small public company task force

July 18, 2007

Nancy M. Morris, Secretary
Securities & Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Reference: File Number S7-24-06

Dear Ms. Morris,

Financial Executives International's ("FEI's") Small Public Company Task Force ("FEI's SPCTF") appreciates the opportunity to provide its views on the U.S. Securities and Exchange Commission's ("SEC's") proposed "Definition of a Significant Deficiency" [Release No. 33-8811] ("the proposal").

FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. FEI's SPCTF is a task force of FEI that reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations, from the perspective of small public companies. This document represents the views of FEI SPCTF, and not necessarily those of FEI or its members individually.

FEI's SPCTF commends the SEC's and Public Company Accounting Oversight Board's (PCAOB's) efforts aimed at making internal control reporting under Sarbanes-Oxley Section 404 more efficient and effective. Our detailed recommendations relating to the proposed definition of significant deficiency, and our comments on the questions contained in the SEC's proposal, are provided in the attachment.

Support for proposed definition of significant deficiency, we recommend some improvements
We concur with the SEC's proposed definition of significant deficiency, which is consistent with the definition of significant deficiency in PCAOB's Auditing Standard No. 5 (AS5). However, we recommend the SEC include certain additional language in its final rule defining significant deficiency to maintain the focus on material weaknesses, and that the SEC instruct the PCAOB to include conforming language in the final version of AS5 currently under review by the SEC. We believe the additional clarifying language is necessary to maintain the goals of maximizing efficiency and effectiveness of internal control reporting by focusing on matters that can have a material impact on the financial statements.

We also reiterate our view, previously stated in our Feb. 2007 comment letter on the SEC's proposed interpretive guidance, that the definition of material weakness included in the SEC's recent final rule and in AS5 be modified to delete the reference to "interim" reporting. This point is relevant to the current proposal on the definition of significant deficiency, since significant deficiencies may aggregate to material weaknesses, and the proposal asks a specific question on quarterly reporting.

Once again, FEI's SPCTF commends the SEC's and PCAOB's efforts aimed at making internal control reporting under Sarbanes-Oxley Section 404 more efficient and effective, and we thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience. Please feel free to contact Serena Dávila, sdavila@fei.org, Director, Technical Activities, in FEI's Washington DC office, if you have any questions or wish to discuss.

Sincerely,

Richard D. Brounstein, Chairman
Small Public Company Task Force
Financial Executives International

Attachment included

ATTACHMENT

FEI DETAILED COMMENTS ON SEC PROPOSED DEFINITION OF SIGNIFICANT DEFICIENCY

1. **Would the definition of a "significant deficiency" facilitate more effective and efficient certification of quarterly and annual reports if it were defined as discussed above?**

   Interim/quarterly: For the reasons detailed in our Feb. 2007 comment letter on the SEC's then-proposed interpretive guidance, we believe the SEC and PCAOB should **delete the reference to "interim"** from the definition of material weakness contained in SEC's rules and in AS5. The SEC Advisory on Smaller Public Companies, and the Commission on Capital Markets Regulation led by Hal Scott/John Thornton/Glenn Hubbard (of which SEC Advisory Committee on Improvements to Financial Reporting, Robert Pozen, was a member) made similar recommendations to delete 'interim.'

2. **Conversely, should the definition of "significant deficiency" include a likelihood component or other specific criteria? If so, should we align such a definition with the PCAOB's auditing standard, and how?**

   Likelihood: Similar to the recommendation made in PwC's comment letter on this proposed rule, we believe it would enhance the SEC's and PCAOB's goals of making Section 404 reporting more efficient and effective, by including a likelihood component in the definition of significant deficiency.

   Specifically, we recommend, **at a minimum, using the term "reasonable possibility" currently used in AS5, or the more specific and potentially more effective terms "reasonable likelihood," or "reasonable assurance"** as recommended by the National Venture Capital Association (NVCA).

   Should the SEC choose to adopt "reasonable likelihood" or "reasonable assurance" for significant deficiency, conforming changes should be made to the SEC's and PCAOB's definitions of material weakness.

3. **We do not anticipate that the definition will impact the amount of time it takes for management to evaluate whether identified deficiencies are significant deficiencies, nor do we anticipate that this definition will affect any existing collection of information. However, are there any additional costs or burdens involved in evaluating whether identified deficiencies meet the definition of significant deficiency? If so, what are the types of costs, and the anticipated amounts? In what way can the definition be further modified to mitigate such costs while still appropriately describing deficiencies that should be disclosed to audit committees and auditors?**

   The SEC's proposed definition of significant deficiency appears reasonable, particularly in connection with the SEC's existing requirement (established in the SEC's original final rule on management reporting, issued in June, 2003) that management inform the external auditors and audit committee of significant deficiencies.

   AS5: However, **we are concerned about the use of the term "significant deficiency" in AS5, which as we saw with AS2, can have a spillover effect on management** – understandably so, since companies and auditors are looking for an optimal mix in which the external auditor can rely on management when that would be most efficient and effective.

   Specifically, although various paragraphs in AS5 focus on material weaknesses, **we are concerned about how auditors will interpret the requirement in AS5, paragraph 80, to <u>"consider"</u> whether there are "any deficiencies, or combinations of deficiencies, that have been identified during the audit that are significant deficiencies"** and that the auditors "must communicate such deficiencies, in writing, to the audit committee."

   In spite of wording that follows in AS 5 paragraphs 82 ("The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware,") and 83 ("Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified **all** deficiencies less severe than a material weakness, the auditor should **not** issue a report stating that **no** such deficiencies were noted during the audit") as well as the scoping requirements in AS5 paragraph 3 focused on material weaknesses, we believe that without adding specific guidance that “**consider”** in paragraph 80 does not mean **“test for**” but, rather, consider the results of testing and other evidence obtained in accordance with the scoping requirements focused on **material weakness**, that auditors will interpret “consider” to mean “conduct further test work” aimed at the significant deficiency threshold.

Accordingly, revisions should be made in the SEC’s final rule defining significant deficiency, and in AS5, to explicitly clarify that “consider” does not equal “test” or “perform procedures” but relates to existing procedures and information obtained in accordance with the material weakness threshold for scoping audit work set forth in AS5.

Aggregation: Additionally, we have some concern that some auditors may not interpret the SEC’s and PCAOB’s requirements to consider aggregation of deficiencies and significant deficiencies. Although we are hopeful auditors and management will suitably apply good judgment in implementing these requirements, there is the danger that a purely mechanical quantitative aggregation may not necessarily provide meaning information of a significant deficiency or material weakness on a qualitative level. Further clarifying instructions in the SEC’s final rule on significant deficiencies and conforming language in AS5 emphasizing judgment is to be used will be helpful with respect to aggregation.

“Possible” indicators, not “indicators,” of material weakness: Furthermore, indirectly related to the definition of significant deficiency, is that we recommend the SEC amend its final rule defining material weakness, and that conforming changes be made to PCAOB’s AS5 currently under review by the SEC, to change the language in AS5 that currently refers to such matters as “restatements” as being “indicators” of material weakness; all such indicators should be referenced in SEC and PCAOB standards as “possible” indicators of material weakness. At a minimum, restatements should be specified as a possible indicator, not an ‘indicator’ due to the prevalence of restatements that occur for even non-material items (in part out of concern to avoid litigation if not restated), as well as many due to what some view as reinterpretations of GAAP by the SEC or auditors, which, we believe, is not an indicator of a material weakness in internal control at small companies or large companies, with small or large audit firms associated with them. Although such restatements may occur more frequently at smaller companies, as shown in some recent studies, that does not necessarily indicate a material weakness in internal control, and small companies that are already challenged to get their message out to investors (given the smaller portion of analyst coverage given to smaller companies) should not be stigmatized (neither should large companies) by equating all restatements with material weaknesses in internal control.

4. **We believe one of the benefits of the definition is that it focuses on the desired result of identifying matters that are important enough to merit attention, which will allow management to use sufficient and appropriate judgment to determine the deficiencies that should be reported to the auditor and the audit committee while allowing management to use its judgment to determine what those matters are. Are there additional potential benefits we have not considered? Additionally, a potential consequence of the definition is that, due to the flexibility provided in the definition, there may be less comparability among companies in terms of what management determines is a significant deficiency. Is this accurate? Are there other potential costs or burdens? How should we mitigate such costs or burdens?**

   We believe the flexibility provided is appropriate, and the full measure of its success will depend on the SEC and PCAOB applying principles-based enforcement. An excess of second-guessing or the threat of second-guessing will cause a retreat to a more transaction oriented, mechanical approach, including gathering documentation for documentation’s sake, rather than focusing on matters that could truly materially impact the financial statements, and on preventing and detecting fraud.

   Additionally, the private communication that necessarily takes place between management, the auditors, and the audit committee will of necessity vary among companies according to facts and circumstances.

5. **Is there any special impact of the definition of significant deficiency on smaller public companies? If so, what is that impact and how should we address it?**

   The impact of the definition of significant deficiency will impact companies of all sizes, although it may impact small companies disproportionately, due to their smaller bottom line.

However, investors will most directly be impacted by high quality external reporting focused on material weaknesses.

We support strong corporate governance, ethics and internal control, and believe the proposed definition of significant deficiency is reasonable, with the added improvements we recommend herein. Of major consequence will be that auditors not supplant their judgment for management's reasonable judgment when it comes to management reporting, including identification and communication of significant deficiencies.

To achieve both efficiency and effectiveness aimed at 'what counts' – material weaknesses, companies cannot afford to be caught in a game of 'gotcha' or cat and mouse, where it's all about who called out the significant deficiency first – management or the auditor – and if not management – with some auditors potentially treating that situation as a significant deficiency or material weakness in itself.

Small companies in particular rely on their auditors since small companies are more thinly staffed than large companies. As such, the SEC and PCAOB should do everything they can to encourage healthy communication between auditors and clients, and not a game of 'gotcha' which can engender overauditing or unnecessary procedures by management that take their eye off the ball of focusing on material matters and preventing and detecting fraud, getting to the heart of investor protection and strong capital markets.