



committee on corporate reporting

September 19, 2006

Nancy M. Morris, Secretary
Securities & Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Reference: File Number S7-11-06

Dear Ms. Morris,

The Committee on Corporate Reporting (“CCR”) of Financial Executives International (“FEI”) appreciates the opportunity to provide their views on the U.S. Securities and Exchange Commission’s (“Commission”) *Concept Release Concerning Management’s Reports on Internal Control over Financial Reporting*. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR, and not necessarily those of FEI or its members individually.

FEI supports the Commission’s continued willingness to solicit input and address various concerns of preparers and auditors on the important topic of internal control reporting. We have long supported the position that effective internal controls are vital to the integrity of the financial reporting process and FEI was one of the first business associations to support the Sarbanes-Oxley Act of 2002 (“the Act”). CCR believes passage of the Act is helping to restore investor confidence in the financial reporting and disclosure practices of larger companies, but as we have previously commented, we also believe there is opportunity for significant additional improvements in compliance practices that will better balance benefits and costs while still achieving the legislative intent of the Act, specifically Section 404 on internal control reporting. These improvements include a number of recommended amendments to the rules for implementation, including those of the Commission as well as the Public Company Accounting Oversight Board’s (“PCAOB”) Auditing Standard No. 2 (“AS2”), but not to the legislation itself. CCR believes the Commission and the PCAOB can and should provide needed balance to the process and address the underlying concerns of our members and those of other public companies (large and small) about inefficiencies prompted by the current rules and auditor practices on internal control reporting. We believe these revisions are necessary to allow the desired changes to be operationalized. CCR members strongly endorse the issuance of additional guidance regarding management’s annual internal control assessment process and believe it would be helpful and useful to all companies. We believe, however, that its level of usefulness is

dependent on the Commission's stated view that any additional guidance must be sensitive to the existing processes already established by many companies and should continue to encourage management to exercise its own experience and judgment in designing its assessment processes.

The Commission has indicated that it anticipates new guidance would be issued in the form of a Commission rule and that AS2 would be revised by the PCAOB to be consistent with this rule. The majority of CCR members would prefer additional interpretive guidance rather than a rule. This preference is driven by a desire to have new guidance available as soon as practicable, ideally no later than the December/January timeframe to enable orderly changes to next year's planning processes for calendar year-end companies. In addition, we believe that interpretive guidance would facilitate a principles-based approach allowing desired flexibility, while minimizing the potential for unintended consequences requiring change or rework to existing processes. However, we also recognize the importance of taking sufficient time to carefully assess proposed changes and the benefit of additional exposure and comment on proposed new guidance. Accordingly, we recommend a 30-day re-exposure of proposed interpretive guidance and AS2 revisions prior to issuance.

Should the Commission decide to proceed with the issuance of guidance in the form of a rule, we encourage a principles-based approach that clarifies expected minimum requirements with sufficient flexibility to not cause rework to existing processes. Regardless, neither approach should create prescriptive rules-based guidance but should focus on practical ways to reasonably simplify and reduce the cost of management's assessment process and the related audit. As the Commission's May 16, 2005 guidance did, the final guidance should emphasize and support the use of management flexibility in implementing the spirit of Section 404, as well as the use of management's judgment. An alternative approach would be to proceed with interpretive guidance and AS2 revisions as soon as possible for the 2007 process, and after monitoring that guidance's effectiveness and gaining additional experience, move to the issuance of a Commission rule. Irrespective of approach, we believe that to be truly effective, changes to AS2 must move in lockstep with guidance issued by the Commission in order to realize the desired changes. Any inconsistencies in the final guidance and AS2 would likely increase costs and introduce new inefficiencies. Currently, significant inefficiencies result as auditors request the specific procedures and documentation required under AS2 even when management's view may differ from the precepts of AS2. Changes in guidance for management become even less meaningful when a company has adopted a reliance model wherein its internal auditors perform much of the detailed test work for the external audit firm. Under these circumstances, management would follow AS2 for its own assessment so as not to incur added costs by applying one method for its assessment and then having to undergo a separate group of tests/requirements (and added cost) to meet the external auditor's assessment requirements.

Risk and Control Identification

We would welcome additional guidance or examples regarding the design of an appropriate top-down, risk-based approach to identify key risks for material financial statement misstatements. A more holistic approach, which allows greater reliance on entity level and compensating controls and a more practical definition of materiality would help management and auditors consistently identify and assess key risk areas. Many auditors interpreted AS2 conservatively, often using very low materiality levels, resulting in continued broad scopes of coverage on transaction cycles and specific accounts supported by detailed low value added transactional testing and documentation. This in part reflects legitimate auditor concerns about litigation risk and a desire to minimize criticisms from PCAOB inspectors. It also significantly increases billable hours.

Without additional guidance (and related revisions to AS2), CCR members do not believe a significant reduction in the scope of coverage or number of controls being assessed can be achieved, and accordingly, at best only modest reductions in the overall cost of compliance would be possible. In particular, we believe additional Commission guidance for management with concurrent changes to AS2 as summarized below would be most helpful:

- *Reliance on Entity-Level Controls* – Improved clarity on the ability to rely on entity-level controls in lieu of activity-based testing. Examples or situations where strong entity-level controls could significantly reduce testing at the activity level would be particularly useful. Today, entity-level controls often tend to be viewed by auditors as supplemental to transactional testing.
- *Scope of Audit Coverage* – Although the May 2005 PCAOB guidance encouraged use of a risk-based top-down approach to determine scope, financial statement coverage ratios are widely used by auditors and generally remain in the 70-80% range. This, in turn, drives management’s scope, and results in large, generally lower-risk areas or accounts being audited every year often to the exclusion of smaller entities with less established control processes. We suggest AS2 clarify that financial statement coverage ratios should be based on risk, after consideration of entity level controls and may vary by company and financial statement element. To improve efficiency and effectiveness, we believe AS2 must be amended to clearly articulate that a risk-based approach based primarily on qualitative rather than quantitative factors meets the requirements of AS2. To make this workable the use of cumulative knowledge must be permitted – see below.
- *Reliance on Cumulative Knowledge* – AS2 currently requires each year’s audit to “stand on its own” and does not permit the auditor to rely on cumulative knowledge. Most transactional processes do not change from year-to-year and a more efficient approach would be to focus on higher-risk areas and changes in routine processes. A review of process documentation can be utilized each year to determine changes. Processes that have not changed should be eligible for periodic testing. Rotational testing should also be permitted for low risk areas even where changes have occurred assuming appropriate change control procedures have been followed. We recommend new guidance that allows management the flexibility to utilize judgment in determining what is an appropriate level of testing on an annual basis for lower risk areas. In some areas this determination may lead to no testing in one year (beyond confirmation of change control procedures), or alternatively, limited assurance through a walkthrough.
- *Risk-based Testing of IT Controls* – IT general controls (and automated controls) currently require significant testing and documentation even though experience has shown they do not pose significant financial statement risk. Deficiencies in IT controls, for example, systems access controls, generally are mitigated by other compensating controls. In addition, since COSO does not provide any specific guidance in this area, the degree of needed testing is open to interpretation.

We believe costs for testing IT controls (both general and automated) can be significantly reduced without adding incremental risk. If IT automated controls are determined not to be key controls then testing for these or the related general IT controls should not be required. Testing for general IT controls should be determined based on experience and risk. Accordingly, we recommend additional guidance that allows management and auditors the flexibility to limit the scope of IT control testing based on cumulative

knowledge and assessed risk. Such guidance could also include use of an IT risk based assessment.

Management's Evaluation

As noted above, CCR members agree that additional guidance for management's evaluation process (and related revisions to AS2) that focuses on key risks and relies more heavily on entity-level controls would be very helpful. Today, many audit firms expect management's assessment process to follow an approach similar to that prescribed in AS2. This facilitates their attestation process and typically also provides a significant amount of work that they can rely upon. As a result, most companies are performing a more detailed, activity-based point-in-time evaluation process to support their year-end control assessment process. Additional guidance or examples on how management's process could be largely based on entity-level and compensating controls rather than a separate, transactional-based evaluation process would be useful. Areas where additional guidance would be most helpful are summarized below:

- How can we better use entity-level controls to minimize detailed transactional testing?
- When are monitoring tools and compensating controls (reconciliations, change controls; analytical reports, etc.) acceptable validation of effective controls?
- How can roll forward procedures be simplified/eliminated? We believe management and auditors should have the flexibility to determine where roll forwards are necessary, depending on risk and the availability of monitoring controls. This also includes controls that operate at service providers during the fourth quarter roll forward period.

As noted above, unless consistent changes are concurrently reflected in AS2, issuing additional new guidance will in all likelihood not achieve the desired scalability and cost reduction and will be in conflict with the auditors evaluation process.

Recommended Changes to AS2

Our recommendations for key AS2 changes are summarized below. Many of these have been referred to earlier in this letter or in previous communications to the Commission and will be included in more detail in a separate letter to the PCAOB, once proposed amendments to AS2 are issued for public comment:

- Amend the language in AS2 to reflect the 2005 PCAOB guidance as well as any new guidance issued by the Commission.
- Revise the definitions of material weaknesses and significant deficiencies. The current language in AS2 that a deficiency exists if "there is more than a remote likelihood that a misstatement of the Company's annual or interim financial statements that is more than inconsequential" has resulted in extremely low materiality thresholds. This, in turn, has resulted in significant transactional testing of lower-risk controls.

We recommend that these definitions be amended to (1) allow for a higher, more practical, probability threshold and (2) follow more traditional materiality definitions and be based on annual rather than quarterly financial data. In addition for potential material

weaknesses, we believe qualitative factors must also be carefully considered and play an important role in assessing materiality.

- Provide for greater reliance on entity-level and compensating controls. This would encourage a more holistic view of the overall control environment and allow for a more balanced assessment process.
- Allow for greater reliance on the work of others. The current AS2 “principle evidence” requirement continues to result in unnecessary and often duplicative testing by restricting auditor reliance on the work of others.
- Provide for reliance on cumulative knowledge including a risk-based approach to scoping IT controls. Rotational testing for strong control environments and for lower risk controls should be permitted.

Documentation to Support the Assessment

We agree with the feedback the Commission has received regarding documentation. It was very burdensome in the initial year of compliance, both as a result of too many key controls being identified and auditor requirements, the latter in part driven by their desire for detailed flowcharts and narratives to assist them in conducting required process walkthroughs. Although ongoing maintenance of documentation in year two was somewhat less burdensome than in year one, documentation still remained the number one issue of concern as to lack of cost-benefit in FEI’s most recent (March 2006) survey of implementation of Section 404.

We believe the most practical approach to reduce the documentation burden is to move forward with new management guidance and revisions to AS2 that is more risk focused with greater reliance on entity-level and monitoring controls, and revised materiality definitions allowing for higher thresholds. This should significantly reduce the numbers of key processes and controls requiring documentation and should be scalable for both large and small companies. In addition, guidance and examples that would help management and auditors better define what is “sufficient” would also be useful.

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In addition to the above, Appendix A includes responses to several of the specific questions raised by the Commission in the Concept Release.

We appreciate the opportunity to express our views on this matter. Members of CCR will be pleased to meet with the Commission and Staff at its earliest convenience to discuss these issues in more depth and to clarify any comments contained herein.

Sincerely,



Lawrence J. Salva, Chair
Committee on Corporate Reporting
Financial Executives International

Appendix A:

We have included below responses to several of the specific questions asked by the Commission in its Concept Release.

4. Are there additional topics, beyond what is addressed in this Concept Release, that the Commission should consider issuing guidance on? If so, what are those topics?

The current literature does not provide sufficient guidance on the testing requirements when a SAS No. 70 report is received with a qualified opinion. The guidance does not clearly define the issuer's and the auditor's testing responsibilities when a qualified opinion is received in a SAS No. 70 report and the service provider's deficiencies are subsequently remediated prior to the issuer's year-end. As SAS No. 70 reports are typically received in close proximity to year-end, this poses a particularly difficult problem for issuers, as it leaves little opportunity to respond to reported exceptions. If the service provider's auditor does not update the SAS No. 70 report, we do not believe that the issuer should have the responsibility to test the remediation of the deficiency at the service provider. We believe that reasonable assurance can be achieved by obtaining a stub period representation letter from the service provider.

6. What types of evaluation approaches have managements of accelerated filers found most effective and efficient in assessing internal control over financial reporting? What approaches have not worked, and why?

Below is an example of a management process used by one of our members. Additionally, attached as Appendix B, is a report issued in November of 2005 by FEI's Research Foundation *Sarbanes-Oxley Section 404 Compliance: From Project to Sustainability*. This report is based on the management practices described by many of our CCR members during a special session of Section 404 practice leaders held last year.

Additional member example:

To assess **control activities** we work backwards from the financial statements and identify the significant work processes that are responsible for the material transactions and for defining and implementing key controls and assertions. Our company has globally standard functional work processes, and each work process owner is responsible for designing questions to assess the operating effectiveness of the key controls (and other important compensating controls) on a global basis. We assess the individuals within the organization who actually perform the tasks as a part of their role. This approach has been very effective from a management perspective; however it does not provide for an "independent" assessment upon which the auditor could rely. For that reason, we have also engaged our internal audit department in testing of key controls in high risk areas. Our external Auditor has been able to place reliance on internal audit's testing in a number of areas. To assess **entity-level controls** we survey executives, managers and employees across the Company. Our entity-level survey is intended to assess the elements of the COSO framework (with the exception of control activities.)

8. Why have the majority of companies who have completed an assessment, domestic and foreign, selected the COSO framework rather than one of the other frameworks available, such as the Turnbull Report? Is it due to lack of awareness, knowledge, training, pressure from auditors or some other reason? Would companies benefit from the development of additional frameworks?

Most CCR companies were familiar with the COSO framework and many had been implementing it in their companies prior to the adoption of the Act. In this sense, companies had

already incorporated many of the concepts of the framework into their company processes and a change to another framework would have required re-education and re-tooling, without much added benefit. Additionally, the COSO framework is U.S. based which is viewed as a benefit to many companies, and is widely accepted.

15. What guidance is needed about the role of entity-level controls in evaluating and assessing the effectiveness of internal control over financial reporting? What specific entity-level control issues should be addressed (e.g., GAAP expertise, the role of the audit committee, using entity-level controls rather than low-level account and transactional controls)? Should these issues be addressed differently for larger companies and smaller companies?

Guidance on procedures to assess the control environment would be helpful – especially in the areas of defining GAAP expertise, defining the role of the audit, compensation and nominating committees, segregation of incompatible duties and procedures to assess the control environment. It would be helpful to have guidance on how the results of the entity-level assessment are considered when determining the nature, extent, timing and extent of independent testing of detailed process-level controls. Greater reliance on entity-level controls should allow for less detailed transactional testing – especially in areas of lower risk and any guidance should include specific examples of how and where strong entity level controls could reduce or eliminate further testing in certain areas. For example, if a company has strong monitoring controls and a strong control environment, can the auditor eliminate additional transactional testing in lower-risk areas such as fixed assets?

In addition, the current language in AS2 should be revised to no longer prohibit Auditors from using the work of others when evaluating the control environment.

23. Would guidance be useful on the timing of management testing of controls and the need to update evidence and conclusions from prior testing to the assessment “as of” date?

We believe the use of the “as of” date restricts effective use of and reliance on ongoing monitoring of controls throughout the year. We believe this is one area where the Commission’s May 2005 guidance should be emphasized (and reflected in amendments to AS2) to allow management to test at any time during the year and rely on company level controls including monitoring, change management controls, supervisory activities, accounting reviews, and analytics to ensure that controls continue to operate effectively through year end. Fourth quarter rollforward testing should be at management’s discretion based on strength of monitoring controls.

Appendix B:

Included below is the Financial Executive Research Foundation Executive Report entitled *Sarbanes-Oxley Section 404 Compliance; From Project to Sustainability*, referenced in Question 6 above.



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**Sarbanes-Oxley Section 404 Compliance:
From Project to Sustainability**

Sarbanes-Oxley Section 404 Compliance
From Project to Sustainability

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