

February 15, 2006

**Via e-mail: rule-comments@sec.gov**

Section 404 Subcommittee  
Advisory Committee on Smaller Public Companies  
Securities and Exchange Commission

**File Number 265-23**

Thank you for the opportunity to provide written comments to the SEC's Advisory Committee on Smaller Public Companies—Section 404 Subcommittee's request for input on its draft recommendations to relieve small companies of the burdens of complying with Section 404 of the Sarbanes-Oxley Act of 2002 (SOx).

I am submitting these comments on behalf of my clients and other companies that fall into the proposed Micro- and Small-Cap tiers who have already complied with SOx. These companies took the initiative to comply that demonstrates their "tone-at-the-top" in the spirit of the legislation to heighten the importance of proper financial controls and transparency of investor disclosures. Now, under the Subcommittee's recommendations, which would dilute the requirements under the guise of lowering compliance costs, these companies would find themselves in a position where they would be forced to compete with companies that have not complied, creating an uneven playing field. Further, the costs that these companies have incurred would essentially represent a significant monetary penalty, which they could have avoided if they had taken a "wait and see approach", hoping for relief that this Subcommittee now recommends. Consequently, the proposals are unfair to companies that have already taken steps to comply and, equally important, also eliminate any incentive for Micro- and Small-Cap companies to move ahead with compliance efforts rather than wait for another extension.

I am a CPA with 20 years of professional accounting experience, which includes public accounting as an auditor, internal audit, financial management and consulting. For the past two years, my firm has consulted with a variety of public companies (both large and small) in their efforts to comply with SOx. Based on my experience in general, and particularly my hands-on SOx experience, I have several observations on the notion that SOx Section 404 overly burdens small public companies.

The Subcommittee's objective of recommending scaling the regulations on internal controls that enhance compliance and reduce costs and rightsizing within the spirit of Section 404 is not an easy task. I appreciate the Subcommittee's work and thank the Subcommittee for the opportunity to comment in this forum.

The Subcommittee cites certain background facts to support its conclusions and recommendations in its PowerPoint presentation (available at the SEC's website <http://www.sec.gov/info/smallbus/acspc/pr-intcontrol.pdf>). I do not dispute these facts. However, I think that the facts presented may not necessarily support clear and convincing conclusions and recommendations; especially when, as in the case of SOx, all facts may not yet be known.

In the following pages, I discuss these conclusions and comment on each category. I have addressed all of the Subcommittee's conclusions, but have re-grouped them into the following categories.

- Macro-Economic Risk                      Conclusions 1 and 9(a)
- Micro Economic Risk                      Conclusions 3, 6 and 7
- Compliance Costs                        Conclusions 2, 4 and 9(b)
- Lack of Specific Guidance                Conclusions 5 and 8

## Macro-Economic Risk

CONCLUSION No. 1: Micro- and Small-Cap Public Companies proportionately represent a significantly smaller risk to the capital markets than large public companies

CONCLUSION No. 9(a): Disproportionate compliance burden will likely have a negative effect on the competitiveness and capital formation ability by smaller companies, thus hurting the U.S. economy.

The Subcommittee's Conclusion No. 1 is that Micro- and Small-Cap companies represent only 6% of the total public market capitalization of companies listed on the stock exchanges in the United States. In so concluding, the Subcommittee appears to be taking a top-down, risk-based approach that is laudable. This risk-based approach seems to suggest that if such a small percentage of the total public capitalization is "at risk" then requiring these public companies to comply is an unnecessary burden. That is, the amount at risk is immaterial to the U.S. economy overall.

The Subcommittee states, in Conclusion 9(a), that burdening new companies with Section 404 and the associated costs to comply would lead to fewer firms going public (that is, decreasing the IPO rate) and, as a result, hurt the U.S. economy.

Taken together, these conclusions appear to be contradictory: while the amount of capital represented by Micro- and Small-Cap companies is immaterial to the economy, a decrease in the growth rate of this immaterial amount would be materially detrimental to the economy.

While each conclusion may be true in theory, these two conclusions cannot both be true.

## Micro-Economic Risk

CONCLUSION No. 3: There are fundamental differences between larger and smaller companies

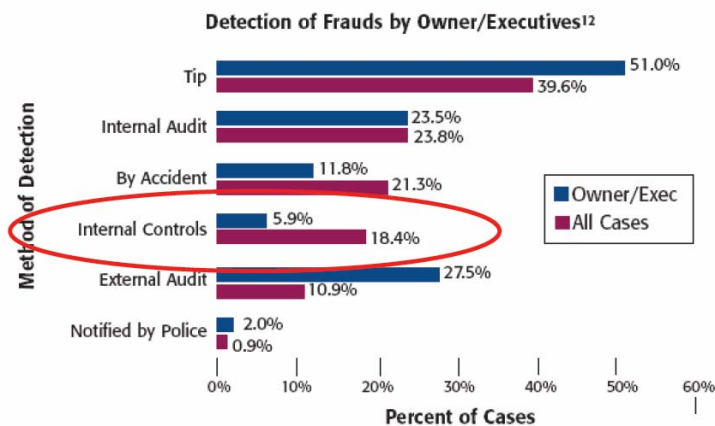
CONCLUSION No. 6: Investors recognize that smaller companies carry greater investment risk.

CONCLUSION No. 7: In smaller companies, the risk of management override is significant; internal controls over financial reporting are not as effective as other techniques to detect and prevent fraud by senior executives.

The Subcommittee lists two ways (Conclusion No. 3) in which small and large companies differ: The first is that management of large companies must rely on internal controls due to sheer size and complexity of their organizations; whereas the managers of smaller companies have the ability to be “hands on” in daily activities. In fact, the Subcommittee explains that:

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.” In small companies, the quality of a limited number of key individuals is generally much more important than detailed controls. While management’s daily interaction can be a highly effective control for smaller companies, it is not practical for the company to document and the auditor to test.

However, under Conclusion No. 7, the Subcommittee suggests that this lack of documented controls provides opportunities for these “hands-on” executives of smaller companies to override any controls that are present to commit fraud. Further, the Subcommittee included the following diagram (the source of which was noted as: Association of Certified Fraud Examiners (ACFE) 2004 Report to the Nation (pre-AS2) on Occupational Fraud and Abuse) to support the claim that executive fraud is not likely to be detected or prevented by internal controls:



While I do not dispute the ACFE’s survey results, I am not sure that it supports the Subcommittee’s conclusion that internal controls are an ineffective means of preventing or detecting executive-level fraud, since **it assumes an effective control environment in all of the responding companies.**

However, under Conclusion No. 6, this situation in which small companies have no demonstrable controls is not as bad as it appears since the Subcommittee concludes that investors understand and, tacitly, accept the inherently greater risk associated with small companies and therefore have lower expectations of (and requirements for) reliable financial information upon which their decisions can be based.

The second difference noted in Conclusion No. 3 is that auditors of larger companies can and must rely on internal controls to reduce the nature, extent and timing of substantive tests of accounts and balances in order to perform an audit efficiently, thereby reducing the cost—whereas small-company auditors understand that there are fewer (or, in many cases, no) controls on which they may rely. The Subcommittee suggests that these auditors of smaller companies adjust their audit plans and rely solely on substantive tests, even though they are less efficient and thereby increase audit costs.

The Subcommittee suggests that investors and auditors must accept greater risk because small companies cannot have reliable controls.

On the contrary, I think that both investors and auditors of small companies would be more likely to rely on a small company's control environment, if the company could demonstrate its effectiveness. Further, company executives would benefit since the paramount goal of an effective financial control environment is more reliable and timely decision-making information for the management team. In this respect, a reliable control environment represents a three-way win.

The issue, then, is not the ability of small companies to have effective financial controls or the value of having effective controls, but the cost of documenting and demonstrating the effectiveness of the control environment.

## Compliance Costs

CONCLUSION No. 2: The costs of Section 404 compliance have been much higher than anticipated

CONCLUSION No. 4: The cost and amount of resources necessarily devoted to Section 404 compliance is not proportional for Micro and Small-Cap companies

CONCLUSION No. 9(b): Smaller companies have limited resources which are being allocated to internal processes for Section 404 compliance, and, as these processes are not relied on for financial reporting, this unnecessary effort results in diminished shareholder value.

This subcommittee has noted that the SEC estimated \$91,000 for Section 404(a) compliance costs in the "Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure" issued in June 2003 were understated (Conclusion No. 2). However, I believe that there are valid reasons that the initial estimate was understated.

### Assumed FCPA Compliance

The SEC discussed the compliance costs estimates and computations, as well as the fact that they believed that the costs would be mitigated by the Foreign Corrupt Practices Act of 1977 (FCPA):

The final rules will increase costs for all reporting companies. These costs are mitigated somewhat because companies have an existing obligation to maintain an adequate system of internal accounting control under the FCPA. Moreover, one commenter noted that some companies already voluntarily include management reports on their internal controls in their annual reports.

The FCPA requires all public companies to:

- (b) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that –
  - (i) transactions are executed in accordance with management's general or specific authorization;
  - (ii) transactions are recorded as necessary
    - (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and
    - (II) to maintain accountability for assets;
  - (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
  - (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The differences between the FCPA internal-control requirement and SOx Section 404 are that:

1. The FCPA does not require companies to use an accepted framework for the control environment such as the Treadway Commission Committee of Sponsoring Organizations (COSO) Framework, the purpose of which is to systematically organize a control environment that can then be documented.
2. The FCPA does not require management to assert that there are no material weaknesses, or, to disclose known material weaknesses.
3. The FCPA does not require a company's independent auditor to verify that there is a control environment, let alone certify that the control environment is documented and free of material weaknesses.
4. The FCPA specifically states that no criminal penalties are imposed for the failure to comply.

Based on the assumption that all companies actually comply with the FCPA, the estimated increased cost of \$91,000 does not seem overly optimistic. And, I would argue that many companies that complied with the FCPA prior to SOx may have had actual-SOx costs more in line with the SEC's estimate.

### **Categories of SOx Costs**

The second reason that the SEC's estimate may have been too low is that all SOx-related (actual and anecdotal) costs are aggregated. Based on my SOx consulting experience, I have observed four costs associated with complying with SOx Section 404(a):

1. The expense of documenting the control environment, identifying and testing Key Controls
2. Remediating control deficiencies including instituting Key Controls when there are gaps in the control environment.
3. Ongoing costs of testing Key Controls, and the additional time required to document the performance of Key Controls.
4. The cost associated with addressing problems that are unearthed as companies comply with Section 404.

The direct cost of Complying with Section 404(b) is the increased independent audit fees to review management's method of assessing the control environment and then re-testing Key Controls.

In addition, each of these costs has two separate but overlapping components: accounting and information technology (IT).

All of these costs are usually lumped together without any disclosure of the underlying character.

There is currently no requirement for companies to disclose their SOx costs, and most have not disclosed voluntarily since these costs may have a negative effect on a company's stock price. In addition, the costs that have been reported, either officially or anecdotally, may be overstated since any and all cost associated with complying have not been broken out by category (as described above), and companies reporting their costs have included estimated internal costs, which may or may not be accurate.

## **Availability of SOx Advisors**

I submit to the Subcommittee that for every company that has expended an inordinate amount of time, effort and expense to comply with SOx, there is a company for which complying with SOx was not problematic or costly. These companies have executive management who rely on timely, complete, accurate and valid decision information every single day. In the SOx world, these executives are known to create an atmosphere of accountability and accuracy that begins with their “tone at the top.”

It is by no accident that these companies have had less-problematic SOx compliance. These companies have a history of valuing their internal audit function and have properly supported their internal auditors by providing them with the tools and continuing education that is necessary to maintain an effective control environment in an ever changing and technologically changing world. In addition, these companies' executives are interested in preventing problems before they get out of hand, and view control deficiencies discovered as a chance for the overall system to be evaluated and streamlined not because they have to comply with SOx, but because they understand that they make better decisions if their information is better.

The dearth of qualified internal auditors had gone unnoticed until 2004, when the accelerated filers needed them to comply with SOx in preparation for their annual audits. However, there is currently no lack of qualified internal auditors. In addition, small issuers require many fewer consultants, which allows smaller firms to compete. This also reduces the compliance costs.

## **Projected SOx-Compliance Costs for Small Issuers**

The Subcommittee states in Conclusions 4 and 9(b), that Micro- and Small-Cap companies are required to expend a disproportionately higher amount of (internal and external) resources, as compared with large companies, which diminish shareholder value overall.

The estimated costs for small issuers are based on companies whose market capitalization is greater than \$75 million and less than \$100 million. Current studies of these companies estimate the all-inclusive SOx-costs to Gross Revenues ratio equal to 2.5% of gross revenues.

However, a company's gross revenues are a poor predictor of the costs associated with SOx compliance. Based on my experience, I suggest that the first component of the estimated SOx-compliance costs directly relate to the complexity of an organization's accounting transactions and the number of distinct accounting locations, both of which impact the ultimate number of accounting processes, which then leads to the number of Key Controls. The amount of revenues is helpful only to the extent that it predicts a level of complexity. The second component of a SOx-cost estimate is the extent to which a company uses customized accounting software and spreadsheets.

Likewise, internal resources required to comply also correlate with the company's complexity. For example, a company with multiple accounting locations and lines of business will have a control environment that is more complex than a company with a single location and single line of business, not matter the size of that business.

The Subcommittee seems to suggest that executives of smaller companies have less fiduciary responsibility to the company's board and shareholders to ensure effective controls, which is not true. These executives may face different compliance issues than larger companies, but only to the extent that their business is different.

Also, the resources necessary to comply with SOx inversely relate to managements "tone at the top". That is, if a company's executives have previously valued an effective financial control and reporting environment, then its cost to comply with SOx will be less than the cost for a company whose management saw no value in these controls and has neglected the controls necessary to comply.

Finally, if the Advisory Committee accepts the recommendations of the Section 404 Subcommittee, then the companies that are more likely to issue inaccurate financial statements as well as more likely to experience fraud will benefit the most from this exemption by not investing in their controls, which is the exact opposite of the initial and ongoing goal of complying with SOx.

I submit to the Subcommittee that there are ways to effectively and efficiently implement SOx for a small company. However, the companies that need SOx the most would prefer not to comply and are using the supposedly high costs to mask their unwillingness to be accountable for accurate financial statements and informative disclosures.

## Lack of Effective Guidance

CONCLUSION No. 5: Based on our consultations with COSO, clear guidance does not yet exist for Micro- and Small-Cap Public Company managers on how to develop and support a proper Section 404 assertion

CONCLUSION No. 8: There are multiple ways to help ensure good internal controls at smaller public companies

The Subcommittee's statement (Conclusion No. 5) that "clear guidance does not exist" hinges on the definition and expectations of "**clear guidance**". Internal controls, by their very nature, depend on a company's unique accounting processes and systems (this is supported by the Subcommittee's Conclusion No. 8). So, expecting or requiring a one-size-fits-all solution for a control environment that is also unique is unrealistic, if not impossible. In addition, having specific requirements would be a double-edged sword, since all companies would then have to meet specific requirements for their documented control environments, as well as standards for exceptions (tests that failed). Even if exact requirements were issued, the compliance costs would probably increase, not decrease.

**The fact is: excellent guidance does exist.** Many publications and resources are available for free over the Internet, including:

- All of the Big Four accounting firms have published guides for management to implement SOx. These firms have published their guidelines to educate their clients on their particular requirements.
  - PricewaterhouseCoopers:  
<http://www.pwcglobal.com/Extweb/manissue.nsf/docid/23FDB9805FEE7EC085256CD20062978F>
  - Ernst & Young:  
[http://www.ey.com/global/content.nsf/US/Issues\\_Perspectives\\_-\\_Dynamic\\_-\\_Index\\_-\\_Sarbanes\\_Oxley](http://www.ey.com/global/content.nsf/US/Issues_Perspectives_-_Dynamic_-_Index_-_Sarbanes_Oxley)
  - Deloitte & Touche:  
<http://www.deloitte.com/dtt/article/0,2297,sid%253D2303%2526cid%253D15159,00.html>
  - KPMG:  
[http://www.us.kpmg.com/microsite/attachments/ACO\\_SO404FAQ\\_040856\\_POST.pdf](http://www.us.kpmg.com/microsite/attachments/ACO_SO404FAQ_040856_POST.pdf)
- In addition, several of the larger consulting firms have published Section 404 guides and FAQs (frequently asked questions). For example:
  - Protiviti: <http://www.protiviti.com/>
- On top of that, the Internet is rife with information and SOx forums. Just to list a few:
  - The Sarbanes-Oxley Act Forum: <http://www.sarbanes-oxley-forum.com/>
  - Karl Nagel & Co.: <http://www.karlnagel.com/>
  - SOx TV: <http://www.soxtv.com/>
  - Sarbanes-Oxley Compliance Journal: <http://www.s-ox.com/index.cfm>

In addition to the free publications and information available that can be found by a quick Google search, the PCAOB has conducted free SOx workshops for audit committee members and small CPA firms

([http://www.pcaob.org/News and Events/News/2006/01-17.aspx](http://www.pcaob.org/News_and_Events/News/2006/01-17.aspx)) emphasis mine:

**Washington, DC, January 17, 2006** - The Public Company Accounting Oversight Board today announced the continuation in 2006 of its Forums on Auditing in the Small Business Environment. These forums, which began in 2004, are designed to help share important information concerning the PCAOB with registered public accounting firms and public companies operating in the small business community.

Held in 10 cities throughout the country in 2004 and 2005, the forums enabled Board members and staff to meet with more than 1,000 representatives of small companies and small registered public accounting firms to provide insight to the work of the PCAOB, including the inspections process and the impact of new auditing standards. The feedback received from these forums assists the PCAOB in understanding and considering the unique needs and challenges of the small business community.

During the 2006 series, small registered public accounting firms will be invited to attend a one-day session in one of eight major cities throughout the country. During these sessions, attendees will have the opportunity to learn about the Board's work and also earn continuing professional education credits. In addition, in four of these cities, directors and financial executive officers of small public companies will be invited to participate in a separate event to be held the following day that will address PCAOB issues affecting smaller public companies. While there is no fee charged to participants for these events, pre-registration is required.

The 2006 schedule is as follows:

- Santa Monica, California - January 23, 24
- Fort Lauderdale, Florida - February 27, 28
- San Antonio, Texas - May 2, 3
- Seattle, Washington - June 21
- Boston, Massachusetts - September 8
- Philadelphia, Pennsylvania - October 16
- New York, New York - November 7, 8
- Chicago, Illinois - December 7

If anything, there is an abundance of information and guidance available. So, the claim that there is none is false, and can only be claimed by those whom have failed to look.

## **Subcommittee's Recommendations**

1. Exempt Micro-Cap companies from Section 404, subject to certain conditions
2. Exempt Small-Cap companies from the external audit requirements of Section 404, subject to certain conditions
3. The subcommittee strongly endorses recommendation #2. However, if the Commission believes that public policy requires some level of auditor reporting on Smaller Public Company controls, preventing the adoption of recommendation #2, then as an alternative, we recommend the SEC change its rule for the implementation of the external audit requirement of Section 404 to a cost-effective standard (ASX) providing for an external audit of the design and implementation of internal controls
4. Additional guidance
5. Certain special cases to be granted Section 404 relief

### **Conclusive Presumption**

The Subcommittee begins and ends with the conclusion that SOx is ineffective and too expensive for public companies to comply.

Aside from a very vocal and well moneyed minority, there appears to be no indication that SOx has anything other than the desired effects, which is to improve investor confidence in the stock markets and increase the accuracy, timeliness and transparency in financial reporting.

I think that the four-fold increase in the number of companies issuing restated financial statements in the past year is indicative of the benefits of SOx. Public companies are taking a good, hard look at their accounting and reporting processes, and are discovering that these past methods to collect and report financial information are lacking. These companies then incur costs to remediate their neglected financial reporting processes and systems, and blame it on SOx compliance, rather than the real cause.

## **SOx-Cost Myopia**

Subcommittee Member Mr. Kurt Schacht, CFA noted in his dissenting statement to the Advisory Committee (available at <http://www.sec.gov/rules/other/265-23/26523-171.pdf>): “We all agree that the costs of SOx are the real issue.” In fact, it seems that SOx costs are the only issue.

All of the conclusions and recommendations focus on the perceived high costs of complying, without acknowledging any potential benefits, either for the markets in general or the companies individually. Each one of the conclusions lead the Subcommittee one step closer to the recommendations that the Micro-Cap companies should be excluded from Section 404 altogether, and removing the audit requirement for Small-Cap companies.

Recommending rolling back SOx seems to be a forgone conclusion, despite the fact that SOx costs data is:

- ❑ Incomplete since companies have not been required to report their actual costs
- ❑ Inaccurate since all SOx costs are aggregated, without regard to the reasons for the cost or the character of the expense
- ❑ Often anecdotal since companies cite future SOx costs but have yet to actually comply.

I am not suggesting that SOx costs are insignificant, just that the available data does not support a definite conclusion. I propose that if cost is the real issue, then requiring companies to report their SOx costs, including the underlying character of such costs and promulgating specific guidelines and definitions of those SOx costs categories is the only way in which we will know the true costs involved.

## **Stratified Compliance Requirements**

The Subcommittee recommends rolling back SOx in a stratified structure public companies by market capitalization and revenues:

- ❑ Micro-Cap companies
  - Market capitalization of less than \$100 million
  - Revenues of less than \$125 million
- ❑ Small-Cap companies
  - Market capitalization of less than \$700 million
  - Revenues of greater than \$125 million and less than \$250 million
- ❑ Large companies
  - Market capitalization of greater than \$700 million
  - Revenues of greater than \$250 million

While stratifying all public companies is possible given the available market data, there may be no correlation of the stratified groups of companies to the SOx costs and benefits. As I stated above, market capitalization and revenue levels are a poor predictor of compliance costs.

Further, the stratified groups of companies are not homogeneous, so no conclusion should be based or used support changes to compliance requirements merely because these companies' market capitalization and revenues fall within arbitrary ranges.

## **Additional Standards & Guidance**

The problem with requiring the PCAOB to develop separate audit guidelines (ASX) for small companies is difficult since, by definition, audit standards are either Generally Accepted or they are not. This is no different than the ongoing calls for FASB to create a watered-down GAAP. The problem with promulgating GAAP-light is that classes of transactions are accounted in a particular way, without regard to the size of the company that accounts for these transactions.

Further, there is a great deal of guidance available, and further “official” guidance from COSO would need to address infinitely many scenarios, which is impossible. On the contrary, COSO’s framework is sufficiently open for management to assess its company’s particular circumstances, and adjust over time as its business and corresponding control environment evolves.

## **Conclusion**

The stability and strength of the U.S. stock markets rely on the timeliness and accuracy of the financial results and disclosures of the companies listed. If companies are exempted from SOx and they fail, who is responsible for the investors’ losses? I believe that we should maintain a minimum standard for public company’s information. SOx may not be the only answer, but implemented efficiently and smartly, it is a good start.

I agree with the old axiom: If it’s not broken, don’t fix it.

Is SOx broken?

Some say that it is, but their claims are often purely anecdotal and supported by incomplete data, all of which leads to no particular course of action.

I believe that the SEC should let SOx run its course, without prematurely concluding that the costs outweigh the benefits.

Thank you for the opportunity to comment on the Subcommittee’s conclusions and recommendations.

Respectfully submitted,

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