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VIA E-Mail

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Re: SEC Release No. 33-8762; 34-54976 (File No. S7-24-06) and PCAOB Release No, 2006-007 (Rulemaking Docket Matter No. 021).

Semiconductor Equipment and Materials International (SEMI) and the Fabless Semiconductor Association (FSA) appreciate the opportunity to comment on the Proposed Changes to SEC rules ("Proposed Rules") and the Proposed Interpretive Guidance on the Management Assessment of Internal Control Over Financial Reporting in compliance with Section 404 of the Sarbanes-Oxley Act ("Proposed Guidance"). We commend the SEC's efforts to reel in the excessive costs that have characterized the implementation of Sarbanes-Oxley Section 404 ("SOX 404").

We also appreciate the opportunity to comment on the PCAOB's Proposed Auditing Standard – *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, commonly referred to as Audit Standard No. 5 (“AS-5” or “the Proposed Standard”). We are also including comments on the Related Other Proposals in the same Release including the new *Standard on the Use of the Work of Others* and proposed changes to PCAOB rules and interim standards. We appreciate the Board's efforts to improve auditor efficiency in the SOX 404 process.

## INTRODUCTION

SEMI is an international industry association representing more than 2,200 companies globally – approximately eight-hundred of which are headquartered in the United States and are involved in the semiconductor and flat panel display equipment and materials markets.<sup>1</sup> These markets are truly global, highly competitive and highly cyclical even by the norms of manufacturing generally.

The Fabless Semiconductor Association (FSA) is also an international industry association, which serves as the voice of the global fabless business model.<sup>2</sup> Members include fabless companies and their supply chain and service partners, representing more than 21 countries across the globe.

SEMI's members registered with the SEC make up an \$18 billion dollar sector of the U.S. economy. Members of both organizations are highly exposed to the competitive consequences of any cost imposed by U.S. capital markets regulation that does not have a commensurate benefit to their customers or their shareholders. Some SEMI and FSA members are large companies with several billion dollars in annual revenue. However, most of our U.S. members are smaller and medium-size accelerated filers, the majority of which are now in their

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<sup>1</sup> SEMI maintains offices in Austin, Beijing, Brussels, Hsinchu, Moscow, San Jose, Seoul, Shanghai, Singapore, Tokyo and Washington, D.C. We are committed to promoting transparent and high-quality financial reporting on a global basis. Among its many other functions, SEMI acts as a source of industry data and information, and facilitates open communication between the industry and investors, particularly the investment analysts who follow the industry and provide research to the investing public. See *generally*, [www.semi.org](http://www.semi.org).

<sup>2</sup> Incorporated in 1994, FSA positively impacts the growth and return on invested capital of the fabless semiconductor business model to enhance the environment for innovation. It provides a platform for meaningful global collaboration between fabless companies and their partners; identifies and articulates opportunities and challenges to enable solutions; and provides research, resources, publications and survey information. See *generally*, [www.fsa.org](http://www.fsa.org).

third year of complying with SOX 404. It is well established that the cost-benefit imbalance of SOX 404 compliance has fallen disproportionately on these kinds of companies.

In addition, many SEMI members and FSA members are “non-accelerated filers” under the SEC rules. These companies continue to prepare for compliance with SOX 404 but are mindful of the Commission’s pledge that “unless and until a framework for assessing internal control over financial reporting for smaller companies is developed that recognizes their characteristics and needs, smaller companies will get relief from Section 404.”<sup>3</sup>

Therefore, FSA and SEMI represent a wide range of companies that bring significant collective experience with SOX 404 compliance as well as an acute awareness of its real benefits and excessive burdens. They also can attest to the impact of these excessive costs on their ability to compete with companies that are not subject to SOX.

## **GENERAL COMMENTS**

Our member companies are committed to maintaining internal controls that provide reasonable assurance that the company has effective and efficient operations and reliable financial reports. The primary benefit of internal control over financial reporting (“ICFR”) is to provide all financial statement users -- management, board, audit committee, shareholders and the investing public -- with a reasonable basis for reliance on the company’s financial reports. We believe that this goal can be accomplished without a disproportionate outlay of resources. As SEMI noted in its 2005 comment letter on the proposed COSO guidance on internal control for smaller companies, and also quoted in its comment on the Draft Report of the SEC Advisory Committee on Smaller Public Companies:

It is important to remember that investors benefit from cost-effective internal controls and are harmed by requirements that cause waste. Investors in our industry are especially sensitive to this point. Excessively costly Section 404 compliance diverts resources that could otherwise be invested in ways that create value and enhance innovation -- new product development, for example. This ultimately affects the ability of American companies to compete with overseas suppliers and to retain technological leadership. The stakes are especially high

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<sup>3</sup> SEC Chairman Christopher Cox, Speech to the SEC Government-Business Forum on Small Business Capital Formation, September 29, 2006. Available at: <http://www.sec.gov/news/speech/2006/spch092906cc.htm>.

when dealing with smaller companies since much of our innovative and competitive edge depends on them.<sup>4</sup>

Therefore we are participating in these rulemakings based on the stated commitments of the Commission and the Board that these rule changes will make a substantial difference in the cost-benefit balance of SOX 404 compliance. Our comments are candid and they are based on the worthy goals that regulators have set for solving the problem of excessive cost arising from the way the SEC and the PCAOB implemented SOX 404.

SEMI and FSA used surveys, email dialogues and conference calls to obtain direct feedback on the experience to date with SOX 404 as well as operational level evaluation of the SEC and PCAOB proposals from member companies. Most of these responses have come from personnel with overall responsibility for financial reporting, internal audit and related functions. From this feedback, we have found that compliance with Sarbanes-Oxley overall has improved their ICFR. New emphasis on audit committee responsibilities, management certifications under Section 302 as well as SOX 404(a)'s requirements for management to assess and report on ICFR have improved ICFR in a number of ways. These requirements have, for example:

- Improved the control environment;
- Increased management awareness of internal control;
- Reduced risk of fraud;
- Improved confidence in the integrity of the financial reporting process; and
- Increased the independence of finance and audit personnel.

A few of our members believe that the first external audit of ICFR helped to achieve some of these benefits. However, the majority believe that the bulk of these benefits would have been obtained without the full external audit of ICFR required by rules implementing SOX 404. Moreover, none of our members -- from the largest to the smallest -- believe that the full annual audit of ICFR as required by current rules can be justified on a cost-benefit basis. Furthermore, they are very doubtful whether the full external audit, under any rules, can be done cost-effectively.

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<sup>4</sup> SEMI comment letter on the Draft Report of the SEC Advisory Committee on Smaller Public Companies (File No. 265-23), p. 5 (April 3, 2006) (quoting SEMI comment letter to COSO on Draft Guidance for Smaller Public Companies (Dec. 22, 2005)). Available at: <http://www.sec.gov/rules/other/265-23/vdhadfield040306.pdf>.

In other words, SOX 302 certification provides the majority of the benefit for ICFR. Some incremental improvement is achieved by management compliance with SOX 404(a). Furthermore, a smaller benefit comes -- at an excessive cost -- from the first external audit of ICFR design and effectiveness. However, each additional audit of ICFR is equally costly and cannot be cost-justified in any true financial sense. As one member put it, "the benefit is soft but the extra cost is hard."

Moreover, while our survey data shows significant cost reductions between Year 1 and Year 2 of SOX 404 compliance, indications are that the reductions from Year 2 to Year 3 will be *de minimus*. In addition, the year 1 to year 2 cost data shows that *internal* compliance cost declined at twice the rate of *external* auditor costs. We believe that management was able in Year 2 to perform work more efficiently after the year 1 experience. In addition, in Year 2 management did some of the work that was done by external auditors in Year 1 once they became aware of the high level of work that the external auditor would require before it considered the audit work complete.

However, the main point our survey data shows is how difficult it is to further reduce overall SOX 404 compliance cost without significantly changing the external audit. As noted, very little cost reduction is anticipated between Year 2 and Year 3 on the external audit side despite significant focus on the need to reduce its cost. The data is reinforced by written and oral comments of our members. Clearly, the external audit cost is growing as a percentage of the overall cost as managements become more efficient in fulfilling their ICFR responsibilities while the external auditors are not. Therefore, we believe that significant additional changes are needed in both the SEC rule proposals and the PCAOB audit standard proposals related to the auditor's role in ICFR reviews. Otherwise, SOX 404 implementation will not achieve the reasonable cost-benefit balance that Congress intended.

Furthermore, we are certain that no one will know how much of an impact these revised rules, standards and guidelines will have until they are implemented. Our survey data shows that companies expect the proposed rule changes to result in no more than 10% to 20% reductions in cost. In fact, a large percentage of survey responses expect no appreciable change in external audit costs at all. We interpret these expectations as reflecting significant experience with the inelasticity, or "stickiness," of the external auditors' requirements and costs.

For the same reasons that the cost of SOX 404 compliance under the original rules and guidance was a surprise to regulators, the complexity and novelty of this process of evaluation and mandatory reporting on ICFR renders every change an experiment. Therefore, whatever revisions are ultimately approved, the results will need to be monitored and both the Commission and the Board will need to shoulder the ongoing responsibility to work this problem of excessive cost until it is solved.

## **SPECIFIC COMMENTS**

### **1. Proposed SEC Guidance for Management Assessment and Rule Changes on Management Reports**

As noted above, SEMI has participated for a number of years in efforts to develop appropriate rules and guidance for management to develop, maintain and report on the effectiveness of ICFR. We see significant progress in the Commission's Proposed Guidance. We also believe the so-called non-exclusive safe harbor in the proposed amendments to SEC Rules 240.13a-15 and 240.15d-15 on management's filing obligations under SOX 404(a) will enhance the level of certainty as to whether a company has in fact performed a SOX-compliant evaluation of ICFR.

From a cost-benefit perspective, the Proposed Guidance raises the potential for two significant achievements. The first, which we think should be an explicit goal of the guidance, is to revive the concept of "reasonableness" within the overall SOX 404 compliance regime. The second is to provide a standard against which management's assessment can be judged separate from the PCAOB's audit standard.

#### **a. Return to Reasonableness**

The Proposed Guidance, set out in pages 18-49 of the Release, provides for a useful approach to management's ICFR evaluation. However, the "Introduction" section of the Release, which is not part of the Proposed Guidance, is equally significant in its tone and direction as to the requirement to implement SOX 404 is a cost-effective, reasonable way.

Therefore, we recommend that a large portion of the Release's "Introduction" section – pages 13-15, in particular -- be incorporated into the Proposed Guidance. This is important because the language in the Introduction places the requirement for "reasonable assurance" in the context of the securities laws, which clearly contemplate "the weighing of a number of relevant factors, including the costs of compliance."<sup>5</sup>

The Guidance should clearly state that management is responsible to determine the scope and depth of the assessment needed to provide reasonable assurance with "cost of compliance" as a key consideration. As with every other aspect of the management's evaluation and reporting process, the audit standard and any relevant PCAOB rules must be harmonized with the Guidance if it is to be effective.

Highlighting the Release's language on reasonableness in the SEC Guidance to which the SEC's rules refer would be an important piece of a larger revision of the SEC's and PCAOB's proposals. At the least, these changes should provide an additional barrier against the risk that audit standards or auditor's interpretations of terms will continue to drive excesses of documentation and testing. This language in the SEC Guidance could also bring reasonable, cost-beneficial assessment to the external auditor's ICFR review processes if more substantial changes to the SEC's auditor reporting requirements, discussed in Part 2 of our specific comments, below, are implemented.

**b. An SEC Standard for Management's Assessment**

The second major achievement that could come from the Proposed Guidance would be to provide a standard against which management's assessment can be judged separate from the PCAOB's audit standard. This is a critical unmet need under the current compliance regime, which has been driven by PCAOB Audit Standard No. 2 (AS-2). This need will continue to be critical under the proposed AS-5, even though it is a substantial improvement over AS-2.

While we generally prefer guidance and flexibility over rules and mandates there are situations where more specific and more mandatory procedures can produce a better result.

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<sup>5</sup> SEC Release Nos. 33-8762; 34-54976, n. 38 (citing 15 U.S.C. 78m(b)(7). AND quoting conference committee report on amendments to the Foreign Corrupt Practices Act, Cong. Rec. H2116 (daily ed. April 20, 1988), from which the "reasonable assurance" language is drawn.

While we applaud the notion of a “safe harbor” for management’s compliance with SOX 404(a), we do not see how this Proposed Guidance sets the boundaries of this safe harbor with the type of clarity typical of effective safe harbors in other aspects of the securities laws. Therefore, we believe it could be helpful if an outline of the Proposed Guidance were incorporated into the relevant SEC rules. The outline of the Proposed Guidance could provide a rule-based template within which management could document the steps they took and the judgments they made in evaluating and reporting on ICFR.

While many of our larger members have already developed their own frameworks for addressing their SOX 404(a) responsibilities, we support use of the SEC’s Guidance as a prerequisite for the “safe harbor” if that is what is necessary to wall off the management assessment and report from auditor-imposed requirements.

Changes to the proposed PCAOB audit standard are also needed to make this possible. As explained in more detail in our comments on AS-5 below, so long as an external audit of the effectiveness of ICFR is required, an audit standard with a more stringent requirement for such an audit will almost certainly become the default standard for management’s assessment. As one member’s CFO stated it, “we need the auditor to sign off -- we can either do it their way ourselves or we can pay them to do it their way.” This is the practical problem that the new SEC guidance and the new PCAOB audit standard must address.

## **2. Proposed SEC Rule Changes on Auditor Reporting**

SEMI and FSA strongly support the elimination of one of the two external auditor reports on ICFR that have been required under current SEC and PCAOB rules. Clearly, substantial duplication of effort has arisen from the requirement that the auditor attest to both management’s assessment of ICFR and to the effectiveness of ICFR.

We understand that careful consideration has gone into the SEC’s decision to propose elimination of the auditor’s role in assessing management’s evaluation and the retention of the external audit of the effectiveness of ICFR. However, our evaluation of the proposals, based



on the responses of seasoned and knowledgeable member company executives, leads us to conclude that the Commission's proposal eliminates the wrong auditor attestation.

We believe that the bulk of the excessive audit fees associated with SOX 404 compliance arises from the requirement that the auditor attest to the effectiveness of ICFR. Furthermore, while the language of SOX 103 muddies the issue, SOX 404(b) certainly is clear as to the requirement to "attest to, and report on, the assessment made by the management."<sup>7</sup> The Act is far from a clear mandate for the auditor to attest to the effectiveness of ICFR. In any case, we will not enter into a legal debate here since our point is practical.

The purpose of these revisions of the rules, standards and guidance for SOX 404 compliance is to significantly reduce the costs and enhance the benefits of the overall exercise. As noted above, SEMI and FSA member company executives with responsibility for ICFR and much experience with SOX 404 compliance have taken the time to review and consider the impact of these proposed changes. They do not believe that the external audit of the effectiveness of ICFR, even with these changes, can be cost-justified. There are good reasons to take these comments to heart.

First, the design and effectiveness of ICFR -- and internal control in general -- is a management responsibility. Furthermore, providing "reasonable assurance" based on the "level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs"<sup>8</sup> is inherently the role and responsibility of management, as steward of shareholder value. An external party such as an auditor providing its independent view, on an annual basis, as to the effectiveness of ICFR will almost certainly involve an amount of testing and detailed evaluation that is duplicative, costly and wasteful.

Second, the audit firm's driver for the necessary "level of detail and degree of assurance" of effectiveness is not the "satisfaction of prudent officials in the conduct of their own affairs." Instead, audit firms face liability risks that drive them to insist upon levels of detail and degrees of assurance that are almost guaranteed to be excessive.

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<sup>7</sup> SOX Section 404(b).

<sup>8</sup> SEC Release, p. 15 (quoting 15 U.S.C. Section 78(m)(b)(7)) (providing the definition of "reasonable assurance," to which SEC Section 404 implementing rule referred).

Third, the economics of SOX 404 audits gives audit firms an incentive to require more work, more documentation and more testing. The only counterweight to this pressure is their client companies, which bargain from a decidedly weak position with an oligarchic industry.

Fourth, it is true that PCAOB's standards can be improved so that the regulator requires less of an audit firm fulfilling its SOX 404 function; however, the PCAOB inspection process appears to be ill-equipped to identify or discipline an external auditor that conducts a SOX 404 audit in an inefficient, or even wasteful, manner. While the PCAOB could inspect audit firms in more innovative ways than they have in the past, documentation of the need for any level of audit work is primarily a matter of auditors' memos in the file. Auditors can always document the need for more work and get paid for doing it.

**Therefore, we believe that the most significant change – perhaps the only change -- that can correct the SOX 404 cost-benefit imbalance will be to eliminate the external auditor's obligation to attest to the effectiveness of ICFR.** While we are aware of the argument that an external auditor cannot comply with SOX unless it evaluates ICFR, we do not believe that an actual attestation is required. Given the importance of legal liability as a driver of excessive audit work, the elimination of the potential liability that arises from the external auditor's attestation of the effectiveness of internal controls has the greatest potential to rebalance the costs and benefits of SOX 404.

We are hopeful that the elimination of this attestation would help drive external auditors toward a reasonable level of assurance since they would have attested only to the fact that management had conducted its evaluation according to the requirements set forth by the Commission. The Commission's Proposed Guidance and new "safe harbor" approach should then be effective in limiting the need for auditors to duplicate work that management has already done.

Given the importance of this matter we would hope that the Commission and the PCAOB would critically evaluate the incremental benefit of an external audit of the effectiveness of ICFR and assess whether its cost is justified. We believe that: it is not justified under the existing standard; that it will not be justified under the proposed standards; and that it is not

likely to be justified under any standard that requires an external auditor attestation of ICFR effectiveness.

### **3. Proposed PCAOB Standards and Rule Changes**

#### **a. Overview on PCAOB Proposals**

As noted above, we believe that both the SEC and the PCAOB have assumed the responsibility for addressing the excessive costs of SOX 404 and that the root of the problem is the external audit of the effectiveness of ICFR. However, given the complexity of this issue, we also wish to provide our comments and recommendations on ways to improve AS-5 on the assumption that it will be developed further as a standard for an external audit of the effectiveness of ICFR. We also offer comments on related PCAOB auditing proposals.

We appreciate the PCAOB's serious attempt to develop a proper standard for an audit of ICFR under SOX 404. We especially appreciate the emphasis in AS-5 on scaling audits of smaller companies. SEMI has been involved in the effort to make SOX 404 work for smaller companies through both the COSO's efforts and the SEC's Advisory Committee on Smaller Public Companies.<sup>9</sup> Indeed we are pleased to see many of the types of recommendations we made for adapting the COSO framework to smaller companies contained in paragraphs 9 – 12 of AS-5.

In general, AS-5 is an improved standard when compared to AS-2. We appreciate its focus on many of the major areas that have led to excessive cost in the past. Indeed, everyone agrees with the PCAOB that the new standard should at least promote a top-down, risk-based approach, eliminate unnecessary audit procedures, permit consideration of knowledge obtained in prior audits, encourage the auditor to rely on the work of others and refine the walkthrough requirements. In addition, it is essential that the new standard provide for audits of smaller public companies that are appropriate to the scale of those companies.

With these goals as a guide, we offer suggestions for ways to improve AS-5 in our specific comments below. However, in general, informed from the perspective of our members who have had to comply with SOX 404, we respectfully suggest that the Board has

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<sup>9</sup> *Supra*, note 3.

underestimated the task at hand. Righting the cost-benefit imbalance of SOX 404 that has arisen from the auditor's role in particular will require a much different standard than the one proposed.

Were AS-5 the first audit standard under SOX 404, it might result in significant progress toward the PCAOB's current goals. Unfortunately, excessive audit costs under the Board's standards are a problem that has defied various attempts at promoting better implementation of the PCAOB's audit requirements. Aside from the formal Implementation Guidance of May 2005, and its November 2005 Report on Initial Implementation of AS-2, the PCAOB has issued 55 Staff Q&A's, many of which have dealt with AS-2 implementation guidance. The fact that audit fees have not responded to this guidance and pressure to reduce wasteful work to date, leaves us skeptical that a standard such as AS-5 can bring this about.

The Proposed Standard needs to state with greater specificity the limits of an auditor's discretion and responsibilities before it can hope to make substantial progress toward the goals the Board has described. Moreover, these limits must be so fully aligned with the guidance or rules prescribed for management by the SEC that they eliminate any need for comparison.

So long as the auditors must attest to the effectiveness of ICFR, audit requirements will trump limits in SEC filing requirements. Despite the SEC's proposed guidance to management as to how they should perform their assessment of ICFR, it is very likely that in practice management's assessment of ICFR will have to be conformed to whatever rules are in AS-5. Therefore, the Proposed Standard should explicitly state that the external auditors should perform their assessments of ICFR using the same guidance and framework used by management. Language in AS-5 and other audit guidance that suggests otherwise should be deleted.

A second major flaw in AS-5 is in the unstated assumption that auditors should not trust management to make sound judgments regarding the effectiveness of ICFR. An audit based on this assumption will never be cost effective for shareholders. The Proposed Standard does not appear to recognize that managers have many strong incentives to maintain effective ICFR and responsibly assess ICFR under SOX 404(a). Moreover, as noted above, other high-profile provisions of SOX, such as SOX 302, make many SOX 404(a) requirements additive, if not duplicative, of management's other duties and liability-creating actions.

While SOX 404 is the accounting professions principal activity around ICFR, it is merely the most expensive aspect of the issuers' extensive and ongoing responsibility to design, operate, assess and report on ICFR. The Board's new ICFR audit standard should therefore be more directive in limiting the auditor's work regarding many aspects of the work already done by management in assessing the effectiveness of ICFR. We offer the following specific recommendations on the assumption – which we hope is incorrect – that the Commission and the Board will continue to require an external audit of the effectiveness of ICFR.

**b. Specific Recommendations for Improving AS-5 as a Standard for the Full Audit of the Effectiveness of ICFR.**

1. The Standard should emphasize the same standard of “reasonableness” in ICFR audits as management is required to follow in its assessment.

AS-5 should prominently incorporate the language of the SEC Release regarding the overarching application of “reasonableness” in each aspect of SOX 404 compliance. See SEC Release, pp. 13-15. At a minimum, the auditor should not apply a more stringent standard of reasonableness than management is required to use in its assessment under SEC rules and guidance. The Board's proposed amendment to Interim Standard AU sec. 230, *Due Professional Care in the Performance of Work*, contains a more stringent standard. It says: “[A]lthough not absolute assurance, **reasonable assurance is a high level of assurance.**” [emphasis supplied].<sup>10</sup>

“Reasonable assurance” is a key concept in the SEC's guidance and it is defined there quite differently than in this PCAOB rule.<sup>11</sup> According to the SEC Release, its definition of “reasonable assurance” is the “level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.”<sup>12</sup> A “high level” of assurance could clearly be contrasted with the SEC definition to cause an auditor to conclude that the auditor's standard for ICFR is higher than management's. In any case, a different way of defining such a central term introduces ambiguity and adds nothing useful. Therefore, either the language quoted above

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<sup>10</sup> PCAOB Release 2006-007, Amendments, p. A4-2 (Dec. 19, 2006).

<sup>11</sup> *Supra*, Note 8.

<sup>12</sup> SEC Release, p. 15 (quoting 15 U.S.C. Section 78(m)(b)(7)) (providing the definition of “reasonable assurance,” to which SEC Section 404 implementing rule referred).

should be removed from proposed AU sec. 230, or AS-5 should explicitly incorporate the SEC definition for purposes of an audit of ICFR instead of AU sec. 230. This is just one example of the need to edit the auditing guidance to ensure that management and the auditor are operating from a common set of definitions and principles. The Proposed Standard and all other auditing rules should be reviewed and amended to conform to the SEC's more cost-effective notion of reasonableness.

2. The auditing standard should require the auditor to begin the determination of audit scope with the management's assessment.

Management is responsible for determining the scope and depth of its ICFR assessment, with "cost of compliance" as a key consideration.<sup>13</sup> Currently, because of the lack of guidance in this area, management has built its SOX 404 approach on the auditors' scoping and testing requirements. These requirements have come from either the PCAOB standards or frameworks developed by others in anticipation of the way the audit firms view their requirements. It would clearly be more cost effective for the audit process to begin with management's scope and considerations of risk. In practice, this approach to scoping could result in a process in which both management and the auditors agree in advance on the proposed scope. AS-5 should, therefore, direct the auditor to begin the scoping process by understanding the risk-based judgments management makes in determining the breadth and depth of its assessment.

3. The risk-based approach to ICFR audits should encourage well-known techniques for limiting cost and effort in areas where mitigating controls or prior knowledge lower the risk of a material deficiency.

While the new standard emphasizes a risk-based approach to auditing, it fails to state that a cost effective audit entails the assumption of risks. These risks include the near certainty that there will be elements of ICFR that management, in good faith, has failed to correctly identify as ineffective. In other words, risk-based audits entail accepting certain risks that material matters will escape both the management's and the auditor's review. Standards on

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<sup>13</sup> *Id.*, "the concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the cost of compliance." Conference Committee Report on amendments to the Foreign Corrupt Practices Act, Cong. Rec. H2116 (daily ed. April 20, 1988).

ICFR audits should clearly embrace such a concept so that the risk threshold used by the external auditor in their assessment of ICFR is not set at a level that requires excessive work. Reasonable assurance for prudent officials in the conduct of their own affairs means accepting a reasonable level of risk. Given the economics, the liability and the general caution that have driven auditors' reading of AS-2, AS-5 will bring about risk-based ICFR audits only if it is clearer and more mandatory regarding the assumption of such risks.

For example, despite its focus on risk-based audits, AS-5 explicitly excludes rotational testing in an area where it could be most effective. Especially in more mature companies, it is not unusual for a situation in a subsequent year to be the same as in a prior year. Such situations exist where, for example, key processes have not changed from the prior year, no material weaknesses or significant deficiencies were noted in the prior year, management's assessments of the significant processes uncover no problems, and inquiry reveals that the processes are the same as in the prior year. This is a case where the auditor should be allowed, or even mandated to test those processes on a rotational basis. AS-5 only takes a half-step in this direction by permitting auditors to take into account knowledge gained in prior years as a basis for a lower level of testing. Far more reliance on a prior year's audit and management's current year work should be permitted or mandated.

AS-5 must also be improved in the area of walkthroughs if it is to promote risk-based audits. The Board has properly focused on walkthroughs as a source of excessive cost. While it is an improvement over AS-2, AS-5 still requires walkthroughs of each significant process. Again the use of rotational testing can increase audit efficiency. Requiring repeated walkthroughs in every significant process year after year is wasteful. It fails to recognize that risks diminish when there have been no changes to controls tested in the previous audit and it is inconsistent with a risk-based approach. Therefore, AS-5 should expand on the meaning of "the use of prior knowledge" to include wide latitude to perform walkthroughs on a rotational basis.

4. The new Standard on the Use of the Work of Others must be more directive.

The Proposed Standard on the use of work of others is a definite improvement over the previous guidance. However, given the incentives of the external auditor, and the many reasons to discount the use of others' work under the new standard, it is very likely that much

acceptable work of others will be duplicated by the auditor. In particular, the standard's provisions on evaluation of the competence and objectivity of others could easily exclude much of their work. Furthermore, it is likely that the auditor would waste significant time merely evaluating the competence and objectivity of others prior to any decision to actually use their work, even in low risk areas.

The new standard has two full pages of considerations and processes for evaluating the competence and objectivity of others for the auditor to apply. A cost-effective standard on the use of the work of others should result in an increase in the use of their work. It also should be easy to apply. With these goals in mind, we recommend that the new standard be simplified. It should explicitly say that the auditor should rely on the work of management, internal auditors or outsourced auditors unless there is an indication that the work of others presents a significant risk of ICFR failure in a financial reporting process. In particular, the auditor should be limited to spot checking the quality of the work done by others. In other words, it should be presumed that work done by others pursuant to management's assessment and reporting obligations under SOX 404(a) is useable. Otherwise, the subjective evaluation of the competence or objectivity of others under this standard will be wasteful.

5. The PCAOB inspection process should involve sanctions for failure to perform ICFR audits efficiently.

Several of our accelerated filer members have noted that financial statement and ICFR audits are not being integrated. In fact, they are being performed by two separate audit teams from the same firm. This duplication of effort leads to excessive costs and is in direct contravention of the statutory language of SOX 404. We appreciate the fact that the Board intends its inspections to focus on audit efficiency. However, it seems that the most serious sanctions against a firm arise from doing too little auditing, not too much. Therefore, there is a need for countervailing incentives to conduct audits efficiently. Thus far auditors have either not adequately planned for integrated audits or have made the choice to protect against other risks and accept the risk that comes from performing an audit inefficiently. Given the very real pressures for auditors to ignore efficiency and the issuers' meager bargaining leverage, the PCAOB inspection process is a key to promoting audit efficiency. Therefore, the PCAOB



should devise some aspect of its inspection process to provide more concrete incentives for the audit firms to conduct ICFR audits efficiently than currently exist.

6. Efforts at “scalability” for smaller companies under AS-5 are not likely to result in cost-effective audits.

We appreciate the effort the PCAOB has made to include guidance as to how assessments of ICFR of smaller companies will vary from audits of larger, more complex companies; however, we are concerned that auditors will not always consider these factors when auditing smaller companies. Liability risks tend to drive external auditors to insist upon levels of detail and degrees of assurance that are excessive. Smaller companies with limited staff and less segregation of duties will heighten auditor liability concerns. Therefore, we believe that in practice, audits of smaller companies will not be scaled and compliance costs for smaller companies will continue to be disproportionately high under AS-5. The Proposed Standard could mitigate this concern by explicitly endorsing the level of \$700 million market capitalization or \$250 million in revenue<sup>14</sup> as indicative of a smaller public company and mandate that the audit of a smaller company should vary from that of a larger company in the six ways cited in paragraph 12 of the Proposed Standard.<sup>15</sup>

## CONCLUSION

Much work has been done to address the problems arising from the implementation of SOX 404. More work is needed. It is critical now that the SEC and the PCAOB rise to the challenge. The goals they have set require more than rules and standards that, in theory, should promote more efficient SOX 404 compliance. The Board and the Commission must force wasteful excess out of the SOX 404 compliance process. We hope our suggestions are helpful.

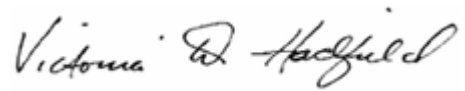
We would be pleased to discuss these and any related matters. Please feel free to contact Ken Schramko of SEMI’s staff or Lisa Tafoya of the FSA’s staff to discuss these matters.

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<sup>14</sup> See *Final Report of the Advisory Committee on Smaller Public Companies*, Part II. Scaling Securities Regulation for Smaller Companies, pp. 14-22 (April 23, 2006).

<sup>15</sup> PCAOB Release 2006-007, Standard, p. A1-8 thru 10 (Dec. 19, 2006).

Sincerely,

Handwritten signature of Victoria D. Hadfield in cursive script.

Victoria D. Hadfield  
President, SEMI North America  
SEMI

Handwritten signature of Jodi Shelton in cursive script.

Jodi Shelton  
Executive Director  
FSA