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March 28, 2005

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
405 Fifth St., N.W.  
Washington, D.C. 20549

Subject: File Number 4-497

Dear Mr. Katz:

We are pleased to respond to the Commission's request to provide feedback from the initial implementation and evaluation involving the Sarbanes-Oxley Section 404 requirements and the related Public Company Accounting Oversight Board and Commission rules.

Our Firm has completed, or is in the process of completing, 31 integrated audits for accelerated filer clients, many of which are for companies that are primarily regulated depository institutions. All of these clients were eligible to take advantage of the November 30, 2004 exemptive order granting certain accelerated filers up to an additional 45 days to include in their annual reports management's report on internal control over financial reporting and the related auditor's report on management's assessment of internal control over financial reporting. Of the 31 accelerated filers, 9 (29%) filed a complete 10-K, including required internal control reports, by March 16, 2005. A small group of filers, 5 (16%), delayed their entire 10-K filing for 15 days. For some, the delay was necessary in order to properly address accounting matters that arose in the course of the audit; certain others delayed the filing in order to include the internal control reports in their initial filing. Seventeen (55%) of the 31 accelerated filers filed their Form 10-K by March 16, 2005 with the intention, as permitted by the exemptive order, of subsequently amending the filing to include the internal control reports.

Also, our firm has or has had consulting engagements with over 100 non-audit-client companies on compliance with Section 404. These companies include a number that have over \$10 billion in revenue and these companies come from a wide variety of industries. These consultations also involved dealing with large auditing firms as well as with a variety of mid-size auditing firms. Our consulting role ranged from assisting companies in planning and managing their 404 efforts, to documenting processes and controls, to testing or retesting controls. We have also assisted companies in evaluating their efforts with best practices seen in other companies.

All our references to companies or filers are generalizations regarding companies in our client base as noted above.

### Observations

1. The internal control reporting and auditing framework presented in the PCAOB's Auditing Standard No. 2 (AS 2) is very detailed and comprehensive, and requires a significant resource commitment on the part of companies and auditors to comply. Many companies underestimated the resource commitment they needed to complete the detailed documentation and testing requirements for their assessments. Some of the reason for the underestimation was due to the relatively late issuance of AS 2 and the corresponding late guidance from the accounting profession and others, and due also to various public statements that may have led companies to conclude that "not much more" was required to document and assess controls or to audit that documentation and assessment. We also note that prior guidance on reporting on internal controls had not involved the level of detail and testing contemplated by AS 2 and, for the future, that AS 2 requires the auditor to start afresh on the testing each year.

Even when the company made the resource commitment, they were sometimes constrained by the fact that their financial accounting staff often did not have meaningful prior experience with internal control reporting.

These factors led to situations such as late or slow starts, wasted effort, need for consultants, revised implementation timelines, and late compliance.

We are also concerned as to whether companies have obtained a sufficient depth of understanding regarding the operations of internal controls, even after having been through it once in completing their internal control assessments. We are also concerned about their expectations of the level of reduction in documentation and testing that they believe they will experience in future years.

2. We are encouraged by what we see in the additional focus that companies are giving to internal control and to the importance of proper controls and financial reporting. Many companies have strengthened their internal control systems and improved the competency of their financial accounting staff. In many companies, personnel in functions outside the finance and accounting functions, such as sales and marketing, have increased their understanding of internal controls, and this can only help improve internal control over financial reporting. Senior executives are becoming more aware of the internal control structure within their companies. All this will have positive results in the future.

3. Companies are frustrated by what they view as inconsistent and contradictory guidance from auditors and regulators. Given what has turned out to be the massive size of the task of implementing internal control assessments, and audits thereof, at all public companies, the lack of consistency should not be surprising. The COSO

framework is analogous to generally accepted accounting principles (GAAP), and is a complex set of rules that can be approached in many ways. AS 2 represents generally accepted auditing standards for internal control audits, and similarly can be approached in many ways. Companies, auditors and regulators have been working on GAAP and GAAS approaches for financial statement audits for many decades, and yet changes continually occur; it seems reasonable that it will take time to develop consensus on the approach to the myriad of judgments and documentation requirements that are required in an internal control assessment and in the audit of internal control. We do not believe that these facts have been highlighted enough by the financial press and regulators or understood by many companies.

4. The lack of detailed guidance for companies other than AS 2 has contributed to difficult implementation issues. There is no AS 2 equivalent for companies; as a result they look to AS 2 for guidance on their documentation, testing and evaluation processes. This causes companies to design assessment processes with the objective of "satisfying the auditor." While it is appropriate for companies to aspire to clean internal control reports from their auditor, their primary objective should be a comprehensive assessment of internal control, under the COSO framework, based on their own approach and thinking about how they operate the company. The lack of company guidance has, in some companies, contributed to an "auditor centric" process.

5. The "rules" of the COSO framework are not disclosed to investors nor is the scope of the internal control assessment. For financial statements, the accounting policies underlying the financial statements are spelled out in great detail in the accounting policy footnote. The financial statements are accompanied by extensive footnote disclosures of significant items in the financial statements. For the management reports on internal control, however, the concepts and management decisions involved, the elements of the COSO framework, and the nature of the testing and analysis done, are not similarly described or detailed.

6. Cost, of course, is a key company concern. Adopting any model of internal control reporting is costly. Apart from the complexity of the internal control reporting model itself, we believe the following are the biggest contributors to cost:

- Lack of good technical guidance for companies
- Poor project management in the initial implementation of management's control assessment process
- Lack of high level executive ownership of the internal control reporting process, in some companies. Some companies have focused the responsibility in risk management or internal audit departments; a higher ownership level is needed
- Performing the work too late in the year (due partly to the late issuance of AS 2). Early completion of work, with appropriate updates to year end, permits efficient coordination with the auditor

- A general lack of internal control documentation that existed in most companies which required creating documentation of controls and processes for the first time
- Having to rework work already done, because of the timing of the issuance of AS 2 and the guidance that the auditing profession could develop
- Existence of many disparate internal control systems in many companies, often the result of prior mergers where systems and operations were not combined but legacy processes were left to continue
- Time compression. The internal control reporting requirements have a very large year end component due to the "as of" nature of the reporting. Combining this effort with the normal year end financial reporting effort creates an enormous peak volume staffing issue for companies. Companies believe they must hire to meet the peak volume needs; if the requirements were more spread out, existing resources would more likely be able to handle the requirements.

We see the distinct possibility that the audit firms will be placed in the middle on this issue of cost. Some companies may insist on reductions in the level of audit firm involvement and in the level of their own internal documentation, attempting to control their costs by reducing their work and pressuring their auditors to cut back too far. The PCAOB's emphasis on full testing, analysis, and documentation for each significant assertion for each account, and their scrutiny of the initial 404 audits, will likely pressure auditors to do more. Investors will have to communicate the desired balance just as the Sarbanes-Oxley Act and AS 2 already have done at the present.

7. A common control weaknesses we observed surrounded the application of generally accepted accounting principles, especially in smaller companies. Our accelerated filer clients are largely regulated companies with historically strong internal control surrounding detail transaction processing and safeguarding of assets. However, the application of GAAP in complex areas, the assembly of financial statements and all the related disclosures, and the preparation of SEC filings were historically largely accomplished by hiring competent personnel who could handle most of the situations and relying on the auditor to review the work of those personnel and advise when matters surpassed the expertise of company personnel. Many smaller companies may have only one or two CPAs on staff, who only prepare one annual report a year and thus who may not have the fluency with financial reporting issues as might be needed for the more complex financial reporting areas. Also, most companies did not have formal, documented controls in this area prior to undertaking their internal control assessment efforts.

8. The internal control reporting requirements are not alone in affecting company financial reporting. The rulemaking and inspection activities of the SEC and PCAOB are having the intended effect of reducing materiality, creating greater precision in financial

reporting and causing greater overall audit effort. This combination of factors is adding a large amount of work in the post year end period when filings are prepared, and result in additional cost.

9. The reporting structure surrounding internal controls may not be transparent to users. We are concerned that the threshold for concluding that "internal control is ineffective" is too low. The types of reported material weaknesses that cause an ineffective conclusion have been extremely broad. While the detail disclosure encouraged by the Commission helps users more clearly understand the nature of the weakness or weaknesses leading to the conclusion that controls are ineffective, some readers may conclude that many of the material weaknesses reported "don't sound so bad." These readers may read the description of the material weakness and note that it appears to be a fairly isolated circumstance, or that it could have lead to a financial reporting difficulty but did not. We believe an "ineffective" internal control conclusion should always be a serious matter, and we fear that readers may become conditioned differently.

10. Companies are de-registering. About a half-dozen of our clients have, or will soon, de-register, largely due to the incremental burden of Sarbanes-Oxley compliance. Others are actively evaluating the pros and cons. These companies are generally those that do not regularly access the public markets; frequently they became registrants due to the number of shareholders increasing to over 500.

11. The Commission has periodically undertaken efforts to accommodate smaller companies. These efforts are laudatory and we have welcomed each rule-making that has made it easier for smaller companies to comply. Now it may be time to reorganize the rules that have resulted. We note that for financial statement purposes a company might be a small business filer. For purposes of timely filing, a company might be a non-accelerated filer. For purposes of filing internal control reports, a company might be a "small accelerated" filer. The degree to which small company relief is provided is based on the filing activity, and varies from activity to activity. This structure is confusing and costly for smaller companies to navigate, although the intent of each rule when issued was laudable.

We note also that the smaller public companies have not yet been through the internal control documentation and testing process. Smaller public companies have even more resource constraints than larger companies, as their financial staff is often limited in number. Because of their smaller size, smaller companies are less likely to have their controls documented in procedure manuals and other documents, and are more likely to have certain control issues due to their size, such as segregation of duties or lack of an internal audit operation. Thus, smaller companies are more likely to have "ineffective" internal control operations, without necessarily being more likely to have a material misstatement.

12. The provisions of AS 2 may need some revisions in practice to be more workable or clearer to companies, auditors, and users. One example may be paragraph 140, which provides some definitions of “strong indicator” that a material weakness exists.

One “strong indicator” of a material weakness is the restatement of previously issued financial statements to correct a misstatement therein. If the 2002 or 2003 financial statements are restated to correct something noted in 2004, what is the material deficiency that exists “as of” December 31, 2004 that caused the 2002 or 2003 financial statements to be misstated? It would seem that there may be no deficiency at December 31, 2004, let alone a material weakness at that date, as the status of controls as of December 31, 2004 has nothing to do with the status of controls as of December 31, 2002 or 2003 that pertained to the 2002 or 2003 financial statements. In fact, it may be a very effective internal control system “as of” December 31, 2004 that detected the misstatement in the 2002 financial statements.

Another “strong indicator” is fraud “of any magnitude” on the part of senior management. The PCAOB definition of fraud includes “misrepresentation in the financial statements of events, transactions” and “intentional misapplication of accounting principles relating to amounts...”. If AS 2 is taken literally, then any matter considered to be a misrepresentation or misapplication, even if clearly immaterial, is considered to be a material weakness. Consider an example where a CFO decides that, because the amount is very small, a tool of \$500 that is useable over two years is nevertheless expensed upon acquisition, to reduce the complexity of keeping depreciation records for that asset and others like it. This can be viewed as a misrepresentation of a transaction and an intentional misapplication of accounting principles, and it is an event “of any magnitude”, but there is absolutely no intent to mislead and no one would call it fraud – more importantly, no investor should be concerned about such a situation. However, the PCAOB rules might literally require this to be a material weakness because it was intentionally expensed instead of being capitalized.

### Recommendations

1. Permanently postpone the final acceleration of annual reports. In order to file an annual report within 60 days after year end, companies and their auditors will need to be effectively done with all of their work within 50 days of year end in order to fulfill the required communications with audit committees prior to filing. Virtually none of our audit clients could have made that deadline this year. We do not believe most could make it in the future without incurring additional resource cost solely because of the peak workflow need after year end. A permanent postponement would reduce the cost burden on smaller accelerated filers, and may be useful for larger entities also.
2. Make the exemptive order permanent. This is another suggestion aimed at reducing peak demand resource cost and it would have the added benefit of improving audit quality. In many companies the same personnel responsible for the financial statements

are also responsible for management's assessment of internal control. Enabling companies to deal with the two matters in separate time frames would allow companies to use their financial reporting personnel more efficiently. The same peak resource issue exists for audit firms--a cost ultimately borne by the companies. We are also concerned that without the exemptive order the peak demand will become so great for both companies and auditors that the quality of the financial statements, the internal control work, and the audit of each could become compromised simply due to fatigue and overload during a compressed post year end time frame.

These factors will be compounded when the requirements for non-accelerated filers become effective.

We do not believe the longer filing period now provided in the exemptive order is significantly harmful to investors, as ensuring the accuracy of the quality of information provided is most important, especially now that there is reporting both on the financial statements and on internal control. Everyone that now believes Enron's numbers are wrong isn't interested now whether they were filed within 60 days or 90 days of year-end. Allow the balance to tip more towards accuracy and completeness than speed-to-file, and allow more time for the necessary post-year-end procedures to be properly and fully performed.

3. Develop model management reports on internal control over financial reporting to explain and describe the COSO model, to provide an indication to the reader about what internal control over financial reporting does and does not include, and to describe the major internal control categories or subdivisions used by the company in performing its analysis and assessment. Right now the report on internal control is the equivalent of management saying "we had a good year" without presenting any detail to support what "we had a good year" means.

4. Provide more issuer guidance. We believe companies would benefit from more active and authoritative interpretive guidance from the SEC and the PCAOB.

5. Modify the internal control reporting model to permit the equivalent of an "except for" opinion, to ensure that the public always interprets an "ineffective" internal control opinion as a very serious matter. Further, require management disclosure of key internal control structure matters (how controls are organized, what is preventive, what is detective, monitoring, segregation of duties, etc.) in a manner similar to the accounting policy footnote supporting the financial statements.

6. Consideration of the impact of internal control reporting on smaller companies should become a formal regulatory project. Smaller companies have a more informal internal control structure than larger companies and reporting should vary based on the formality and complexity of the internal control structure. The current reports on internal control look the same for a multinational company with tens of thousands of employees and elaborate operations as for a start-up company with ten employees and

little in the way of revenues or operations. We understand that COSO is undertaking a project to provide guidance related to smaller companies by the middle of 2005. While we endorse this effort, we believe that a project led by the SEC would command more resources and surface more matters for consideration, and we are not confident that COSO has sufficiently reached out to enough small companies so as to be able to present a model for them. We note, for example, that COSO apparently has not inquired, or at least has not widely inquired, of mid-size or small auditing firms as to whether they could provide input to COSO in its project on smaller companies.

7. Rationalize the differential regulation by company size. We recommend the Commission adopt a system that categorizes companies into discrete regulatory classifications. For example, a four category system might classify a company as exempt, small, intermediate or large. Classification could be based on market capitalization or other objective factors for companies with no readily-determinable market capitalization, and all rules related to financial statements, disclosures, internal control reporting, filing deadlines and so forth would be based on a company's designation. Such an approach would streamline the current process, and allow companies, regulators and auditors to scale efforts in proportion to the investor dollars involved.

8. We suggest the SEC conduct a study to determine the effect on small businesses of the cost of Sarbanes-Oxley compliance, as that cost may adversely affect smaller companies' decisions as to whether to enter the public markets to obtain capital for expansion and growth, or as the cost may adversely influence the decisions of smaller businesses that are already public as to whether they should remain public.

9. We suggest that the provisions of AS 2 may need to have additional testing and refinement so that all parties – companies, auditors, investors – have a clear understanding of what is and what is not considered a material weakness in internal control leading to an ineffective system.

Thank you for the opportunity to share our thoughts. We commend the Commission for its interest in improving the internal control reporting process.

If you have questions, please contact Jim Brown or Rick Ueltschy.

Very truly yours,

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