



February 21, 2007

**Via Electronic Mail**

The Honorable Christopher Cox, Chairman  
U.S. Securities and Exchange Commission  
Attn: Nancy M. Morris, Secretary  
100 F Street, NE  
Washington, DC 20549  
Electronic Address: rule-comments@sec.gov

The Honorable Mark W. Olson, Chairman  
Attn: Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006-2803  
Electronic Address: comments@pcaobus.org

**Re: SEC File Number S-7-24-06; Management's Report on Internal Control Over Financial Reporting (71 Fed. Reg. 77,635); PCAOB Release No. 2006-007; Proposed Auditing Standard**

Dear Chairmen Cox and Olson:

The Office of Advocacy (Advocacy) of the Small Business Administration (SBA) respectfully submits this comment letter on the U.S. Securities and Exchange Commission's (SEC) proposed interpretative guidance and proposed rule, *Management's Report on Internal Control Over Financial Reporting*,<sup>1</sup> and the Public Company Accounting Oversight Board's (PCAOB) proposed revised auditing standard, *An Audit of Internal Control Over Financial Reporting*.<sup>2</sup> Advocacy acknowledges the efforts undertaken by the SEC and the PCAOB to make the internal controls reporting requirements under Section 404 of the Sarbanes-Oxley Act (SOX)<sup>3</sup> more cost-effective and efficient for small public companies.

<sup>1</sup> *Management's Report on Internal Control Over Financial Reporting; Proposed interpretation; Proposed Rule*, 71 Fed. Reg. 77,635 (Dec. 27, 2006).

<sup>2</sup> *Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Proposals*, Release No. 2006-007 (Public Company Accounting Oversight Board, Dec. 2006), available at: [http://www.pcaobus.org/Rules/Docket\\_021/index.aspx](http://www.pcaobus.org/Rules/Docket_021/index.aspx).

<sup>3</sup> *Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745 (2002).

Advocacy hosted a roundtable on Friday, January 26, 2007, to solicit input from small business representatives on the new proposals by the SEC and the PCAOB. Advocacy applauds the many dedicated members of the SEC and the PCAOB who attended this roundtable and explained the proposals, answered questions, and listened to the concerns of the small business community. This comment letter discusses a few of the major problems raised by small businesses, in particular: 1) the need for further exemptions due to the recent receipt of the guidance and the revised auditing standard, 2) the request for clarifications of major provisions in these proposals, and 3) the issue of whether these proposals actually “fix” the problem of scalability and high costs in internal controls reporting for small public companies.

Based on small business comments, Advocacy believes that the Section 404 requirements may still impose large and disproportionate costs on small public companies after these proposals are finalized, which may restrict the ability of a new generation of small, innovative companies from seeking capital in the U.S. capital markets. Advocacy strongly recommends that the SEC continue to provide further exemptions for small public companies until such time as more cost-effective procedures for internal controls reporting can be developed.

## **I. The Office of Advocacy**

Congress established the Office of Advocacy in 1976 by Pub. L. 94-305 to represent the views and the interests of small business within the federal government. Advocacy is an independent office within SBA, so the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. The Regulatory Flexibility Act (RFA),<sup>4</sup> as amended by the Small Business Regulatory Enforcement Fairness Act (SBREFA),<sup>5</sup> gives small entities a voice in the rulemaking process. For all rules that are expected to have a significant economic impact on a substantial number of small entities, federal agencies are required by the RFA to assess the impact of the proposed rule on small business and to consider less burdensome alternatives.<sup>6</sup> Advocacy regularly hosts small business roundtables to solicit feedback and information from small business representatives on regulatory proposals.

## **II. Background**

In 2003, the SEC adopted rules implementing Section 404 of SOX, which required public companies to submit reports on their internal controls, or systems in place in a company to guard against fraudulent or mistaken transactions and to ensure the accuracy of annual financial reports.<sup>7</sup> Section 404(a) requires that management provide a report assessing the effectiveness of their internal controls. Section 404(b) requires an external auditor to

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<sup>4</sup> *Regulatory Flexibility Act of 1980*, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified as amended at 5 U.S.C. § 601 et seq.).

<sup>5</sup> *Small Business Regulatory Enforcement Fairness Act*, Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq.).

<sup>6</sup> 5 U.S.C. § 603.

<sup>7</sup> *Sarbanes-Oxley Act of 2002*, Pub. L. 107-204, Title IV, 116 Stat. 789 (2002) (codified in 15 U.S.C. § 7262).

submit one report on whether the management's assessment is fairly stated and another report on whether the company's internal control is effective.<sup>8</sup> The Public Company Accounting Oversight Board (PCAOB), a non-profit corporation created by SOX to oversee the auditors of public companies, created Auditing Standard No. 2 (AS2) as a guide for auditors evaluating a company's internal controls reporting under Section 404(b).<sup>9</sup>

The SEC divided public companies into two categories, non-accelerated filers (small public companies with a market capitalization of below \$75 million); and accelerated filers (companies with a market capitalization of above \$75 million). The SEC estimates that there were over 4,000 small public companies that make up 44 percent of the listed public companies in 2005.<sup>10</sup>

In the absence of management guidance in 2004, accelerated filers complying with Section 404 had to utilize the complicated auditing standard AS2. These entities testified that AS2 was a one-size-fits-all standard that had onerous requirements and resulted in excess costs and redundancies. In April 2006, the SEC's Advisory Committee on Smaller Public Companies ("Advisory Committee") recommended that the SEC provide exemptions from the internal control requirements of Section 404 for smaller public companies, unless and until a cost effective framework was developed that recognizes the characteristics and needs of these companies.<sup>11</sup>

On December 15, 2006, the SEC extended the compliance deadlines to Section 404 for non-accelerated filers (small public companies).<sup>12</sup> In this same month, the SEC released their proposed interpretative guidance and proposed rule, and the PCAOB released their proposed revised auditing standard. The SEC's proposed interpretation sets forth a "top-down, risk-based" approach for management to complete Section 404(a), which is supposed to make this process more effective and efficient. The SEC's proposed rule states that management can fulfill Section 404(a) by following the interpretative guidance. The SEC is also proposing to change Section 404(b) by requiring only one auditor attestation report on the effectiveness of management's internal controls reporting.<sup>13</sup> The PCAOB's revised auditing standard also incorporates this "top-down, risk-based" approach.

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<sup>8</sup> SEC Advisory Committee on Smaller Public Companies, Final Report of the SEC Advisory Committee on Smaller Public Companies 31 (Apr. 23, 2006) (*Advisory Committee Report*), available at: <http://www.sec.gov/info/smallbus/acspc.shtml>.

<sup>9</sup> 15 U.S.C. § 7262.

<sup>10</sup> *Advisory Committee Report*, at E3. The data on this graph was from the Center for Research in Security Prices. It lists 4,171 public companies that had a market capitalization of up to \$75 million in 2005.

<sup>11</sup> *Advisory Committee Report*, at 6.

<sup>12</sup> *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies*, 71 *Fed. Reg.* 76580 (Dec. 21, 2006).

<sup>13</sup> 71 *Fed. Reg.* 77,635 (Dec. 27, 2006).

### **III. Small Entities Have Expressed Serious Concerns with Both Proposals**

Over 35 people participated in Advocacy's small business roundtable, including small business owners and representatives, trade association staff, congressional staffers, and personnel from the SEC and the PCAOB. Participants raised many concerns with the SEC's management guidance and the PCAOB's revised auditing standard, in particular: 1) the need for further exemptions due to the recent receipt of the guidance and the revised auditing standard, 2) the request for clarifications of major provisions in these proposals, and 3) the issue of whether these proposals actually "fix" the problem of scalability and high costs in internal controls reporting for small public companies.

#### **1) Small Public Companies Need Further Exemptions Due to Recent Receipt of Management Guidance and Revised Auditing Standard**

Small public companies expressed concern with the timing of these draft proposals. The SEC and the PCAOB just released these proposals in December 2006, but most small public companies are expected to complete a management report on internal controls reporting by the end of the year and submit an auditor's report attesting to these internal controls next year.<sup>14</sup> Participants at the roundtable strongly recommended that the SEC provide a further extension for small public companies, to provide management with extra time to understand and implement these complex Section 404 proposals. Small entities commented that they had already planned and budgeted for FY 2007 the prior year, and it would be difficult and costly to start a new internal control reporting process in the middle of spring 2007.

Participants at the roundtable explained that it will take a longer time for small public companies to create and implement an internal controls reporting process. Although small public companies regularly submit annual financial reports to the SEC, the internal controls reporting process is time intensive because it adds the new requirements of identifying processes, assessing risk levels, and documenting and testing the internal controls. Small companies are at a disadvantage in complying with Section 404 process because they have more informal processes, fewer personnel and accountants and have no experience complying with Section 404 of SOX. William Zaiser, the Chief Financial Officer at a small public company with a market capitalization of \$64 million, hired an external consultant, and it still took four months to begin the internal controls reporting process. Zaiser stated that it would be very difficult if his company had to start the Section 404 process at this late date, because his company would have to hire extra staff or he would have to devote a large amount of his time on this project.<sup>15</sup> According to the Government Accounting Office survey of small business companies in 2005, 81 percent

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<sup>14</sup> 71 *Fed. Reg.* 76,580 (Dec. 21, 2006). Under the SEC's extensions, non-accelerated filers would submit a management assessment report with its annual report for the first fiscal year ending on or after December 2006. These entities would not be required to submit an auditor's attestation report until the following year, or the first fiscal year ending on or after December 15, 2007.

<sup>15</sup> Telephone interview with William J. Zaiser, Chief Financial Officer, MHI Hospitality Corporation, in Greenbelt, Md. (Feb. 13, 2007).

of the respondents hired a separate accounting firm or external consultants to assist them with Section 404 requirements, at an individual cost of \$3000 to \$1.4 million.<sup>16</sup>

## **2) Small Businesses Request Clarifications of Major Provisions in Proposals**

### **a. The SEC and The PCAOB Must Resolve Differences Between the Management Guidance and Revised Auditing Standard**

The Institute of Management Accountants (IMA) has commented that the SEC and the PCAOB have created two rule books for the same task of internal controls reporting, and this is a source of confusion and complexity.<sup>17</sup> Small businesses at the roundtable were concerned that the management guidance is “ambiguity disguised as flexibility,” because the standard is so vague that it does not provide any practical guidance that the management of small public companies need on how to complete internal controls reporting under Section 404(a). The SEC guidance seeks to provide flexibility and scalability for small public companies, and therefore “does not prescribe a particular methodology for the identification of risks and controls.”<sup>18</sup> In contrast, the PCAOB’s revised accounting standard is very prescriptive, and contains detailed bullet points on how auditors must evaluate a management’s internal control reporting process. The IMA has also commented that it has identified three very significant differences and/or inconsistencies between the two documents, on topics such as the control environment evaluation, identifying significant accounts and strong indicators of material weakness.<sup>19</sup>

Small business representatives have stated that they will be using the PCAOB’s revised auditing standard as their de facto guidance, because they are afraid that following the SEC’s vague and flexible management guidance will result in a negative audit by an auditor utilizing the more detailed and prescriptive revised auditing standard. Advocacy believes that the SEC and PCAOB must work together to resolve any differences or inconsistencies between the management guidance and the revised auditing standard. Participants have also recommended that additional information be provided in the management guidance, without being overly prescriptive. For example, the SEC guidance should provide examples and case studies of sample or successful audits of different types and sizes of companies.

### **b. The SEC and the PCAOB Must Address Management and Auditor Liability**

Participants at the roundtable raised the issue of liability in the Section 404 process as an important factor that most impedes the ability of these proposals to provide a scalable and cost-effective audit.

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<sup>16</sup> GAO, *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, at 17. (April 2006) (GAO Report) available at: <http://www.gao.gov/new.items/d06361.pdf>.

<sup>17</sup> Comment letter from Paul A. Sharman, President and CEO, Institute of Management Accountants, to the SEC and the PCOAB (Feb. 13, 2007) (*IMA Comment Letter*), available at: <http://www.sec.gov/comments/s7-24-06/lddevonish-mills5470.pdf>.

<sup>18</sup> 71 *Fed. Reg.* 77,635 (Dec. 27, 2006).

<sup>19</sup> *IMA Comment Letter*, at 2.

Roundtable participants stated that the management of small public companies needs assurances that they will not be held liable for completing a scaled-down audit pursuant to the management guidance, because the incentive is for management to complete extra work to protect themselves and their company from liability. In particular, small businesses seek clarification of the provision which states that “the proposed amendments would be similar to a non-exclusive safe-harbor.”<sup>20</sup> According to this proposed amendment, if management chooses to follow the management guidance, they will have complied with Section 404(a). Normally, a safe harbor affords some protection from liability or a penalty. Participants of the roundtable asked for further details of this safe harbor, such as how this safe harbor can be claimed and what type of liability protection this would afford.

Participants noted that auditors also need assurances from the PCAOB that they will not be penalized for auditing and approving a scaled management report in the inspections process. Auditors have every incentive to complete a larger audit, since they could charge extra fees and protect themselves from liability in PCOAB inspections. One participant at the roundtable stated that auditors are attributing a large percentage of their auditing fees to the potential liability and litigation exposure for these Section 404 audits. These new Section 404 requirements are likely to increase the potential liability of auditors, and increase the costs of these audits.

### **3) Small Public Companies Question Whether Proposals Will Actually Fix Problems of Scalability and High Costs**

Many small business representatives at the roundtable commented that there needs to be a further exemption to test if these two proposals will actually result in scalability and cost savings for these small public companies. Laura Phillips, Deputy Chief Auditor at the PCAOB, told participants at the roundtable that the PCAOB is currently conducting a field test of accelerated filers with their revised auditing standards in 2007 to see if this standard results in cost savings, in preparation for the 404(b) audit of small public companies in 2008. Small businesses commented that a further exemption would allow for corrections in the standard, if the testing shows that the standard needs to be revised. One participant at the roundtable asked how the SEC and the PCAOB would measure the benchmarks or effectiveness of their proposals in providing scalability and cost savings to small public companies. This small business representative commented that “if the cost of the full audit continues to be disproportionately high for small companies, the incremental benefit of this full blown audit to investors should be separately evaluated using rigorous quantitative methods rather than vague notions of investor protection.” While these proposals are helpful, Advocacy believes that the SEC and the PCAOB have overestimated the cost savings these proposals would create.

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<sup>20</sup> 71 *Fed. Reg.* at 77,649 (Dec. 27, 2006).

#### **IV. Section 404 Requirements Will Still Impose Large and Disproportionate Costs on Small Public Companies**

Based on these comments made by small business representatives at the roundtable, Advocacy believes that the Section 404 requirements will still impose large and disproportionate costs on small public companies.

In June 2003, the SEC estimated that the average annual internal cost of compliance with Section 404 would be \$91,000, and that the cost would be proportional relative to the size of the company.<sup>21</sup> Surveys of actual Sarbanes-Oxley Section 404 costs indicate that non-accelerated filers spent approximately \$935,000 to comply with Section 404.<sup>22</sup> According to the SEC's Advisory Committee Report, costs in relation to revenue will be disproportionately borne by smaller public companies. To comply with Section 404 requirements, smaller public companies with a market capitalization under \$100 million are expected to spend 2.55 percent of their revenue, while larger companies with a market capitalization of over \$1 billion are expected to spend 0.16 percent of their revenue.<sup>23</sup> A study by W. Mark Crain found similar disproportionate costs borne by small entities, finding that very small firms with fewer than 20 employees annually spend 45 percent more per employee than larger firms to comply with federal regulations.<sup>24</sup>

Recent studies backed by Treasury Secretary Henry Paulson,<sup>25</sup> New York City Mayor Michael Bloomberg, and U.S. Senator Charles Schumer<sup>26</sup> provide evidence that the burdensome SOX requirements have already made the United States capital markets an increasingly unattractive environment to list shares, decreasing the number of initial public offerings (IPOs), and forcing companies to go private or to foreign stock exchanges. In a study by Foley & Lardner LLP, 81 percent of respondents felt that the SOX requirements were too strict, and 21 percent of respondents are considering going private as a result.<sup>27</sup> SOX requirements will likely impose major obstacles to small public companies seeking capital, perhaps to such an extent that their application to small issuers would prevent small businesses entirely from accessing U.S. capital markets.

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<sup>21</sup> *Advisory Committee Report*, at 29.

<sup>22</sup> FEI, *Survey on SOX Section 404 Implementation*, Exhibit A: Costs by Filing Status (March 2006).

<sup>23</sup> *Advisory Committee Report*, Page 33.

<sup>24</sup> *The Impact of Federal Regulations on Small Firms*, an Advocacy-funded study by W. Mark Crain, Sept. 2005 available at: <http://www.sba.gov/advo/research/rs264tot.pdf>.

<sup>25</sup> Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (Nov. 30, 2006), available at: [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf).

<sup>26</sup> McKinsey & Co, *Sustaining New York's and the US Global Financial Services Leadership* (Jan. 22, 2007), available at:

[http://schumer.senate.gov/SchumerWebsite/pressroom/special\\_reports/2007/NY\\_REPORT%20FINAL.pdf](http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20FINAL.pdf).

<sup>27</sup> Thomas E. Hartman, Foley & Lardner LLP, *The Cost of Being Public In the Era of Sarbanes-Oxley 1* (June 16, 2005), available at: [http://www.fei.org/download/foley\\_6\\_16\\_2005.pdf](http://www.fei.org/download/foley_6_16_2005.pdf).

## **V. Regulatory Flexibility Act Determinations**

Advocacy commends the SEC and the PCAOB for developing these proposals in an effort to make Section 404 more cost-effective and efficient for small companies. Advocacy strongly recommends that the SEC continue to provide further exemptions for small public companies until such time as more cost-effective procedures for internal controls reporting can be developed.

Advocacy also recommends that the Securities and Exchange Commission complete a revised final regulatory flexibility analysis (FRFA) under Section 604 of the Regulatory Flexibility Act. The last regulatory analysis was completed in August 14, 2003, and this final regulatory flexibility analysis severely underestimates the cost of compliance with Section 404 of SOX. The SEC's 2003 FRFA states that small public companies will be "subject to an added reporting burden of approximately 398 hours and the portion of that burden that is reflected as the cost associated with outside professionals is approximately \$35,286. We believe, however, that the annual average burden and costs for small issuers are much lower."<sup>28</sup> Current industry estimates place the Section 404 compliance burden at almost \$1 million for small public companies.<sup>29</sup>

Advocacy also recommends that the SEC complete a required Small Business Compliance Guide for this rule. Under Section 212 of the Small Business Regulatory Enforcement Fairness Act (SBREFA), "for each rule or group of related rules for which an agency is required to prepare a final regulatory flexibility analysis...the agency shall publish one or more guides to assist small entities in complying with the rule."<sup>30</sup>

## **VI. Conclusion**

The Office of Advocacy has worked closely with the SEC and the PCAOB since the Sarbanes-Oxley Act was enacted in 2002, and appreciates the continuing efforts of these entities to make the internal controls process cost-effective and efficient for small public companies. Small businesses provided input at our roundtable, and were concerned about the timing of the proposals, the need for further clarifications and the commented that these proposals will not fix the problems of scalability and high costs in internal controls reporting. Advocacy strongly recommends that the SEC provide further flexibility for small public companies.

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<sup>28</sup> *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure In Exchange Act Periodic Reports*, Exchange Act Release No. 3308238; 34047986; IC-26068 (Aug. 14, 2003), available at: <http://www.sec.gov/rules/final/33-8238.htm>.

<sup>29</sup> See note 22.

<sup>30</sup> *Small Business Regulatory Enforcement Fairness Act*, Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq.).



Advocacy is pleased to forward the comments and concerns of small businesses. Please feel free to contact me or Janis Reyes at (202) 619-0312 (Janis.Reyes@sba.gov) if you have any questions or require additional information.

Sincerely,

//signed//

Thomas M. Sullivan  
Chief Counsel of Advocacy

//signed//

Janis C. Reyes  
Assistant Chief Counsel

cc: Steven D. Aitken, Acting Administrator, Office of Information and Regulatory Affairs