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financial executives international

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June 6, 2005

Jonathan G. Katz, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

File Number: 265-23

Dear Mr. Katz,

The Small Public Company Task Force of Financial Executives International [FEI] is pleased to provide feedback regarding the implementation of Section 404 of the Sarbanes-Oxley Act of 2002 relating to internal control over financial reporting for smaller public companies. We appreciate the Commission's willingness to solicit feedback as it relates to implementation for smaller public companies.

FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. This document reflects the views of the SEC Small Public Company Task Force and not necessarily those of FEI.

As it relates to smaller public companies, the definition of which is also under consideration by the SEC's Advisory Committee of Smaller Public Companies, we recommend that consideration be given to the definition based upon revenue in addition to market capitalization. This will avoid companies being in and out of the category given the whims and bubbles of the market. We suggest that a public company with less than $500 million in revenue and less than $700 million in market capitalization be considered a "smaller public company". We also suggest these calculations be based upon the prior year historical financial statements to ensure that companies have the requisite time to determine which category they will fall in for the present fiscal year and be able to plan their work accordingly.

We believe the following suggestions for refining existing guidance and implementation practices will significantly reduce (without diminishing value) the current burden to comply with Section 404 for smaller public companies.

1. Align the May 16, 2005 guidance issued by the Commission and the PCAOB with provisions of Auditing Standard 2 [AS2].

We refer to the letter sent to the Commission on April 1, 2005 from the Committee of Corporate Reporting [CCR] of FEI [File Number 4-497]. Since this letter was issued, the Commission and the PCAOB has issued additional guidance on May 16, 2005, regarding the implementation of Section 404. We find this implementation guidance helpful and especially appreciate the tone of the guidance, stressing a greater use of judgment and a "risk-based" approach to the audit procedures. However, we note that there are still several areas in AS2 where judgment or a risk analysis is not permitted to be considered in determining auditing procedures. These include the following:

i. Lack of documentation is automatically considered a deficiency [Para. 138]

In many cases, smaller company policies may not be formally documented, but are equally as effective and communicated. We note the following guidance provided in the COSO framework, Executive Summary, Chapter 6 [Monitoring]:

> "Many controls are informal and undocumented, yet are regularly performed and highly effective. These controls may be tested in the same ways as documented controls. The fact that controls are not documented does not mean than an internal control system is not effective, or that it cannot be evaluated".

We suggest that for smaller public companies, lack of documentation should not be automatically considered a control deficiency.

ii. Auditor must focus on combinations of controls, in addition to specific controls in isolation [Para. 51]

In many cases, compensating controls may be the primary control for smaller public companies due to lack of resources and costs associated with maintaining primary controls. Therefore, we suggest that the auditors be permitted to test the compensating, or combinations of controls, and not waste time and resources testing controls in isolation that they may already know are not being relied upon.

iii. Auditor must perform a walk through for each major class of transactions and cannot rely on the work of others [paras. 78-80 and 116]

We suggest that the auditors be permitted to exercise judgment and determine the appropriate risk to determine whether a walk through is necessary.

2. Allow reliance on cumulative knowledge.

AS2 requires that each year's audit must stand on its own: therefore, the auditor is not currently permitted to rely on cumulative knowledge or to consider the rotation of testing of key controls year to year. The standard fails to recognize the value of cumulative knowledge in assessing potential risk. We believe that management and the auditors should be permitted to rotate the testing of key controls based on a risk assessment related to each material account. This would allow for modulation of the frequency and scope of testing based on the risk and the underlying control environment. The requirement to start over ignores the fact that many controls, IT controls in particular, do not necessarily change from year to year.

3. Certain items should be excluded from the scope for one year for smaller public companies.

In answer to Question 3 of the SEC's Frequently Asked Questions regarding "Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Report", the SEC provides guidance that allows for a transition period of at least one year for processes related to material acquisitions that could not be fully integrated by year end to test the processes for Section 404 compliance. This exception was provided to ensure that companies could make appropriate business decisions associated with acquisitions and integrate such acquisitions in a thoughtful manner. We believe that there are other circumstances, particularly for smaller public companies, that might require similar treatment. We suggest a one year exception for joint venture and start-up divisions as well as for new systems [IT] implementations.

This would enable smaller public companies to ensure that new processes were appropriately integrated, documented, monitored and tested in accordance with Section 404. At the very least, these items should be permitted to be "scoped out" of the audit requirement.

4. Stay the extension of requirements for smaller public companies until the COSO committee studying the issue presents its results.

COSO has recently convened a committee to study the applicability of the COSO Internal Control Framework to smaller companies. We suggest that the Commission consider staying the delay in implementing Section 404 for smaller public companies until that committee has presented its results.

5. Consider separate guidance for smaller public companies focused on the control environment.

In many smaller public companies, senior management has direct hands-on knowledge and performs detailed reviews of results that can often serve the purpose of lower level control activities typically found in larger companies. An appropriate segregation of duties can present difficulties in smaller companies, for which direct oversight by senior management can provide the necessary control. For smaller public companies, entity-level controls have a more pervasive effect on the organization due to lower layers of management and more first hand contact with senior management. AS2 currently places too much reliance on preventive controls, versus detective controls, which can be just as effective, particularly for smaller public companies.

The behavior of senior management is critical and must be consistent with the communication, whether oral or written, to employees. Senior management's commitment to integrity and ethical behavior is exhibited visibly through direct involvement with their employees, customers, and other stakeholders.

Therefore, we suggest, that while the concepts won't vary with AS2, a separate standard with a clear focus on the increased role that the control environment plays in smaller companies be developed.

"Tone at the top" in particular should be robustly monitored and tested in smaller public companies.

Conclusion

In summary, we would like to reinforce that the Small Public Company Task Force fully supports the spirit of the Act and believe that the recommendations noted above will significantly decrease the current burden on smaller public companies in implementing Section 404, without diminishing the value.

Thank you for considering our views. Task Force members would be happy to discuss at your convenience any of the observations and recommendations noted above. In the meantime, if you have any questions or wish to discuss this letter, please feel free to contact Serena Davila at the FEI Washington, D.C. office at 202-626-7809 or myself at 510-774-1969.

Sincerely,

Richard D. Brounstein

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Financial Executives International and
Member of the SEC Advisory Committee on Smaller Public Companies