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Ms. Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, NE, Washington, DC 20549-1090

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

File Number 4-511 / Internal Control Roundtable

Second-Year Feedback on Implementation of the Auditing and Reporting Requirements of Section 404 of the Sarbanes-Oxley Act of 2002

BDO Seidman, LLP ("BDO") appreciates this opportunity to share our perspectives on Section 404, *Management Assessment on Internal Controls,* of the Sarbanes-Oxley Act of 2002 ("Section 404") and on the Public Company Accounting Board's ("PCAOB") Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS 2"). The Sarbanes-Oxley Act was a significant and necessary milestone for investor protection, and the requirements of Section 404 are a reasonable and important part of achieving the objectives of the Act. However we believe there are still significant issues that need to be addressed by regulators, standard setters and auditors in order to ensure that the intent of Section 404 is achieved in an efficient and effective manner for all public companies.

Our perspectives are organized in the following sections:

- The Integrated Audit
- Cost-Benefit Debate
- Possible Approaches for Smaller Companies
- Restatements
- Concluding Remarks

The Integrated Audit

BDO believes the theory with respect to the integrated audit of internal control over financial reporting in conjunction with a financial statement audit, as set forth by AS 2 and supplemented by implementation guidance issued by the PCAOB, is fundamentally sound and does not require any significant changes for many companies, although certain further clarifications would be useful. Implementation of Section 404 and AS 2, taken together with the PCAOB's inspections of audit firms, has substantially improved the understanding of internal controls by both companies and auditors, and the overall quality of financial reporting and of audits being performed. Investors are benefiting from the improved quality of financial reporting, including increased disclosure of material weaknesses in internal controls, and management is benefiting from an improved understanding of financial reporting processes and systems and underlying risks. We also believe AS 2, as currently written, is sufficiently scalable for many companies to allow for flexibility in auditor testing based on risk, as well as flexibility to vary the nature, timing and extent of testing on a year-to-year basis, based on auditor judgment.

While we are confident of the benefits of the integrated audit of internal control over financial reporting, we believe ongoing work is still needed to continue improving both its efficiency and effectiveness. Successful performance of an integrated audit is a complex process involving both companies and auditors, including a strong foundational understanding achieved through training and experience, development of tools and methodologies, close coordination and execution, and ongoing development of judgment. These aspects take time to achieve, and will be continuously improved over a number of years.

With the benefit now of two years of implementation experience, BDO is focused on ways to continue improving both our effectiveness and efficiency in performing integrated audits. Internally we have recently held regional debrief meetings to assess what is working well and to identify areas for greater focus, and we are using this information to further refine our policies, practices, and training. At this juncture, we believe the two most important elements to continued improvement of integrated audits are judgment and experience.

Efficient execution of integrated audits is dependent on the quality of a company's implementation of Section 404. First and foremost, audit efficiency is dependent on the quality of a company's control environment and its implementation of a top-down, risk-based approach to assessing and implementing controls with pro-active audit committee and board of directors involvement to provide more than just lip-service to their oversight responsibilities. While many public companies appear to be making great progress in this area, others continue to struggle with this for various reasons. We also note that the control environment and company-level controls constitute one of the more difficult areas for

auditors to evaluate, particularly since existing guidance in AS 2 with respect to evaluating and testing these areas is minimal. Due to the importance of these areas for all companies, we recommend that guidance for both auditors and companies be expanded to help ensure that both management and auditor testing of company-level controls and the control environment is effective and efficient, and the results of such testing is appropriately considered by auditors in planning the nature, timing and extent of detailed control activities.

During the past year, there has been much focus on the use of a top-down, risk-based approach to the audit of internal controls. We believe these concepts are essential to an effective system of internal controls, and to an effective integrated audit approach. However, we do not believe that effective implementation of these concepts necessarily results in significant simplification for companies or auditors. Because of the current complexity of financial reporting, and since the majority of companies are not static in nature, we believe the number of "key" controls that companies must maintain will continue to be significant. Evaluating risk, and assessing whether controls appropriately address identified risks, is an ongoing and demanding process that should not be left on auto-pilot.

The concept of an integrated audit is not new. Many audits of financial statements of larger, more complex companies have historically included auditor testing of and reliance on certain internal controls to significantly reduce the nature and extent of substantive testing of selected account balances and transactions. This occurs because it is impractical and sometimes not possible to substantively test balances and transactions at larger, more complex companies due to complexity and large volumes of activity. As a result, it is essential to the efficient and effective performance of financial statement audits of these companies to also test and rely on some effective internal controls. Also, the evidence gathered during performance of the financial statement audit is an essential component of the auditor's assessment of the effectiveness of internal controls. These interrelationships of the internal control and financial statement audits are in fact what give rise to the concept of an "integrated audit." Due to these interrelationships, we do not agree with the suggestion of some that the audit of internal controls may be performed by someone other than the financial statement auditor.

Cost-Benefit Debate

There has been much discussion and rhetoric with respect to the costs and benefits of Section 404, particularly with respect to attempts to quantify and analyze specific data. The assessment of costs (including non-monetary burdens) and benefits is inherently subjective in nature and does not lend itself to objective quantification. Most studies and statistics regarding this subject are therefore inherently limited and, as a result, can be misleading.

At BDO, we believe that the benefits of Section 404 strongly outweigh the costs for many companies, particularly the larger, more complex companies. The increased focus on internal controls at these companies is resulting in higher quality financial reporting, AS 2 is resulting in more robust audits, and managements of the larger companies are generally supportive of the benefits. We also believe auditor testing of internal controls at larger, more complex companies is a necessary component of an efficient and effective financial statement audit due to the previously described auditor reliance on selected internal controls for purposes of the financial statement audit. The guidance within AS 2 is theoretically sound and has helped auditors to better connect their work on internal controls with financial statement risks. While, on certain engagements, auditors have historically tested and placed reliance on selected internal controls prior to AS 2, we believe that they may not have always clearly linked internal control testing with financial statement risk. As a result of improvements in this area primarily due to AS 2, and due to increasing integration of the financial statement and internal control audits, we believe it is difficult to isolate the costs and benefits of the audit of internal controls from the costs and benefits of the integrated audit as a whole. Thus, any measure of improvement of audit costs should focus primarily on comparing total audit costs on an apples-to-apples basis.

The cost-benefit debate becomes more challenging in the context of smaller public companies. There are many reasons why smaller public companies are different and why AS 2, as currently written, and the COSO exposure draft on smaller public company reporting on internal controls may not result in an effective or efficient approach for documenting and testing internal controls for such companies. Important differences to consider include the following:

1. Managements of larger, more complex companies generally need to rely on strong systems and controls in order to ensure that financial data is sufficiently reliable to effectively manage the business. The simpler organizational structure at smaller companies means top management is less reliant on systems and detailed controls and more reliant on company-level controls, or controls performed by the CEO and CFO – i.e., “management’s daily interaction” – and on other less formal, people-based controls. While management’s daily interaction and other people-based controls may be an effective means of control for smaller companies, these types of controls are difficult for companies to sufficiently document and for auditors to test.
2. AS 2 is based on the premise of an integrated audit. However, smaller public companies often cannot obtain the same benefit as larger ones from the integrated audit concept. As previously stated, for auditors of larger, more complex companies, it is often both necessary and beneficial to place significant reliance on controls when performing the financial statement audit, since it is often not practicable to substantively test detailed balances and transactions to the same extent as if there were no controls reliance. However, for smaller companies with less complex environments,

it is generally unlikely that the auditor will adopt an audit strategy of placing significant reliance on effective internal controls to reduce the scope of substantive testing. This occurs since there is less efficiency of scale at a smaller company and since it is more difficult for the auditor to establish that people-based controls can be relied on when system-based controls are not as strongly developed.

3. Smaller public companies generally do not have the same depth of internal resources as larger ones and typically have fewer internal staff dedicated to understanding and implementing the large number of complex accounting standards. As a result, smaller public companies are more dependent on external service providers, and qualified, cost-effective external services are more difficult for these companies to secure in today's resource-limited environment. As a result, smaller public companies are more dependent, within the constraints of the independence rules, on interaction with their audit firms with respect to financial reporting matters.
4. Due to the increased importance of management's daily interaction with other company personnel and the lack of depth of internal resources, top management of smaller companies generally is required to spend a greater proportion of time to initially achieve and subsequently maintain compliance with the requirements of Section 404, or hire resources to do this. These same members of top management are often central to the competitive success and well-being of smaller companies, and unduly burdensome compliance requirements have a direct negative effect on top management's ability to focus on other aspects of the business.[1]

While many companies will successfully reduce the monetary cost of compliance with Section 404 over time, because of the above factors, we believe the costs and burden will continue to be disproportionately higher for many smaller public companies. We also believe the costs and burden of Section 404 are particularly acute in certain industry segments, most notably emerging technology companies. The ability of these companies to succeed is primarily based on their ability to innovate, adapt, and remain nimble. However, the systems and processes necessary to comply with Section 404 as currently being implemented are not always consistent with these characteristics. In this regard, we note that Section 404 does not, and is not intended to, address controls pertaining to the effectiveness of operations at a company.

In order to improve the cost-benefit equation, we believe it is essential to develop a right-sized, scalable approach to internal controls that is better suited to the unique needs of the smaller companies while still providing investors with the protection intended by Section 404.

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[1] Refer to the National Venture Capital Association letter dated April 3, 2006 that discusses "management and board distraction," among other factors, including cultural differences and entrepreneurship.

Possible Approaches for Smaller Companies

Depending on how one chooses to define a smaller public company, up to 80% of all public companies could be characterized as smaller. Due to the large number of smaller public companies participating in the U.S. capital markets, and the importance to these smaller companies of access to our capital markets, we believe it is important to reach agreement on an acceptable approach to internal controls for these companies that provides an appropriate level of investor protection in a cost beneficial manner. We believe this can be accomplished, notwithstanding the current polarized debate, which seems to be unduly focused on the extremes of "exemption" or "one size fits all" regulations and auditing standards.

We believe all public companies, including smaller public companies, should be required to maintain effective internal control over financial reporting, including controls to prevent and detect fraud, and management of all public companies should be required to assess and publicly report on the effectiveness of those controls. We also believe that auditors should be required to perform some level of procedures to identify and report on internal control deficiencies. However, because of the differences between larger and smaller companies, we think this should allow for a more flexible approach with respect to internal controls for smaller companies and we believe there may be a number of potential alternative approaches, some of which are set out in our letter to the SEC dated April 3, 2006, relating to the Exposure Draft of the Final Report of the Advisory Committee on Smaller Public Companies.

Based on the previously discussed unique characteristics of smaller public companies, it is more difficult and burdensome for these companies to design and document internal controls using the existing COSO framework or the proposed COSO guidance for smaller companies in a manner that is sufficient to allow for external audit of internal controls in accordance with AS 2. We believe that additional internal control implementation guidance is needed for smaller companies. However we do not believe that auditability should be a primary consideration. Reducing the focus on auditability should reduce the burden on management to an appropriate level and, for smaller, less complex companies, should also result in a more realistic and effective approach that is not overly focused on detailed controls and auditor documentation. We support creation of a multidisciplinary pilot program that has been proposed by others consisting of representatives of smaller company investors and management, accounting firms, regulators, standard setters, as well as members from the existing Advisory Committee to explore various approaches and develop additional implementation guidance.

In considering various approaches for smaller companies, we do not believe that an audit of internal controls for smaller companies is necessary to ensure that investors can place the same degree of reliance on the annual financial statements of these companies as on

those of larger public companies. At smaller, less complex companies, auditors typically perform a substantive financial statement audit based on more extensive testing of account balances and transactions, and do not place substantial reliance on internal controls to reduce the nature and extent of this testing. This approach is used at these companies because it is more efficient, and because it is difficult to obtain sufficient evidence that controls are effective to rely extensively on those controls. As a result, when a substantive audit approach is used by auditors of smaller companies, the reliability of the annual financial statements is not necessarily enhanced by the performance of an audit of internal controls, whereas for larger, more complex companies, testing of balances and transactions is often significantly reduced based on auditor reliance on internal controls and, as a result, the audit of internal controls is a necessary component of the integrated audit.

In a smaller company environment, we believe the majority of material weaknesses in internal controls can be identified through performance of the financial statement audit without detailed audit testing of specific control activities. The auditor's identification of material weaknesses during the financial statement audit requires the auditor to be alert to and consider various indicators that a material weakness could exist. The auditor's understanding of the design and implementation of internal controls that should be gained on all audits from the performance of walkthroughs of a company's processes and controls can contribute significantly to the auditor's ability to identify potential material weaknesses without performing detailed tests of internal controls. This approach could allow management to take a more flexible approach to designing and documenting a company's controls, since management's approach would no longer be driven by auditability considerations. However, under AS 2, this approach would likely not be sufficiently robust to allow the auditor to report on the effectiveness of controls.[2]

Any deficiencies in internal controls identified as a result of the auditor's substantive financial statement audit testing should be evaluated to determine if they represent material weaknesses (as required by SAS 60). Smaller companies could then be required to disclose any identified material weaknesses in addition to any disclosures that would currently be required under Section 302 and these could be included in some manner in the auditor's attestation report on the financial statements. Such inclusion could go so far as to conclude that when material weaknesses have been identified, a company's internal control over financial reporting is not effective.

In developing the appropriate right-sized approach, it is important to keep in mind the existing benefits of the other non-Section 404 investor protections mandated by the Sarbanes-Oxley Act that continue to apply to all public companies, including smaller ones. It is also important to keep in mind the proposed recommendation for increased

[2] AS 2 Paragraph 158 states "the absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective."

governance requirements for smaller public companies that has been made by the Advisory Committee on Smaller Public Companies. We support this recommendation.

It is clear that there is no perfect solution to the application of Section 404 to smaller public companies, and any final approach will involve trade-offs. For example, the regulations to implement Section 404 currently contain other significant trade-offs, such as the exclusions for recent acquisitions and for new registrants. In the latter case, investors in an initial public offering ("IPO") do not receive any of the protections offered by Section 404 until at least one year after completion of the IPO, and we believe many investors in IPOs are unaware of this exemption. We believe the rationale behind these existing policy accommodations should be considered in any analysis of the needs of investors in smaller public companies.

Restatements

There has been much focus and debate concerning the increasing number of restatements by public companies. It has been recently reported that there were 1,295 restatements in 2005, compared with 650 in 2004. Some have also pointed out that a large portion of these restatements occurred at smaller public companies. While some number of the restatements resulted from identification of errors through improved controls, we believe that many restatements, particularly with respect to smaller public companies, are primarily due to the ever increasing complexity of accounting standards. Many smaller public companies lack the internal resources necessary to correctly apply the numerous complex accounting standards that exist today, and auditors also struggle to consistently identify all of the issues that arise. As a result, particularly for smaller public companies, we expect there will continue to be a high rate of restatements regardless of the smaller companies' compliance efforts with Section 404.

The increased number of restatements may also be attributable to a significant change in auditor diligence due in large part to the PCAOB's robust inspection process. In this regard, we encourage the PCAOB to continue to provide meaningful feedback to auditors on ways to improve the effectiveness and efficiency of audits while also continuing to encourage professional judgment, which we believe is essential to the audit process. We believe comments provided to BDO on our own inspection have been valuable in helping us improve the quality of our audits.

Concluding Remarks

In summary, we believe the question with respect to Section 404 is **how** it can be implemented in an efficient and effective manner at smaller public companies, and not **if** it should be implemented. Accordingly, we believe that auditors, regulators, standard setters, investors and other stakeholders should work closely together to further consider alternative approaches and guidance for smaller public companies and to develop a right-

sized, cost effective approach to implementing Section 404 that gives appropriate weight to investors’ needs.

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We would be pleased to answer any questions you have about our comments and look forward to continued participation in the standard setting process. Please contact Jay Howell, Associate Director of Assurance, at (415) 490-3270 or via electronic mail at jhowell@bdo.com, Wayne Kolins, National Director of Assurance, at (212) 885-8595 or via electronic mail at wkolins@bdo.com, or Lee Graul, National Director – SEC Practice, at (312) 616-4667 or via electronic mail at lgraul@bdo.com.

Very truly yours,

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