

September 15, 2006

Nancy M. Morris, Secretary  
Securities & Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

**RE: File Number S7-11-06- Concept Release Concerning Management's Reports on Internal Control over Financial Reporting**

Dear Ms. Morris:

The Financial Reporting Committee (the "Committee") of the Institute of Management Accountants appreciates the opportunity to provide feedback on the United States Securities and Exchange Commission's (the "SEC") *Concept Release Concerning Management's Reports on Internal Control over Financial Reporting* (the "Concept Release").

Overall, the Committee believes compliance with Section 404 of the Sarbanes Oxley Act of 2002 ("Section 404") has been useful in helping to improve controls over financial reporting and disclosure practices of large companies across corporate America. More importantly, the Committee believes Section 404 has helped improve investor confidence. With that said, the Committee believes that the cost of compliance with Section 404 is far greater than the benefits derived from annual Section 404 compliance. We, therefore, applaud the SEC's continued willingness to solicit input and address various concerns of preparers and auditors on this important topic. Within Appendix A, the Committee has responded in detail to the specific questions raised in the Concept Release. Additionally, in the balance of this cover letter, we discuss what the Committee believes to be the major issues surrounding compliance with Section 404 that the Committee believes should be addressed. These issues are discussed under the following major headings: (1) Need for Principles-Based Management Assessment Guidance; (2) Guidance on Scope and Identifying / Testing Key Controls over Financial Reporting; (3) Guidance on Assessing Effectiveness of Information Technology Controls; (4) Guidance on Assessing Effectiveness of Controls over Fraud Prevention; (5) Evaluating Deficiencies Identified; and (6) Public Company Accounting Oversight Board's ("PCAOB") Examination Process.

## **1. Need for Principles-Based Management Assessment Guidance**

As noted above, the costs of complying with the requirements of Section 404 have been significant across corporate America. Specifically, it is not unusual for large public companies to spend over one hundred thousand hours and several million of dollars to comply with the requirements of Section 404. It has been the experience of the Committee that many of the hours spent by financial statement preparers in complying with the requirements of Section 404 are attributable to what is currently being interpreted to be fairly prescriptive requirements of the PCAOB's Auditing Standard No. 2 ("AS2"). Such prescriptive interpretations not only undermine the efficiency of the assessment process, but in the view of the Committee, can undermine the effectiveness in the long-term as compliance gravitates to a "check-the-box" mentality resulting in form versus substance. Accordingly, the Committee strongly supports the issuance of additional guidance regarding management's annual internal control assessment process and believes such guidance would be helpful and useful to all companies. The Committee believes, however, that it is important that such guidance be principles-based and allow for the exercise of judgment by management in performing the assessment. Additionally, such guidance should include realistic examples, which illustrate the requirements necessary to assess the effectiveness of controls in a risk-based, top-down approach to the assessment process. As an example, it would be helpful if the guidance included practical illustrations on the use of higher/company level controls other than control activities to reduce the extent of testing at the control activity level. In addition, the Committee believes that it is important for any additional guidance to be sensitive to the existing investment in time and systems made by many companies in support of their current assessment processes.

It is our understanding that the SEC plans to issue new guidance in the form of an SEC rule and that AS2 would be revised by the PCAOB to be consistent with this rule. It is critical that the SEC and PCAOB guidance are in alignment. Any differences will result in the auditors continuing to require companies to fulfill the PCAOB requirements in support of their audit process. The Committee believes this is a reasonable approach provided that such final rules can be issued in time to be incorporated into the planning for the 2007 assessment process. In the event the SEC does not believe that a rule can be issued in sufficient time to be incorporated into next year's planning process, the Committee would recommend that the SEC issue interpretative guidance (again in time for planning the 2007 assessment process) dealing with the most significant issues identified in responses to the Concept Release. After seeing how such interpretative guidance is working, the SEC could issue a formal SEC rule which incorporates such guidance along with any modifications deemed necessary given the experience that is observed.

## **2. Guidance on Scope and Identifying / Testing Key Controls over Financial Reporting**

### *Scoping of Significant Accounts and Information Streams*

The May 2005 PCAOB guidance encouraged use of a risk-based, top-down approach to determine the scope of significant accounts and information streams to be tested. Notwithstanding the encouragement to use a risk-based, top-down approach, the Committee believes in practice that registrants and auditors are interpreting that a minimum coverage of 70-80% of the financial statement accounts and information is required to achieve an effective assessment process. As a result, the Committee observes that a substantial amount of time is spent documenting, testing and evaluating operating effectiveness in areas that are high dollar values but yet low risk. Such a mechanical interpretation causes disproportionately less time to be allocated to higher risks accounts and information streams (e.g., related party relationships and controls over fraud prevention). In addressing this issue, the Committee believes guidance should be issued which makes clear the need for a risk-based approach to assess internal controls over financial reporting. Such approach should clearly articulate that there is no required minimum coverage percentage and should include illustrations that show how both quantitative and qualitative factors impact the scope of significant accounts and information streams tested.

### *Identifying and Testing Key Controls over Financial Reporting*

The Committee noted that, during the first two years of performing assessment of internal controls over financial reporting, a significant amount of time and effort was devoted to testing controls whose risks of not operating effectively is fairly low. Similarly, the Committee noted that the nature, timing and extent of testing of key controls was not altered even if there were strong entity-wide controls (e.g., existence of strong internal audit program, performance of detailed financial statement analyses) that reduced the risk to a fairly low level that such controls were not operating effectively. For these reasons, the Committee believes preparer management and auditors would benefit from a clear understanding of the attributes that make controls “key”. Such guidance should be risk-based and provide practical examples illustrating acceptable ways of identifying the relevant control activities to be tested and the nature, timing and extent of testing to be performed after factoring in complementary and mitigating entity-wide controls and historical experience with the control. Further, the Committee believes that the risk profile of a key control is mitigated by successful execution and testing in a prior year, and as a result, should be considered in the current year planning. Moreover, we believe any management guidance issued should clarify that internal controls can be tested throughout the year (as opposed to solely at year-end) and still support the operating effectiveness at the reporting date.

### **3. Guidance on Assessing Effectiveness of Information Technology Controls**

As you are aware, most registrants use the COSO framework for assessing the effectiveness of internal controls over financial reporting. Since COSO does not provide any specific guidance relating to the nature and extent of testing of information technology (“IT”) controls, the Committee members have found that this is an area that is open to varying interpretations. In particular, registrants and auditors are spending a significant amount of time documenting and testing IT general controls (and application controls) even though past experience has shown these controls are effective and pose low risk as it relates to a misstatement of financial reporting. For example, consider system access controls over a network housing significant computer applications. Assume that the control in place was that all terminated employees were required to be taken off of the network within 3 days of termination. Also assume that testing of this control identified that users were able to access the network subsequent to the 3-day period. While such deficiency in the operation of this control may need to be addressed as a business operations matter, we do not believe this type of deficiency is significant from a financial reporting standpoint. Specifically, if this were the type of deficiency noted there would typically be a number of compensating controls (e.g., physical access is limited, manual account analyses and reconciliations are performed) such that the risk of material financial reporting misstatement occurring attributable to this type of control deficiency is low. However, it is the experience of Committee members that in the past two years a significant amount of time and effort has been spent in testing and analyzing these issues from a Section 404 assessment perspective.

As a result of the above observation, the Committee would strongly support the issuance of additional guidance regarding management’s assessment of the effectiveness of IT controls. The Committee believes such guidance should address the identification of key IT controls (both general and application) and address the nature and extent of IT control testing. In addressing the nature and extent of testing IT controls, the guidance should stress the exercise of management judgment and have a risk-based focus considering such factors as the cumulative knowledge (i.e., past experience) of the functionality of the IT control, the inherent risks associated with the functionality of the control and any mitigating/compensating controls.

### **(4) Guidance on Assessing Effectiveness of Controls over Fraud Prevention**

In looking back at many of the corporate scandals that occurred in recent years, they were attributable to fraudulent behavior on the part of key senior personnel. COSO does not provide any guidance to registrants on the objectives, nature or extent of testing to be done on controls over fraud prevention. The formal guidance that some companies are using (“*Management Antifraud Programs and Controls*”) has been published for auditors by the American Institute of Certified Public Accountants as an exhibit to Statement on Auditing Standards No. 99, “*Considerations of Fraud in a Financial Statement Audit.*”

While the Committee believes this guidance is sufficient it would be helpful if the SEC and PCAOB acknowledge that this is an example of appropriate guidance for preparer management to consider in assessing fraud.

#### **(5) Evaluating Deficiencies Identified**

The current language in AS2 states that a significant 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.” As a result of this language, there is an inordinate amount of time spent on evaluating the implications of any deficiencies found - even though professional judgment would tell you that certain deficiencies are not significant. Similarly, the Committee believes this language is resulting in an extremely low materiality threshold, which, in turn, has resulted in significant transactional testing of lower-risk controls.

The Committee recommends that, as part of the guidance to be issued by the PCAOB, the definition of a significant deficiency be amended to follow more traditional materiality definitions that consider both quantitative and qualitative factors and provide for the exercise of professional judgment. Additionally, such definition should be based on annual rather than quarterly financial data.

#### **(6) PCAOB Examination Process**

While the issuance of new guidance in the areas noted above will enhance the efficiency and effectiveness of management’s assessment process, the Committee believes equally important to the execution of the process is the execution of the PCAOB inspection process. In this regard, it is important to recognize that the PCAOB field inspections set the tone and may have a significant impact on how auditing firms interpret and apply AS2. Said differently, it is important that the actions of the PCAOB inspection teams match the spirit of any guidance that is issued. Accordingly, the inspection teams must have a balanced view that respects reasoned judgments made by both management and the auditors of registrants. While it is still too early to predict what benefits will come out of this, 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 of Section 404 in light of the 2005 PCAOB and SEC guidance. Without a measured approach to the inspection process, the Committee believes that any guidance issued by the SEC and the PCAOB will be undermined as registrants and auditors have been and will continue to be overly cautious in making judgments because of the fear of being second guessed in the PCAOB inspection process.

Finally, in an effort to advance the discussions on this important topic, the IMA, the sponsoring organization of the FRC, is developing proposed risk-based implementation guidance which it believes can be used in conjunction with several global internal controls frameworks in assessing the effectiveness of internal controls over financial reporting. Such proposed guidance, which the IMA indicates is based on market experience and research, will be submitted to the SEC in draft form as a separate comment letter. However, since the IMA guidance is still under development at the time we are submitting this letter to the SEC, the FRC has not reviewed the IMA guidance.

Again we appreciate the opportunity to provide feedback to the SEC on the Concept Release and would be pleased to answer any questions that you have. I can be reached at (212) 484-6680.

Very truly yours,

A handwritten signature in black ink, appearing to read "Pascal Desroches". The signature is fluid and cursive, with a large initial "P" and "D".

Pascal Desroches  
Chair, Financial Reporting Committee

1. Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?

*Additional principles based guidance would be useful on how to evaluate the effectiveness of internal controls over financial reporting. As facts and circumstances over control structures determined to be appropriate will differ among industries, size and complexity of organizations, principles-based guidance is recommended to provide companies with the necessary flexibility for its application.*

2. Are there special issues applicable to foreign private issuers that the Commission should consider in developing guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting? If so, what are these? Are such considerations applicable to all foreign private issuers or only to a sub-group of these filers?

*We do not have a comment with respect to issues associated with foreign private issuers.*

3. Should additional guidance be limited to articulation of broad principles or should it be more detailed?

*The Committee believes that guidance should be principles based. However, it would not be sufficient to only have broad-principles as these would need to be supplemented with practical examples illustrating acceptable applications. See also response to question number 1.*

4. Are there additional topics, beyond what is addressed in this Concept Release, that the Commission should consider issuing guidance on? If so, what are those topics?

*No additional topics identified for discussion.*

5. Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?

*It would seem to the Committee that a rule can not be issued in sufficient time to be incorporated into next year's planning process; therefore, we would recommend that the SEC issue interpretative guidance (in time for planning the 2007 assessment process) dealing with the most significant issues identified in responses to the Concept Release. After seeing how such interpretative guidance is working, the SEC could issue a formal SEC rule which incorporates such guidance along with any modifications deemed necessary given the experience that is observed.*

6. What types of evaluation approaches have managements of accelerated filers found most effective and efficient in assessing internal control over financial reporting? What approaches have not worked, and why?

*As process level management are responsible for the controls, management self-assessment increases ownership and control consciousness throughout the organization. This self-assessment is validated by periodic monitoring procedures performed by an internal controls group and the internal audit department.*

7. Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? If so, what are they? How might those drawbacks or other concerns best be mitigated? Would more detailed Commission guidance hamper future efforts by others in this area?

*Overly prescriptive guidance could undermine the progress and significant investment that companies have made in their current programs, especially those mature programs that have been well thought-out and agreed to with their auditors. In this regard, the Committee believes that it is important that any new guidance issued be principle-based and allow for the exercise of judgment by management in performing the assessment. Additionally, such guidance should include realistic examples, which illustrate the requirements necessary to assess the effectiveness of controls in a risk-based, top-down approach to the assessment process. As an example, it would be helpful if the guidance included practical illustrations on the use of higher/company level controls other than control activities to reduce the extent of testing at the control activity level.*

8. Why have the majority of companies who have completed an assessment, domestic and foreign, selected the COSO framework rather than one of the other frameworks available, such as the Turnbull Report? Is it due to a lack of awareness, knowledge, training, pressure from auditors, or some other reason? Would companies benefit from the development of additional frameworks?

*We believe that many reporting companies had previously implemented various objectives of COSO. As such, to become familiar with other available frameworks in order to evaluate their potential use would have been inefficient. Although we are not opposed to the development of other frameworks, we would be concerned if, as a result, COSO would no longer be allowed for future assessments. We also believe that the objectives identified in COSO allows for sufficient flexibility.*

9. Should the guidance incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting"? Should any portions of the May 16, 2005 guidance be modified or eliminated? Are there additional topics that the guidance should address that were not addressed by that statement? For example, are there any topics in the staff's "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6,

