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

Re: File No. S7-06-03
Release No. 33-8618
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

Dear Mr. Katz:

BDO Seidman, LLP is well positioned due to the nature of our client base to provide meaningful input with respect to the Staff's questions in the Release pertaining to application of internal control reporting requirements to smaller public companies.

In that regard, we appreciate this opportunity to comment on the application of internal control reporting requirements to smaller public companies. We commend the significant efforts of the Commission and the Advisory Committee on Smaller Public Companies in considering internal control reporting requirements specifically in the context of smaller public companies, and also commend the Commission's recent decision to further delay Section 404 compliance dates to provide additional needed time to appropriately consider the internal control reporting requirements for these companies.

Our comments with respect to the Commission's questions are organized as follows:

- Key distinguishing characteristics of smaller public companies
- Recommended approach to internal control at smaller public companies
- Definition of smaller public companies
- Ensuring costs are commensurate with benefits

Key Distinguishing Characteristics of Smaller Public Companies

Should there be a different set of internal control over financial reporting requirements that applies to smaller companies than applies to larger companies? Would it be appropriate to apply a different set of substantive requirements to non-accelerated filers, or for management of non-accelerated filers to make a different kind of assessment? Why or why not?

BDO believes smaller public companies should be required to maintain internal controls over financial reporting based on a recognized framework that is specifically tailored to them. We also recommend a different set of auditor attestation requirements pertaining to internal control over financial reporting for smaller public companies that is better suited to address their unique characteristics.

Section 404 was enacted as a result of control related business failures at large companies that had widespread impact on investors, employees and other interested parties. Section 404 and the related auditing standards created to implement it were not designed with consideration of smaller companies, so the risk equation and cost-benefit analysis with respect to Section 404 generally appears to be significantly different for smaller companies than for larger ones. We believe this because:

1. Capital at risk for these companies is much smaller. A control failure at a smaller company does not have the same potential for widespread effect on investors and other stakeholders.

2. Risk taking is generally more critical to a smaller company's business strategy than for a larger company, particularly for entrepreneurial growth oriented smaller companies. Smaller companies are generally less diversified than larger companies, and as a result, have a higher volatility rate attributable to business risk. Risk management, as opposed to risk taking, and the resultant controls become more important as a company grows larger and more established. As a result, at smaller companies the risk of failure of internal controls over financial reporting is ordinarily less important to the ultimate success of the company, and thereby to investors, in proportion to the risk of failure from competitive factors than for larger companies.

3. Management of larger, more complex companies need to rely on strong systems and controls in order to ensure that financial data is reliable to effectively manage the business. The simpler organizational structure at smaller companies means top management is less reliant on systems and resultant 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 people based controls. Therefore, in a smaller company, the quality of a limited number of key individuals is generally more important to the reliability of financial reporting than underlying systems and detailed controls. While management's daily interaction and other people based controls can be an effective means of control for smaller companies, they are not practical to formally document and test, although some measure of less formal corroboration may be possible.

4. Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS 2), is based on the premise of an integrated audit. However, smaller public companies may not receive the same benefit as larger ones from the integrated audit concept. For auditors of larger, more complex companies, it is sometimes necessary to place significant reliance on controls when performing the audit, since it is typically not practicable to substantively test to the scope that would be required if reliance on controls were not warranted. However, with smaller companies with less complex environments, it is less likely 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 reliance based on people dependent controls as opposed to system dependent controls.

5. Smaller public companies generally do not have the same depth of internal resources as larger ones and typically do not have internal staff dedicated to understanding and implementing the latest accounting standards. As a result, smaller public companies are much 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. In addition, smaller public companies are more dependent, within the constraints of the independence rules, on their audit firms for guidance with US GAAP and financial reporting matters.

6. Due to increased importance of management's daily interaction 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 wellbeing 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.

7. The cost of implementing and maintaining 404 is proportionately significantly higher for smaller companies.

Based on the above factors, the existing COSO framework and audit requirements of AS 2, when taken together, are a less than optimal approach for smaller public companies. Accordingly, we believe alternative guidance for smaller companies and alternative audit approaches should be considered. While we believe aspects of COSO's draft <u>Guidance for Smaller Public Companies on Internal Control over Financial Reporting</u> should be useful to smaller public companies, this guidance has just recently been exposed for public comment. We believe additional work is needed to assess whether the COSO framework itself is appropriate for smaller public companies, or whether a better framework can be developed. While smaller public companies should be required to maintain internal controls over financial reporting and publicly attest to the effectiveness of those controls, we believe this requirement is dependent on first reaching agreement on an appropriate framework that balances the needs of all stakeholders and is tailored to the unique aspects of smaller public companies.

Recommended Approach to Internal Control at Smaller Public Companies

If you think that there should be a different set of requirements for companies that are not accelerated filers, what should those requirements be? What would be the impact of any such differences in the requirements on investors? Should the independent auditor attestation requirement be different for smaller public companies? If so, how should the requirements differ?

Described below for consideration is our recommended alternative approach for ensuring that smaller public companies maintain effective controls over financial reporting. It focuses on tests of the control environment, including relevant company level controls and proper tone at the top (hereinafter referred to as the "overall control environment"), and the substantive financial statement audit procedures. We believe our proposed alternative approach reflects the many unique aspects of smaller public companies discussed above, and appropriately balances the importance of maintaining strong controls with the needs and concerns of smaller public companies and their investors. We recognize that our proposed alternative approach would require changes to existing SEC rules and PCAOB auditing standards in order to be implemented.

Ultimately, any approach required for smaller companies will be a balance of numerous considerations and embody a degree of compromise. The objective is to design an approach that continues to provide investors with reasonable assurance that financial statements are fairly stated while not burdening them with excessive costs.

Proposed Substantive Audit / Overall Control Environment Based Approach

The following alternative model to the existing audit requirements of AS 2 places primary emphasis on the substantive audit and overall control environment, and is based on a premise that, for smaller public companies, an effective overall control environment is the most important element of maintaining effective controls over financial reporting. We believe this model is the basis for a more suitable approach to fulfill the intentions of Section 404 than the existing audit requirements of AS 2.

Key elements and concepts of our proposed approach include the following:

1. Management's Assessment. Smaller public companies would still be required to maintain internal controls based on a recognized framework of internal controls over financial reporting and would be required to document and report on management's assessment of the effectiveness of those controls. Management's assessment would not be required to be evidenced by formal documentation and testing of detailed control activities, and instead would typically be based on management's knowledge and understanding of controls based on its daily interaction and oversight of the entity and informal testing as determined appropriate by management. This approach allows management to determine how best to meet its responsibility to maintain effective internal control over financial reporting in accordance with the internal control framework used, and recognizes that there is a broad

array of evidence available for management to use in making its assessment. However, due to the particular importance of the overall control environment, management would be required to more formally document its testing and assessment of the effectiveness of this element of controls. Appendix B to COSO's draft guidance for smaller public companies contains an evaluation matrix that management could use for this purpose.

2. Auditor Attestation. The auditor would attest to the effectiveness of the overall control environment based on specific testing of this element of controls, and based on findings in the financial statement audit that have a meaningful bearing on the auditors' understanding of the effectiveness of the overall control environment. However, because the auditor would not be required to test detail control activities, the auditor's report would disclaim an opinion on the effectiveness of internal control over financial reporting as a whole. This disclaimer would not cause the audit of an issuer's financial statements to be viewed as incomplete as long as the report on the effectiveness of the overall control environment is included.

3. Reporting of Material Weaknesses. Any deficiencies in internal controls identified as a result of testing the overall control environment or through the auditor's substantive financial statement audit testing would be evaluated to determine if they represent material weaknesses (as required by SAS 60), and all identified material weaknesses would be disclosed by the company and included in the auditor's attestation report. In this situation, the auditor's report would indicate that internal controls over financial reporting are not effective. Failure by an issuer to correct identified material weaknesses on a timely basis would be a strong indicator of a material weakness in the overall control environment.

4. The Overall Control Environment. Additional guidance for companies and auditors with respect to the overall control environment should be considered to ensure that company practices and auditor testing are each sufficiently robust to support the auditor's opinion on the effectiveness of the control environment. The overall control environment includes tone at the top, effective board oversight, corporate governance policies and practices, and codes of conduct and fraud prevention programs. In addition, the overall control environment should be defined to encompass relevant company level controls such as management's risk assessment process and controls to monitor results of operations.

5. Substantive Audit Procedures. Performance of substantive audit procedures can provide significant indirect evidence with respect to the effectiveness of internal controls over financial reporting at smaller public companies. Particularly for smaller companies, the material weaknesses that exist are more often identified through substantive audit tests than through detailed testing of controls. As a result, for smaller companies, we believe the performance of substantive audit procedures is the more effective way to identify material weaknesses. Expanded guidance for auditors with respect to identification of material weaknesses in internal control over financial reporting when performing the substantive audit procedures would be useful. This could include indicators that auditors should look for and expanded procedures to perform to determine if a material weakness exists.

6. Walkthroughs. Walkthroughs are an important element of any financial statement audit and should also still be performed in accordance with AS 2 for each major class of transactions.

7. General Awareness. The significant increase in general awareness about internal controls among auditors, management and audit committees that has occurred in the past couple years will also benefit smaller public companies, and is an important element of the effectiveness of this approach. As a result of this increased awareness, auditors are now much more likely to recognize material weaknesses as a result of substantive testing and to require disclosure of those weaknesses. We expect this increased awareness to continue due to the ongoing application of AS 2 to larger companies.

8. Placing Reliance on Controls. When the auditor decides to place extensive reliance on internal controls to reduce the nature and extent of substantive testing, the auditor should be required to test those controls in accordance with AS 2, and issue a report on the effectiveness of those controls. It would only be in situations where the auditor performs a substantive audit, and does not place extensive reliance on controls, that the alternative approach we are recommending would apply. Auditors could still place some reliance on controls in limited situations based on limited testing of those controls without performing an AS 2 audit. As a company grows and becomes more complex, this provides for a natural mechanism to transition to the requirements of AS 2 as follows:

    a. The company's systems and controls will presumably become more developed since management requires more formally developed systems and controls to manage the business. People dependent controls will become more systems based.
    b. As a result, it will become possible for the auditor to adopt an audit strategy of extensively relying on controls.
    c. Placing reliance on controls to reduce the substantive work, including performance of an AS 2 audit, will become a more cost effective way to audit the company.
    d. Placing extensive reliance on controls will at some point become necessary due to the size and complexity of the company – i.e. it is no longer practical to audit the company substantively.

   In order to address situations where, due to the nature and complexity of a particular smaller public company, reliance on controls is more pervasive, we recommend consideration of the following audit committee requirements:

    a. Discuss with the auditor the planned audit approach with respect to reliance on internal controls in the context of the nature and complexity of the company.
    b. Determine whether the auditor should perform a full audit of internal controls over financial reporting in accordance with AS 2 based on its discussions with the auditor, its consideration of investors' views, and any other considerations deemed appropriate by the audit committee.

Definition of Smaller Public Companies

Would a public float threshold that is higher or lower than the $75 million threshold that we use to distinguish accelerated filers from non-accelerated filers be more appropriate for this purpose? If so, what should the threshold be and why? Would it be better to use a test other than public float for this purpose, such as annual revenues, number of segments or number of locations or operations? If so, why?

We generally support the work and recommendations of the Size Committee of the Advisory Committee on Smaller Public Companies as presented in that committee's report dated August 10, 2005.[1] The Size Committee's report recommends two separate tiers of smaller public companies be considered:

> Smaller Public Companies – approximately the bottom 6% of market capitalization
> Microcap Public Companies – approximately the bottom 1% of market capitalization

We support the use of this multi-tiered approach in order to separately distinguish the microcap companies since they represent a much smaller portion of total market capitalization, their structures are even more compact, and their sensitivity to regulatory burden is more pronounced. In that regard, we recommend the alternative approach described above for internal controls audits first be successfully implemented for the smaller public companies excluding the microcaps. Once the new approach has been successfully implemented, an appropriate approach for the microcaps can be considered. Accordingly, for microcaps, we recommend that the internal control reporting requirements continue to be deferred until a new approach has been successfully implemented for the smaller public companies. Therefore, we believe it is premature at this time to permanently exempt microcap companies from the requirements of Section 404.

In addition to the Size Committee's work, we note that because smaller companies vary greatly in nature and complexity, use of market capitalization alone is not necessarily a meaningful way to determine whether a company should be subject to an audit of internal controls under AS 2. Accordingly, our proposed alternative model also provides a mechanism to determine the applicability of AS 2 based on the audit approach taken (i.e. substantive versus controls reliance) based on the nature and complexity of the Company.

To supplement the above proposed approach, we believe it would still be appropriate to use a market capitalization metric to ensure that companies exceeding a certain market capitalization (say $700 million) are required to obtain an audit in accordance with AS2, regardless of the audit approach used.

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[1] The Size Committee's report is publicly available at http://www.sec.gov/rules/other/265-23/adavernslides081005.pdf

Ensuring Costs are Commensurate with Benefits

How can we best assure that the costs of the internal control over financial reporting requirements imposed on smaller public companies are commensurate with the benefits?

Implementation of a new approach to reporting on internal control for smaller public companies based on our recommended approach as described above should help ensure that costs are commensurate with benefits. We also believe that this approach could lead to a more effective audit of internal controls for these companies because of the sharper focus on those COSO elements that would tend to highlight material weaknesses.

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We would be pleased to answer any questions the Commission might have about our comments and look forward to continued participation in the standard setting process. Please contact Wayne Kolins, National Director – Assurance Practice, 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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