**Submission of Comments to the SEC/PCAOB Roundtable, May 10 2006**

We appreciate the opportunity to provide feedback on our experiences with implementation of Section 404 of the Sarbanes Oxley act of 2002.

We believe that the Sarbanes-Oxley Act has contributed to the overall success in improving the quality of financial reporting and corporate governance for public companies. Section 404 of the Act along with the PCAOB's Auditing Standard No.2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" (Audit Standard No. 2), have focused significant attention on internal controls. We have always valued and have implemented strong internal controls, which have helped enable the production of high quality financial statements and meaningful disclosures in our SEC filings.

We are writing today with recommendations on changes to the Sarbanes-Oxley Section 404 legislation that we feel will maintain the spirit of the legislation while significantly reducing the compliance burden that large public companies currently face.

In summary, these recommendations are:

1. **Require external auditors to form an opinion on management's assessment of internal controls only, and NOT require a separate audit of internal control**
2. **Allow external auditors to perform "rotational" (less frequently than annual) testing of controls that have performed without exception upon repeated testing**
3. **Allow external auditors to rely on management's work in testing for low-level, low-risk transactional controls**
4. **Provide additional clarity on materiality thresholds (for what constitutes a significant deficiency and a material weakness) over the "rule-of-thumb" percentage of net income thresholds currently being used**
5. **Change management certification of internal controls date and required auditor attestation date from an "as of" date to a "for the period ending" date**
6. **Relax the requirements of a "recognized risk framework" (with specific reference to the COSO framework) or further specify requirements of acceptable risk frameworks**

Detail on each of the recommendations is included below.

__Recommendation #1:__ **Require external auditors to form an opinion on management's assessment of internal controls only, and NOT require a separate audit of internal control**

For material weaknesses tracked from June 2005 through March 2006, 76% of material weaknesses were identified by management, while 24% were identified by the external auditor in conjunction with management or by the external auditors themselves. The vast majority of material weaknesses, therefore, have been identified by management.

In addition, it has been clear over the past 2 years that investors are treating material weakness disclosures with relative indifference. If one excludes the small subset of companies that have disclosed multiple material weaknesses, the overall negative market reaction to a material weakness disclosure relative to the S&P500 market index[1] is less than 0.5%.

One may conclude that material weakness disclosures, in the vast majority of cases, are unearthed by management testing processes, do not appear to contain any material new information for investors, and do not impact investor confidence. Given lack of significant investor reaction, companies have no disincentives to disclose material weaknesses, even in the absence of a separate external auditor controls audit. As you are aware, the PCAOB chose to write Audit Standard No. 2 to require the auditor to conduct an audit of internal control, though section 404 of the Act did not require such an audit.

We recommend, therefore, that the requirement for a separate auditor internal controls audit be removed.

**<u>Recommendation #2:</u> Allow external auditors to perform "rotational" (less frequently than annual) testing of controls that have performed without exception upon repeated testing**

The Section 404 compliance cost burden remains high. Companies having greater than $1 billion in revenue spent over $9 million[2] on average in total Section 404 compliance costs. The median decline in audit fees for large companies has been a mere 2.4%[3] in year 2. A vast majority of this cost includes testing for effectiveness of routine, low-level controls. Fewer than 1% of disclosed material weaknesses in year 1 related to "tone-at-the-top"–related issues, confirming the disproportionate focus on testing transactional controls.

Detailed transaction-level controls actually do very little to prevent the types of fraud the Act was meant to address, and the lack or failure of these controls was not the primary cause of the corporate governance failures of the past. Rather, these failures were precipitated by unethical practices, collusion and override of controls by senior management. Other sections of the Act which provide for expanded whistle-blower protection and increased accountability for wrongdoing are much more effective in preventing and detecting fraud than the implementation of Section 404.

[1] Market reaction 5 days prior and 30 days after material weakness disclosure; Corporate Executive Board research; http://www.executiveboard.com
[2] Corporate Executive Board research; http://www.executiveboard.com
[3] Source: Compliance Week; http://www.complianceweek.com

Despite the 2005 SEC and PCAOB guidance calling for a more principles- and risk-based approach to scoping, our experience has been that auditors remained reluctant to change audit practices. It must be pointed out that the PCAOB's own inspection reports on the Big 4 accounting firms highlighted auditing deficiencies primarily related to transactional controls, making the accounting firms much less willing to embrace risk-based controls scoping.

We are therefore recommending that management be allowed more flexibility in determining what transactional controls are tested and when, based on prior performance of the control and risk of material changes to the control.

**Recommendation #3: Allow external auditors to rely on management's work in testing for low-level, low-risk transactional controls**

53% of large companies[4] indicate that auditor reliance on management testing is their primary discussion issue with their external auditors. We believe that auditors should have more flexibility to rely on management's work, including process owners, for areas that are not considered to be at high risk. For example, automated transaction controls or controls over routine processes involve lower risk and can be tested by process owners. It is important that process owners are accountable for effective controls, but auditors believe that AS2 prevents them from relying on process owner assessments. This causes duplicate testing and is disruptive to operations. Auditors should be allowed to rely on the quality of managements' overall compliance approach, including the presence of a robust compliance environment and entity-level controls, rather than focusing on individual assessor independence.

We are therefore recommending that external auditors be required to rely on management's work in testing (irrespective of entity performing the testing) for a mutually-agreed upon universe of low-risk controls.

**Recommendation #4: Provide additional clarity on materiality thresholds (for what constitutes a significant deficiency and a material weakness) over the "rule-of-thumb" percentage of net income thresholds currently being used**

There remains a significant need among companies for clarification on what control exceptions constitute material weaknesses and significant deficiencies on a purely quantitative basis. External auditors are most commonly applying 1% of pre-tax net income and 5% of pre-tax net income thresholds to significant deficiency and material weakness evaluations, in addition to qualitative filters. These thresholds, however, unfairly and severely penalize companies in break-even, low net income or negative net income situations, in addition to being too volatile to permit fair and consistent evaluation of deficiencies across multiple periods.

Given the large degree of subjectivity around controls exception evaluations, we recommend that the PCAOB should provide examples of findings that should and

[4] Corporate Executive Board research; http://www.executiveboard.com

should not be considered a significant deficiency or material weakness. The controls environment context should also be considered to distinguish a singular exception from a systemic controls issue.

**Recommendation #5: Change management certification of internal controls date and required auditor attestation date from an "as of" date to a "for the period ending" date**

The current requirement that testing validates controls in place at the relevant balance date greatly complicates the scheduling of testing (forcing work at several times during the year) and could inappropriately influence the implementation and compliance with controls to satisfy only that certification date. We believe that a more effective approach would be to simply require that for each certification year, controls have been evaluated and tested at some time during the course of the year. We believe that this is consistent with the notion that investors and management are interested in a continuously effective controls system, and not a defined point-in-time snapshot. An annual controls validation that is not tied to the end of the financial year will allow companies to minimize disruption to operations and enable more efficient planning and execution of controls testing. The suggested approach is similar to the requirements in accounting standards that assets be assessed for impairment at least once per year.

We recommend, therefore, that companies be required to certify to effectiveness of internal controls not "at year end" or "throughout the year" but simply "annually".

**Recommendation #6: Relax the requirements of a "recognized risk framework" (with specific reference to the COSO framework) or further specify requirements of acceptable risk frameworks**

Many companies have strong enterprise risk frameworks in place; however, integrating those with Section 404 work is difficult and prone to rejection by external auditors due to their dependence on the explicit guidance referring to the COSO framework. As a result, many companies have had to dissociate Section 404 work from other risk management activities across the firm, which would appear to be a gross inversion of the principles that Section 404 espouses.

In addition, our experience has shown that the COSO framework is largely ineffective in prioritizing the work required for SOX 404. We also see the COSO framework as a large source of duplicative scope creep into operational areas that Section 404 was not intended to address.

We recommend, therefore, that the PCAOB relax the requirements of a "recognized risk framework", or further specify the requirements of acceptable risk frameworks that allow companies flexibility in using risk frameworks that integrate with companywide risk management efforts.

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