

December 30, 2005

The Committee of Sponsoring Organizations of the Treadway Commission

Re: COSO Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting

Dear COSO:

The Center for Public Company Audit Firms (the Center) of the American Institute of Certified Public Accountants (AICPA) is pleased to submit written comments on the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) exposure draft, *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting* (the Guidance).

The Center was established by the AICPA to, among other things, provide a focal point of commitment to the quality of public company audits and provide the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB), when appropriate, with comments on their proposals on behalf of Center members. There are approximately 900 Center member firms that collectively audit 97% of all SEC registrants (and 91% of the non-accelerated filers are audited by Center member firms). All of the Center's member firms are U.S. domiciled accounting firms. The AICPA is the largest professional association of certified public accountants in the United States, with more than 340,000 members in business, industry, public practice, government and education.

We applaud COSO for their efforts in responding to the SEC and requests by smaller public companies and their auditors for additional guidance on the implementation of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX Section 404). We believe that the Guidance will be an excellent and valuable resource to not only smaller public companies, but to companies of all size. We appreciate the opportunity to contribute the following comments which are addressed in response to COSO's request for feedback on the Guidance. We changed the format of the statements in COSO's request for feedback to that of questions to facilitate responding to them in this letter.

1. Does the Guidance provide guidance that will help companies develop and implement internal controls over financial reporting?

The general discussions toward the beginning of the Guidance labeled “Controls Need to Be Cost Effective for Smaller Businesses” (on page 3) and “Challenges in Implementing Internal Control in Smaller Businesses” (on page 14) provide good insight and important considerations for managing these issues within smaller public companies as they begin to implement and assess internal control over financial reporting. While we believe that the Guidance successfully meets COSO’s objective of providing guidance to assist in applying the Framework for many of the smaller public companies and their auditors, some of the approaches and examples provided need to be tailored further for the smallest public companies, which are particularly challenged in achieving effective internal control because of resource constraints, lack of segregation of duties, etc. For instance, there are a number of examples depicting the effective achievement of certain principles in the Guidance that refer to the use of an internal audit function; however, in many cases, and especially, at the smaller end of spectrum of public companies, such functions do not exist. Accordingly, we offer some recommendations that we believe will improve the Guidance by scaling it further to include more guidance for the smallest public companies (more specifically identified in response to question number 7 below).

In addition, we believe that the Guidance could be further enhanced by including an illustrative project plan of the Framework to offer an example of a top-down approach to the evaluation and documentation of internal control over financial reporting as endorsed by the SEC. Further, illustrative project plans could be included based on characteristics of two sample public companies of different sizes within the smaller public company category; one on the larger end and one on the smaller end of the spectrum.

2. Does the Guidance help smaller organizations strengthen their internal control processes in a cost effective manner?

In general, while the Guidance will help smaller companies, we believe that it can be improved upon as discussed in our response to question 1.

3. Does the Guidance improve your understanding of the Internal Control - Integrated Framework?

Through the use of the 26 principles and the related attributes, approaches and examples, the Guidance effectively explains and illustrates possible ways to achieve effective internal control over financial reporting for the five key components of internal control in a fairly robust manner. Accordingly, this Guidance would be useful to larger companies as well as smaller companies in implementing and evaluating internal control over financial reporting in a cost-effective manner.

However, we believe that the Guidance is somewhat inconsistent with the Framework in that the Guidance focuses more on the 26 principles rather than the five key components of internal control. Accordingly, we recommend that the Guidance be refocused more toward the achievement of the five key components of internal control rather than on the achievement of the 26 principles, particularly for attributes and/or controls which may not be applicable or possible for the smallest public companies. Further, we noted that the Guidance introduces a new term “principles,” whereas the COSO Framework used the term “control objectives.” The change in terminology may result in added inefficiencies for public companies and auditors that believe that they should adjust their methodologies previously developed in accordance with the Framework for the change. Accordingly, COSO may want to consider how to limit inefficiencies in implementing the Guidance on top of the preexisting Framework. One possible way to alleviate some of the potential inefficiencies would be to provide an exhibit to the Guidance which effectively reconciles the principles in the Guidance to the control objectives in the Framework so that auditors and public companies can effectively bridge the two documents in their methodologies without having to completely reconstruct the methodology.

4. Are the 26 principles set out in the Guidance sufficient for effective internal control over financial reporting?

We noted that some inconsistency and potential confusion are created by the fact that the Framework focuses on the five components of internal control, whereas the Guidance focuses more on the 26 principles. Below in response to question 7, we offer a recommendation on the benefits of alleviating this inconsistency. While we believe that the dissection of the five key components of internal control into the 26 principles with the related attributes, approaches and examples offers effective guidance to assist smaller public companies and their auditors in applying the Framework, as discussed below in response to question 7, we believe that many of the principles are redundant and some of the attributes and examples are not applicable to the smallest public companies. The redundancies in the 26 principles may create additional unnecessary steps for management that may lead to reduced efficiency in smaller companies’ assessment of internal control. We believe that there are several principles that could be condensed to simplify the process for smaller companies, making it easier to follow and facilitating the efficiency of the evaluation of internal control by smaller companies. The following are examples of somewhat redundant principles where consolidation into one principle might be appropriate, but it is not necessarily an all-inclusive list:

- principles 2 and 25 on the Board’s role
- principles 1, 3 and 17 on tone at the top
- principles 5 and 8 on the importance of retention of competent personnel and the establishment of objectives for reliable financial reporting

In addition, we recommend that further clarification be included as to what extent monitoring could be used effectively in a smaller public company environment. Since smaller companies are often more reliant on tone at the top and management oversight to achieve effective internal control, the Guidance should specifically address how monitoring can be effectively used in the smallest public companies which have fewer employees and one or more actively involved owners/directors. Exhibit 2.3 on page 19 in the Guidance demonstrates that the Framework components of internal control may be weighted differently in smaller companies than larger ones. We recommend that COSO elaborate through the use of approaches and examples in the Guidance as to how smallest companies could use monitoring controls and the manner in which effectiveness of these controls should be addressed. In addition, the Guidance should provide more guidance and examples for smaller public companies on alternate controls that effectively compensate for a lack of segregation of duties controls. For example, outsourcing key financial responsibilities and even monitoring responsibilities can be an effective way of controlling the financial process. COSO should provide further guidance on outsourcing of financial responsibilities to third parties, including a discussion of management's responsibilities with respect to ensuring the quality of the work of the third parties and the competencies of those individuals.

5. Are there principles in the Guidance that are not required for effective internal control over financial reporting?

As discussed in response to question 4 above, we believe that the Guidance should be simplified to condense certain redundant principles in order to make the Guidance easier to follow and to facilitate the efficiency of the evaluation of internal control by smaller companies.

6. Is the guidance useful to diverse groups, including management, internal auditors and external auditors?

We believe that the Guidance is useful to diverse groups, including management, internal auditors and external auditors to companies of all sizes.

However, to prevent any confusion or misinterpretation by management, audit committees, auditors or the general public, we recommend that language be added to the Guidance to clarify that the specific attributes, approaches and examples included in the Guidance offer examples rather than all-inclusive, mandatory guidelines. Although this point is alluded to on pages 6 and 7 of the Guidance, we believe this clarification needs to be more directly articulated both in the main section of the Guidance as well as in the exhibits in order to limit confusion. The potential for confusion is particularly relevant for controls related to information technology. Here is an example of language to consider adding to the Guidance to clarify this point:

“The attributes included in this document for each principle and the related approaches and example controls represent illustrative best-practices examples

of attributes and controls and do not all need to be present to have effective internal control. The absence of any one or more of these attributes or approaches or the use of different attributes or approaches does not mean that the objectives of internal control have not been achieved.”

7. Are there additional examples that can be provided to enhance the Guidance? If so, please indicate the related principle.

As discussed in response to question 1, we believe that many of the approaches and examples under the 26 principles in the Guidance are more relevant to the larger end of smaller companies and would not be applicable to the smallest public companies. We believe that the Guidance should concentrate more directly on managing the five challenges in implementing internal control in smaller businesses identified on page 14 of the Guidance. Also, as noted in response to question 4, we believe that some redundancies exist in the 26 principles that may reduce the efficiency with which smaller companies can evaluate internal control using the Guidance. We believe that some of the 26 principles can be condensed where redundancies exist in order to simplify the Guidance for smaller companies.

Further, as noted in response to question 6, the Guidance should acknowledge that the objectives of effective internal control can be met by smaller companies even if certain types of controls or attributes do not exist. The Guidance should clarify, particularly in the illustrative tools, that certain principles and related controls may not be necessary to achieve internal control objectives, particularly if effective compensating controls are in place. For example, for a company with few employees, constant informal communication may forego the need for newsletters, formal meetings, etc. and senior management’s active involvement and review may compensate for a lack of segregation of duties controls.

We urge COSO to reevaluate all of the principles to determine whether the underlying internal control objectives could be effectively achieved even if certain attributes and/or controls do not exist in the smallest public companies. We recommend that the Guidance be revised to include examples of alternate controls applicable to the smallest public companies and/or additional guidance regarding the effective use of compensating controls, such as monitoring or outsourcing of key financial reporting responsibilities, to achieve the five key components of internal control even when the achievement of certain principles and/or controls is not possible. Below we have listed a sample of approaches and examples that likely are not feasible in the smallest public companies. The following is not an all-inclusive list, but rather provides examples intended to provide some insight as to some of the areas where we believe that additional guidance is necessary for the smallest public companies.

- **Control Environment – Importance of Board of Directors** (Pages 30-34) – An “independent audit committee” is referenced throughout many of the examples under this principle, particularly example 3 on page 31, entitled

“Audit Committee’s Independence and Financial Expertise.” However, for many of the smallest public companies, it may be economically challenging to have an audit committee with three independent members.

- **Control Environment – Authority and Responsibility** (Pages 42-44) – Most of the approaches and examples for this principle focus on achievement of appropriate segregation of duties and assignment of responsibilities to various individuals. However, in many of the smallest public companies, there are a relatively small number of finance employees to share the responsibilities, or in some cases only one employee.
- **Information and Communication – Information Needs** (Page 93) – The first example discusses the effectiveness of management meetings between the CEO, CFO and all department heads as a control. However, the Guidance should clarify that constant informal communications within the smallest public companies can also effectively accomplish the objective.
- **Information and Communication – Information Control** (Pages 95-97) – Many of the examples for this principle discuss the use of a compliance officer within the company as a control over documentation and effectiveness of system controls. Many smaller companies would not have this type of individual nor would they have the resources to hire or outsource one.
- **Information and Communication – Board Communication** (Pages 103-104) – There are approaches and examples for this principle that discuss meetings between the board and the internal auditors. Many smaller public companies do not have an internal audit function, nor do they have the resources to establish or outsource one.
- **Information and Communication – Board Communication** (Pages 103-104) – For this principle, as well as others throughout the Guidance, meetings between senior management (CEO, CFO, Controller, etc.) and the board are recommended. However, in many of the smallest companies, senior management may consist of a small number of individuals who are also members of the board.
- **Monitoring** (Pages 107-115) – As discussed in response to question 4 above, we recommend that the approaches and examples be expanded in the monitoring area to provide specific guidance for the smallest public companies on how monitoring controls (alone or in conjunction with other controls) can be effectively used to compensate for a lack of segregation of duties controls.
- **Roles and Responsibilities – Management Roles** (Pages 117-118) – All of the approaches and examples for this principle assume a multi-tiered management structure where there is some level of segregation of duties and checks and balances between senior, middle and lower management. However, in many smaller public companies, these various levels of

management do not exist, and in some companies all responsibilities are divided amongst only a few individuals.

- **Roles and Responsibilities – Other Personnel** (Page 121-122) – Most of the approaches and examples for this principle focus on having or outsourcing an internal audit function. However, for the smallest public companies, having an internal audit function would not be practicable and even outsourcing one may not be feasible due to resource constraints.

8. In helping plan for the future, are there areas where COSO can provide additional guidance?

To this point, COSO has developed *criteria* that might be used to assess internal control over financial reporting. We believe COSO could provide helpful guidance on the procedures management might use in performing an assessment of the effectiveness of internal control over financial reporting using the COSO criteria.

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The AICPA Center for Public Company Audit Firms appreciates the opportunity to provide COSO with comments on the Guidance. We would be pleased to discuss these comments with you at your convenience. In addition, the Center would be pleased to draw from our membership of approximately 900 firms that audit public companies of all sizes to assist COSO in enhancing the Guidance with additional guidance and example controls more relevant to the smallest public companies.

Sincerely,



Robert J. Kueppers
Chair
Center for Public Company Audit Firms