



committee on corporate reporting

May 1, 2006

Nancy M. Morris, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

Reference: File Number 4-511

Dear Ms. Morris,

The Committee on Corporate Reporting (“CCR”) of Financial Executives International (“FEI”) is pleased to provide additional feedback regarding the implementation of Section 404 (“Section 404”) of the Sarbanes-Oxley Act of 2002 (“the Act”) relating to internal control over financial reporting. While most companies realized incremental improvements in their compliance process from Year 1 (2004) to Year 2 (2005), we believe there is continuing opportunity for clarity in both the interpretation of Auditing Standard No. 2 (“AS2”) and in its application to support the annual compliance process. We are encouraged by the Commission’s continued willingness to solicit input, and recommend that the Commission take swift action to allow auditors and preparers sufficient time to implement further improvements this year.

FEI is a leading organization of 15,000 members, including Chief Financial Officers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR, and not necessarily those of FEI or its members individually.

FEI was one of the first business associations to support the Act. We believe that many aspects of the Act, including Section 404, have indeed resulted in enhanced investor confidence in our financial reporting and disclosure practices, corporate governance and auditor independence. As one of the sponsoring organizations of COSO, FEI has long supported the position that effective internal controls are vital to the integrity of financial reporting. As previously stated, we see the need for greater balance in implementing the regulations and guidance.

The cost of Section 404 compliance continues to be high and disproportionate to the benefits derived from annual compliance. The results of a March 2006 FEI survey of 274 public companies (of which 238 are accelerated filers) indicate that the accelerated filers’ average cost for Section 404 compliance was \$3.8 million during fiscal year 2005, down 16.3 percent from 2004. Based on a March 2005 FEI survey it was anticipated that non-auditor expenditures would drop 39 percent and auditors fees would drop 26 percent. So while it appears that accelerated filers have benefited from some reduction in costs, it is not nearly as much as was expected by our members. Additionally, according to the March 2006 survey, Section 404 audit fees constituted 45 percent of the accelerated filers total audit fees; indicating that attestation fees are almost as much as the base fees paid for financial statement audits. The data shows that many of the cost reductions can be attributed to lower staff and consultant time and reduced auditor fees

for the Section 404 audit. Despite these reductions, the accelerated filers who participated in the survey also stated that their internal employees were still spending a significant number of hours (on average 22,786 hours) to comply with Section 404 during 2005. Also, a 2005 survey of CCR members on total audit fees indicated, on average, financial statement audit fees increased by 8 percent, which partially offset the savings incurred from the reduced Sarbanes-Oxley audit fees. As such, the costs to conduct Section 404 procedures still remain high and, in fact, 85 percent of companies still believe that the costs associated with Section 404 compliance far exceed the value.

While the previous interpretative guidance, most significantly in May 2005, from the SEC and PCAOB was helpful; the practical implementation of this guidance has for many been very conservative and inconsistent, as was the initial implementation of AS2. While some members have noticed improvement, many have witnessed the auditors continuing to adhere to the literal wording of the audit standard, rather than focusing on the spirit of the Act. This continues to result in a very conservative interpretation and a rules-based, "check-the-box" approach to compliance rather than a principles-based approach that allows for judgment and flexibility. We believe much of this behavior was driven by timing of the issuance of the guidance during the 2005 planning process coupled with the fear of second-guessing from the PCAOB inspection process. We also believe there continue to be considerable inconsistencies in the implementation approaches used by the auditing firms.

Many of the following recommendations were included in FEI's letter to the SEC dated April 1, 2005; however, we believe there is a need for further improvements in these areas. The 2005 guidance resulted in some changes during the year, such as improved communications between management and the audit firms, and most FEI companies believe that this is no longer an issue. We also recognize that the guidance was not published in time for many companies to fully implement all of the suggestions. Additionally, audit firms were reluctant to modify their approach until after completion of the 2005 PCAOB inspections.

Our recommendations are summarized as follows:

- Amend the language in AS2 to reflect the 2005 PCAOB guidance. This includes a more principles and risk-based approach, the establishment of more reasonable materiality thresholds, greater reliance on cumulative knowledge and flexibility to test throughout the year.
- Modify AS2 to allow for benchmarking of controls beyond IT, and to prescribe a risk-based approach to the scoping of IT controls.
- Clarify that management is not expected to follow the same AS2 prescribed procedures as the auditor to conclude on the effectiveness of its internal controls.
- Issue more timely PCAOB inspection reports that are publicly transparent and supportive of the 2005 guidance.

The following comments expand on these recommendations:

#### **1. Revise AS2 to reflect the 2005 guidance supporting a more principles and risk-based approach and allow for the establishment of more reasonable materiality thresholds**

Clear and consistent interpretation and application of AS2 is absolutely critical to reducing the compliance burden on companies, while still ensuring that the objectives of the Act are met. Therefore, we suggest the text of AS2 be formally amended to clarify the intended application of the standard and to clearly establish a conceptual framework that relies heavily on auditor judgment for implementation.

In our letter of April 2005, FEI requested that the PCAOB clarify several areas in which auditors were being overly-conservative and attempting to obtain *absolute* versus *reasonable* assurance. The 2005 guidance resulted in several improvements; however, we see the need for the SEC and PCAOB to change the text of AS2 to prescribe a more principles-based approach that provides auditors and management more flexibility and the ability to apply greater judgment. Many of the

words used in AS2 are highly prescriptive and appear to leave few decisions to professional judgment. Although AS2 states that the auditor "...must obtain sufficient evidence to provide a reasonable basis for his or her opinion..." interpretation of this statement has driven behaviors that support auditors obtaining "absolute assurance." We firmly believe that audit behavior will not change until AS2 is revamped.

We recommend that AS2 be revised to consider the following:

- a) *A risk-based approach to scoping, testing and evaluating materiality*- The firms' interpretation of AS2 language drives a non risk-based approach. AS2 states that a deficiency exists if "there is 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." We have seen a wide variation in the auditors' interpretation of "more than inconsequential." This can result in an extremely low threshold for identifying deficiencies, and does not support a risk-based approach based on the potential for a material error to occur. We suggest that only Significant Deficiencies (SD) and Material Weaknesses (MW) need be tracked and addressed, as opposed to today's practice of identifying and correcting minor deficiencies that never could rise to the level of an SD or MW.
- b) *Greater reliance on company-level controls* - The November 2005 PCAOB report of its monitoring of AS2 implementation indicated that, to varying degrees, audits were approached from the bottom-up. The PCAOB asserted that auditors who deployed a bottom-up approach often spent more time and effort than was necessary to complete the audit. The report emphasized that the PCAOB expects auditors to use a top-down approach in the future, and as a result audits should be more efficient. A top-down approach begins with an evaluation of company-level controls; however, auditors still appear to be using company-level controls as a supplement to transaction and work process controls rather than as the starting point for auditing internal controls over financial reporting. Auditors should begin with company-level controls to assess the risk of the organization and modify their transactional testing accordingly. AS2 should be modified to indicate that company-level controls be initially reviewed early in audit planning and then be considered throughout all audit testing to ensure that subsequent detailed control testing is appropriately risk-based.

## **2. Revise AS2 to reflect a greater reliance on cumulative knowledge and prior year's work, management and/or internal audit testing, and flexibility to test throughout the year based on risk**

- a) *Reliance on cumulative knowledge* - AS2 requires that "each year's audit must stand on its own"; therefore, the auditor is not currently permitted to rely on cumulative knowledge to determine scope or to consider rotating the testing of key controls each year. The 2005 PCAOB guidance encouraged auditors to use a risk-based, top down approach to determine the scope of the audit, while considering both quantitative and qualitative factors. While auditors lowered their "financial statement coverage ratios" from 80-90 percent in 2004 to 70-80 percent in 2005, this quantitative approach was essentially the same and was not risk-based. The 2005 guidance also indicated efficiencies could be achieved through modulating test sample sizes based on cumulative knowledge and through expected auditor learning curves. We agree with these comments but believe AS2 should be amended to clearly articulate this guidance, particularly to allow the use of cumulative knowledge and to encourage an effective risk assessment process in determining the scope and extent of testing.

We recommend the PCAOB revise AS2 to clarify that scope and testing should be determined primarily on qualitative risk factors. We also recommend that auditors have the flexibility after the initial year of compliance to modulate the scope and testing of certain controls based on risk and their cumulative knowledge of the control environment. In reality, many transactional processes are not subject to change from year to year. Rather than completely re-testing entire transactional or process cycles, a more effective and efficient approach would be to emphasize the higher risk areas – and changes in routine processes.

In addition, we recommend that AS2 be updated to formally recognize and support the use of “financial statement coverage ratios” as these metrics are used by public accountants – albeit inconsistently, thus far. Financial statement coverage ratios can be helpful, in conjunction with other qualitative factors, in determining the relative risk of significant accounts, locations, processes across industries and over time. However, it does not appear that external audit firms are employing these tools in a consistent or efficient manner. While we are not asking for AS2 to set a specific coverage percentage, we do think guidance surrounding the use of these ratios would be helpful.

- b) *Greater reliance on management and/or internal audit testing* - AS2 mandates that the auditor must rely on their own work to provide the “principal evidence” for their conclusions. This has caused the auditor to place limited reliance on management and/or internal audit testing, resulting in significant duplicative testing by the auditor – even in low risk areas. The resulting audit inefficiency exacerbates a severe shortage of trained staff and has led to significant increases in the rates per hour charged by audit firms in 2004 and 2005.

The 2005 PCAOB guidance defining “principal evidence” and encouraging auditors to use the work of others as permitted by AS2 (e.g. Staff Q&A # 35) was helpful, and resulted in audit firms placing somewhat more reliance on companies’ internal audit testing. However, duplicative testing is still an issue, and auditors have not consistently and formally assessed the extent to which they could rely on the work of others. We believe further improvements can be made without jeopardizing the effectiveness of the audit.

We recommend the PCAOB revise the AS2 requirements to allow for reliance on the work of others to be risk-based. High risk areas, such as certain company-level controls and transaction controls involving significant estimates or judgments, should continue to require independent auditor testing. However, in lower risk areas, the auditor should be allowed to rely on their cumulative knowledge about management’s internal controls and the complete assessment process. This would also affirm the PCAOB guidance encouraging auditors to spend more time on high risk areas.

In addition, the guidance on self-assessments contained in the May 16, 2005 Staff Q&A #48 is overly-conservative, as it prohibits external auditor reliance on a self-assessment conducted by the same person responsible for performing the control. We recommend that the PCAOB amend AS2 to allow self-assessments in lower risk areas with objective and competent oversight (e.g. internal audit) and periodic quality control testing to be considered an acceptable testing approach that provides a proper balance of risk and efficiency.

- c) *Flexibility to test throughout the year based on risk* – As mentioned in our April 2005 letter, the current audit standard requires management to assess, and the auditor to attest, to the internal controls of a company “as of” the end of the fiscal year. We realize this “as of” date is legislatively mandated; however, we believe that additional changes in this area could address the practical challenges this presents – particularly with regards to roll-forward testing.

In 2005 the PCAOB provided some additional factors to consider in determining when roll-forward testing is required. However, this guidance was essentially in line with AS2, and the auditors continue to do significant testing late in the year resulting in substantial year-end inefficiencies for management. We recommend the PCAOB reconsider these requirements and revise AS2 to enable the auditor to conduct testing throughout the year and only conduct roll-forward testing in high risk areas.

### **3. Change AS2 to allow for additional benchmarking of controls – beyond IT**

The 2005 PCAOB guidance provided a helpful explanation of how auditors can use a benchmarking strategy to test automated controls – primarily related to IT controls.

We recommend the PCAOB consider other areas where benchmarking controls and reliance on change management processes could enable certain controls to be tested less often. As an example, we believe certain company-level controls remain stable unless the organization undergoes a significant change. We recommend that the auditor have flexibility in determining which company-level controls should be tested annually based on a risk assessment versus a review of significant changes that have occurred. Alternatively, we recommend that the extent of certain company-controls testing should be significantly less if no changes have occurred after the initial year of compliance.

#### **4. Change AS2 to prescribe a risk-based approach to scoping IT controls**

The COSO framework identifies that IT general computer controls (GCCs) support other automated controls by ensuring there is a continued operation of the applications. As such, if GCCs are not operating effectively, it may not be possible to rely on the related automated controls. Therefore, both GCC and automated controls must be evaluated when assessing internal controls over financial reporting. Since COSO does not provide detailed IT requirements or guidance, the scoping of these IT controls is subject to interpretation. In addition, AS2 provides that GCCs should be in place to reduce risks to an acceptable level. In most cases, once companies identified significant processes and the related applications, the GCCs supporting the applications were tested. This testing was typically performed irrespective of the risk that GCCs had on the specific financial process controls.

If IT automated controls (or manual controls dependent on IT reports) are determined not to be a key control, then it should not be necessary to test the automated controls or the related GCCs. The nature and extent of testing required for GCCs should be based on the risk that these controls have on financial reporting controls. Typically, GCCs present a moderate risk and control deficiencies in these areas either do not materially impact financial reporting or are mitigated by compensating controls such as account reconciliations, supervisory reviews, and external reporting controls. The last two years have shown that very few companies have actually had a material weakness in GCCs, yet audit firms have performed extensive testing of these controls.

We recommend the PCAOB allow the auditor the flexibility to limit the scope and frequency of testing of GCCs based on their cumulative knowledge of the control environment and on specific factors unique to a particular year, such as significant changes. The testing of IT general controls should be commensurate with the risk and the reliance upon these controls, consistent with the testing strategy for all other controls. For example, many companies spent a significant amount of unnecessary time in documenting and testing user access controls. While access controls are important, in some cases, they present a low risk to financial reporting. For example, if a financial process relies on an application to perform sophisticated calculations that are difficult to independently re-calculate, an auditor should consider the application higher risk than an application that is generating detailed transaction information in a standard system-generated report.

#### **5. Issue clarifying guidance that management is not expected to follow the same AS2 prescribed approach as the auditor to evaluate and conclude on the effectiveness of internal control over financial reporting**

AS2 was designed as an audit standard. However, many audit firms expect management to follow the same prescribed approach to evaluate internal control over financial reporting and conclude on its effectiveness. Company management has designed the control environment and experiences the controls on a daily basis, and, therefore, should not be expected to evaluate the effectiveness of these controls through the lens of AS2. We believe that management's approach should be flexible and dependent on risk, and allowed to vary by company; it does not have to follow the same prescribed approach as the auditor.

#### **6. Require more timely completion of the PCAOB inspections and oblige the reports to be more publicly transparent**

The PCAOB inspection process is designed to monitor the application of AS2, and is a critical factor in facilitating consistency between the firms. However, the elapsed time between the audit work and internal control opinion and the PCAOB inspections and report is far too long. Companies and audit firms are now one-third of the way through their Year Three compliance efforts (2006) and have not received complete feedback from the PCAOB relative to Year One (2004). The inspection reports for the Big Four Accounting firms that were issued between September 29 and November 17, 2005 were generally based on procedures conducted prior to the completion of the Section 404 Year One process. Furthermore, the inspection reports for the smaller firms were not issued until 2006. If the intent of the inspections is to drive improvements in the auditors' approach and to ensure greater consistency among the firms, then the feedback must be provided on a timely basis. Assuming the same pace continues, auditors would receive complete feedback on the 2004 inspections during the second half of 2006, enabling them to incorporate any changes in 2007, but that is three years after their internal control opinion was issued. Additionally, the inspection report should be more transparent to clients, investors and the audit committee, and should specifically communicate the results of the inspection and any deficiencies found.

Additionally, it is important to recognize that the PCAOB field inspections set the tone and may have a significant impact on the auditor's approach to an engagement, and their interpretation and application of AS2. Therefore, the inspection teams must have a balanced view that respects reasoned judgments made by both the auditor and management of the client company. We are encouraged by the PCAOB's approach to 2006 inspections (on 2005 filings) of internal control audits as outlined in its May 1<sup>st</sup>, 2006 statement; specifically that the inspections will focus on the "efficiency" of the audit firms implementation in light of the 2005 PCAOB and SEC guidance.

## **CONCLUSION**

In summary, we would like to reiterate that CCR fully supports the intent of the Act, and believe that our recommendations would clarify the intent of the audit standard, allow for greater consistency among the firms, and reduce the burden of compliance - without diminishing the control environment.

Thank you for considering our views. We would be happy to discuss any of the observations and recommendations noted above at your convenience.

Sincerely,

A handwritten signature in black ink that reads "Lawrence J. Salva". The signature is written in a cursive, flowing style.

Lawrence J. Salva  
Chair, Committee on Corporate Reporting  
Financial Executives International