

**Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090**

Re: File Number PCAOB-2007-02

Dear Ms. Morris:

I appreciate the opportunity to provide my perspective to the Securities and Exchange Commission (SEC) regarding PCAOB-2007-02 and the critical questions surrounding cost-effective SOX 404 implementation for small- to mid-size (“smaller”) companies. As a Sarbanes-Oxley (SOX) practitioner and professional internal auditor, I continue to be very impressed by both the recent guidance and the participative process used to develop it. The top-down, risk-based approach, flexibility, and continuing support from SEC leadership should enable a more cost-effective assessment for companies of all sizes.

However, I remain concerned that the cost reductions possible under the new SEC interpretive guidance and PCAOB AS 5 will not be sufficient for smaller companies. The *Final Report of the Advisory Committee on Smaller Companies* dated April 23, 2006, indicated a significant disparity in the 2004 SOX 404 costs incurred as a percentage of revenue between the largest and smallest companies, to the tune of .06% and 2.55%, respectively. Subsequent annual cost surveys by Finance Executives International (FEI) also indicate a wide disparity. As cited in the *Final Report*, this is because a SOX 404 assessment has “fixed” elements, in addition to variable elements proportional to revenue.

As you are aware, the U.S. Senate recently emphasized the importance of reducing compliance costs promptly for smaller companies through an overwhelming vote in favor of the Dodd-Shelby Amendment to S. 761. In addition, a recent study by FEI indicated that audit fees did not decline from 2005 to 2006, although other company costs declined by 23%. In my opinion, the new SEC guidance and PCAOB AS 5 have the potential to reduce management’s costs similarly in 2007, but more work is needed to ensure auditor costs also decline. It is critical that the SEC demonstrate effective “tone at the top” through frequent, direct communication with the PCAOB and public accounting firms. Most companies have applied top-down principles in both their 2005 and 2006 assessments as a result of the May 16, 2005 PCAOB Staff Q&A, so the new guidance is not necessarily new in practice.

To achieve the 50%-60% cost takeout I believe is appropriate for smaller companies and (arguably) intended by the U.S. Senate, additional guidance and emphasis from the SEC will be necessary, to overcome the “fixed” cost aspects. The paradigm that one set of guidance is applicable to companies of all sizes should be revisited; a second set of guidance for smaller companies may be warranted in key topic areas.

Summarized below is an overview of several ideas the SEC might consider to ease the burden on smaller companies more promptly and consistently, while protecting investors. While these

ultimately may need to be incorporated in SEC guidance, certain ideas can be modified for inclusion in the final modifications to PCAOB AS5. They are direct and simple to implement.

1. Exclude Transactional Processes and IT General Controls from Scope

The SEC should provide specific scope exclusions regarding low-risk transactional processes and IT General Controls (ITGC) for smaller companies. Consistent with the top-down risk assessment guidance, the elements of the SOX 404 assessment generally fall into the following categories, from “Level 1” (highest risk) to “Level 5” (lowest risk):

1. *Entity-level controls*, as defined in the COSO Framework and SOX guidance;
2. *Period-end financial reporting process*, as defined in the existing guidance, amended to specifically include balance sheet account reconciliations or balance-substantiating analyses;
3. *Revenue recognition process*, the most critical transactional process, due to the prior history of fraudulent overstatement of revenue and GAAP complexity;
4. *Other transactional processes* (e.g., accounts payable, payroll, treasury); and
5. *IT general controls (ITGC)*. This topic falls to the bottom due to the indirect impact on financial statements and likelihood of mitigating manual controls for nearly any deficiency scenario.

The SEC should consider removing Levels 4 and 5 entirely from the scope of the assessment for smaller companies. These two areas involve significant effort, yet have limited financial reporting risk relative to levels 1-3.

Nearly all ITGC have mitigating manual controls, so why bother with them in small companies? Further, by defining account reconciliations (or equivalent analyses to support balances) as part of the period-end process, thereby retaining these critical controls in-scope, management retains reasonable control over the transaction-intensive processes.

Deloitte & Touche LLP published a guide titled “Lean and Balanced: How to Cut Costs without Compromising Compliance” in early 2006 that estimated this transaction work at 80% of the SOX effort, despite its low-risk nature. The SEC can remove some or this entire transactional control assessment burden, with limited risk to investors, with a simple directive. This alone should reduce compliance costs by approximately 30-40% for smaller companies.

2. Allow Rotation Testing Strategy for Manual Controls in Transactional Processes

The SEC should permit smaller companies to “rotate” testing of their manual controls in transactional processes, if transactional processes are not removed from scope as suggested above. For example, once controls within an accounts payable process have been tested, they should not be tested further unless significant changes occur. Inquiry procedures should be completed each year to identify changes. The benchmark might be revisited approximately every three years, meaning some type of process rotation on a three-year schedule would be established, with major changes tested in the year of implementation.

3. Emphasize “Primary” Over Other Assertions in Scoping Transactional Processes

The SEC should exempt smaller companies from testing controls related to anything other than the primary assertion for each transaction class, if transactional processes are not removed from scope as suggested above.

In each major transaction class, the primary risk relates to either understatement or overstatement. For example, the risk of overstatement of revenue (i.e., the “Existence or Occurrence” financial statement assertion) is considerably more important than the understatement of revenue (i.e., the “Completeness” assertion). For expenses, the opposite is true. However, both “sides” of the misstatement risk are tested extensively today.

In practice, the completeness, existence/occurrence, and valuation assertions require testing for nearly all major transaction classes, creating a minimum level of effort for all companies. This is because the scoping decision is based upon *inherent* risk. These risks occur in companies of all sizes, meaning a certain “fixed floor” exists in the scope, along with related costs. This is unfortunate; investors derive limited protection from management’s testing of controls related to revenue understatement or expense overstatement.

4. Limit Testing of Controls Applied at the Individual Transaction Level

The SEC should communicate the expectation that smaller companies can generally rely upon controls that summarize transactions (e.g., exception reports, period-end controls, and effective monitoring controls) rather than transaction-specific controls that operate with each iteration of the transaction (e.g., manual invoice approval). The current guidance likely will result in a fair amount of transaction-specific control testing, which is costly and generally low-risk in nature. The need to perform transaction-specific control testing should clearly be identified as a last-resort for smaller companies.

5. Exempt Smaller Companies from Certain Evidence & Testing Requirements

Roll-forward Testing

The SEC should exempt smaller companies from roll-forward testing, except in two high-risk areas:

- The period-end financial reporting process; and
- High-risk controls known to have changed before year-end

Re-performance Evidence

The SEC should exempt smaller companies from obtaining re-performance evidence (the most expensive, time-consuming type of evidence), except for two control types, both of which are part of the period-end reporting process:

- Account reconciliation controls; and
- Calculations related to critical estimates and judgments

6. Address the Concept of “Regression Testing” or “Baselining” of IT Systems

A widespread practice among public accounting firms involves using SOX as support for requiring companies to “regression test” or “baseline” their financial systems, by mandating the completion of a Y2K-like testing effort. This testing is used to validate that financial systems function as designed and reports are generated accurately.

This is a costly and disruptive effort in many companies. Management presumably tested its systems when they were implemented. In addition, the external auditor conducts substantive testing to address the risk of error as part of an integrated audit, affording investor protection.

The SEC and PCAOB should specifically direct accounting firms not to mandate such activity under the SOX umbrella. There should be a presumption that accounting systems are working. While not a perfect assumption, it should be correct in the vast majority of cases. Companies can decide if they want to undergo the testing exercise, as major errors identified through the auditor’s substantive testing may potentially be classified as a material weakness.

7. Exemption for Newly-Public Small Companies

Smaller companies going public should be exempt from Section 404 until the third fiscal year in which they file their annual report on Form 10K. For example, a company going public in June of 2007 with a 12/31 fiscal year-end would be required to comply with Section 404 for its 2009 fiscal year.

There is a broad understanding among investors that new, smaller public companies are higher-risk. In fact, many investors historically have sought out the higher risk associated with “small-cap” companies to attain higher returns. Allowing such companies to focus on growth for the first 24 months of their public life should reduce the deterrent to becoming publicly traded on U.S. exchanges.

8. Additional Investor Protection Measure – Diversification

One of the few credible counter-arguments to SOX 404 is that investors can diversify their holdings, thereby mitigating the risk of catastrophic corporate failure (whether due to fraud or competition). Unfortunately, a recent study by Fidelity Investments indicated that the average investor has 29% of their 401K assets in their company’s stock. This is arguably an unacceptably high percentage from a public policy standpoint, as those who take such a significant risk (placing many eggs in one basket, so to speak) potentially create a burden for the rest of us. The SEC can urge Congress to pass legislation to require that each individual’s 401K portfolio (or similar vehicle) be prudently diversified. This would be enforced automatically by the service provider of the 401K plan, after some notice to the investor that gives them a reasonable period of time to make their diversification choice. This would cushion the impact of corporate debacles on individual investors and provide further support for SOX cost reduction.

Conclusion

The new guidance, while extremely helpful for larger companies, is unlikely to provide sufficient, timely and consistent cost relief for small companies. Several risk-based suggestions have been offered herein, to support the current guidance with more detailed examples or prescriptive exemptions. Targeted at smaller companies, such adjustments to the guidance should help ensure SOX 404 becomes a more cost-effective means of supporting investor confidence, the reliability of financial statements, and the competitiveness of our markets.

Continued support from senior leadership at the SEC will be critical to ensuring public accounting firms support the new guidance, as some firms may argue that they have been doing top-down risk assessments all-along, allowing only incremental cost reductions. The vast amount of work involved in assessing low-risk transaction controls and ITGC should be a continued focus area for SEC attention.