The Institute of Internal Auditors

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

Response e-mailed to: rule-comments@sec.gov

Re: SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06
MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Dear Ms. Morris:

The Institute of Internal Auditors (The IIA) welcomes the opportunity to comment on the referenced release. Our comments are based on in-depth analysis and discussions, harnessing the experience of a core team of prominent chief audit executives from major U.S. corporations who serve on The Institute of Internal Auditors' Professional Issues Committee.

The following are our principal observations. Detailed responses to each of the questions contained in the release can be found in Attachment A.

The draft document prepared by the SEC staff is helpful in establishing clear general principles regarding management's assessment of internal control over financial reporting (ICFR). While we commend the SEC staff for this initiative, we do not believe the document fully addresses the pressing need of management — whether of large or small companies — for more detailed guidance in specific areas (such as the scoping of information technology general controls, see our attached survey results – Attachment C). We identified many of these areas in our comments dated September 18, 2006 on the Concept release.

The IIA recommends that the SEC staff proceed with the following steps:

- Refine the draft document as one documenting general principles, incorporating the items commented on in this response.

- Work with the Public Company Accounting Oversight Board (PCAOB) to upgrade Audit Standard No. 2; we have attached our comments on their revised standard draft – see Attachment B. The most efficient approach for management is to align its approach to that used by the external auditor, as discussed in our answer to question 1 in Attachment A.

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- Additional detailed authoritative guidance can then be issued by the SEC where management's approach should vary or where clarification is necessary. For example, the external auditors need to follow existing standards when establishing materiality levels. Plain English guidance should be provided for management, who also need to establish materiality levels but are not required to follow auditing standards. This additional guidance could take the form of an authoritative Q&A.

Further, as stated in our responses to the SEC in May and September 2006, The IIA continues to believe the intent and the benefit of the Sarbanes-Oxley Act[1] are met with only two attestations – namely, management's attestation, and the external auditor's attestation over management's attestation. We believe that the third attestation – the auditors own report on internal control over financial reporting – represents a fundamentally unrealistic and unfair expectation on the part of the auditors, which in turns leads to operating inefficiencies and costs. The essence and sole responsibility of auditing is to give an opinion on management's statement not to create a management statement. Making statements about operations status, financials, internal controls accomplishments, tone at the top, and strategy, is the sole responsibility of management and are duties that solely management has capacity to fulfill. For the auditors, the best auditing methodologies and techniques cannot compete nor make up for

- Management position in an organization
- Management responsibility over operations and processes
- Management accountability

We also continue to believe that the principle of identifying areas as automatic sources of significant deficiencies and strong indicators of material weaknesses is inappropriate. Each situation should be assessed on its specific facts and circumstances, determining whether there is at least a reasonable likelihood of a significant or material misstatement of the financial statements.

An area of concern to our practitioners is that while the assessment date is the registrant's year-end, many, if not most, of the year-end procedures and controls are performed after year-end. The external auditors test those year-end controls and consider as deficiencies any failures in their execution, even though they are performed after the assessment date. We believe the assessment date should be changed to a date proximate to the filing date for the financials on Form 10-K (or equivalent). Guidance should limit tests of transactions to those included in year-end balances and tests of controls to those performed prior to the assessment date. We have included this recommendation in our response to the PCAOB.

One area not covered by our comments below, and where we believe additional guidance would be of value in both a general principles document and in detailed guidance, relates to the linkage between the annual assessment of internal control over financial reporting required by Section 404 of the U.S. Sarbanes-Oxley Act of 2002 and the certifications required under its Sections 302 and 906.

Sarbanes-Oxley Act - §404. Management's Assessment of Internal Controls. (b) "Internal control evaluation and reporting – with respect to internal control assessment required by subsection (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. An attestation made under this subsection shall be made in accordance with standards for attestation engagement issues or adopted by the Board (PCAOB). Any such attestation shall not be the subject of a separate engagement.

Again, The IIA would like to offer its support to the SEC in the development of their guidance. We have an extensive volunteer network of individuals with specific knowledge in this area that could be valuable contributors to the SEC.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you. We would suggest spending two hours in an open dialogue with a few members of our volunteer network to discuss our comments, the basis for them, and suggestions that will support companies in their compliance efforts.

Best regards,

David A Richards

David A. Richards, CIA, CPA

Attachment – (A) Detailed Comments to SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06 (included herein)
Attachment – (B) IIA's Response to PCAOB Rulemaking Docket Matter No. 021
Attachment – (C) IIA's GAIN Survey Results – Scoping Information Technology General Controls (ITGC)

About The Institute of Internal Auditors

The IIA is the global voice, acknowledged leader, principal educator and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 25 languages. The IIA represents more than 130,000 members across the globe, and has 247 affiliates in 92 countries that serve members at the local level.

Attachment A

Institute of Internal Auditors (IIA)
Response to SEC Release Nos. 33-8762; 34-54976; File No. S7-24-06

Questions from the Release are **bolded**, with IIA responses following.

1. **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 do not believe that the high-level interpretive guidance alone is sufficient to enable an efficient and effective evaluation. It does not address and provide guidance on the difficult issues for management. We refer the SEC staff to our prior comments (attached) on the Conceptual Release. We identified a number of areas (particularly in our answers to questions 11, 16, and 24) where more specific, practical guidance would be valuable.

   To work toward providing more detailed guidance in difficult areas, we suggest that the SEC focus attention on the proposed standard issued by the PCAOB with consideration of how the standard will impact actions by management. While management does not have to follow the same process as the external auditors, there are significant advantages to following a process that is substantially the same. For example:

   - Management desires an approach that is efficient when considering the cost of its own assessment and the external auditor's audit. One way to optimize costs is maximize reliance by the auditor on the work of management, which may be performed by the internal audit function. That is best obtained when the external auditor and management identify the same significant accounts and locations, and test the same key controls. The likelihood of reliance is enhanced when management's testing methods are similar to those preferred by the auditor.

   - The work of the external auditor is more efficient when the auditor is able to review and benefit from management's risk assessment, identification of significant accounts and locations, and selection of key controls. If management and the auditor identify the same key controls, documentation of the design of those controls will be available for the auditor, and operating management will be better prepared to assist the auditor.

   - When a process is used that is substantially the same, it is likely that both management and the auditor will identify the same deficiencies, compensating or mitigating controls, and arrive at the same assessment of their significance.

   Our recommendation is for the SEC to work with the PCAOB to enhance its guidance to the external auditors. We have attached our response to the PCAOB with comments on the proposed revised standard. There are a number of areas where we disagree with the proposed standard, some of which also apply to sections of the SEC's draft interpretive guidance (e.g., the assessment of significant deficiencies and material weaknesses).

Once the PCAOB's standard has been updated and released, the SEC should issue guidance — potentially through *authoritative* questions and answers (Q&A) — on areas of difficulty for management. The SEC and the PCAOB should ensure consistent guidance is provided to auditors and management. The Q&A also can be used to explain how management may take different approaches to those required for the auditor. The Q&A should be focused on specific areas, for example the assessment of the control environment, where management may not be truly objective in assessing the tone at the top.

With respect to the control environment, we continue to believe there is too much focus in both the PCAOB and the SEC guidance on control activities. In our response to the Conceptual Release, we said:

> "We suggest that SEC Staff perform an assessment of risk related to materially misstated financials, with particular reference to those incidents (many of which companies have become household names) that led to significant investor losses. The root causes should be identified. We believe that such an assessment will identify more issues existed within the COSO Controls Environment layer, with little risk within Control Activities.
>
> "This assessment and the identification of root causes should determine what the Commission should require both of management and their auditors. The current approach under §404 and Auditing Standard 2 is not, in our opinion, addressing the root causes and therefore not providing the assurance to investor that the SEC and Congress desires.
>
> "One alternative for consideration is the development, together with parties such as The IIA, the National Association of Corporate Directors, the AICPA, the FEI, and the Ethics and Compliance Officer Association, of a corporate governance standard. Companies could be asked to assess their practices against such a standard and explain any exceptions."

We again make these recommendations.

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

Please see our answer to question 1 above.

The discussion of the role of entity-level controls needs to be repositioned and clarified. The first part in the evaluation process included in the draft (identifying financial reporting risks and controls) has five steps:

- Identify financial reporting risks.
- Identify controls that adequately address financial reporting risks.
- Consider entity-level controls.
- Role of general information technology controls.
- Evidential matter to support the assessment.

The order of these steps can be improved as consideration of entity-level controls should come before identifying controls placed in operations to address financial reporting risks. The identification and review of specific controls (i.e., control activities) discussed in the second step should only be performed after careful consideration of the entity-level controls — especially the control environment. With the recommended change in the order of these steps, the guidance would encourage the appropriate practice of assessing control activities only after considering the risk-based impact of the control environment.

3. **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?**

   Please see our answer to question 1 and our response to the SEC dated September 18, 2006. Additional detailed guidance should be based on an updated PCAOB Auditing Standard No. 2, clarifying issues not sufficiently addressed in that standard or where additional guidance is required specifically for management.

4. **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 May 2005 Staff Guidance was extremely valuable and remains relevant. There are no areas that should be retracted at this time.

   If the SEC agrees with our recommended approach, the May 2005 FAQ can be used as a starting point for preparing the more detailed guidance we are recommending.

   We recommend that the SEC work closely with the PCAOB to ensure that its guidance is authoritative for both management and the external auditor.

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

   The proposed guidance is general and should not affect established evaluation processes.

6. **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?**

   Please see our response to question 1. The proposed interpretive guidance is high-level and does not conflict with the PCAOB's draft standard. However, we disagree with a number of elements of the draft standard, some of which also apply to elements of the SEC's draft guidance.

7. 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 have proposed to the PCAOB a change in the definition of *significant deficiency* (please refer to our answers to their questions 7 and 8). Our recommendation is that *significant deficiency* be defined as:

> “A condition (generally one or more control deficiencies) that the auditor believes represents a risk to the business (which may not be limited to the integrity of the financial statements) of such significance that it should be reported to the audit committee.”

We understand the intent of the SEC is to ensure all important matters related to the system of internal control are discussed with the audit committee. As a result of this intent, guidance in both the auditing standard and the interpretive guidance direct the assessment of control failure as significant deficiencies — even if they do not represent a reasonable risk of material misstatement in future periods — based on the quality of the system of internal control as of the assessment date. Examples discussed in our response to the PCAOB include the assessment as significant deficiencies restatements of previously issued financial statements to correct a material misstatement or the identification of a material misstatement by the auditor in the current period when it is not reasonably likely that an error would reoccur in future periods. In addition, the examples provided in footnote 74 of the proposed guidance define deficiencies as significant deficiencies without regard to their potential impact on the company, their likelihood of occurrence, etc. An assessment of risk elements should always be included in the determination of a significant deficiency.

8. 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 the guidance in paragraph B3 is sufficient. However, as stated above, we disagree with some of the guidance in paragraph B1 relative to the assessment of deficiencies.

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

We believe that both the high-level guidance and the needed more detailed guidance should be codified as authoritative guidance, which can be in the form of an interpretation.

10. Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance? If yes, what are they?

While we believe they should be addressed as recommended in our response to question 1 above, there are a number of issues relevant only for foreign issuers:

- The use of internal control frameworks other than COSO, and how their use may be reconciled to the external auditor’s use of a different framework.

- Efficiencies that may be obtained by assessing controls not only over financial statements filed with the SEC, but also those filed with other countries’ regulators.

- Reconciliations between financial statements prepared in accordance with the issuer's local GAAP with U.S. GAAP requirements.

- Varying governance standards and practices (e.g., the impact on the control environment of the absence of an audit committee).

QUESTIONS ON THE PROPOSED REVISIONS TO EXCHANGE ACT RULES 13A-15(C) AND 15D-15(C) AND RULES 1-02 AND 2-02 OF REGULATION S-X

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

   If the guidance is issued, compliance should be voluntary.

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

   We do not believe that the guidance addressing high-level principles is sufficiently detailed to support the assessment that management's evaluation was appropriate.

   Assuming more detailed guidance is also prepared, rules revisions are not likely needed.

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

   We recommend that the need to amend the rules be deferred until the updated PCAOB Auditing Standard No. 2 has been released and the need for additional management guidance is fully addressed.

4. **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?**

   Please see our answer to question 2 in this section.

5. **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?**

   Please see our answer to question 2 in this section.

6. **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?**

   Please see our answers to questions 2 and 3 in this section.

7. **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?**

   We understand that the requirement for the external auditor to review management's assessment will be removed, with the auditor only required to perform an independent assessment of the system of internal control.

We disagree with this decision. We believe the auditor should only attest to management's process as we recommended in our letter of September 18, 2006.

The revised language requires the auditor to "attest to, and report on, such [i.e., management's] assessment." It also requires the auditor to audit management's assessment. This language is not consistent with the intent of removing the requirement to review management's assessment. In fact, it supports our position that the auditor should only review and attest to management's assessment and not perform an independent audit of the system of internal control.

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

As noted earlier, we believe the definition of a significant deficiency should be revised. It will enable all important internal control issues to be brought to the attention of the audit committee without misleading them or others that there is a risk of significant misstatement in future periods.

We also believe that the assessment of internal control should reflect the quality of the system of internal control as of the assessment date, and the assurance provided that there will not be material misstatement of financial statements to be filed with the SEC in the next year.

Further, we believe guidance should clarify that testing of events subsequent to the assessment date (e.g., the operation of controls involved in the preparation of the Form 10-K) should only be performed when clearly relevant to the assessment as of the assessment date. Tests of routine controls (e.g., approvals of vendor invoices) within a few days after the year-end are likely reflective of the quality of the system of internal control as of the effective date. However, testing the operation of controls in February for a December year-end company may not be reflective of the assessment date quality.

9. 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?

We have no comment on this point.

COMMENTS ON THE COST AND BENEFITS OF THE PROPOSED AMENDMENTS

We request comment on the nature of the costs and benefits of the proposed amendments, including the likely responses of public companies and auditors concerning the introduction of new management guidance. We seek evidentiary support for the conclusions on the nature and magnitude of those costs and benefits, including data to quantify the costs and the value of the benefits described above. We seek estimates of these costs and benefits, as well as any costs and benefits not already identified, that may result from the adoption of these proposed amendments and issuance of interpretive guidance. With increased reliance on management judgment, will there be unintended consequences? We also request qualitative feedback and related evidentiary support relating to any benefits and costs we may have overlooked.

We do not believe the proposed guidance and rule amendments, with the exception of the removal of the requirement for the external auditor to provide an opinion on management's assessment, will result in significant change in companies' assessment processes. The proposed guidance of high-level principles is unlikely to have a fundamental impact on the processes most companies follow.

However, we do believe that detailed guidance on some specific issues — like those we identified in our response dated September 18, 2006 to the Concept release — could result in significant changes in a company's assessment process.

The proposed changes to Audit Standard No. 2, especially if our recommendations are adopted, should result in significant improvement in the efficiency of the external auditors' work, and accordingly, reductions in auditor fees.

QUESTIONS ON THE INITIAL REGULATORY FLEXIBILITY ANALYSIS

1. **The number of small entity issuers that may be affected by the proposed extension;**
2. **The existence or nature of the potential impact of the proposed amendments on small entity issuers discussed in the analysis; and**
3. **How to quantify the impact of the proposed amendments.**

We do not believe the proposed interpretive guidance will result in a significant change in approach for small entity issuers.

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