September 18, 2006

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

Re: File No. S7-11-06 Concept Release Concerning Management's Reports on Internal Control over Financial Reporting

Dear Ms. Morris:

The American Institute of Certified Public Accountants (AICPA) respectfully submits the following written comments on the U.S. Securities and Exchange Commission's (SEC or the Commission) concept release concerning management's reports on internal control over financial reporting (the Concept Release).

The AICPA is the largest professional association of certified public accountants in the United States, with more than 340,000 members in business, industry, public practice, government and education. The comments in this letter represent the views of those members who audit public companies.

The AICPA commends the SEC for soliciting input for consideration in the development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting to ensure that the guidance addresses management's need as well as the public interest.

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We are pleased to respond to your request for feedback on the areas of comment you have identified in the questions included in the Concept Release.

General Comments

We are very supportive of the Commission developing additional guidance to assist management in its assessment of the effectiveness of internal control over financial reporting. We believe that additional guidance for management is essential to ensuring effective evaluations and assessments of internal control over financial reporting.

However, as we expressed in our comment letter on the SEC's proposal entitled *Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies*, we urge the SEC to ensure that the transition provisions for the Commission's guidance issued as a result of the Concept Release is sufficient to allow issuers sufficient time to properly adopt and fully implement such requirements in an orderly and effective manner.

We believe the guidance should be in the form of broad principles rather than be prescriptive in its requirements. Illustrative examples should accompany the principles, wherever possible, to demonstrate how the principles can be applied. Excessive specificity in guidance runs counter to the development of guidance that is scalable in its implementation by companies of all sizes. We further believe that this type of guidance will provide companies with the flexibility to be able to tailor their evaluation and assessment approaches and apply them to their own specific circumstances which, we believe, will achieve the Commission's intent that the guidance "will be scalable and responsive to individual circumstances."

We believe that the SEC should ensure that its guidance is well aligned with any amendments to Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2 *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS 2) and other existing guidance, i.e., COSO and the SEC's May 16, 2005 guidance, in order to ensure consistency between management and the auditor, to avoid confusion and to guard against impugning other acceptable approaches that companies have been using. Along these lines, we believe that it is important that the public comment periods for management guidance and amendments to AS 2 overlap to provide issuers, investors and auditors the opportunity to comment with the benefit of knowing the views of both the SEC and the PCAOB.

There has been much scrutiny of the efficiency and costs of the implementation of the provisions of Section 404. It is important that we not lose sight of the benefits to the capital markets of Section 404 in search of incremental efficiencies. Additional management guidance relative to its evaluation and assessment of internal control over financial reporting should be designed to improve the effectiveness of management's assessment of internal control over financial reporting and contribute to meaningful efficiencies in compliance with the provisions of Section 404.

In our responses below, we identify some critical topics which we believe are necessary to achieve the full benefits of an efficient *and* effective implementation of Section 404. We have addressed several topics in this letter that we believe should be highlighted and addressed in the guidance, all of which will significantly contribute to the efficiency and effectiveness of Section 404 and serve to enhance the transparency and quality of financial reporting for the benefit of investors and the public interest. These topics include company-level controls; comments on what the concepts of a "top-down, risk-based" approach should include; management documentation; and evaluation of deficiencies.

As the Commission develops guidance, it should recognize that if management eliminates significant steps in completing its Section 404 assessment, upon which the auditor might otherwise have relied on in performing its audit, that may result in a decreased ability by the auditor to rely on management's efforts and in a corresponding increase in the testing the auditor must perform and the amount of documentation that the auditor must complete.

Responses to Questions Posed:

Following are our responses to some of the questions posed in the Concept Release.

1. ***Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the Section 404 of the Sarbanes-Oxley Act of 2002 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?***

   We believe that additional guidance to management on how to perform an assessment of internal control over financial reporting would be very useful not only to management, but investors and auditors as well. Providing such guidance for issuers, coupled with the continued evolution of the Section 404 process and the lessons learned, will contribute significantly to improving the effectiveness and efficiency of the Section 404 effort. Further, as noted in our general comments, we believe that such guidance should be principles-based with illustrative examples, where appropriate, and would have the most impact if provided by the SEC directly.

   We also believe that all companies, regardless of size, would benefit from such guidance. Since the underlying principles of how management completes an internal control assessment, such as scoping and evaluation are similar, regardless of the size of the company, such guidance should be equally applicable to all reporting companies. While we believe that smaller public companies could benefit from some illustrative examples incorporated in the guidance, particularly as it relates to areas such as information technology and segregation of duties, we do not believe that separate management guidance regarding how to conduct an assessment is needed for smaller companies. The SEC could reference the COSO *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting* (COSO guidance for smaller companies) in its guidance as a good source of illustrative examples for those companies who selected to follow the 1992 Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control – Integrated Framework* (COSO Framework).

3. ***Should additional guidance be limited to articulation of broad principles or should it be more detailed?***

   We believe that the guidance should be articulated in such a way that management has a clear understanding of what is required of them in completing their assessment. While we believe that issuing the guidance in the form of broad principles would allow for more flexibility and scalability, we also believe it is critical that the guidance provide illustrative examples wherever possible to support the guidance. In other words, we believe that the guidance should identify the major steps of the assessment process and supplement the guidance, wherever possible, with examples.

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

   Another topic we have identified as needing further guidance, in the form of examples, relates to segregation of duties for the smallest of public companies. We believe that additional guidance is necessary beyond that provided in the COSO guidance for smaller companies. Since many smaller public companies have a relatively few number of people to perform certain duties, we believe that further guidance is needed on what would or would not constitute adequate mitigating controls where there are limited or lack of segregation of duties, particularly as it relates to the use of monitoring controls.

   An additional topic is testing of the controls over preparing financial statement disclosures. The controls in this area are among the most important in the financial reporting process because of the relatively high risk of material misstatement or omission due to fraud or error.

   We also believe that guidance on the appropriate extent of management's assessment when pervasive material weaknesses exist should be provided. For instance, we believe that there could be instances where the number and severity of material weaknesses identified are so significant that there is no point in continuing the evaluation of internal control over financial reporting, as completing the process would not provide investors with new or useful information. In such situations, we believe management should report that internal control over financial reporting is ineffective and disclose the extent and severity of identified material weaknesses.

5. ***Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?***

   While we have no definitive opinion on what the format of the guidance should be, we do believe that it should be viewed as authoritative guidance that must be followed by all issuers and that it is principles-based. We believe that this guidance should carry similar weight for issuers as AS 2 carries for auditors.

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

   Based on our members' experiences, the better the risk assessment in identifying the areas of higher risk of material misstatement of the financial statements, the more effective and efficient is the assessment approach. Our members have observed that management was generally more successful when its approach included elements of a top-down, risk-based approach rather than one that started at the detail process or business location level.

   In addition, it has been our members' experiences that the companies that experienced the most effective and efficient Section 404 processes were those that built their controls and evaluation processes into their business processes, rather than treating their assessments as a separate one-time exercise. By building the evaluation processes into the business processes, these companies also are making their evaluation of internal control a sustainable process which provides significant efficiencies in future years as well.

7. ***Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? If so, what are they? How might those drawbacks or other concerns best be mitigated? Would more detailed Commission guidance hamper future efforts by others in this area?***

   The SEC should ensure that its guidance is aligned with AS 2 and other existing guidance, i.e., COSO and the SEC's May 16, 2005 guidance, in order to ensure consistency between management and the auditor, to avoid confusion and to guard against impugning other acceptable approaches that companies have developed. In addition, a principles-based approach allows existing processes to be utilized. Our recommendation is consistent with the statement in the Concept Release that "Any additional management guidance that we may issue is not intended to replace or modify the COSO framework or any other suitable framework."

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

   Both the SEC's rules and AS 2 require that the assessment of the effectiveness of internal control be based on a "suitable, recognized control framework established by a body of experts that followed due-process procedures including the broad distribution of the framework for public comment." Because the COSO framework is a comprehensive framework and is the only one developed in the United States, and the vast majority of companies that have completed internal control assessments are domestic companies, it makes sense that COSO is the framework selected by the majority of companies who have completed a Section 404 assessment. Also, since the COSO framework concepts are an integral part of PCAOB Standards and International Auditing Standards, auditors and management personnel who have a public accounting background are familiar with these concepts.

Overall, we believe that a certain amount of consistency among public companies in regard to general approach to internal control design, implementation and assessment would be beneficial. While we are not recommending that the use of the other existing frameworks be prohibited, we believe the costs and potential confusion created by developing additional frameworks outweigh the likely benefits.

9. ***Should the guidance incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting"? Should any portions of the May 16, 2005 guidance be modified or eliminated? Are there additional topics that the guidance should address that were not addressed by that statement? For example, are there any topics in the staff's "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004)" that should be incorporated into any guidance the Commission might issue?***

   We believe that the guidance should be aligned with both the SEC's May 16, 2005 guidance and the staff's "*Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions* (revised October 6, 2004)."

   Particularly, we believe that re-emphasizing and/or clarifying the following concepts contained in the May 16, 2005 guidance would be useful:

   - Use of proprietary frameworks and appropriately assessing how information technology (IT) impacts internal control over financial reporting would be useful in focusing management on IT risk assessment and testing only those IT controls that relate to internal control over financial reporting.
   - With regard to the definition of significant accounts, we believe that an account should be considered significant if it is quantitatively material. Also, an account that is not quantitatively significant may be considered a significant account based on qualitative factors that increase the risk of material misstatement.
   - The consideration of interim and segment measures in evaluating deficiencies.
   - When a restatement is not considered to be indicative of a material weakness (e.g., when management had a reasonable basis to conclude the accounting was previously correct).

10. ***We also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b).***

Should possible alternatives to the current approach be considered and if so, what? Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?

We believe that a critical aspect to achieving the purpose of the Sarbanes-Oxley Act of 2002 lies in the requirement that the auditor test the effectiveness of internal control over financial reporting and express an opinion on the effectiveness of internal control. Without the auditor reporting on the effectiveness of internal control over financial reporting, we do not believe that Section 404 will accomplish the objective of restoring and maintaining investor confidence in the capital markets. Our members have experienced that some companies tend to be less rigorous about internal controls in the absence of external oversight and monitoring. Auditor attestation, for example, adds rigor that increases the probability that internal control deficiencies are identified and remediated. It also enhances financial reporting through the use of an integrated audit and reduces the risk of fraud. Research conducted by Lord & Benoit (2006) suggests that only 1 in 12 companies (47 of 586 companies) with ineffective controls identified by Section 404 previously self-reported control deficiencies either under Section 302 or under Section 404 readiness or management assessment activities performed in prior periods. As a result of this and other studies, we firmly believe that the absence of auditor attestation could reduce the rigor of management's review and diminish confidence in the reliability of management's assessment.

Moreover, we also do not believe the needs and expectations of investors would be met if the auditor reported on the effectiveness of internal control based on less than reasonable assurance. The existence of different standards and different levels of audit assurance from company to company could confuse investors and may provide false confidence in instances where investors believe the level of assurance is greater than it is. Another suggested alternative that some companies may opt in one year and opt out in another year (or vise-versa) may also lead to inconsistency in the level of assurance for a given company from year to year, adding further complexity for investors.

11. What guidance is needed to help management implement a "top-down, risk-based" approach to identifying risks to reliable financial reporting and the related internal controls?

We believe that guidance that clearly articulates what a "top-down, risk-based" approach means would be extremely helpful to management in completing their assessment process.

We believe that the "top-down, risk-based" approach is a process whereby management:

- Identifies the significant accounts and relevant assertions (Identification of significant accounts is addressed in our response to question 16);
- Assesses risk;

- Determines the population of controls that are designed to address all significant accounts and relevant assertions and areas of higher risk; and
- In determining this population of controls, management looks first to entity-level controls or other controls that address multiple accounts and assertions. Management would then proceed to identify process, transaction, or application level controls at progressively lower-levels within the organization as necessary to complete its assessment of internal control.

The objective of a "top-down, risk-based" approach is to focus greater attention and effort on higher risk areas and less attention and effort on lower risk areas, limit the controls that are included in the scope of management's assessment to the minimum number necessary to provide reasonable assurance that material misstatements will be prevented or detected, to identify those controls that address the largest number of significant accounts and relevant assertions, and to test those controls that provide the rigor and precision necessary to address the risk of material misstatement.

In following a "top-down, risk-based approach", however, it is important to be aware that the effectiveness of many controls is dependent upon whether other process or transactional level controls are adequate and effective. For instance, the effectiveness of controls, including those related to the control environment, general computer controls, and others that ensure the data being used is accurate, will have an impact on whether other controls are adequate and operating effectively. In addition, many times entity-level controls do not operate at a level of precision or rigor to prevent or detect material misstatements due to error or fraud with a high degree of reliability.

The term "top-down, risk based approach" seems to only imply less work to some. When properly applied it will likely reduce work in some areas, however it may also increase work in higher risk areas. For example, consider payroll expense, although it may be a material amount on the financial statements, it may possess lower risk of material misstatement due to its nature (i.e., large number of small transactions), and therefore may entail less work and time to test the related internal controls. On the other hand, accounts that are based on significant estimates may not be as material, but will require more work and time to test the related internal controls. Accordingly guidance should clarify these points regarding the limitations of the approach.

12. Does the existing guidance, which has been used by management of accelerated filers, provide sufficient information regarding the identification of controls that address the risks of material misstatement? Would additional guidance on identifying controls that address these risks be helpful?

We believe that sufficient information exists regarding the identification of controls that address the risks of material misstatement, including general methodologies being used by management in practice to assess materiality and qualitative factors, as well as examples given in the COSO guidance for smaller companies.

We do not believe that additional guidance on identifying controls that address these risks should be issued by the SEC. Since the designing of controls to meet certain criteria would vary based on the facts and circumstances of each scenario, this type of guidance would be impractical to develop and would interfere with the SEC's goal of making the guidance "scalable and responsive to individual circumstances."

13. ***In light of the forthcoming COSO guidance for smaller public companies, what additional guidance is necessary on risk assessment or the identification of controls that address the risks?***

The guidance set forth in the recently released COSO guidance for smaller companies will be helpful to companies in performing an effective risk assessment.

Although the COSO guidance for smaller companies provides illustrative examples that are helpful, it does not provide a specific "how to" for management. Accordingly, we believe the Commission could set forth in its guidance the principles of conducting a risk assessment (based on the COSO framework).

14. ***In areas where companies identified significant start-up efforts in the first year (e.g., documentation of the design of controls and remediation of deficiencies) will the COSO guidance for smaller public companies adequately assist companies that have not yet complied with Section 404 to efficiently and effectively conduct a risk assessment and identify controls that address the risks? Are there areas that have not yet been addressed or need further emphasis?***

With respect to management's risk assessment process, although the COSO guidance for smaller public companies does not specifically address how to conduct a risk assessment, we believe the guidance does provide sufficient information to assist management in developing such a process. The risk assessment process followed by management is critical to the Section 404 assessment process and following a risk-based approach. By diligently identifying the risks of material misstatement of the financial statements and the related relevant controls at the front end of the assessment process, management's process will be more efficient and effective and unnecessary documentation efforts will be avoided.

With respect to identifying controls that address the risks, please refer to our answer to question 12.

With respect to management's documentation, management has often used paragraphs 42-46 in AS 2 as a guideline for purposes of documenting the design of controls. We believe that the elements outlined in paragraphs 42-46 are appropriate for management's documentation, and such guidance should be written in the context of management's requirements and included in guidance issued by the Commission.

Assessing the design of controls is complicated as it requires management to identify controls and match the controls to risks and assertions, among other activities. In order to accomplish such an assessment, management will need to create some form of written documentation. The production of appropriate and adequate documentation is an important element of management's performance of an internal control assessment.

In addition, as we mention in our response to question 4, we believe that further guidance, in the form of examples, is needed for the smallest of companies in the area of segregation of duties. Although the COSO guidance for smaller companies addresses this area, we still believe more guidance is necessary on how the smallest companies could use monitoring controls and other controls, such as outsourcing key financial responsibilities to third parties, to effectively compensate for a lack of segregation of duties controls.

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

With respect to entity-level controls, we believe guidance that addresses the nature of entity-level controls and how they impact the nature, timing, and extent of management's assessment process would be very helpful. Additionally, we believe significant confusion exists as to whether the terms entity-level controls and company-level controls (as used in AS 2) refer to the same types of controls and how such controls differ from process-level controls. In our view, entity-level controls and company-level controls are synonymous.

Guidance on entity-level controls provided by the Commission should explain that most entity-level controls operate at the "company level" and are not designed to directly address risks associated with significant accounts and relevant assertions. While it is possible that certain entity-level controls (such as monitoring controls designed at a sufficiently precise level to detect material misstatements) may operate at the "account-level" and address specific risks associated with significant accounts and relevant assertions, such entity-level controls are not common in practice.

Since most entity-level controls are not designed to directly address the risks and potential misstatements due to errors or fraud associated with significant accounts and disclosures, an internal control assessment, by definition, would need to include the evaluation of relevant process or transactional level controls that relate to significant accounts and relevant assertions not otherwise addressed. For example, although the effectiveness of entity-level controls such as the "tone at the top" or an effective audit committee may impact <u>*the nature,*</u>

timing and extent of management's evaluation of process or transactional level controls, it would not eliminate the need for management to evaluate the effectiveness of relevant controls over revenue recognition. However, a company with a strong "tone at the top" and effective monitoring of controls may need less evidence about the effectiveness of controls at the process or transactional level.

In performing a top-down, risk-based assessment, the most efficient way to establish the population of controls to test is to include within the scope of management's assessment those entity-level controls that specifically address relevant assertions associated with significant account balances and disclosures. For example, financial analysis and other operational metrics, such as those designed to identify and investigate variances over a certain threshold, may be designed at a specific level of precision to address specific assertions related to significant account balances and disclosures by setting the threshold at an amount that would be material to the financial statements. However, reliance on these detective controls alone is generally not sufficient as they are 1) dependent upon the effectiveness of the underlying controls to produce reliable information to analyze and 2) unlikely to address all significant accounts and relevant assertions (as discussed above).

We believe that the challenge for all companies is determining the extent to which entity-level controls are designed at an appropriate level of precision to address the relevant assertions of the significant accounts.

16. Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of an error, should be used when assessing risks and identifying controls for the entity? If so, what factors should be addressed in the guidance? If so, how should that guidance reflect the special characteristics and needs of smaller public companies?

Guidance with respect to how management should approach the identification of significant accounts and the relevant account-level risks that impact financial reporting, including the use of quantitative and qualitative factors, would be extremely helpful, and would be critical in assisting management determine the scope of their assessment. While quantitative assessments are generally more familiar to management and auditors, qualitative assessments are often highly judgmental and less familiar in practice.

We believe that in order to ensure a consistent approach among issuers, the guidance should explain that an account is significant if it is: (1) quantitatively material to the financial statements; or (2) affected by qualitative factors that increase the risk of material misstatement. In addition, the guidance should provide typical examples of qualitative factors to consider.

We believe that the consideration of quantitative and qualitative factors should be the same, regardless of the size of the company. Accordingly, in determining the scope of management's assessment, guidance regarding "special characteristics and needs of smaller public companies" is not necessary.

17. Should the Commission provide management with guidance about fraud controls? If so, what type of guidance? Is there existing private sector guidance that companies have found useful in this area? For example, have companies found the 2002 guidance issued by the AICPA Fraud Task Force entitled "Management Antifraud Programs and Controls" useful in assessing these risks and controls?

We believe guidance to help issuers better understand the nature of antifraud controls and how they interact with other controls would be beneficial. While some entity-level controls like whistle-blower hotlines may be specifically focused on anti-fraud, we do not consider "fraud controls" to be a separate set of controls, but rather they represent those existing controls within the company's system of internal control over financial reporting that are integral to addressing the risk of fraud.

We believe that the SEC should provide a list of available antifraud tools and publications including the guidance issued by the AICPA Fraud Task Force entitled "*Management Antifraud Programs and Controls*."

18. Should guidance be issued to help companies with multiple locations or business units to understand how those affect their risk assessment and control identification activities? How are companies currently determining which locations or units to test?

We believe guidance should be developed to assist issuers with multiple locations or business units understand how they affect their risk assessment and control identification activities. We believe the guidance should assist management in determining how to approach its assessment in order to achieve its objective of identifying material weaknesses rather than merely focusing on *coverage*, which could ultimately lead to an incorrect assessment that there are no material weaknesses.

19. What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at the individual account or transaction level? If applicable, please provide specific examples of types of entity-level controls that have been useful in reducing testing elsewhere.

As discussed in question 15, guidance on entity-level controls should explain that most entity-level controls operate at the "company level" and are not designed to directly address risks associated with significant accounts and relevant assertions. While it is possible that certain entity-level controls (such as monitoring controls designed at a sufficiently precise level to detect material misstatements) may operate at the "account-level" and address specific risks associated with significant accounts and relevant assertions, such entity-level controls are not common in practice. Further, effective entity-level controls (such as specific financial analysis used as monitoring controls) that operate at the "account-level" are not very common. Entity-level controls that do not directly address the significant accounts and relevant assertions can not eliminate the need to evaluate and test the controls that do address significant accounts and relevant assertions; however, the effectiveness of entity-level controls can impact the nature, timing and extent of testing of process-level controls.

20. Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of controls, such as on-going monitoring activities, be useful? What are some of the sources of evidence that companies find most useful in ongoing monitoring of control effectiveness? Would guidance be useful about how management's daily interaction with controls can be used to support its assessment?

We believe that guidance regarding how management's assessment can be based on evidence other than that derived from separate evaluations would be useful.

Under the COSO framework, management can evaluate internal control through a combination of on-going monitoring activities and separate evaluation-type testing. Confusion has arisen on the part of management around the use of these terms, how to use on-going monitoring and separate evaluation-type testing effectively, and what evidence is needed under each type of monitoring to provide sufficient evidence of operating effectiveness of controls.

The guidance should explain how and when to effectively use on-going monitoring and separate evaluation-type testing methods to evaluate the company's internal control.

We also suggest clarifying that in order to be an effective source of evidence, on-going monitoring activities (often through management's daily interactions) should be supported by documentation and evidence of the following:

- What the on-going monitoring activities consist of;
- Process for communicating findings (regardless of whether there are exceptions identified);
- How exceptions, when identified, are evaluated and resolved.

21. What considerations are appropriate to ensure that the guidance is responsive to the special characteristics of entity-level controls and management at smaller public companies? What type of guidance would be useful to small public companies with regard to those areas?

As discussed in the answers above to questions 15 and 19, entity-level controls can be used to reduce the need for testing at the individual account or transaction level, if they address the relevant assertions of significant accounts. This is true regardless of the size of the company. In a smaller company, it might be the case that entity-level controls are effectively designed to address specific assertions related to significant accounts. However, the same is true at a larger public company.

In addition, guidance as to the competencies needed and segregation of duties that should be achieved at the management level would be useful as noted in previous responses.

22. ***In situations where management determines that separate evaluation-type testing is necessary, what type of additional guidance to assist management in varying the nature and extent of the evaluation procedures supporting its assessment would be helpful? Would guidance be useful on how risk, materiality, attributes of the controls themselves, and other factors play a role in the judgments about when to use separate evaluations versus relying on ongoing monitoring activities?***

We believe that guidance regarding the use of separate evaluation-type testing versus relying on ongoing monitoring activities would be useful to management. Such guidance should explain how the use of on-going monitoring or separate evaluations as a basis for management's assessment will depend upon the nature of the control, the risks associated with the control, the frequency of its operation, the sources of information about the control, among other factors.

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

We believe that it would assist management to have guidance on the timing of management testing of controls and the need to update evidence and conclusions from prior testing to the assessment "as of" date. Management's assertion regarding the effectiveness of internal control over financial reporting is provided "as of" the date of the company's fiscal year end. However, the evidence management gathers to support such an assertion may be gathered throughout the year and then updated as of year end to support management's assertion as of that date.

We also believe that it would be helpful if the guidance addressed situations that might require procedures to update evidence of operating effectiveness to the "as of" date (e.g., when there are changes in the organization or its controls). In addition, it would be helpful to provide guidance on the nature and extent of update testing and how entity-level controls might affect the nature and extent of such testing (e.g., the extent of ongoing monitoring activities).

24. ***What type of guidance would be appropriate regarding the evaluation of identified internal control deficiencies? Are there particular issues in evaluating deficient controls that have only an indirect relationship to a specific financial statement account or disclosure? If so, what are some of the key considerations currently being used when evaluating the control deficiency?***

Management and auditors should evaluate deficiencies in the same manner using the same criteria. AS 2 contains the governing standard surrounding the evaluation of internal control deficiencies for auditors. Management guidance with respect to evaluating deficiencies should be based on the same criteria.

A Framework for Evaluating Control Exceptions and Deficiencies[1] developed by representatives from nine public accounting firms and a professor was a tool utilized by both issuers and auditors to assist them in evaluating deficiencies in the same manner. We believe this framework or a similar framework, updated for any revisions to AS 2, should continue to be used to ensure consistency and uniformity in the implementation of Section 404 by both issuers and auditors.

25. Would guidance be helpful regarding the definitions of the terms "material weakness" and "significant deficiency"? If so, please explain any issues that should be addressed in the guidance.

We do not believe more guidance, other than codifying the definitions in the PCAOB's May 16, 2005 guidance, would be useful. In fact, we believe that any further guidance may cause confusion.

26. Would guidance be useful on factors that management should consider in determining whether management could conclude that no material weakness in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the financial statement close process? If so, please explain.

We believe the Commission should develop guidance that management should follow in determining whether they can conclude that no material weakness in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the financial statement close process. The guidance that the Commission develops should be consistent with question 7 in the PCAOB's Staff Questions and Answers on *Auditing Internal Control over Financial Reporting* dated June 23, 2004 (Revised July 27, 2004).

27. Would guidance be useful in addressing the circumstances under which a restatement of previously reported financial information would not lead to the conclusion that a material weakness exists in the company's internal control over financial reporting?

Guidance in this area would be useful and is particularly needed with respect to restatements, when the company has a good process in place to arrive at a reasonable position that is later discovered to be the wrong conclusion and results in a restatement. Accordingly, we recommend that the Commission provide guidance and examples on the types of circumstances when a restatement was not caused by a material weakness.

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[1] *A Framework for Evaluating Control Exceptions and Deficiencies* may be accessed on AICPA CPCAF website at http://cpcaf.aicpa.org/ or directly at http://www.aicpa.org/cpcaf/download/Framework_Version3.pdf.

28. How have companies been able to use technology to gain efficiency in evaluating the effectiveness of internal controls (e.g., by automating the effectiveness testing of automated controls or through benchmarking strategies)?

Our members have observed that some companies have been able to gain efficiencies by using various forms of Sarbanes-Oxley compliance software as well as other automated software tools. These software tools have helped companies gain efficiencies by aiding them, among other things, in their scoping and testing strategies as well as assisting them in tracking issues and monitoring progress in completing management's assessment. We believe that by investing in these software tools, companies have been able to enhance the sustainability of effective and efficient maintenance of Section 404 requirements.

An area that could be significantly leveraged is continuous controls monitoring. While this area is generating interest, there is a shortage of general-purpose tools and software to effectively implement the concept. As this type of software matures, it likely will create opportunities to further automate testing of IT and other related controls.

29. Is guidance needed to help companies determine which IT general controls should be tested? How are companies determining which IT general controls could impact IT application controls directly related to the preparation of financial statements?

We believe general guidance is needed to help companies determine which IT general controls and application controls should be scoped into their assessment and tested. While we do believe guidance is needed, we do not believe that the guidance should be prescriptive in nature or that an exact checklist of the general computer controls and application controls to be tested can or should be provided.

31. Were the levels of documentation performed by management in the initial years of completing the assessment beyond what was needed to identify controls for testing? If so, why (e.g., business reasons, auditor required, or unsure about "key" controls)? Would specific guidance help companies avoid this issue in the future? If so, what factors should be considered?

Generally, our members observed that some issuers started at the most detailed level early in the process since they did not have the full benefit of the subsequent guidance that was issued (i.e., the May 16th Guidance). Since the issuance of this guidance, we believe that the level of documentation was properly adjusted with the development of a more efficient process. We do, however, believe management would benefit from additional guidance regarding documentation as discussed in the answers to questions 32 and 33 below.

32. What guidance is needed about the form, nature, and extent of documentation that management must maintain as evidence for its assessment of risks to financial reporting and control identification? Are there certain factors to consider in making judgments

about the nature and extent of documentation (e.g., entity factors, process, or account complexity factors)? If so, what are they?

We believe that guidance regarding the form, nature and extent of documentation that management must maintain would be very useful. As discussed in response to question 14 above, assessing the design of controls is complicated as it requires management to identify controls and match the controls to risks, assertions, among other activities. In order to accomplish such an assessment, management will need to create some form of written documentation. The production of appropriate and adequate documentation is an important element of management's performance of an internal control assessment.

Further, we believe that the documentation has value to management as it provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls. Such documentation will prove particularly valuable in contributing to efficiencies, among other things, when personnel change roles and responsibilities.

Lastly, the requirement that management's assessment of internal control over financial reporting must be subject to an audit drives a certain amount of formality of documentation for management. We believe that in order for management to adequately perform its assessment of risks to financial reporting and control identification, an appropriate level of documentation needs to be produced in support of those assessments. Accordingly, the guidance should provide some specific guidelines regarding the form, nature and extent of documentation necessary to support management's assessments. More specifically, we believe that the SEC and PCAOB need to be consistent with respect to the requirements for management documentation. Accordingly, the guidance issued by the SEC should be consistent with the management documentation requirements within AS 2.

33. What guidance is needed about the extent of documentation that management must maintain about its evaluation procedures that support its annual assessment of internal control over financial reporting?

We believe that the guidance should clarify that the level of documentation that management must maintain in support of its evaluation procedures of its annual assessment of internal control over financial reporting needs to be: (1) sufficient so that an officer who is certifying the financial statements, or other third party with sufficient expertise could follow the methodology and the conclusions reached based on the documentation, and (2) auditable. In addition, we believe that the documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached and should be appropriately organized to provide a clear link to the significant findings and issues.

Additionally, including record retention guidance on how long management should maintain such documentation is also recommended.

34. Is guidance needed about documentation for information technology controls? If so, is guidance needed for both documentation of the controls and documentation of the testing for the assessment?

Our response to this question is consistent with our response to question 33 above.

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We appreciate the opportunity to comment on the Concept Release. We are firmly committed to the development of additional guidance for public companies that both addresses the concerns of public companies and is in the public interest. We would welcome the opportunity to meet with you to clarify any of our recommendations.

Sincerely,

Susan S. Coffey, CPA
Senior Vice President – Member Quality and State Regulation
AICPA

cc: <u>SEC</u>
Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Annette L. Nazareth
Commissioner Kathleen L. Casey
Conrad Hewitt, Chief Accountant
John W. White, Director of Division of Corporation Finance

<u>PCAOB</u>
Mark W. Olson, Chairman of the PCAOB
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Willis D. Gradison, Member
Charles D. Niemeier, Member
Thomas Ray, Chief Auditor and Director of Professional Standards