Direct Dial: 202-637-2242
john.huber@lw.com

555 Eleventh Street, N.W., Suite 1000
Washington, D.C. 20004-1304
Tel: (202) 637-2200 Fax: (202) 637-2201
www.lw.com

LATHAM&WATKINS LLP

FIRM / AFFILIATE OFFICES

Boston	New York
Brussels	Northern Virginia
Chicago	Orange County
Frankfurt	Paris
Hamburg	San Diego
Hong Kong	San Francisco
London	Shanghai
Los Angeles	Silicon Valley
Milan	Singapore
Moscow	Tokyo
New Jersey	Washington, D.C.

April 11, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Roundtable on Implementation of Internal Control Reporting Provisions (File Number 4-497)

Dear Mr. Katz:

It is an honor to be invited to participate in the Commission's Roundtable on April 13, 2005. Given the topic of my panel *Reporting to the Public*, I will limit my remarks to disclosure.[1]

I was a young attorney in the Commission's Division of Corporation Finance when Congress passed the Foreign Corrupt Practices Act ("FCPA") which amended the Securities Exchange Act of 1934 to require companies filing periodic reports to "devise and maintain a system of internal accounting controls... ."[2] I watched with interest as the FCPA was implemented in the late 1970's without specific disclosure requirements pertaining to the adequacy of internal controls. It was not until SOX that disclosure controls and procedures and internal control over financial reporting became the subject of specific rules requiring disclosure.[3] While Item 9A of Annual Reports on Form 10-K and Item 4 in Quarterly Reports on Form 10-Q are of recent vintage, the disclosure has developed rapidly from short discussions

---

[1] For my other views on the Sarbanes-Oxley Act of 2002 ("SOX"), please see my outline co-authored with Julie K. Hoffman, "Sarbanes-Oxley Act of 2002 and SEC Rulemaking" which is printed in the ABA's The Practitioner's Guide to the Sarbanes-Oxley Act, Vol. 1, I-1, (2004), the editors of which are Stanley Keller, Vasiliki Tsaganos, Jonathan Wolfman and me.

[2] Section 13(b)(2)(B) of the Exchange Act.

[3] See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release Nos. 33-8238, 34-47986, 68 Fed. Reg. 36,635* (June 5, 2004) (available at http://www.sec.gov/rules/Final/33-8238.htm).

with oblique references to internal controls to specific disclosure[4] of material weaknesses[5] which also drill down into what management is doing to remediate the material weaknesses and when management estimates the process will be completed.[6]

This year, managements of accelerated filers are, for the first time, providing evaluations under Section 404(a) and outside auditors are providing attestations under Section 404(b) of SOX. As with the disclosure that has been provided in 2004, the presence or absence of a material weakness,[7] as defined in AS 2, drives the disclosure in Section 404 reports by management and audits by the outside auditor. The disclosure is part of the procedural requirements established by SOX, which are all interrelated and should be viewed as a whole, rather than individually. Put simply, it is one big procedural ball of wax.[8]

---

[4] The Staff of the Division of Corporation Finance is to be commended for guiding the development of this disclosure through the comment process.

[5] Paragraph 10 of Public Company Accounting Oversight Board ("PCAOB") Audit Standard No. 2 ("AS 2").

[6] See my remarks set forth in the "SEC 'Hot Topics' Teleconference" sponsored by Glasser LegalWorks on July 27, 2004 ("Hot Topics"), "Impact of Internal Controls on M & A" sponsored by DealLawyers.com on January 19, 2005 and "Demystifying Internal Controls Disclosure" sponsored by The Corporate Counsel.net on February 2, 2005 ("Demystifying Teleconference"), the transcripts for which teleconferences were provided to the Commission on April 7, 2005.

[7] While some have advised that management should disclose significant deficiencies in periodic reports in addition to material weaknesses, I do not believe it is required. Moreover, such disclosure would not promote the disclosure policy that I believe these regulations are intended to promote, as discussed below.

[8] The linkage can be described as follows: Certification under Section 302 of SOX covers disclosure controls and procedures, which significantly overlaps with internal control over financial reporting. In my opinion, internal control over financial reporting is critical to enhancing the reliability of the financial statements. Internal control over financial reporting is one component of internal control under the FCPA and upon which the Report of the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Report"), first published in 1977 and republished in 1992, is based. In addition, the concept of disclosure controls and procedures is based – and indeed could be viewed as an extension of – internal control as defined in the COSO Report. Moreover, management's evaluation of internal control over financial reporting must be based on an established framework, and the Commission has designated the COSO Report as an acceptable evaluation framework for purposes of this evaluation and the disclosure requirements under Rule 13a-15(c) and Rule 15d-15(c) under the Exchange Act. No other framework prevalent in the United States has been so designated. Another way of explaining the interrelationship is to compare financial reporting to a house: the foundation is auditor independence; the infrastructure from the frame through the plumbing and electrical

Underpinning these procedures are the definitions of terms, one of which – material weakness – is critical to public disclosure. If a company has a material weakness, management cannot find that internal control over financial reporting is effective in its evaluation report. The auditor must disclaim an opinion in its 404 audit. Disclosure is required in periodic reports and can include a risk factor in the Form 10-K. Moreover, under the current system, the auditor cannot conclude that the material weakness has been remediated during interim periods unless it conducts a new audit.[9]

Given its importance, the issue I see is whether the definition of material weakness strikes the right balance from a disclosure policy point of view. The answer to the question includes consideration of the function it is intended to fulfill and how successful it has been in restoring investor confidence and protecting investors.

To me, the disclosure policy of material weakness is to act as the "canary in the mineshaft." Since the disclosure in periodic reports follows the requirements relating to disclosure controls and procedures and internal control over financial reporting, that disclosure is also focused on material weakness. Yet, I would respectfully submit that not all material weaknesses are created equal. A material weakness in revenue recognition is fundamentally different than a documentation failure for an overseas subsidiary or a one-time error made by a finance person in a complicated tax issue which is unlikely to reoccur. While material weaknesses are not the same, the current disclosure requirements do not differentiate between different types of material weaknesses. Therefore, the same quantity and quality of disclosure is required for every material weakness. Thus, it is understandable when investors become confused or get the wrong impression from the disclosure. The purpose for the disclosure requirement is not being achieved because the term material weakness is producing unnecessary disclosure to investors, disclosure which does not serve the function of the "canary in the mineshaft."

I believe the Commission and the PCAOB should consider whether the current definition sets the bar too low. If the threshold is set too low, the purpose is not being fulfilled[10] and the marketplace's reaction may well be to ignore or discount the significance of the disclosure because "everyone has one." And if "everyone has one," the marketplace will soon draw its own distinctions as to what is important and alternatively decide how to differentiate between

---

systems is internal control over financial reporting; and the outside of the house, what you see when you look at it, are the financial statements

[9] The PCAOB recently proposed an Auditing Standard, Reporting on the Elimination of a Material Weakness which, if adopted, would permit an outside auditor to report on the elimination of a material weakness between annual audits under Section 404.

[10] Managements that have spent much time and expense in designing and maintaining this system are often concerned that the low threshold for identifying a material weakness, coupled with a conservative approach in applying the definition, is resulting in disclosure which is not indicative of what their situation really is.

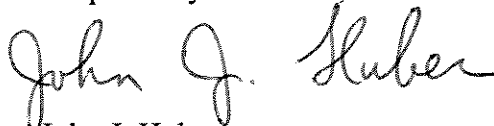
material weaknesses that can affect the financial statements and those that the marketplace determines are unlikely to do so.

Rather than have the marketplace develop its own criteria, [11] I believe that the Commission and the PCAOB should consider revising the definition of material weakness. The alternatives available range from a major change – revising Staff Accounting Bulletin No. 99 which is part of the basis for the definition – to a more modest approach, such as amending the definition to recognize that a pervasive weakness that cannot be easily remediated in a short period of time is fundamentally different from a one-time error which is isolated and quickly fixed. Whichever approach is chosen depends, in part, on how well the Commission and the PCAOB believe the term material weakness is accomplishing its purpose as well as what is expected when the non-accelerated filers become subject to Section 404. I would respectfully submit that change is necessary to avoid the possibility of the definition losing its meaning and to promote, rather than undermine, investor confidence. Given our experience with the new system thus far, changes to the term material weakness would enhance investor understanding by eliminating unnecessary disclosure and could have the added beneficial effect of making the other elements of internal control over financial reporting more effective.

Regardless of the approach, I would recommend that the proposed change, as well as any changes to SAB 99, be the subject of notice and comment under the Administrative Procedure Act. These terms are too important not to be subject to public comment before being finalized.

Again, I commend the Commission for conducting the Roundtable and appreciate the opportunity to participate.

Respectfully submitted,



John J. Huber
of LATHAM & WATKINS LLP

---

[11] <u>See</u>, <u>e.g.</u> *Moodys Investor Services Special Comment, Section 404 Reports on Internal Control: Impact on Ratings will Depend on Nature of Material Weakness Reported* (October 2004) and *Institutional Shareholder Services, The Friday Report* (April 8, 2005).