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February 26, 2007

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

Re: File Number S7-24-06

Dear Ms. Morris:

Microsoft appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's ("SEC") proposed interpretive guidance ("proposed guidance") for management regarding its evaluation of internal control over financial reporting and related rule amendments.

Microsoft recognizes and appreciates the time and effort that the SEC has dedicated to developing guidance that is responsive to concerns that have been raised, particularly about the effectiveness and efficiency of the management internal controls assessment process. We support the direction of the guidance in improving the balance between quality and efficiency of the assessments by supporting a top-down, risk-based approach, encouraging broader management flexibility and judgment, and supporting the use of prior knowledge and assessment results. We have strong concerns about maintaining consistency between the management assessment and external audit approaches and about the support the auditors will receive from the Public Company Accounting Oversight Board ("PCAOB") in implementing its proposed auditing standards, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and *Considering and Using the Work of Others in an Audit* ("proposed standards"). We also have comments on a few other topics.

<u>Improvement in efficiency and quality</u>

Microsoft will gain efficiencies by fully implementing the top-down, risk-based approach that is the foundation of the proposed guidance. That approach will enable us to focus more attention on the critical controls, which will improve the quality of our assessments and allow for a more efficient assessment effort overall. The narrowed focus on controls that would detect a material misstatement, rather than a significant deficiency, could result in a meaningful reduction in the number of key controls tested. The change in the wording of the likelihood component of the material weakness definition from "more than remote" to "reasonable possibility" should reduce the time spent on evaluating deficiencies.

The proposed guidance also promotes quality and efficiency by providing for broad management flexibility and judgment in performing the assessments. We will have more flexibility in the choice of controls to include in the assessment, the documentation of the control design and evidence of operational effectiveness, and the testing approach. All of these areas of flexibility should improve the efficiency of the assessment, within the bounds of management's judgment about the adequacy of the assessment and supporting documentation.

The approach to risk assessment described in the proposed guidance is clear, and the guidance also includes a useful list of relevant risk factors for significant accounts and also the controls themselves. Because the proposed guidance discusses these two risk assessments separately, it makes it clear that they are not interdependent. A key control over a high risk significant account or process could be assessed to be low risk in terms of its operating effectiveness, which would affect the type and extent of testing. We believe that this flexibility to apply judgment to the testing process would be beneficial.

Finally, the proposed guidance encourages the use of prior knowledge and assessment results to guide the risk assessment and testing approach. After the initial assessment, subsequent assessments of risk and design can be focused on changes in risks and controls. Prior testing results can be used to guide the risk assessment of both the significant accounts and the controls.

Consistency with external audit approach

With the expected significant changes in our management assessment approach, we are concerned with maintaining good coordination and consistency with our external auditor's standards and practices, including PCAOB audit standards and inspection practices, and the audit firm's policies, practices and guidance. To optimize reliance and achieve quality and efficiency objectives, management's assessment approach will need to be consistent with and acceptable to the external auditors' standards. Even though the requirement for an opinion on management's assessment process has been recommended for elimination, a management assessment approach that varies too greatly from the auditor's viewpoint could be of concern.

As a general statement, we believe that external auditors may not move as quickly as companies in reducing the scope and extent of testing of internal controls. It seems likely that auditors will be concerned about whether the PCAOB inspection practices will mirror the new audit standards.

To alleviate these concerns, auditors will need to be assured that the PCAOB inspections will be aligned with the proposed standards. Because of the time lag between audits and inspections, the PCAOB will need to clearly communicate that the inspections will be aligned with the proposed standards for audit years starting with the effective date of the standards. This communication can take a variety of forms, including workshops or educational forums. We are making that comment to the PCAOB in a letter in response to its proposed standards. We are also suggesting that the PCAOB monitor the external audit firms' guidance for implementing the proposed standards and be involved in any efforts to develop additional interpretations or practice aids that elaborate on the concepts in the proposed standards.

Other comments

Consideration of interim financial statements

For purposes of deficiency evaluation, the proposed guidance includes a misstatement of the company's "annual or interim financial statements" in the definition of material weakness. We believe that the reference to interim financial statements could result in companies' having to use an inappropriately low quantitative threshold to evaluate control deficiencies. In our view, deficiencies should be evaluated and classified based upon their potential future impact on annual financial statements, since the management assessment addresses whether controls are operating effectively at the end of the year. The impact of control deficiencies that are identified during the year should be extrapolated and compared to an annual quantitative threshold (in addition to considering qualitative factors, of course). Therefore, we believe that the words “or interim” should be removed from the definition of a material weakness.

Entity-level controls

At Microsoft we have documented and tested entity-level (or company-level) controls where possible in lower risk areas to allow us to focus on the most important and pervasive controls, with the additional benefit of reducing or eliminating testing of process level controls. We expect to expand this practice next year with the support of the proposed guidance. Controls that we have relied on include variance analyses, management reviews, and monitoring activities, which have a direct relationship to financial statement assertions. From our discussions with other companies, we believe that these are fairly common types of direct entity-level controls. If needed, we are willing to provide examples of entity-level controls that we rely upon and/or participate in efforts to develop supplemental information about entity-level controls.

IT general controls

The proposed guidance includes a short discussion of general IT controls**.** While the proposed guidance does make the point that “management only needs to evaluate those general IT controls that are necessary to adequately address financial reporting risks,” we believe that additional language including examples would be valuable. General IT controls are a difficult area for many companies in that they are often over-scoped and over-tested. Because general IT controls tend to be similar between companies, we feel that this is an area that lends itself to more detailed guidance. Suggestions of additional guidance and/or examples are as follows:

1. Access to programs and data - User access testing should be limited to the few high risk accesses that create potential for material misstatements. These accesses should be directly tied to identified financial statement risks. Any guidance that could be developed about types or expected numbers of accesses that might be relevant for a typical large-sized, complex company would be helpful.

2. Program development and changes – Examples of adequate controls to prevent material misstatements. We expect these examples might include a small number of key controls, such as final user acceptance testing and move-to-production final sign-offs.

3. Operations – Examples of typical critical key controls, such as backup of key financial data tied to material risks.

Deficiency evaluation

For many companies, deficiency evaluations have been structured using a framework that was developed by several of the larger audit firms. This framework has been useful in driving consistency of thought and communication but has also been restrictive. The factors laid out in the proposed guidance to consider in evaluating control deficiencies or combinations of deficiencies are helpful and provide more room for judgment. We suggest that the proposed guidance include a statement that the deficiency evaluation factors in the guidance can be used instead of the more prescriptive framework.

Cost/benefits

We expect that if we fully implement the proposed guidance, we could realize a meaningful cost saving in our management assessment. As mentioned earlier, this cost saving would be offset by increased external audit fees if the management assessment changes triggered a decrease in the external auditor reliance on management testing due to poor coordination or inconsistency in audit standards. On the benefit side, we agree that the focus on high-risk accounts and controls increases the likelihood that companies will more effectively detect material weaknesses.

We believe that the proposed guidance should result both in cost reductions and in stronger management control structures, as companies focus on and improve high level analytic and monitoring controls.

In addition to the comments above, we have included responses to several of the specific questions posed in the proposed guidance in the Appendix to this letter.

In conclusion, we want to reiterate our appreciation for the thoughtful consideration of input and the development of proposed guidance that we believe will allow for meaningful improvements in the management internal controls assessment process. If you have any questions or would like to discuss any of our comments, please contact Marilee Byers at (425) 706-2122 or marileeb@microsoft.com.

Sincerely,

Frank H Brod

Frank H. Brod
CVP Finance and Administration

Robert W. Weede
Assistant Corporate Controller

Marilee Byers

Marilee Byers
Director, Financial Compliance Group

APPENDIX

• **Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?**

We believe that the proposed guidance will be helpful in facilitating an efficient and effective evaluation in several ways. The top-down, risk-based approach that is the foundation of the proposed guidance will enable companies to focus more attention on the critical controls, which will improve the quality of our assessments, and allow for a more efficient assessment effort overall. The narrowed focus on controls that would detect a material misstatement, rather than a significant deficiency, could result in a meaningful reduction in the number of key controls tested. The change in the wording of the likelihood component of the material weakness definition from “more than remote” to “reasonable possibility” should reduce the time spent on evaluating deficiencies.

The proposed guidance also promotes quality and efficiency by providing for broad management flexibility and judgment in performing the assessments. We will have more flexibility in the choice of controls to include in the assessment, the documentation of the control design and evidence of operational effectiveness, and the testing approach. All of these areas of flexibility should improve the efficiency of the assessment, within the bounds of management’s judgment about the adequacy of the assessment and supporting documentation.

The approach to risk assessment described in the proposed guidance is clear, and the proposed guidance also includes a useful list of relevant risk factors for significant accounts and also the controls themselves. Because the proposed guidance discusses these two risk assessments separately, it makes it clear that they are not interdependent. A key control over a high risk significant account or process could be assessed to be low risk in terms of its operating effectiveness, which would affect the type and extent of testing. We believe that this flexibility to apply judgment to the testing process would be beneficial.

Finally, the proposed guidance encourages the use of prior knowledge and assessment results to guide the risk assessment and testing approach. After the initial assessment, subsequent assessments of risk and design can be focused on changes in risks and controls. Prior testing results can be used to guide the risk assessment of both the significant accounts and the controls.

•Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?

We have documented and tested entity-level (or company-level) controls where possible in lower risk areas to allow us to focus on the most important and pervasive controls, with the additional benefit of reducing or eliminating testing of process level controls. We expect to expand this practice next year with the support of the proposed guidance. Controls that we have relied on include variance analyses, management reviews, and monitoring activities, which have a direct relationship to financial statement assertions. From our discussions with other companies, we believe that these are fairly common types of direct entity-level controls. If needed, we are willing to provide examples of entity-level controls that we rely upon and/or participate in efforts to develop supplemental information about entity-level controls.

Also, the proposed guidance includes a short discussion of general IT controls. While the proposed guidance does make the point that "management only needs to evaluate those general IT controls that are necessary to adequately address financial reporting risks," we believe that additional language including examples would be quite valuable. General IT controls are a difficult area for many companies in that they are often over-scoped and over-tested. Because general IT controls tend to be similar between companies, we feel that this is an area that lends itself to more detailed guidance. Suggestions of additional guidance and/or examples are included in the body of the letter.

• Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?

With the expected significant changes in our management assessment approach, we are concerned with maintaining good coordination and consistency with our external auditor's standards and practices, including PCAOB audit standards and inspection practices, and the audit firm's policies, practices and guidance. To optimize reliance and achieve quality and efficiency objectives, management's assessment approach will need to be consistent with and acceptable to the external auditors' standards. Even though the requirement for an opinion on management's assessment process has been recommended for elimination, a management assessment approach that varies too greatly from the auditor's viewpoint could be of concern.

• Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?

The previous guidance should not be retracted and continues to be relevant. The existing staff guidance might be a source for additional information about IT since it is more detailed on that topic. Also, the section on Communications with the Auditors from the previous guidance is not addressed in the proposed guidance and remains very relevant as it includes some good guidelines for interaction between management and auditors.

• Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.

Microsoft's annual assessment has been on a path that is directionally consistent with the proposed guidance. In any case, companies are not required to adopt the proposed guidance, so it should not result in unnecessary changes to effective evaluation processes that are already in place.

•Considering the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?

As a general statement, we believe that external auditors may not move as quickly as companies in reducing the scope and extent of testing of internal controls. It seems likely that auditors will be concerned about whether the PCAOB inspection practices will mirror the new audit standards.

To alleviate these concerns, auditors will need to be assured that the PCAOB inspections will be aligned with the new audit standards. Because of the time lag between audits and inspections, the PCAOB will need to clearly communicate that the inspections will be aligned with the new standards for audit years starting with the effective date. This communication can take a variety of forms, including workshops or educational forums. We are making that comment to the PCAOB in a letter in response to its proposed standards. We are also suggesting that the PCAOB monitor the external audit firms' guidance for implementing the proposed standards and be involved in any efforts to develop additional interpretations or practice aids that elaborate on the concepts in the proposed standards.

• **Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?**

We would like to see more detail in a few areas, including the calculation of materiality, more clarity around the risk of control failure (page 32) and what is included in and considered in computer operations (page 28).

• Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?

We believe that the guidance will result in sufficient information.

• **Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?**

We believe that the guidance should be issued as an interpretation since there is not a requirement for adoption.

• **Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?**

We agree with the idea of voluntary compliance with the interpretive guidance, so that companies will not necessarily need to change aspects of their programs that are currently effective.

• **Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?**

The rule revisions that are proposed seem appropriate.

• **Should the rules be amended in a different manner in view of the proposed interpretive guidance?**

The rule revisions that are proposed seem appropriate.

• **Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?**

Yes, that assurance seems to be appropriate.

• **Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?**

Neither too much nor too little.

• Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?

Yes

• **Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?**

This rule is confusing as a separate report over management's assessment is not required from the auditors.

• **Should we consider changes to other definitions or rules in light of these proposed revisions?**

Yes. This is not clear.

• **The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?**

The proposed revision seems to be appropriate and adequate.