

NEW YORK
CITY BAR

COMMITTEE ON
FINANCIAL REPORTING

September 18, 2006

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Via email: rule-comments@sec.gov
Nancy M. Morris, Secretary,
Securities and Exchange Commission, 100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-11-06 – Concept Release Concerning
Management’s Reports on Internal Control Over Financial Reporting

Ladies and Gentlemen:

This letter is submitted on behalf of the Financial Reporting Committee (the “Committee”)¹ of The Association of the Bar of The City of New York in response to Release No. 34-54122, Concept Release Concerning Management’s Reports on Internal Control Over Financial Reporting (the “Release”), in which the Commission requested comment on the development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting (“ICFR”). Our Committee is composed of lawyers with diverse perspectives on financial reporting, including members of law firms, counsel to major corporations, financial institutions, public accounting firms and institutional investors.

Overview

The following summarizes the main themes the Committee seeks to advance:

- We support additional Commission guidance to management on how to evaluate the effectiveness of ICFR and encourage the Commission to provide this as soon as possible.
- We suggest that the Commission, in particular, clarify the extent to which companies can use on-going monitoring, benchmarking and rotation of testing of non-critical controls based upon risk, materiality and other considerations.

¹ Please note that this letter does not necessarily reflect the individual views of each member of the Committee, nor does it necessarily reflect the views of institutions with which Committee members are affiliated.

- We encourage the Commission and the Public Company Accounting Oversight Board (the “PCAOB”) to address certain issues with respect to PCAOB Auditing Standard No. 2 (“AS-2”) to help establish a more efficient, cost-effective approach to the implementation of Section 404 of The Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”):
 - Recalibrate the definitions of “material weakness” and “significant deficiency”;
 - Reconsider the “strong indicators” of a material weakness;
 - Provide additional guidance on the extent to which enterprise-level risk controls can be used to make the review process more efficient.
- We suggest the Commission reiterate the relevance of qualitative as well as quantitative factors when making materiality determinations in the evaluation of ICFR.
- We recommend that for foreign private issuers, the Commission should exempt the reconciliation to U.S. GAAP from the scope of the Section 404 rules.
- We suggest that the Commission consider certain changes to the disclosure rules regarding ICFR and disclosure controls and procedures (“DC&P”).

Discussion

Additional Commission guidance to management would be useful

The Committee believes that additional Commission guidance to management on how to evaluate the effectiveness of a company’s ICFR would be an important part of establishing an approach to the implementation of Section 404 of Sarbanes-Oxley in which costs to companies and shareholders would be more in line with the benefits to investors. We also believe that additional guidance will produce disclosure that is more useful to investors. The Committee believes that principle-based guidance will allow for a risk-based, top-down approach and will eliminate needless confusion and costs if supplemented with detailed examples of how these principles should be applied to various types of companies. This would provide practical guidance that could be used by management, the Audit Committee and the auditors.

We encourage the Commission to continue to emphasize that management of each company can, and should, design its evaluation on a risk-based, top-down focused approach in light of its particular facts and circumstances and that there is no “one size fits all.” Procedures that, for example, are appropriate for large companies with multiple lines of business or multiple locations or a large number of international subsidiaries may not be appropriate for smaller companies engaged at a single line of business in a single location.

We also suggest that the Commission clearly state that whatever procedures auditors feel are necessary for them to undertake for purposes of AS-2 are not automatically required of management for its ICFR evaluation. Rather, as the Commission has recognized, management and auditors clearly have different duties and responsibilities. In addition, management has an understanding of its business that enables it to design and apply the risk-based top-down and focused approach intended by the Commission, and thus it is important that the Commission and the PCAOB clearly state that in many (if not most) circumstances it is appropriate for auditors to rely upon, or at least give due consideration to, management's judgments and approach, depending of course on facts and circumstances. Critical to any effort to reconcile management's requirements under the Commission's rules and those of the auditors under AS-2 would be a clear statement by the PCAOB that good faith reliance by auditors on certain work and representations of management, internal auditors and certain third parties is encouraged under AS-2.

As suggested above, the Committee believes the Commission's guidance should be principle-based, but provide detailed examples. We suggest as a guide the Commission's proposal on critical accounting policies; although this proposal has not been adopted, the Committee believes that the guidance provided to companies in the proposing release has resulted in significant improvements in Management's Discussion and Analysis of Financial Condition and Results of Operations. That proposal provided principle-based guidance, but also contained detailed examples of how the principles should be applied. It also contained other practical guidance that has proven to be very helpful to practitioners, such as its comments on the number of critical accounting estimates expected to be addressed.² While specific numerical guidance would not be appropriate in the Section 404 context, we believe that practical guidance such as this would avoid situations where companies have been forced to identify tens of thousands of purportedly significant controls that needed testing.

Timeliness of Commission guidance; unintended consequences

We also believe that the form of Commission guidance should turn in part on the timeliness with which the Commission can deliver it and management can apply it. We suggest the Commission consider various forms of written guidance, such as additional interpretive guidance based upon an initial review of comments received on the Release, to be followed, if necessary, with a rule making process. This could operate to provide timely guidance to companies with fiscal years soon coming to a close.

We caution the Commission and the PCAOB to avoid any guidance that could result in accelerated filers being required to reformulate their procedures and again incur the "year one" costs. These filers have made significant investments in their procedures; any guidance should

² The Commission made the following statement in its proposing release on critical accounting policies:

While the number of critical accounting estimates will vary by company, we would expect a very few companies to have none at all and the vast majority of companies to have somewhere in the range of three to five critical accounting estimates. The number could be at the high end of the range, or be slightly higher, for companies that conclude that one or more critical accounting estimates must be identified and discussed primarily because of particular segments. Release No. 33-8098 at text following footnote 55 (May 10, 2002).

permit accelerated filers to continue current procedures to the extent they exceed what is required, while permitting them, and other filers, to implement management's assessment in a more practical and cost-efficient manner.

Recalibration of the definitions of the terms "material weakness" and "significant deficiency."

The Committee encourages the Commission and the PCAOB to recalibrate the definitions of the terms "material weakness" and "significant deficiency" to help establish a more efficient, cost-effective approach to the implementation of Section 404 of Sarbanes-Oxley. While we recognize that the Commission and the PCAOB may be reluctant to change these definitions, the Committee believes it will be difficult to properly realign the benefits and burdens without new definitions that set higher thresholds.

In 2003, the Committee submitted a comment letter to the PCAOB on its release proposing AS-2. In that letter, that Committee commented that the proposed definitions set thresholds that were too low, and suggested that a "reasonable possibility" was a more appropriate standard. Specifically, we suggested the following definitions:

- "Significant deficiency" is a single deficiency, or a combination of deficiencies in the same or closely related reporting area, that result in a reasonable possibility that a misstatement of the annual or interim financial statement in an amount that is more than de minimis but less than material will not be prevented or detected.
- "Material weakness" is a significant deficiency that, by itself or in combination with other significant deficiencies in the same or a closely related reporting area, results in a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected.

We stated that:

These definitions have higher thresholds using terms with which accountants already have experience and extensive accounting literature and guidance. We believe the higher thresholds are more likely to provide practical warning flags rather than extensive laundry lists of false negatives.

We encourage the Commission and the PCAOB to reconsider our suggestion to shift from a standard of "a more than remote likelihood" to a standard of "reasonable possibility."³

³ While we do not believe rigid numerical standards for materiality should be adopted, we agree with the diagnosis presented by Professor Grundfest regarding the problems with the current definitions of "material weakness" and "significant deficiency" and support his proposed changes to the definition of "material weakness." Joseph A. Grundfest, *Fixing 404*, forthcoming in the Michigan Law Review, May 1, 2006 draft available at <http://www.sec.gov/spotlight/soxcomp/jagrundfest050106.pdf>.

Clarify the scope of management's assessment

We suggest that the Commission clarify the extent to which, in conducting their annual assessment, companies can rely upon on-going monitoring, benchmarking and rotate the testing (or lengthen the testing cycle) of non-critical controls based upon risk, materiality and other considerations. We believe clarifications such as these can usefully reduce the inefficiency that has plagued the implementation of Section 404 without compromising investor protection.

Reconsideration of "strong indicators"

One area where guidance from the Commission would be helpful concerns the situations that are identified in Paragraph 140 of AS-2 as a "strong indicator" that a material weakness in ICFR exists. For example, a restatement of previously issued financial statements to reflect the correction of a misstatement is identified as such an indicator. Companies would welcome guidance from the Commission and the PCAOB in the form of examples of situations in which management and auditors could conclude that such a restatement did not involve a material weakness. One suggestion is to state that a restatement resulting from the clarification of an existing accounting standard or a change in interpretation by an auditing firm should be treated the same as AS-2 treats a restatement resulting from the adoption of a new accounting standard – i.e., not a material weakness. Similar guidance about other strong indicators, such as the "identification of fraud of any magnitude on the part of senior management," would also be welcome, in particular, that fraud on the part of lower-level employees is to be considered on its facts and circumstances, and not automatically a strong indication of a material weakness.

The inclusion in Paragraph 140 of ineffective audit committee oversight as a "strong indicator" has in some cases encouraged inquiries that are inconsistent with the proper relationship between auditors and the audit committee to which they report. The inclusion of identification by the auditor of a material misstatement in the current period has also contributed to the disruptive effect of Section 404 on the relationship between auditors and their audit clients.

We also suggest that the architecture of Paragraph 140 of AS-2 is causing unnecessary mischief. The phrase "strong indicator" has resulted in auditors viewing the circumstances described in Paragraph 140 as presumptions of a material weakness. We suggest that they should more properly be characterized as circumstances that should be the subject of inquiry and scrutiny by an auditor.

Enterprise-level risk controls

Guidance from the Commission also would be welcome on how enterprise risk controls can be used in connection with the management review to mitigate review time and expense. In particular, we believe the Commission should validate the use of entity-level controls rather than low-level account and transactional controls and recognize the importance of the cumulative knowledge, experience and judgment of management, internal audit and the role of the audit committee.

Clarification of materiality

We suggest that the Commission use this opportunity to clearly state that the principles of Staff Accounting Bulletin 99 ("SAB 99") apply to materiality determinations made in respect of management's evaluation of the effectiveness of ICFR, and the auditor's attestation of that evaluation. We also recommend that the Commission revisit with the PCAOB the requirement of AS-2 that auditors should apply the concept of materiality in an audit of internal control over financial reporting at both the financial statement level and at the individual account balance level,⁴ or, in the alternative, the Commission itself clarify that any account balance level materiality determinations must be made in light of all available information, including financial statement level materiality analysis.

We make these suggestions in large part because we are aware of instances in which auditors have relied on a single quantitative factor relating to a single account balance (such as 5% of pre-tax income) to the apparent exclusion of qualitative factors affecting the overall financial statements in the course of their audit of management's determination of the effectiveness of ICFR.

Companies that operate in volatile industries, or that face other isolated, non-recurring yet material events (such as the impact of the adoption of FAS 123R in expensing stock options) that have nothing to do with the effectiveness of their control environment, can find themselves facing significantly more detailed and costly attestation procedures in years when their financial results declined (and, conversely, at least in theory significantly reduced costs and procedures in years when their results improved). Undue reliance upon a fixed numerical threshold of a single account balance in framing an internal control audit would also appear to contradict statements by the PCAOB to the effect that auditors should take into account the amount of risk associated with controls being tested as well as the adequacy of design and effectiveness of prior operation of that control in determining the nature and scope of such an audit. The unpredictability and cost associated with inappropriate materiality determinations in framing the audit are inconsistent with the efforts of the Commission and the PCAOB to increase the efficiency of the 404 attestation process.

We would suggest that the Commission and the PCAOB, in light of the cumulative experience of regulators, issuers and auditors since the adoption of AS-2, reconsider the appropriateness of the dual materiality determinations mandated by Paragraph 22 of AS-2. In particular, the Committee believes that account balance determinations are not appropriate when analyzing materiality for purposes of creating thresholds for a coming year's attestation.

To the extent the account balance materiality determination of Paragraph 22 of AS-2 is retained, we believe that the Commission can usefully clarify that when an item is material at the account balance level, but is unquestionably immaterial at the financial statement level, any materiality determination by the auditor should be made after consideration of all factors, including the significance of the account balance in question to the financial statements as a whole. We believe that this clarification would not involve a change in current law or guidance

⁴ Paragraph 22 of AS-2.

in the accounting or auditing literature but instead would be in the spirit of a reiteration of the fundamental principles enunciated in SAB 99.

Finally, we would suggest that the Commission reiterate in this context the need for the auditor's audit of the issuer's financial statements to be integrated with its attestation of management's evaluation of the effectiveness of ICFR. If these audits are truly integrated, then we believe that the auditors will have ample opportunity to evaluate the reasons underlying the change in year-to-year results. The auditors can then include this information in the overall mix of information that they consider in making both the quantitative and qualitative analyses necessary to formulate their materiality thresholds for the coming year's attestation process.

Foreign private issuer relief

The Commission should temporarily or permanently exempt the reconciliation to U.S. GAAP required of foreign private issuers from the scope of the Section 404 rules. The U.S. GAAP reconciliation presents specific problems because it is not typically integrated with the financial reporting systems on which the primary GAAP financial statements rely. The issue is *sui generis*, and the balance between burdens and investor protection in applying Section 404 is significantly different for the U.S. GAAP reconciliation than it is for the primary financial statements. This exemption should be adopted promptly, before the first round of annual reports by foreign private issuers that are required to comply with the Section 404 rules. If the Commission does not provide an exemption, we suggest that AS-2 and the Section 404 rules should be amended so that ICFR with respect to the U.S. GAAP reconciliation may be addressed separately from the ICFR with respect to the primary financial statements, thereby reducing the possibility of investor confusion.

Changes to disclosure rules

We suggest the Commission consider certain changes to the disclosure rules regarding ICFR and DC&P. The Commission should furnish additional guidance on the definition of DC&P and, in particular, where evaluations of DC&P and ICFR can diverge. This will enable companies to better understand those circumstances where one might be able to conclude that no material weakness exists with respect to one even where there may be one or more material weaknesses found in the other. Currently, a registrant that has a material weakness in ICFR generally concludes – without further consideration of the matter – that the material weakness makes its DC&P ineffective, and this perversely results in less useful disclosure because no independent analysis of the effectiveness of DC&P is performed.

We also suggest that the Commission provide public guidance discussing the consequences of a disclaimed auditors' report on ICFR. Specifically, the Commission should state that while management's failure to complete and report on its assessment of ICFR results in an annual report that does not comply with the Commission's requirements, the inclusion of a disclaimed auditors' report on ICFR in an annual report is permitted by the Commission's rules⁵ and management may conclude that its assessment of ICFR is complete, even if the auditors

⁵ Item 2-02(f) of Regulation S-X is clear on its face that it permits a disclaimed opinion, but there is confusion among practitioners that is partly attributable to uncertainty about the views of the Commission and its staff.

provide a disclaimed report on ICFR. This would clarify difficult reporting problems that affect a handful of companies with serious reporting difficulties. The Commission should also state that the failure of an annual report to comply with its Section 404 rules (at least in the case where the report on the assessment of ICFR is incomplete or the auditors' report is disclaimed or qualified as to scope, and appropriate supplemental disclosures are provided) does not (a) result in the unavailability of Form S-8 or (b) require a securities exchange to commence delisting procedures. This would eliminate the possibility of certain inappropriate and unintended consequences of ICFR reporting difficulties that have serious adverse effects on registrants and third parties.

In addition, the Commission should amend its rules to eliminate inconsistencies that have arisen because of the order in which various elements of the rules, and AS-2 itself, were adopted. In addition to clarifying the definition of DC&P, as discussed above, these amendments would (a) conform the description of the auditors' report in the Commission's rules to the requirements of AS-2,⁶ and (b) define "material weakness" and "significant deficiency" in the Commission's rules.


Conclusion

Much of the difficulty arising from Section 404 can be attributed to AS-2 and the interaction between management's performance of its obligations and the auditors' performance of their obligations. It is critical that whatever additional Section 404 guidance is furnished by the Commission be coordinated with efforts by the PCAOB to amend AS-2 so that any benefits to companies from further Commission guidance are not undermined by unnecessarily rigid positions taken through interpretation of AS-2. The desired efficiency benefits of many of the proposals set forth above will simply not be realized without corresponding changes to the auditor process under AS-2.

We commend the Commission for issuing the Release and support additional guidance by the Commission on how to evaluate the effectiveness of ICFR.

Members of the Committee would be pleased to answer any questions you might have regarding our comments.

Respectfully submitted,



Norman D. Slonaker
Chair of the Committee on Financial Reporting

⁶ Rule 2-02(f) of Regulation S-X and Item 308(b) of Regulation S-K refer to an attestation report.

cc: Securities and Exchange Commission
Hon. Christopher Cox, Chairman
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Annette L. Nazareth, Commissioner
Hon. Kathleen L. Casey, Commissioner

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