

Accountants and Business Advisors

May 10, 2006

VIA ELECTRONIC MAIL

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

Re: File Number 4-511

**Comments Re: Overview of the Second Year**

Dear Ms. Morris:

Grant Thornton LLP appreciates the opportunity to comment on our second-year experiences with the implementation of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley” or “the Act”). Equally welcome is the opportunity to participate again in this year’s public roundtable being held by the Securities and Exchange Commission on May 10, 2006, in Washington, D.C.

Specifically, we would like to comment on (1) the nature and extent of changes in the processes in the second year as companies and their auditors gained more experience; (2) whether resources were allocated more efficiently and effectively; and (3) whether progress has been made toward the goal of improving the integrity of financial reporting.

**Intent and early benefits are incontrovertible**

Without a doubt, Section 404 of the Sarbanes-Oxley Act of 2002 has helped improve the quality of companies’ financial reporting. It was designed to do so by facilitating three incontrovertible and inextricably related goals:

- (1) Every company should have good internal controls;
- (2) Management should be in a position to be able to tell their investors, at least annually, that they have good internal controls;
- (3) There should be a reasonable and efficient way for auditors to perform appropriate procedures to say whether they agree with management’s assessment.

Equally without question is that these early experiences with implementation have been costly, but we cannot and should not go back. At this critical two-year junction, we are on the brink of effecting fundamental and lasting improvement in the quality and efficiency of both financial reporting and auditing:

**A continued focus on improving the real-world application of Section 404 will afford a unique opportunity to ensure that the true intent of the legislation – improved quality in financial reporting – is realized.**

This is the most opportune time to capitalize on what has already been accomplished, while also working to bring costs down.

Nancy M. Morris  
May 10, 2006  
Page 2

### **The need for practical internal control guidance**

Of course, there were start-up and catch-up costs, but the greatest driver of high costs has been related to “wandering in the wilderness” of internal control:

**There has never been, nor is there now, the practical, ground-level guidance that both companies and auditors need to determine – in a consistent fashion – what constitutes an effective internal control environment across all businesses, regardless of size.**

The COSO Framework provides an excellent set of internal controls principles for all companies, but we have not yet defined how different companies can follow those principles effectively in various risk environments. If the financial reporting profession gets this right, we will have the strongest financial reporting system in the world – one which yields the most reliable financial statements in the world.

Saving companies compliance costs is critical – public companies are not in the business of financial reporting – but if the playing field isn’t level, smaller companies are going to pay the most in the long term through loss of investor confidence. Section 404 and Auditing Standard No. 2 (AS2) are not the problem; the problem is a void where collaborative judgment should evolve and be available publicly through exchange on what defines “good” internal controls.

In a country based on the power of shared voices, this gap is a problem that can be bridged through the formation of a qualified body of professionals (e.g., auditors, practitioners from industry, regulators, investors and academics) to solicit and receive questions from the field and to debate them publicly, arriving at consensus in the gray areas where auditor judgment is required. That consensus opinion could then be published as appropriate guidance for developing sound internal controls.

We don’t need a set of rules; we need to offer guidance on using judgment in the gray areas. One size never fits all. This organic and ongoing exchange is the best way to find our way to accomplishing the ultimate goal and the greater good – more reliable and cost-efficient financial reporting.

### **Specifically addressing the benefits**

To put the magnitude of the benefits of Section 404 in context, it is useful to offer additional detail. These benefits fall into three main categories:

- (1) A significant number of “material weaknesses” in internal controls over financial reporting (ICFR) have been identified and corrected, particularly in the larger public companies to which the requirements of Section 404 have applied to date. As a result, untold numbers of future restatements have been prevented, and investors now have more reliable information.
- (2) An even greater number of “significant deficiencies” in internal controls have also been identified and corrected, further improving the quality of financial reporting.
- (3) Corporate management and audit committees of these companies are now squarely focused on the quality of the financial information they produce.

Nancy M. Morris  
May 10, 2006  
Page 3

### **Discovery and elimination of material weaknesses**

Arguably, the most obvious benefit of Section 404 has been the result that a significant portion of our public companies (i.e., accelerated filers or only those companies required to comply with Section 404) have now identified and resolved internal control problems, in many cases resolving problems of which they were unaware until responding to the legislation.

Audit Analytics™ recently published a report<sup>1</sup> that assessed the first full year of compliance with Section 404 of the Act. Their analysis focused on accelerated filers and found that, of such companies, 591 discovered at least one material weakness. This total excludes those companies that may have discovered, reported on, and resolved material weaknesses, but that were not required to do so.

The Audit Analytics™ report demonstrates that at least 15 percent of our largest companies identified at least one material weakness in internal controls and have now either resolved the problem or are in the process of resolving it. In and of itself, this benefit is of enormous importance and value to the marketplace.

The scope of benefit is greater still if added to the untold number of significant deficiencies in internal controls that have been identified and corrected. Clearly, companies identifying significant deficiencies would be eager to prevent their problems from eroding into material weaknesses.

As a result, although it is impossible to quantify, it is fair to say that the two years during which Section 404 has been in force have led to greatly improved financial reporting, even in these early stages.

If left in place, Section 404 will gain additional momentum toward its intended goal. Those 70 percent to 80 percent of companies that have not yet had to comply with Section 404 will be compelled to do so, and, by and large, these smaller companies will likely reveal the greater number of reporting problems. Our expectation is that by applying Section 404 properly (i.e., equally across the playing field, regardless of company size), smaller companies will benefit to an even greater extent than have larger accelerated filers.

Clearly, that is not to imply that smaller companies must have the same internal controls, but rather that they must follow the same principles and meet the same broader quality and risk management standards of good internal controls. It is incumbent upon the financial reporting profession to provide additional, detailed guidance on how *all* companies can meet those universal quality and risk management standards.

In reviewing progress to date, it is safe to say that the primary source of improvement is straightforward – focusing formal attention on the problem. Moreover, this intensified, focused scrutiny is coming from three fronts simultaneously – management, audit committees and auditor evaluation of internal controls.

---

<sup>1</sup> Audit Analytics™, *Section 404 Internal Control Material Weakness Dashboard Results for the Second Year of Section 404 Disclosures Based on filings as of April 15, 2006.*

### **Costs are moving in the right direction**

The level of deferred maintenance of ICFR, the level of complexity in properly evaluating internal controls and a general lack of guidance (and agreement) regarding what “good” internal controls look like – in practice in various corporate settings – has caused the implementation of Section 404 to be inefficient and costly.

Initial higher costs can be traced to at least three primary causes. First, performing evaluation of internal controls is new, and financial reporting is more complex than ever before. Experience over time will heal this wound.

Second, we must address the central problem. As noted earlier, companies need guidance on determining what internal controls are necessary to achieve the requisite high-level control principles.

Finally, collaboration on gray or judgment areas is critical. Auditors have neither discussed openly – nor formally shared – best-practice audit procedures, leaving each firm to develop its own procedures in a vacuum. This approach has been especially destructive to smaller firms.

Even without resolving the core issue of consistent guidance, various studies have supported the general belief that second-year costs have been lower for public companies than they were for the first year. An April 2006 study by CRA International<sup>2</sup> (sponsored by the Big 4) suggests that overall costs for smaller and larger public companies declined 30.7 percent and 43.9 percent, respectively. Another 2006 non-statistical internet study published by Financial Executives International (FEI),<sup>3</sup> suggests more modest declines in costs. Clearly costs have come down, but there is still much room for improvement.

### **Costs are decreasing for several reasons**

Costs have come down in the second year for a number of reasons:

- (1) The first and simplest reason is experience. We had done it before so that the second time around was more efficient.
- (2) In addition, we had completed documentation during the previous year. (Although significant business changes affect that general premise on a case-by-case basis.)
- (3) The second year also brought efficiencies in understanding; e.g., we were more adept at eliminating duplicative work. For example, we may have tested controls over the same risk in multiple areas, and this year we were able to eliminate that redundancy.
- (4) The first time around, we were able to identify and address internal control deficiencies. The improvement in internal controls made the second overall evaluation more efficient.
- (5) The second year afforded additional time and firsthand experience for planning and execution.
- (6) Finally, efficiency is no boon if it exposes the company to increased risk. As experience grows, we become increasingly more effective at linking our testing strategies to the relative risk profile. For example, we were able to focus our efforts on critical financial statement assertions and use more of the work of others in less critical areas.

---

<sup>2</sup> CRA International, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update*, December 8, 2005.

<sup>3</sup> Financial Executives International, *FEI Survey on Sarbanes-Oxley Section 404 Implementation*, March 2006.

Although occasionally cost-efficiencies were offset by labor costs, this consequence is not inherent in the process. Every situation is unique, and catching up or cleaning up is a valuable investment for going forward in this more regulated environment. Returning to our original premise, although we expect costs to continue declining with experience, the real catalyst for lowering costs will stem from a combination of agreed-upon guidance regarding what constitutes good internal controls and an agreement among auditors to share best practices or perhaps collaboratively author a guide on the subject.

### **Redefining responsibilities**

Cultural attitudes have shifted many times over the years with respect to assuming responsibility for choices and actions, often swinging from one extreme to the other. Understanding, clarifying or reiterating roles in the financial reporting process is long overdue. Many small companies still erroneously believe that the auditor has the primary responsibility to “get the financial statements right.” There are three parties involved in this process for a reason. The roles of management, the audit committee and the auditor need to be clarified and articulated for company management.

Once again, it is the small companies that stand to lose the most. For these companies, particularly small companies with low net incomes, the SEC’s Staff Accounting Bulletin No. 99 (SAB 99) has driven some audit scopes to a very low level, thus increasing the relative cost of the audit.

In evaluating the propriety of reported financial information, SAB 99 rightly demands that companies and auditors consider not only the quantitative dollar amounts involved, but also the qualitative effects of identified misstatements. It is important to note, however, that the suggested qualitative criteria, such as whether the misstatement changes a loss into income or vice versa, can be very small in absolute dollars for many small companies. The SEC should take a look at SAB 99 and consider providing additional guidance for smaller companies.

One final point should be addressed with respect to smaller companies and compliance with Section 404. Some have argued that compliance for smaller companies should be voluntary. Few small companies would sign up initially without being compelled by legislation. This voluntary scenario would force investors into the position of having to sort through which companies are compliant and which are not. If Section 404 is the right path for realizing the ultimate objective – and it is – then compliance should be mandated, and legislation should be accompanied by reasonable and efficient guidance on how to comply with both the letter and the spirit of the law.

### **Conclusion**

Some have proposed reducing or eliminating Section 404 requirements, in part or all together, for some public companies; but drastic and short-sighted decisions such as this will, in the end, cause significant harm to investors, companies, their audit committees and the capital markets.

The pain of change has already been felt; let’s allow the process of fine-tuning to continue to bring progress towards the ultimate goal of greater transparency, accuracy and efficiency in financial reporting. Grant Thornton wrote extensively on this subject in the attachment to our April 3, 2006, letter to the SEC.<sup>4</sup>

---

<sup>4</sup> Grant Thornton LLP, *Report on the Effective Application of Section 404 of the Sarbanes-Oxley Act of 2002*, March 2006.

Nancy M. Morris  
May 10, 2006  
Page 6

The inefficiencies and other glitches in the process must be addressed, and they can be addressed effectively, but not by reducing the reasonable requirements of Section 404. Our industry needs to lead the cause of creating guidance regarding best practices – from auditing to developing, maintaining and enhancing internal controls – on an ongoing basis.

We thank the SEC for this opportunity to add the benefit of our experience to this very critical debate.

Please direct your questions to me at 312.602.8007, or [edward.nusbaum@gt.com](mailto:edward.nusbaum@gt.com), or Trent Gazzaway, Managing Partner Corporate Governance, at 704.632.6834, or [trent.gazzaway@gt.com](mailto:trent.gazzaway@gt.com).

Very truly yours,



Edward E. Nusbaum  
Chief Executive Officer  
Grant Thornton LLP