



Deloitte & Touche LLP
1633 Broadway
New York, New York 10018
USA

Tel: 212-492-4000
Fax: 212-492-4388
www.deloitte.com

May 1, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

File No. 4-511

May 10, 2006 Roundtable on Second-Year Experiences with Implementation of Internal Control Reporting and Auditing Requirements

Dear Ms. Morris:

Deloitte & Touche LLP (“Deloitte & Touche”) is pleased to submit written comments to the Securities and Exchange Commission (the “SEC”) for the upcoming roundtable on second year experiences with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, related to internal control over financial reporting.

We have organized our letter into the following topics:

- Costs and Benefit Trends in Year Two
- Guidance for Smaller Companies
- Observations on Standards for Assessing and Auditing Internal Control

In summary, our experience in the second year of implementation of the Section 404 confirms our assessment at the end of Year One that the process for reporting on and auditing internal control over financial reporting is functioning as intended, implementation is improving, and significant revisions are not required. Year Two results have also confirmed our expectation that costs would decline and benefits would increase as companies and their auditors gained experience. We continue to believe that the internal control assessments required by Section 404 bring important and valuable benefits to investors in companies of all sizes: they increase the reliability of financial statements, reduce the risk of fraud and identify opportunities for operational efficiencies and other savings.

Despite this overall positive appraisal, as we noted in our April 2005 letter on our first-year experiences implementing Section 404, there are certain provisions of the SEC and the Public Company Auditors’ Oversight Board (PCAOB) standards for assessing and auditing internal control where additional guidance would be helpful to enhance the efficiency and effectiveness

Nancy M. Morris

May 1, 2006

Page 2 of 9

of compliance. Although the staffs of the SEC and the PCAOB have clarified many of the matters we identified in our April 2005 letter, further guidance would be beneficial in several areas.

Most prominent is the need to develop additional guidance and tools, particularly for management, to make compliance with Section 404 reporting requirements cost-effective for smaller businesses. To that end, we recommend a plan to prepare and field test implementation guidance for smaller companies during 2006 and 2007. Further details on this proposed plan are included later in this letter.

While we fully support the need for additional guidance customized to the specific needs of smaller businesses, it should be noted that we strongly oppose the recommendations of the Advisory Committee on Smaller Public Companies for either (1) broad, permanent exemptions to the Section 404 reporting requirements or (2) the adoption of weakened standards requiring reporting only on the design and implementation of internal control over financial reporting.

In addition to the need for guidance for smaller businesses, we have identified several other areas of the Section 404 standards where clarification would benefit companies of all sizes and their auditors. These are discussed in the last section of this letter.

COST AND BENEFIT TRENDS IN YEAR TWO

Although debate continues over the relative costs and benefits of the Section 404 requirements, there is growing evidence that costs are declining and benefits are becoming increasingly visible and quantifiable. Three recent surveys attest to a substantial decline in costs for both smaller and larger accelerated filers in the second year of Section 404 implementation, as well as an increase in the benefits and savings realized. In addition, a new academic study provides evidence of another major market benefit of strong internal controls – a lower cost of capital.

Declining Costs –

The latest of three surveys conducted for the four largest accounting firms by CRA International, an economic and business consulting firm, shows that Year Two Section 404 implementation costs decreased significantly. The responses came from a random sample of smaller and larger companies selected by CRA International, and the survey was performed after the second year Section 404 work was complete or nearly complete. Thus its results should be deemed the most accurate cost information available.¹

¹ Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update, CRA International, April 2006 (http://www.soxinternalcontrolinfo.com/pdfs/CRA_III.pdf).

- Total 404 costs (including internal costs, third party costs and fees for the 404 internal control audit) fell 30.7 % for Smaller Companies and 43.9 % for Larger Companies. The cost decrease for larger companies was slightly higher than the 42% predicted in a similar CRA study in the fall of 2005. For Smaller Companies the decrease was somewhat less than the 39% that had been estimated earlier.²
- All components of Section 404 costs declined for the companies surveyed. Of the total 404 costs in year two, the 404 audit fees declined an average of 20.6% for Smaller Companies and 22.3% for Larger Companies.

Another survey released in April 2006, by Financial Executives International, found lower but still significant average total cost reductions of 16.3%, also reflecting reductions in all cost components.³ A third survey by Oversight Systems, a provider of control and monitoring software, of over 260 financial executives reported that costs decreased by 26% or more for 56% of the companies surveyed.⁴

The CRA survey identified three primary reasons for the cost savings from Year One to Year Two:

- Increased efficiency (learning curve effects) in implementing and assessing controls;
- Reductions in new documentation required; and
- Reduced use of outside third parties to perform readiness activities for management.

At both smaller and larger companies, both management and the auditor reduced the number of key controls tested. Auditors also increased their reliance on the work of others, doubling that reliance at smaller companies and increasing it by two-thirds at larger companies. All of these factors are consistent with the transition of the 404 compliance effort from a first-year project to an ongoing, sustainable process.

Increasing Benefits –

The Year Two improvements were not limited to decreases in compliance costs. Even more noteworthy, recent surveys, as well as extensive anecdotal evidence, have reported significant increases in the types and amount of benefits from the second year of Section 404 compliance.

² For purposes of the CRA Survey, the term “Larger Companies” refers to a sample of the firms’ Fortune 1000 clients with market capitalization over \$700 million. The term “Smaller Companies” refers to a separate group of public companies with market capitalization between \$75 million and \$700 million.

³ http://www.fei.org/news/404_survey_4_6_06.cfm

⁴ <http://www.oversightsystems.com/survey/index.php>

Surveys - First, in terms of the quality of control systems, the CRA study found a sharp decline in the number of material weaknesses and significant deficiencies, which indicates that Section 404 is achieving its primary objective and improving internal control and the reliability of corporate financial data.

- For Smaller Companies, the number of material weaknesses and significant deficiencies combined fell from an average of 5.3 in Year One to 1.3 in the second year.
- For Larger Companies, the number of material weaknesses and significant deficiencies combined declined from 5.0 on average in Year One to 2.5 on average in Year Two.

Respondents to the FEI survey identified benefits such as more reliable and accurate financial statements and stronger protection against fraud. In general, larger filers attributed more value to these benefits than smaller accelerated filers, a result which supports our recommendations discussed further below, that additional guidance is needed for smaller issuers.

Similarly, the Oversight Systems findings reflected significantly greater benefits in Year Two than were reported in a survey a year earlier:

- Almost two thirds (65%) reported enhanced accountability of individuals involved both in financial reporting and in operations, versus 46% in 2004
- 47% of the financial executives reported improved accuracy of financial reports, compared to 27% in the prior year
- 48% reported reduced errors in financial operations, versus 31% in the earlier survey
- Other double digit increases in benefits related to empowerment of the audit committee, decreased risk of financial fraud and strengthening investors' views of the company and confidence in the market as a whole.

The consistent and dramatic increase in financial executives citing these benefits in Year Two, as compared to Year One, is a strong indication that Section 404 benefits are building over time, and that this is increasingly recognized by financial executives.

Taken together, these benefits are clear evidence of the value of Section 404 compliance activities, not only to investors, but also to management.

Company Examples – The reported benefits are not limited to survey results. We have encountered numerous instances in our practice where clients of all sizes identified important control procedures, such as account reconciliations, data integrity checks, or contract reviews, that were actually being overlooked or inadequately performed, thus creating risk for the company or reducing their profitability. Correcting these lapses has yielded valuable benefits. Even more significant, companies are increasingly focusing on leveraging their investment in the compliance process to obtain a broader return for shareholders. To cite just two examples:

- A Fortune 500 manufacturing company consolidated hundreds of formal and ad hoc procedures for journal entries into just three. The CFO commented that as a result data became more reliable and fewer employees and man-hours were required to accomplish the same task.
- A mid-sized technology company realized that a single set of controls could monitor compliance with multiple requirements under Sarbanes-Oxley, HIPAA, and the Social Security Administration. According the vice president of finance, this process convergence generated cost savings, but in addition, it enabled the company to free up people and reallocate their time to other activities.

Academic Study - In addition to the decreases in material weaknesses and the benefits perceived by company management, an academic study published in April 2006 has identified a new dimension in the advantages that accrue from strong internal control. The study found that “internal control risk matters to investors and that firms reporting strong internal controls or firms that correct prior internal control problems benefit from lower costs of equity capital beyond that predicted by other internal control risk factors.” Companies with internal control deficiencies had a significantly higher cost of capital (50 -150 basis points) than companies without such deficiencies, and that the remediation of the deficiencies was followed by a reduction in capital cost. Moreover, the research found that companies perceived to be “risky” before the implementation of Section 404 requirements benefited from a decline in the cost of capital if they received an unqualified report from their auditors on internal control over financial reporting. In other words, the study provides evidence that the market puts a premium on good internal control and incorporates that benefit – or cost – into a company’s cost of equity capital.⁵ It is important to note that in the virtually all instances, this lowering in the cost of capital would greatly exceed the cost of compliance.

GUIDANCE FOR SMALLER COMPANIES

As indicated in our April 3, 2006, comments on the Exposure Draft of Final Report of the Advisory Committee on Smaller Public Companies, we recognize that the cost and complexity of implementing Section 404 may be particularly challenging for smaller companies. For many reasons, as discussed in our April 3 letter, we oppose either exempting smaller companies from the Section 404 reporting and audit requirements or weakening the rules and standards to effectively mandate a partial audit. Instead, we believe there is a need for customized guidance, for both management and auditors, that considers the specific characteristics of smaller companies. We propose a plan to develop such implementation guidance for smaller companies, along with field testing of the guidance through a pilot program, during 2006 and 2007.

⁵ Ashbaugh-Skaife, Hollis, Collins, Daniel W., Kinney, Jr., William R. and LaFond, Ryan, "The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital" (April 13, 2006). Available at SSRN: <http://ssrn.com/abstract=896760>

In making this recommendation, we acknowledge the strides made by the PCOAB and SEC in providing additional 404 guidance in May 2005, and the efforts of COSO to date, to provide improved implementation materials for smaller companies. However, we believe that a more focused set of guidance is still needed to achieve the scalability that we believe is possible for the Section 404 requirements for both management and auditors. This should include:

- Additional guidance for management covering the implementation of control enhancements, documentation, management's assessment and common challenges encountered in implementation. Specific components could be as follows:
 - Simplified COSO principles for smaller companies, which could provide a simpler control framework, and should include examples showing how such principles can be satisfied in practice.
 - Clear standards for management's assessment, including guidance on the performance of a top-down risk assessment, the identification of key controls, the necessary level of detail in documentation of the control structure, as well as the scope, nature and timing of testing which management should perform.
 - An implementation guide, which should be in plain English and which could be viewed by smaller company executives as a "how to" guide. This could be supplemented with guidance on the key project management elements of management's assessment effort, including best practices in project organization and other suggested resources.
 - A summary of common challenges and solutions for smaller public companies, dealing directly with such issues as the role and design of entity level controls (including monitoring controls) at smaller issuers, the risk of management override, the difficulties in achieving segregation of duties, and the depth of experience of personnel responsible for financial reporting.
- Complementary guidance and tools for auditors to facilitate increased cost-effectiveness in the application of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2) in a smaller company environment. This could take the form of an Audit Guide, and should address such areas as testing monitoring controls, evaluating the risk of management override, and assessing segregation of duties limitations, all of which can be challenges in auditing smaller issuers.

It is obviously important for this management and auditor guidance to be developed through coordinated parallel efforts, in order to help bridge the Section 404 requirements to smaller companies and achieve scalability for both management and auditors.

Project Participants - The project should include all affected constituents – issuers, investors, and auditors, as well as observers from the SEC and PCAOB. Technology providers could also participate as observers, and could be encouraged after the project to develop tools, including

related internal control content, that could increase the efficiency of implementation. In addition, a diverse group of smaller public companies (including both non-accelerated and smaller accelerated filers) could participate.

Field testing should immediately follow the development of additional customized guidance, in order to track and analyze cost drivers and to ensure that the guidance is as practical as possible, and that it forms a sound foundation for smaller public companies to meet internal control reporting requirements on a cost effective basis.

Project Timing – We recommend that the project planning begin immediately in order to develop draft guidance over the summer and begin field testing in the early fall of 2006, with enhancements, if warranted, made in 2007.

OBSERVATIONS ON STANDARDS FOR ASSESSING AND AUDITING INTERNAL CONTROL

Our April 2005 comment letter identified a number of provisions of AS 2 that posed particular implementation challenges. The May 16, 2005, guidance from the staffs of the SEC and the PCAOB was helpful in clarifying many of those areas. However, the absence of specific guidance for management to apply in discharging their responsibilities continues to create challenges for management and auditors alike. In addition, the determination of materiality for interim periods remains unclear and frequently generates considerable debate.

Standards for Management's Assessment - Section 404 requires management's assessment of internal control over financial reporting, followed by the auditor's evaluation of management's assessment and an independent opinion on effectiveness of control. In the absence of direct guidance for management, the AS 2 standards for the auditor have been used as de facto management guidance, often creating confusion and questions about management's responsibilities. We strongly recommend that the SEC provide, or develop a mechanism for others to provide, additional clarification and guidance for management of companies of all sizes in a number of areas, such as the following:

- the degree of the required documentation of controls and of management's assessment;
- management's responsibilities to perform walkthroughs of major classes of transactions;
- the scope and extent of management's testing of controls, with specific guidance on management's testing of controls in multi-location entities; and
- the nature and extent of evidence required to support quarterly certifications.

This additional guidance for management would result in increased consistency in management's approach to documenting and testing controls. It would also enable the auditor to judge more readily and efficiently whether management had fulfilled their responsibilities. Importantly, the auditor would then be better able to apply a top-down, risk-based approach to their audit of

Nancy M. Morris

May 1, 2006

Page 8 of 9

internal controls and, in many cases, would likely be able to increase the extent of reliance on management's testing and other procedures.

Materiality - The determination of materiality for quarterly reporting periods presents major challenges for company management and auditors alike. In practice, materiality for quarterly reporting periods, including quarterly periods within previously issued annual financial statements, is often the subject of significant debate among management, auditors and audit committees. The lack of guidance on this subject poses particular challenges in implementing AS2 because the assessment of whether a significant deficiency represents a material weakness depends on the potential impact of the deficiency on both interim and annual periods. In 2005, the PCAOB provided some additional guidance to auditors, which was helpful. We believe that further clarification of the guidance by the SEC staff regarding materiality and quarterly financial statements would facilitate the application of AS 2 as well as the application of accounting standards.

SUMMARY

The internal control reporting requirements under Sarbanes Oxley are part of a comprehensive effort to restore investor confidence and enhance financial reporting, and there have been significant benefits from the implementation of these requirements. In our view, investor confidence, though still fragile, has been enhanced and the SEC, consistent with its mission of investor advocacy, should not step away from these reforms. The fundamental pillars of Section 404 -- that management should periodically assess its control structure, that it should document this assessment, and that an auditor should independently test this assessment -- are reasonable, regardless of the size of a public company.

The demonstrated moderation in costs of Section 404 compliance, coupled with the continuing emergence of benefits over time, makes a compelling case about the ongoing value of Section 404 for investors and companies. In that regard, we look forward to working with public companies, the Commission and the PCAOB toward ongoing improvements in Section 404 compliance for accelerated filers and the sound implementation of Section 404 for the non-accelerated filers next year.

We appreciate the opportunity to comment and would be pleased to discuss these matters with you further. If you have any questions, please contact Robert J. Kueppers at 212-492-4241.

Very truly yours,

/s/ Deloitte & Touche LLP

Nancy M. Morris

May 1, 2006

Page 9 of 9

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Annette L. Nazareth

Willis D. Gradison, Acting Chairman of the PCAOB
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Charles D. Niemeier, Member
