Grant Thornton

Accountants and Business Advisors

April 6, 2005

VIA ELECTRONIC MAIL

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Comments Re: Sarbanes-Oxley Roundtable, Panel Two – Reporting to the Public

Dear Mr. Katz:

Grant Thornton appreciates the opportunity to participate in the Securities and Exchange Commission's Roundtable on Implementation of Internal Control Reporting Provisions and to join Panel Two, Reporting to the Public.

Panel Two has been charged with addressing whether management's and the auditor's reports have generally been useful to the various users of a company's financial statements. The answer is "yes" for the following reasons:

- Management's report on internal controls establishes management's ownership of the financial reporting process and gives financial statement users reason to believe that management has an appropriate focus on producing complete and accurate financial information.
- An auditor's unqualified opinion on management's process for evaluating internal controls confirms that management's assessment was conducted appropriately, further lending support to the user's increased confidence. Conversely, an auditor's adverse opinion on management's process for evaluating internal controls highlights a possible lack of commitment to appropriate financial reporting practices, thus alerting users to potential problems.
- Similarly, an auditor's opinion on the effective design and operation of internal controls over financial reporting can either affirm or refute management's stated assertions, thus giving users independent information to support their level of reliance on those assertions.

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- By increasing the focus on internal controls and the potential penalties, the new internal control reporting requirements have served as a deterrent to material financial statement fraud.
- The increased expectations of others charged with corporate governance such as directors, internal auditors and attorneys has improved the oversight of the financial reporting process and given financial statement users increased confidence that appropriate questions are being asked and answered.

Yet, while these assertions and reports are useful to financial statement users, their effectiveness and the effectiveness of financial reporting in general could be further enhanced by the following:

- Plain-English communication of identified material weaknesses and remediation plans
- Sharing auditor best practices
- Emphasizing the business value of strong internal controls
- Developing principles-based auditing standards
- Supporting a market-driven approach to meet the broad information and assurance needs of the capital markets

Communication of material weaknesses and remediation plans

The most important component of management's assertion and the auditor's opinion on internal controls is the description of identified material weaknesses. A clear and concise description of existing material weaknesses assists users in evaluating the level of impact those weaknesses might have in current and future periodic filings if they are not corrected. In addition, effective disclosure of any remediation plans will help users determine if management is taking appropriate action. Accordingly, the Commission should require plain-English communication of material weaknesses and provide examples of effective disclosures. In addition, the Commission should provide for a way for management to discuss their action plans for remediation of material weaknesses without requiring the auditor to disclaim an opinion as required by paragraph 190 of Auditing Standards No. 2 (AS No. 2).

Sharing auditor best practices

Audit effectiveness would be significantly improved if the major public accounting firms would share best practices, including audit procedures, evaluation of fraud risk and possibly even audit software. We first published our stand on sharing best practices as part of our February 2002 five-point plan to restore public faith and trust in the accounting profession. We are proud of Grant Thornton's audit methodology and are willing to share what we consider to be our best practices with others. We are certain the other major firms feel the same about their methodologies and hope they are also willing to share with the entire accounting profession. We, like every firm, can learn from the best practices of others, and as a whole, the profession can improve the audit process. This unprecedented sharing of best practices would serve the public interest by ensuring that all auditors of SEC registrants follow the best practices in the profession, increasing the confidence users can have in the quality of an audit.

The business value of internal controls

Entry into the capital markets confers a responsibility to maintain effective internal control processes. Furthermore, it is difficult to weigh the costs of Section 404 implementation against the intangible value to the capital markets that occurs when effective controls identify a potential fraud or unintentional error and management executes corrective measures before the problem becomes material to the financial statements. In addition, effective and efficient internal controls often generate operational cost savings to a company by reducing risk and providing greater visibility to the operating information.

However, while there are potential operational benefits, the initial costs for meeting the new internal control reporting requirements are high, particularly for small and mid-cap companies. In addition to the unavoidable effort of conducting a first-time-through evaluation of controls, these high costs are driven primarily by:

- A lack of guidance that differentiates the internal control requirements for small and mid-cap companies from those of large-cap companies
- A lack of interpretative guidance on the variables that influence the scope of management's and the auditor's evaluation and testing of internal controls, including the definitions of "significant account" and "significant processes and major classes of transactions" contained in AS No. 2, paragraphs 60-67 and 71-73

Accordingly, the Commission and the PCAOB should look for ways to demonstrate the business value of good internal controls over financial reporting, while at the same time identifying ways to make the establishment, evaluation and testing of those controls more cost-efficient.

Principles-based standards

A factor contributing to perceptions about the high cost of Section 404 implementation was uncertainty about applying the requirements of AS No. 2. In general, auditors interpreted AS No. 2 narrowly and conservatively. Simply stated, there was a focus on technical compliance with complex rules. We believe actions can be taken to make the Section 404 process more cost-efficient, without diminishing the overall benefit of Section 404 to the capital markets. Efficiencies could be achieved if regulators and standards-setters provided broad guidance (or principles) on audit objectives and on the use of good-faith professional judgments to meet those objectives.

In our February 2002 five point plan, we advocated a principles-based approach to standards setting. Our view was subsequently advanced by the report of the 103rd American Assembly which recommended the establishment of principles-based standards[1].

The current rulebook approach for standards-setting fosters a culture where there is more concern about form rather than substance – in other words, an environment where compliance with the rules becomes a surrogate for quality.

Principles-based auditing standards could give auditors greater flexibility to address assurance on non-financial business information, for example, key performance indicators. In addition, principles-based standards could also permit auditors to provide commentary and observations for qualitative information, such as management's use of judgments and estimates; business risks, uncertainties and opportunities; liquidity; and forward-looking information. Most importantly, principles-based standards would result in auditor reports that are more useful to investors than what the rules-based standards currently allow.

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[1] 103rd American Assembly, Columbia University, *The Future of the Accounting Profession*

The information and assurance needs of the capital markets

The overall reporting landscape should be viewed using a wide-angle lens. Therefore, we urge the SEC to consider future roundtables from a different perspective; a narrow focus on only internal control reports may cause us to miss an opportunity to address a variety of related issues.

Financial statements and notes are not the sole decision-making tool used by investors, creditors and management. In addition, research shows that about 25% of an entity's market value can be attributed to accounting book value. The remaining 75% of market value, or the unexplained value, is based upon intangibles such as strategy, market growth, product innovation, people, customer loyalty and expectations of future growth. Non-financial measures and qualitative information are critical to decision-making; but they are often nowhere to be found in today's financial reporting.

We urge the SEC to convene more comprehensive roundtable events to address disclosure of a wide variety of non-financial information, including value drivers (e.g., customer satisfaction, speed to market); key performance indicators (e.g., retail sales per square foot, revenue ton-miles); and information about business opportunities, risks, strategies and plans.

Conclusion

This first round of Section 404 reporting has taken a toll on the business community. Corporate management worked diligently (and at times feverishly) to ensure that internal control systems and processes were designed and operating effectively. The public accounting profession implemented new standards for auditing internal control. Regulators too were under pressure from various constituencies eager to make a case for one point or another. Now is the time for the capital markets to digest and assess internal control reports.

The ability to provide the capital markets with relevant information to support decision-making is supported by several individual components: (1) a supportive internal environment, i.e., a culture of transparency, accountability and integrity; (2) a means to efficiently and effectively accumulate, validate, prepare, disseminate, exchange and analyze business information; (3) internal controls over financial reporting; (4) a structured approach to providing relevant non-financial information; and (5) auditor assurance. The components of high quality business reporting are interdependent. Changes to one or two elements will not provide the solutions that are necessary to ensure that the U.S. capital markets remain the strongest in the world. We urge the SEC to support a market-driven collaborative approach to meeting the broad information and assurance needs of the capital markets.

Very truly yours,

Ed Nusbaum

Edward E. Nusbaum
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