

April 1, 2005

Jonathan G. Katz  
Office of the Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

**File No.: 4-497**  
**Feedback on Experiences with the Implementation of the Auditing and Reporting Requirements of Section 404 of the Sarbanes-Oxley Act of 2002**

Dear Mr. Katz:

Deloitte & Touche LLP is pleased to respond to the request from the Securities and Exchange Commission (SEC) for comments on our experiences with implementation of the auditing and reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).

We have organized our comments to align with the topics for the six panels that will appear at the Commission's Roundtable scheduled for April 13, 2005, as follows:

- Where Are We?
- Observations on Standards for Assessing Internal Control over Financial Reporting
  - Reporting Model
  - Scope and Testing
  - Reliance on the Work of Others
  - Definition of Significant Deficiency and Material Weakness
- Where Do We Go From Here?

Overall, despite the challenges of implementing a new reporting process, we believe that the Section 404 compliance process has functioned as intended in its initial year of application and should not be revised at this time. We do feel that clarification to some of the provisions of Audit Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2), as discussed in detail below, would enhance the effectiveness and efficiency of the auditing and reporting requirements of Section 404.

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## **WHERE ARE WE?**

Most large market cap calendar year-end filers have now completed the first 404 reporting season. The spotlight has moved from an effort to timely file the required reports to an understanding of the lessons learned, including the costs and related benefits of compliance with Section 404.

All market participants must be sensitive to the costs and effort required to comply with Sarbanes-Oxley, including Section 404. However, we should not be premature or incomplete in our assessment of the relative balance of costs to issuers and benefits to investors and the capital markets. The problems that Sarbanes-Oxley was designed to address did not arise overnight, and similarly, it will take time to realize the full benefits of Section 404. Now that we have completed one cycle of 404 reporting for a large number of companies, it is appropriate that we begin to evaluate the costs and benefits of implementation based on actual experience. It is prudent to do so carefully and thoughtfully. We must be mindful that while the costs, which are presumably at their peak as discussed below, are immediate and easily quantifiable, the benefits tend to lag the costs and are more qualitative but expected to be very substantive.

### **Benefits of Section 404 Compliance**

Although mentioned less frequently than the costs of Section 404 compliance, our partners have observed significant benefits that are also starting to be cited in surveys and articles and acknowledged in the public comments of corporate officials. Additionally, the increase in financial statement restatements in the past year could be viewed as an indication that Sarbanes-Oxley compliance activities are causing greater scrutiny of financial reporting and are detecting more areas of noncompliance than were identified historically.

Another very relevant measure of the benefits of the Section 404 compliance process is the number of control deficiencies, some of which represented potential material weaknesses that companies identified in the compliance process and remediated prior to the year-end assessment date. Incremental to the remediated deficiencies, we have observed that as of March 30, 2005, approximately 140 calendar year-end companies have reported material weaknesses in their systems of internal control over financial reporting.

The Chairman of the SEC, William Donaldson, recently conveyed a similar message of Section 404 compliance in a letter to the Wall Street Journal. He stated:

“...Public companies have been working overtime to document and assess the effectiveness of their internal controls over financial reporting, and their accounting firms have been diligently testing and preparing reports regarding those controls. This effort will, of course, help to protect against fraud and the misuse of corporate assets. But it should also improve the quality of information companies report to their shareholders, along with the quality of information management relies on to make decisions. So while investors will benefit from enhanced protection against misconduct, they may also find that the companies they have invested in are better managed.

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We are already seeing the results. A number of companies have uncovered lurking weaknesses in their controls and disclosed what they have found, and are working to strengthen them. Armed with information about these weaknesses and the remediation plans, investors appear to be making reasoned judgments about whether those disclosures affect the mix of information they use to make investment decisions.”

Our experience with clients is consistent with the Chairman’s statements. For example, many of our engagement partners have observed substantial improvements not only with internal control over financial reporting, but also:

- Development of operating efficiencies as a result of the detailed review of processes and internal controls required by Sarbanes-Oxley, for example one client noted that as a result of their compliance efforts with documenting and assessing controls, management had realized that there were many redundancies in the organization. As a result, the company plans to implement a shared service center to centralize many of the redundant functions.
- Increased due diligence employed when making important business decisions, for example one client delayed the implementation of a new software system until substantial testing by management was completed to ensure that the implementation of this new system would not result in the identification of an internal control deficiency. Management had commented that pre-Section 404 those precautions may not have taken place.
- Implementation of standard processes across recently acquired domestic and foreign subsidiaries. For example, one client had acquired over 200 companies over many years and had failed to fully integrate those subsidiaries into the rest of the organization, the implementation of Section 404 resulted in accelerating the efforts and the resources allocated to achieve consistency.

These experiences are not unusual in our practice. In our opinion it is important that the cost and benefit analysis appropriately includes all relevant data points. In addition to our experiences, many external surveys and articles also highlight benefits as discussed below.

### Surveys

In the recent 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley Compliance<sup>1</sup>, financial executives commented positively on the results of Section 404 implementation:

- 74% said that their companies had experienced benefits from Sarbanes-Oxley requirements, such as ensuring the accountability of individuals involved in financial reports, decreasing the risk of financial fraud, reducing errors in financial operations, improving financial statement accuracy, empowering Audit Committees, and increasing investor confidence

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<sup>1</sup> [http://www.oversightsystems.com/news\\_events/survey.pdf](http://www.oversightsystems.com/news_events/survey.pdf)

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- 79% said that their controls were stronger today than before the Act
- 57% said they felt costs incurred were a good investment for shareholders
- 60% had implemented additional controls as a result of 404 compliance

Similarly, in a January 2005 Institute of Internal Auditors (IIA) survey<sup>2</sup>, more than 60% of the respondents agreed that 404 compliance had improved audit committee and board knowledge, as well as their involvement in controls, monitoring of controls, the financial closing process and the overall control environment.

In February 2005, Deloitte conducted an informal polling of individuals participating in a web-based seminar on Sarbanes-Oxley and 86% of the respondents indicated that their organization either had implemented, or were planning to implement control enhancements as a result of Sarbanes-Oxley compliance. In another recent poll during a similar web-based seminar, 57% of the over 500 respondents said that their organizations had received business benefits from Sarbanes-Oxley compliance activities, and 71% said their companies had identified opportunities to enhance quality in processes and systems for producing financial information.

#### Articles and Public Statements

An article in the March 21, 2005 edition of *Information Week*<sup>3</sup> entitled “Gaining Strength from Sarbox” highlighted the business improvements that many companies, such as MasterCard International, Nextel Communications, Brightpoint Inc., and York International Corp. are gaining from Sarbanes-Oxley compliance.

A number of senior corporate leaders have also spoken favorably on the benefits of Section 404 compliance. For instance, in his 2004 Letter to Shareholders, Jeffrey Immelt, Chairman and CEO of General Electric<sup>4</sup> stated:

None of us likes more regulation, but I actually think SOX 404 is helpful. It takes the process control discipline we use in our factories and applies it to our financial statements. Implementing SOX 404 cost GE \$33 million in 2004. But we think it is a good investment ... Investors should demand high standards of governance and great performance. Some managers failed investors in the late '90s. Companies were destroyed, value was lost, and billions are being paid because of fraud. This happened. SOX 404 is by no means perfect, but it is a price we are willing to pay to restore investor trust.

Michael Caplan of E\*Trade made the following comments on the benefits of Section 404 in his July 22, 2004 testimony before the U.S. House Financial Services Committee:

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<sup>2</sup> [www.theiia.org/?doc\\_id=5161](http://www.theiia.org/?doc_id=5161)

<sup>3</sup> <http://www.informationweek.com/story/showArticle.jhtml?articleID=159902183&tid=13692>

<sup>4</sup> <http://www.ge.com/ar2004/letter6.jsp>

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The process of complying with Section 404 has had many incidental and beneficial effects. It has reinforced management's understanding of accountability for processes and financial reporting across the business. It has provided management with a better understanding of various processes. We have identified necessary control design improvements and identified where processes were deficient, inconsistent, or inadequate. ...For a company in our stage of growth, the Section 404 process came at a perfect time.

**Appendix A** to this letter contains a number of similar comments from leaders of other companies.

### Costs of Implementing Section 404

Based on the results of a number of surveys, actual first-year costs to comply with Section 404 have significantly exceeded the SEC's initial estimates of less than \$1.5 billion. Average per company costs have been estimated to be in the millions of dollars for the largest companies, defined by the SEC as accelerated filers.

To properly assess first-year compliance costs, several key factors must be considered, in particular the variability of costs across organizations of differing size and structure, the nature of the costs incurred in the first year of compliance, and expectations for ongoing costs.

#### *Variability of Costs*

Reported average cost estimates are skewed dramatically upwards by the higher costs of the largest organizations. For instance, a March 2005 Financial Executives International (FEI) survey<sup>5</sup> reported that first year 404 compliance costs averaged \$4.3 million. However, companies with over \$5 billion in revenue had average costs of over \$10 million, while the average for companies under \$5 billion in revenue was \$2.7 million.

Moreover, compliance costs of individual companies are influenced by a number of diverse factors, including significant international operations, highly decentralized management models, significant use of different enterprise systems, and major recent acquisitions. Depending on these factors, companies of similar revenue or asset size may incur widely differing costs.

#### *Nature of First-Year Costs*

Similar to any new process or activity, there were significant start-up costs as each company had to develop its own methodology and approach. Each company had to fully document their design of controls, educate, and train their organizations on the requirements including the COSO concepts and fundamentals such as how to evaluate effectiveness, all in a short timeframe. The start-up costs were also magnified by the fact that the standards governing this process are new and in some cases not entirely clear. In particular, there was a lack of detailed guidance as to management's responsibilities for

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<sup>5</sup> [http://www.fei.org/404\\_survey\\_3\\_21\\_05.cfm](http://www.fei.org/404_survey_3_21_05.cfm)

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documentation and testing, which resulted in differing interpretations in practice and a wide range of costs incurred by issuers. Our suggestions for clarification of certain sections of the standards are discussed below.

However, in our experience, the most significant reason for much of the high level of first-year costs is what could broadly be described as *deferred maintenance*. Over the past ten to fifteen years, growth, bottom-line focus, downsizing of staff functions, significant merger activity and the implementation of new enterprise systems often served to reduce the prioritization, resources and investment in control functions. Examples include (i) a reduction in corporate resources, including the redeployment of internal audit into operational auditing, which often decreased the control focus of this monitoring function, (ii) the growth of decentralized operating models where business units were given more autonomy, (iii) the failure to properly or fully configure the control features of new ERP systems and (iv) the lack of initial implementation of effective controls by companies growing rapidly either organically or through acquisition. Although companies have been required to maintain adequate internal controls since the passage of the Foreign Corrupt Practices Act in 1977, prior to Sarbanes-Oxley there was no requirement for most companies to regularly assess or report on those controls or for auditors to report on controls. Consequently, the level of rigor and discipline devoted to the documentation, management and oversight of controls received less focus and investment.

The result of this protracted inattention was the need to invest a significant amount of time and resources simply to identify and document controls in many organizations, frequently including the identification and remediation of numerous control deficiencies. Such remediation often involved the design and installation of new controls, including the addition of resources to manage the assessment process and additional staff in financial reporting, to bolster a company's accounting and reporting competency and to rebuild monitoring capabilities.

In addition to the first year requirements of Section 404 and AS 2, the new audit documentation requirements of Audit Standard No. 3 have had a direct and significant impact on the cost of an audit and an indirect effect on issuers in terms of the extent of documentation that auditors require from management.

#### Future Costs

In future years, costs can be expected to decrease as a result of the non-recurrence of many start-up costs, benefits of the learning curve and process improvements. Financial institutions had a similar experience with high costs in the first year of the internal control requirements under the Federal Deposit Insurance Corporation Improvement Act (FDICIA). In the FEI's recent (March 2005)<sup>6</sup> survey, 85% of the more than 200 companies surveyed expected costs (including internal personnel costs, third-party assistance and external audit costs) to decline in total in the second year of Section 404 compliance.

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<sup>6</sup> [http://www.fei.org/404\\_survey\\_3\\_21\\_05.cfm](http://www.fei.org/404_survey_3_21_05.cfm)

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In the January 2005 IIA Survey<sup>7</sup>, only 36% of the respondents expected cost to exceed benefits in second year of 404 compliance, even though 72% believed that costs had exceeded benefits this past year. This is a very important and insightful survey observation.

Another significant factor, in our view, impacting the effectiveness of Section 404 is the extent that companies embed effective internal control over financial reporting into their daily business activities, as opposed to a once a year assessment to comply with Section 404 annual reporting requirements. Due to the circumstances of this first year, the benefits of such a program were not fully realized by management or the auditor in the scoping and performing their integrated audits. Even though AS 2 describes the combined audit of financial statements and internal controls as an integrated audit too often audit execution would be more aptly described as a parallel audit. In year two and beyond, in many cases, an integrated audit should result in greater efficiencies.

#### Auditor Investment

Not unlike our clients, audit firms have made significant investments in complying with Section 404, in terms of hiring additional specialized resources and additional training of professional staff. Deloitte has invested more than 110,000 hours of professional time in Section 404 related training. We have hired an additional 2,000 personnel to meet our clients' needs in connection with these new reporting requirements.

### **OBSERVATIONS ON STANDARDS FOR ASSESSING INTERNAL CONTROL OVER FINANCIAL REPORTING**

We believe that AS 2, in conjunction with the provisions of Section 404 of Sarbanes-Oxley and the related SEC rules, draws an appropriate balance between the responsibilities of management to design, oversee and obtain reasonable assurance about internal controls over financial reporting and the auditor's responsibilities to test and report independently on those controls in connection with the annual financial statement audit.

Accordingly, we reaffirm the fundamental principles in Auditing Standard No. 2, which include:

- Management must maintain effective documentation of internal control and perform an assessment that achieves reasonable assurance
- Each year sufficient evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures must be obtained; i.e. no rotating of tests across years.
- The same concept of materiality that applies to financial reporting also applies to internal control over financial reporting
- External auditors must perform sufficient testing themselves to obtain the principle evidence to achieve their own reasonable assurance

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<sup>7</sup> [www.theiia.org/?doc\\_id=5161](http://www.theiia.org/?doc_id=5161)

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- The requirement for the external auditor to perform substantive procedures for all relevant assertions related to all significant accounts and disclosures; i.e. the financial statement audit must not become a byproduct of the Section 404 assessment

It is premature to make changes given the limited experience with the implementation of 404 and its impact on investor confidence. However, there are a number of areas that have posed particular implementation challenges. In these areas, which are discussed below, we believe that additional clarification or guidance could improve consistency in application and help reduce unnecessary costs.

## **General**

The Committee of Sponsoring Organizations of the Treadway Commission - COSO provides a solid framework for effective internal control over financial reporting but the content and considerations for each of the components have not been updated in many years and were not developed within the context of issuing 404 reports. The fact that virtually all companies and auditors are using COSO as the framework for determining internal control effectiveness leads us to believe that it is critically important to establish a protocol to “maintain” the content to reflect current and evolving issues. It is also particularly important to continue to build out the content related to areas most important to mitigating the problems that Section 404 was intended to address, such as better definitions and benchmarking of entity-level components such as the control environment, including anti-fraud controls, risk assessment and monitoring components, to help ensure that Section 404 can meet the objective of being an “early-warning” system for investors.

Lessons Learned/Best Practices - We recommend that a representative group of issuers be chartered to identify and disseminate lessons learned and best practices to achieve consistency in practice and support the initial Section 404 implementation for non-accelerated filers in 2006.

## **Reporting Model**

### *Responsibilities of Management*

Section 404 compliance is a two-step model that 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 the effectiveness of control. AS 2 provides guidance to the auditor in the evaluation of management’s assessment and the execution of the internal control audit. However, there is a lack of detailed guidance for management to apply in discharging their responsibilities. We strongly recommend that the Commission provide additional clarification in the following areas:

- Scope and Testing – As discussed in our comments in the “Scope and Testing” section below, additional guidance is needed for testing performed by management as well as the auditor.

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- Documentation – Development of a “standard” for the nature and extent of documentation of processes and the related design of internal controls (i.e. assertions, control objectives, and control activities) to clarify and reduce the costs of developing and maintaining excessive documentation.
- Quarterly Procedures - Beginning with the first quarter following management’s initial Section 404 report, management and the auditor have expanded requirements, yet there is general uncertainty as to the scope, nature and extent of evidence that management should maintain to support their certifications. Accordingly, it is important to clarify management’s responsibilities and requirements related to their Section 302 certifications and related disclosures to avoid the extra costs that can result from inconsistency in application.
- Concluding Framework – The Framework for Concluding on Deficiencies (Framework) was released in late 2004. Many companies did not have the level of understanding or time to fully implement the Framework. We recommend that a concerted effort be undertaken to fully disseminate and educate issuers on the Framework. For Section 302 certification purposes, it will be important for companies to formalize their process for accumulating, tracking and evaluating deficiencies on a continuous basis.

Provisions of Auditing Standard No. 2

It is our understanding that the “as of” assessment date is intended to be a “hard line.” As a result, companies have to remediate any deficiency prior to the “as of” date for a “sufficient period” of time, which is not defined, to demonstrate that the control was operating effectively at the “as of” date. During this year of implementation, many controls were remediated late in the year that resulted in considerable judgment as to whether the control had operated for a sufficient period. To help eliminate some of the tension around this judgment, we believe that AS 2 should allow for the consideration of evidence of operating effectiveness after the “as of” date, when the control was properly designed and in place on the “as of” date. This is analogous to the audit of financial statements where subsequent evidence may be considered when concluding on the appropriateness of balances at the “as of” date, such as assessing the collectibility of accounts receivables.

As discussed above in the Responsibilities of Management section, there is also a need for clarification of the auditor’s responsibilities with respect to management’s quarterly disclosures to avoid inconsistencies in practice. We recommend that the required auditor procedures be included in section AU 722 of the auditing standards as an expansion of the interim review procedures. We suggest that procedures similar to those provided in AU 722 be developed, including:

- Procedures regarding the auditor’s understanding of management’s process for maintaining their internal control over financial reporting and identifying changes.

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- Procedures to be performed by the auditor with respect to management's disclosure that a material change in internal control has occurred.
- The extent of procedures required regarding management's conclusions as to the significance of any unremediated deficiencies. The PCAOB Frequently Asked Questions (FAQs) have stated that the auditor is not required to evaluate and conclude on deficiencies at an interim date for Section 404 purposes. This has created uncertainty in terms of the auditor's responsibilities under the AS 2.

### Auditor Reporting

The dual opinion is unnecessarily complex. We recommend that the auditor express an opinion only on the effectiveness of internal control over financial reporting. An explanatory paragraph could be added to highlight those limited circumstances when the auditor's and management's conclusion on the identified material weaknesses are different. Additionally, the SEC could also require management to disclose and discuss such circumstances to provide full and clear disclosure in Item 9A of Form 10-K.

## **Scope and Testing**

### Scope of Internal Control over Financial Reporting

Third Parties - Expanded guidance as to what constitutes an entity's internal control over financial reporting is needed, particularly as it relates to business relationships with third parties, including service organizations, specialists, royalty and sell-through relationships, investments in undivided interests or other business model arrangements that are not specifically covered by the SEC's Rule or FAQs. In complex business models, it is often difficult to distinguish where the boundaries are with respect to an issuer's internal control over financial reporting. If these boundaries are defined to include controls at third parties that interact with an issuer, the cost of Section 404 will continue to expand. Accordingly, we believe that a practical approach is critical to defining these boundaries; we recommend that AS 2 apply only to those controls that management has the authority to dictate or modify, to maintain a practical scope in the requirements.

Service organizations - The current auditing standards regarding service organizations and the use of a service auditor's report were written over ten years ago and were not intended to support management's assessment under Section 404. Combined with the proliferation of the use of service organizations, this creates significant challenges for issuers when assessing internal control over financial reporting at a point in time, including obtaining adequate evidence in the absence of a SAS 70 report, determining the scope of a SAS 70 report, evaluating any deficiencies identified at the service organization and roll-forward procedures for the SAS 70 report. Accordingly, we recommend that the approach to service organizations be considered.

Multi-location Entities - For purposes of documenting significant processes and the design of controls, more explicit guidance is necessary to clarify that the scope includes all locations that are individually significant (and those that are significant when aggregated),

not solely those locations that constitute a “large portion” of controls. Documenting and evaluating only the locations that constitute a “large portion” inappropriately limits the auditor’s scope to those locations. For testing to determine the operating effectiveness of controls, we support the “large portion” threshold contained within the standard; however, applying it in practice to the different organizational structures and business models is very judgmental and has likely resulted in inconsistent scoping by companies. Accordingly, it would be beneficial to provide additional guidance on applying this concept to different types of organizational models, such as a retail company with a large number of essentially homogeneous outlets versus a conglomerate with a portfolio of disparate operations.

Testing of Internal Control over Financial Reporting

- Self-assessment – As companies’ processes for maintaining internal controls become more continuous, we expect companies to increase their use of self-assessment processes to obtain evidence of the operating effectiveness. This would reduce the significant first-year costs that resulted from management obtaining their evidence principally from independent testing often performed by third parties. However, the concept of self-assessment is not well defined. Accordingly guidance as to the proper construction of a self-assessment approach should be developed, including:
  - Clarifying that the self-assessment should be performed with respect to each control activity, and not a high-level sub-certification process
  - Suggesting that the company should provide guidelines and training regarding the timing, nature and extent of the evidence to be documented to support the self-assessment process
  - Requiring that a self-assessor should obtain first-hand knowledge that the control was operating and should document the scope of testing, and the evidence the self-assessor considered, in arriving at their conclusions
- Interim testing – The Standard is predicated on “as of” date reporting. This past year, much of management’s evidence was obtained during the fourth quarter. Some companies have indicated that they intend to perform their assessment in the fourth quarter this next year in order to eliminate the need to update or roll-forward interim tests. However, internal control over financial reporting is intended to be a continuous process. Accordingly, we recommend that additional guidance be provided to both encourage and support testing by management (and the auditor) throughout the year, including clarifying the scope of roll-forward tests to the “as of” date. It will be important that the costs of such testing do not make companies reluctant to perform interim testing and provide an appropriate balance between the evidence obtained at an interim date and evidence obtained closer to the “as of” date. An additional potential benefit could be derived from specifically allowing the auditor to consider the assurance derived when internal controls are determined to be reliable for the entire audit period, not just at the “as of” reporting date in

determining the scope of their substantive tests. This benefit was only partially realized this past year due to the timing of management's assessment and the number of deficiencies identified.

- Joint testing- In certain areas, the redundancy of management and the auditor performing separate tests is cumbersome and costly. Examples would include interviews of employees and audit committee members and related surveys. We recommend that consideration be given to the acceptability of "joint testing" and identifying those areas in which joint testing would be appropriate.

### Information Technology (IT) Considerations

There was considerable uncertainty by issuers (and auditors) as to the scope and testing of (i) IT general controls, (ii) IT application controls, including those controls that are programmed into the software by a software vendor and those controls that the user chooses to implement in their configuration of the software and (iii) the underlying functionality of the application systems that other controls depend upon (e.g. calculations, formulas and reports). The uncertainty may have resulted in excessive documentation and testing. We support the concept that requires management (and the auditor) to obtain evidence each year about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures to conclude on the effectiveness of internal control over financial reporting. However, we recommend that additional guidance be provided when IT controls are determined to be effective and have remained substantially unchanged, on how management (and the auditor) may vary the nature, extent and timing of their tests of those IT controls. We support varying the extent of tests related to those controls that are not subject to user override and come pre-programmed into the software, or that relate to the underlying functionality of the application system.

### Reliance on the Work of Others

In our view, the Standard adequately provides for the auditor to use the work of others, particularly in the lower risk areas. We do not support expanding the use of the work of others, except for certain specified areas within the control environment that are considered lower risk, such as appropriate aspects of human resource policies and procedures, including hiring practices, job descriptions, and training.

### Definition of Significant Deficiency and Material Weakness

Given the construct of AS 2, the distinction between a significant deficiency and a material weakness is a critical judgment. The following represent some of the more critical issues that should be clarified to improve consistency of application in practice:

- Application of the definitions of significant deficiency and material weakness in the context of both annual and interim periods has proven to be difficult in a couple of respects.

- First, consideration of the effect on interim financials has reduced the threshold of what constitutes a material weakness or significant deficiency. The fact that the accounting principles and reporting requirements applied for interim periods are different from annual periods exacerbates the problems in trying to “pro forma” a deficiency that exists at year-end, to an interim period. The lack of an adequate framework to help issuers and auditors in making these judgments has resulted in inconsistent application in terms of deciding which deficiencies at the “as of” date may have an impact on interim financial statements, and how to consider the potential misstatement.
- Second, AS 2 is inherently inconsistent in that the auditor must plan and perform the audit to obtain reasonable assurance that deficiencies that, individually or in the aggregate, would represent material weaknesses are identified (paragraph 27), yet the definition of a material weakness is a “significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected” (paragraph 10). Thus on an ongoing basis AS 2 would require an auditor to scope their audit based on interim materiality that would significantly increase the cost beyond what was done this first year. Although the PCAOB issued a FAQ to clarify that this was not intended to affect the scope of the audit, only the evaluation of any deficiencies identified, the consideration of the effect on interim financial statements (for which the materiality threshold is certainly lower than the annual financial statements) will have an indirect effect on management’s and the auditor’s scope. Accordingly, we recommend that AS 2 be clarified to remove the “or interim” from the definitions of a significant deficiency or material weakness.
- We agree with the concept that the evaluation of a deficiency needs to consider the potential misstatement, not just the actual misstatement. Additional guidance and examples for different types of deficiencies should be provided to reduce the uncertainty and inconsistency in practice.
- It is not clear to issuers and auditors under what circumstances does the company get “credit” for performing the right steps, yet getting the wrong answer, including assessing when a material weakness or a significant deficiency exists. This consideration was relevant for many of the material weaknesses reported this past year. For example, a company that has an effective process and controls but reaches a wrong conclusion in a technical area of generally accepted accounting principles (GAAP) gets the same adverse opinion as a company that has a poor process and controls. This also highlights the disconnect in the logic of stating that internal control is inherently unable to provide absolute assurance, but then insisting that any error demonstrates a failure in the internal control system – since the system was never designed to prevent or detect absolutely all errors in the first place. The requirement that an auditor-identified error automatically result in a control deficiency has also inhibited management-auditor communication and has adversely affected the timing of when management is willing to provide the auditor their “position”, which in some

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cases delayed the year-end audit work by as much as three weeks. We do support the concept that issuers have to take responsibility for their application of GAAP and thus should have sufficient competent resources. We believe that Section 404 has had a very positive impact on this objective. Without diluting this objective, we do recommend that consideration be given to expanding the evaluation of a deficiency to consider the expected precision of a control (e.g. process level controls would be expected to operate with more precision than controls related to the application of GAAP in complex areas) and the nature of the deficiency (e.g. a deficiency in design would generally indicate a more severe deficiency, than a well-designed process that won't always get the right answer in judgmental, technical areas).

### **WHERE DO WE GO FROM HERE?**

All stakeholders need to recognize that while the costs of Section 404 are immediately evident and quantifiable, substantial qualitative benefits for investors and issuers are already apparent and will become increasingly visible over time, particularly when considered with the benefits of other changes from Sarbanes-Oxley. Accordingly, the primary focus right now should be on clarifying implementation matters related to the existing standard and developing sustainable processes for ongoing compliance.

We do recommend expanded implementation guidance as set forth in the letter above, and we also recommend that the PCAOB carefully consider the positions and expectations it applies in its ongoing annual inspections, as the findings of the inspection process will heavily impact the consistency of application in these areas by registered public accounting firms.

One overriding and critical benefit for investors is the renewed focus on the vital importance of effective internal control as the foundation for reliable financial statements. In fact, the very intensity of some of the current protest against the burdens of Section 404 suggests that the new standard is working as intended - as it requires companies to pay close attention to not only the theory but also the objectives and operational details of internal control and provides increased transparency.

We need open dialogue among all market participants to evaluate ways to enhance the process in the interests of investors and the capital markets. However, given the extent to which investor confidence has eroded and its fundamental importance to our capital market system, we should give the new model time to demonstrate its full benefits and should not undertake to change the basic regulations and standards at this time.

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We appreciate the opportunity to comment and would be pleased to discuss these matters with you further. If you have any questions or would like to discuss any of these issues, please contact Robert J. Kueppers at (203) 761-3579.

Very truly yours,

/s/ Deloitte & Touche LLP

## APPENDIX A

### Selected Quotations from Issuers on Benefits of Section 404 Compliance

- Tom Gelston, director of investor relations at Terex, said Terex had replaced an “antiquated” financial-reporting system in order to comply with Sarbanes-Oxley and that the new system revealed the problems. “Getting ready for the internal controls review helped discover this.” (Tom Gelston, Director of Investor Relations, Terex, Wall Street Journal – March 2, 2005)
- “As much as I was upset when it first came out, I don’t think it’s been all that onerous, at least for us ... I think that Sarbanes-Oxley is working pretty well...The law triggered a comprehensive review of how Eli Lilly documents corporate controls, and the discipline of that “has been tremendous.” The review uncovered some redundancies, allowing the firm to eliminate some steps it was taking needlessly. “We added some controls as well.” In all, “it was time and money well spent.” (Arnie Hanish, Chief Accounting Officer, Eli Lilly, Wall Street Journal – June 21, 2004)
- [A] dollar invested in the securities of a small registered company is subject to the same risk of capital loss as one invested in large companies. Therefore, in my view, the management of smaller companies have the same responsibilities to their investors as the management of larger companies with respect to disclosing complete and accurate information to the public in a timely matter. Clearly, therefore, the control environment of smaller companies must be complete and operating effectively in all respects. This is a matter of law and is not negotiable. (James Steffes, Manager of Compliance, Alkermes, Inc. Comment Letter to SEC – February 24, 2005)
- We’re going to be a better organization for having gone through this. (Jody Taylor, CFO, RC2 Corp. Chicago Tribune, January 3, 2005)
- *Information Week* Article – March 21, 2005
  - Nextel Communications reported that the compliance process began as an administrative task but evolved into a basis for achieving competitive advantage.
  - MasterCard is trying to leverage Sarbanes-Oxley work into a broader-based enterprise risk management initiative. MasterCard also found opportunities for improvement by replacing manual controls with automated controls already built into its systems but not yet used.
  - York International found that a survey tool they implemented for Sarbanes-Oxley compliance actually gave them a view they hadn’t previously had of which operations were not running effectively