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The Securities and Exchange Commission
To the Commissioners

I appreciate the chance to provide feedback on my experiences in implementing and evaluating the requirements of Section 404 of the Sarbanes-Oxley Act. Over the past two years, I have written two books on Section 404 implementation and conducted numerous training seminars. I also have worked with CPA firms to help them understand and implement the requirements of Section 404, both as auditors and as consultants providing Section 404 compliance services to non-attest clients. As a result of this work I periodically receive inquiries from practitioners, and we exchange thoughts on 404 matters. It is from this perspective and set of experiences that I offer the following observations.

Determining Whether a Control Deficiency is a Material Weakness

Company management and their auditors seem to be able to identify and reach agreement on the existence of control deficiencies. Where most disagreements occur is in distinguishing between material weaknesses and significant deficiencies. The differences I have observed involve judgments about the likelihood that a given control deficiency could result in a material misstatement. For example, differences of opinions may relate to the perceived effectiveness that compensating controls can have in mitigating the risks posed by missing or ineffective controls or to the extent to which company-level control deficiencies can result in actual financial statement misstatements.

Appendix D of PCAOB Auditing Standard No. 2 is an excellent resource, but I am concerned that these examples may be under-used or perhaps misundarstood. For example, I was indirectly involved in a situation where the issuer had a control deficiency that seemed analogous to Example D-2 of Auditing Standard No. 2. The fact pattern, which both the client and its auditors agreed on, was quite similar to Scenario A in the AS No. 2 example, in which the PCAOB reached the conclusion that the control deficiency was a significant deficiency but not a material weakness. In the situation I was involved with, company management made a case that was consistent with the facts and tracked the reasoning provided in the AS No. 2 example. Nevertheless, the auditors concluded that the control deficiency was a material weakness. In my opinion, their reasoning did not give adequate consideration to the effect of other controls that met the same control objective.

This experience and others have left me concerned that some auditors are reluctant to conclude that a control deficiency is significant but not a material weakness. Rather than disagree with their auditors, management goes along with their conclusion and reports a material weakness.

There is merit to the argument that, historically, many control deficiencies that probably were material weaknesses were not designated as such and therefore went unreported. Section 404 has sent the pendulum swinging back the other direction, which is appropriate. However, there is a danger in having the pendulum swing too far. If everything is a material weakness, then nothing is a material weakness. That is, a large part of the value of the disclosure is that management and the auditor have evaluated the significance of the deficiency and distinguished between those that are truly material and those that are not. To delegate that evaluation process to the users of the financial statements does not do them any favors.

I suspect that many of the differences of opinion regarding the relative magnitude of control deficiencies stem in large part from inexperience on both sides in analyzing and discussing internal control matters. Over time, I believe that the profession will become better at understanding control deficiencies and their relative significance. To accelerate that evolutionary process, I encourage the Commission and the PCAOB to expand the existing examples of material weaknesses and significant deficiencies and to take

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other appropriate actions to ensure that companies and their auditors do not automatically default to classifying as material all control deficiencies that are more than inconsequential.

Management Involvement as a Compensating Control

Many smaller issuers are now beginning to implement Section 404. These companies typically have a less formal internal control system that may lack important controls such as adequate segregation of duties. To compensate for missing controls, these companies rely on the active involvement of management. Under some circumstances it may be possible for management involvement to effectively reduce the likelihood of a material misstatement that otherwise could occur as a result of a missing or poorly designed control.

When answering questions on this topic, I try to emphasize that--

- Management's involvement in the day-to-day operations of the business should be distinguished from their involvement in the financial reporting process. Management activities that are directly related to financial reporting objectives are the most effective as compensating controls.

- If management involvement is considered a compensating control, then it's design and operating effectiveness must be tested and evaluated. This includes evaluating whether management has the qualifications to perform effectively the control activities related to financial reporting

- Perhaps these points are common sense, but the issue comes up regularly and probably will continue to be raised as more non-accelerated filers work to comply with Section 404. Any guidance the Commission of the PCAOB could offer in this area would greatly improve the consistency with which companies evaluate their internal control.

Management's Responsibility to Prepare Financial Statements

The answer to Question 7 of the PCAOB's Staff Questions and Answers provides guidance on the nature and extent of the external auditor's involvement with the company's financial reporting process. In spite of the publication of this guidance, many questions on this topic persist, especially from non-accelerated filers who traditionally have relied on their external auditors to help them in the financial reporting process.

In their response, the PCAOB staff emphasized the need for management to take responsibility for its financial reporting process. This guidance is appropriate, and my sense is that most filers understand the need to take this responsibility and to modify the traditional audit process so that they are less dependent on their external auditors. The question they have is now whether but how to assume this responsibility. What specifically should management take responsibility for?

For example, I think that management should, at a minimum, be able to—

- Determine the facts and assumptions that are necessary to apply the company's significant accounting policies and to identify which information is most significant to the application of those policies, and how changes to that significant information affect the financial statements.

- Identify emerging accounting issues that affect their financial statements and be able to articulate the underlying accounting questions

- Appropriately supervise and evaluate the work of an independent third party engaged to help with the financial reporting process (e.g., a business valuation expert engaged to assess a possible goodwill impairment, or an outside accounting firm hired to perform stock-based compensation calculations.)

- Complete an accounting disclosure checklist in good faith

The preparation by the Commission or the PCAOB staff of a list of management's responsibilities with regard to the financial reporting process would help both companies and their auditors modify appropriately the traditional audit process and communicate more clearly with each other.

Thank you for considering my comments.

Michael Ramos