



September 18, 2006

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

Re: File Number S7-11-06

Dear Ms. Morris:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the above-referenced Concept Release,² which requests feedback on the need for additional guidance to assist management in assessing the effectiveness of internal control under Section 404 of the Sarbanes-Oxley Act of 2002. MBA has considered the Commission's request and determined that the most critical need now is for different audit guidance rather than additional management guidance. Specifically, MBA believes efforts to amend AS 2³ should take priority over other initiatives aimed at improving the Section 404 reporting process, particularly since changes to that standard could affect the need for additional management guidance.

I. MBA Position

MBA commends the Commission and the Public Company Accounting Oversight Board (PCAOB) for issuing staff guidance⁴ that addresses many of the recommendations in MBA's previous letters (see attached letters) and for continuing to pursue initiatives aimed at improving

¹The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

² The Commission Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting dated July 18, 2006.

³ Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," released by the PCAOB December 3, 2004.

⁴ See May 16, 2005, Commission Staff Statement on Management's Report on Internal Control Over Financial Reporting, and May 16, 2005, PCAOB Staff Questions and Answers, Auditing Internal Control Over Financial Reporting.

the cost effectiveness of the Section 404 reporting process. However, in reflecting on the continued high costs of engagements, MBA believes that recent efforts to improve the reporting process address the symptoms of the problem (e.g., excessive testing of routine controls) rather than the source of the problem (the guidance in AS 2). Consequently, MBA believes the costs of engagements will continue to remain excessively high regardless of attempts by management to improve the reporting process until the guidance in AS 2 is changed.

MBA offers the following specific recommendations for the Commission's consideration in amending that standard.

II. MBA Recommendations for Amending AS 2

A. Revise the Description of "Reasonable Assurance"

MBA believes the high cost of reporting on internal control is attributable most directly to guidance in AS 2 that states that the "...objective of the audit of internal control is to provide reasonable assurance that no material weaknesses exist as of the date specified in management's assessment."⁵ Moreover, because "reasonable assurance" is described in AS 2 as "...the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis"⁶ the standard indicates there should be a "slight chance"⁷ that material misstatements are not detected in the course of engagements. MBA believes this encourages management and auditors (but primarily auditors, who do not bear the cost of engagements) to focus on finding control weaknesses, rather than on judging the effectiveness of internal control on an enterprise wide basis *taken as a whole*.⁸

In considering the inclusion of the "remote likelihood" language in AS 2, MBA discovered that it appears for the first time in the context of internal control engagements in AS 2. It is not in the pre-existing audit and attestation literature on internal control nor is it mentioned in the SEC's June 5, 2003 Final Rules on Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.⁹ In fact, the "remote likelihood" term appears in SEC staff guidance¹⁰ only after the release of AS 2 and only in connection with rendering judgments about deficiencies in controls. Interestingly, the staff response to questions about the appropriate level of testing necessary to achieve "reasonable assurance" (about the effectiveness of internal control) refers to existing Exchange Act guidance that defines the term in the context of information that would satisfy prudent investors.

The Exchange Act and AS 2 descriptions of "reasonable assurance" are as follows:

⁵ See paragraph 4 of AS 2.

⁶ See paragraph 17 of AS 2.

⁷ See description of "remote" under paragraph 9 of AS 2.

⁸ Paragraph 147 of AS 2 reads, in part: "The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*."

⁹ See <http://www.sec.gov/rules/final/33-8238.htm>.

¹⁰ See part B of the SEC May 16, 2005 Staff Statement on Management's Report on Internal Control Over Financial Reporting.

“Exchange Act Section 13(b)(7) defines “reasonable assurance” and “reasonable detail” as such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.” [See SEC staff guidance]¹¹

“...Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis.” [par. 17 of AS 2]

MBA believes these definitions are substantively different because only AS 2 includes a *specific* likelihood threshold. Moreover, the AS 2 definition includes a *very conservative* likelihood threshold.

Given this background, MBA sought to understand why the PCAOB decided to expand the SEC’s definition of “reasonable assurance” to include a “remote likelihood” threshold. MBA did not find a description of the Board’s decision in AS 2, but assumes it reflected a desire to better serve the public interest by encouraging greater consistency in reporting, which is cited as one of the reasons the Board decided to incorporate a “more than remote likelihood” threshold into the definitions of significant deficiency and material weakness.¹² It is unclear, however, why the Board believed such a conservative threshold for evaluating internal control was necessary to achieve consistency in reporting.

The Board apparently also decided to incorporate the “remote likelihood” term into the guidance in AS 2 because auditors are familiar with its use in the context of FASB Standard No. 5, *Accounting for Contingencies*. MBA believes, however, that there is a significant difference between using the term to distinguish between known contingencies for the purpose of recording liabilities under FAS 5 and using it to set the scope of audit engagements. MBA knows of no other audit guidance that *effectively* requires auditors to consider, and opine on, the likelihood that there is no more than a “slight chance” that misstatements could go undetected as a result of an engagement. And, as has been proven, obtaining this level of assurance can be extremely expensive for the enterprise in terms of both internal and external audit costs.

For all these reasons, MBA urges the Commission and PCAOB to amend AS 2 to replace the “reasonable assurance” description in AS 2 with the description used in the Exchange Act.

B. Make the Guidance Less Prescriptive

A secondary factor driving up the costs of Section 404 engagements is the overabundance of guidance in AS 2. While a certain amount of guidance is helpful, too much guidance promotes a “check the box” attitude and “one size fits all” approaches to engagements, which the

¹¹ Footnote 15 to SEC Staff Accounting Bulletin Topic 1M2, Immaterial Misstatements That Are Intentional, provides some more information about “reasonable assurance” as used in the Exchange Act, as follows: “U.S.C. 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act (“FCPA”). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated: The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.”

¹² See paragraph E82 of AS 2.

Commission and PCAOB have witnessed and are now expressly discouraging.¹³ MBA believes that this is a case of “less is more” as less guidance would promote more cost effective engagements by allowing auditors and management the flexibility to tailor engagements as they deem most beneficial, unconstrained by laundry lists of factors that must be taken into account in the process.

The definitions of “significant deficiency” and “material weakness” in AS 2, for example, are far more prescriptive than they need to be. Consider, for example, that under pre-existing audit literature,¹⁴ a “significant deficiency” was a reportable condition, and a material weakness was:

“... a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a *relatively low level* the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal courses of performing their assigned functions.” [See pre-existing AU 325]

The SEC’s Final Rules adopted these definitions.¹⁵

By contrast, the definitions for the same terms in AS 2 are as follows:

“A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is a more than remote likelihood that a misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be reported.” [See par 9]

“A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.” [See par 10]

MBA does not believe these definitions are an improvement over the prior ones. In fact, an argument could be made that they are less clear. Consider, for example, that the meaning of “*more than* remote likelihood” could mean opposite things to different people.¹⁶ Complicating matters further is that management and auditors are advised in paragraph 133 of AS 2 that they must consider a variety of factors (including but not limited to “the interaction of the deficiencies” and “the possible future consequences of the deficiency,”) in judging “likelihood” under these definitions. The result is an overload of guidance that is more confusing than clarifying.

MBA believes this is a good example of how the layering of guidance in AS 2 complicates decision-making in internal control engagements. Moreover, because the decision-making process is highly subjective in nature, MBA believes too much guidance is counterproductive as it provides limited, if any, additional assurance to investors. Indeed, to the extent too much

¹³ See May 16, 2005 Commission Staff Statement on Management’s Report on Internal Control Over Financial Reporting which includes the following: “One size does not fit all and control effectiveness is affected by many factors.”

¹⁴ See AU 325, Communications of Internal Control Related Matters Noted in an Audit.

¹⁵ “For purposes of the final rules, the term “material weakness” has the same meaning as in the definition under GAAS and attestation standards.” See SEC June 5, 2003 Final Rules on Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.

¹⁶ The words “more than” could be interpreted to mean the likelihood of occurrence is more remote than just remote, or more likely than remote. Paragraph 9 of AS 2 indicates that the latter interpretation is correct, such that the likelihood of occurrence is “more than remote” if it is reasonably possible or probable.

guidance discourages thoughtful, tailored approaches to the performance of engagements it reduces their benefits at a greater expense for all concerned.

MBA recommends that the Commission and PCAOB work to amend AS 2 to reduce the amount of factors that management and auditors must consider in evaluating, documenting, and testing the effectiveness of internal control.

C. Develop Guidance to Rebalance the Management/Auditor Relationship

Another factor which has adversely affected the cost/benefit relationship in engagements is that auditors have the upper hand in deciding the scope of engagements. This is the case despite guidance in AS 2 and elsewhere indicating that it is the responsibility of management, not the auditor, to determine the appropriate nature and form of internal controls to be evaluated.¹⁷ This has driven up engagement costs because auditors benefit from increased testing through substantially higher audit fees, and perceived greater protection from liability.

In reality, auditor decisions almost always trump management decisions because auditors have the final word on whether sufficient evidence exists to support management's assessment and whether it is accurate. The authority conferred on auditors by the structure of Section 404 engagements is emphasized because management has limited, if any, opportunities to replace them (because the supply of nationally recognized firms is limited) and because a change in auditors generally is viewed unfavorably by third parties and may not be cost effective. Consequently, management efforts to defend their positions tend to just extend engagements and drive up audit fees to management's detriment.

MBA believes the Commission should work with the PCAOB to develop audit guidance that explains more fully auditors' responsibilities with respect to evaluating management assessments and reporting on internal control directly in a way that shifts more authority and responsibility to management.

D. Develop Guidance to Encourage Greater Audit Integration

Many companies have witnessed an increase in their auditors' tests of controls performed in connection with the audit of their financial statements despite assurances that AS 2 would reduce the need for that testing. In some cases, MBA member companies have reported that their auditors' tests of controls became more extensive and detailed after the first round of PCAOB audit firm reviews. This has resulted in unnecessarily high financial statement audit costs and raised questions about the scope of AS 2.

MBA understands that AS 2 was written as an audit, rather than an attestation engagement, in part because the PCAOB believed the term "audit engagement" would emphasize this dual reporting requirement and the "...integrated approach described in the standard and the requirement in Section 404 that this reporting not be subject to a separate engagement."¹⁸ This suggests that the PCAOB intended for Section 404 to complement the financial statement audit

¹⁷ The Release includes the following: "An overarching message of that guidance [the May 16, 2005, Commission staff guidance] was that it is the responsibility of management, not the auditor, to determine the appropriate nature and form of internals for the company and to scope their evaluation procedures accordingly."

¹⁸ See E22 of AS 2. See also E123-E130, Mandatory Integration with the Audit of the Financial Statements.

by reducing the amount of control testing that is necessary to support reduced substantive year-end testing. Our members' escalating financial statement audit costs indicate the opposite has occurred.

MBA recommends that the Commission and the PCAOB develop additional clarifying guidance that illustrates how tests of controls under the Section 404 engagement should reduce tests of controls under the financial statement audit. As this phenomenon is linked to the imbalance in the management/auditor relationship, some discussion regarding the interaction between the two issues would be helpful. The extent to which auditors' integrate the performance of Section 404 and financial statement audit engagements should also be made a focal point of the PCAOB's review of auditor performance, and accountants should be made accountable for their performance.

Relative to auditor reviews, MBA commends the regulators for deciding recently to incorporate a review of auditors' performance under Section 404 engagements into the PCAOB's inspection process. MBA believes, however, that the PCAOB should develop a proposal for public comment on how it intends to measure auditor performance because issuers and others may provide insights that could prove helpful to improving the process. As an example, MBA strongly believes that judgments made by auditors about the proper application of generally accepted accounting principles -- where the principles are subject to interpretation -- should *not* be cause for subsequent disciplinary action by the PCAOB.

III. Conclusion

In conclusion, MBA believes the greatest contributing factor to the inefficiencies in the performance of Section 404 engagements is the guidance in AS 2, and most specifically the guidance on "reasonable assurance" which incorporates a "remote likelihood" threshold for evaluating the effectiveness of internal control. Consequently, MBA recommends that the Commission first work with the PCAOB to amend that standard to replace the definition of "reasonable assurance" with the description used in the Exchange Act. MBA believes that change would have a profound effect on reducing the cost of internal control engagements, particularly by sending an appropriate message to the auditors concerning testing levels and expectations, and leading to benefits to investors and the economy in general.

MBA recommends also that the Commission and PCAOB work to reduce the amount of detailed guidance in that standard. MBA recommends also the Commission and PCAOB develop additional guidance that: 1) transfers more authority to management to make engagement related decisions; and, 2) illustrates how the performance of internal control engagements should be integrated with financial statement audit engagements. Finally, MBA recommends also that the PCAOB release for comment a proposal regarding how auditors' performance of Section 404 engagements will be evaluated as part of the PCAOB's firm inspection process.

In addition to the foregoing, MBA *strongly supports* suggestions by issuers, trade groups, and other interested parties that unaccelerated filers should be allowed to report under Section 404 on a voluntary basis and accelerated filers should be allowed to report on a rotational basis. MBA agrees with those who believe that providing issuers with flexibility in reporting would give investors a greater voice in judging the benefits of Section 404 engagements, which is consistent with a free market system.

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Again, MBA greatly appreciates the opportunity comment on the Release. For further information about MBA's views, please contact Alison Utermohlen, CPA, Senior Director of Government Affairs, at (202) 557-2864 or autermohlen@mortgagebankers.org.

Most sincerely,

A handwritten signature in black ink that reads "Jonathan L. Kempner". The signature is written in a cursive style with a large, stylized initial 'J'.

Jonathan L. Kempner
President and Chief Executive Officer
Mortgage Bankers Association

Attachment

CC: Mark W. Olson, Chairman, Public Company Accounting Oversight Board



May 10, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
Washington, DC 20549-1090

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

Re: Internal Control Roundtable and File Number 4-511

Dear Sir or Madam:

Early last year, the Mortgage Bankers Association¹ (MBA) submitted the enclosed letter recommending that the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) issue regulatory guidance to help reduce our members' high costs of reporting on internal control under Section 404, *Management assessment of internal controls*, of the Sarbanes-Oxley Act of 2002 (the "Act"). MBA's letter attributed the high costs of companies' 2004 engagements primarily to ambiguities in the guidance in PCAOB Auditing Standard No. 2 (AS 2)² and offered some suggestions for reducing those costs. With no noticeable reduction in costs this past year, this letter describes our MBA members' current views of the state of reporting under Section 404 and the changes they believe are needed to bring the costs in line with the benefits of engagements.

MBA Position

Last year, MBA recommended that the SEC and PCAOB clarify the guidance in AS 2 to reduce the costs of our members' internal control engagements, including clarifying numerous subjective terms³ upon which audit decisions are required to be made, developing guidance to help reduce testing of process level controls, and encouraging greater communication among

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

² "An Audit of Internal Control over Financial Reporting performed in Conjunction with An Audit of Financial Statements" released in March 2004.

³ For example: "reasonable assurance," "more than inconsequential," "significant weakness," "materiality," etc. as used in AS 2.

auditors and clients throughout audit engagements. MBA notes that while some of these recommendations are reflected in risk-based guidance released by the PCAOB last year,⁴ the cost of reporting under Section 404 is still extremely high. Consequently, while our members continue to support our previous recommendations, MBA now believes that the current system of reporting is not sustainable without significant regulatory changes that force a fundamental shift in auditor focus away from concerns over liability to cost/benefit considerations in the performance of engagements.

The following MBA observations about mortgage companies' 2005 audit experiences relate to their Section 404 and financial statement audits because the performance of the engagements is intertwined. Consequently, our members believe it is more appropriate to describe their reporting experiences under both engagements, rather than their Section 404 engagements alone.

Observations from 2005 Engagements

MBA members report that the costs of their 2005 audits were comparable to the costs of their 2004 audits. They note that while their auditors placed more emphasis this past year on testing company-level controls, as opposed to process-level controls, the shift did not translate into cost savings because decreased testing in certain areas was offset by increased testing in other areas. They report also that while their communications with auditors improved last year, they improved only marginally. In addition, they note that far too many audit decisions continue to be referred by practice partners to more expensive technical partners in the firms' national offices. Our members also believe auditors are uncertain what is expected of them under Section 404 and AS 2.

Our members now believe that the continued high cost of audits is attributable to: (1) auditors' reactions to recent PCAOB criticism of firm audits; (2) the potential penalties imposed by the Act, the SEC and the PCAOB; and (3) continued lack of understanding of the objectives of Section 404 engagements, including the guidance in AS 2. The combination of these factors has caused a shift away from an environment in which reasoned decisions are made based on all the facts and circumstances to one in which decisions are made for primarily risk avoidance reasons. The result is that audit costs have remained high because testing is unreasonably excessive, and because management is spending increasing amounts of time and money supporting their assertions regarding the effectiveness of controls and their interpretations of the authoritative accounting literature. The result is a significant net loss for business, as the incremental costs are not offset by incremental benefits to the investment community.

To illustrate how testing has continued to be excessive, one MBA member reported that their auditors required fluctuation analyses at the income statement and balance sheet line item level in 2004 but required those analyses to be performed at the general ledger account level in 2005. To provide some perspective, they explained that one income statement line item (i.e. "gain on sale of mortgage loans") has thirty different general ledger accounts. Further, they said that while management was required to provide explanations for fluctuations in income statement line items above \$2 million and 10% in 2004 that threshold was decreased to \$1 million in 2005. When applied across the consolidated company, the company's analysis work increased exponentially in 2005 for no added assurance that its financial statements were properly stated. This is truly a no-value added requirement imposed by the auditors.

⁴ See May 16, 2005, PCAOB Staff Questions and Answers "Auditing Internal Control over Financial Reporting."

Furthermore, our members note that whereas auditors formerly tested controls early in the year to establish their substantive transaction testing later in the year, the controls are now tested throughout the year with little measurable impact on substantive testing. Currently, auditors:

- Review internal control
- Test internal control
- Perform very detailed and thorough interim substantive tests
- Perform very detailed and thorough year-end substantive tests
- Perform detailed analytical review procedures at quarter-end and year-end
- Review and test internal control again through review of audit workpapers.

Consequently, our members are being subjected to tests of controls throughout the year for no additional assurance regarding the accuracy of their financial statements.

Also, and to illustrate how audit costs are increasing in other ways, auditors are now requiring their mortgage clients to obtain legal “true sale” opinions to substantiate their assertions that transfers of their mortgages to the secondary market agencies (Fannie Mae, Ginnie Mae and Freddie Mac) are “legally isolated” from them pursuant to the criterion for sale treatment in paragraph 9.a. of FASB Statement 140⁵ (FAS 140). These opinions are being required regardless of the fact that: (1) such loan transfers (either as collateral for agency-guaranteed securities or as whole loans) have been happening every day of the week all year long by mortgage companies throughout the country for more than twenty years, and (2) the guidance in FAS 140 provides for judgment to be exercised in deciding whether such opinions are warranted. Clearly, auditors are abandoning the use of judgment in favor of the no risk approach of requiring registrants to obtain costly legal opinions for even the most routine transactions.

These examples are illustrative of the types of risk averse decisions being made today. They are not isolated cases as our members described many similar examples. Nevertheless, those additional examples are not described here as MBA believes the high costs of our members’ 2005 audits attest to the fact that their audit experiences were similar.

MBA Conclusion and Recommendations

MBA believes that the costs of mortgage companies’ audit engagements are still much too high. While our members believed last year that the costs could be brought down through clarifications of the guidance in AS 2, they now believe the problem is broader than uncertainties about that standard. MBA now believes that audit costs will remain unreasonably high without significant regulatory changes that force a fundamental shift in auditor focus away from concerns over liability to cost/benefit considerations in the performance of engagements.

MBA believes the Commission and the PCAOB should work together to:

- Require audit testing to be redirected toward more entity-level controls (codes of ethics, design of compensation plans, segregation of duties, independent internal audit functions, outside board members, etc.) as opposed to process-level controls;

⁵ “Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities.”

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- Develop and release for public comment guidelines about how the performance of audit engagements will be judged by the PCAOB. MBA recommends that those guidelines place primary emphasis on the extent to which cost/benefits are taken into consideration in testing under a *true* risk-based approach. The guidelines should also describe how cost/benefit considerations will be measured; for example, how the strength of entity-level controls should reduce testing of process-level controls;
- Identify the specific sources that are driving auditors' concerns about liability, and seek to alleviate those concerns where appropriate. For example, guidance should provide that judgments about the proper interpretation of the financial reporting or audit literature -- where the literature is subject to interpretation -- will *not* be cause for disciplinary action.

MBA will continue to consult with members to consider possible additional approaches for reducing audit costs and will be pleased to share their thoughts and suggestions with the Commission and PCAOB. In the meantime, please direct any questions about the comments in this letter to Alison Utermohlen, MBA Senior Director of Government Affairs, at 202 557 2864 or autermohlen@mortgagebankers.org.

In closing, MBA greatly appreciates the opportunity to comment on the costs of our members' audit engagements.

Most sincerely,



Jonathan L. Kempner
President and Chief Executive Officer

Enclosure

Cc: Robert H. Herz, Chairman, Financial Accounting Standards Board



February 25, 2005

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File Number 4-497

Dear Mr. Katz:

The Mortgage Bankers Association¹ recently solicited the views of members that are subject to the Sarbanes-Oxley Act of 2002 (the "Act") regarding the law's impact on the mortgage banking industry and, more specifically, whether MBA should support calls for the appeal or amendment of sections of the legislation. Interestingly, while our members expressed unanimous support for the Act's objectives of promoting greater integrity and responsibility in corporate financial reporting and disclosure, they also agreed that the manner in which Section 404, *Management assessment of internal controls*, has been implemented within the mortgage banking industry has served to undermine these objectives by unnecessarily reducing investors' investment returns. Our members are so concerned about the high costs of complying with Section 404 that they have requested that I convey their observations to you, along with a request that they be given the opportunity to discuss them with SEC staff and the staff of the Public Company Accounting Oversight Board (PCAOB).

MBA Position

MBA agrees with the intent and goal of the Act. We believe CEO and CFO accountability is appropriate and that a formal structure for management and their

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auditors to opine on the effectiveness of the internal control structure should be in place for all public corporations. Consequently, we are not seeking a change in the legislation but, rather, assistance in reducing our members' compliance costs. We believe there are a number of ways in which the Commission can ease our members' Section 404 compliance burden, as described below.

General MBA Comments

MBA believes the high cost of compliance with Section 404 is attributable primarily to the excessive amount of testing and documentation required by Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (AS 2), released by the PCAOB in March 2004. The guidance in the standard and the increased penalties for inaccurate financial reporting imposed by the Act have created an atmosphere of "near paranoia" where auditors generally conclude that more testing and documentation is always better than less, regardless of cost/benefit considerations. Contrary to the intent of the Act, the high cost of reporting on internal control² is sapping mortgage banking companies' resources to the detriment of investors who will experience lower investment returns and, thus, declines in the values of their investments.

It is important to recognize that while the extent of testing and documentation being performed in internal control audits is not *explicitly* required by AS 2, the general perception is that the standard effectively mandates the amount of work being performed by the extensive array of factors and overlapping myriad of highly ambiguous terms (e.g. "remote likelihood," "more than inconsequential," "reasonable assurance," "material weakness," "significant deficiency," etc.) that must be considered by management and auditors in planning and performing internal control engagements. Taken as a whole, the guidance in the standard effectively puts management and their auditors on notice that they must ascertain *with near certainty* whether fraud or an error in reporting could *ever, possibly occur or go undetected* by the internal control structure. The amount of testing being performed within our industry appears to be aimed at providing almost "absolute assurance" that no fraud or errors could ever occur, which, by the PCAOB's own admission,³ is an illusory concept given inherent limitations in internal control.

Some of our members' specific comments about their experiences with AS 2 and its impact on the mortgage banking industry are repeated below.

Specific MBA Observations

Observation #1: The concept of materiality is obsolete

Our members contend that any concept of materiality is gone – as everything and anything in practice is deemed to be material. Generally, they have noted that independent public accounting firms have significantly increased their aversion to risk to an extreme degree. In some instances, auditors have gone overboard on their testing

² One MBA member company noted that Section 404 compliance costs were close to 10% of their 2004 pre-tax profits.

³ "...internal control cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations", see paragraph 16 of AS 2.

requirements, regardless of cost/benefit considerations or materiality, to avoid any possible future criticism of the scope of testing. This excessive testing has translated into much higher than necessary audit costs and internal costs in preparing or pulling data for the auditors.

One MBA member suggested that one possible solution would be to permit management, in consultation with their auditors, to define materiality as a threshold, formula or amount and to require disclosure of that threshold, formula or amount in management and audit reports. By using a clearly communicated materiality threshold, formula or amount, companies and accounting firms would be able to better communicate their approaches to testing internal control to investors and others. Better disclosure in this area would lead to better understanding of the nature of internal control engagements, and would help dispel misguided notions that a clean audit opinion represents a level of guarantee that errors or fraud will never occur or go undetected by a company's internal control system.

Observation #2: Auditing firms have different interpretations of the rules

Our members have discovered that the public accounting firms, including the Big Four firms, can differ substantially in their interpretations of the amount and type of controls that are necessary to render an opinion on management's assessment of internal control. The audit firms also differ in their opinions of the amount of reliance they can place on work performed by internal staff, which is too low in most areas, particularly in the performance of walkthroughs and in the internal technology and other non-risk or low-risk areas. Consequently, companies can be required to assess substantially greater or fewer controls than their competitors depending upon their selection of audit firms.

Observation #3: Auditors are reluctant to advise clients about the proper interpretation and application of GAAP

MBA members whose auditors are one of the Big Four firms contend that almost every significant audit related decision now is being referred to the firms' national offices rather than being addressed at the practice office level. Further, some of our members have been told that their auditors can no longer help them with the application of generally accepted accounting principles (GAAP) and that management has to form its conclusions independently or seek advice from another resource. This puts our members in the untenable position of seeking advice from other audit firms only to risk the possibility that their auditors may disagree with the other firm's response.

Observation #4: Aggressive identification of deficiencies and "material weaknesses" discourages early communication with auditors and shareholders

The implementation of the Act has led management to consult with their external auditors less frequently than is appropriate due to concerns that a consultation regarding the proper application of complex accounting standards may be viewed as an internal control deficiency or a reportable "material weakness." Also, because any change in any number in the financial statements or any note to the financial statements from preliminary to final could be deemed a reportable event, many companies will not let

their auditors start their audits until the exhaustive quarterly due diligence is completed by management. This aversion to sharing information with auditors adversely impacts the timeliness of management reports to shareholders and compromises the accuracy of final products by discouraging early, productive communication between management and auditors regarding the proper application of accounting rules.

MBA believes discussions between management and auditors should be encouraged, rather than discouraged, as more communication can only lead to improved financial reporting. Moreover, the audit firms, especially the Big Four firms, have an extensive network of resources and individuals with significant technical expertise that can be utilized without impairing auditor independence. It only makes sense that management be allowed to avail themselves of the significant advice and assistance that their auditors can provide.

Observation #5: Reasonableness in testing has been lost

Our members have noted that the current system for auditing internal control has no tolerance for the type of human error that could reasonably be expected to occur in situations involving the compilation of large amounts of data in short time periods. For example, some of our members have been told by their auditors that errors found during reviews of their draft Forms 10-Q and 10-K could be considered significant deficiencies or reportable material weaknesses, despite the fact that the forms have not yet been filed and could still be in ongoing stages of final review processes.

Similarly, some of our members have been told by their auditors that any computational errors found in their routine Excel spreadsheets, which are used to add, subtract, multiply and divide numbers, could be considered reportable also. These members have been required to document their “tests” of changes to the spreadsheets. This is so onerous that some of our members are considering reverting back to doing financial analysis on less efficient columnar, paper worksheets where the audit requirements are less severe.

Observation #6: Levels of testing in internal technology and operational areas are especially excessive

Our members have noted that the following specific factors and requirements⁴ have contributed to the high costs of compliance in the internal technology and operations areas:

- Excessive testing of routine process-level controls where there is little risk in most companies and, thus, little additional benefit to investors.
- Requirements that companies hire “experts” to validate the operation of application software *each and every time* a new version of the software is utilized.

⁴ “Requirements” as used here refers to requirements explicitly imposed by AS 2, or imposed by auditors based on their interpretations of AS 2.

- Limitations on management and auditor discretion to design and rotate tests of controls between reporting periods.
- Requirements to retest controls between interim periods and the “as of” date.
- Requirements that SAS 70 reports be obtained from all outside service bureaus that perform certain data processing functions.

We are concerned also that some may believe that SAS 70 reports provide a much higher level of assurance regarding the effectiveness of controls over certain processing functions than is actually the case. In fact, management has limited influence on: (1) the service provider’s internal control structure; (2) the corrective actions that may be required to remediate a material weakness in the provider’s internal control; and/or (3) the quality of the SAS 70 engagement performed to identify material weaknesses in the provider’s internal control. In the event concerns are raised about a service provider’s internal control, management also has limited options to quickly terminate the use of the provider, even if other reasonably priced providers – that are willing to subject themselves to SAS 70 engagements -- are available.

Observation #7: “Point in time” opinion creates timing issues

Management assessments and auditor opinions on internal controls must be made, pursuant to Section 404, as of a point in time, typically, at December 31st for calendar year companies. A point in time assertion requires controls to be tested as of that day or throughout the year with roll forward tests applied on the assertion date. This approach causes operational challenges with management, finance and auditors since all have conflicting priorities at year-end. Additionally, with a point in time assertion, if a control that is identified as being effective throughout most of the year, but is tested as ineffective at year-end, then the assertion that the control is ineffective is accurate, but somewhat misleading to investors. Although we realize the point in time assertion is legislatively mandated, we believe implementing regulations could address some of the challenges it presents; for example, by permitting management and auditors more flexibility to rotate tests of controls and more time to address reporting deficiencies.

Observation #8: Audit resources are limited

There is a limited pool of individuals with the requisite experience to perform internal audit engagements, both on the company side and external audit side. In particular, the ability of external auditors to perform quality audit procedures has been reduced due to the requirement to perform – what amounts to -- two separate engagements: an audit of the financial statements and an audit of internal control. The strain imposed on all who are involved in these engagements threatens to impair judgment necessary for good decision-making and has created unnecessary tension and discord among management and auditors.

Observation #9: Guidance is still evolving

The PCAOB guidance, both formal and informal, has been evolving throughout the year, with the latest formal question and answer document being issued several months ago.

It is difficult to plan and execute engagements when guidance is evolving or simply lacking, as is the case with the Committee on Sponsoring Organizations of the Treadway Commission's Internal Control-Integrated Framework which provides little guidance on matters outside control activities. Many of our members have had to rely upon informal guidance received by their auditors directly from the PCAOB.

MBA Conclusion and Recommendations

MBA believes that if the cost of reporting on internal control is not reduced, compliance with Section 404 will undermine our country's economic growth and reduce the competitive position of US public companies versus their private and foreign counterparts. Many emerging companies, traditionally the source of new jobs and economic growth, may decide not to go public rather than incur the costs of reporting on internal control while existing companies may not prosper as they otherwise might because their resources are being redirected to unproductive testing and documentation activities. Ultimately, every cent spent on Section 404 compliance represents one cent less in earnings available for re-investment in research, capital equipment, and new jobs which underlie our country's future economic growth. Our members also believe that, over time, companies will not be able to secure the "best and brightest" to be a CFO of the company because their main responsibility has evolved from analyzing and improving business performance to filling out checklists and designing and testing compliance with numerous procedural internal processes.

For these reasons, MBA believes the Commission and the PCAOB must work to reduce the costs of complying with Section 404. Because the highly publicized instances of corporate accounting fraud and abuse which gave rise to the Sarbanes-Oxley legislation were due to "tone-at-the-top issues" and not process-level errors of the type being focused on under Section 404, we believe the Commission should begin by analyzing the reasons for past material errors or improprieties in financial reporting and change the current audit guidance to focus on areas of greatest risk. We recommend also that the Commission and PCAOB seek to promote more cooperation between management and auditors in the determination of reasonable levels of testing, and that auditors should be reminded that cost/benefit considerations are an important aspect of planning and performing internal control engagements.

Additionally, we recommend that:

- "Rules-based guidance" be replaced with more "principles or objectives-based guidance" as much as possible;
- Management be permitted, in consultation with their auditors, to define materiality as a threshold, formula or amount and to require disclosure of that threshold, formula or amount in audit reports;
- Information discussed or disclosed to the audit firm prior to the public release of financial data not be construed as a significant deficiency or reportable material weakness, unless it is not corrected prior to the release of the data (or longer timeframe, see following point);
- The time available to correct control weaknesses be extended in order to properly address issues (maybe prior to next year's release). Currently, if a

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- weakness is identified in December (for a calendar year company), it has to be corrected immediately so it is not identified as a material weakness;
- Model testing be eliminated or reduced as much as possible;
 - Limits be placed on the circumstances in which SAS 70 reports are required to be furnished by outside service bureaus or other service providers;
 - Management and auditors be allowed greater flexibility in the timing of tests of controls;
 - Greater communication and cooperation between management and auditors be encouraged throughout the audit process.

Thank you for the opportunity to share our views on this important matter with you. As mentioned at the outset of this letter, our members would appreciate the opportunity to meet with Commission and PCAOB staff to discuss our concerns. If the Commission and PCAOB are unable to accommodate a face-to-face meeting, we request the opportunity to participate in the Commission's roundtable discussion on April 13. I have asked Alison Utermohlen, staff representative to MBA's Financial Management Committee, to contact your office within the next week to discuss our requests. If you have any questions about our observations or recommendations, please do not hesitate to contact Alison at 202/557-2864 or at autermohlen@mortgagebankers.org.

Most sincerely,



Jonathan L. Kempner
President and Chief Executive Officer

Cc: The Honorable Richard C. Shelby, United States Senate
The Honorable Michael G. Oxley, United States House of Representatives
Mr. William J. McDonough, Chairman, Public Company Accounting Oversight Board