



CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

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July 12, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number PCAOB-2007-02; File Number S7-24-06

Dear Ms. Morris:

The U.S. Chamber of Commerce is the largest business federation in the world, representing the interests of some three million companies of every size and industry. We have been an advocate for the issuance of specific guidance by the U.S. Securities and Exchange Commission (the "SEC") for issuers under Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") and for revisions to Auditing Standard No. 2 ("AS2") as promulgated by the Public Company Accounting Oversight Board (the "PCAOB"). We appreciate the opportunity to comment on the SEC's interpretive guidance and rule amendments with respect to SOX 404 (the "SEC Guidance") and the PCAOB's new Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS5").

Overview

Since we submitted our comments on the proposed SEC Guidance and AS5 in our letter dated February 26, 2007, the PCAOB has filed a revised version of AS5 with the SEC and the SEC has finalized its interpretive guidance on SOX 404. We commend the SEC and the PCAOB for addressing in their revisions some of the significant issues that we and others have noted with respect to AS5 and the SEC Guidance.

However, we are concerned that certain core issues remain, meaning that the audit process will remain too costly and burdensome. Most significantly, unmitigated auditor exposure to class action litigation will continue to force audit firms to place disproportionate emphasis on their own risk and, as a result, place unreasonable pressure on audit firms to “over-audit”. While this issue is generally beyond the immediate scope of the discussion on AS5 and the SEC Guidance, it – and the related issues of the auditing and accounting expectations gaps – cannot be ignored.

Our concerns that are within the direct scope of AS5 and the SEC Guidance are:

- As adopted by the PCAOB, AS5 remains an imprecise road map. Many of the key terms used in AS5 are too vague and do not provide the necessary guidance.
- The PCAOB should clarify Auditing Standards No. 3 and 4 to fully realize the benefits of AS5 and the SEC Guidance.
- The SEC should supplement its Guidance on SOX 404 by clarifying its defined terms and providing more illustrative examples and prospective advice to management on how the Guidance should be implemented.
- The new SOX 404 safe harbor is not structured to enable companies to comply with sufficient certainty.
- Smaller companies remain particularly vulnerable to high SOX 404 compliance costs due to continuing doubts about scalability. Therefore, we encourage the SEC to further delay compliance with SOX 404 for smaller public companies for one additional year.

The Chamber has been very supportive of most provisions of SOX and, with respect to Section 404, strongly advocates for good systems of internal controls in public companies. We appreciate the efforts of the SEC and the PCAOB to address the widespread concerns expressed by the business community, investors, and many other interested parties.

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As you know, in recent years public companies have struggled to reconcile the increased costs associated with SOX 404 compliance with critical ongoing expenditures for research and development, investment in new initiatives, and efforts to attract, retain, and develop employees that allow U.S. businesses to compete in a highly competitive global market. For quite some time, we have been concerned that the implementation of Section 404 is having a negative effect on the competitiveness of U.S. companies and the U.S. capital markets and has created unanticipated and unnecessary burdens on these companies and their management. If these issues remain unaddressed, the cost of capital in the U.S. will continue to rise while it is decreasing elsewhere in the world. As a result, the negative effects currently suffered by U.S. public companies will continue, smaller issuers will face barriers to entering the public market, and foreign companies that may have hoped to list here in the future will be dissuaded from doing so.

We look forward to additional action by the SEC and the PCAOB (in the form of new rules and guidance, as appropriate, as well as precise and consistent implementation of the rules) that will provide companies and their auditors with the certainty necessary to conduct their SOX 404 compliance activities in a cost-effective manner.

We set forth below some specific comments on revised AS5 as well as the revised SEC Guidance. We note again that the true impact of the new standard and guidance on public companies and their auditors will depend largely on the way that they are implemented. The manner in which the SEC enforces SOX 404 and interprets its guidance and the way in which the PCAOB implements its new audit standard in its reviews will determine whether the appropriate balance is struck between providing investors reasonable assurance regarding the adequacy of internal controls and offering investors meaningful investment opportunities by allowing companies to conduct their businesses in a competitive and cost-effective way.

To ensure effective implementation, we strongly recommend that the SEC and the PCAOB carefully scrutinize implementation, including conducting a post-adoption cost-benefit analysis of the new guidance and standards. AS5 should be applied appropriately and consistently throughout the PCAOB's inspections process so that ongoing expectations for companies and their auditors are clear and reasonable. The PCAOB should issue timely inspection

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reports and periodically identify for companies and independent auditors any specific trends that it has noted in its inspections. Additionally, the PCAOB should consider how its inspection process could develop a more direct understanding of management's assessment process instead of relying solely on the auditor's summarization of this process. These post-adoption steps will permit the SEC and the PCAOB to assess implementation issues and the content of the guidance with respect to audits of internal control in smaller companies that the PCAOB has indicated will be forthcoming next year.

Discussion

Adoption of Final AS5

As adopted by the PCAOB on May 24, 2007, AS5 represents the PCAOB's effort to coordinate with the SEC to provide practical guidance for companies and auditors. We appreciate the significant steps taken to ensure that companies and auditors will be able to comply with the internal control requirements with certainty and in a cost-effective manner, and we commend the PCAOB for revising AS5 to respond to some of the comments received on the earlier version.

In particular, AS5 now includes a more prominent discussion of the risk of fraud and the importance of anti-fraud controls. We appreciate the clear statement by the PCAOB in this regard, and we encourage the SEC and the PCAOB to take the lead in communicating to the public about the nature and limits of an audit and the internal control certification process. We also commend the PCAOB for a number of changes to AS5 that increase the flexibility of auditors to properly scope their audits and to distinguish between different kinds of entity-level controls in determining whether further testing is necessary. We are pleased that the PCAOB has incorporated within AS5 the material portions of its proposed new standard on using the work of others in an audit and that AS5 now permits auditors to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee, as part of the internal control audit.

However, we are concerned that, without additional changes and further coordination between the SEC and the PCAOB, the benefits of AS5 will not be fully realized. In particular:

Definitions. We commend the PCAOB for its efforts to align its key terms and concepts with terms that are used in the SEC rules and guidance – for example, the definitions of “material weakness” and “significant deficiency.” However, we remain concerned that the definitions themselves are unnecessarily vague and do not provide the tools that management and independent auditors need to define and calibrate their procedures. While we understand that the determination of whether a significant deficiency or a material weakness exists involves qualitative judgments, it is important for companies and auditors to have as many objective, quantitative benchmarks as possible to guide their evaluation – otherwise, costly over-testing and over-documentation will continue. The “indicators” of a material weakness need to be made more specific, with more illustrative examples, so that they may serve as a practical guide to companies and auditors that are implementing and evaluating internal controls.

Need to Rethink AS3 and AS4. As we noted in our earlier comment letter, we recommend that, just as the PCAOB has reconsider AS2, it reconsider the procedures required by Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (“AS4”), which sets forth guidelines that must be followed in order for a company to emerge from being characterized as having a material weakness. Also, we recommend that the PCAOB coordinate with the SEC and make necessary revisions to Auditing Standard No. 3 (“AS3”), which governs audit documentation, to provide detailed guidance to auditors regarding the documentation necessary to conduct an effective audit of internal controls. Without reconsideration of AS3, many of the benefits of AS5 and the SEC Guidance will likely not be achieved.

Interaction between SOX 404 and AS5. We remain concerned that AS5 may have the unintended consequence of increasing the focus on the auditor’s assessment as opposed to management’s assessment of internal controls under SOX 404. We believe that neither the SEC nor the PCAOB has adequately conveyed to the investing public the reality that an audit of management’s internal controls assessment is inherently limited and management ultimately

bears responsibility for internal controls. This is an example of an opportunity to narrow the auditing expectations gap and, until this occurs, independent auditors are likely to remain highly concerned about the scope of their own liability, thus adding to – rather than diminishing – an adversarial relationship between management and independent auditors as well as increasing the pressure on over-auditing. Auditors will continue to apply existing standards and guidance in an overly conservative way, and the testing and documentation required by SOX 404 and AS5 will remain too costly and inefficient.

Final SEC Guidance

The SEC's interpretive guidance regarding management's report on internal control, which took effect on June 27, 2007, represents a significant step towards clarifying management's SOX 404 obligations. We were pleased to note some of the changes from the proposed interpretive guidance that the SEC made in response to comments that it received. As noted above, the SEC has more closely aligned the SEC Guidance with the final AS5 in a number of areas, particularly with respect to definitions, the factors for identifying financial reporting risks and the indicators of a material weakness. The expanded discussion of the role of different types of entity-level controls is particularly helpful in guiding management in its determination of whether an assessment of additional, lower-level controls is necessary. We also note that the SEC Guidance, like AS5, now includes a more prominent discussion of fraud controls and explicitly states that there is no definitive correlation between the adequacy of internal controls and the incidence or risk of fraudulent conduct.

However, we continue to be concerned that the SEC Guidance does not provide certain important information that management needs in order to comply with SOX 404 fully and cost-effectively. In particular:

Use of Illustrative Examples and Feedback. We continue to recommend that the SEC Guidance be supplemented with more illustrative examples of how the guidance should be implemented. We agree that there should be no single road map to effective compliance and we understand the SEC's concern, expressed in the final Guidance, that more specific examples could have the negative effect of establishing "one size fits all" evaluation approaches. However, we believe that examples that are illustrative, rather than dispositive,

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would go a long way towards assuring companies that they are on the right path. We urge the SEC to consider ways to provide prospective advice and guidance to companies so that they can receive feedback on their internal control efforts as they are being implemented rather than after the fact.

Defined Terms. The SEC should consider providing more specific language and/or examples in order to clarify various defined terms that are used in its Guidance. For example, while the definition of “material weakness” has been aligned with the PCAOB definition and accompanied by a non-exclusive list of “indicators” of a material weakness, the definition itself continues to be unnecessarily vague.

The proposed SEC definition of “significant deficiency” (identical to the AS5 definition) is easier for management to apply than the old definition because it no longer incorporates a “likelihood” component. However, we still believe that the requirement to evaluate “significant deficiencies” has given rise to another set of required procedures and conclusions on significant deficiencies, in addition to the inquiries that are required for material weaknesses. This results in unnecessary duplication and confusion.

We continue to feel strongly that the SEC and PCAOB need to further clarify the meaning of “material,” perhaps through the use of illustrative examples. It is important to guide companies and their auditors in their determinations of materiality with as much precision as possible.

Safe Harbor. As we noted in our earlier comment letter, we believe that the safe harbor for companies that perform an evaluation of their internal controls in accordance with the SEC Guidance is not structured in a way that provides companies with the necessary level of certainty. We appreciate the SEC’s efforts to add certainty to the SOX 404 compliance process. However, the SEC Guidance is too vague as to the specific procedures that companies should follow to establish and evaluate their internal controls. While some level of vagueness may be necessary to give companies the flexibility to adapt their procedures to their own circumstances, the resulting safe harbor is not specific enough to provide meaningful protection for companies that wish to comply. Any safe harbor should set forth reasonable, well-defined criteria for compliance, and the guidelines should be specific and achievable enough to be a practical guide to compliance for all public companies.

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We believe that the safe harbor does little to reduce the uncertainty that has been inherent in the compliance process to date. Also, we still believe that, in order to provide the greatest level of certainty for companies that wish to comply, the safe harbor should be incorporated in its entirety as an amendment to the Exchange Act rules. It is not enough for the rule to direct companies to the interpretive guidance to determine whether they comply.

Application of SOX 404 to Smaller Companies

We commend both the SEC and the PCAOB for noting the special burdens that SOX 404 and AS2 have placed on smaller public companies. However, we are still concerned that the SEC Guidance and AS5 do not sufficiently address the concept of scalability so that smaller companies may reduce costs while remaining in compliance.

Our members, particularly those that are smaller public companies, are struggling to scale their internal controls appropriately, and they need to be assured that they can do so without radically changing their business or operations. Smaller companies need SOX 404 guidance that clearly defines what is acceptable. This does not mean that smaller companies should be subject to different standards or levels of assurance. However, they should be able to use different procedures to reach the same level of assurance, which could include reliance on the direct involvement of internal audit and finance personnel in company activities. Smaller companies should not feel compelled by SOX 404 and AS5 to outsource much of their testing of internal controls to third parties, at significant cost, in order to satisfy their auditors' evaluation requirements.

It will be helpful for the SEC to more clearly set forth how a small public company can appropriately tailor its span of control in ways that are different from larger companies – e.g. by establishing personal control, observation and oversight by senior management of the processes or assets in question. Also, our members are particularly concerned with documentation requirements. Even though companies can have strong internal controls without voluminous documentation, auditors continue to focus on documentation as an indicator of internal controls. In the absence of clearer guidance, over-documentation remains a threat, and it is a particular burden for smaller companies. We encourage the SEC to evaluate specific lower-cost

documentation solutions, determine whether they are acceptable for smaller companies and, if so, include them in future guidance.

We also urge the SEC to closely examine the experience of large accelerated filers and accelerated filers in determining the nature and scope of compliance that will be required by non-accelerated filers. We encourage the SEC to further delay compliance with SOX 404 for smaller public companies until the new standards have been tested with a full year's worth of experience for larger issuers. Failure to do so will seriously undermine the cost-cutting objectives of the new standards. Companies, auditors, and regulators will need at least a full year of experience to know how well the efforts of the SEC and the PCAOB to fix SOX 404 implementation are working.

Conclusion

The U.S. Chamber of Commerce strongly supports the core ideas behind SOX 404 of increasing management accountability, strengthening internal controls over financial reporting, and facilitating accurate and fair disclosure for investors. We are pleased that, with the SEC Guidance and AS5, the SEC and the PCAOB have made a real attempt to maintain the goals of the internal control requirements while reducing the unanticipated costs and uncertainties that have characterized the SOX 404 compliance process to date.

However, the internal control requirements remain ambiguous. The SOX 404 safe harbor will not be of much use until the SEC determines and publicizes more specific compliance criteria. Without more guidance on scalability, SOX 404 will continue to impose undue burdens on smaller companies.

As an unintended result of the breadth and ambiguity of SOX 404, companies have incurred excessive and unnecessary compliance and audit costs that ultimately have damaged the interests of investors. These include the costs of independent auditors, external consultants, additional internal audit and compliance functions, and the additional demands placed on management. These additional costs reduce the cash available to a company to invest in its business, deter companies from accessing the U.S. capital markets, and dilute the focus of management from creating value for company shareholders. The uncertain application of SOX 404 has led many companies to be overly

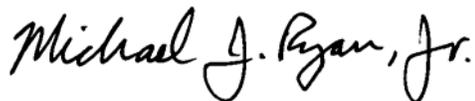
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conservative and spend large sums on internal controls, which can come at the expense of critical operating activities and inhibit innovation and creativity. Also, independent accountants will not significantly reduce the current levels of time and expense involved in a public company audit in the absence of clearer, more specific guidance.

Moving forward, these costs will depend in part on the interpretation and implementation of the SEC Guidance and AS5 by the SEC and PCAOB. We urge the SEC to consider all of these costs, and particularly the burdens that they impose on smaller public companies, in examining the full cost/benefit balance of SOX 404.

While the SEC and the PCAOB have made commendable strides towards easing the burdens of SOX 404 compliance, the core issues with SOX 404 will remain until companies of all sizes have specific guidance on how to comply and the rules and guidance are interpreted and enforced in a reasonable and consistent manner. Thank you for your consideration.

Sincerely,



Michael J. Ryan, Jr.
Senior Vice President and Executive Director
U.S. Chamber Center for Capital Markets Competitiveness

cc: Christopher Cox, Chairman, U.S. Securities and Exchange Commission
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