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To: SEC Office of Small Business Policy; CFLETTERS
Subject: Comments on proposed changes to SEC 404 rules

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To: The Small Business Advisory Panel

I am a consulting internal auditor to a number of small banks after years as director of internal audit and audit management in larger banks. Several of these small banks are subject to Sarbanes-Oxley (SOX) while some are closely held and one has “gone private” to reduce the burden of SOX compliance. I am normally hesitant to disagree with a colleague in the public arena; however I think the letter from another audit director asking not to “water down” SOX requirements for smaller companies is not completely accurate.

If I understand the Commission current directions, it is to reduce the burden of Section 404 evaluation and documentation – NOT to reduce the requirement to maintain the internal controls standards of the law and the Commissions Rules. In my view, the cost of the assessment of controls under the current Rules for Section 404 is the issue; not the requirement to maintain appropriate internal controls over financial reporting. I see my banks suffering from the cost burden of 404 assessment.

The issue has never been – in these banking companies – whether to have good internal controls in all areas. The issue is the cost of the activities to **demonstrate** the quality of those controls. Surveys by a state bankers association of its members and a national survey by one of the largest accounting firms bear out the cost issue. In the case of some small banks the cost of SOX compliance (404 activities and increased audit bills) is as high as 25% of pre-tax profits. This is a perverse outcome for “protecting” the shareholders.

It is the understanding of all of these banks that SOX requires their auditors to criticize weakness in controls up to and including a ‘qualified opinion’ on controls if the company fails to maintain appropriate controls. They feel that the degree and precision of documentation – and therefore the cost of documentation – is the issue; NOT whether they should have good controls. In banking virtually all internal controls are linked to financial reporting because of the nature of the business. Thus management never laughs at any requirement for maintaining the highest quality of internal controls in all areas – an allegation that the previous letter writer casts rather broadly.

There is no question that a highly regulated industry like banking has a number of master to serve; all of them demand strong internal controls. This has a decided effect on the attitude of bank management to maintain good internal controls; that fact is never a laughing matter. The concern in smaller banking companies that the objective is being lost when the focus is on the quality of the documentation **more** than on the quality of the

controls themselves.

The requirement that independent auditor render an opinion on the documentation THEN render an opinion on the controls has turned true objective – high quality controls – on its ear. The wise company – bank or other – document their controls to instruct employees, to support internal decision making AND to help reduce the cost of independent audit through higher efficiency of that audit. The style and form of documentation should NOT be the objective; high quality controls should be.

The auditor’s opinion on those controls should be sufficient leverage to assure good controls. The quality of control requirements should not be reduced in any way by a restructuring the Rules on 404 for smaller companies. That objective does not of necessity require the extensive documentation work in the original Rules regarding 404.

If a company “laughs” at the requirements for good controls, the last laugh should come when the auditor renders an opinion on the controls. The current Rules regarding 404 documentation which applies from largest to smallest do not guarantee good controls; they encourage them. The Commission should be sure that all issuers understand that the objective is the controls and auditors will be required to opine on them. The nature, form and (assumed) quality of a documentation exercise is not the objective.

Finally, delaying reporting dates does not improve this situation. The ultimate objective will best be achieved if the Commission quickly declares that the stringent assessment requirements current in effect do not apply to small cap companies – under \$700million, if I understand the current thinking. That position should be accompanied by a strong statement that the Rules for compliance with the control standards are not changed and any company failing to maintain such controls does so at the risk of SEC sanctions.

Thank you for the opportunity to express my views on these issues.

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