



**SOCIETY OF CORPORATE SECRETARIES
& GOVERNANCE PROFESSIONALS**

**** We sent this letter to the PCAOB in February 2006. We are resubmitting it to the SEC electronically in connection with the upcoming roundtable meetings and the SEC's request for comments under File Number 4-511. ****

February 15, 2006

Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via Regular Mail

Dear Ms. Gillan and Messrs. Goelzer, Gradison and Niemeier:

We truly appreciate that many of you were able to meet with members of our Securities Law Committee on January 10, 2006, and we look forward to continuing our discussions with you and your staff. We wanted to address a few issues that you raised at that meeting.

By way of background, The Society of Corporate Secretaries & Governance Professionals (formerly The American Society of Corporate Secretaries) is a professional association, founded in 1946, with over 4,000 members who serve more than 3,000 issuers. Responsibilities of our members include supporting the work of corporate boards of directors, their committees and executive management regarding corporate governance and disclosure. Our members assure issuer compliance with the securities laws and regulations, corporate law, stock exchange listing requirements and the accounting rules, and have been on the front-line in implementing the structural changes necessitated by the Sarbanes-Oxley Act of 2002 and the resulting rules of the Securities and Exchange Commission, the Public Company Accounting Oversight Board and the exchanges. The majority of Society members are attorneys, although our members also include accountants and other non-attorney governance professionals.

At our meeting, we discussed Auditing Standard No. 2 and you asked us what we would want to change about Auditing Standard No. 2 if we had a "wish list." We actually do have a "wish list" relating to Auditing Standard No. 2, and our wishes relate primarily to creating efficiency and eliminating confusion. While our members are not all of one mind, many of our issuer members are reporting that these issues are creating friction with the audit firms, which is not helpful in promoting an effective but efficient audit process.

1. Limitation of Testing and Walkthroughs

We would like to see modifications to AS-2 that limit the frequency of testing and walkthroughs in some circumstances. Specifically, we believe that testing should be required every other year, or even every third year, for those controls that are highly automated, have not changed from the prior year and have had no significant deficiencies or material weaknesses in the past three years. This would save costs and enable issuers and their auditors to focus on the more manual, subjective controls.

Similarly, we propose that the frequency of required walkthroughs of “major transactions” be limited such that if a control process for a major transaction has not changed in any significant way, then a walkthrough be required only every other or every third year. This would greatly reduce external audit costs. Obviously, we support required walkthroughs for any process for which there has been a significant change during the fiscal year.

2. Definition of Remote

We are interested in receiving further guidance as to what the PCAOB considers “remote” to mean – can it be quantified as a 5% or 10% likelihood of occurrence? Although the PCAOB’s November 30, 2005 report on implementation of AS-2 discusses “More Than Remote Likelihood” on page 16 and indicates that the term is understood to have the same meaning as the use of the term in FAS No. 5, *Accounting for Contingencies*, we nevertheless believe that further, more objective guidance is needed. We understand that something that is remote may actually occur or, put another way, its likelihood of occurring is greater than zero. The November 30 release indicates that “more than remote” means that there is at least a reasonably possible likelihood of occurrence. However, in some cases, our members have found that the registered public accounting firms have taken the position that something that may occur, however unlikely, can never be categorized as remote.

3. Focus on Internal Controls During a Specified Period Rather Than at a Date Certain

AS-2 , Regulation S-K Item 307 and Rules 13a-15(b) and 15d-15(b) require that management assess the effectiveness of the company’s internal control over financial reporting as of the end of the company’s most recent fiscal year. As a result, if an issuer changes its systems or controls immediately prior to year-end then the system that was in place for virtually all of the fiscal year is excluded from the assessment, and the new system is included in the assessment even though it did not materially impact financial results for that fiscal year. Therefore, some of our members have suggested that the assessment should instead be required to cover the effectiveness of the company’s internal control over financial reporting that existed during the fiscal year and were material to the company’s results. This would eliminate the need for issuers to ensure that systems are put in place with adequate time for testing, providing issuers with

flexibility to make decisions regarding systems and controls that are instead in the best interests of the company.

4. Impact of Restatements

In our experience, the registered public accounting firms generally believe that a restatement of financial statements is automatically a material weakness, notwithstanding the SEC's May 2005 guidance that indicates that it is only a strong presumption of a material weakness. We have actually heard a representative of one external auditor state definitively that a restatement automatically results in a material weakness. Further, we are only aware of one restatement that was not also categorized as a material weakness (see United Auto Group's Form 8-K dated January 23, 2006). We understand that certain SEC staff members may have expressed some informal views on the subject of the existence of material weakness following restatements. We believe that expanded formal guidance should be provided jointly by the PCAOB and SEC (and ultimately include such guidance in a modification of AS-2) to ensure consistent interpretation and application. Specifically, we believe that the following should be provided as examples of situations in which a restatement will typically not be evidence of a material weakness:

- GAAP is silent or ambiguous concerning an acceptable interpretation of a standard and the SEC staff announces interpretive guidance that mandates an approach that requires one or more companies to restate previously issued financial statements (e.g. classification of cash flows from discontinued operations);
- A company and the SEC disagree on a matter that is the subject of judgment or estimate and, notwithstanding the support the company has for its position, the SEC requires restatement (e.g. materiality; segment reporting, fair value determinations, method of determining loan loss allowances; use of particular discount rates or other assumptions);
- A company misapplies a technical and arguably immaterial GAAP issue (e.g. reclassification of certain cash equivalent or cash flow items); or
- A company has been following an acceptable accounting approach of its industry and an objection is raised by the SEC subsequent to the issuance of financial statements (e.g. debt classification of refundable residents' deposits held by continuing care companies).

We believe that, in all of these examples, the restatement that follows is not an indication of inadequate controls within the company.

5. Disincentive to Apply Judgment

Certain of our members have indicated that the recently released inspection reports have caused registered public accounting firms to modify their procedures in an effort to enhance the possibility of ultimately receiving an inspection report with no negative findings. While this is an understandable objective in the current environment, we believe that in some instances this has caused the accounting firms to apply an undesirable rigor in reaction to the findings contained in their PCAOB inspection reports. Further, in some cases, certain audit engagement teams appear to have established rigid criteria for audit procedures that must be performed that do not give appropriate consideration to the materiality of the items being tested. For example, certain of our members have reported the following:

- If an inspection finds that the auditor failed to review all material contracts, then the auditor is correcting this issue by requiring increased diligence with respect to contract reviews. While increased diligence is appropriate if there has been a deficiency, our members have reported that certain firms are insisting on reviewing even immaterial contracts. It can require significant time and effort to gather and review these contracts, and we believe efficiencies would be gained if this review was limited to the appropriate scope.
- As a result of the PCAOB's inspections, some independent registered public accounting firms are requiring enhanced procedures around inventories, in some cases even for service companies for which inventories represent an immaterial portion of company assets.
- PCAOB findings related to the failure of independent registered public accounting firms to send confirmations of accounts receivable have resulted in an effort to send widespread confirmation requests, even for companies that rely heavily on individual customers with small outstanding bills. Clearly, receipt of such a confirmation request would confuse many individual customers, and they are likely to either send payment to the auditing firm or simply ignore the request.

These reactions to the inspection reports that were issued in the fall of 2005 reflect an ongoing problem experienced by some of our members notwithstanding the May 2005 guidance: in some cases the engagement teams of the firms appear reluctant to apply appropriate judgment. We have heard some individuals at the registered public accounting firms question the intent and meaning of the guidance, noting the findings in their inspection reports and stating that they are required to instead follow the more restrictive language of AS-2. Therefore, we request that AS-2 be updated to incorporate all later guidance that has been published. In the interim, we request that the PCAOB provide guidance to clarify the relationship between the guidance that has been published and how the deficiencies enumerated in the inspection reports are to be addressed in light of that guidance.

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Our final request would be that the PCAOB continue to communicate to the auditing firms the importance of exercising appropriate judgment – and that the 2006 inspections of 2005 audits note instances where judgment was not appropriately applied. As we discussed with you on January 10, we also ask that the PCAOB consider including their findings with respect to application of the 2005 guidance by the audit firms in the public portions of the inspection reports.

We appreciate this opportunity to share our views with you, and would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,

The Society of Corporate Secretaries and Governance Professionals

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