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March 27, 2006

File No. 4-511

Second-year Experiences with Implementation of Sarbanes-Oxley Internal Control Reporting and Auditing Provisions

I have been involved in SOX audit and documentation for two years, working for a Canadian company. During this time I witnessed how the noble and wholehearted SOX initiative evolved and grew from a compliance and goodwill project aimed at protecting shareholders' interests, to a grotesque bureaucratic beast that is voraciously eating away companies' resources. Most of these developments stem out from the lack of clear and precise guidelines from the SEC and the PCAOB as to what is required for compliance, how is it required, and what are the means to accomplish that requirement. All foreign filers understand that this is "the law" and they have spent a lot of money for compliance. It all comes back to the value added and most companies do not really see it. Below are some of the issues I have identified throughout my experience with SOX, followed by some recommendations.

ISSUES:

1. Sky-rocketing costs

To achieve compliance companies have gone crazy to no avail to hire consultants, form SOX compliance teams, document, test and re-test internal controls over financial reporting. With all this SOX hype, costs are just going up and up to a point that the business has lost faith in the overall effectiveness of this project. Business's attitude toward SOX has shifted from a **revered "SOX-appeal"**, to a **feared "SOX-reveal"** and more and more companies believe that the shareholder is the one who's being robbed with the increasing costs for compliance.

2. Why do we have to pay the price?

In the information age and the global village that we all live in, the world is unmistakably getting smaller. Anyone can be "virtually" anywhere, at anytime. Companies are fighting for a bigger market share and expansion but at the same time they are also reluctant and RESISTANT to enter US markets and get listed on US exchanges, fearing the financial burdens and bureaucracy of SOX compliance. The general attitude, especially of the major European corporations, is "Why do I have to suffer and pay the price for a few US companies that went bankrupt?" This new reality undoubtedly has shifted the focus of these companies toward the Asian and Latin American markets. At the end the SOX project can prove to be detrimental for the US economy as most of the foreign filers are unwilling to undergo the SOX endeavor.

3. External auditors still DO NOT get it!

One of the major roadblocks for SOX compliance, throughout my exposure to the project, has been working with the external auditors and trying to get their “buy-in”. Most of them still CANNOT distinguish between substantive audit and SOX compliance audit. The latter one is an audit over the effectiveness of Internal Controls Over Financial Reporting (ICOFR) to prevent the risk of any material misstatement to the financial statements. SEC, in its May 2005 release, stated that management needs to use a top-down risk-based approach. The primary objective is to identify material weaknesses...NOT to identify all control problems if they are not material. Keep in mind the magic word is “MATERIAL”. Many companies have been overly conservative in their compliance and assessment. Rather, we need to step back from focusing on the detail to look at the OVERALL control objectives. External auditors still fail to grasp this idea and they try to pursue the SOX audit following the guidelines for a substantive audit. Both the means and end result of these two audits are DIFFERENT. **The goal of the SOX audit is to validate the financial reporting processes, as opposed to the actual financial data, which is still covered by the traditional audit.** After all SOX is all about management’s assessment (key word is “management” NOT “auditors”) of the effectiveness of Internal Controls Over Financial Reporting to prevent any MATERIAL misstatements.

A logical question is being raised “Have the audit firms found a real cash cow to benefit from and charge exuberant audit fees for SOX compliance audit? Is this another hype like the Y2K project when companies spent a great deal of dollars for compliance?” A study conducted by a co-worker of mine showed that year one US filers with disclosed material weakness did not suffer any drops or changes in stock price. Further analysis showed that if the stock price of a company with a material weakness went down, it was not due to the disclosure but rather to a drop in the overall industry index. Issues like this do come to question the whole effectiveness of the SOX Act.

4. Bureaucracy and paper

Another problematic area of the SOX endeavor is the level of documentation required and the definition of a key control. This has never been clearly defined by the SEC and the PCAOB and no precise guidelines have been issued. I have to agree with Mr. Norman D. Marks and his comments to the SEC and the PCAOB regarding the definition of a “key control”. I think that many a company have shifted from the “material” aspect of SOX towards the nitty-gritty details of documentation and key controls. A key control should be a control, which if not properly performed, or if failed, would have a more than remote likelihood for a “MATERIAL” misstatement. Again, keep in mind the magic word is: material.

RECOMMENDATIONS:

1. The SEC and the PCAOB should reconsider the requirement for foreign filers to comply with Section 404 of SOX, or at the least diminish and re-evaluate these

- requirements for foreign filers. The cost has proven to be tremendous and at the end it does not really justify the end result, as the shareholder is the one being robbed AGAIN.
2. Foreign filers should be required to comply with Section 302 and Section 906 of the SOX Act as well as the Statement of CEO Regarding Facts and Circumstances Relating to Exchange Act Filings (as defined in Exchange Act Rules 13a-15(e) and 15(d)-15(e)).
 3. SEC and the PCAOB should provide clearer guidelines to the foreign filers as well as to their external auditors, regarding the level of documentation need, identification of key controls, and level of testing.
 4. SEC and PCAOB should provide “auditor’s testing handbook” as to how to test SOX internal controls. This handbook should CLEARLY distinguish between a substantive year-end audit and a SOX audit. As mentioned earlier, the means and end results of both audits are completely different, even though they can be done in conjunction to one another.
 5. SEC and PCAOB should come with new and more efficient ways of “selling” the SOX initiative to the new foreign filers. Those ways should include, but not limited to, more roundtables, more benchmarking with other companies, more frequent guidelines, more precise instructions regarding testing and documenting of processes. Failure to do so will simply drive foreign filers away from the US markets and may jeopardize the goodwill SOX initiative.

Sincerely,

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