

on small entities of the new certification requirements.

C. Small Entities Subject to the Amendments

The new disclosure items affect issuers that are small entities. Exchange Act Rule 0-10(a)¹⁸⁴ defines an issuer, other than an investment company, to be a “small business” or “small organization” if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 2,500 issuers, other than investment companies, that may be considered small entities. For purposes of the Regulatory Flexibility Act, an investment company is a “small entity” if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.¹⁸⁵ We estimate that there are approximately 190 registered management investment companies that, together with other investment companies in the same group of related investment companies, have net assets of \$50 million or less as of the end of the most recent fiscal year.¹⁸⁶

The new disclosure items with respect to management’s report on internal control over financial reporting and the registered public accounting firm’s attestation report apply to any small entity, other than a registered investment company, that is subject to Exchange Act reporting requirements. The new certification requirements apply to any small entity that is subject to Exchange Act reporting requirements.

D. Reporting, Recordkeeping and Other Compliance Requirements

The amendments require a company’s management to disclose information regarding the company’s internal control over financial reporting, including management’s assessment of the effectiveness of the company’s internal control over financial reporting. All small entities that are subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act, other than registered investment companies, are subject to these evaluation and disclosure requirements. Because reporting companies already file the forms being amended, no additional professional skills beyond those currently possessed by these filers

necessarily are required to prepare the new disclosure, although some companies may choose to engage outside professionals to assist them in complying with the new requirements. We expect that these new disclosure items will increase compliance costs incurred by small entities. We have calculated for purposes of the Paperwork Reduction Act that each company would be subject to an added annual reporting burden of approximately 398 hours and the portion of that burden that is reflected as the cost associated with outside professionals is approximately \$35,286.¹⁸⁷ We believe, however, that the annual average burden and costs for small issuers are much lower.¹⁸⁸ For the new certification requirements, we estimate that a company, including a small entity, will be subject to an additional reporting burden of eight hours per year.¹⁸⁹ These burden estimates reflect only the burden and cost of the required collection of information.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

Several of these alternatives were considered but rejected, while other alternatives were taken into account in the final rules. We believe the final rules fulfill the intent of the Sarbanes-Oxley Act of enhancing the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets.

Sections 302, 404 and 906 of the Sarbanes-Oxley Act make no distinction

based on a company’s size. We think that improvements in the financial reporting process for all companies are important for promoting investor confidence in our markets. For example, a 1999 report commissioned by the organizations that sponsored the Treadway Commission found that the incidence of financial fraud was greater in small companies.¹⁹⁰ However, we are sensitive to the costs and burdens that small entities will face. The final rules require only a quarterly evaluation of material changes to a company’s internal control over financial reporting, unlike the proposed rules that would have required management to evaluate the effectiveness of a company’s internal control over financial reporting on a quarterly basis. In response to comments, including comments submitted by the Small Business Administration, we have decided not to adopt this proposal.

We believe that a blanket exemption for small entities from coverage of the requirements is not appropriate and would be inconsistent with the policies underlying the Sarbanes-Oxley Act. However, we have provided an extended transition period for companies that do not meet the definition in Exchange Act Rule 12b-2¹⁹¹ of an “accelerated filer” for the rules implementing Section 404 of the Sarbanes-Oxley Act. Under the adopted rules, non-accelerated filers, including small business issuers, need not prepare the management report on internal control over financial reporting until they file their annual reports for fiscal years ending on or after April 15, 2005. This deferral provides non-accelerated filers more time to develop structured and formal systems of internal control over financial reporting.

We believe that the new disclosure and certification requirements are clear and straightforward. The amendments require only brief disclosure. An effective system of internal control over financial reporting has always been necessary to produce reliable financial statements and other financial information. Our amendments do not specify any particular controls that a company’s internal control over financial reporting should include. Each company is afforded the flexibility to design its internal control over financial reporting according to its own set of circumstances. This flexibility should

¹⁸⁴ 17 CFR 240.0-10(a).

¹⁸⁵ 17 CFR 270.0-10.

¹⁸⁶ This estimate is based on figures compiled by the Commission staff regarding investment companies registered on Forms N-1A, N-2 and N-3, which are required to file reports on Form N-CSR.

¹⁸⁷ This estimate includes the burden for one annual report and three quarterly reports.

¹⁸⁸ Under the method we used to estimate the PRA burdens associated with the Section 404 rules, we estimated that companies with less than \$100 million in revenues would be subject to an added annual reporting burden of approximately 100 hours.

¹⁸⁹ The estimated burden for one annual report and three quarterly reports.

¹⁹⁰ See Beasley, Carcello and Hermanson, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (Mar. 1999) (study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission).

¹⁹¹ 17 CFR 240.12b-2.