



September 14, 2006

Via Facsimile and 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

Re: File Number S7-06-03; Internal Control Over Financial Reporting in Exchange Act; Periodic Reports of Non-Accelerated Filers and Newly Public Companies (71 Fed. Reg. 47,060).

The Office of Advocacy (Advocacy) of the Small Business Administration (SBA) is pleased to submit these comments on the U.S. Securities and Exchange Commission's (SEC) proposed rule, *Internal Control Over Financial Reporting In Exchange Act; Periodic Reports of Non-Accelerated Filers and Newly Public Companies*.¹ Advocacy supports the SEC's proposal to extend the compliance deadlines to Section 404 of the Sarbanes Oxley Act of 2002 for non-accelerated filers and newly public companies.² The extension provides those entities with the benefit of the SEC's forthcoming management guidance and revised accounting standards. Advocacy believes that the new Section 404 requirements will still impose large and disproportionate costs on smaller public companies, and urges the SEC to continue and provide flexibility to these small entities until such time that internal control audits can be completed in a cost-effective manner.

The Office of Advocacy, created in 1976, monitors and reports on agency compliance with the Regulatory Flexibility Act of 1980 (RFA), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA). The RFA requires federal agencies to determine a rule's economic impact on small entities and consider significant regulatory alternatives that achieve the agency's objectives while minimizing the impact on small entities. Because it is an independent office within the SBA, the views expressed by the Office of Advocacy do not necessarily reflect the views of the SBA or the Administration.

¹ *Internal Control Over Financial Reporting In Exchange Act; Periodic Reports of Non-Accelerated Filers and Newly Public Companies*, 71 Fed. Reg. 47,060 (August 15, 2006).

² *Id.*

I. Advocacy Supports the Section 404 Compliance Extensions For Non-Accelerated Filers and Newly Public Companies.

A. Section 404 Compliance Extensions for Non-Accelerated Filers

The proposed rule extends the deadline for a management assessment report by five months and the auditor's attestation report by 17 months. Under the proposed rule, non-accelerated filers would submit a management assessment report with its annual report for the first fiscal year ending on or after December 15, 2007. These entities would be not required to submit an auditor's report attesting to these internal controls with its annual report until the following year, or the fiscal year ending on or after December 15, 2008.³

Advocacy supports this "phase-in" approach to internal control reporting.⁴ According to the SEC, internal control reporting costs are higher for smaller public companies than larger ones, and the auditor's attestation report represents a large percentage of those costs.⁵ Under the SEC's "phase-in" approach, postponing the auditor's attestation report until the second year would help non-accelerated filers smooth the significant cost spike that has been experienced by many accelerated filers in their first year of compliance with Section 404 requirements.⁶

B. Section 404 Compliance Transition Period for Newly Public Companies

Advocacy also supports the SEC's proposed transition period for newly public companies. Under the proposed rule, a newly public company would not be required to comply with the management assessment report and the auditor's attestation report in their first annual report. Newly public companies would begin to comply with these requirements in their second annual filed with the SEC.⁷ An April 2006 report by the U.S. Government Accountability Office (GAO) found that the new requirements "may have been a contributing factor in the reduction of the number of public offerings issued by small companies since 2002."⁸ Companies choosing to go public must spend additional time and resources to comply with Section 404 to attract investors.⁹ Advocacy believes that Section 404 presents a major barrier for small public companies seeking capital, perhaps to such an extent that it would discourage small businesses entirely from accessing U.S. capital markets. Advocacy believes that the proposed one-year transition period will help these newly public companies comply with Section 404 requirements.

³ *Id.*

⁴ *Id.* at 47,063.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 47,064.

⁸ 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 18. (April 2006) (*GAO Report*) (available online at <http://www.gao.gov/new.items/d06361.pdf>).

⁹ *Id.*

II. Advocacy Supports Forthcoming Guidance and Revised Accounting Standards

The SEC's proposed rule states that the Section 404 compliance extensions were given to provide non-accelerated filers and newly public companies the benefit of forthcoming SEC guidance on management assessment reports and anticipated changes that the Public Companies Accounting Oversight Board (PCAOB) makes to Auditing Standard No. 2. Advocacy believes that these entities would greatly benefit from the forthcoming SEC management guidance and revised accounting standards that are tailored or scaled to "address the specific manner in which smaller companies operate."¹⁰

Advocacy believes that guidance on management assessment is crucial, because small public companies currently use Auditing Standard No. 2 of the PCAOB, a guide developed for external auditors to assess a company's internal control effectiveness.¹¹ SEC rules require management to base their assessment of internal control on a recognized framework, such as the favored framework published by the Committee of Sponsoring Organizations of the Treadway Commission.¹² Both of these frameworks provide the criteria to test a company's controls, but there currently is no guidance for management on what constitutes adequate internal controls for smaller public companies.¹³ In the April 2006 GAO Report, a survey found that 81 percent of smaller public companies that responded hired a separate accounting firm or consultant to help them comply with Section 404 and in particular with creating internal controls for their companies.¹⁴ These small companies paid fees that ranged from \$3,000 to more than \$1.4 million for these external consultants.¹⁵

Smaller public companies have different characteristics from larger companies, which make it difficult for the smaller companies to comply with the rigid requirements of the SEC-approved Auditing Standard No. 2 of the PCAOB. Large companies have a more bureaucratic organizational structure, which allows them to segregate duties and create stable processes for internal control reporting.¹⁶ Smaller public companies need to be flexible to compete effectively with their larger competitors, and this dynamic nature leads to constant changes in their internal management and organization.¹⁷ Small entities also have "resource limitations which make it difficult to achieve economies of scale, segregate duties and responsibilities, and hire qualified accounting personnel to prepare and report financial information."¹⁸ Advocacy is pleased that the PCAOB is revising Auditing Standard No. 2 to reflect the differences in small public companies.

¹⁰ *GAO Report*, at 18.

¹¹ *Advisory Committee Report*, at 31.

¹² *Id.* at 30.

¹³ *Id.*

¹⁴ *GAO Report*, at 17.

¹⁵ *Id.*

¹⁶ *Advisory Committee Report*, at 36.

¹⁷ *Id.*

¹⁸ *GAO Report*, at 18.

III. Advocacy Recommends Further Flexibility in Section 404 Compliance for Small and Newly Public Companies

Advocacy commends the SEC for developing management assessment guidance and for supporting the revisions to Auditing Standard No. 2, and avoiding the one-size-fits-all approach to regulation. However, Advocacy believes that the new Section 404 requirements will still impose large and disproportionate costs on smaller public companies.

According to the SEC's Advisory Committee Report, costs in relation to revenue have been disproportionately borne by smaller public companies.¹⁹ 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.²⁰ A study by W. Mark Crain found similar disproportionate costs borne by small entities, finding that very small firms with fewer than 20 employees spend 45 percent more per employee than larger firms to comply with federal regulation.²¹ Surveys of actual Sarbanes-Oxley Section 404 costs indicate that annual small company compliance costs approach \$1,000,000. For example, Financial Executive International's most recent survey, completed in March of this year, shows that non-accelerated filers each spent approximately \$935,000 to comply with Section 404.²² Advocacy urges the SEC to explore ways to provide further flexibility to these small entities until such time that internal control audits can be completed in a cost-effective manner. In the alternative, Advocacy recommends that the SEC exempt small public firms from additional burdensome outside audit requirements.

Advocacy is pleased to submit these comments on behalf of small businesses. If you should have any questions on this letter or related issues, please feel free to contact me or Janis Reyes at Janis.Reyes@sba.gov or (202) 619-0312.

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

¹⁹ *Advisory Committee Report*, Page 33.

²⁰ *Id.*

²¹ *The Impact of Federal Regulations on Small Firms*, an Advocacy-funded study by W. Mark Crain, Sept. 2005 (available online at www.sba.gov/advo/research/rs264tot.pdf).

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