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COSO

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Sent by e-mail

Dear Sirs

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

The Institute of Chartered Accountants in England and Wales welcomes the opportunity to submit comments to COSO on its proposed *Guidance for Smaller Listed Public Companies: Reporting on Internal Control over Financial Reporting*. We note that a substantial amount of time and work has gone into the preparation of the consultation document ('the document') and we commend COSO on its efforts to date.

The Institute is the largest accountancy body in Europe, with more than 126,000 members operating in all sizes of business, public practice and within the investor community. The Institute operates under a Royal Charter, working in the public interest.

The Institute has substantial experience in the development of public policy and related guidance on internal control for the directors of companies listed in the UK. In 1999, under the auspices of the London Stock Exchange, we prepared the Turnbull Guidance (guidance on internal control to directors of UK listed companies), and subsequently assisted the Financial Reporting Council with its 2004/5 comprehensive review of the Turnbull Guidance.

In responding to the document, we have chosen to make some general observations. We have not answered the multiple-choice questions. Our comments are provided in the appendix.

If you require further information, please contact Jonathan Hunt, Head of Corporate Governance (jonathan.hunt@icaew.co.uk), or myself.

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INVESTOR IN PEOPLE

Top-down, principles and risk-based approach

At an event organised by this Institute in Washington, D.C. on 6 December 2005, and in the context of Section 404 of the Sarbanes-Oxley Act, SEC Commissioner Cynthia Glassman said “*..there has been widespread criticism of the burdens and costs of implementation. It appears that what was intended as a top-down, risk-based management exercise has become a bottom-up, non-risk-based exercise with an apparent focus on controls for controls’ sake.*”

We commend COSO for using a principles-based approach via the dissemination of its 26 principles for internal control over financial reporting (ICOFR). However, we have some concerns that, when taken together in the same document as over 100 supporting attributes and all the information in the appendices, that the principles-based approach could be abandoned in favour of a compliance driven, checklist approach. We refer to this matter later in our response.

The attraction of a principles-based approach, based on UK experience, is that it forces those to whom guidance is directed to think for themselves and then to ask questions of those in positions of management responsibility within the company.

In the appendix to the Turnbull Guidance, we adopted an approach of turning statements into questions. COSO may care to consider turning the 26 principles into questions of principle about internal control that senior management should ask of themselves and others. In a much smaller document, this might have the desired outcome that senior management will read the document and take the appropriate action.

Size and structure of the document

Our experience of the preparation of public interest documents that need the attention of senior people is to help them to want to read the document. We believe that the more succinct a document, the greater the chance that the intended senior management audience will read, understand and act upon its contents. It should therefore be concise and clearly written.

The Turnbull guidance (2005), which is principles-based and takes a wider approach to internal control is 15 pages in length. By way of contrast, at about 200 pages, the COSO consultation document is substantial.

We suggest a restructuring of the current document into two documents. The first document could contain only the principles, preferably in question format. The second, larger document could reiterate the principles and include the attributes, appendices, and other supporting information. The second document should be clearly labelled ‘non-binding and for illustration only’.

The second document might thus be perceived as a source of useful information rather than compliance requirements. There is a danger, despite protestations to the contrary, that the current document would encourage a one-size fits all approach and the attraction of the principles-based approach, forcing people to think for themselves, could well be diminished.

Attributes for each principle – scope creep?

Page 6 of the guidance refers to attributes. The document states (with our emphasis in bold type) that “*supporting **each principle** are attributes of the principle. The attributes are characteristics associated with the principle and are **generally expected to be present within a company**. However, depending on unique factors in each company, it **may** be possible to accomplish the principle without addressing each individual attribute. The objective is to demonstrate that the principle has been achieved.*”

The 26 principles each contain a number of attributes. In total, there are over 100 attributes which are “generally expected to be present within a company”. Page 6 of the guidance suggests that “it may be possible to accomplish the principle without addressing each individual attribute”. However, when working within the litigious culture that exists in the US, we can see a general cautious view emerging amongst management and external auditors that the principles and all the attributes should be present and that unnecessary work may be undertaken by companies and auditors. The management of smaller companies, especially those with more limited resources, could do without the resulted wasted time and additional costs involved.

We suggest two options:

1. as previously suggested, put all the attributes, appendices, and other supporting information into a second document that is clearly labelled ‘non-binding and for illustration only’.
2. minimise the wording currently on page 6. Perhaps something along the lines of “*supporting each principle are voluntary attributes which are characteristics associated with the principle. In practice, it is likely that the principle can be accomplished without addressing each individual attribute. The overriding objective is to demonstrate that the principle has been achieved.*”

Our preference would be for the first option and substituting the existing wording on page 6 with that used in the second option above.

Recent developments: SEC Advisory Committee on Smaller Public Companies

We understand that the intention behind the document is to provide guidance to senior management of small companies (such as companies with revenues of \$200m or less) that might otherwise use the full COSO Internal Control-Integrated Framework (1992) for the purposes of meeting the public reporting requirements of Section 404 of the Sarbanes-Oxley Act. We note that the document states that its intended audience includes boards, senior management, other personnel (such as internal audit) plus the external auditors.

We note with considerable interest the recent draft proposals from the SEC's Advisory Committee on Smaller Public Companies. We read that, if approved, these proposals would affect approximately 80 percent of all publicly traded companies in the US and that:

- Micro-cap companies (market cap approx \$100m and revenues less than \$125m) would be exempt from section 404 requirements; and
- Small-cap companies (market cap approx \$700m and revenues less than \$250m) would be exempt from the external audit requirements of section 404.

Whether or not these proposals are accepted by the SEC, we suggest that the document should be less driven by the need for management to document what it does to meet the documentation needs of third parties for external reporting purposes. Arguments in favour of a document that is more of a management tool will become even more compelling if the external audit requirements are dispensed with. We trust that COSO will carefully consider this matter.

The use of electronic multiple choice questionnaires

We were somewhat disappointed at, and wary of, the use of web-based multiple choice questionnaires for such a complex topic. Whilst it makes it much easier for those undertaking the analysis of answers and in the production of supporting statistics, the results need to be regarded with caution as it is only 'top-line analysis'. It is also possible for individuals with only a partial understanding of the complexity of the issues to complete the on-line questionnaire and to perhaps disproportionately influence the outcome of the consultation.

The written responses to the consultation will therefore require very careful analysis and consideration by COSO and we strongly recommend that much greater significance be given to the written responses that provide analysis of the issues than to the purely numerical statistics that will be generated electronically.