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Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F St., NE
Washington, DC 20549-9303

RE: File Number 4-511
May 10, 2006 Roundtable on Second-year Experiences with Internal Control Reporting and Auditing Provisions

Dear Ms. Morris:

I appreciate the opportunity to participate in the 2006 Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions and to submit the following comments. The perspective I offer is that of a director with over twenty-five years of service on corporate boards and as a director of the National Association of Corporate Directors (NACD).

I have served on fourteen audit committees of both large and small companies, chaired the audit committees of The Dow Chemical Company and Aetna, Inc., currently chair the audit committee at MedImmune, Inc., and serve on the audit committee of GenVec, Inc. Next week, I will resume chair of the audit committee of Dow Chemical.

**Second year implementation has been smoother and, in general, control systems are more effective.**

Implementation in the second year has been smoother, as both management and auditors became accustomed to the requirements of Auditing Standard No. 2 (AS 2). In particular, it raised awareness for many in management who had thought little about internal controls and had limited understanding of their function or their importance. As a result, I believe that internal controls across corporate America are more effective and while the benefits are difficult to quantify, I believe they are there.

The approach to Section 404 implementation which has produced the best results has included these elements: good up-front planning about scope and process with "buy-in" by management, the auditor, and the audit committee; a competent project manager, highly enough placed in management to get attention when needed; competent management by the auditor; appropriate milestones for accomplishing various tasks; timely execution by management and the auditors; and vigilant oversight by the audit

committee. In my experience, where troubles and tensions have arisen, it is because one or more of these elements faltered or was missing altogether. These elements are cornerstones of an effective 404 compliance process and must remain in place.

**Costs are still thought to be too high vis-à-vis benefits.**

A key concern last year was that the costs associated with implementation were too high and were deemed not commensurate with the benefits. Costs have come down in the second year though not as much as was anticipated.[1] Apparently no one fully anticipated the ongoing effort needed to maintain and test the system of controls, so it is quite possible that the estimates of second year cost reduction were optimistic. But optimistic or not, the fact remains that the prevailing opinion in corporate America is that the costs of compliance are still too high.

**Audit firms are sticking to the letter of the standard.**

The propensity of audit firms to follow literally the letter of the standard rather than to exercise the judgment the PCAOB intended also contributed to the increase in costs. This issue was raised last year and audit firms continue more or less in that mode today, and with good reason. The memory of the demise of Arthur Andersen lingers and the firms are still settling into the new PCAOB-led regulatory environment. In particular, there is a concern about what could emerge in the PCAOB inspection process.

**To make the compliance process even more efficient, it would be helpful to amend AS 2.**

Last year, I believed that new guidance provided in May 2005 by the SEC and PCAOB would be helpful in the second year. I did not believe that there was cause to amend AS 2 until we could assess how well the new guidance worked. Now, with another year under our collective belts and some of the same issues still with us, I have come to the conclusion that amending AS 2 would be useful.

The following are several recommendations for consideration.

1. **Amend AS 2 to be specific about a risk-based approach. Risk-based thinking would apply to setting scopes, doing the testing, and deciding what is or is not material.**

As we commented last year, the definitions of "significant deficiency" and "material weakness" are wordy, cumbersome, and open to a variety of interpretations. For example, how should auditors interpret "more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected"? "More than a remote likelihood" and "more than inconsequential" are subject to too many different interpretations, possibly resulting in too-low thresholds for determining deficiencies. I would support a

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[1] The 2006 Financial Executives International survey of 274 public companies indicates that the average cost for Section 404 compliance for accelerated filers declined 16% in 2005 from the previous year. Non-auditor costs were projected to decrease 39% and auditors fees, 26% in the second year.

more precise refinement of these terms, both qualitative and quantitative. This would help to give auditors a clearer mandate to employ a risk-based approach and exercise judgment where needed.

With respect to testing, some audit firms are now applying a more risk-based approach. But they still require management to test numerous transactions, some of which may be low risk. More clarity in what is acceptable through a risk-based approach would allow management to reduce any excessive transactional testing.

**2. Clarify AS 2 so that the auditor is able to rely to a greater extent on management and/or internal audit's testing.**

Audit committees still are hearing that there is too much duplicative testing. Even though last year's guidance helped in this regard, more clarity is needed about when and where reliance on the work of others makes sense. The risk-based approach should be the basis for making those decisions.

It would also be helpful to clarify that re-testing by the auditor in low risk areas, year after year, may not be needed if the transactional processes remain unchanged. This would allow the auditor to use knowledge gained in previous cycles about these controls and to apply judgment about the extent and frequency of re-testing.

**3. The PCAOB inspection process of the audit firms' work should be more timely.**

If the purpose of the inspection is to drive improvements in the audit process, the publication of the reports must follow more closely the particular audit year in question. The inspection reports for 2004 were not issued until the latter part of 2005 and some were not issued until 2006. Perhaps the delays in issuing the 2004 reports were caused by start-up issues at PCAOB, but going forward, these reports should be more timely.

It would also be helpful if audit committees could have access to these reports. I appreciate the need for confidentiality to prevent such reports from leaking, but audit committees need this access in order to better evaluate the performance of the audit firm.

Thank you for hosting this Roundtable and for the opportunity to comment on these issues. I would be pleased to discuss any questions you may have and invite you to call me at 202-337-9100 if I can be of further assistance.

Sincerely,

Barbara Hackman Franklin
President and CEO
Former US Secretary of Commerce

Nancy M. Morris
May 3, 2006

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

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