

**ABA**

**AMERICAN BAR ASSOCIATION**

**Defending Liberty  
Pursuing Justice**

**Section of Business Law**  
321 North Clark Street  
Chicago, Illinois 60610  
(312) 988-5588  
FAX: (312) 988-5578  
email: [businesslaw@abanet.org](mailto:businesslaw@abanet.org)  
website: [www.abanet.org/buslaw](http://www.abanet.org/buslaw)

via e-mail to: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

September 28, 2006

By Electronic and United States Mail

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

Re: File No. S7-06-03  
Release Nos. 33-8731; 34-54295  
Internal Controls over Financial Reporting in Exchange Act  
Periodic Reports of Non-Accelerated Filers and Newly Public Companies

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of Section of Business Law of the American Bar Association in response to the request for comments by the Securities and Exchange Commission (the "Commission") in its August 9, 2006 release referenced above (the "Proposing Release").

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the American Bar Association (the "ABA"). In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

September 28, 2006

Page 2

As an initial matter, the Committee commends the Commission for revisiting its previously established deadlines for compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX”) by non-accelerated filers and its recognition that the burdens of compliance by smaller public companies should merit specific additional consideration. The Committee believes that various initiatives undertaken by or at the direction of the Commission in an effort to be more responsive to smaller public companies and to minimize such burdens on them is an appropriate first step in seeking to balance the objectives of Section 404 with the substantial time and disproportionate resources that must be committed to that end by such smaller public companies.

#### Extension of Compliance Dates for Non-Accelerated Filers

The Commission has proposed delaying the date by which non-accelerated filers must furnish their management’s report on internal control over financial reporting (“Management Assessment”) until the filing of their annual report for a fiscal year ending on or after December 15, 2007 and also delaying the date by which the auditor’s attestation report on internal control over financial reporting (“Auditor’s Attestation”) will be required by such filers until the filing of their annual report for a fiscal year ending on or after December 15, 2008.

As a preliminary matter, for the reasons stated in the Committee's letter of November 28, 2005 to the Commission in response to Release Nos. 33-8618 and 34-52492, we believe the Commission should continue to consider whether the attestation requirement can be appropriately dispensed with for a certain class of smaller public companies. We agree with the Advisory Committee on Smaller Public Companies' recommendation that "[u]nless and until a framework for assessing internal control over financial reporting for [certain smaller companies] is developed that recognizes their characteristics and needs, . . . [the Commission should] provide exemptive relief from external auditor involvement in the Section 404 process." Our Committee's comments on the Concept Release Concerning Management’s Reports on Internal Control Over Financial Reporting will be the subject of a separate letter to be submitted jointly by this Committee and the Committee on Law and Accounting of the Section of Business Law of the American Bar Association.

However, to the extent that non-accelerated filers are required to provide a Management Assessment and to obtain an Auditor’s Attestation, the Committee agrees with the Commission that an extension of the period of time for compliance with Section 404 of SOX by such filers is necessary until such time that the Commission and the Public Company Accounting Oversight Board (“PCOAB”) have completed their consideration of the actions that need to be taken to provide guidance and relief with respect to the implementation of Section 404 as it applies to smaller public companies. In establishing the time frame for requiring compliance with Section 404 by non-accelerated filers, the Committee further agrees that such filers should have the benefit of any guidance furnished by the Commission, as well as any revisions to, or guidance with respect to the implementation of, Auditing Standard No. 2, *An Audit of Internal Control*

*over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (“Auditing Standard No. 2”), prior to planning or conducting their internal control assessments.

Accordingly, the Committee would urge that once these efforts have been completed, a reasonable period of time thereafter be afforded to non-accelerated filers prior to requiring their compliance with any portion of Section 404. If revisions to Auditing Standard No. 2 or the Commission’s release of guidance for management is not completed sufficiently in advance of a non-accelerated filer’s required compliance with Section 404 so that such non-accelerated filer and its auditors are able to implement or rely on them, then the Commission should provide additional extensions until such non-accelerated filer is able to do so.

#### Phase-In of the Management Assessment and the Auditor Attestation Requirements

To the extent that the Commission decides not to eliminate the Auditor Attestation requirement for non-accelerated filers, the Committee does not believe that the obligation to furnish the Management Assessment should be independent of the Auditor Attestation.

Although the Committee understands the basic premise behind the Commission’s proposed sequential implementation of Sections 404(a) and 404(b) of SOX, the Committee does not believe that the benefits of the phase-in approach will outweigh the likely inefficiencies, potential inconsistencies, second guessing, and other risks that may result from such an approach. The Committee does not view the phase-in as a workable approach to compliance with Section 404.

Accordingly, as discussed below, to the extent that an Auditor Attestation will be required to be provided by non-accelerated filers, the Committee believes that the Management Assessment should likewise be delayed to first apply to fiscal years ending on or after December 15, 2008 or such later date as the Auditor Attestation is ultimately required to be provided by such filers.

#### *Inefficient Allocation of Resources*

The establishment, implementation, and monitoring of a system of internal control over financial reporting by a non-accelerated filer will necessarily rely substantially on the input from and objective testing done by its independent auditor and the application of Auditing Standard No. 2, as revised, to such filer. Unlike larger corporations which often have the necessary resources to hire a trained internal staff dedicated to developing, testing, and monitoring internal controls that will satisfy Auditing Standard No. 2, non-accelerated filers generally lack the resources and the necessary expertise to accomplish such an undertaking without seeking outside assistance. Integral to establishing such controls will be the input and feedback received from a non-accelerated filer’s outside auditor following the testing of such controls in accordance with Auditing Standard No. 2.

Furthermore, the Committee believes that the phase-in approach will not provide the benefits anticipated by the Commission. In the Proposing Release, the Commission indicates that the principal benefits of this approach will be to spread the costs of compliance over a two-year period by allowing non-accelerated filers to avoid the costs associated with the Auditor Attestation during the period that changes to Auditing Standard No. 2 are being considered and to enable management to more gradually prepare for full compliance with Section 404 while gaining efficiencies in the review process of their internal controls.

Under this proposed approach, non-accelerated filers would be expected to expend the resources necessary to establish their internal controls over financial reporting in order to provide the Management Assessment. However, because these same controls will be evaluated by the company's outside independent auditors one year later, it seems likely that the company will want to involve its auditors to some extent during the first year. Moreover, if the standards are revised (or further guidance is provided) between the first year and the second year, the company may end up spending resources to set up controls during the first year that are not required the second year. Accordingly, non-accelerated filers may have to "re-invent the wheel" during the second year, both due to auditor feedback and changes in the requirements. This does not seem like a good use of resources.

As a result, we believe that the phase-in approach will likely be inefficient and more costly to implement in the long run. Instead of developing internal controls with the input and feedback of all of relevant professional advisors of non-accelerated filers, including their auditors, which are designed to satisfy the auditing standards ultimately adopted by the PCOAB, the phase-in approach will likely result in unnecessary overlapping expenditures and misappropriation of personnel resources.

#### *Consistency of Internal Control Evaluation Procedures*

The Committee believes that stand-alone Management Assessments can certainly provide meaningful disclosures to investors. However, under the Commission's proposal, the Management Assessment would be a stand-alone filing only in the first year. Under the phase-in approach, inclusion of a Management Assessment in the first year has the potential of causing confusion if it is later questioned by the auditors in the second year of the phase-in or is inconsistent with the anticipated revisions to the Auditing Standard No. 2 expected to be revised after the first year of the phase-in.

Management Assessments of smaller public companies will be based on properly prepared internal controls developed by management with the input of all necessary professionals, including outside independent auditors, and will likely be evaluated, reviewed and tested using procedures and processes that such professionals and management agree are adequate to identify material weaknesses under applicable auditing standards.

As the Commission has acknowledged, the process for an auditor's assessment of the internal controls of smaller public companies should not necessarily be as stringent as those applied to larger public companies. In the Proposing Release the Commission states that it has delayed the time for compliance with the Auditor Attestation requirement so that, among other things, it will have adequate time to finalize revisions to Auditing Standard No. 2 (including clarification of the auditor's role in evaluating the company's process for assessing the effectiveness of its internal control over financial reporting) and for the PCOAB to provide implementing guidance for auditors of smaller public companies. The Committee strongly supports and encourages the Commission to take the time necessary to study, consider, and develop appropriate standards for auditors to assess the internal controls over financial reporting of smaller public companies.

The processes used by management to evaluate the company's internal controls for purposes of the Management Assessment should be based on the same criteria that are used by auditors to test the company's internal controls. Small public companies, which will rely heavily on the assistance of third party professionals, including their independent auditors, to develop their internal controls and review processes, should have the benefit of the insights and determinations of the Commission and the PCOAB before preparing their initial Management Assessments. Otherwise, the initial Management Assessment may not be based on the same principles and criteria that are ultimately applied to the second year Management Assessment after receiving the benefit of the revised Auditing Standard No. 2 and the PCOAB guidance. The Committee is concerned that this could cause investor confusion as to the efficacy of the first year Management Assessment.

#### *Potential for Liability and Auditor Disagreement*

To achieve the maximum benefit from the requirements of Section 404 of SOX, management must work together with its professionals to develop, evaluate and maintain a well developed and effective set of internal controls. Because of the pressure facing auditors under the regulatory oversight of the PCOAB and the threat of litigation, auditors have had a tendency to be less flexible than they should be in their interpretation of appropriate internal controls and their determination of what constitutes a material weakness. It is not hard to envision a scenario where the auditors, when preparing the Auditor Attestation, question the efficacy of the Management Assessment used by the non-accelerated filer in the first year. In that situation, management will likely be put in the unenviable position of either defending their Management Assessment or attacking the procedures used by the auditors. Instead of working together with their auditors to improve its internal controls, non-accelerated filers would be expending their time and effort in the opposite direction. Given the likelihood that Auditing Standard No. 2 will not be revised prior to the proposed date for furnishing the first Management Assessment, as well as the anticipated lack of any meaningful input from outside auditors in the preparation of such Management Assessment, it is not unreasonable to anticipate that a significant number of these disagreements will result. Accordingly, once management has provided its first Management Assessment, the competing liability concerns of management and the auditors will set the stage

for significant disputes in connection with the Auditor Attestation in the second year, which is not presented when both evaluations are made at the same time.

Although the Committee believes that the “furnished but not filed” dichotomy suggested in the Proposing Release is useful, we are concerned that it may not be sufficient to protect against second guessing and the potential negative impact thereof. The non-accelerated filer still faces the potential for negative consequences ranging from adverse publicity to anti-fraud actions being brought against it. Auditors also face potential litigation, regulatory sanctions, and similar adverse publicity that may affect their business. Because of these potential consequences, auditors may decide that they still do not have the flexibility to consider management’s interpretations in a context different from that used for larger companies.

#### *Recommendation*

Based on the foregoing, if the Commission requires non-accelerated filers to obtain and file an Auditor Attestation, the Committee believes that the Management Assessment should not be furnished or filed until such time as the Auditor Attestation is required to be filed. We believe that the potential risks, the costs and efforts involved outweigh any potential benefit that will actually be achieved through a phased-in approach.

Accordingly, we would urge the Commission to delay compliance with any portion of Section 404 until after the Commission’s guidance to management of non-accelerated filers has been issued and Auditing Standard No. 2 has been revised, and that adequate time be given to incorporate such guidance and revisions into effective internal controls.

#### Transition Period For Newly Public Companies

The Committee agrees with the Commission that it is appropriate to provide a transition period to newly public companies prior to requiring such companies to conduct their first assessment of internal controls and we concur with the proposal that newly public companies not be required to comply with Section 404 of SOX until their second annual report needs to be filed.

Based on the anecdotal evidence, the Committee believes that the current timing requirements for initial compliance with internal controls reporting discourage initial public offerings and listings on United States securities exchanges. The commitment of resources, both in terms of personnel and costs, in undertaking an initial public offering (“IPO”) and the distraction of management from a company’s core business during this period of time are enormous. Likewise, the adjustment to the basic ongoing public reporting required under the Securities Exchange Act of 1934 during the first year following the IPO, as well as the attendant investor relations pressures, also requires the expenditure of significant resources and attention. Accordingly, imposing the obligations of Section 404 of SOX at this same time would overly burden newly public companies and would not provide sufficient time for giving careful

consideration to the establishment of strong internal controls. The further diversion of management from the core business would not be in the best interests of investors.

Because non-accelerated filers are not yet subject to the requirements of Section 404 and a company cannot meet the definition of an "accelerated filer" or "large accelerated filer" until it has been a reporting company for at least 12 months and has filed at least one annual report, currently all public companies have a built-in transition period before they are no longer deemed to be non-accelerated filers and are required to comply with Section 404. Unfortunately, as described above, this transition period may not be long enough. Moreover, once non-accelerated filers become subject to the requirements of Section 404 of SOX, the transition period currently enjoyed will end.

The Committee believes that a newly public company should be given the opportunity to operate as a public company for a full fiscal year prior to being required to comply with Section 404.

The adoption of the Committee's proposed transition period for newly public companies should decrease the burdens on newly public companies and allow them ample time to create strong internal controls without unnecessarily diverting management from their primary responsibilities during the critical transition period from being a private company to be a public reporting company. Internal controls would be more efficiently and effectively implemented if newly public companies were not rushed into the establishment of such controls without adequate historical experience. After operating for a full fiscal year and going through the audit and reporting process as a public company, management should be in a better position to understand what processes will be necessary to implement and document internal controls and how to avoid any material weaknesses in such controls. Management also would have the opportunity to work with its professionals to evaluate and test such controls without the pressure of having to submit the controls and procedures to scrutiny and final judgment prematurely.

\*\*\*\*\*

The Committee appreciates the opportunity to comment on the Release and respectfully requests that the Commission consider the recommendations set forth above. We are prepared to meet and discuss these matters with the Commission and the staff and to respond to any questions.

Respectfully submitted,

/s/ Keith F. Higgins

---

Keith F. Higgins,  
Chair, Committee on Federal Regulation of Securities

September 28, 2006  
Page 8

Drafting Committee:

Richard A. Denmon  
Pranab Bhattacharya  
Bonnie Roe  
David A. Sirignano  
Ann Yvonne Walker  
Gregory C. Yadley

cc: Christopher Cox, Chairman  
Paul S. Atkins, Commissioner  
Roel C. Campos, Commissioner  
Cynthia A. Glassman, Commissioner  
Annette L. Nazareth, Commissioner  
John W. White, Director, Division of Corporation Finance