



May 17, 2004

Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549-0609

Re: SEC Release No. 34-49544; File No. PCAOB-2004-03:  
***Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting  
Performed in Conjunction with an Audit of Financial Statements (AS)***

Dear Mr. Secretary:

Thank you for the opportunity to comment on the recently released AS. We believe the PCAOB addressed many important issues through the previous public comment process and the resulting refinements to the AS should serve to better enable both independent auditors and registrants to more effectively and efficiently carry out their responsibilities in audits of internal controls over financial reporting. Despite the preceding, we would like to bring to your attention one critical issue that we believe, if not addressed, would undermine a fundamental objective of issuing the AS by allowing inconsistent interpretations of one of its key elements. More specifically, the definition of "more than inconsequential" must be more clearly, concisely, and objectively defined to ensure that all reporting entities and independent auditors consistently identify items that individually and collectively meet the definition of a significant deficiency in the design or operation of internal controls over financial reporting. In the following paragraphs we provide suggestions on how to more clearly, concisely, and objectively define the term "more than inconsequential" which we believe you may find helpful as you consider final refinements to the AS.

**Proposed Definition of a Significant Deficiency in the AS**

*A significant deficiency is an internal control deficiency that adversely affects a reporting entity's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency is a deficiency that, by itself or a combination of deficiencies, results in more than a remote likelihood of a misstatement of the annual or interim financial statements that is more than inconsequential in amount and would not be prevented or detected.*

### **Providing Interpretive Guidance for the term “More than Inconsequential”**

The identification of a significant deficiency involves both a quantitative and qualitative analysis. Moreover, in determining whether a control deficiency is a “significant deficiency” the AS requires a determination of whether the likelihood of misstatement is “more than remote” and if so, whether the potential misstatement would be “more than inconsequential”. When determining whether the likelihood of a misstatement is “more than remote”, registrants and independent auditors will follow the authoritative guidance in FASB Statement No. 5, *Accounting for Contingencies*, which provides sufficient quantitative and qualitative guidance to determine whether a likelihood is “more than remote”. In contrast to the term “more than remote”, the term “more than inconsequential” is not defined (or otherwise discussed) in any authoritative accounting or auditing literature other than the AS. Moreover, we believe the AS itself does not adequately define the term “more than inconsequential” which will likely result in inconsistent interpretations of the term by registrants and independent auditors responsible for applying the AS. We believe that every effort should be made to avoid inconsistent application given the significant importance stakeholders (i.e. investors, creditors, employees, etc.) now place on the maintenance of adequate internal controls over financial reporting since the introduction of the Sarbanes-Oxley Act and the negative consequences that will likely result from the identification and communication of control deficiencies. Accordingly, we believe it is of paramount importance that the quantitative and qualitative threshold related to the term “more than inconsequential” be clearly, concisely, and objectively communicated so as to sufficiently reduce the potential for inconsistent interpretations between registrants and independent auditors which we believe could seriously undermine the credibility of the certifications required by both Section 302 and 404 of the Sarbanes-Oxley Act.

### **Setting a Reasonable Threshold for “More than Inconsequential”**

Although our primary concern is that the definition of “more than inconsequential” is consistently interpreted and applied, we believe it is equally important that any additional quantitative and qualitative interpretive guidance be designed to reduce the potential that minor deficiencies, that exist in even the most well-controlled business environments, are not designated as significant deficiencies as that could have the unintended consequence of desensitizing stakeholders of the importance of significant deficiencies.

In providing quantitative and qualitative interpretive guidance of the term “more than inconsequential” we suggest introducing examples in addition to those contained in the existing AS (which we do not believe provide clear, concise, and objective guidance) that apply evaluative criteria such as whether the deficiency would cause a reasonable investor to make a different decision with regard to the purchase or sale of the registrant’s debt or equity securities. For example, a deficiency that has the potential to change the reported earnings of a registrant by one percent, after-tax, would not likely exceed the “more than inconsequential” threshold as it would not likely impact the investing decisions of a holder of the registrant’s debt securities both because the amount of the potential misstatement is clearly immaterial and also because it is unlikely to affect the financial strength ratings of the registrant. In contrast, if the potential misstatement either affected the financial strength ratings of the registrant or more significantly impacted reported earnings (e.g. an after-tax impact of 2 percent or more) the deficiency would be considered a significant deficiency.

When determining a quantitative threshold for “more than inconsequential” one can look to the AICPA Audit Sampling Guide which provides general quantitative guidance for materiality in paragraph C5 wherein it states, “A common rule of thumb for materiality is 5 percent to 10 percent of pretax net income.” The 5 percent threshold is widely recognized as the threshold at which an item is considered material. In terms of defining the level at which an item is quantitatively “more than inconsequential” we believe a threshold of 2 percent is appropriate as it equates to a level of precision between 2 and 3 standard deviations. In contrast, the 5 percent level of materiality implies a level of precision slightly less than 2 standard deviations. Given the inherent potential for human error in the financial reporting process we believe adopting a level of precision higher than that implied by the 2 percent threshold would be neither cost beneficial or consistent with the indication that the term implies a level of materiality such that the item would affect the “judgment of a reasonable financial statement user”. Stated differently, it is unlikely that a “reasonable financial statement user” expects that financial statements are prepared at a level of precision exceeding 98 percent.

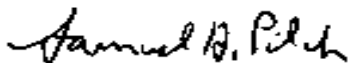
#### **Level of Reporting Precision and Risk Factors**

The Management Discussion and Analysis (MD&A) section of financial statements filed with the Securities and Exchange Commission contain forward-looking statements that are based on management’s expectations, estimates, projections and assumptions. Forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. As a result of the preceding, management identifies the principal risk factors that it believes may cause actual future results and trends to differ materially from what is forecast in its forward-looking statements.

Due to stakeholders’ familiarity with forward-looking statements and risk factors we believe it may be appropriate for all registrants to add a risk factor concerning internal control related matters. More specifically, the risk factor would indicate that although the registrant’s system of internal control over financial reporting has been designed to prevent and detect situations that could lead to a material misstatement of such registrant’s financial statements, any system of internal control has inherent limitations due to human involvement, and therefore errors may arise that could cause actual future results and trends to differ materially from what is forecast in the registrant’s forward-looking statements.

I can be reached at (847) 402-2213 if you would like to discuss the contents of this letter.

Sincerely,



Samuel H. Pilch  
Controller  
The Allstate Corporation