INSTITUTE OF MANAGEMENT ACCOUNTANTS
Advancing the Profession™

February 13, 2007

Re: SEC File No. S7-24-06 and PCAOB Rulemaking Docket No. 021

The **Institute of Management Accountants** applauds the efforts made to date by the SEC and PCAOB to make SOX implementation more cost-effective and practical while still protecting investors. We are pleased to continue sharing our extensive global research and recommendations with the SEC, PCAOB, professional accounting associations, the trade media, the U.S. Chamber of Commerce, Members of Congress and other security regulators around the world interested in this issue.

IMA's conclusion, after careful consideration of the SEC and PCAOB December 2006 proposals, is that significant additional actions are required to optimize the cost/benefit equation. This letter contains a **main body (7 pages)** and **3 attachments** (Attachment 1 – IMA Risk-Based Framework; Attachment 2 – Technical Analysis of SEC Guidance; Attachment 3 – Technical Analysis of PCAOB draft audit standard).

We have summarized below the five interrelated issues that we believe remain to be addressed, together with our technical analysis and recommendations for change. These five issues have been identified through extensive research and careful consideration of the reasons cited by Canada, the EU and Japan for not fully adopting the current U.S. SOX regulations.

- **Issue 1**: Two rule books (SEC, PCAOB) for the same assessment task – a recipe for unintended confusion and complexity. In short, without major changes to the draft rules ASX/5 will likely replace AS2 as management's de facto standard.
- **Issue 2**: The proposals are not risk-based by global risk management standards, reducing the benefits that could accrue from an assessment approach that focuses on identifying specific significant risks and understanding residual risk status.
- **Issue 3**: The current "quality bar" of zero material defects in draft financial statements is expensive without significantly increasing investor protection. This situation is compounded by the current requirement that identification of even one material control weakness requires management publicly report ineffective ICFR.
- **Issue 4**: The draft proposals call for elimination of the audit opinion on management's ICFR assessment process and retention of the auditor's subjective opinion on ICFR effectiveness. While some agree with this interpretation of the Act, it is contrary to IMA's and IIA's publicly reported views, some early comment letter responses, and the current stance of the U.S. federal government, Japan, Canada, and the EU capital market regulatory bodies.
- **Issue 5**: The draft proposals are still not practical for smaller public companies – all four issues listed above disproportionately impact smaller public companies.

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Issue #1/Impact	*What Needs to Change*
Two rule books for the same task – a recipe for unintended confusion and complexity. The SEC proposed rule is high level and broad to the point of being vague on minimum expectations in a number of key areas, including but not limited to the need to specifically identify, document and assess major risks and residual risk status. The PCAOB standard is more granular, prescriptive and control focused. The PCAOB rules constitute the "exam grading rule book" auditors must use or risk severe PCAOB sanctions and increased litigation exposure. Because under the current proposals auditors will still determine ICFR pass/fail rating, PCAOB rules will likely continue to be the de facto rule book for management that want a passing grade. This is a sub-optimal situation and contrary to what we believe is the true intent of the Act. A few examples of the more significant differences and/or inconsistencies that exist between the SEC and PCAOB proposals include: 1. **Control Environment Evaluation** – ASX/5 indicates that the auditor should assess the company's control environment and lists 5 specific areas for attention. The SEC guide makes passing reference to the concept but does not provide specific evaluation criteria or any information on what would constitute a failing grade on control environment. 2. **Identifying Significant Accounts** – ASX/5 lists 9 specific factors that should be used to identify significant accounts. SEC guidance has no parallel guidance for management. 3. **Strong Indicators of Material Weakness** – ASX/5 lists almost 3 pages of specific factors that are relevant to determining if a material weakness is present. The SEC guidance starting on page 41 provides similar but different criteria to be used by management.	**The SEC guidance should be the only ICFR "how to" assessment guidance.** Management teams that follow SEC interpretative guidance should be fully entitled to say they have done what is expected of them without fear of being overruled and/or contradicted by the more prescriptive, granular and control-centric PCAOB rules. Although the SEC proposed rule states that this result is indeed a goal, we believe that management will have to use and conform to the PCAOB rules in order to satisfy their external auditors. When revisions to the draft PCAOB standard are done following the comment period, we recommend all sections that describe how to complete an assessment of ICFR should be deleted from the Standard and **auditors directed to use the same SEC interpretative guidance used by management.** The focus in ASX/5 should be solely on audit considerations. However, the SEC primary ICFR assessment guidance should be revised to reflect IMA recommendations made in Issues 2-5 below.

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Issue #2/Impact	*What Needs to Change*
The SEC proposed rule and PCAOB revised standard are still not top-down/risk-based by global risk management standards. If these documents were truly top-down/risk-based users would be encouraged and allowed by the SEC to use globally accepted risk assessment frameworks such as AS/NZ 4360, COSO ERM, or the IMA top-down/risk-based ICFR assessment framework proposed in September. Application of any of these approaches would require that assessments start by formally documenting and assessing significant risks at both the entity and account/note level - risks that are already known to have resulted in materially unreliable financial statements. We would argue that this level of guidance is the appropriate balance between ambiguity at one extreme and prescription at the other. Although there is some reference to this step in the SEC guidance this step is not emphasized sufficiently or clearly enough. No examples or guidance on how to complete this step are currently in either set of draft rules. It is also important to note that nowhere in the SEC or PCAOB draft guidance do the authors use the words "residual risk" or "residual risk status". Identification and assessment of residual risk is a key element of any true risk-based assessment methodology and a cornerstone of all internationally recognized risk management standards. For example, the PCAOB proposed standard on page 5 directs auditors to start by examining and testing company level controls without first carefully identifying and assessing entity-level risks. In contrast, the SEC guidance alludes to starting with risks but does not take advantage of globally accepted methods to provide some level of practical "how to" guidance.	**Both the SEC and PCAOB proposals should be rewritten to reflect and require a true top-down/risk-based ICFR assessment approach. We are seeking "balance, not bias" between risk and controls-based methods.** A true top-down/risk-based approach starts with management identifying major risks at the entity level that are already known to be primary causes of material financial statement errors. Controls in place to mitigate these statistically predictable risks are then documented and specifically linked to the risks identified. Management must decide whether to mitigate the significant risks identified using controls, share or transfer risks using vehicles like outsourcing and/or insurance, accept the risk, or avoid the risk entirely. Residual risk status, including current detected error rates, is identified, documented and assessed by both management and auditors. Auditors are entitled and expected to adjust their audit approach to fully compensate for any retained ICFR residual risks the company has decided to accept. In severe cases where the ICFR systems in place exhibit levels of residual risk totally unacceptable to the company's auditor, they have the right and ability to refuse to provide an opinion on the company's financial statements and/or resign from the engagement. Well-run and tightly controlled companies will be rewarded with a lower cost of capital and significantly lower audit fees relative to companies that prepare poor quality ICFR assessments and/or accept higher levels of ICFR residual risk. **IMA's top-down/risk-based ICFR framework is included as Attachment 1 to this letter with greater detail available at**: www.sec.gov/comments/s7-11-06/s71106.shtml

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Issue #3/Impact	*What Needs to Change*
The draft financial statement and ICFR "quality bars" are set too high, resulting in high cost without a commensurate increase in investor protection. Current SEC and PCAOB regulations require management produce draft financial statements with zero material defects for their external auditors or risk being publicly labeled in SEC filings as having "ineffective" ICFR. This is a complex issue that is directly linked to Issue 4 below. We believe that retaining the audit opinion on control "effectiveness" combined with the high quality bar on draft financial statements and ICFR is a dangerous mix. It is important to note that zero material defects is a level of draft financial statement quality and ICFR that is not currently expected, or required, by capital market regulators anywhere else in the world, including Canada, the UK, Europe or Japan. While zero material defects in ICFR and financial statement drafts prepared by management is a laudable "goal", we believe that it is a level of perfection that will result in the U.S. being at a competitive global disadvantage relative to countries viewed as having similarly reliable corporate governance systems without this requirement. In January, 2007 the McKinsey Report "Sustaining New York's and the US' Global Financial Services Leadership" study referenced the UK regulatory approach of discussing (draft) issues constructively and not penalizing companies for proactively coming forward with a potential issue; by contrast, in the U.S. "executives by and large are hesitant to raise even minor problems with regulators for fear that simply broaching the subject will lead to immediate enforcement action or, worse yet, a highly charged public prosecution".	**Allow companies to have ICFR systems that are less expensive than zero material defect systems. Require, via specific PCAOB auditing standards, that auditors adjust their work to fully compensate for control deficiencies identified by management and, in cases where management's ICFR assessment work was not rated as fully reliable, their own supplemental ICFR analysis. Auditors should publicly report on the reliability of management's ICFR assessment process (see Issue 4).** We believe that the primary goal of management's assessment of ICFR should be to clearly identify and candidly report areas of significant residual risk (using robust quality management systems) to the company's audit committee and external auditors. Using this type of approach external auditors audit and report on the reliability of the risk and control assessment <u>process</u> maintained by management. Auditors are required to modify the scope and extent of their substantive audit work to compensate for any areas of residual risk currently being accepted by the company's management and audit committee. Any errors identified in the draft financial statements by the company's auditors must be corrected by management prior to filing the accounts with the SEC. The frequency and magnitude of auditor detected errors in drafts prepared by management should be an important input to auditor opinions on the reliability of management's ICFR assessment process. A Glass & Lewis research study published in June 2005 provided clear evidence that literally hundreds of U.S. public companies claimed to have fully effective disclosure and ICFR systems right up to the point in time auditors had to provide an opinion on the reliability of their assessment work. At that point in time management, under the zero material defect rule, had to acknowledge material ICFR deficiencies existed. Good regulation should result in providing <u>positive</u> incentives to management to be candid and proactive in identifying issues in the financial statement drafting process.

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Issue #4/Impact	*What Needs to Change*
Misapplication of what we believe was Congress' intent in Section 404 (b), resulting in external auditors duplicating management's accountability for controls testing and assessment. Section 404 (b) of the Act states: "With respect to the internal control assessment required by sub-section (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer …". We do not believe that it was the intent of Congress to require that a company's auditor provide their own subjective view on whether control is or is not "effective". IMA research and other studies demonstrate that current ICFR standards and frameworks are not mature enough to produce repeatable conclusions on controls effectiveness. In other words, we do not believe that any framework is "fit for purpose" in terms of the SEC's four suitability criteria which include repeatability, sufficiently complete, free from bias and relevance. Revenue generation opportunities combined with a litigious environment provide tangible incentives for auditors to "raise the control bar". While this is a contentious issue, we fully support what we believe is the true intent of 404 (b) – an independent report on whether management is taking the responsibility assigned in section 404 (a) seriously and conscientiously. There is growing support for IMA's stance on this issue: 1. Global regulatory regimes that have carefully studied the U.S. SOX regime and chosen not to include the audit opinion on effectiveness (e.g., Japan, Canada and the U.K.), 2. The public position taken on the issue by the Institute of Internal Auditors, and 3. The comment letter from The Alamo Group, a $400M accelerated filer.	**Eliminate the costly and subjective audit opinion on controls effectiveness but retain/strengthen the audit opinion on management's assessment process in the context of a true risk-based approach**. Our basis for this recommendation is that current frameworks are not fit for purpose in making the pass/fail effectiveness conclusion, the process is costly and inefficient, it de-emphasizes management's accountability, and further increases the enormous litigation exposure of auditors (passed on to management in the form of higher fees). Additionally, an audit of management's (true) risk-based assessment process is more likely to uncover fraud (leading indicator of material weakness vs. lagging indicator of controls effectiveness). We recommend instead that the company's auditors audit and report on whether the company's management "has conformed, in all material ways, with SEC requirements to complete a top-down/risk-based ICFR assessment and reported the results to the company's audit committee and to us, the company's external auditors". This process would include careful analysis of residual risk status (the risk remaining after considering risk treatments) by both management and external auditors. It is important to note that the need for a redefined Section 404 (b) is building globally. Preliminary evidence suggests that, unfortunately, in countries where there is a requirement that management publicly report on ICFR – but, without a requirement for the auditor to report on the quality of that work – some companies do very little formal assessment work to support their public representations. The situation is even worse in countries that have no mandatory requirements for management to assess and report on ICFR. Canadian securities regulators have explicitly acknowledged this very real risk and are currently monitoring the situation to determine if corrective steps are necessary. We believe that audit opinions issued should reference the revised SEC guidance for management as the benchmark.

Issue #5/Impact	*What Needs to Change*
The draft regulations are still not practical or scaleable for smaller public companies. ("SPCs") As one example, control structures capable of achieving zero material defects in draft statements are very expensive - money that is often better directed in SPCs to growing the company and producing increased shareholder value. All four issues described above disproportionately impact smaller public companies. It is important to note that the AICPA in the U.S. and audit standard setters in countries like Canada, the UK and Europe continue to believe and assert, correctly or otherwise, that auditors can produce a level of audit opinion quality and reliability on financial statements on par with SOX audit opinions without the use of a SOX-like assessment of ICFR. Investors are not currently being explicitly told that there is any differential in audit opinion quality on audited financial statements (e.g., non-accelerated vs. accelerated, public companies vs. private, etc). There is currently no empirical research we are aware of that validates the premise of differential audit quality. The recent study commissioned by the City of New York prepared by McKinsey & Company has recommended that U.S. listed SPCs be allowed to "opt out" of current PCAOB audit requirements but be required to make conspicuous disclosure of the risks that come with less emphasis on ICFR and potentially lower audit opinion reliability. We respectfully do not agree with the study suggestion that SPCs be allowed to opt out of SOX because of the implications of a "grade B" audit opinion, but we do understand the motivation. It is important to note that the U.S. government has, itself, not adopted a requirement that auditors provide opinions on the effectiveness of ICFR in federal departments and agencies at this point.	**We believe that if all four primary issues above are addressed "disproportionate *benefits*" will accrue to smaller public companies**: one set of assessment rules with management in the lead; a practical and scalable risk assessment process; and, setting the quality bar for material defects in financial statement drafts at a reasonable level combined with auditors opining on the assessment process (and not the pass/fail subjective audit opinion on effectiveness). In addition to generally increasing the practicality of the SOX rules through the reforms we are proposing, the skills and tools necessary to complete true risk-based/top-down assessments can be used in companies of all sizes and types not just for ICFR. They can be applied to other key areas like product quality, customer service, safety, cost control, revenue generation and other areas key to longer term business success. This helps improve the overall ROI of a true risk-based approach for all types of organizations. With due respect to the preeminent committees that have examined this issue, we do not believe that any public company should be exempted from section 404(b) of the Act but do believe the interpretation of the section should be redefined. Investors should be provided with information on the quality of the assessments prepared by management – a very good indicator of ICFR assessment skill and "tone at the top". This should include assessments made on the quality of operations driven by a robust QMS (Quality Management System). The mantra "building quality in" better enables sustainable financial reliability. Additional research on audit opinion reliability with, and without, ICFR assessment and audit assurance on management's ICFR assessment process should be initiated by the SEC, PCAOB, and/or the AICPA as soon as possible. If audit opinions produced under the SOX reporting regime prove to be no more reliable than Canadian or UK audit opinions that do not require similarly costly audit assurance on ICFR, Congress should reevaluate the cost/benefit of section 404(b).

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IMA solutions-oriented resources available to practitioners include:

1. **IMA Research Study**: "Internal Control: COSO 1992 Control Framework and Management Reporting on Internal Control: Survey and Analysis of Implementation Practices", Professor Parveen Gupta, LLB, Ph.D.

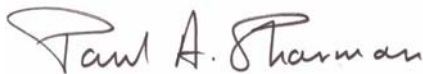
2. **IMA Discussion Paper**: "A Global Perspective On Assessing Internal Control Over Financial Reporting" submitted to the SEC 9/15/06.

3. **IMA Statement on Management Accounting**: "Enterprise Risk Management: Frameworks, Elements and Integration" released January 17, 2007. Professor William Shenkir, Ph.D.,CPA, Professor Paul L. Walker, Ph.D.,CPA. A second SMA focused on ERM Tools and Techniques ("how to") will be available in the early Spring of 2007.

The IMA is a global organization representing a diverse constituency and as such the observations and recommendations in this letter are meant to have broad application in the private and public sectors in countries around the world. This comment letter went through a formal exposure process with the IMA membership.

We would be pleased to assemble our senior team (including practitioners) and provide further details on the issues we have identified and corrective actions we have recommended. As always, the IMA stands ready to share transformational solutions to SOX 404 implementation that protect and grow shareholder investments, allow company management to get on with the business of doing business, and restore U.S. global competitiveness for sustained long term growth.

Sincerely,



Paul A. Sharman, ACMA
President and CEO

Jeffrey C. Thomson
Vice President of Research & Applications Development

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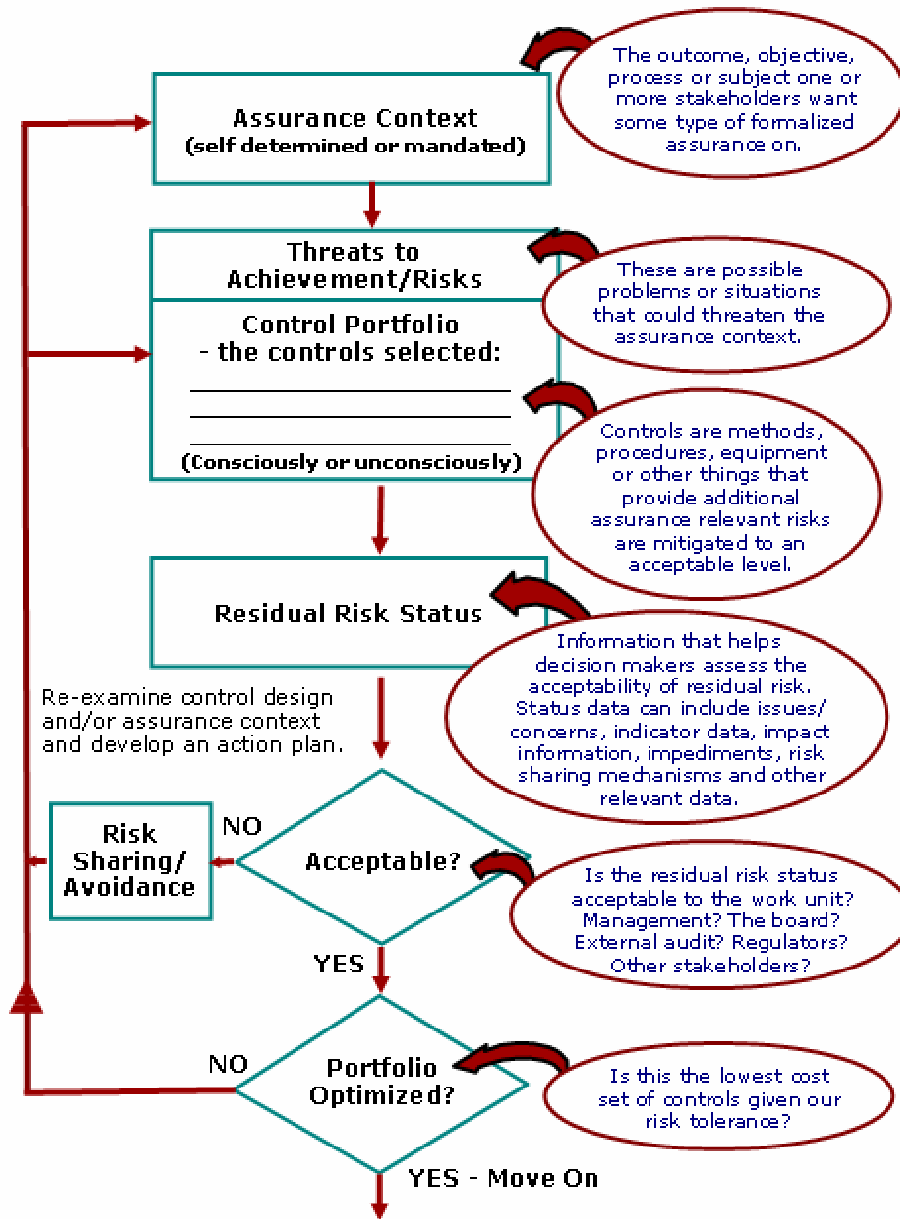
Attachment 1 – IMA Global Risk-Based Framework

Core Components of a Risk-Based Approach



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Attachment 2

IMA Technical Analysis & Commentary
SEC December 2006 Exposure Draft for Comment
Management's Report on Internal Control over Financial Reporting

Organized in ascending page order – IMA selected topic headings

PRIMARY AIM OF THE INTERPRETATION

SEC Draft Guidance:

Page 1 SUMMARY section states "The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting".

IMA Analysis/Comment:

With respect, this draft does not accomplish that aim, at least in terms of methods and terminology generally used and understood in risk management.

The words "top-down/risk-based" have been used frequently in guidance issued by the SEC and PCAOB over the past 3 years. A major problem appears to be definitional – what do the SEC authors actually mean by the term "top-down/risk-based"? What is clear from a detailed analysis of the document is that when the term "top-down/risk-based" is used, it is not consistent with globally accepted risk management assessment methods or standards, or in the sense described in the 2004 COSO ERM framework.

Although there are no references anywhere in the guidance that discloses the source of the SEC/PCAOB interpretation of the term "top-down/risk-based", the evidence suggests that the term has been interpreted primarily drawing from traditional U.S. audit literature and guidance issued over the past 30 years. If a guess was to be ventured as to the primary interpretation source, it appears to most closely align with notions espoused in how to evaluate "audit risk", the risk of giving an incorrect audit opinion, and the type of steps that should be done during the audit planning phase. Auditing methodologies in use today have not in any significant way adopted internationally accepted approaches to risk management, approaches that focus heavily on determining risk likelihood and consequence, and careful, formal monitoring of the status and acceptability of residual risk. Litigation risk related to adopting a true risk management approach to audits may be at the root of the non-adoption of true risk management methods.

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