



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 under 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 cost 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.”

- 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

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