

April 27, 2006

U.S. Securities and Exchange Commission  
Public Companies Accounting Oversight Board  
Washington, DC 20549-1070

**RE: File Number 4-511**

We submit this report with the intent of providing insights into a cost effective way for small and micro-cap companies to satisfy Section 404 requirements while complying with Small Company COSO standards. The approach is consistent with recent SEC recommendations concerning risk assessment and derives from well established "Deming" type concepts. This report is being submitted for consideration as a topic for the roundtable scheduled for May 10, 2006.

As someone who has:

- taught numerous courses associated with "Complying with Sarbanes-Oxley Section 404" throughout the U.S.,
- performed over 400 Peer Reviews,
- worked as an internal auditor and financial professional within three publicly held companies;
- served on the AICPA Peer Review Acceptance Board for the past ten years in Massachusetts,

I believe that the creation of a Section 404 framework for small and micro-cap companies is not only essential but realistic as well. I believe you will find the attached framework worthy of consideration.

Please feel free to contact me if you have any questions.

Best regards,

***Bob Benoit***

Robert Benoit, CPA  
President and Director of SOX Research



## Summary and Introduction

Historical evidence in the **Lord & Benoit Report: Bridging the Sarbanes-Oxley Disclosure Control Gap** [http://www.section404.org/pdf/Lord\\_Benoit\\_Report\\_1\\_.pdf](http://www.section404.org/pdf/Lord_Benoit_Report_1_.pdf) shows the need for Section 404 internal controls compliance for Small Cap and MicroCap companies. Only 8% - 14% of the *accelerated* filers with material weaknesses self reported under Section 302 (a lower standard) the year and quarter before being required to under an adverse Section 404 circumstance. Additionally, more than half of *all* the companies in the U.S. with material weaknesses were smaller companies with revenues under \$250 million.

Additional **Lord & Benoit Research: Share Price movements Associated with Accelerated Filers** during the last two years provides evidence that good internal controls produces positive company and investor benefits. One must recognize, however that Section 404 compliance for smaller companies, if not introduced prudently, can divert much needed resources for product and market development.

We therefore offer a simple, efficient and cost effective approach for MicroCap and SmallCap companies to comply with Section 404 of the Sarbanes-Oxley Act. In summary, some key elements follow.

The key to efficient compliance is not necessarily the content of the framework, although that is important; but it is the **way** the project is approached. Our methodology starts by asking the "Deming" question; what actual or peer incurred errors in internal control development and implementation have occurred and why have they occurred? We start from the end and work backwards.

Our **Framework** does not require a different PCAOB or COSO standard. We believe it is consistent with both. It is also consistent with previous SEC/PCAOB roundtable recommendations (risk based, top down), which many companies have not yet embraced. The utilization of this Framework, both within companies and by external auditors, can expect to save significant time and costs while demanding that risk areas be analyzed and to an extent possible deficiencies be remediated prior to testing.

## Why No Need for a New Company, COSO or PCAOB Standard?

- Auditors of smaller companies have been adjusting to big company standards for years (SASs, FASBs, SOPs, EITFs, FINs). Although the argument has been made, there is still no big company and small company GAAS/GAAP. Auditors of smaller companies simply check "N/A" because many of the audit steps do not apply. Since there is a chance that a standard could apply to a company,

## Lord & Benoit *MicroSox*<sup>TM</sup> Implementation Framework

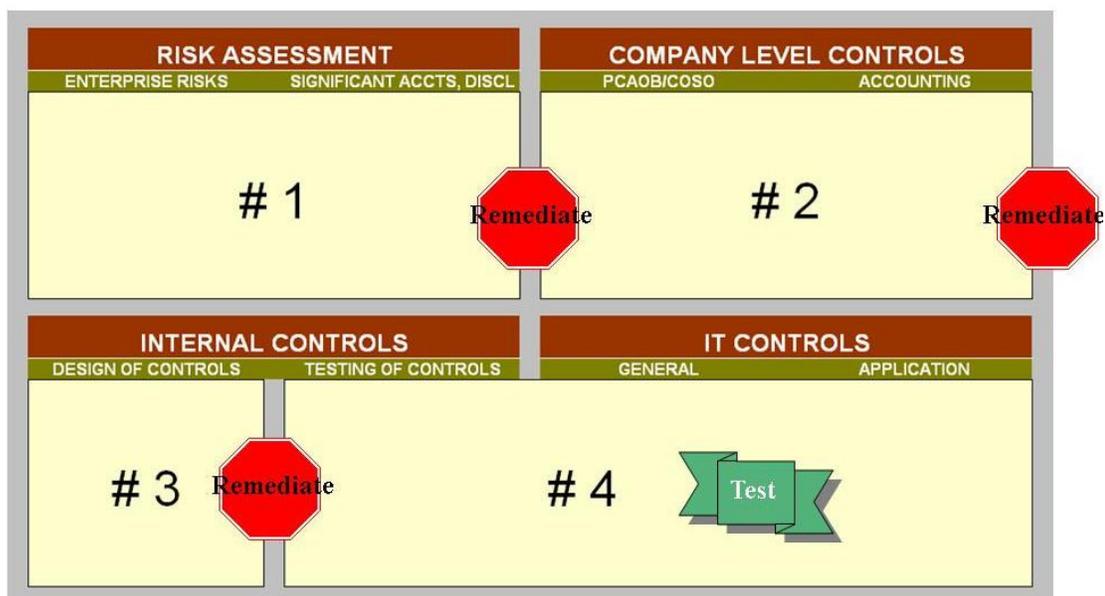
it is safer to ask the question and check "n/a", rather than creating a new standard that excludes that question. We therefore believe the standards should remain unchanged. With the help of third party audit program providers, we see important COSO components, risk assessment, fraud, disclosure checklists and other professional standards adjusted to smaller companies, without a change in standards.

- With regards to internal controls, both internal and external auditors of smaller companies have been adjusting for years. Internal control principles are simple in nature and easy to understand. Small Company COSO proved that point. Even in small companies, one cannot expect to eliminate:
  - Antifraud testing,
  - Segregation of duties analysis,
  - IT controls reviews,
  - Accounting principle application analysis,
  - Cultural and ethics assessments,
  - Audit committee effectiveness evaluations and,
  - Industry/peer risk assessments?

We can and should simply adjust control documentation and testing to the size of the MicroCap....like auditors of smaller companies have been doing for years.

### The Perspective is the Key

We believe a significant reduction in time and redundancy in Section 404 compliance can be accomplished by changing the implementation approach. The following chart illustrates by steps:



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## Step #1 - Risk Assessment:

Risk assessment is the first step in the **Framework**.

Using recently available database tools and web based technologies<sup>1</sup> one can focus in on the internal control problems and accounting issues that peer companies have historically faced or are facing currently. One can quickly mine compelling and detailed data related to the following internal control risk areas related to a company's peers;

- Section 404 internal control deficiencies,
- Section 404 accounting application deficiencies
- Section 302 internal control deficiencies, including significant deficiency analysis
- Section 302 accounting application deficiencies
- Financial restatement analysis of accounting application and reporting deficiencies
- Legal exposure issues and;
- Other issues associated with auditor changes, fees and non-financial risk indicators

In other words, one starts with data analysis that provides predictable and verifiable evidence of errors or vulnerabilities in a target company's internal controls and works backward to identify and correct control area deficiencies. What risks have companies in similar peer groups experienced? What were their internal control deficiencies, restatements, legal issues and disclosure control issues? Effectively, one understands the possible issues on day one and starts working to identify and correct them. The objective of doing risk assessment first is that early detection of *significant* issues leads to early correction.

In fact, one of the unexpected benefits of delayed implementation of Section 404 requirements is that error data is now available from the reviews of more than 14,000 Section 404 reports (management and auditor), 120,000 Section 302 reports, 4,500 financial restatements, and 5,000 legal cases being faced by public companies to assist with the risk assessment process. Utilizing peer analysis to narrow areas for Section 404 review is now a very realistic option for almost all small and micro-cap companies. Obviously, this process only serves to supplement the good judgment of internal and external accounting professionals. Ultimately, they will need to be able to defend their decision-making processes.

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<sup>1</sup> The best and most complete dataset is distributed by [www.AuditAnalytics.com](http://www.AuditAnalytics.com), an affordable premium based independent research company that specializes in collecting and adding expertise to audit, internal control (404 and 302), financial restatements and legal exposure related disclosures for all public companies. We have been utilizing this service for the past several months to do advanced research in the area of SOX compliance. We have no financial or other ties to Audit Analytics other than through a subscription arrangement.

## Lord & Benoit *MicroSox*<sup>TM</sup> Implementation Framework

An important reminder is that only significant controls need be tested. Our experience has been that many companies have been fully documenting *non key controls*: assertions, processes, sub processes, preventive, detective, responsible person, etc. Only to arrive at the final column of the excel spreadsheet asking, "Key Control?" answered "no". This should be in the first column eliminating the need to document all the other insignificant items.

RISK ASSESSMENT	
ENTERPRISE RISKS	SIGNIFICANT ACCTS, DISCL
Discussions ( <i>outside auditors, key people, audit committee</i> )	Preliminary materiality calculation Identify Significant f/s level accounts Identify Significant acct level accounts Identify Significant locations Identify Significant business units Identify Significant disclosures Identify Key controls
Company risk assessment ( <i>level of risk/impact</i> ) ( <i>likelihood</i> )	If Key - <i>then document relevant assertions, processes, subprocess, detective, preventive, ownership</i>
Risk assessment tools ( <i>industry comparatives, restatements</i> )	
Obj: What are <b>key</b> risks?	Obj: What <b>key</b> controls <i>need</i> testing?

### Step #2 - Company Level Controls:

For a smaller company, many of the internal control weaknesses and accounting deficiencies are found in the Company Level Control area.

COMPANY LEVEL CONTROLS	
PCAOB/COSO	ACCOUNTING
COSO Control environment COSO Risk COSO Monitoring COSO Communication	Accounting principles, estimates, judgements Significant related party transactions Significant Intercompany accounts Significant Service organizations Significant Disclosures (checklist) Period end reporting (testing) Closing process (testing)
Obj: Company Level COSO Controls	Obj: High level acctg controls

By testing Company Level Controls next, it is possible that testing could be minimized at the activity level. This is particularly true in cases where Company Level Controls are considered to be compensating controls. Q&As essentially suggest that a deficiency does not constitute a material weaknesses or a significant deficiency in cases where there is an effective compensating control.

Smaller companies are typically run by Company Level Controls, not Activity Level Controls. The Small Company COSO draft reiterated this point. Stated differently, we know that most MicroCap companies will not typically have good segregation of duties. However, segregation of duties is just a preventive control that can be mitigated from being a significant deficiency or material weakness if an effective compensating Company Level Control is in place. Therefore Company Level Controls should be evaluated first.



## Step #4 – IT and Internal Control Testing:

IT Systems are controls on which other controls are dependent. They drive much of the accounting process so that they cannot be ignored. However, many of these smaller entities are using “canned” packages or smaller ERP systems supported by an outside vendor as needed. Therefore the IT *General Controls* should be able to be documented and tested using an IT controls questionnaire (i.e. either using a SAS 55 questionnaire or the IT Governance Institute’s questionnaire called [IT Control Objectives for Sarbanes-Oxley](#)). IT *Application Controls* are typically tested simultaneously with activity level control testing in the previous section. Most checklists are designed this way anyway. Plus most checklists reference relative assertions and fraud schemes.

INTERNAL CONTROLS		IT CONTROLS	
DESIGN OF CONTROLS	TESTING OF CONTROLS	GENERAL	APPLICATION
	Test activity level control matrixes <i>(also includes fraud tests)</i>  Document sampling  Obj: Activity Level COSO Controls	General IT Controls Questionnaire <i>(and documentation of tests)</i>  Obj: Is IT Dept (if any) in control?	Application IT Controls Questionnaire <i>(mostly tested in activity control matrix area)</i>  Obj: Are IT program controls proper?

## Final Step - Evaluation and Reporting

This should be consistent with current practices.

## An Argument for Contract Internal Audit in Smaller Companies

Although not required by professional standards, we recommend a company hire contract internal auditors for implementation, particularly in smaller companies for three reasons.

- It best satisfies the monitoring component of COSO
- It provides a little more independence testing credibility as recommended by PCAOB Standard 2.
- It should be less expensive for a smaller firm to hire a contract internal auditor than hiring a full time internal auditor.

## Internal Controls are an Iterative Process

A recommendation was made to review internal controls every other year. We believe COSO standards make it clear that the review of internal controls is not a once a year project, but *an iterative ongoing process* of reviewing internal controls.

## One Suggestion

MicroCap and SmallCap companies will almost always have segregation of duties and training issues. Auditors need to be reminded that the lack of segregation of duties does not by itself constitute an ineffective control environment. This is a key issue if we are to make Section 404 successful for MicroCap companies. Segregation of duties is a preventive control that *can* be overcome with good compensating controls. PCAOB Q&A specifically says that it does not automatically lead to an ineffective Section 404 report, unless the compensating controls are not working.

## Expected Costs

We have estimated that a full Section 404 compliance examination and remediation effort should cost less than half of the outside auditors' fee for small and micro-cap companies.

## In Summary:

- √ No need for new PCAOB, Company or SEC Auditing Standard
- √ No need for new Small Business COSO Standard
- √ Uses PCAOB/SEC Roundtable recommendations - risk assessment and company level controls (top down) approach
- √ Costs should be about half the audit fee - or cost of good executive assistant
- √ By changing the approach, we get all the benefits of a good control environment, affordably.

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Written by Robert Benoit, CPA. Benoit has been teaching Complying with Sarbanes-Oxley Section 404 throughout the U.S. through the State CPA Societies. He has been on Massachusetts AICPA Peer Review Acceptance Board for the past ten years, has performed over 400 peer reviews of over 100 CPA firms and is President and Director of SOX Research at Lord & Benoit, LLC a national Sarbanes-Oxley Research and Compliance firm [www.Section404.org](http://www.Section404.org).

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