

# THE FINANCIAL SERVICES ROUNDTABLE



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**RICHARD M. WHITING**  
EXECUTIVE DIRECTOR AND  
GENERAL COUNSEL

May 1, 2006

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

Public Company Accounting Oversight Board  
Attention: Office of the Secretary  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

Re: Internal Control Roundtable / File Number 4-511

Dear Sir or Madam:

The Financial Services Roundtable<sup>1</sup> appreciates this opportunity to submit a comment letter to the SEC/PCAOB Internal Control Roundtable scheduled for May 10, 2006. Accurate and reliable corporate disclosure is the keystone for the successful functioning of our financial markets. The Financial Services Roundtable supports the goal of the Sarbanes-Oxley Act to improve the quality and accuracy of financial reporting. The Roundtable also supports the efforts of the SEC and PCAOB to seek to implement the Sarbanes-Oxley provisions in a cost effective and reasonable manner. We very much appreciate your effort to gain input from the public through the Internal Control Roundtables held last year and this year. In furtherance of these goals, we would like to offer the following suggestions:

- **Risk-Based Approach to Section 404 Audits**

The Roundtable and its member companies propose a risk-based, three-to-five year full audit cycle with annual testing of critical, high-level entity-wide internal controls on a cyclical basis. This proposal is one in which companies could be given the choice of “opting in” or maintaining their current systems. The Roundtable’s proposal would commence with a full Section 404 base-year testing and be followed by annual, limited testing of critical, high-level entity-wide controls in other years.

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<sup>1</sup> The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America’s economic engine accounting directly for \$18.3 trillion in managed assets, \$678 billion in revenue, and 2.1 million jobs.

This approach would be available to companies with a “clean” base year audit if their full-scope audit showed no indication of material weaknesses in internal controls or other objective *indicia* of problems, such as a required financial restatement, evidence of fraud or other significant violation of laws. Qualifying companies would continue to be required to comply with the management certification on internal controls, and also would be subject to an external assessment and reporting on its entity-wide controls and significant transactions. Further, a company would not be able to take advantage of the risk-based audit cycle if the SEC determined that it was no longer a “qualified” company or there was any indication of material internal control lapses. In addition, management could determine that the company no longer qualified for the exemption due to various changes that occurred during the fiscal year, including major acquisitions.

Companies opting into this risk-based audit cycle would immediately reap significant compliance cost reductions, while at the same time retain powerful economic incentives to maintain effective internal controls. Investors would still have the benefits of annual company-wide testing of critical controls, as well as the full-scope audit every three-to-five years. The Roundtable believes this is a suggested approach for solving the critical issues of high external audit costs, as well as the loss of managerial productivity associated with excessive audit testing. While we appreciate that other proposals will be presented in this comment process and the May 10<sup>th</sup> Roundtable, we urge serious consideration of this proposal. Whatever final course of action is chosen, the Roundtable advocates a solution that provides meaningful disclosure and testing, but done in a way that makes best use of managerial resources and also makes sense financially.

In addition to this primary suggestion to adopt a risk-based, five-year audit cycle, the Roundtable suggests the following possible changes that could result in lower costs without undermining the goals of Section 404.

- **Re-examination of PCAOB Full Audit Requirement**

Section 103 of Sarbanes Oxley requires the SEC to issue regulations regarding audit reports, and states that such regulations must require the audit report to include a description of the scope of the auditor’s testing of internal control structure under Section 404, the findings of such testing, and an evaluation of the internal control structure, *etc.* Section 103 does not require an audit of a company’s internal control structure.

Section 404, likewise, does not require an independent audit of management’s assessment of internal controls. The statute only requires the external auditor to “attest to and report on the assessment made by management of the issuer.” Nonetheless, the PCAOB has interpreted the statute to call for a “full-blown” audit. The elimination of the separate audit would significantly lessen the compliance burdens imposed by Section 404, without impairing the integrity of the Section 404 process as envisioned by Congress and set out in Section 103 of Sarbanes-Oxley.

- **Issuance of a More Forceful Policy Statement**

The SEC should consider issuing a new, more forceful policy statement, similar to the statement the SEC adopted in 1981, following passage of the Foreign Corrupt Practices Act (“FCPA”).

FCRA Policy Statement

In 1981 the SEC published a policy statement in light of concerns that the FCRA internal control provisions were diverting resources to overly burdensome compliance systems that went beyond the requirements of sound management. The policy then explained:

1. The test of the internal control system is whether, taken as a whole, it reasonably meets the statute’s specified objectives.
2. Reasonableness, as a standard, includes a consideration of feasibility. One measure of reasonableness of a system relates to whether the expected benefits from improving it would be significantly greater than the anticipated costs of doing so. Thousands of dollars should not be spent conserving hundreds.
3. Considerable deference should be afforded to the company’s reasonable business judgments. The selection and implementation of particular control procedures, so long as they are reasonable, remain managements’ prerogatives and responsibilities.
4. The accounting provisions principal objective is to reach knowing or reckless conduct, not inadvertent conduct.
5. Corporate management and the board have important roles to play in monitoring and evaluating the adequacy of internal controls, but not involvement in the minutia or recording and accounting for every transaction.

New Policy Statement Should Define “Reasonable.”

The Roundtable also suggests that the SEC policy statement further clarify what is “reasonable” in light of the purposes of Section 404. This Section is designed to help assure the accuracy of financial reports. Therefore, the SEC should clearly state that “reasonableness” in the context of Section 404 includes consideration of whether the controls relate to transactions that would be considered “material” for purposes of financial reports. If the internal control does not relate to a transaction or process that would have a material affect on the company’s financial statements, the attestation and reporting requirements should not apply.

- **Lack of Reliance on the Work of Others**

Some of our members tell us that auditors have interpreted Auditing Standard No. 2 as preventing significant reliance on the work of a company’s internal auditors or outside regulators, such as the NASD, SEC, or Federal banking agencies. The May 16, 2005 PCAOB

Policy Statement clarified that this is not the case for low-risk areas, but still requires the auditor to perform his own work directly in “high risk” areas. Considerable benefit would be achieved by further sanctioning the use of work performed by a company’s internal auditors for all areas, and if available and relevant, the use of regulatory examinations, audits and tests.

- **Relaxation of Restriction on Communications With Auditors**

The PCAOB Policy Statement issued in May 2005, explains that outside auditors may communicate certain matters with company management, such as the sharing of draft financial statements, and providing technical advice on the proper application of GAAP. The Roundtable believes that increased communication between management and auditors would be very beneficial in additional areas, and in particular with respect to questions on the structure and operation of internal control systems.

- **Section 302**

The SEC requires management of a public company to assess the company’s disclosure controls, which are the controls designed to ensure that material information is reported, in a timely manner. This rule is based on Section 302 of the Sarbanes-Oxley Act, which more generally requires that management certifications that the financial reports fairly present the condition of the company in all material respects. The focus of the certification on disclosure controls should likewise be focused on *material* information. Moreover, to the extent that Section 302 and Section 404 both require management reports on internal, the regulations concerning the such reports under Section 302 and Section 404 should be combined into one consistent rule.

- **Compliance Costs**

The Roundtable notes that there have been two recent studies released regarding compliance costs for Section 404. These costs include both external costs for outside auditors and consultants, internal costs for internal audit staff, design, testing, and systems development, and non-quantifiable costs in the form of the diversion of management time and attention away from the product development and competitive aspects of their business. One study, released by Financial Executives International (FEI), in March, 2006, showed the cost of compliance with Section 404 for the average public company was reduced by 17 percent from 2005, but still remains high at approximately \$3.7 million per company. The FEI concluded that the cost of compliance is still disproportionately high and that more work needs to be done. Another study, conducted by CRA International (CRA) found reductions of 44 percent for large cap companies and 31 percent for small cap companies. The experience of our members do not support the CRA findings.

- **Lack of Sufficient Competition**

Finally, the Roundtable would like to express its serious concern about the “logjam” of conflicts that has arisen with only four large accounting firms capable of servicing the larger

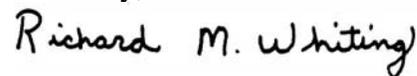
public issuers in the United States. While the Roundtable has no specific proposal on how to increase competition by bringing new entrants into the marketplace, or other methods to reduce or eliminate the conflicts created when such a small pool of providers exists, we are deeply troubled that the lack of meaningful alternatives available to many of our member companies exacerbates the problems of Section 404 compliance and unnecessarily drives up the costs associated with this provision.

## **Conclusion**

The Financial Services Roundtable is very much encouraged by the actions of the SEC and PCAOB in calling for this Roundtable discussion and for soliciting comments on Section 404 compliance. We believe that many improvements came out of the Roundtable held in 2005, and that the SEC and PCAOB have attempted to ameliorate the concerns raised in these meetings and through the comment letter process. Substantial improvements were made in 2005 through the issuance of policy guidance and question and answer documents. However, considerable work still needs to be done. The costs of compliance with Section 404 are huge, and both money and management resources are diverted from more productive endeavors. We believe that additional changes are needed to further reduce the compliance burdens, and that such changes will not undermine the legitimate public policy goals Section 404 is intended to achieve.

We would be pleased to answer any follow-up questions that you or the staff of the Commission might have.

Sincerely,

A handwritten signature in black ink that reads "Richard M. Whiting". The signature is written in a cursive, slightly slanted style.

Richard M. Whiting  
Executive Director and General Counsel