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To the Commission

I appreciate the chance to provide feedback relating to internal control reporting for smaller public companies. Over the past two years, I have spent considerable time working in this area, writing books and providing advice to both issuers and their auditor. It is from this set of experiences and my continued research and thinking on this topic that I make these observations.

The Cost of SOX 404 for Smaller Entities

Much of the concern expressed by small issuers is related to the anticipated high cost of compliance. This concern is understandable, and I empathize with the uncertainty that management at these must feel. However, I do believe that the cost of compliance is largely variable, not fixed, and so the compliance costs for smaller issuers will be commensurate with their relative size, the complexity of their business processes, and theiry financial reporting risks.

Smaller issuers should experience lower absolute compliance costs because they generally will have fewer, less complex business processes. Consequently, it should be less time consuming to—

- Understand financial reporting risks
- Understand the related controls
- Document and test controls

Additionally, I would caution smaller business issuers about projecting the first year costs of accelerated filers onto their implementation efforts. The guidance issued by the staffs of the SEC and PCAOB on May 16 will help greatly in tailoring the entity's approach to assessing and reporting on internal control effectiveness to one that is more efficient. As both management and auditors become more adept at applying the "Top-Down Approach" and making judgments about internal control matters based on the risk of material misstatement, these skills and this knowledge naturally will diffuse throughout the profession. The documentation, testing and evaluation processes followed in 2006 will be much more efficient and effective than those followed in 2004. Smaller issuers will benefit greatly from this learning curve.

Extent of Documentation

The COSO framework acknowledges that at smaller entities, internal control may be less formal. Many of us have linked "formality" to "documentation," that is "less formal" means "less extensive documentation."

Paragraph 45 of AS No. 2 states that inadequate documentation is a control deficiency, which raises the question, in a smaller business entity, where less formal internal control is appropriate, how extensive should control documentation be before it is considered adequate under paragraph 45?

For example, suppose that the company's operations have been extremely routine for many years. As a practical matter, management rarely, if ever, has had to address issues related to

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non-routine transactions. If one of these transactions were to arise, then it would quickly surface and be brought to the attention of the appropriate personnel during the normal preparation of the accounting records.

In this situation, is the company required to document a policy related to controls over non-routine transactions? Or is the existing ad hoc system, which is not explicitly stated, "adequate." What if senior management's risk assessment process is similarly informal, done on an as needed basis? Is that process required to be documented?

I have heard some arguments that essentially state that all financial reporting controls (especially those specifically identified in AS 2) must be documented, otherwise a control deficiency exists. I disagree with that argument, particularly in light of the May 16th guidance. I believe that the lack of documentation should be evaluated against the risk of material misstatement of the financial statements. It is conceivable that in a smaller entity such as the one described, there is only a remote likelihood that a misstatement could result from minimal (or even non-existent) documentation of controls over non-routine transactions or management's risk assessment process.

Any guidance and examples that would help clarify the extent of documentation necessary for smaller entities would be beneficial.

Reliance on External Auditors for Accounting Advice

Both the SEC and the PCAOB staffs have addressed on several occasions the type of advice that auditors are allowed to provide their clients on internal control related matters. This guidance has been quite helpful, particularly the comments made in the May 16th documents. However, the topic continues to be raised as an area of concern for both the smaller business issuer and their auditors. My experience has been that there are two basic questions.

- *What is the minimum level of accounting knowledge we should require of the small business manager?* When I have raised this question among my clients or in the classroom, a consensus fairly quickly emerges. It seems unreasonable to require company management to be able to implement or apply generally accepted accounting principles. However, management should be able to *identify the existence* of an accounting issue and be willing to assume responsibility for making a reasonable decision about how to address it. Put another way, if company management regularly relies on their external auditors to tell them that a new accounting standard affects the company, then a control deficiency exists.

- *As part of assessing internal control, are we required to assess management's ability to make informed judgments about accounting matters?* Some of the auditors I have worked with have said that the PCAOB guidance implies that the discussions between an auditor and his or her client should be conducted as "a discussion of equals." I don't happen to read that idea in the guidance, but I do believe that it is a reasonable approach. The problem that auditors of smaller issuers are concerned with is that in many instances, they will be unable to have a "discussion of equals" on matters of accounting. Company management will automatically default to the auditor's view on technical matters. This default position will not be explicitly stated. Therefore, does the auditor have the responsibility for determining whether management has not just the willingness but also the ability to assume responsibility for decisions relating to the application of accounting principles? If so, then how should the auditor fulfill this responsibility?

Management Involvement as a Compensating Control

The COSO framework provides guidance on the how the framework should be applied to smaller entities, and it notes that the direct involvement in internal control by senior management can obviate the need for detailed controls at other points in the information processing stream. Intuitively, this guidance makes sense, but my experience has been that it is misunderstood by most auditors.

I am concerned that auditors, management, or both may place undue reliance on "management involvement" to compensate for missing or ineffective controls elsewhere at the company. The examples of management involvement that are provided in the COSO report are quite specific. For example, it is clear that the examples relate to management involvement *in internal control activities* that acts as a compensating control. I have seen many instances of auditors citing management involvement in general business matters (e.g., sales and marketing, supply chain management, etc.) as a compensating control for financial reporting matters.

I think it would be helpful if the Commission or the PCAOB would issue guidance that echoed the guidance provided in COSO relating to management involvement, as this would alleviate the confusion that currently exists.

Additionally, senior management that is too involved in the financial reporting process or involved inappropriately in that process raises another control issue, namely management over-involvement increases the likelihood of the inappropriate override of controls. Any guidance that is offered relating to management involvement in internal control would be enhanced if it included direction on how this involvement interacts with risks of management override.

Providing Examples

The examples provided by both the SEC and PCAOB have been extremely helpful in understanding and applying the related guidance. I have found Appendix D of AS 2 to be particularly helpful because it provides two different scenarios from the same company and illustrates how under one fact pattern, the control deficiency is a material weakness, but under a slightly different fact pattern, it is only a significant deficiency. This ability to compare two scenarios "side-by-side" reinforces the need for risk based judgments, and it allows the reader to understand how various factors should be considered when making those judgments.

I hope that the SEC and PCAOB decide to provide examples of the application of the standards to small business entities. If examples are provided, I encourage the staff to follow the organization of Appendix D of AS 2, when it makes sense, by placing the smaller issuer "side-by-side" with a large issuer. For example, I have thought that this type of organization would be particularly helpful for illustrating issues relating to the extent of documentation.

Thank you for considering my comments.

Michael Ramos