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U.S. Securities and Exchange Commission
450 Fifth Street, NW
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File No. 4-497, Implementation of Sarbanes-Oxley Internal Controls Provisions

Ernst & Young LLP ("E&Y") is pleased to share views derived from our experience in connection with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") and subsequent regulations, standards and guidance issued by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB").

As E&Y Chairman Jim Turley stated in testimony last September before the U.S. Senate Committee on Banking, we believe the Act is working positively in many ways. Furthermore, we believe that the effective implementation of Section 404 will benefit the investing public in the form of more reliable and transparent financial reports, increased investor confidence, lowered cost of capital for issuers, and a reduced risk of corporate fraud.

It has been our experience that the overwhelming majority of issuers has embraced the requirements of the Act and has worked hard to meet the rigorous standards set by Section 404 and the relevant SEC and PCAOB implementing rules. We have found that the attitude of a company going into the process has considerably influenced the value derived from it. Many companies that have approached the challenges of 404 as a compliance exercise found themselves checking the boxes and finding it of little value; those who approached it as an opportunity to establish lasting and improved processes found value as they strengthened their risk management and control environment and will likely reap the benefits from an improved culture of ownership and accountability. These companies also likely will experience cost reductions and operational efficiencies in the future.

Was the first year implementation of 404 perfect? No. Neither by auditors nor issuers. It is a work in progress that can and will be improved. But to be clear, it has already yielded benefit for investors. Section 404 should be retained, and implementation should be refined with the perspectives of investors, auditors, issuers, and regulators all considered.

From our perspective as an auditing firm, we believe it is appropriate and necessary to examine specific experiences after this initial year of 404 implementation for the purpose of increasing effectiveness and reducing inefficiencies of the process, provided that the core investor protections afforded by the requirements are not undermined.

A review of this first year implementation of 404 should not focus solely on changes that will reduce costs in the future. Based on our experiences, costs will go down significantly in the future, absent any modifications to the current requirements. There are inefficiencies in the 404 process that do not increase effectiveness and, to a degree, may have made life unnecessarily difficult for those involved. With those areas in mind, the examination or review of the first year's experience with 404 must be conducted thoughtfully to achieve the right adjustments going forward so that all capital markets' stakeholders truly benefit by an enhanced, effective environment of greater control and less risk.

General Discussion

With first-year implementation results beginning to be revealed, it is appropriate to reflect on what public companies and registered public company audit firms have been through, assess where we are today, and look ahead to the second and subsequent years of 404 implementation. As we do so, any close examination of the Act and the rules, regulations, and standards issued to implement its requirements should be from the perspective of what is good for the economy and investors in the long run.

For most everyone on the front line of implementation, 404 has proven challenging and difficult. Undoubtedly, 404 has not been without significant cost and consternation. The first year of implementation has not always been smooth and has raised basic questions around reliance, duplication of effort and reworking of previously completed tasks that have amplified some of the concerns regarding the cost of 404 implementation.

We believe that many provisions of the Act were intended to address a number of concerns that had built up over time. For example, concern with the effectiveness of the accounting profession's self-regulatory structure led to the creation of the PCAOB and transferred to it authority over public company auditors. The PCAOB now oversees public company auditors relative to ethics, discipline, investigations, inspections and the setting of standards that govern the conduct of audits, including those under Section 404. Similarly, long-standing concern with the effectiveness of internal controls over financial reporting led Congress to enact Section 404.

SEC Chairman William Donaldson recently observed that the 404 requirement "offers significant long-term benefit in helping to prevent fraud and misdirection of corporate resources and in improving the accuracy of financial reporting." For investors, the most immediate proof of this statement is evident in the recent disclosures resulting from the 404 process. Several companies have disclosed material weaknesses in internal controls over financial reporting. Additionally, many improvements resulting from the process are not readily apparent as disclosure is only required for deficiencies that rise to the PCAOB standard for a material weakness and have not been appropriately remediated prior to year end.

What is less apparent is the fact that the process in 2004 resulted in companies identifying numerous control deficiencies, significant deficiencies, and potential material weaknesses and remediating them prior to the fiscal year end such that disclosure was not required.

These less apparent or hidden benefits have to be considered in weighing the overall value of the process. While there have been and will continue to be significant benefits resulting from the process, achieving such benefits has not been without significant cost and effort by many parties. It is clear that there is concern by many with the rigorous requirements of the rules, regulations, and standards issued to implement the requirements of 404, the strength and scope of the processes imposed, and the increased work that issuers and auditors are required to perform. We believe that it is very important to maximizing the long-term benefits from the Act, and from Section 404 specifically, for these concerns to be aired, examined, and resolved.

We hope our input to the SEC and PCAOB provides insight relative to the benefits and costs and, importantly, provides constructive and thoughtful suggestions on ways to increase effectiveness and reduce inefficiencies in a manner that makes sense from the perspective of all concerned. Our comments include suggestions that we believe would improve the guidance for issuers and auditors on 404 implementation, including revisions to PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" (AS2).

Benefits of 404

We believe that the Section 404 requirements for annual evaluations and reporting on internal control over financial reporting are among the most important provisions of the Act. The potential benefits to investors from the effective implementation of 404 are significant in terms of improvements in the reliability of periodic financial reports, not just annual reports subject to a financial statement audit but also unaudited quarterly reports. These benefits will be realized over time.

Internal controls are the policies and procedures that a company must have in place to ensure that all its assets, liabilities and transactions are properly reflected in its financial statements. Effective internal control involves people at all levels of the organization, including those who maintain accounting records, prepare and disseminate policies, monitor systems, and function in a variety of operating roles. They reduce the risk of non-compliance with laws and regulations; reduce the risk of restatements and fraud; increase the reliability of financial statements; and provide an ongoing monitoring process for management, a company's internal accountants and auditors, and the audit committee. In short, they enhance investor confidence by improving the accuracy of reported financial results. More importantly, if investor confidence is in fact enhanced through the effective implementation of 404, U.S. and foreign SEC issuers should have a lower cost of capital, an outcome that would have a significant, positive economic impact.

Without a doubt, the first-year implementation of 404 was a major undertaking by SEC issuers that are accelerated filers and one that dominated the boardrooms during the past year. Much of what we have read and heard about with respect to 404 are the enormous difficulties and high costs of 404 implementation. But we also are aware of meaningful success stories resulting from the process and more will be realized by investors over time. Quantifying the future benefits of improved, more reliable financial reporting is not fully possible, nor is determining the amount of the total benefit attributable to 404 as compared to other new requirements of the Act or other variables. However, it is intuitive that the benefits will be quite significant given the importance of effective internal control to the accuracy of financial reporting. Our insight and experience suggests the benefits resulting from the process are quite real.

The most visible present signs of the significant attention paid to internal controls are the annual and other periodic reports that have been or will be filed by issuers identifying material weaknesses in internal control existing as of the year end assessment date. Based on our experiences, we expect approximately 10 percent of the SEC issuers that currently are filing 404 reports as part of their annual reports will disclose one or more material weaknesses that were unremediated as of their fiscal year ends.

What are less visible, because they are not required to be reported in the same manner, are the other control deficiencies, significant deficiencies, or potential material weaknesses that were discovered by the issuer or auditor and appropriately evaluated and considered for remediation prior to the year end assessment date. Although these deficiencies were not required to be reported under 404, identification and correction of such deficiencies served to improve internal controls and, in some cases, to prevent material weaknesses from developing if these deficiencies had not been identified and corrected.

In terms of benefits, equally important and perhaps also underappreciated is the "process" that has been put in place by issuers to identify, document and evaluate their controls. Issuers and their stakeholders will derive lasting benefit from this process, if like any other asset, they continue to reinvest and provide maintenance.

The necessity of having financial reporting systems that are free of material weaknesses has been widely discussed and is well chronicled. In discussions with our engagement teams and clients we have identified numerous related benefits derived as a result of the collective effort of issuers and their auditors, including:

- Reinvestment in infrastructure and internal controls
- Identifying and remediating significant deficiencies before they become material weaknesses
- Greater focus on controls over higher risk estimates and judgments
- More timely account reconciliations
- More rigor in selecting accounting policies
- Control consciousness and ownership pushed down in the organization
- Control consciousness and ownership extended beyond finance and accounting
- Reassessment of financial management competencies
- Greater focus on IT general controls
- Identification of additional opportunities for automation of controls
- Greater emphasis on fraud and risk of management override
- Greater awareness and focus by the audit committee on risks and controls

Although each issuer's experience was different and we would not assert the ones that follow necessarily to be representative of issuers' experiences, we thought it would be beneficial to share some of our clients' experiences with 404 implementation.

Company A's Story

Throughout its assessment process, this company identified a significant number of unexpected deficiencies, not all of them significant, but many more than they had originally anticipated. The company was able to complete remediation prior to year-end, which resulted in a vastly improved financial close process. The process established an increased level of accountability in general and more clearly established primary control responsibility. Further, the process increased the focus of the CEO and President on providing clearer and more robust disclosures. While not pleased with the overall cost of 404, the company willingly admits to clear and significant benefits. More specifically, the company:

- Significantly increased attention on information technology general controls, particularly those related to logical access.
- Was able to better "integrate" various completed acquisitions. Due to significant decentralization of operations, the number of hours and level of expenses incurred (both internally and externally) were abnormally high for a company of this size. The 404 process caused management to re-focus on integrating prior acquisitions (which will likely result in future cost savings) and establish a more rigorous "up-front" process for evaluating potential targets, including the target's existing control environment, and developing detailed integration plans.
- Will continue to increase the resources and qualifications of its internal audit department, which should result in future cost savings as well as a stronger compliance monitoring process.
- Has experienced an increased number of "hotline" calls – which is likely correlated to the emphasis and importance driven from the "tone at the top".

Company B's Story

A small manufacturer with revenues of $100 million has operations in several foreign countries. While management and the directors cite cost as a "downside," they believe there were significant benefits derived from the 404 implementation, including:

- The process clearly highlighted the need to strengthen the financial capabilities of personnel at the foreign locations – particularly related to the accounting for taxes – which the company plans to address further in 2005.
- Although only a small company, it has now created an internal audit function and hired a highly qualified person to run the internal audit efforts.
- Driven in part by 404, the company upgraded the membership of its outside board and added two "financial experts" to the audit committee. Further, the involvement of the audit committee increased substantially over prior years.

Costs of 404

Reporting on the effectiveness of internal control over financial reporting has been a major undertaking for SEC issuers that are accelerated filers and thus currently subject to 404. They have spent large sums over the past two years designing, implementing, testing, and improving their internal controls over financial reporting. These large expenditures have understandably fueled a debate about the costs of the new requirements.

Anecdotally, it has been our experience that approximately 50 percent of the costs were internal costs to the issuers spent documenting controls and identifying and remediating control deficiencies. Approximately 25 percent of the costs were spent by the issuer on third parties other than the auditor to assist them in the 404 process with the remaining 25 percent of total issuer costs spent on audit fees associated with reporting on management's assessment and issuing an independent opinion on the effectiveness of the internal controls. As previously observed, based on in-depth feedback from our engagement teams regarding the experiences of several hundred companies that implemented 404 this past year, we are confident that there will be major reductions in issuers' total 404 costs in the second year, with the most significant component being reduction in their internal costs. This is understandable as much of what they accomplished in year one in terms of building internal control processes and identifying, documenting and remediating control deficiencies will not recur --at least not to such a great extent-- in year two or future years.

Companies with strong internal controls already in place had far fewer problems complying with the new 404 requirements. Many leading companies got started implementing 404 as soon as possible after passage of the Act, well before the rules and standards to implement the 404 provisions were finalized. Companies with weaker or outdated controls, or those who were slower to start the assessment process, found their implementation efforts to be much more difficult and costly. And some companies found years of deferred maintenance, or even neglect, that demanded even far greater effort and cost.

Clearly the costs associated with the first-year implementation of 404 were higher than was generally anticipated early in the process. This can be attributed to a number of factors. Because this was the first time such reports were required, and there were limited benchmarks against which to predict costs, there was a certain inherent level of uncertainty in the original cost estimates. In fact, the original cost estimates were made well in advance of the PCAOB's development of the rigorous auditing standard that became AS2. The first-year costs would have been quite substantial even if the implementation process had been ideally staged in its execution. But, given the timeframe and circumstances under which standards and guidance were developed, issuers and auditors had to start their work in advance of having final requirements and lacked a complete understanding of what was expected of them. And as the work progressed and many deficiencies were noted, an iterative process of identification of deficiencies followed by remediation and retesting ensued.

Before moving on to a more in-depth discussion of costs and potential ways to reduce inefficiencies, we want to acknowledge the challenges 404 has posed for our firm and our people. Perhaps not as obvious or it may not have been voiced as much, the implementation of 404 has posed significant challenges not just for issuers, but also for Ernst & Young and other public accounting firms. The new auditing requirements and obligations have created a huge strain on our firm's resources, despite the fact that we have greatly increased our hiring of experienced professionals and new college graduates. Our people have worked diligently to learn and implement the 404 auditing requirements set forth in AS2 and to complete our work in time for issuers to meet their filing deadlines. We have made major investments in the redesign of our audit methodologies and guidance for AS2 and the PCAOB's new audit documentation standard, and we have redesigned and significantly increased the amount of training provided to our audit professionals. Since December 2002, our people have participated in hundreds of thousands of hours of training in the specific areas of Section 404 and internal controls and audit risk assessment. In addition, we formed a dedicated network of experienced audit partners in each of our area offices to serve as our internal control and methodology leaders, who assisted our engagement teams in their implementation efforts.

In the following sections of this letter, we describe in more detail the reasons why costs were as high as they were in the first year of implementation, how many of those costs will be reduced in the second and succeeding years, and some ideas on improving the efficient implementation of 404 requirements.

Costs Should Come Down

While the amounts of cost reduction are difficult to predict with certainty and will vary considerably from company to company, we anticipate that significant costs associated with 404 will come down in the immediate future and other components of the total cost will come down more gradually. Much of the debate regarding the high costs of 404 implementation seems to be centered on audit fees. However, we find that such audit fees on average comprise approximately 25 percent of issuer costs attributable to 404. As a result, we believe the larger, more immediate cost reduction opportunities will be derived from substantially reduced activities by management and its advisors/other service providers related to management's assessment of its internal control and management's installation of controls or remediation of identified control deficiencies.

In the first year of 404 implementation, many issuers had to build or substantially rebuild their internal control systems. These up front costs will not have to be incurred every year. In many situations, issuers realized that they had not fully designed effective controls and needed to implement new or enhanced controls. In many other situations, issuers realized during their testing that properly-designed controls were not operating effectively and corrective measures were required. To gain sufficient comfort that deficiencies in design or operating effectiveness were corrected before the year end assessment date, additional analysis and testing was required. Although we cannot quantify an exact percentage of issuers' first-year costs comprised of establishing a baseline system of effective internal control by year end, we believe it to be substantial, and therefore anticipate substantial reductions in 2005 and beyond as companies make their processes of maintaining their internal controls sustainable by building them into their everyday processes.

An additional factor that we believe made the 2004 costs unique was the huge learning curve for issuers and their advisors in the first year of 404 implementation – a steep curve in virtually every aspect of the 404 process, including (1) establishing the project team and developing timetables, work plans, and communication protocols, (2) training personnel and developing methodologies for documentation and testing, (3) gaining experience in performing the internal control assessment and evaluating the effects of control deficiencies (generally in the absence of any framework for evaluating deficiencies until late in the year when several of the larger accounting firms collaborated on a framework for issuers and auditors), and (4) prioritizing and remediating identified deficiencies. For an undertaking of this magnitude, it is not surprising that the first-year effort would be very large in relation to the level of the ongoing effort to maintain and update the process.

In addition, complicating the effort was the need for recalibrating the project and performing rework as the requirements of the SEC and particularly of the PCAOB became known or better understood. Much of the preparation for 404 implementation started in 2003 and was in full swing throughout all of 2004. However, most of the guidance for issuers (and for auditors) came in the form of the requirements of the PCAOB's AS2, which was adopted by the PCAOB in March 2004 and then subject to SEC approval which occurred in June 2004. For decades prior to the formation of the PCAOB, auditing standards have been developed with the active participation of practicing auditors, who in turn were able to consider and provide input on implementation issues in advance, make plans for implementation, and appropriately educate issuers on pending requirements. However, after commenting on the exposure draft of the new standard, issuers and auditors were not substantively involved in the development of the final standard and, as noted, first became aware of the final standard's requirements in March 2004. Only then, subsequent to AS2 being issued, did auditors have the opportunity to actively start identifying implementation issues and seeking answers to their questions from the PCAOB staff. Additional interpretive guidance was issued by the SEC and PCAOB during the latter half of 2004 (in June, July, October, and November) and in January 2005.

A third factor that will result in reduced issuer costs is the fact that virtually all companies had to prepare extensive documentation of their controls because such documentation did not exist previously. This critical first step in the 404 process was a massive undertaking for many companies. Updating the documentation in year two and subsequent years that was created in year one generally should require considerably less time and effort.

Another cost reduction factor relates to auditor fees. We certainly expect that the fees paid to auditors for 404 attestation procedures and reporting will decline from year one levels although not nearly to as great a degree as the reduction in the other costs incurred by issuers as described above. Clearly there was a first year learning curve for the auditing firms and audit engagement teams and the same need for recalibration and rework as the firms gained a better understanding of the requirements and expectations of the PCAOB. Additionally, auditors gained a tremendous amount of knowledge during this first-time undertaking of the significant obligations under 404 and AS2. As a result, the recurring incremental audit fees related to 404 generally will be lower in 2005 and subsequent years than they were in the first year of implementation. It is appropriate to note, however, that the essential tasks of an auditor under AS2 in executing the audit of internal control over financial reporting and reporting on the results of such evaluation and testing are relatively unchanged from year to year. As described further in a later section of this letter, we believe a key factor affecting audit fees going forward is the opportunity to perform a truly "integrated audit" as contemplated by AS2, enabling auditors generally to place a greater degree of reliance on the results of their testing of internal controls in determining the nature, extent, and timing of their substantive audit procedures for financial statement accounts

We believe it is important that issuers, auditors, and regulators have a common understanding and shared view of the ongoing level of work required of auditors resulting from audits of internal control over financial reporting. Although some cost savings should result, as noted above, the effort required by the audits of internal control under 404 and AS2 is substantially greater than the effort traditionally required for consideration of internal control solely in connection with audits of financial statements. The end result will be a substantial permanent increase in audit fees over historical levels. Elimination of start-up costs and maximizing efficiency opportunities generally will not modify elements of the costs related to the specific audit performance requirements of this new work and the resulting new assurance for the benefit of the capital markets.

Improving the Guidance for Implementation of 404

The PCAOB and its staff deserve much credit for the quality of AS2, particularly considering the importance and complexity of the subject matter and that it was the first major standard developed by the PCAOB. AS2, like any new standard, could not possibly foresee and address all of the issues that would surface during implementation. We believe that the PCAOB should draw on the experiences of issuers and auditors during the first-year implementation of 404 and the results of its 2005 inspection activities to improve its guidance in AS2 and staff interpretations. We also believe that the SEC likewise should expand and improve its guidance for issuers.

We are supportive of changes that would improve effectiveness of or eliminate inefficiencies in the implementation of the 404 requirements of the SEC and PCAOB. However, we believe that the key tenets of AS2 are fundamental and essential to management and auditor reporting on internal control over financial reporting, and in evaluating possible changes to AS2, the PCAOB and SEC should determine that the fundamental elements are retained and any changes to AS2 are wholly consistent with its key objectives.

When considering potential changes, AS2 should continue to seek to be more "principles-based" than "rules-based" and, as is the case today, should not require the same audit plan for a company regardless of the size, nature of the business, and complexity of its systems and controls. We believe changes to AS2 should more explicitly focus on and recognize the importance of professional judgment (and, as described in a separate section of this letter, appropriate respect should be given to the exercise of sound professional judgment) in allowing the auditor to design and implement an effective audit plan. At the same time, AS2 is very specific in many respects, and it does contain many specifically required steps the auditor must perform in every integrated audit; we believe AS2 must retain an appropriate level of prescription for performance requirements to achieve and maintain consistency in application. Getting the correct balance, of course, is difficult, but is the right answer.

The threshold for assurance on the effectiveness of internal control over financial reporting is "reasonable assurance," consistent with the level of assurance provided in a financial statement audit and described in AS2 as a "high level of assurance." Both the issuer and auditor must have an appropriate basis for providing that high level of assurance. When evaluating suggestions regarding the scope of the evaluation and testing of internal controls, the PCAOB and SEC need to be mindful that the requirements for management and the auditor to obtain evidence to support their opinions must be commensurate with this high level of assurance provided at each internal control reporting date. Just as the preparation of financial statements by issuers and the auditing of financial statements by independent auditors requires that all significant accounts be addressed each year, so should the assertions by management and attestations by auditors regarding internal control over financial reporting. Therefore, AS2 should continue to require testing controls over all relevant assertions related to all significant accounts and disclosures for each annual reporting date. However, as further described below, we believe auditors should be allowed, within reasonable boundaries, to use judgment in reducing, but not eliminating, the testing required for controls in lower risk areas (e.g., routine transaction level controls for which there have been no changes in the design of controls from prior audits and where entity level controls are strong), and the concepts of "benchmarking" or "baselining" should be considered further by the PCAOB with enhanced guidance on how issuers and auditors may consider testing performed in prior years in the situation where the design of controls has not changed.

Consistent with the objectives of 404, the key tenets of AS2 stated above, and the needs of investors and the capital markets, we believe there are other areas where the PCAOB and SEC could take actions with respect to their rules, regulations, and standards related to 404 that would enhance implementation by issuers and auditors. We have summarized our primary observations below and would be pleased to further elaborate on them.

Guidance for Issuers

The PCAOB issued AS2 to establish the performance requirements auditors must meet in auditing internal controls over financial reporting as part of an integrated audit, and the guidance in AS2 is quite comprehensive. However, AS2 provides only indirect guidance to issuers regarding the process they must follow in assessing controls. The only direct guidance on 404 to issuers on how they should perform their assessments is in the COSO *Internal Control - Integrated Framework* and requirements set forth in the SEC rule issued in June 2003 to implement the 404 requirements of the Act and subsequent SEC staff FAQs. We believe that the consistent implementation of 404 would be facilitated by the issuance of additional guidance and examples by the SEC on an issuer's assessment process (e.g., system documentation, role of internal audit in the assessment process, approach to testing for multi-locations, etc.).

We believe that a particularly fruitful area for additional guidance and clarification is in the area of management testing in support of its assertions. There was a high degree of emphasis by most issuers in this first year of implementation on management's use of internal audit or third party testing of controls to provide a basis for its assertion, and much less emphasis on monitoring and self-assessment activities. Although independent auditors are appropriately limited to performing tests of controls to obtain evidence that they are functioning effectively, we believe management should be able to use a combination of detailed testing of controls, self assessment accompanied by independent verification, and reliance on its entity level processes (including aspects of its control environment, risk assessment and monitoring controls) to provide it a basis for making its assertion**.** Related to this, AS2 requires testing controls in each COSO component, but does not provide guidance on how entity level controls affect the nature, timing and extent of transaction level tests of controls, or to what extent management may rely on its entity level controls as a basis for its assertion. We believe it could be potentially cost beneficial for the SEC, in working with the PCAOB, to expand on the guidance for issuers regarding its testing requirements.

Definition, Evaluation, and Communication of Deficiencies

The definitions of a significant deficiency and a material weakness in AS2 are based on the likelihood of an error occurring and the magnitude of such an error. The threshold established by AS2 is low, and the effects of the low threshold in these definitions are magnified by the manner in which control deficiencies are to be evaluated as potential significant deficiencies or material weaknesses. The combined effect of the definitions and the evaluation process is that management's assessment and the audit of internal control is conducted at a low level of materiality, resulting in significant documentation, testing, retesting, remediation, and communication – and in some instances too much attention being paid by both management and auditors to what may be relatively inconsequential deficiencies in controls. We do not advocate diluting the performance requirements of AS2 in such a manner that one would not be obtaining reasonable assurance with respect to the identification of material weaknesses. However, we believe the definitions and evaluation criteria should be reconsidered if in fact too much time and effort is being spent on low risk aspects of controls that could not reasonably rise to the level of a material weakness.

Audit Scopes and Thresholds

As discussed above, we believe that AS2 should continue to require the auditor to obtain evidence about the effectiveness of controls (either by directly performing tests of controls or by using the work of others) for all relevant assertions related to all significant accounts and disclosures in the financial statements for each annual reporting date. However, auditors should use judgment, within reasonable boundaries, to determine the extent of testing that would be appropriate for controls in lower risk areas. We suggest that the PCAOB consider providing additional guidance on decision-making by the auditor regarding extent of testing for lower risk areas and its interrelationship with work performed by internal auditors.

AS2 requires testing controls in each COSO component, but does not provide guidance on how entity level controls affect the nature, timing and extent of transaction level controls. We believe implementation of AS2 would be improved by additional guidance for issuers and auditors on how the presence of strong entity level controls, and how the entity's assessment of risk, affects the evidence required for transaction level controls.

There are unresolved technical issues that could significantly expand the scope of 404 for both issuers and auditors, including controls over the issuer's use of a specialist and whether controls over supplementary disclosures are included within the scope of the 404 process. We encourage the SEC and PCAOB to carefully consider these issues and to gather input from issuers and auditors on the ramifications of the decisions to the 404 process.

Principal Audit Evidence

A fundamental requirement of AS2 is that the independent auditor needs to obtain the principal evidence for the auditor's opinion from the auditor's own work. We fully support this requirement. However, we believe AS2 or the PCAOB's interpretive guidance should be revised to enable the independent auditor to consider the work of internal auditors when providing direct assistance to the independent auditor and working under the direct supervision of the independent auditor. Presently, AS2 permits the independent auditor to use the work of internal auditors (subject to certain limitations), but not to consider such work as part of the principal evidence supporting the independent auditor's opinion. Internal auditors generally perform monitoring and testing of controls as part of management's assessment process, in which case we agree that the independent auditor's use of this work would not constitute principal evidence. However, in some cases, internal auditors may perform tests or other procedures solely for purposes of the audit and under the independent auditor's direct supervision. We recommend that the PCAOB staff reconsider its views on this matter and specify that internal auditors providing direct assistance are under the direct supervision of the independent auditor, and that the independent auditor may consider the results of such work as principal evidence.

The Integrated Audit in 2005 and Future Years

The PCAOB developed and issued AS2 as the authoritative auditing standard for an audit of internal control over financial reporting performed *in conjunction with* an audit of an SEC issuer's financial statements, i.e., an *integrated audit* of both the issuer's financial statements and its internal controls over the preparation of its financial statements. In previous years, auditors performed considerably less work in understanding, evaluating and testing internal controls than as required when performing audits in accordance with AS2. However, even then, auditors were able to place reliance on their audit procedures related to internal control in determining the nature, timing, and extent of their audit procedures directed to significant financial statement accounts. In an integrated audit as contemplated by AS2, the auditors often will be able to place even more reliance on effective controls than in the past, and accordingly have even more flexibility regarding the substantive procedures performed on significant financial statement accounts.

In this initial year of 404 implementation, the audits of SEC issuers in most cases were not fully integrated audits as contemplated by AS2 and other PCAOB auditing standards. The planning for audits of larger accelerated filers usually commences early in the year (often immediately after completing the prior year's audit) and interim testing begins shortly thereafter. Much of this work in 2004 was well underway by the time AS2 was finalized, let alone by the time issuers and auditors gained familiarity with its provisions, additional guidance was issued and interpretive matters were discussed with the PCAOB staff. In addition, in many situations, auditors did not have an existing base of detailed knowledge on the effectiveness of controls as of the beginning of the year when planning their substantive audit procedures; as a result, substantive audit procedures often were planned based on prior years' approaches because any possible scope reductions that would be dependent on the results of controls testing likely would not be known until too late in the audit process.

We believe that the opportunity to plan and begin to execute a truly integrated audit will enhance the effectiveness of an audit and--more to the point--will improve the efficiency of the financial statement and internal control audit procedures. Starting this year's audit with a current, detailed understanding of the effectiveness of internal controls over financial reporting will enable auditors to more fully plan, where appropriate, for increased reliance on effective internal controls and thus more efficient auditing of significant accounts. We note that some of the efficiencies from the integrated audit will not be realized to the fullest extent in many situations in 2005, because the current year's audits will commence while SEC issuers and auditors are awaiting any changes that might result from the retrospective reviews of first year implementation of 404.

Future Implementation Shaped by PCAOB Inspections

We have read and heard the complaints that auditors required excessive amounts of work and documentation from their clients and performed too much testing themselves during this first year implementation of the 404 requirements. At a time when auditors are working diligently to regain investor confidence and public trust, we are not surprised-- nor do we believe others should be--that auditors might feel compelled to err on the side of caution when guiding their clients' efforts and determining their own efforts on such an important, new undertaking.

As we learned of increasing levels of work beyond our initial estimates, we took steps to communicate to our audit partners and staff that they should exercise their best professional judgment in determining the scope of their work, and that we expected a very reasoned approach by the PCAOB to its inspection of 2004 financial statement and internal control audits. These communications might have been too late in the process to have significant effects, but seemed to help as our professionals did a very good job of completing their audits such that our clients could meet their filing deadlines.

As E&Y Chairman Jim Turley indicated in testimony before the U.S. Senate Committee on Banking last September, "[T]he significance of the creation of the PCAOB must not be overlooked and the PCAOB's impact in driving future auditor behavior should not be underestimated. New requirements in PCAOB standards and the close scrutiny of PCAOB inspections already demonstrate how its actions will drive auditor behavior with lasting and controlling effect across the profession."

We have been and continue to be very supportive of the benefits that the auditing profession should derive from the PCAOB inspection process – each firm should continually improve its performance based on its inspection results and communications from the PCAOB on best practices identified during the PCAOB's inspection of other firms. We believe that the 2005 inspections by the PCAOB are particularly important to efforts directed toward improving the effectiveness and efficiency of 404 implementation in the future. The PCAOB inspection staff obviously should determine whether the audit teams for selected engagements fully complied with the provisions of AS2. Given the lack of experience with this new standard as compared to experience implementing other long-lived auditing standards, we expect the PCAOB inspection staff to be more constructive than critical in their assessment of compliance with AS2. In addition, we certainly hope that the PCAOB inspection staff will challenge whether the audit teams implemented AS2 in a manner consistent with the PCAOB's expectations or performed a level of work in excess of the PCAOB's expectations. Such a focus on efficiencies would enable us to make adjustments to our guidance for all teams or the scope of the particular engagement, as appropriate.

We intend to take a similar approach – a constructive approach to identify both necessary improvements in effectiveness and opportunities to achieve efficiencies - during our annual internal quality inspections of our 2004 audits of financial statements and internal controls over financial reporting.

The Case for Exercise of Professional Judgment

We believe the issue or question of exercising professional judgment is fundamental. The challenges demonstrated in the implementation of 404 on this question are representative of something much larger. We are confident that audit professionals, like any true professional, consider and value themselves as professionals because of their ability and duty to exercise judgment. If they fail to exercise appropriate professional judgment, they would expect to be disciplined in some manner. But what we have witnessed in this country is that the exercise of professional judgment is subject to being overturned or challenged by any number of authorities. In auditing, this has been a driving force behind the relatively heightened use of "rules" versus "principles" in the U.S. as compared to the rest of the world. This is a concern that runs deep.

The exercise of professional judgment will suffer absent the instillation of confidence in the professional that his or her judgment, appropriately exercised, will be respected. Without instilling confidence in the individual that appropriate exercise of professional judgment will be respected by all authorities, we will continue to struggle as a nation seeking to converge with the world's capital markets that operate in a framework based more on principles rather than rules.

Bringing this back to 404, individual auditors do have anxiety over the PCAOB inspection process. It is new and the experience of auditors with it is limited. With the leadership of the PCAOB publicly pushing for appropriate use of professional judgment, more experience with the PCAOB inspection process will hopefully lead to greater confidence on the part of individual auditors. However, the PCAOB and SEC inspection and enforcement actions aren't the only factors. We would be remiss not to acknowledge the influence of the U.S. litigation system. Plaintiffs often bring securities fraud cases alleging that the auditors did not do enough work as to a particular matter, and allege that if they had done additional work the auditors would have uncovered a fraud or some other impropriety. This litigation risk poses fundamental threats to the private sector public company auditing function and undermines the confidence of auditors that appropriate exercise of professional judgment will be respected. This is not an issue that is new or one necessarily within the power of the SEC or PCAOB to fix, but is a matter that must be addressed.

Relationship Between Public Companies and Independent Auditors

We have read and heard that one consequence from the first year implementation of 404 has been a more distant relationship between SEC issuers and their independent auditors Some concerns have been expressed regarding a separation with respect to the provision of advice on accounting and reporting matters to the degree that, if true, would be a step backward in terms of improving the quality of financial reporting to investors and other users of financial statements, whereas the requirements of 404 were intended to have the opposite, positive effect on the quality of financial reporting. In recent years, heightened concern regarding auditor independence has caused some auditors to be very cautious about the effects on auditor independence of providing advice on accounting or reporting matters to their audit clients**.** We fully support the independence rules of the SEC, PCAOB, and others and wish to clearly operate safely within those boundaries that govern our consultations and assistance to our audit clients. At the same time, we want to encourage our audit clients to consult with us on significant issues as needed, recognizing that bringing the depth and breadth of our professionals' knowledge to bear on such issues in a timely manner should enhance financial reporting.

To the extent such interactions between management and auditors have been impeded by independence concerns, the situation worsened in 2004 due to concerns by some SEC issuers that their independent auditors might be viewing requests for consultation and assistance as indicative of a material weakness in internal control.

We urge both the SEC and PCAOB staffs to consider what additional guidance they might be able to provide that would encourage appropriate consultations between management and the auditors without undermining the objectives of independence rules and AS2. We appreciate the difficulty in providing clear, bright lines, and we can envision situations where the extent of auditor involvement in an audit client's financial reporting process could result in an independence violation or be indicative of a material weakness. However, the demand for advice and consultation is not likely to abate given the volume and complexity of new accounting standards and reporting requirements, and causing SEC issuers to not seek out such advice or to turn to firms other than their auditing firm for this type of advice would be detrimental to the quality of financial reporting, inefficient for the issuer and its stakeholders, and likely be unhealthy for the auditing profession.

Considerations for Smaller Public Companies

We fully support the SEC's decision to defer for one year the implementation of 404 by nonaccelerated filers and the formation of the SEC Advisory Committee on Smaller Public Companies. Conducting an assessment of lessons learned and evaluating potential improvement opportunities before requiring 404 implementation by nonaccelerated filers makes considerable sense.

Excluding any costs that must be incurred to remediate control deficiencies (which naturally will vary considerably based on the circumstances), clearly both the internal costs for a smaller, less complex public company to effectively comply with the SEC's 404 requirements and the audit fees for attestations pursuant to AS2 by such a company's independent auditors should be less than for larger, more complex entities. From the auditor's perspective, the audit effort required by the application of AS2 to the audit of internal control over financial reporting varies considerably based on size and complexity, in the same manner that the audit effort for an audit of financial statements in accordance with PCAOB auditing standards varies based on these same factors. However, because the objectives, performance requirements, and levels of assurance in an AS2 engagement are the same irrespective of size and complexity (just as they are the same for a financial statement audit irrespective of size and complexity), the audit fees for an integrated audit of a smaller, less complex public company will be disproportionately higher than the audit fees for a larger, more complex public company. As a result, there should not be unrealistic expectations regarding any degree to which their 404 costs may be proportionately lower.

Should the level of costs necessary to do the job right be determined to be unacceptable in relation to the benefits provided to investors in smaller public companies, the SEC could then consider using its exemptive authority to provide alternatives, including annual reporting by management on the issuer's internal controls over financial reporting with no auditor attestations or with less frequent auditor attestations (for example, auditor attestations every other year) or even complete elimination of annual reporting by management on the issuer's internal controls over financial reporting. However, we do not believe there is sufficient information to conclude that the 404 requirements of the Act should not be fully applicable to smaller public companies. In fact, over a longer period of time we would expect that the benefits to investors of the 404 requirements would be proportionately higher with respect to smaller public companies and we believe a bifurcated approach may have unintended consequences in terms of investor risk and cost of capital.

Considerations for Foreign Private Issuers

We also fully support the SEC's decision to defer for one year the implementation of 404 by foreign private issuers. Many foreign private issuers face the challenge of adopting International Financial Reporting Standards as their primary basis of accounting in 2005, an enormous task that requires the full-time focus of executive and financial management who would also be integral to 404 implementation.

Foreign private issuers and their independent auditors have contemplated the eventual implementation of 404 and identified issues that are unique to non-U.S. public companies. Although the additional one-year deferral of 404 should help by providing more time for identification and remediation of control deficiencies prior to the first 404 reporting by foreign private issuers, we understand that foreign private issuers likely have unique issues that could result in many more material weaknesses under the PCAOB's definitions and guidance in AS2. One pervasive issue is that U.S. GAAP is not the primary basis of accounting for many foreign private issuers, who as a result have not developed robust infrastructures to support an annual footnote disclosure requirement involving U.S. GAAP. In addition, foreign private issuers face many of the same issues that U.S. public companies have experienced, but often the effects are magnified due to language differences, business environments, regulatory requirements, and other considerations. Given the additional time before implementation of 404 is required, we suggest the PCAOB consider whether AS2 revisions might be appropriate to address the unique issues facing foreign private issuers.

Elimination of Acceleration of Filing Deadlines

In recognition of the potential adverse effects of the additional workload arising from the first-time implementation of 404, the SEC adopted amendments in November 2004 that postponed for one year the scheduled acceleration of annual report filing deadlines applicable to accelerated filers from 75 days after year end to 60 days after year end. The filing deadline of 75 days after year end was an acceleration of the 90 days after year end deadline applicable in prior years. Later in November, after carefully assessing the preparedness of accelerated filers, the SEC issued an exemptive order that provided accelerated filers with market capitalization of less than $700 million a one–time deferral option whereby the filing of the annual financial statements by the scheduled filing deadline could be followed by the filing of the internal control reports within a 45-day period.

We fully supported both of these actions by the SEC. Although we have not seen a tabulation of final numbers as of the date of this letter, we understand that there was an increase this reporting season in the number of SEC issuers that filed their annual reports (or at least their 404 internal control reports) after the scheduled filing deadlines, either utilizing the always available 15-day 12b-25 extension or the one-time 45-day deferral period. Although some portion of this increase undoubtedly is attributable to first-year issues, we and many of our public company audit clients experienced the strain of doing more this year in the same amount of time as last year (and less time than in the past), and are quite concerned about the prospect of a 20% reduction (from 75 to 60 days) in the filing deadlines for all accelerated filers next year We suggest that the SEC reconsider the acceleration of filing deadlines scheduled for next year and instead retain the current 75-day deadline, or at least for some subset of accelerated filers, such as those with a market capitalization of less than $700 million.

Conclusion

We agree with the recent comments of Congressman Mike Oxley when he stated, "Sarbanes-Oxley compliance is an investment in every company, it is an investment in our financial system, and it is an investment in the strength of the United States capital markets."

Ernst & Young is committed to working with the SEC, PCAOB, and all stakeholders in the financial reporting process to evaluate the historic first-year implementation of section 404 and explore ways to enhance the process in a way that will best serve investors and the economy as a whole. We applaud the effort to explore the experiences of registrants, accounting firms, and others in the implementation of Section 404 and appreciate the opportunity to contribute to that process.

In this letter, we have summarized our key observations on the first-year implementation of 404, the lessons we have learned, and our recommendations for improving the effectiveness and efficiency of the internal control reporting process. We would be pleased to discuss any of these observations in greater detail with the staffs of the SEC and PCAOB or with Commissioners or Board members.

Very truly yours,

Ernst + Young LLP

Ernst & Young LLP