Association for Financial Professionals

September 14, 2006

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

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

The Association for Financial Professionals (AFP) appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC) *Concept Release Concerning Management's Reports on Internal Control over Financial Reporting*. AFP represents 15,000 finance and treasury professionals employed by over 5,000 corporations and other organizations.

Secure, transparent and efficient capital markets is a goal shared by AFP members and regulators. AFP members are concerned that current regulations have become a barrier to efficient capital markets. Increased oversight of the capital markets was necessary as a response to the corporate scandals of the early 2000's and AFP appreciates much of the work done by the Securities and Exchange Commission (SEC) in implementing the Sarbanes-Oxley Act (SOX). However, our concern is that regulations are being interpreted and implemented in such a way that imposes excessive cost on companies and act as a barrier that locks out companies from the capital markets.

The SEC has requested comments on the *Concept Release Concerning Management's Reports on Internal Control over Financial Reporting*. AFP comments on the concept release and recommendations for additional guidance:

Additional Time for Non-Accelerated Filers and Foreign Private Issuers

AFP agrees with the recently announced one year extension for non-accelerated filers and certain foreign private issuers. This extension is especially timely since the SEC is currently reconsidering SOX 404 rules and the Public Company Accounting Oversight Board (PCAOB) is re-drafting Auditing Standard 2 (AS-2). Requiring companies to comply with rules that may shortly change will only add additional cost and confusion for both companies and regulators.

Overemphasis on Processes and Excessive Engineering of SOX 404 Documentation

The process for performing SOX 404 work by external auditors seems to be lacking adequate understanding at the senior auditor level. Audit firms continue to send staff accountants with computer, paper and a checklist ready to tick off the "little boxes." This process provides little protection for the public and requires companies to allocate significant funds and staff to an inefficient and unproductive exercise. While the SEC and PCAOB have encouraged a top-down risk-based approach to the audit and section 404, the audit staffing and audit systems used by the

7315 Wisconsin Avenue • Suite 600 West • Bethesda • Maryland 20814
Phone: 301.907.2862 • Fax: 301.907.2864 • www.AFPonline.org

audit firms leads to a bottom-up approach. With the bulk of the audit work performed by "staff auditors," the audit and internal control programs are designed to give limited discretion and flexibility. This rigidity leads to the bottom-up audit process. The result is that substantial time and resources must be allocated to allow the completion of both of these functions to ensure that there are no delays in the filing of the year-end or quarterly financial reports.

Internal Control Compliance Problems for Mid-Sized and Small Companies

The disproportionate cost burdens arising out of the "one-size-fits-all" approach of section 404 hampers the ability of smaller public companies to invest and gain access to the capital markets. It jeopardizes the competitiveness of smaller companies that are the growth engines of the U.S. economy. The combination of SOX 404 compliance requirements and the implementation of that compliance by management and auditors have made it almost impossible for mid-sized and small companies to comply without hiring extra, often unnecessary, staff. In the majority of cases, auditors first look to see that certain functions are performed by separate individuals and/or departments to assure the effectiveness of internal controls. While this "segregation of duties" approach may be workable for large companies, it is impractical to depend so heavily on this internal control model for mid-sized and small companies.

This internal control framework does not take into account the increased involvement of executive management oversight within the process. While much of the SEC and PCAOB guidance issued to date emphasizes the importance of the "tone at the top," auditors and regulators have limited understanding on how to modify their evaluations based on the assessment of the "tone at the top." This is especially problematic for smaller companies that have fewer staff or layers of management between executives and transactions. To resolve the difficulties outlined above, AFP recommends that internal control requirements be scaled and proportional to the size of revenues and complexity of corporate structures.

Excessive Emphasis on the COSO Framework

While Section 404 did not expressly mandate the use of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework, audit firms continue to overwhelmingly choose this framework for their SOX 404 work. The COSO framework may not fit well with smaller and midsize companies, yet most auditors and companies choose it as the only acceptable model. The fear of litigation and the specific reference to COSO by the SEC causes auditors to believe that COSO is a "safe harbor" model.

Testing By Exception for Years after a Clean 404 Report

For companies that have completed and provided a clean SOX 404 report, it should not be necessary for them to go through the entire process each year. Once a clean opinion is attained, the next two to four year reporting cycle should not require a 404 report except to report on changes during the year. Changes might include corporate reorganizations, mergers, purchases, downsizing or unusual staff turnover. To require a full SOX 404 compliance report every year is simply transferring wealth from the corporation to the auditors.

Impact of PCAOB Influence over the Accounting Firms
The concept paper states that “one cause (regarding the large number of internal controls that some companies identified, documented and tested) may have been the overly conservative application of AS 2 by auditors in the initial years.” This “overly conservative application” may be fostered by the PCAOB’s actions. The PCAOB needs to be more judicious in its audit reviews. Many corporate officials believe that the PCAOB has been excessive in its search for auditor deficiencies and that this practice is contributing to the high and unreasonable audit costs to companies. Too often, an auditor will spend an excessive amount of time documenting unnecessary items in the belief that this is needed to satisfy the PCAOB.

The high degree of criticisms against auditors by the PCAOB Inspection Team for failure to document everything is extremely detrimental to the auditor-company process. The auditor must perform and document the work for someone from the PCAOB who has no familiarity or long-term history with the client. It is unrealistic for companies and auditors to document in such a way that educates someone unfamiliar with all the material activity of this client and/or to build a court case to defend a position for every material transaction made.

The PCAOB inspection reports seem to be less focused on whether the auditor is doing a good job and more focused on the auditor’s ability to document everything for fear of a negative report. The majority of the audit firms received an inspection report from the PCAOB that stated that the “the firm did not obtain sufficient competent evidential matter to <u>support its opinion on the issuer’s financial statements</u>”.

Limited Number of Professional Audit Firm Choices
AFP is concerned with the limited number of CPA firms and their control of the market. Due to the increased independence requirements imposed upon auditors, many companies are already using more than one of the Big-4 firms to provide services to their company. Independence rules have required auditing to be separated from valuation services and, in some cases, tax services. Also, under the independence rules, the auditor cannot provide consulting services for internal control systems and IT software systems. The domination of the market by four CPA firms limits free market choices available to companies and risks unbalanced influence by the audit firms at the expense of public companies and their investors.

Problems with Auditor Independence
Auditors are so fearful of the rules on independence that companies no longer receive the auditors’ advice on how to further improve their systems. Corporate management is left to guess what must or must not be documented and tested because the experts knowledgeable about their company and about internal controls no longer will talk with them. It should be made clear that the auditor can advise companies on improving their internal control systems without running afoul of the independence rules.

Continued Market Perception that the Big-4 are the Only-4 Acceptable to the Capital Markets
There is a continued view from the market that a company’s financial statement has more credibility if it is audited by one of the Big-4 accounting firms. This perception does not encourage a level playing field and compromises a free market system for audit services. The SEC and PCAOB need to do more to foster additional competition among audit firms.

This does not mean that a local CPA firm should have the same chance of auditing an international company as a global CPA firm if the capacity and knowledge does not exist. Nor should the SEC or the PCAOB distribute audits to all registered CPA firms through some form of lottery. However, there should be an effort by both the SEC and the PCAOB to carry two important messages to the market. The first message is that all qualified auditors have the same legal authority to provide a financial report, regardless of their firms' size. The second message is to encourage "right-sizing" of companies and audit firms. The skill sets and the size, character, price and demographics need to be considered to properly match the audit firm with the company. Let the market place determine auditor and company relationships.

As we stated at the outset, "secure, transparent and efficient capital markets is a goal shared by AFP members and regulators." Unfortunately, it seems that in the current environment there has been a shift to where the SEC, PCAOB and the auditors are not acting in cooperation but rather as separated and distinct pieces of the process. Regulators and auditors appear to have forgotten that they all are an integral part of the entire internal control process. The independent reviews by the auditor and the regulatory oversight and authority of the SEC is part of the total system. By working together we can reduce material misrepresentations and improve financial reporting. More accurate reporting allows investors to make better decisions and generally increases the efficiency and transparency of our capital markets.

AFP and its membership appreciate the opportunity to comment on these matters before the SEC. If you have any questions, please contact John Rieger, AFP Director of Accounting and Reporting at jrieger@afponline.org 301-961-8844.

Ross Guyer
Chairman of the AFP Government Relations Committee

James Bickmore
Chairman of the AFP Financial Accounting and Investor Relations Task Force