Donald H. Chapin, CPA

March 15, 2006

Chairman Christopher Cox
US Securities and Exchange Commission

Re: File No. 265-23

Dear Mr. Cox:

I have been involved with internal control and related enforcement issues through most of my professional life.[1] I am now an independent financial management consultant and a member of the Standing Advisory Group of the PCAOB.

This letter presents reasons why the SEC should reject substantially all the Recommendations of its Advisory Committee on Smaller Companies, especially the Primary Recommendations of Parts II and III. The accompanying Critique[2] of the Arguments made by that Committee provides support for my reasons and demonstrates the weaknesses of the Committee's Arguments.

The Committee's Recommendations would establish a new track inconsistent with expectations for Sarbanes Oxley. There are substantial risks and concerns relating to their effectiveness. I believe they will have very disappointing consequences.

- They will probably further delay reforms for small companies where the need is greatest. Investors and the markets will continue to suffer in the meantime from lack of 404 protection, as they will later from the much reduced protection offered by the Committee's Parts II and III Primary Recommendations.

- They may reduce investor protection even beyond what is now expected. They may cause the large companies which have much stronger controls to justifiably seek similar "relief'. PCAOB may be pressed to reduce the strength of its AS#2 and other existing and pending control related standards.
- They are not likely to quell the dissatisfaction of companies who may seek even greater unwarranted cost reductions.

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1 *As Director of Auditing for Arthur Young & Company and client handling partner I dealt with control related management fraud problems and with FCPA implementation issues. In the late 80's and most of the 90's, as Assistant Comptroller General and Chief Accountant, I was a chief critic of the lack of enforcement for COSO's internal control proposal and assisted the Comptroller General in helping to frame the provisions of FDICA following the S&L crisis. As an independent consultant I evaluated the quality and degree of coordination of internal and external audits, advised on professional standards issues at Enron and Tyco, and served as an advisor on NASDAQ's listing standards following the passage of SOX. I participated in early thinking that led to the provisions of AS #2.*

2 An earlier version was sent to PCAOB and its Standing Advisory Group on March 8th.

The following is a list of specific reasons why the SEC should reject the Committee's Recommendations:

1. Small companies are where weak controls and restatements exceed those of larger companies. This is supported by the convincing data and analysis provided by Glass Lewis. In those circumstances, "scaling" makes no sense.

2. The judgment by the Committee about the cost-benefit relationship in support of weakening 404 may not recognize the consequent unnecessary imputed costs to those companies, and does not recognize either the great past or potential future damage to both individual investors and confidence in the markets.

3. That judgment should not outweigh the experienced judgment by former SEC Chairmen and Conference Board members that 404 should not be changed.

4. The history of internal control efforts shows that specific compliance requirements are necessary. But, they are only imposed immediately after crises and public outrage. Opposition by companies concerned primarily with their own interests has been successful in the past and continues to be unrelenting.

5. History, as well as current information provided by Glass Lewis, indicates that competent independent audits are necessary to assure that companies establish and maintain effective internal controls

6. Over reliance on "tone at the top" and management monitoring has facilitated fraud and led to restatements. Even for honest management, and that is impossible to tell without a body of internal controls and competent audits, it is probably not a prudent way to run a business. Balancing "documenting, testing and certifying controls" are also essential to an effective audit.

7. Cost reducing measures have been and are being developed by the private sector and much useful guidance has already been offered by the SEC and the PCAOB. On going private sector efforts can be improved and coordinated by the staffs of the SEC and the PCAOB working in concert. Any needed additional authoritative guidance should flow from those efforts, PCAOB inspections and SEC investigations.

8. The COSO concepts provide a flexible platform to tailor controls to the particular circumstances of individual companies. This is happening, and with more experience and improved guidance, this will happen even more quickly. It is the only way to achieve a "perfect fit" of adequate controls and least cost to individual companies, their investors and the markets.

My conclusions:

- The proponents of curtailing the application of COSO and weakening 404 compliance, should be required to carry the burden of proof that smaller companies are less risky to investors. Current data and the weak Arguments of the Committee do not provide that proof.

  Therefore the Committee's Recommendations affecting internal control (Recommendations II.P.1 and III.P.1, 2, and 3) should be rejected because they would compromise the Securities Laws and the SEC's duty to protect the investing public.

- In making decisions relating to the Committee's Recommendations the SEC should give careful consideration to Arthur Levitt's recommendations.

- The controls of smaller companies are likely to be inherently weaker, as well as being historically weaker.

  Therefore, the SEC and the PCAOPB should also consider ways to strengthen the audits of these and other companies when top management dominates the control environment and the monitoring function.

- The SEC can be very helpful to smaller companies by continuing to join with the PCAOB in promoting, evaluating and coordinating cost effective approaches to implementing COSO.

Mr. Cox, I hope my letter and accompanying Critique will be helpful in dealing with this difficult problem. Also, I hope that early on you will seek the advice of the PCAOB, and particularly its very knowledgeable Standing Advisory Group.

Sincerely,

Donald H. Chapin

Cc: PCAOB Board members
Standing Advisory Committee members and observers

CRITIQUE OF THE ARGUMENTS MADE BY THE SEC ADVISORY COMMITTEE

<u>Summaries of Arguments (and page numbers where they are made) are underlined.</u>
A brief critique follows each argument

In dealing with each of the Committee's Arguments I have tried to avoid repetition and so I ask that the reader of this Critique to consider how some of my points in opposition to certain Arguments might be carried over to other Arguments.

Arthur Levitt's January 27, 2006 article published by the Wall Street Journal provided information, informed opinions and suggestions before the Committee's Final Report was issued. Most of these do not appear to have been fully considered by the Committee. I suggest that Mr. Levitt's article be read in conjunction with this Critique.

<u>There is precedent of "scaling" regulation for smaller companies. This would affect companies representing 6% of equity market capitalization (pages 12 to 19).</u>

The Glass Lewis – Turner letter and report of 9/14/05 and 3/2/06 provide this critically important information:

- A major cause for dramatic loss of market cap for many smaller companies is related to fraud and faulty accounting that led to restatements, something that better controls and audits might have prevented.
- Smaller companies measured by market cap were nearly twice as likely to restate their financial statements as the largest companies, and their reported material weaknesses were twice as large.
- Most companies that had restatements but didn't disclose material weaknesses were non-accelerated filers, and 388 of them since 11/4/04 were not required to have their internal controls audited.

The precedent of "scaling" regulation cannot be a reason for failing to properly address the manifest control problems of smaller companies. Control failures in this large group of companies, measured either by the very large number of them or even by market cap, argue against relaxation of 404.

<u>Documenting, testing and certifying internal controls are of lesser value than "tone at the top" and high level monitoring controls (pages 19 and 20).</u>

This comparative may possibly be true, but these processes are still essential elements of good controls. Documenting expresses the result of control analysis, assists conformance with controls and facilitates auditing. Testing is essential to confirm control effectiveness. Both documentation and testing are essential underpinnings of required Certifications by company officers and auditors.

Furthermore, the control environment and monitoring are more subject to abuse by small company executives. And, the principal way that executive manipulation and fraud can be discovered by auditors is by their involvement with company people in the documenting, testing and certifying process.

The dominate role of top management in both company operations and controls suggests that for small companies the internal controls over financial reporting may be inherently weaker.

<u>We do not accept the view that the benefits of 404 for smaller companies outweigh the costs, that authoritative guidance will be sufficient, and 404 expenditures will decrease substantially overtime. This is based on our collective experience and the outpouring of testimony, comment letters and input. (page 20).</u>

The Committee does not consider the high costs that are imposed on their investors and the effects on the markets for their securities from non-compliance with 404.

They do not consider the reduction of company imputable costs that will result from compliance with 404. Nor, do they recognize the continuing development of authoritative and useful non-authoritative guidance. Nor, do they recognize the decreasing costs of the companies that are compliant with 404.

It appears that the basis for the Committee's position may be largely anecdotal and biased by the views of those Committee members whose primary objective is to reduce the compliance costs paid by small companies.

The most credible judgments about the overriding importance of maintaining 404 are those of Arthur Levitt, three other former Commissioners of the SEC, and very knowledgeable former Conference Board members.

<u>The value of the proposed COSO guidance for smaller companies is questionable because it will not reduce the costs of 404 compliance (page 22)</u>

The principles, and some of the related attributes, in the that guidance will make it easier to see how the more conceptual guidance of the long accepted COSO framework could be applied. I commented favorably on the exposure draft, suggesting only that one aspect of monitoring be strengthened. I did not have access to other comments, nor did I see a satisfactory justification for it being set aside

I believe that this and other types of guidance being developed will be cost reducing.

For example, the recent Glass Lewis - Turner report includes a basic questionnaire approach to determining and documenting internal controls for small companies. It suggests a coordinated effort by the company and its auditors, and provides a basis for documentation and a roadmap for essential testing.

These documents, each in a different way, should reduce the not inconsiderable cost of small company management confusion about what to do. The questionnaire should also help to reduce the cost of uncoordinated actions.

These useful documents, and others that have been developed and are in use, have no official sanction, and they are not integrated. Any important problems with them, and with coordinating them, could be identified and remedies suggested, possibly by the staff of the SEC and PCAOB working in concert. Such a body of tools, even without official endorsement, would be helpful in implementing COSO and AS #2.

Other helpful cost reducing approaches will emerge as small companies try to become compliant with 404. Larger companies that are now compliant have developed approaches that involve some cycling based on considerations of risk and materiality, and consultants are developing software that will ease compliance.

Arthur Levitt's suggestion to rely on effective monitoring to reduce the need for repetitive testing by companies deserves early consideration. The primary problem with it that needs to be addressed is how to insure an effective monitoring process. Shortly after the passage of SOX, I suggested that Nasdaq require its companies to have an internal audit function responsible to the audit committee.

<u>Foreign Corrupt Practices Act: Uncertain standards of compliance combined with liability exposure following its enactment in 1977 caused departures from this statute's intent. In 1981, fears were calmed by an SEC approach based on reasonableness and minimal intrusion in corporate decision making (pages 23 to 25).</u>

In actual fact, after initial attempts at compliance with the statute's short and simple statement about the need for internal controls, two attempts by the SEC to provide needed compliance requirements were rebuffed by objections. Compliance then diminished over time to the point where the controls part of the statute was largely ignored.

What else happened that should affect current views on the need for maintaining 404 requirements?

First, COSO framework issued in the early 90's did not incorporate compliance encouragement suggested by GAO. The influence of this almost "toothless" framework in strengthening internal controls was modest early on and diminished over time. Most of the GAO suggestions were later incorporated in SOX.

Second, also in the 90's, and following the S&L crisis where the absence of good internal controls was a significant factor, the FDICA Act was passed requiring, among other reforms, that auditors report on the adequacy of the internal controls of banking institutions. But, this beneficial requirement was diluted after the "storm" had passed, when small institutions were exempted by the Congress. The full damage that this retreat might have caused was offset by improved safety and soundness examinations by the banking examiners.

Third, the AICPA made it easy for commercial and industrial companies to ignore internal control because its auditing standards, applicable until AS #2 was adopted, permitted the flexibility to substitute substantive procedures for all controls work, and thereby to obviate the need for any reliance on internal controls to get a clean audit opinion.

The argument advanced by the Committee when it is corrected, and further countered by later historical experience with standards, actually proves both the necessity to have "certain standards", and the danger of too much reliance on "reasonableness and minimal intrusion".

<u>Because the COSO framework does not provide management with guidance on how to document and test internal control and evaluate deficiencies, AS #2 has become the de facto guide to management and little attempt has been made to "scale" regulation to smaller companies (pages 26 – 27).</u>

After the first year of implementation, PCAOB affirmed that AS #2 is not applicable to companies, and directed auditors not to require that AS # 2 be followed by companies. Both the SEC and the PCAOB have criticized "check the box mentality" and have urged the use of good judgment and a "top down approach". The PCAOB inspection process looks for over-auditing and criticizes auditing firms when that is found.

The following may be the some of the reasons why the regulators should continue to support COSO. First, the COSO document deals with basic control concepts because it is always necessary to tailor controls to the needs and circumstances of particular companies. Second, any effort to produce a single regulatory model applicable to all small companies is likely to fail as a cost reducer unless, as it seems from some of the Report's arguments, that the COSO control concepts are to be compromised. Third, any such model will not be totally cost effective because small companies among themselves have different types of activities that need to be controlled.

<u>Information technology controls are not risk based (page 27).</u>

IT is the heart of the accounting operations for large companies and for many smaller ones. It is also an area exposed to management override, and it has been and increasingly may be an area where future frauds are facilitated.

It may be true that there is unneeded testing. But, if so, this is a shortcoming for both large and smaller companies, and is probably more high cost for large companies who have complex information systems

PCAOB thus far has had to give priority to other more pressing internal control issues.

“The smaller you are the harder you are hit”. (pages 28 to 30).

This provocative headline speaks in terms of the relationship of company incurred costs to size of company.

In terms of incurred costs, the headline true.

But, incurred costs are only part of the picture. Imputable costs that could be avoided are not recognized in this Argument. For example, the weak controls of smaller companies increase the cost of capital to them, lower the market prices of their stocks, hamper their ability to move to larger company status, etc. The headline may still be true for some small companies, but is probably not true for companies that experience the consequences of severe control problems and restatement.

Not at all recognized by the headline are the sudden losses to investors in the stock of a smaller company that must restate its financials because of the lack of good controls. Neither, is the cost to all investors from the effect on the securities markets of the large number of frauds and misstatements of poorly controlled smaller companies.

The headline also does not recognize that incurred costs for the companies who have been compliant are coming down. No doubt, presently non-compliant companies will have higher costs in the first year of compliance compared with the second and later years. But the initial year costs will be less than they would have experienced had the large companies not been through the process, auditors not learned, and helpful guidance not been developed.

Management override is a higher risk for smaller companies, but conversely, honest management will discover error because of the necessity to be closely involved. Close management involvement is necessary because of the inherent inability to segregate duties and the rapidity of needed changes in small company operations (pages 30 to 34).

Management override is a big problem that is harder to head off without good controls and related audits. And, honest management cannot and should not try to act without the assistance of other controls. It is likely to be less effective and may sometimes, if management is diligent, consume more management time than otherwise necessary.

COSO does not require each component of internal control to be weighted equally when judging whether controls are adequate. Nor does COSO deny that the strength of one control component cannot offset some degree of weakness in another. Also, the relative simplicity inherent in smaller company operations make control evaluation, testing and documentation easier. Granted, the need to respond to changes in operations requires frequent updating of these control activities. But, having updated controls has advantages when operating changes introduce increased business risks.

The repetitive Arguments advanced later in this section of the Report, when my critiques of earlier Arguments are considered, do not help to support its conclusions.

I believe my Critique rebuts the Arguments offered in support of the Committee's Primary Recommendations of Parts II and III; and supports the necessity of keeping 404 in place without change, as well as the desirability of applying COSO without change and in the comprehensive and reasonably flexible manner intended.

Donald H. Chapin
March 15, 2006