

# ABA

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November 28, 2005

By Electronic Delivery

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, D.C. 20549-9303

Re: File Nos. S7-40-02; S7-06-03  
Release Nos. 33-8618; 34-52492  
Management's Report on Internal Control Over Financial Reporting and  
Certification of Disclosure in Exchange Act Periodic Reports of  
Companies that are not Accelerated Filers

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law (the "Committee") in response to the request for comments by the Securities and Exchange Commission (the "Commission") on its September 22, 2005 release referenced above (the "Release").

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

The Committee commends the Commission for its ongoing consideration of the application of Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") to smaller public companies and its recognition that different attestation requirements, auditing standards or other distinctions might be appropriate given the disproportionate compliance costs that smaller public companies face today.

Elimination of the Auditor Attestation Requirement for Smaller Public Companies

We believe there should be a different approach to reviewing and testing internal controls concerning financial reporting requirements for smaller public companies than for larger public companies. Specifically, we believe that the independent auditor attestation requirement of SOX Section 404(b) as it has been implemented by Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, adopted by the Public Company Accounting Oversight Board (the "PCAOB") and approved by the Commission is unnecessary and overly burdensome for smaller public companies. As the Commission has recognized by its decisions to postpone effectiveness of Section 404 for non-accelerated filers, the process of implementation of the auditor procedures under Auditing Standard No. 2 is both time-consuming and expensive. While the independent auditor's rigorous review and testing may provide additional assurance that material weaknesses will be exposed, we believe that the cost of such assurance for smaller public companies is disproportionate and provides limited benefit to shareholders and potential investors.

We believe that reasonable assurance as to the effectiveness of internal controls may be achieved without a separate auditor attestation for the following reasons:

1. CEO and CFO Certification. Under SOX Sections 302 and 906, written certifications signed by the chief executive officer and chief financial officer regarding a company's disclosure controls, internal controls and significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting are required to be included in periodic reports filed with the Commission on a quarterly basis. These same individuals are entrusted by a company's board of directors to oversee the management and operation of all other aspects of the business. Because these officers have personal liability for their failure to act reasonably in making the certifications, they have every incentive to review and scrutinize the adequacy of internal controls and to make any necessary changes as well as to require that other company employees take their responsibilities in this area seriously.

2. Improved Audit Committee Oversight. Corporate governance reforms over the past three years, spurred by the efforts of the Commission, the self-regulatory organizations and SOX, have led to greater accountability by the board of directors and have substantially enhanced the power of audit committees. Now, all companies listed on the New York Stock Exchange, the American Stock Exchange and Nasdaq are required to have an audit committee comprised of financially literate and independent members as well as at least one member who qualifies as a financial expert. Furthermore, many other public companies not listed on a national securities exchange or association now have audit committees. These salutary corporate governance changes markedly increase the probability

that significant deficiencies in internal controls will be identified and addressed, that fewer material weaknesses will develop and that they promptly will be remediated.

3. Management Letters. The auditor, as part of its audit of a company's financial statements, must review the adequacy of internal controls in order to issue a report on the financial statements. Significant deficiencies and material weaknesses in a company's internal controls can lead to an auditor's inability to issue a "clean opinion." Further, an auditor's concerns about internal controls can and should be raised through the customary "management letter" and discussed with management and the audit committee. Where the auditor's comments are not adequately addressed – or, even if addressed, are not resolved to the auditor's satisfaction – the auditor can and should reiterate its concerns to the audit committee. At the end of the day, if the auditor believes that the company's internal controls are inadequate, it can and should refuse to issue a clean opinion or, possibly, any opinion at all.

4. Items 307 and 308 Disclosure Requirements. Under Item 307 of the Commission's Regulation S-K, companies are required to report on the principal executive and principal financial officers' conclusions regarding the effectiveness of disclosure controls and procedures. Pursuant to this requirement, companies today are disclosing information regarding disclosure controls and procedures, including internal accounting controls, and steps are being taken to remediate any deficiencies in such controls and procedures. Under Item 308 of Regulation S-K, companies will also be required to report specifically on internal accounting controls and to include language in the CEO and CFO certifications under SOX Section 302 addressing internal controls.

The Committee believes that Congress took an important and significant step in enacting SOX Section 404(a). Under this statute, management is responsible for establishing and maintaining an effective system of internal controls. The additional requirement of SOX Section 404(b) for a company's outside auditor to provide an attestation report on management's assessment of internal controls, however, adds enormous additional costs and burdens on management that are not justified, in the case of smaller public companies, by the benefit provided to investors. At the hearing held by the SEC Advisory Committee on Smaller Public Companies, it was noted that compliance with the SOX 404(b) attestation requirements is costing small public companies as much as 5% of their revenues. This is in part due to the unfortunate reality that auditors are applying a "one size fits all" approach to their review and analysis of internal control procedures, notwithstanding contrary guidance from the Commission and the PCAOB. It is also due to the auditing firms' extreme fear of liability if they get it wrong, causing

them to leave no stone unturned, which in turn, substantially increases the fees they charge companies.

As expressed above, the Committee believes the most effective way to assure that the costs of the internal control over financial reporting requirements imposed on smaller public companies are commensurate with the benefits is to remove the auditor attestation requirement. Keeping the responsibility where it properly belongs – on management of the company with audit committee oversight-is the most effective way to protect public investors without financially harming the company through excessive auditing costs. Moreover, as part of the regular audit process the auditor already has and will continue to have involvement with the internal control process. While auditor attestation may provide greater assurance, the expected benefit does not justify the additional cost. Investors would be better served if that money were used for business operations.

While the Committee believes that eliminating the auditor attestation requirement for smaller public companies is justified, if the Commission declines to provide this targeted exemption from SOX Section 404(b), we recommend that the auditor attestation be limited to addressing management’s report rather than requiring the auditor to perform an independent audit of internal controls.<sup>1</sup> This could provide additional protection without requiring an inordinate amount of additional expense.<sup>2</sup>

#### Threshold for Accelerated Filers for Purposes of Section 404

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<sup>1</sup> Although Section 404(b) requires an auditor to “. . . attest to, and report on, the assessment made by management of the issuer,” we believe that Auditing Standard No. 2 as presently written essentially mandates a second audit by auditors. It is our belief that this “second” audit is not only not required under Section 404(b), but creates an expensive, time-consuming process that duplicates many existing requirements and procedures.

<sup>2</sup>We believe that the Commission’s authority in this regard stems from both the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and SOX itself. Section 36(a)(1) of the Exchange Act gives the Commission broad exemptive authority under the Exchange Act. SOX section 3(b)(1) provides that a violation of SOX will be treated as a violation of the Exchange Act. Therefore, under Exchange Act Section 36(a)(1), the Commission can adopt rules exempting classes of persons (here, smaller public companies) from compliance with Sox provisions, including SOX Section 404(b).

In addition, SOX Section 3(a) provides that the Commission shall promulgate rules as may be necessary in the public interest and in furtherance of SOX. For the reasons set forth in this letter, providing an exemption from SOX Section 404(b) for smaller public companies is in the public interest because over-spending on analyzing and testing internal controls negatively impacts the company’s business and stock value, which, in turn, hurts investors. Therefore, we believe that the Commission has the authority to exempt smaller public companies from SOX Section 404(b) as being in the public interest.

We believe that \$75 million in public float is not the appropriate threshold for purposes of SOX Section 404. Using this very low threshold subjects a substantial number of public companies to a significant new expense that disproportionately impacts such companies' financial performance and, in turn, shareholder value.<sup>3</sup>

Although companies with a public float of \$75 million or greater must comply with SOX Section 404 for fiscal years ending after July 15, 2005, increasing the threshold to eliminate these requirements would still benefit many smaller public companies in future years. Even though the initial implementation costs already would have been incurred, ongoing compliance costs still will be extremely high, perhaps 50% or more of the first year costs. In addition, every time a company changes its auditors or implements a new accounting or other material software system, significant new documentation and testing costs will be incurred.

We also believe that it would be better to consider a test other than public float for this purpose, since public float is not a characteristic that a company can directly or easily control or change. Further, the precise amount of a company's public float can change quickly, often as a result of market factors and not individual issuer factors. The Committee shares the Commission's concern that issuers not be permitted to move in and out of a reporting status frequently. We recognize that a larger public float generally means that there are more public investors and, therefore, potential greater regulatory need. However, the benefit to investors of management assessment and auditor attestation is more properly determined by other factors – such as size and complexity of the company – rather than public float. We believe that the most relevant factors are the total revenues, number of employees, number of business segments, number and nature of locations and similar measures of internal size and complexity. Use of a matrix of tests to identify the company as a non-accelerated filer may be useful in this regard. The Committee urges the Commission to consider an alternative approach and would welcome the opportunity to assist in developing data for this purpose.

#### Auditing Standards

We commend the efforts of the Commission and the PCAOB in providing guidance that emphasizes that “one size does not fit all” with respect to auditing smaller public

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<sup>3</sup>The August 10, 2005, Report of the Size Subcommittee to the Commission's Advisory Committee on Smaller Public Companies noted that companies with a market capitalization of less than \$100 million represented 1.0% of all U.S. public companies' market capitalization and approximately 50% of all U.S. public companies. Approximately 80% of all U.S. public companies have less than \$700 million in market capitalization.

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companies. As in all areas of auditing, judgment plays a major role. Therefore, whether the discussion is couched in terms of *standards* or *application*, we believe that the type and degree of testing and documentation should be commensurate with the risks presented by the particular company's business and operations. Nevertheless, despite the encouragement of the Commission and the PCAOB to avoid a "one size fits all" approach to internal controls, this has not been the case. Outside auditors are routinely taking an overly granular approach and applying the detailed requirements that are necessary for large enterprises to much smaller companies, rather than using a risk-based analysis. This adds a significant cost (in auditor costs and legal fees) and requires company personnel to sacrifice time that should be devoted to their normal business activities in order to complete tasks required by the auditors. For many, if not most, smaller public companies, the size, scope and complexity of operations, number of locations and number of employees simply do not require the rigorous and costly overlay of an independent review of internal controls beyond what already is required for auditors to pass on the company's financial statements.

Recently the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") issued an exposure draft, *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting*, seeking comments on proposed guidelines on the current internal controls framework, particularly as it applies to smaller public companies. We also are aware that the PCAOB is continuing to review its Auditing Standard No. 2 and shortly intends to issue guidance on internal control reviews to auditors based on common problems the board has observed in inspections of audit firms. Because of the potential significance of these efforts, we recommend that the Commission postpone the effectiveness of Section 404(b) for all companies with a market capitalization of less than \$700 million until the current COSO and PCAOB reviews are complete and the Commission has had the opportunity to evaluate the impact of any guidance or rules from these organizations. In addition, as the Commission noted in the Release, companies not currently subject to internal control requirements may be able to benefit from the experiences of accelerated filers in the second year of compliance with the internal control reporting requirements as best practices emerge and increased efficiencies are realized.

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The Committee appreciates the opportunity to comment on the Release and respectfully requests that the Commission consider the recommendations set forth above. We are prepared to meet and discuss these matters with the Commission and the staff and to respond to any questions.

Respectfully submitted,

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/s/ Dixie Johnson

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