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September 20, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington D.C.
20590

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

Dear Ms. Morris:

We are submitting this letter in response to Release No. 34-54122, Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, which requests comment on the development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting ("ICFR") under Section 404 of the Sarbanes-Oxley Act of 2002.

General observations

1. The Commission and the Public Company Auditing Oversight Board (the "PCAOB") should work together to produce both (a) amendments to Auditing Standard No. 2 ("AS-2") and (b) Commission guidance on its Section 404 rules or amendments to those rules.[1]

[1] We refer in this letter to "the Section 404 rules" as shorthand for the rules governing management's obligation to evaluate ICFR annually, to report on that evaluation and to provide an auditor report on ICFR—*i.e.*, Rule 13a-15(c) and Item 308(a) & (b) of Regulation S-K. We do not mean to include the rules defining ICFR (Rule 13a-15(f)), requiring the establishment and maintenance of ICFR (Rule 13a-15(a)) or governing reporting of changes in ICFR (Rule 13a-15(d) and Item 307 of Regulation S-K).

The most significant difficulties in complying with the Section 404 rules result from AS-2 and from the interaction between management's performance of its obligations and the auditors' performance of their obligations. These difficulties can only be addressed successfully in a coordinated process that results in both amendments to AS-2 and Commission guidance.

2. Unless it does so in coordination with PCAOB amendments to AS-2, the Commission should not try to reduce the general burdens of compliance by amending the Section 404 rules, or by adopting guidance for management under those rules. The Commission provided general guidance in its May 2005 release on the subject. Unless AS-2 is concurrently amended, rulemaking and further guidance will be ineffectual, and they present a risk of unintended consequences or deepened confusion. (There are, however, some related changes that we believe the Commission should undertake, as described in paragraphs 8-11 below.)

Changes in AS-2

3. A central goal of a coordinated amendment process would be to encourage, or even require, auditors to rely on certain management determinations regarding ICFR. Unless this is successful, the balance of incentives will continue to undermine the "top-down, risk-based" approach advocated in the May 2005 releases of the Commission and the PCAOB. Commission guidance under the Section 404 rules and amendments to AS-2 should together establish a mechanism or process that provides a safe harbor for auditors to rely on management representations, at least with respect to specified problem areas under AS-2 such as documentation requirements, reliance on internal audit, reliance on third parties, rolling or rotating assessment and reliance on cumulative knowledge. The Commission and the PCAOB should not, however, provide a detailed or prescriptive list, which experience suggests will be incomplete and will foster rigid application. Nor should they require or stimulate any additional public disclosure, which experience suggests will be formulaic and uninformative.

4. Paragraph 140 of AS-2, which identifies certain circumstances as "strong indicators" of material weakness, should be amended to eliminate (a) restatement to correct errors, (b) identification by the auditor of a material misstatement in the current period and (c) ineffective audit committee oversight. The inclusion of these factors was understandable, but they have proven to be a source of mischief. In different ways, each has perverse effects on the financial reporting process and on the relationship among management, the audit committee and the auditors.

5. The definitions of material weakness and significant deficiency in AS-2 effectively require management and auditors to search for low probability, low magnitude

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(For simplicity, we generally refer in this letter to the rules applicable to a domestic issuer reporting on Form 10-K pursuant to Section 13(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), but our remarks apply equally to the similar rules for small business issuers, foreign private issuers, and issuers reporting pursuant to Section 15(d) of the Exchange Act.)

control deficiencies. We agree with the proposal advanced by Professor Grundfest to address this problem.[2]

Foreign private issuers

6. The Commission should temporarily or permanently exempt the reconciliation to U.S. GAAP[3] from the scope of the Section 404 rules. The U.S. GAAP reconciliation presents specific problems because it is not typically integrated with the financial reporting systems on which the primary GAAP financial statements rely. The issue is *sui generis*, and the balance between burdens and investor protection in applying Section 404 is significantly different for the U.S. GAAP reconciliation than it is for the primary financial statements. This exemption should be adopted promptly, before the first round of annual reports by foreign private issuers that are required to comply with the Section 404 rules.

7. AS-2 and the Section 404 rules should be amended so that ICFR with respect to the U.S. GAAP reconciliation is addressed separately from ICFR with respect to the primary financial statements.

Changes in other disclosure rules

8. The Commission should provide an instruction under the rules governing disclosure of changes in ICFR,[4] to clarify that a material change is only required to be disclosed if (a) the effect is adverse or (b) it remedies a previously reported material weakness. We believe the better view is that the rules do not currently require reporting a routine improvement, the remediation of a significant deficiency, or the remediation of a material weakness that was identified and remedied before it was required to be reported. In our experience, however, registrants are extremely conservative on these matters, partly because they are covered in the "Section 302" certifications.[5] It would accordingly be helpful for the Commission to provide clarity.

9. The Commission should revisit the definition of disclosure controls and procedures ("DC&P"),[6] to reduce the overlap between the definitions and reporting requirements applicable to DC&P and ICFR, which result from their history. Whether or not it does so, the Commission should amend the rules governing the evaluation of effectiveness of DC&P and the

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2 Joseph A. Grundfest, *Fixing 404*, forthcoming in the Michigan Law Review, May 1, 2006 draft available at http://www.sec.gov/spotlight/soxcomp/jagrundfest050106.pdf.

3 Item 17(c)(2) of Form 20-F.

4 Item 308(c) of Regulation S-K. There would be no change to Rule 13a-15(d), requiring an evaluation of changes in ICFR.

5 Paragraph 4(d) of the certification set forth in Item 601(b)(31) of Regulation S-K. There would be no need to amend the certification language, but it would be interpreted in light of the proposed instruction.

6 Rule 13a-15(e).

related disclosures,[7] to exclude ICFR from the scope of the required quarterly evaluation of DC&P, since ICFR is not otherwise required to be evaluated more often than annually. The partial overlap between two separate sets of evaluation and reporting requirements is unnecessary and confusing.

10. The Commission should provide public guidance discussing the consequences of a disclaimed or qualified auditors' report on ICFR. Specifically, the Commission should state that (a) the inclusion of a disclaimed or qualified auditors' report on ICFR in an annual report is permitted by the Commission's rules,[8] and (b) management may conclude that its assessment of ICFR is complete, even if the auditors provide a disclaimed or qualified report on ICFR. This would address uncertainties that affect a handful of companies with serious reporting difficulties. The Commission should also state that the failure of an annual report to comply with the Section 404 rules (at least in the case where the report on the assessment of ICFR is incomplete or the auditors' report is disclaimed or qualified, and appropriate supplemental disclosures are provided), while it will make short-form Securities Act regulation unavailable, does not (a) result in the unavailability of Form S-8 or Rule 144, (b) require a securities exchange to commence delisting procedures or (c) result in a violation of the reporting requirements of Section 314(a) of the Trust Indenture Act of 1939, as amended. This would eliminate the possibility of certain inappropriate and unintended consequences of ICFR reporting difficulties that have serious adverse effects on registrants and third parties.

11. The Commission should amend its rules to eliminate inconsistencies that have arisen because of the order in which various elements of the rules, and AS-2 itself, were adopted. In addition to clarifying the definition of DC&P, as discussed above, these amendments would (a) conform the description of the auditors' report in the Commission's rules to the requirements of AS-2,[9] and (b) define "material weakness" and "significant deficiency" in the Commission's rules.

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7 Rule 13a-15(b) and Item 307 of Regulation S-K.

8 Item 2-02(f) of Regulation S-X is clear on its face that it permits a disclaimed or qualified opinion, but there is confusion among practitioners that is partly attributable to uncertainty about the views of the Commission and its staff.

9 Rule 2-02(f) of Regulation S-X and Item 308(b) of Regulation S-K refer to an attestation report.

We thank you for the opportunity to submit this comment letter. Please do not hesitate to contact Nicolas Grabar or Leslie Silverman in New York (212-225-2000) if you would like to discuss these matters further.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON