identify examples of higher risk areas such as:

- Revenue recognition
- Cost and expense capitalization
- Accounting for income taxes
- Derivatives
- Judgments and estimates
- Financial statement closing processes

and lower risks areas such as:

- Payroll expenditures
- Non-complex treasury functions
- Non-complex debt transactions

The guidance should indicate that determination of whether an area is higher or lower risk depends on the nature of the business and the industry.

The AICPA has historically issued such guidance in the form of Audit Guides that cover complex auditing standards, accounting issues or industries. We urge the PCAOB to publish similar guidance for Auditing Standard No. 2.

<u>Evaluating management's assessment process and documentation</u> – AS No. 2 contains a total of six paragraphs that address the auditor's evaluation of management's assessment process and documentation. Additional guidance in this area and examples of good documentation would be valuable both to auditors and to corporate management.

<u>Multi-location testing</u> – AS No. 2 contains guidance that is moderately helpful in determining the control tests to be performed when a company has multiple locations or business units. The implementation group discussed previously has worked to expound on that guidance by discussing various multi-location scenarios which might warrant different approaches to control testing. For example, a company with a corporate office, one warehouse location, one primary manufacturing facility and two immaterial manufacturing facilities warrant different financial reporting structures and control tests than a company with a corporate office and 500 restaurant chain locations. The former company fits well within the guidance presented in Auditing Standard No. 2, while the latter does not. Accordingly, the implementation group agreed on a table that would suggest an appropriate number of locations to perform control testing for a company with a large number of homogeneous locations – the greater the number of locations, the more locations that should be visited.

Many companies with a large number of homogeneous locations believe that the number of location visits being "required" by the profession is unwarranted. They argue that very few financial reporting controls reside at the location level and that the monitoring controls at the corporate office would easily detect any financial reporting anomalies that could possibly be material to the consolidated financial statements. We believe that this argument is reasonable in many cases. In the restaurant chain example, the primary financial reporting areas are recognition of revenue, safeguarding of cash, proper recognition of payroll expense and control over procurements. Examples of the effectiveness of the monitoring controls over these areas to detect material financial misstatements follow:

- Revenue is normally recognized through the point-of-sale system that is linked to the corporate office. To misstate revenue materially, a substantial number of stores would have to record sales that did not occur. Such misstatements would be detected through the daily cash reconciliation process and through store-to-store comparisons.

- Access to cash is highly controlled through the daily store closing and reconciliation process. Again, multiple stores would have to lose a substantial amount of cash that was undetected by the company's reconciliation and store-to-store comparisons in order for the effect on the financial statements to be material.

- Per-employee comparisons of payroll expense, analytical review of procurements, and store-to-store comparisons should detect any material misstatements in payroll expense or payables.

Accordingly, testing the controls solely at the corporate office may be reasonable. We recognize that the foregoing scenario might not apply to every company with a large number of homogeneous locations; however, it is applicable to many. We, therefore, encourage the PCAOB to develop additional guidance to help companies and auditors determine the proper amount of testing to perform in entities with multiple locations.

<u>Impact of increased audit and accelerated filing requirements</u> – The Act has increased the overall amount of external audit work required for public companies. Much of that work must be conducted in conjunction with the annual year-end financial reporting process. At the same time, auditors and companies are faced with the acceleration of periodic report filing dates mandated by the Commission. The combination of increased work in shorter timeframes places significant stress on the financial reporting and auditing processes. The Commission should reassess the periodic report filing deadlines or provide additional guidance regarding ways in which management and the auditors can conduct more of their internal control evaluation and audit work as of a preliminary date.

<u>Document retention</u> – Auditors now must adhere to very specific retention requirements for their audit documentation; however, similar requirements do not exist for public companies to retain documentation supporting their assertions regarding internal controls over financial reporting. This inconsistency creates an environment where auditors must

either make and retain a complete copy of their clients' supporting documentation, or obtain an often unenforceable agreement from their clients to retain the documentation for a specified time period. The Commission should require companies to retain documentation supporting their assertions for the same period of time auditors are required to retain documentation supporting their opinions.

Conclusion

Implementation of Section 404 of Sarbanes-Oxley and Auditing Standard No. 2 has improved the quality of financial reporting. As is expected with any significant regulatory change, there are lessons to be learned from those who adopted the requirements first. The Commission, the PCAOB and the auditing profession have an opportunity to modify and build on this foundation so that the benefits to investors and companies will exceed the costs of compliance.

We thank you for the opportunity to comment and would be pleased to discuss any of our comments with the Commission or its staff. Please direct your questions to me at (954) 331-1178 (shelley.stein@gt.com), or to Trent Gazzaway, Managing Partner of Corporate Governance at (704) 632-6834 (trent.gazzaway@gt.com).

Very truly yours,

Shelley S. Stein

Shelley S. Stein
Chief Operating Officer
Grant Thornton LLP