

THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.



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February 26, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, DC 20549-1090

Re: File No. S7-24-06

Dear Ms. Morris:

The Financial Services Roundtable¹ appreciates the opportunity to comment on the Securities and Exchange Commission's proposed interpretive guidance for management regarding internal control over financial reporting ("ICFR"), and related proposed regulatory amendments.

The proposed interpretive guidance is intended to assist management in complying with Section 404 of the Sarbanes-Oxley Act, and the SEC's implementing regulations. While Section 404 has produced some benefits to the public and to reporting companies, the excessive costs, both in terms of fiscal outlays and diversion of management time and attention, have far outweighed the benefits. While the administrative burden faced by smaller companies is particularly severe, companies of all sizes have been adversely affected by the overly prescriptive implementation of this requirement. Further, costs have also affected the competitive position of U.S. markets, and have been noted as one of the leading reasons why some companies have decided to list in overseas exchanges.²

The SEC was made aware of these and other concerns through public roundtable discussions held in 2005 and 2006, and through an Advisory Commission study and report issued on April 23, 2006. The SEC is to be congratulated for organizing these discussions and for considering steps to ameliorate the concerns raised by the public.³ This proposed interpretive guidance to management is the latest step in the SEC's process of reducing the excessively burdensome, costly and overly prescriptive nature of Section 404 implementation with a more risk focused and principle based approach. The Financial Services Roundtable applauds the efforts of the SEC in this regard, and believes that this proposal is a very good step in the right direction. The remainder of this letter will highlight some particular issues in the proposal that the Roundtable believes can be improved upon.

¹ Insert.

² Cite.

³ See, e.g. SEC Statement on Implementation of Internal Control Reporting Requirements (May 16, 2005).

1. Management Requirement

The proposed guidance provides that management is to issue an annual report of its assessment of whether there is a material weakness in internal controls over financial reporting. A material weakness exists if there is a reasonable possibility that a material misstatement will not be prevented or detected. This language could be interpreted as requiring a management finding that “there is no reasonable possibility” of a material misstatement in a financial report. However, the proposal goes on to explain that a management evaluation is sufficient if it provides a “reasonable basis” for the assessment, and that the goal of the evaluation is to determine if ICFR is effective in providing “reasonable assurance” regarding the reliability of financial reports.

The proposal also explains that “reasonable assurance” does not mean “absolute assurance,” and that internal controls cannot prevent or detect all misstatements. The SEC notes that Section 404 is similar to the requirements in the Foreign Corrupt Practices Act where the SEC has taken the position that reasonable assurance is the level of assurance that would satisfy prudent officials in the conduct of their own affairs.

The Roundtable supports the standard for ICFR as explained in the proposal, and believes that the management evaluation should provide a level of assurance that would satisfy “prudent officials in the conduct of their own affairs” and that the internal controls are sufficient if they provide a “reasonable basis regarding the reliability of financial reports.”

2. Incorporation of the Entire FCPA Policy Statement

The preamble to the proposed guidance notes that Section 404 is legislatively similar to the internal control requirements found in the Foreign Corrupt Practices Act (“FCPA”) in that both statutes require internal controls that provide “reasonable assurance” over the accuracy of a company’s financial activities. In 1981, the SEC issued a Policy Statement with respect to the FCPA,⁴ parts of which are discussed in the preamble. The Roundtable urges that the SEC make clear that the entire 1981 Policy Statement applies to the concept of “reasonable assurance” as used in the Sarbanes-Oxley Act as well as the FCPA.⁵

⁴ SEC Release No. 34-17500 (January 29, 1981).

⁵ With respect to the concept of “reasonable assurance,” the Policy Statement explained:

The test of the internal control system is whether, taken as a whole, it reasonably meets the statute’s specified objectives.

Reasonableness, as a standard, includes a consideration of feasibility. One measure of reasonableness of a system relates to whether the expected benefits from improving it would be significantly greater than the anticipated costs of doing so. Thousands of dollars should not be spent conserving hundreds.

There is an almost infinite variety of control devices which could be utilized in a particular business environment. Thus, considerable deference should be afforded to the company’s reasonable business judgments in this area. The selection and implementation of particular control procedures, so long as they are reasonable under the circumstances, remain management’s prerogatives and responsibilities.

3. Focus on Material Weakness and High-Risk Areas

The proposed guidance makes clear that the focus of the evaluation should be on “material weaknesses” in ICFR, and that management is not required to assess other internal controls. The proposal states that management attention and evaluation resources are to be directed on those controls that management believe adequately address the risk of a material misstatement in financial reports. Further, management is to use a risk-based approach regarding the amount of evidence needed for the evaluation. This will allow management to align the nature and extent of its evaluation procedure with those areas of financial reporting that pose the greatest risks of causing a material misstatement in reports. The guidance suggests that management use less intensive methods, such as self-assessment in low-risk areas, and more extensive testing in high-risk areas. The Roundtable heartily supports this approach.⁶

4. Reliance on Company-Level Controls

The proposed guidance states that there is no requirement to identify every control in a process or document the business processes impacting internal controls. Instead, management is to focus on those controls that it believes adequately address the risk of a material misstatement. If management determines that the risks for a particular reporting element are adequately addressed by a company-level control, no further evaluation of other controls is required. However, company-level controls that are only indirectly related to a reporting element will probably not be sufficient. The Roundtable encourages the use of company-level controls as a cost effective means of complying with Section 404 requirements.

5. Reliance on Prior Work

The proposal makes clear that considerable reliance may be placed on the prior year’s assessment of ICFR. The guidance states that for most companies, management’s efforts should be significantly less following the first year’s assessment, because subsequent evaluations should be focused on changes in risks and controls rather than identification of all financial reporting risks and related controls. Further, in each subsequent year, the evidence necessary to reasonably support the assessment will only need to be updated from the prior year, and not recreated anew. The Roundtable supports this approach and believes that this clarification will play an important role in reducing the regulatory burden on large and small companies. The SEC should work with the PCAOB to make a similar clarification with respect to the auditor requirement, and that other techniques to ease burden, such as the use of random testing of controls, be authorized in lieu of a full scope audit.

The accounting provisions principal objective is to reach knowing or reckless conduct, not inadvertent conduct.

Corporate management and the board have important roles to play in monitoring and evaluating the adequacy of internal controls, but not involvement in the minutia or recording and accounting for every transaction.

⁶ The Roundtable also suggests that the definition of “financial reporting risks” in Section III.A.1.a of the proposed guidance be clarified to make it even clearer that such risks only relate to the risk of a material misstatement in a financial report.

The Roundtable also suggests that the SEC work with the PCAOB to permit auditors to utilize examinations conducted by Federal and State regulatory agencies, such as by the bank examinations conducted by the Federal Reserve, Federal Deposit Insurance Corporation or Comptroller of the Currency, and insurance examinations conducted by State insurance regulators. Further, we believe that auditors should be encouraged to work with management's internal auditor to minimize repetitive testing and that management should be allowed to communicate openly with the outside auditor on all aspects of the audit.

6. Scope

The proposal explains that management's assessment of internal controls generally includes all of the company's locations and business units. However, management may determine that financial reporting risks are addressed by centrally operated controls, and thus treat the company as a single unit. Further, if the risks arising from an individual location are low, management may rely on self-assessments or other on-going monitoring activities, combined with evidence from a centralized control that monitors evidence from remote locations. The Roundtable supports this approach.

On the other hand, the Roundtable notes that the proposal states that management's evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end.⁷ The Roundtable recommends that this statement be amended to permit the evaluation to be based on evidence accumulated during the year, but not necessarily at year-end. The end of the fiscal year is not the most opportune time for testing internal controls, will increase auditor costs, and may not be as efficient as a testing process that occurs at other points in the fiscal year. Management can draw conclusions as to the efficiency of internal controls as of year-end without necessarily conducting tests at year-end.

7. Auditor's Responsibility Under Section 404

Section 404(b) provides that public accounting firms shall attest to and report on the assessment *made by management* of the issuer concerning ICFR. One of the proposed regulatory revisions suggested by the SEC is to require the auditor to express an opinion directly on the effectiveness of the ICFR, rather than on management's assessment. The Roundtable believes that this change is inconsistent with the statutory language and would result in a redundant review of ICFR. The Roundtable opposes this provision.

8. Combine Sections 302 and 404

Section 302 of Sarbanes-Oxley requires a certification by a company's principal executive officer and principal financial officer that in each annual or quarterly report, based on the signatory's knowledge, the internal controls are designed to ensure that material information is disclosed, that the effectiveness of the internal controls have been evaluated, and that these

⁷ Section 111.A.2.b of the proposed guidance.

officers have presented in the report their conclusions about the effectiveness of their internal controls. The report must also state that these officers have disclosed to the company's auditors and audit committee all significant deficiencies in the design or operation of internal controls, and any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

The Roundtable urges that the SEC use this guidance to articulate that the requirements of management under Section 302 are consistent with the requirements of management under Section 404, including the interpretive guidance applicable to Section 404. It would be extremely inefficient and unnecessarily costly for management to have different standards and responsibilities under these two similar statutory provisions.

9. Criminal Liability

The Roundtable believes that the provisions in the statute that impose potential criminal liability for knowingly filing a false report or certification has caused a level of concern in both the accounting profession and among company management that is counterproductive to efficient and reasonable audits. As a result, some auditors have adopted a zero tolerance policy that is based more on the threat of criminal prosecution than on good accounting practices. Likewise, companies are finding it harder to attract and retain managers who are concerned with potential liability for making good faith errors. Whether or not the statute actually creates such liability is not the point. The problem is that the statute creates a perception that such liability exists. The Roundtable urges the SEC to emphasize to the accounting industry that there is no criminal liability for good faith errors, and to encourage Congress to clarify that the statutory criminal sanction does not require perfection.

10. Auditor Competition

The Roundtable supports enhanced competition in the audit industry. Currently, the number of accounting firms that have the capability of auditing a large sophisticated company is very limited. If one of these firms is also providing other services for the company, a conflict will often arise that prevents the same firm from auditing that company's internal controls, thus further limiting competition. We urge the SEC to take all reasonable steps to increase the number of qualified accounting firms and to eliminate the need to disqualify a firm due to a de minimis conflict. In this regard the SEC should work with the PCAOB to develop new and more realistic conflict of interest standards that reflect the need to increase competition. Further, smaller accounting firms should be encouraged to take innovative measures, such as forming joint ventures, that would allow these smaller firms to compete for large company business.

Conclusion

The proposed guidance developed by the SEC goes far in alleviating many of the compliance burdens associated with Section 404. The Roundtable supports the Commission's efforts in this regard. However, the Roundtable does believe that some modifications would enhance the proposal even further, and have made some suggestions that will permit more efficient implementation of these requirements while retaining the benefits intended by the law. For any additional information, please feel free to contact me at 202-589-2410 or Irving Daniels at 202-589-2417.

Best regards,

A handwritten signature in blue ink, appearing to read "Steve", with a horizontal line underneath.

Steve Bartlett
President and CEO