

May 1, 2006

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

**2006 Roundtable on Second-year Experiences with Internal Control  
Reporting and Auditing Provisions (Commission File No. 4-511)**

Dear Ms. Morris:

Ernst & Young LLP is pleased to share our views derived from our experience in connection with the requirements of Section 404 of the Sarbanes- Oxley Act of 2002 (the “Act”) and related regulations, standards and guidance issued by the Securities Exchange Commission (“SEC”) and the Public Company Accounting Oversight Board (“PCAOB”).

With the second year of Section 404 implementation now complete for many filers, it appears that auditors, issuers and regulators are achieving effective application of the Act while achieving meaningful efficiencies.

Our recent comment letter of April 3, 2006 on the Draft Final Report of the SEC Advisory Committee on Smaller Public Companies goes into considerable detail regarding the need for practical implementation guidance for smaller public companies. That letter also describes in detail the reasons why we are not in agreement with the Advisory Committee’s primary recommendations regarding internal control over financial reporting with respect to smaller public companies.

It is critically important to focus on, understand and appreciate the significant benefits resulting from implementation of the requirements of Section 404 of the Act. We believe that the effective implementation of Section 404 benefits the investing public in the form of more reliable and transparent financial reports, increased investor confidence, lower cost of capital for issuers, and a reduced risk of corporate fraud.

While the benefits and protections afforded to investors from the Section 404 process are generally recognized, less discussed are the direct benefits to companies that have implemented Section 404. The discipline, rigor, and focus on financial reporting and the associated evaluation and reporting on internal controls helps management and boards of directors, including their audit committees, better identify and manage the specific risks they face. Implementing the requirements of Section 404, along with other requirements of the Act, has promoted significant

improvements in the culture in which many public companies now operate. We have witnessed this first-hand. Many members of management and directors have benefited, not just investors, and in the long run the successful implementation of Section 404 should help every company compete for talent and capital. As a result, we have concerns with proposals to apply different requirements to classes of companies based on size.

At the same time, we recognize the unique characteristics of the small company environment and the disproportionate level of effort they might incur in implementing the requirements of Section 404, and believe additional steps by regulators are warranted prior to the first year implementation by non-accelerated filers.

### ***The Need for Practical Implementation Guidance for Smaller Public Companies***

Today, the views of many observers of the Section 404 process are based on a first-year implementation experience for accelerated filers that was, by all accounts, challenging and difficult. We have previously commented that no party – management, auditors, or regulators – performed perfectly in that first year of execution. Clearly, the second year experience was markedly improved, and the third year experience promises further benefits in effectiveness and efficiency.

Notwithstanding the improvements brought on by time, experience and previously issued regulatory guidance, we believe that additional steps should be taken to further benefit the first year implementation experience of the smallest half of U.S. public companies, so they will not have a first year experience akin to that of many of their larger accelerated filer counterparts. The concern and interest in this regard underlies our view that the SEC and others should undertake a collaborative effort to develop practical materials outlining what management of a smaller, non-complex public company needs to do in identifying, evaluating, and testing key controls to assess their operating effectiveness. Today, despite significant time having passed, and significant effort by the SEC, PCAOB, COSO and others, the type of practical performance guidance that is warranted does not yet exist in our view.

Importantly, such a collaborative effort to develop practical performance guidance holds promise not only for the non-accelerated filers who have yet to implement Section 404, but also for smaller accelerated filers that are seeking improvements in their ongoing processes. While such companies have already been through the most challenging aspects of initial Section 404 implementation, there remain opportunities for improving management's processes and we should seek to do so.

We believe it is essential for any effort that is focused on issuer guidance to have the full and active support of the SEC, and note that many parties have previously advocated more guidance for issuers from the SEC. Issuers will rightly want to know that their regulator, the SEC, has determined to be appropriate any guidance or examples on what constitutes effective internal control for a smaller, less complex public company and what constitutes appropriate testing and

assessment procedures in such an environment. Additionally, we recognize the PCAOB may have to rationalize the performance requirements for management's assessment in PCAOB Auditing Standard No. 2 (AS2) with this new guidance.

***Uniqueness of Small Company Environment Must Be Recognized***

In developing guidance for management, there are unique considerations—practical realities-- in the smaller, less complex public company environment that must be considered and addressed, including the following:

- Less formality in the way the company operates and a much wider span of control by management with more direct channels of communication.
- Direct supervision of employees and a more “hands-on” approach to management review and oversight.
- Detect controls and monitoring, rather than prevent controls generally play a more prominent role.
- The unique approaches to risk assessment.
- The risk of management override is likely different.
- Additional challenges relative to the segregation of duties and in some cases retaining competent accounting personnel.
- Board level oversight plays a more critical role in the system of internal control.
- Unique documentation challenges as many important controls may be undocumented and the need to develop guidance and practicable examples regarding the required level of documentation.
- The roles of the board of directors, audit committee, senior management, the CFO and other financial accounting personnel can be tailored to optimize the system of internal control.
- The unique characteristics and role of IT in a small company environment, including how, in some instances, the nature of the accounting software (e.g., purchased accounting software packages) may serve as a control.
- The need for guidance on the process to be followed and examples of documentation required for the annual assessment of internal control over financial reporting.

The need for regulatory guidance regarding management's obligations is underscored by a recent study submitted to the SEC and PCAOB by Ernst & Young and other major accounting firms.

This study, undertaken by CRA International and published April 17, 2006, examined both larger and smaller company experience in the second year of 404 implementation. The report found issuers' total costs associated with 404 implementation, on average, fell nearly 44 percent for larger companies (above \$700 million in market capitalization) and nearly 31 percent for smaller companies (\$75 million to \$700 million in market capitalization).

Such overall issuer cost reductions are noteworthy. Even more instructive is the breakdown of issuers' total 404 costs. The study examined three components of an issuer's total 404 costs: two related to management's performance requirements, either internal costs for efforts performed directly by management or third party costs for assistance to management, and the third component for costs resulting from 404 external audit fees.

The study found that costs associated with management's performance requirements comprised the largest portion of issuers' total costs, with year two 404 external audit fees accounting for 33% of the total 404 costs of larger companies and 39% of total 404 costs of smaller companies. While larger and smaller issuers achieved similar percentage cost reductions relative to 404 external audit fees, there was a significant disparity between larger and smaller companies relative to cost reductions associated with management's performance requirements. While larger companies achieved cost reductions of 51% for such costs, smaller companies achieved a 36% reduction. Thus, focusing additional guidance on the performance requirements of management has the potential for considerable positive effects. Not only do the performance requirements of management comprise the largest portion of issuers' total costs, but also it appears to be an area of disparity between larger and smaller companies in terms of achieved efficiencies.

### ***Concern with Other Suggested Approaches***

As noted and explained fully in our April 3, 2006 comment letter, we do not believe broad-based exemptions, weakened standards, or audits that attest to the appropriateness of the design and implementation of internal controls but skirt the question of their actual effectiveness, are appropriate policy considerations in response to concern over the application of Section 404 to smaller public companies. Such proposals would, in our view, undermine significant gains in financial reporting, corporate accountability and investor protection.

Further, we believe AS2 is scalable and, along with additional practical performance guidance for the management of smaller public companies, can result in an efficient audit fully aligned with the intent of the Act. We do not believe it or the underlying Section 404 statute should be amended at this time. In our experience, AS2 is clearly scalable for audits of all sizes, but a critical element in the success of that scalability is practical guidance for management of smaller public companies in enhancing internal control, performing periodic assessments of internal control, and reporting on its effectiveness. That is why we believe the issuance of additional practical implementation guidance directed towards the management of smaller public companies is so important.

### ***Conclusion***

As noted, there is a need for practical implementation guidance to provide management of a small, less complex public company with a useful “roadmap” to approach its assessment, and guidance to specify what constitutes effective controls in more problematic areas for such a company. There are number of different processes that could be undertaken to create this guidance. Whatever the process, the implementation guidance crafted must be practicable and bridge the gap between improved COSO guidance and the realities facing smaller public companies.

The SEC will need to oversee the process, or at least play an active role in establishing the process and place its stamp of approval on the output such that the resulting guidance is objective, practicable, authoritative and, most important, germane to the issues faced by smaller public companies. The SEC, PCAOB, issuers, and auditors will need to have a hand in the development of this guidance to achieve the desired outcome.

In our view, the steps outlined here are the appropriate course of action to balance the needs and interests of all parties in a manner that maintains the significant gains in financial reporting, corporate accountability and investor protection that result from implementation of the Section 404 process.

We appreciate the opportunity to share our views on how to improve the process going forward and stand ready to assist in any way.

Very truly yours,

*Ernst & Young LLP*