National Retail Federation
The Voice of Retail Worldwide

May 1, 2006

Mr. William Gradison, Acting Chairman
Attention: Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Internal Control Roundtable

Dear Mr. Gradison,

The National Retail Federation (NRF), on behalf of its members, is pleased to submit comments regarding second-year experiences implementing the internal control reporting requirements required by Sarbanes-Oxley, Section 404. We look forward to the May 10, 2006 roundtable and appreciate the opportunity to provide our feedback in advance.

The National Retail Federation is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, chain restaurants, drug stores and grocery stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees—about one in five American workers—and 2005 sales of $4.4 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

The May 16, 2005 guidance from the PCAOB contributed significantly to improvements in the application of Section 404 during Year Two. Our members agree that as a whole the compliance process was more efficient than Year One. They have seen a decrease in the need for external resources, mainly due to all parties having a greater understanding of the internal control requirements and related expectations. Additionally, the May 16 guidance led to a reduction in the total number of key controls for many companies as a more risk-based approach was implemented. Other positive improvements include a more collaborative environment between issuers and external auditors, less time spent on documentation since the practice involved updating what already existed, and improvements in planning and resourcing. While we are pleased with the progress made to date, there are still opportunities for improvement. As requested by the SEC and PCAOB in their February 16 call for comment, our members offer the following suggestions to improve the efficiency and effectiveness of the internal control assessment and audit:

Tone at the Top

A strong "tone at the top" in an organization should lead to a reduction in the number of controls tested. Some retailers, even those who have been recognized as establishing best practices in this area, are not seeing these benefits. While we understand how difficult it is to establish a set of criteria to evaluate effective tone, we encourage the Board to take this matter into consideration.

Increase Reliance on Internal Work
Companies can play an important role internally in the testing and documentation of Section 404 of the Act. We believe additional efficiencies could be realized if even greater reliance is placed on the work of these company employees, including Internal Audit. We encourage the Board to consider the work that this group can contribute, especially in organizations with a strong tone at the top.

Continue Efforts to Integrate the Financial Statement and Internal Control Audits
While we have seen some improvements in the integration of the financial statement audit and the internal control assessment, the two are not yet fully integrated. Opportunities for greater synergies from management and external auditors still exist in this area. In particular, we believe that the scope of the control work performed for the 404 assessment should be the same scope as that for the financial statement audit. We ask the Board to consider opining on this view.

Encourage a Risk-Based Approach
NRF and its members firmly believe a risk-based approach is the best and most efficient way to evaluate a company's internal controls. We are encouraged by the Board's May 16th support of this concept and ask that they re-emphasize existing standards which support a risk-based approach.

Clarify Material Weakness
In its current context, a very disparate group of events, with varying levels of financial statement impact, can trigger a finding of material weakness. A material weakness at one company could indicate tone at the top and ethical issues, while at another company it could signify a change in accounting policy from one clearly disclosed interpretation to another interpretation that is more consistent with current SEC views. Most would agree that weak or unethical tone at the top issues suggest a far more onerous weakness than a change in a previously disclosed accounting practice. We encourage the Board to provide more guidance surrounding the interpretation of material weakness to recognize the different levels of severity in the event of nonconformance and potential subsequent restatement of prior period results.

Recognize Maturity Factor
Most well run companies have internal controls that have been in place for a period of time and have had zero exceptions in prior years' testing. These would be considered mature controls. In order to reduce the costs (both in time and resources) and inefficiencies associated with testing numerous controls—particularly medium and low risk controls that have had zero exceptions in Years One and Two—we propose that guidance be issued to allow for the testing of certain controls on a rotational basis. Recognizing that most companies stratify their controls on a high, medium, and low risk basis, we recommend that high risk controls be tested annually, and medium and low risk controls that have had no exceptions (or very few exceptions) in prior years be tested on a two or three year rotational basis.

Alternatively, we propose that guidance be issued to allow for a reduced sample size when certain controls have been tested without exception for consecutive years.

Affirm the Benefits and Acceptability of Interim Period Testing
The PCAOB's May 16 guidance supports testing throughout the year and notes that reliance on such tests is acceptable subject to auditor judgment, complexity of the control, the subjectivity of judgment, and level of risk. The PCAOB understands the efficiencies inherent in avoiding duplicative or repetitive testing where evidence indicates that interim tests can suffice. We ask the Board to emphasize and encourage the reliance on interim tests wherever possible, subject to the conditions noted above. Such reliance could relieve some of the year-end burdens companies face, especially retailers for whom the winter holiday season falls in Q4. If year-end high level reviews of controls—consisting mostly of inquiry and observation—confirm remediation of exceptions noted during the year, as well as a validation that no systemic changes have occurred, such reviews should suffice in many cases.

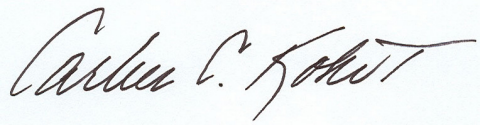
Reevaluate the Need for Three Opinions
External auditors must issue three opinions annually: 1) an opinion on management's assessment of the company's internal control over financial reporting, 2) an assessment of the company's internal control over financial reporting and 3) the financial statement audit opinion. This seems to be a duplication of effort. Some synergies could be recognized and costs saved if one of these opinions could be eliminated. An alternative approach would be to change the external validation from an annual requirement to once every two or three years while keeping the annual management attestation in place.

Clarify the Interpretation of Auditing Standard 2 (AS2), Paragraph 27
Paragraph 27 of AS2 states that "in an audit of internal control over financial reporting, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements." This statement has, in some cases, led to additional work in the field due to confusion surrounding the intended scope of "all relevant financial statement assertions related to all significant accounts and disclosures." We ask the Board for guidance on which assertions should be considered relevant and whether the intent is that all significant accounts and disclosures need evidence of effectiveness for the auditor or only all material accounts and selected significant accounts.

These suggestions are offered in the hope that with continued communication and discussion among all parties, the application of the internal control assessment requirement will fully realize all of the benefits intended by the Sarbanes-Oxley Act, while keeping costs and inefficiencies to a minimum. NRF again thanks you for your time and consideration of our ideas in advance of the May 10, 2006 Internal Control Reporting Requirements Roundtable. We wholly support financial transparency and strong internal controls and anticipate the discussion that will follow to make this process more efficient for all involved.

We welcome any further discussion on this topic.

Sincerely,



Carleen C. Kohut
SVP and CFO

cc: Mr. Christopher Cox, Chairman, Securities and Exchange Commission