



**KPMG LLP**  
757 Third Avenue  
New York, NY 10017

Telephone 212-909-5600  
Fax 212-909-5699  
Internet www.us.kpmg.com

May 1, 2006

Ms. Nancy M. Morris  
Federal Advisory Committee Management Officer  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20540-1090

**File No. 4-511**  
**Internal Control Roundtable**

Dear Ms. Morris:

KPMG LLP welcomes this opportunity to comment on experiences related to our ongoing role in implementing the internal control reporting provisions of Section 404 of Sarbanes-Oxley. We commend the PCAOB and the Commission for sponsoring the May 10, 2006 Roundtable, and fully support the respective efforts taken to review Section 404 and Auditing Standard No. 2 implementation to date, with the expressed intent of improving implementation effectiveness and efficiency.

We believe that Section 404 has served to enhance the reliability of financial reporting in the US to the benefit of the investing public. Compliance with the provisions of Section 404 has increased management attention and commitment to internal control over financial reporting, focused attention on ethics and anti-fraud policies and procedures, and enhanced transparency associated with issuers' public reporting obligations.

We believe that year two of compliance with Section 404 has shown significant progress in addressing concerns about inefficiencies associated with implementation during year one.<sup>1</sup> We would like to recognize and commend issuer managements and board members, the PCAOB, the Commission, and the registered public accounting firms for their respective contributions to furthering the effectiveness of internal control reporting during the past year. The improvements made in internal controls, financial reporting, corporate governance, and audit quality serve to further the interest of the investing public and strengthen confidence in our capital markets. We also believe that further progress toward enhancing the effectiveness and efficiency of compliance with the provisions of Section 404 will be realized as issuer management and auditors gain additional experience in reporting on internal control over financial reporting.

---

<sup>1</sup> CRA International, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006*, April 17, 2006 (Attached)



Nancy M. Morris  
May 1, 2006  
Page 2 of 4

## **Auditor Reporting**

Integrating the financial statement audit with the requirements of Auditing Standard No. 2 has presented significant challenges during the last two years, requiring substantial investment of time and resources, a new mindset, and evolving work processes by all parties involved in the financial reporting process. However, both issuer managements and auditors have moved forward along their respective learning curves, as evidenced in part by a decrease in the total cost of year two compliance with the provisions of Section 404, and a general improvement in processes and controls associated with financial reporting.

We would like to state our overall support for Auditing Standard No.2. We believe that Auditing Standard No. 2 is fundamentally sound, generally scalable, and well-suited to achieve its objective of enhancing the reliability of public company reporting. The May 16, 2005 PCAOB guidance furthering the concepts of an integrated audit, the importance of exercising sound professional judgment, executing integrated audits based on a top-down, risk-based audit approach, and using the work of others, has advanced the facilitation of the effective execution of integrated audits as contemplated in Auditing Standard No. 2.

We acknowledge that one recommendation of the Commission's Advisory Committee on Smaller Public Companies contemplates the development of an alternative approach to reporting on internal control over financial reporting. However, we believe that an alternative approach to internal control reporting providing for an audit of the design and implementation of internal control, but not operating effectiveness of such controls, is not advisable at this time. An alternative that provides only for an auditor's report on design and implementation of internal controls - at a time when much attention has been directed toward reporting on the operating effectiveness of internal controls - will result in users' misunderstanding the level of assurance provided by the auditor.

It is important to note that a well-designed system of internal control, while vital, does not equate to the generation of reliable financial information if effective internal control operations are absent. Accordingly, we believe that an alternative approach to internal control reporting providing for an audit of the design and implementation of internal control only would serve to widen the current expectation gap relative to auditor assurance, at a time when emphasis should be directed toward narrowing that gap.

## **Issuer Guidance**

While important strides are being made, it is imperative that all parties continue to challenge and improve Section 404 implementation activities. With respect to smaller public companies, we believe that the missing element in the formula to furthering cost efficiencies in such an environment is enhanced management guidance for developing an effective internal control structure, and completing an assessment and evaluation of internal control over financial reporting consistent with the provisions of Section 404.

To that end, we recommend that the Commission facilitate a collaborative effort by regulators, issuers, investors, and auditors to examine the practical challenges of Section 404 compliance that smaller public companies face. The objective of this effort should be to develop specific



Nancy M. Morris

May 1, 2006

Page 3 of 4

management guidance focused on the characteristics of these smaller public companies and their internal control structures, in order to further improve Section 404 compliance efforts. Specifically, this implementation guidance should address the following:

- Significance of monitoring controls;
- Risk of management override;
- Lack of segregation of duties;
- Extent and formality of company documentation and assessment; and
- Evaluation of the competency of a smaller company's accounting and financial reporting function.

Prior to its issuance, we also recommend that such guidance be pilot tested, including appropriate cost analyses, to facilitate well-informed decisions regarding the reasonable application of the provisions of Section 404 in a smaller public company environment. For example, it may become evident, as a result of field testing and meaningful cost analysis, that an audit of internal control over financial reporting may not be justified for certain very small public companies that demonstrate certain characteristics. It also may become evident that, for some issuers, an additional extension of the Section 404 compliance deadlines may be appropriate to allow for completion of the pilot test and development of additional guidance. However, those judgments should be reached only after we have the benefit of the pilot tests.

We believe that the alternative approach outlined above would result in meaningful improvements in the implementation of Section 404 by smaller public companies, and application of the provisions of Auditing Standard No. 2 by auditors, and we stand ready to commit our firm's resources to support efforts of the Commission directed toward that end.

### **Looking Forward**

Section 404 was intended to place additional responsibilities on issuers and independent auditors, requiring significant effort to yield substantive benefits. We believe that substantial benefits have in fact accrued to the investing public, even as the effectiveness and efficiency of issuers' and auditors' efforts have measurably improved. Recognizing these improvements, we believe that further progress is necessary in integrating the financial statement and internal control audit and in the effective and efficient application of the provisions of Auditing Standard No. 2. To that end, we continue to drive the application of our top-down, risk-based audit methodology through training and communication with our professionals. In addition, we continue to emphasize our previously issued guidance indicating that integrated audit plans should be tailored to the specific risks presented by a particular issuer, including the consideration of the effective use of the work performed by management and others. We believe that audit engagement teams will continue to improve performance in the area of devising effective and efficient responses to identified risks as they gain additional experience in applying the provisions of Auditing Standard No. 2.



Nancy M. Morris  
May 1, 2006  
Page 4 of 4

We believe that ongoing, constructive discussion among all constituents will further improve the effectiveness and efficiency of compliance with the provisions of Section 404. The Commission/PCAOB-sponsored Roundtable scheduled for May 10, 2006 represents an important forum to facilitate that continuing discussion. If based on these organized forums and discussions there is a consensus that further guidance is necessary from the PCAOB and/or the Commission, we encourage the dissemination of such guidance on a timely basis, similar to the May 2005 guidance, with the goal of helping to drive even more efficiency and consistency into the process.

\*\*\*\*\*

If you have questions regarding the information included in this letter, please contact Sam Ranzilla, (212) 909-5837, [sranzilla@kpmg.com](mailto:sranzilla@kpmg.com), or Craig W. Crawford, (212) 909-5536, [ccrawford@kpmg.com](mailto:ccrawford@kpmg.com).

Very truly yours,

**KPMG LLP**

Cc: SEC Commissioners

Mr. Christopher Cox, Chairman  
Ms. Cynthia A. Glassman  
Mr. Paul S. Atkins  
Mr. Roel C. Campos  
Ms. Annette L. Nazareth

PCAOB Board Members

Mr. Willis D. Gradison Jr., Acting Chairman  
Ms. Kayla L. Gillan  
Mr. Daniel L. Goelzer  
Mr. Charles D. Niemeier

Attachment: [CRA III](#)