

Preliminary Report of the Internal
Controls Subcommittee
to the
Advisory Committee on
Smaller Public Companies

Preliminary as of 12-7-2005

Introduction

Janet Dolan

Chairman, Section 404 (S404) Internal Controls Subcommittee

Background on the Internal Controls Subcommittee

- **Subcommittee Objective**
 - To give the Advisory Committee recommendations scaling the regulations on internal controls to enhance compliance and reduce cost
 - Rightsizing within the spirit of S404
- **Overarching Principles of the Advisory Committee**
 - Further Commission's investor protection mandate
 - Seek cost choice/benefit inputs
 - Keep it simple
 - Maintain culture of entrepreneurship
 - Capital formation should be encouraged

Background on the Internal Controls Subcommittee

Subcommittee Primary Recommendations

1. Exempt Microcap companies from S404, subject to certain conditions
2. Exempt Smaller Public Companies from the external audit requirements of S404, 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 S404 to a cost-effective standard (ASX) providing for an external audit of the design and implementation of internal controls

Background on the Internal Controls Subcommittee

- **Subcommittee Members**
 - Janet Dolan (Retired CEO, Tennant)
 - Richard Brounstein (EVP Calypte Biomedical, Chairman of FEI Small Public Company Taskforce)
 - Alex Davern (CFO National Instruments, Chairman of the AeA Committee on Section 404)
 - Mark Jensen (Partner Deloitte, National Director Venture Capital Services)
 - Deborah Lambert (Co-Founder, Johnson Lambert & Co.)
 - Kurt Schacht (Executive Director, CFA Institute)
- **Official Observer**
 - Daniel Goelzer (Member of the Board of the PCAOB)
- **SEC Guidance**
 - Gerald Laporte, Chief, Office of Small Business Policy, SEC Division of Corporation Finance
 - Cindy Alexander, Assistant Chief Economist for Corporation Finance and Disclosure, SEC Office of Economic Analysis
 - Jennifer Burns
 - Mark Green
- **Process for Determining the Recommendation**
 - Analytical support from the SEC staff
 - Analytical support and proposals from the subcommittee members
 - Extensive meetings, with active participation by all subcommittee members
 - Oral and written presentations to the Advisory Committee

Purpose of Presentation

- **To seek:**
 - Approval of the Internal Control subcommittee's recommendations
 - A good awareness of our work
 - A sound understanding of the supporting facts we used
 - An appreciation for the logic and reasoning applied in the formation of our recommendation

Background and Recommendation

S404 Internal Control Subcommittee

Factors considered for recommendations

- Background:
 - During recent years there have been continuing large scale internal control failures and financial frauds committed by senior executives at public companies which have resulted in major financial losses for investors and which weakened investors' confidence in the capital markets
 - The Sarbanes–Oxley Act was passed to address the concerns of Congress about the health of the U.S. financial markets
 - The Congressional directive to the SEC (Section 3(f) of the '34 Act) requires “Consideration of Promotion of Efficiency, Competition, and Capital Formation”
 - Whenever pursuant to this title the SEC is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the SEC shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation
 - Investor perception of business and operating risk is different relative to small versus large companies
 - The role of the Advisory Committee is to further the Commission's investor protection mandate and to examine ways to ensure that the cost of the regulation of smaller public companies is justified by the benefits

Factors considered for recommendations, cont

- Costs of implementation of S404
 - The initial internal implementation cost of S404 has been dramatically higher than originally estimated by the SEC in its July 2003 release adopting the internal control rules – surveys indicate materially higher
 - The relative costs of S404 compliance was to be proportional for companies of different sizes - survey and proxy data show that smaller public companies have incurred relative costs that are significantly higher than large public companies
 - Despite the interpretive guidance issued by the PCAOB in May 2005, it is believed costs will continue to be very significant through year 2 and beyond. This is a significant issue for smaller companies as they are extremely dynamic and systems and controls change significantly on a year-to-year basis. This dynamic environment will continue to cause cost to be very high
 - Due to the complexity and tone of AS2 combined with the liability environment which impacts both the external auditor and the company, the amount of work required to reduce audit risk to an acceptable level appears to be excessive in the Smaller Public Company

Factors considered for recommendations, cont

- Internal control and fraud prevention measures:
 - Investors expect smaller public companies to maintain good internal controls over financial reporting including controls to prevent and detect fraud
 - 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
 - While S404 encourages stronger internal controls, smaller companies can more efficiently and cost effectively be encouraged to maintain controls over financial reporting through:
 - Management's 404 assertion (with additional guidance)
 - Applies to Smaller Public Companies only; without auditor attestation
 - External auditor's financial statement audit
 - Management's 302 and 906 certifications
 - Increased threat of criminal penalties
 - Independent audit committees/financial experts on audit committee
 - Whistleblower provisions

Factors considered for recommendations, cont

- Economic factors (competition and capital formation):
 - US economy depends on smaller companies, particularly for innovation & jobs
 - The cost burden and management time commitment required for smaller public companies to comply with the regulatory requirements of S404 adversely impacts these companies' ability to compete
 - An excessive regulatory burden may encourage smaller companies and foreign issuers to avoid becoming public issuers in the U.S., weakening our capital markets relative to foreign exchanges.
 - The failure of a smaller public company poses a significantly lower risk to the U.S. capital markets than failure of a large public company.

Some of the data the Subcommittee considered and related conclusions

CONCLUSION No. 1

Microcap and Smaller Public Companies proportionately represent a significantly smaller risk to the capital markets than large public companies

Distribution of Public Companies (Total Market Capitalization)

	Approximate % of all U.S. Public Companies	Approximate % of all U.S. Public Company's Total Market Capitalization	Approximate Market Capitalization Cutoff
Microcap Companies	50%	1.0%	< \$100M
Smaller Public Companies	80%	6.0%	< \$700M
Large Public Companies	20%	94.0%	> \$700M

Source: *Background Statistics: Market Capitalization of Public Companies*
SEC Office of Economic Analysis

Preliminary 12/7/05

CONCLUSION No. 2

The costs of S404 compliance have been much higher than anticipated

S404 costs much higher than anticipated

- SEC's July 2003 release adopting the internal control rules anticipated that the average internal cost of complying with S404 would be \$91,000
 - Both industry surveys and proxy examination shows that the costs have been materially higher than anticipated
 - Public testimony before our Advisory Committee showed S404 as implemented as a significantly more onerous and expensive requirement than anticipated
- There is a great deal of confusion as to the real effort and cost to comply with S404. Investor groups support S404 but also caution that it needs to be cost effective
- The liability environment is a key factor in this unexpected outcome and this has resulted in excessive costs and burdens

CONCLUSION No. 3

There are fundamental differences between larger and smaller companies

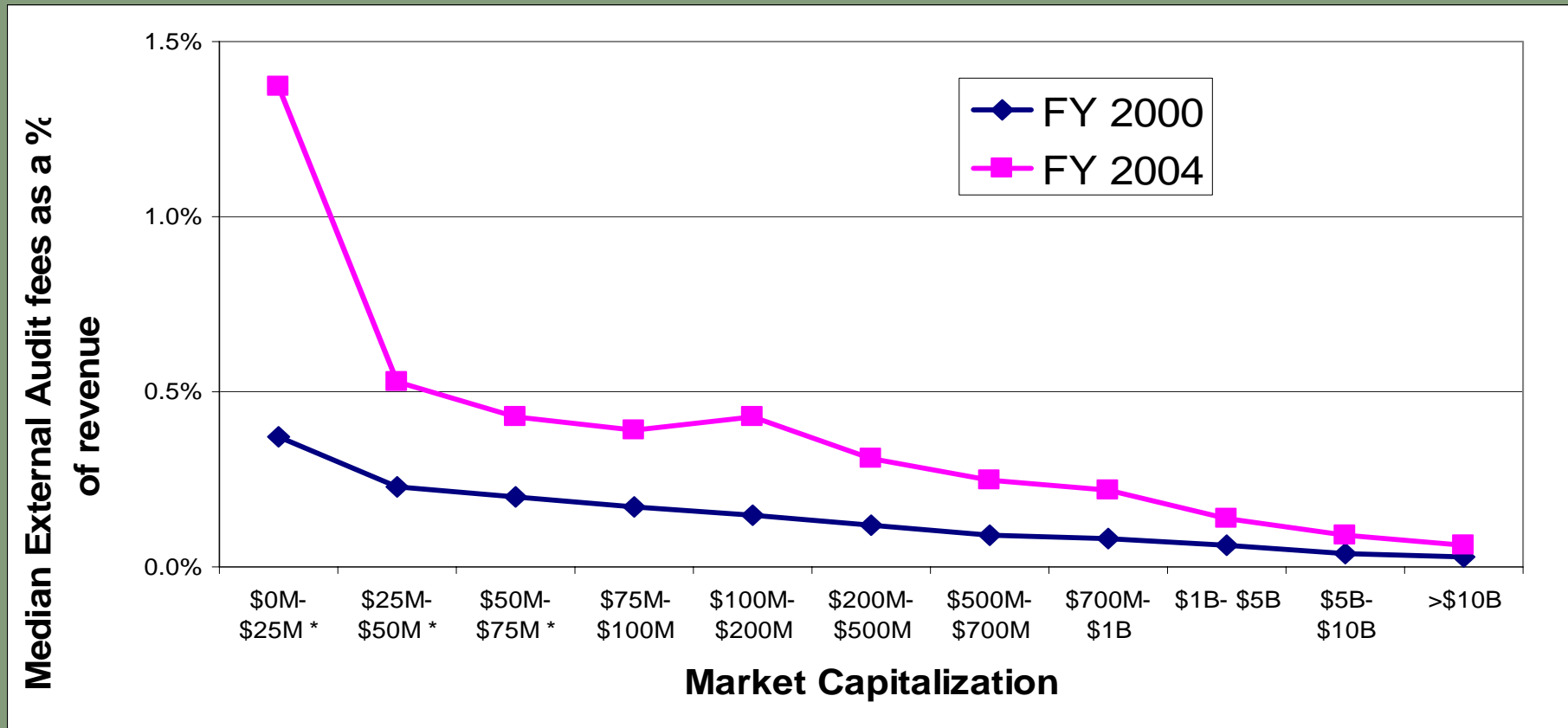
Some fundamental differences between larger and smaller companies

- Management's Daily Interaction:
 - Management of larger, more complex companies must rely on strong systems and controls in order to ensure that financial data is reliable. 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.
- The Financial Audit/Substantive vs. internal control reliance:
 - Smaller companies do not receive the same benefit from the integrated audit concept of AS2. For auditors of larger, more complex companies, it is necessary to place significant reliance on controls when performing the audit, since it is typically not practical to test to a sufficient level of substantive detail that would be required if reliance on controls were not warranted. However, in smaller companies with less complex environments it is often less effective for the auditor to adopt an audit strategy of placing significant reliance on effective internal controls to reduce the substantive audit testing. As a result, there is less efficiency of scale at a smaller company. It is also more difficult for the auditor to establish reliance based on people-dependent controls, where segregation of duties may not be possible, as opposed to system-dependent controls.

CONCLUSION No. 4

The cost and amount of resources necessarily devoted to S404 compliance is not proportional for Microcap and Smaller Public Companies

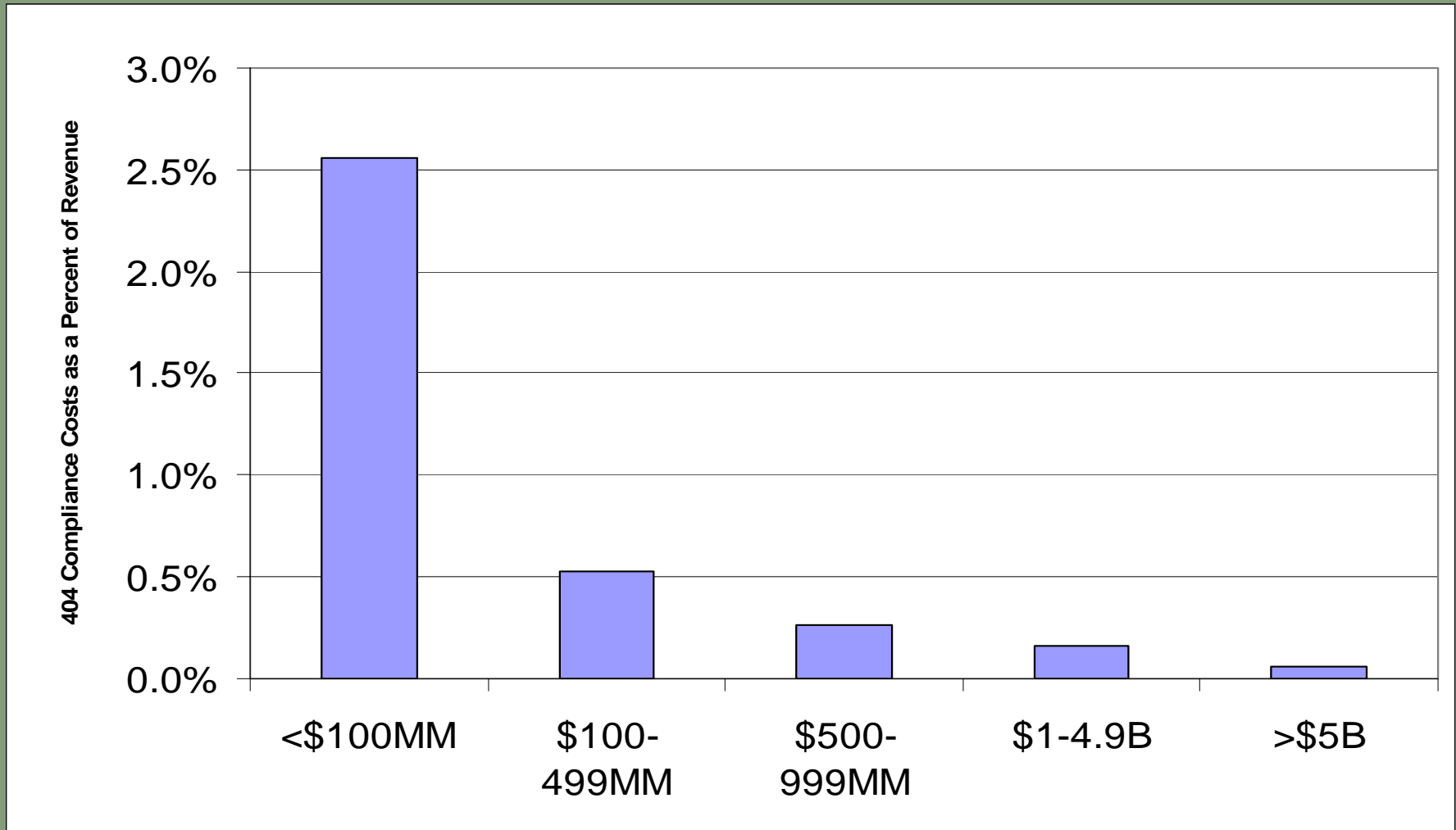
Median External Audit fees as a % of revenue



* Companies with a market capitalization of <\$75M generally did not have to comply with Section 404 of Sarbanes-Oxley in 2004. It is expected that their audit costs will be much higher when they are required to comply.

Example - much higher relative S404 (total) compliance costs

(Note: <\$100M category includes only accelerated filers)



CONCLUSION No. 5

Based on our consultations with COSO, clear guidance does not yet exist for Microcap and Smaller Public Company managers on how to develop and support a proper S404 assertion

Managements' S404 Assessment

- There are actually 3-S404 reporting requirements:
 - Managements' assessment
 - External audit of managements' assessment/conclusion
 - External audit of control effectiveness
- While COSO has proposed additional guidance for smaller companies, which assumes an AS2 environment, there is currently little practical guidance available to assist smaller companies in implementing the COSO internal control framework in a cost-effective manner
- AS2 provides guidance for an auditor; it was not intended to be management guidance
- Today AS2 is the default (and only) standard and thus management uses AS2
- Managements' approach in Microcap and Smaller Public Companies can be tailored with additional guidance that is not linked to AS2

CONCLUSION No. 6

Investors recognize that smaller companies carry greater investment risk

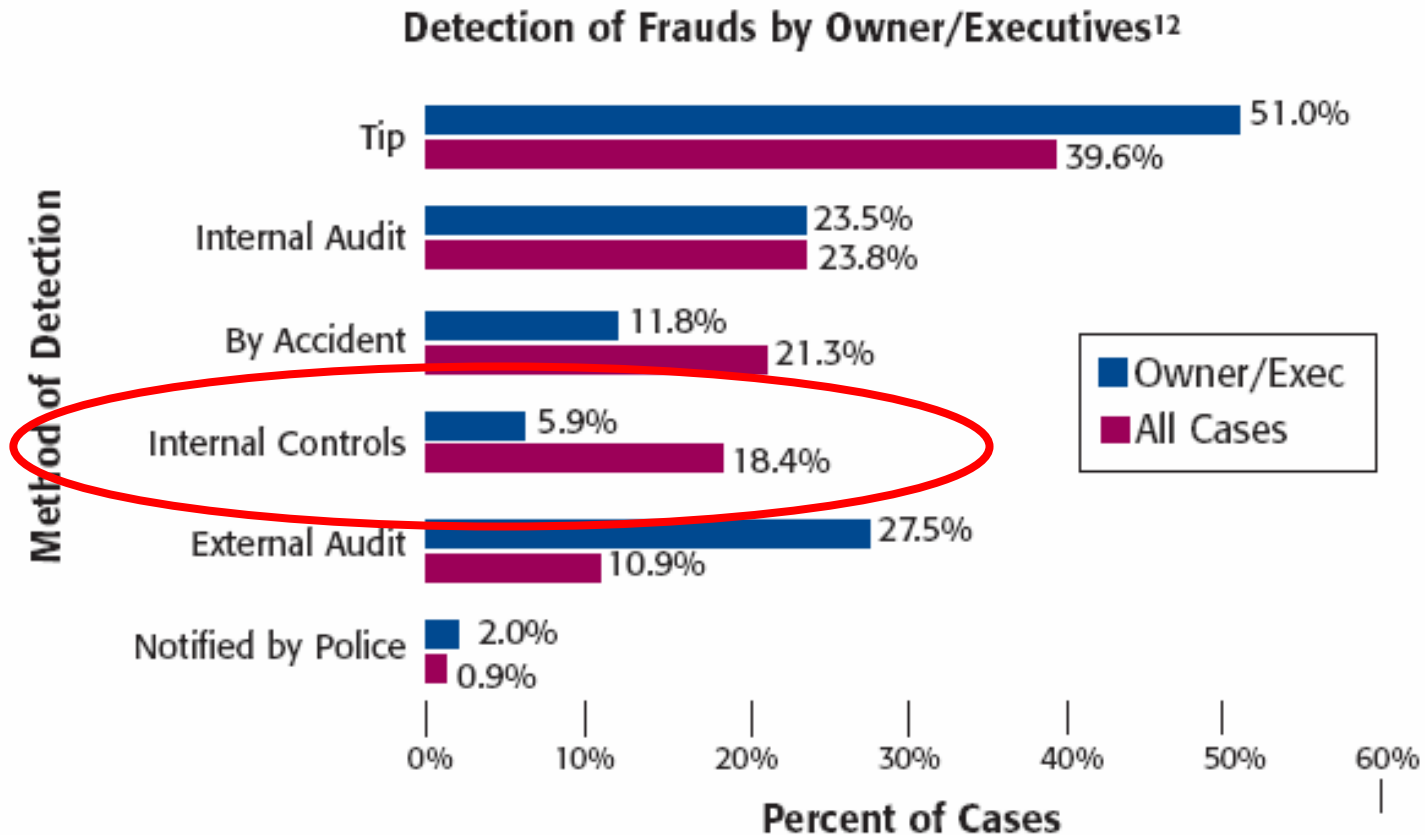
Investor perception of risk relative to size

- Investors currently allocate companies to different categories relative to size
- Smaller companies are generally considered to have higher business and operating risk
- Most institutional fund managers consider a stock with a market capitalization of <\$1B to be a smaller capital stock

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

Methods of detecting fraud by senior executives



CONCLUSION No. 8

There are multiple ways to help ensure good internal controls at smaller public companies

Alternative ways to ensure effective internal controls

- The Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) 1992 report did not recommend external auditor attestation on the effectiveness of internal controls as a cost effective method of improving internal controls
- There are multiple other cost effective methods of helping to ensure effective internal controls are in place and operating
 - Management's S404 assertion (for Smaller Public Companies)
 - CEO/CFO certifications
 - Independent audit committees/ financial experts on audit committee
 - Whistleblower provisions
 - Traditional financial audits
 - Increased threat of criminal penalties

CONCLUSION No. 9

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

Smaller companies have limited resources which are being allocated to internal processes for S404 compliance, and, as these processes are not relied on for financial reporting, this unnecessary effort results in diminished shareholder value

Adverse impact on smaller companies

- The regulatory burden of S404 on smaller companies is currently decreasing competitiveness through higher operating costs and management distraction from business opportunities and risks. The ability to respond and adapt quickly to business opportunity and risk is a key aspect of the ability of smaller companies to compete
- This regulatory burden is disproportionately higher on the Microcap and Smaller Public Companies
- Management Burden:
 - Due to increased importance of management's daily interaction and the lack of depth of internal resources, top management of smaller companies are required to spend a higher proportion of time to initially achieve and subsequently maintain compliance with the requirements of S404. Top management are central to the competitive success and wellbeing of smaller companies, and unduly burdensome compliance requirements have a direct negative effect on top management's ability to focus on other aspects of the business

Recommendations

Recommendations - Size criteria

For S404 purposes, Microcaps have a market capitalization and revenue trigger

- Market cap is the lower 1% of all US Public Companies (below approx. \$100-125 million) and last fiscal year revenues no greater than \$125 million
- Microcap companies exceeding the revenue threshold are subject to meeting the requirement of Smaller Public Companies below (and could be classified as a larger public company)

For S404 purposes, Smaller Public Companies have a market capitalization and revenue trigger

- Market cap is the lower 6% of all US Public Companies (below approx. \$700-750 million) and last fiscal year revenues no greater than \$250 million

Larger public companies are in the upper 94% of all US Public Companies or have last-year revenues of at least \$250 million

Recommendations - Size criteria

Public Companies, by Revenue & Market Capitalization

Revenue Interval (\$MM)	Market Capitalization Interval (\$MM)					Total
	0-125	125-250	250-500	500-750	750+	
\$0-125MM	5,252*	534	343	75	74	6,278
125-250	152	94	178	97	119	640
250-500	79	76	118	102	248	623
500-750	24	33	53	53	197	360
750-\$1B	8	18	29	27	149	231
\$1B+	16	12	43	64	1,161	1,296
Total	5,531	767	764	418	1,948	9,428

* The 5,252 smallest companies include 2,578 companies for which Compustat provides data on revenue and market capitalization, and an estimated 2,674 companies traded over NASDAQ and OTC Bulletin Board for which revenue and market capitalization data are missing (not reported in Compustat as of March 31, 2005).

Source: This table was compiled by members of the staff of the SEC Office of Economic Analysis (OEA) and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff. For details on the data, see notes to Table 19 in OEA, "Background Statistics: Market Capitalization & Revenue of Public Companies," August 2, 2005.

Recommendation 1

Microcap

- **Exempt Microcap companies from S404, subject to achieving certain corporate governance standards**
 - These companies remain subject to all other SEC regulations and requirements, e.g. S302 certifications, external financial audits and all applicable corporate governance standards set by the exchanges on which they trade. In addition, unlisted companies, as a condition of exemption from S404, would need to comply with the corporate governance standards established by the Corporate Governance and Disclosure Sub-committee of this Advisory Committee.
- **Consistent with current SEC S404 rules, companies relying on the exemption would be required to disclose all material weaknesses known to management, including those uncovered by the external auditor and reported to the audit committee**

Recommendation 2

Smaller Public Companies

- **Exempt Smaller Public Companies from the external audit requirements of S404**
 - Smaller Public Companies would still be required to complete a management assessment of internal controls under S404
 - These companies would remain subject to all other SEC regulations and requirements, e.g. S302 certifications and external financial audits. In addition, they would be required to comply with all applicable corporate governance standards set by the exchanges on which they trade or, if unlisted, by the Corporate Governance and Disclosure Sub-committee of this Advisory Committee. The latter is required for an unlisted company to be exempt from full auditor reporting under Section 404(b)
 - These companies would also be required to disclose all known material weaknesses
- **Exemption to be effective immediately**
 - Smaller public companies currently subject to S404 should immediately be exempted from mandatory compliance with existing internal control audit requirements under AS2
 - Smaller public companies can still elect voluntarily compliance with internal control audit requirements under AS2

Recommendation 3

Smaller Public Companies

- 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 S404 to a cost-effective standard (ASX) providing for an external audit of the design and implementation of internal controls
 - The SEC should direct the PCAOB to develop a new standard for Smaller Public Companies, an external audit of the design and implementation of internal controls only, to make it more efficient and effective for these companies
 - This report would be similar in scope to the report described in Section 501.70 of the AICPA's Standards for Attestation engagements, plus walkthroughs. It would not involve any testing of the operating effectiveness of controls
 - This recommendation is subject to cost-benefit analysis prior to such a standard being issued in proposed form, with follow-up analysis prior to issuance
 - This requirement would be effective for fiscal years starting one year after the PCAOB issue this new audit standard (ASX) expected for fiscal years beginning after December 31, 2007, and subject to complimentary additional guidance for companies (see recommendation #4)

Recommendation 3

Smaller Public Companies, cont.

- **Additional aspects for consideration by standard setters with respect to the recommended design and implementation approach**
 - Setting a new standard should involve all stakeholders in audits of internal control over financial reporting, and should include a field trial period to insure the approach is both practical and achieves required objectives
 - A company and its auditor would more likely choose to implement an AS2 audit as the company gets more complex and the auditor plans to/needs to place a high degree of reliance on internal controls to significantly reduced substantive audit procedures
 - However an auditor would still be permitted to place reliance on controls to reduce substantive testing in selected areas by testing specific controls without performing an AS2 audit
 - For smaller public companies, the audit of the design of internal controls should be performed by the same auditor that is performing the financial statement audit and these audits should be integrated

Recommendation 3

Smaller Public Companies, cont.

- **Additional aspects for consideration by standard setters with respect to the recommended design and implementation approach (cont.)**
 - Control deficiencies identified during the financial statement audit should be evaluated to determine their impact with respect to the auditor's report on the design of controls
 - The audit of the design and implementation of controls should be integrated with the financial statement audit
 - Where the integrated audit identifies material weaknesses in either the design or the operation of controls, the auditor should disclose the material weaknesses in its report and state that internal controls are not effective

Recommendations 1-3

Determining applicable size category

- A public company should be able to determine its applicable size category on the first day of its fiscal year
- Transition between size categories should follow rules similar to the two year transition rules defined by Regulation SB

Recommendation 4

Additional Guidance - COSO

- **Ask COSO for assistance to help management assess IC's (based on testimony, these are areas that could make a significant cost and efficiency difference)**
 - Add post-year 1 monitoring guidance with selective testing where appropriate
 - Emphasize that "materiality" is to be determined on an annual, but not on a quarterly, basis
 - Expand ability to rely on compensating controls, especially for smaller public companies
 - IT controls are a primary compliance cost; reduce, in a way that is consistent with underlying risks
- **Ask COSO to develop additional guidance for management of Smaller Public Companies**
 - If no external audit - The SEC should request COSO issue guidance on the conduct of managements' assessment of internal controls over financial reporting for exempted Smaller Public Companies. This assessment will be conducted without an external audit and therefore more guidance is needed in order for these companies to perform their assessment efficiently on a stand alone basis. Management requirements would be significantly less since there is no external management assessment or auditor attestation
 - If ASX – The SEC should request COSO issue guidance on the conduct of managements' assessment of internal controls over financial reporting for all Smaller Public Companies in an effort to allow management to conduct an efficient assessment without following AS 2 guidance. Guidance would be sufficient to satisfy the requirements of auditors (assuming a new ASX) and support managements' assertion
 - Project is to set clearer standards for small company managements' S404 assessments (and reports)
 - **THERE IS LITTLE PRACTICAL GUIDANCE (NO STANDARD) TODAY FOR MANAGEMENT OF SMALLER COMPANIES TO ESTABLISH INTERNAL CONTROLS**

Recommendation 4

Additional Guidance - SEC

- Ask SEC to provide greater clarity and to encourage greater cost-effectiveness in management's design and assessment of controls
 - Emphasize that “materiality” is to be determined on an annual, but not on a quarterly, basis (See May 16th SEC guidance)
 - Expand ability to rely on compensating controls, especially for smaller public companies
 - IT controls are a primary compliance cost; reduce, in a way that is consistent with underlying risks
- SEC should allocate resources to developing a “Center of Excellence for Reporting and Corporate Governance for Smaller Public Companies”, e.g., a free website containing best practices, FAQs, advice on accounting for complex transactions and so on

Recommendation 4

Additional Guidance - PCAOB

- Ask PCAOB to provide greater clarity and to encourage greater cost-effectiveness in the application of AS2
 - May 16 and November 30 Guidance helpful, but the points they make need to be aggressively implemented
 - Stress the need for a risk-based approach
 - Controls should provide management with reasonable assurance, not absolute or perfect certainty
 - “More than remote” means “reasonably possible”
 - Scale back substantive testing to finding material weaknesses; testing is not to find deficiencies and significant deficiencies
 - Integrate the financial audit and the internal control audit, especially at smaller public companies
 - All restatements should not be treated as material weaknesses; accounting complexity, not control deficiencies, are at the root of many restatements
 - Materiality is to be determined on an annual, but not on a quarterly, basis
 - IT control testing is a primary source of excessive cost; reduce, in a way that is consistent with underlying risks
 - Consider additional ways to reduce the complexity of AS2 as currently being implemented

Recommendation 4

Additional Guidance – PCAOB (cont.)

- **Ask PCAOB to implement the foregoing promptly**
 - PCAOB should consider whether this is most effectively accomplished by amendments to AS No. 2, by additional interpretive guidance, through the work of its inspection program, or through a combination of these or other approaches
 - It is important that auditors receive the same message from Board inspections as from the Board's interpretive guidance
- **A question remains regarding whether AS2 is appropriate, even with all the existing and suggested guidance, or if it is now time to reevaluate or amend the standard**

Recommendation 5

S404 exemptions for special cases

(As of today the committee has not had time to consider all the implications of the non-accelerated filers entering the system)

- The SEC staff should carefully analyze the categories of issuers below \$750M in market capitalization with S404 in mind
 - This review should be focused on avoiding unintentional consequences on smaller companies that file with the SEC but do not trade in active markets
- This analysis should occur in the spirit of our other recommendations
- Debt Only Issuers, for example, need some relief; debt documents can control reporting of the issuer

Purpose of this presentation

- **To seek:**
 - Approval of the internal control subcommittee's recommendations
 - A good awareness of our work
 - A sound understanding of the supporting facts we used
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Subcommittee's recommendations

1. Exempt Microcap companies from S404, subject to certain conditions
2. Exempt Smaller Public Companies from the external audit requirements of S404, 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 S404 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 S404 relief

Conclusion

- The Internal Controls Subcommittee recommends that the SEC Advisory Committee on Smaller Public Companies approve these recommendations
- Subcommittee Members
 - Janet Dolan (Retired CEO, Tennant)
 - Richard Brounstein (EVP Calypte Biomedical, Chairman of FEI Small Public Company Taskforce)
 - Alex Davern (CFO National Instruments, Chairman of the AeA Committee on Section 404)
 - Mark Jensen (Partner Deloitte, National Director Venture Capital Services)
 - Deborah Lambert (Co-Founder, Johnson Lambert & Co.)
 - Kurt Schacht (Executive Director, CFA Institute)

- Questions

- Motion for a vote