

April 3, 2006

Mr. Kevin O'Neill  
Special Counsel  
Office of Small Business Policy  
Division of Corporate Finance  
Securities and Exchange Commission  
100 F St. NE  
Washington, DC 20549

RE- File Number 265-23

Dear Mr. O'Neill:

We urge the SEC to not exempt small or "micro cap" companies from complying with Section 404 (404) of the Sarbanes-Oxley Act of 2002 (The Act). While we agree that the cost of complying with 404 is disproportionate for smaller companies, we have observed that the following factors significantly contribute to the excess cost of compliance for all public companies:

1. External auditors and consultants have often not used a "top-down" risk based approach to auditing 404 compliance, as prescribed by the PCAOB in its Policy Statement released 5-16-05.
2. Many companies did not have adequate documentation or sufficient knowledge of the effectiveness of internal controls prior to the act, thus requiring a significant investment of time, effort, and expense in order to develop, document, and test an effective system of internal controls and become compliant. Further, in year 2 of compliance for accelerated filers we see the cost of compliance as reported not drop significantly as originally predicted. During this two year time frame, the audit firms have been standardizing and documenting their approach according to AS2 and other authoritative guidance issued by the PCAOB. In other words, for several years Audit firms have been trying to hit a "moving target" in order to ensure their audits were compliant with the PCAOB and appropriately address firm liability exposure. It stands to reason that in external audit's approach to documentation and testing, they have tended to err on the side of conservatism.
3. There is a lack of standard guidance for management or external audit relating to control materiality judgment and procedures for risk assessment.
4. Based on our experience and discussions with others, external auditors often do not rely on internal audit or management testing to the extent allowed by the PCAOB.
5. Some external auditors do not appropriately reduce substantive testing based on control testing results, primarily because obtaining an understanding of internal controls is often performed late in the audit. Instead, we have observed external audit teams assess control risk at maximum, resulting in maximum sample size selections for substantive testing in the financial audits.
6. We have observed that audit groups and consultants typically use standard sample sizes for tests of controls related to 404 testing. Regardless of the given sample universe or exposure, sample sizes for control testing are often not adjusted.

## **Why 404 is Important to All Public Companies, Their Employees, and Their Investors**

Despite its initial ultra-conservative application, we have discovered through our experience with 404 that companies and investors benefit considerably from the internal control documentation and testing provisions. Many public companies prior to The Act had very little documentation of their understanding of accounting and reporting process risk and control relationships. We have observed through our own experiences, through discussions with peers, and our own research that many public companies have considerable exposures in their systems of controls. The provisions of 404 required those companies to remediate those conditions in order to have a clean internal control report from their external auditors. By using the top-down, risk-based control assessment approach as required in the PCAOB 5-16-05 Policy Statement, in conjunction with AS2, companies can flush out material problems in their control structure. By requiring external auditors to use a top-down risk based approach and enforcing those requirements by PCAOB review, companies can be assured that the effort and expense undergone is directly relative to the risk exposure the company faces.

### **The Top-Down Approach and Why it Works**

The Top-Down approach prescribed by the PCAOB in its policy statement on 5-16-05 simply states that in order to assess material risk to the financials, one must begin at the top of the company; at its entity wide controls. For example, if a type of material misstatement is likely to be caught during the review in the financial closing process, then controls affecting that account do not need to be assessed as key on the input or major process level. When assessing risk to the financials, if a risk –control relationship on the process level is covered by a control on the entity level, or by controls from another process, then there is no need to assess the corresponding process level control as key and test it, because that material risk is already sufficiently addressed by an entity level or other process level control.

The PCAOB approach significantly reduces the amount of key controls required to be tested and will result in a lower cost of compliance annually. Instead, we have observed that external auditors and consultants have often documented and tested all controls matched to material risks on the entity, process, and sub-process level and have not appropriately cross-referenced the process and sub-process risks up to higher level controls.

### **No Investment Deterrent**

Some small firms have de-listed claiming the compliance costs to be too high. However, the number of new small companies listing on US markets has more than doubled since 2003. In 2005 over 900 small companies filed S-1 registration statements, compared with 435 in 2003. [Compliance Week 3-20-06](#) It thus does not stand to reason that the 404 documentation rules are a deterrent to listing in the US. If more small companies are listing, and small company's compliance efforts are more costly as a percentage of revenue, then it is difficult to argue that foreign institutions and other listing companies will be swayed by the higher cost of compliance. It is arguable instead that by more effective regulation, and by setting proper example of those who do not comply or who break the law, the US markets will eventually become a more attractive haven for investors who are weary of riskier markets, thus attracting more foreign and domestic capital. Our US key indexes are strong. As compliance increases, the substance behind those numbers increases, and stability is added to the marketplace.

## **The Road Half-Traveled**

Smaller and Micro cap companies as defined in The Committee recommendations have invested millions of dollars in order to become compliant with the documentation and internal testing requirements of Section 404. Companies with a public float higher than 75 million have already paid millions in fees for the *audit* of these internal controls. To take away the external audit requirement for these firms would undermine the effort and expense these companies have undertaken.

Without a means of enforcement, it will be difficult to ensure documentation and control testing provisions of Section 404 have taken place. By exempting any class of company from the external audit requirement, investors are exposed to a system of un-verified controls which may or may not exist or be effective within the company. As can be observed in Table 7, page I-10 of the Final Report of the Advisory Committee (The Committee), 28% of shares held by institutions are for companies with market capitalizations below \$200 M. The provisions set forth in The Committee recommendations do address protecting capital markets as a whole, however; they do not protect 80% of the American investment choices made by institutional and private investors. Final Report of the Advisory Committee on Smaller Public Companies  
Draft 2/14/06 pg 4

If the Sub-Committee's recommendations are implemented, the number of internal control audits performed by smaller firms will decrease dramatically, thus concentrating the skills and the workforce necessary to perform internal control audits within the larger 6 firms. We believe smaller firms will then have significantly greater difficulty demonstrating their ability to audit larger public companies, which will provide an even greater competitive advantage to the larger 6 firms and foster further consolidation in the audit profession. We believe this concentration of skills is not in the best interest of the profession or the capital markets.

## **Recommendations**

We recommend the SEC and the PCAOB consider the following steps in order to decrease the 404 compliance burden on *all* public companies:

1. Ensure the PCAOB holds audit firms accountable to assessing inherent risk using a "Top Down" approach as defined during their reviews of audit firm compliance.
2. Define a framework that that auditors should use in order to quantify material risk. This should include the definition of a material misstatement in quantitative terms relative to the financial statements.
3. Develop a framework that smaller public companies could follow in order to ensure 404 compliance, including reference charts that management and control owners can use when evaluating the required key controls.
4. Provide guidance on the appropriate method for determining sample size for tests of controls based on the sample universe and materiality.

5. Firms should be inspected by the PCAOB to ensure that their audits are properly integrated, that control testing is used also as a basis for substantive test sample sizes, and that reliance on management or internal audit control testing is reasonable. Auditors should be held accountable to integrate their Sarbanes testing with the audit to reduce substantive testing appropriately based on tests of controls in accordance with GAAS and PCAOB Policy Statement 5-16-05.
6. Define reasonable compliance timeframes for firms crossing market capitalization thresholds, and new listings, so that all companies are given a reasonable time frame in which to comply with increased documentation requirements.

We respect and recognize the committee's efforts to provide relief for smaller public companies. We empathize with the effort and the expense incurred by all companies to become compliant. However, we have observed first-hand that it is the application, interpretation, and measurement of Section 404 requirements that have resulted in excess expense to public companies. We ask the SEC and the PCAOB to address these recommendations and give this critical law time to work.

We will appreciate any questions you may have regarding our recommendations and we enthusiastically volunteer in advance to participate in any studies or workshops related to the above where we may be of assistance. Please direct your questions and inquiries to Kurtis Wolff, National Director of Audit and Accounting at (404)-250-4148 or [kurtis.wolff@reznickgroup.com](mailto:kurtis.wolff@reznickgroup.com)

Sincerely yours,



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