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September 14, 2006

Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-06-03
Release No. 33-8731
Internal Control over Financial Reporting in Exchange Act Periodic Reports of
Non-Accelerated Filers and Newly Public Companies

Dear Ms. Morris,

This letter is the response of BDO Seidman, LLP to your request for comments regarding the above proposal.

Deferral of Compliance Dates

We support the Commission's proposal to further delay the Section 404 compliance dates for non-accelerated filers. We believe that an effective case has been made that requiring non-accelerated filers to comply as scheduled would place an undue burden on them. We agree that a deferral is needed to provide time for the Commission to develop and issue guidance for management's internal control assessment process and the Public Company Accounting Oversight Board to complete its planned amendment of Auditing Standard No. 2¹ and its guidance on the application of AS 2 to smaller public companies.

At this point, it is not clear to us whether the proposed extended compliance dates will be sufficient. That will depend on when the management guidance and AS 2 amendment are issued. It will also depend on the content of that guidance and the degree to which it is able to achieve what has been the elusive goal of cost-effective internal control assessments and audits for smaller companies. If it takes longer than expected to provide this guidance, we believe the Commission should consider further delaying the compliance dates.

As discussed below, we have concerns as to whether implementing management and auditor reporting on internal control sequentially is appropriate. If the Commission

¹ Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (AS 2).



concludes that this is not appropriate, then we believe the Commission should further delay management reporting, rather than accelerate auditor reporting.

Sequential Implementation of the Compliance Dates for Sections 404(a) and 404(b)

We understand the practical considerations underlying the proposal for sequential implementation of management and auditor reporting on internal control and, accordingly, we do not disagree with it. However, we have concerns about the approach of having management report on internal control without an auditor attestation.

While we agree that requiring non-accelerated filers to begin the internal control assessment process now, rather than allowing them to wait another year, is the right course of action, it should be recognized that investors will not be provided the same high level of assurance that would otherwise be achieved through a combined effort of management assessment overlaid with auditor attestation. While auditors of financial statements have responsibilities relating to internal control matters (e.g., obtaining an understanding of internal controls sufficient to plan the audit, communicating certain internal control deficiencies to management, and reading other information in a document and taking action if he or she concludes that it contains materially misleading information), these procedures are not sufficiently rigorous to provide the degree of assurance contemplated by Section 404. As discussed in our comment letter on the Commission's *Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting*,² we encourage the Commission to provide guidance to help management perform evaluations that are sufficiently rigorous to provide a high level of assurance that effective internal control was maintained, regardless of whether there is concurrent auditor reporting on internal control.

Given these concerns, if the Commission decides to proceed with sequential implementation, we believe it should require prominent disclosure designed to ensure that investors understand that the management-only reports furnished in the first year are unaudited and that the auditor has not rendered an opinion on the effectiveness of the company's internal control. We expect that auditors will continue to communicate this in their reports on their audits of financial statements.

As the Commission considers the potential risks and benefits of sequential implementation, we urge it to consider the possibility that sequential implementation may lead to difficulties in the second year if auditors reach different conclusions regarding internal control effectiveness than management reached in the first year. While the Commission's proposal to allow the initial management-only report to be furnished rather than filed may reduce management concerns about litigation risk in this situation, when management has

² Release No. 34-54122, File No. S7-11-06.



publicly stated a different earlier view regarding control effectiveness, they might be motivated to dispute the auditor's conclusion. To reduce this risk, we encourage the Commission and its staff to continue to encourage issuers to involve their auditors in the first year management-only reporting process.³

Transition Period for Section 404 Compliance Dates for Newly Public Companies

We believe investors would be well served if companies were required to report on internal control in their initial registration statements, particularly if the offering covers a large amount of securities. However, because of the practical problems the Commission articulated in the proposing release, on balance we support the Commission's proposal to provide a transition period for newly public companies before they become subject to compliance with Section 404.

We suggest that the Commission clarify in the commentary in the adopting release how the transition rules will apply when a company becomes an Exchange Act registrant after its year-end but before it is required to file financial statements for that year-end. In the commentary in the proposing release, the Commission stated that in the future, any company filing an initial registration statement will be required to report on internal control "as of the end of the fiscal year in which it becomes a public company," so the Commission has proposed transition rules to avoid this. It is not clear to us how the rules would apply in situations where a company has its initial registration statement declared effective shortly after its fiscal year-end using financial statements covering nine months (six months in the case of a foreign private issuer) of its latest completed fiscal year instead of full-year financial statements. In these situations, the company's first Form 10-K is due shortly after the effective date – within 90 days of the company's fiscal year-end if it registers under the Exchange Act. For example, a domestic company with a calendar year-end could have its initial Securities Act registration statement declared effective on February 10, 2008, even though the most recent financial statements included in that filing were for the nine months ended September 30, 2007. We read the proposed rules to say that that company's Form 10-K for the year ended December 31, 2007 would be considered its first required annual report, and it would be required to report on internal control in its Form 10-K for the year ended December 31, 2008 – as of the end of the fiscal year in which it became a public company. Conversely, if the company did not register under the Exchange Act it would be required to file a "special financial report" for the year ended December 31, 2007 under cover of Form 10-K pursuant to Exchange Act Rule 15d-2, the Form 10-K for the year ended December 31, 2008 would appear to be considered its first required annual report, and it would not appear to be required to report on internal control in its 2008 Form 10-K.

³ See speech by John W. White, Director, Division of Corporation Finance, *SOX 404 – Moving Forward*, September 12, 2006.



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We appreciate the opportunity to express our views to the Commission. We would be pleased to answer any questions the Commission or its staff might have about our comments. Please contact Wayne Kolins, National Director of Assurance, at (212) 885-8595 or via electronic mail at wkolins@bdo.com, or Lee Gaul, National Director – SEC Practice, at (312) 616- 4667 or via electronic mail at lgraul@bdo.com.

Very truly yours,

BDO Seidman, LLP