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Advisory Committee on Smaller Public Companies
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Thank you for the opportunity to provide comments to the SEC Advisory Committee on Smaller Public Companies (the "Committee") regarding the exposure draft of the Committee's final report ("Report"). We have followed the work of the Committee closely and recognize the many hours of hard work Committee members applied to the difficult issues surrounding the uneven incidence of cost and administrative burden arising from today's securities laws and regulations. The Report contains many excellent recommendations for easing the regulatory burden on smaller companies. The purpose of our letter is to provide suggestions where we believe the recommendations could be improved.

Scaling Securities Regulation

We are supportive of the Committee's recommendation II P 1 to create a single scaling system for the application of all securities regulation.¹ The Committee noted that the existence of different sizing criteria for different rules, such as the Small Business filer rules and the filing size rules created a disjointed regulatory system with no effective conceptual tie to company size. However, we believe the Committee's recommendation could be modified to more effectively achieve its objectives.

The Report establishes the categorization based solely on market capitalization. While we agree this is the best starting place, we believe other measurements of scale are important and those measurements should be included in this foundational recommendation. We believe that the measurements should also consider sales revenue, asset size (sales revenue is not an effective

¹ In our letter dated March 28, 2005 to the Securities and Exchange Commission in connection with the Roundtable on Implementation of Internal Control Reporting Provisions, we recommended, "Rationalize the differential regulation by company size. We recommend the Commission adopt a system that categorizes companies into discrete regulatory classifications. For example, a four category system might classify a company as exempt, small, intermediate or large. Classification could be based on market capitalization...and all rules related to financial statements, disclosures, internal control reporting, filing deadlines and so forth would be based on a company's designation."

measurement of scale for certain investment and financial services companies), and in the case of debt-only issuers, the face amount of outstanding public debt.

The Committee agreed that other measurements are important; however the Report indicates that such other measurements should be applied on a rule by rule basis. The Committee cites their own recommendation on internal control over financial reporting as an example. We disagree. Such an approach will simply lead to a different set of fragmented sizing rules. As we considered the other recommendations within the Report directed at microcap and smallcap companies, we concluded that sales or asset size metrics would frequently apply.

The scaling recommendation should also be expanded to include a fourth category, "exempt companies." This is not a minor issue. The Report acknowledges the disproportionate impact smaller companies have in our country's economic growth. While some of that impact comes from smaller public companies, the largest part of that impact is from smaller non-public companies. We believe that the existence of an explicit fourth category will cause regulators to specifically consider the impact of their regulations on these companies. That impact can be significant, as we explain below.

Two examples related to the interaction of the securities laws and the impact on smaller companies can help illustrate the need to keep in mind the potential impact of rulemaking on non-public companies while ostensibly undertaking rule making only for public companies.

Many companies take advantage of Regulation D to raise capital in transactions which are exempt from federal securities regulation. While these transactions are in theory exempt from federal securities regulation, to the extent the Regulation D offering requires audited financial statements, the auditor must meet the public company rules related to auditor independence. As is well known, the Commission has established a series of rules related to auditor independence, many of which are more restrictive than the independence rules established by the American Institute of Certified Public Accountants and state Boards of Accountancy that apply to auditors performing audits of non-public companies. Many non-public companies use their audit firms to provide non-audit services permitted under the AICPA and state independence rules, but which are not permitted under the Commission's independence rules, because the auditor's existing knowledge base results in the most effective, and lowest cost, option for the non-audit service. In such circumstances, if the company finds itself undertaking an exempt offering, prior audits performed by the company's auditor could not be used because the more restrictive SEC rules would apply to the audits performed when the company was non-public. The cost of a re-audit in this circumstance is an unnecessary regulatory burden.

Another example applies to companies undertaking an initial public offering. While the largest IPOs garner the most publicity, many IPOs are from smaller non-public companies raising modest amounts of capital. The offering documents for such offerings require several years of audited financial statements. As with exempt offerings, the auditor in such offerings must be independent under the SEC's rules for audits of public companies for all periods included in the offering document. Once again, many of these companies will have used their auditor to perform services

permitted under AICPA independence standards but not the Commission's standards. In such circumstances, re-audits of multiple years by other auditors would be required.

With the recent PCAOB extension of auditor independence restrictions on the tax-related services that can be performed for owners and officers of companies, the likelihood is greatly increased that an auditor of a company going public may be disqualified on independence reasons because that auditor prepared the income tax return of an owner, or main officer, thereby requiring a costly reaudit under the new rules.

We believe that the auditor independence rules for public company audits should permit the use of the AICPA's independence rules for exempt offerings and for IPOs of companies that would be classified as microcap based on their post-offering pro forma equity. Such a rule would remove an unnecessary cost burden from non-public and publicly emerging smaller companies. Removing the need for re-audits will reduce audit fees for companies and allow them to access capital more quickly, with little incremental risk to investors. Additionally, since re-audits are normally performed by seeking a larger firm to do the re-audit, such a more permissive rule would have the effect of reducing the concentration of audits of public companies into the four largest firms.

While it may be suggested that regulations apply only to the entities directly regulated, there is nevertheless the truth that regulations also apply to entities attempting to enter a regulatory environment. If regulations are considered only from the perspective of those already regulated, an important element will be missed, which is the restrictive or hurdle effect of those regulations on those attempting to enter the regulatory system.

COSO as Standard-Setter

We do not now support recommendation III S 2 that would serve to establish COSO as a standard setter. We believe that COSO is performing very important work supporting public policy discussions. However, there is no compelling need to move their work, including the primary internal control framework, to an "official standard" level.

In COSO's recent project to develop guidance for internal control assessments in smaller public companies, COSO made a series of specific recommendations. These recommendations for smaller companies required small companies to demonstrate compliance with each of 26 elements of internal control in order to be deemed to have acceptable controls. We think this is excessive and does not properly reflect a cost-effective approach by COSO to small public companies or a proper understanding of the characteristics of smaller public companies. Many of these 26 elements could be easily combined into fewer elements, and in fact we have done that, resulting in 13 elements. These 13 elements will be submitted to COSO by an AICPA task force and we urge COSO to utilize the 13 elements, instead of the 26 they proposed, to make the COSO recommendations more cost-effective and focused on the objectives of internal control rather than the details.

Auditing Internal Control over Financial Reporting

By all measures, including the amount of public testimony, the number of Report pages devoted to the topic, and the three detailed dissents by Committee members, the recommendations related to internal control over financial reporting were the most difficult for the Committee. The Report presents a good overview of the conflicting perspectives held by a wide range of constituencies, and makes some excellent points and observations regarding the implementation of internal control over financial reporting. However, we believe that the recommendations included within the report fall a bit short of a Solomon-like solution.

We have consistently supported a scaled approach to implementation of the internal control over financial reporting provisions of the Sarbanes Oxley Act.² We do not believe the “in or out” recommendations included within the report represent an effective scaling approach. The approach to smallcap companies is particularly problematic. Despite 1) the fact that the Report acknowledges the lack of guidance for issuers, 2) the fact, supported by testimony, that smaller companies are least likely to have the resources to effectively understand the rules and conduct self-assessments, and 3) the fact, stated in the report, that the larger portion of implementation costs are internal rather than auditor costs, the Committee recommends an approach under which the company undertakes a full assessment with no auditor involvement. Such an approach would still be costly and much less effective.

We believe that there are a number of ways to achieve much better scaling, resulting in significantly lower costs for smaller issuers. Following are several approaches, not completely mutually exclusive, which we believe represent better scaling solutions.

The current standard for internal control reporting is very high. Auditing Standard No. 2 (AS2) requires a conclusion that controls are “effective” or “ineffective.” In order to be effective there can be no more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. It takes a lot of testing and analysis, by management and auditors, to get to the “remote” conclusion across all significant financial statement assertions for all significant accounts. This comprehensive conclusion is appropriate for larger issuers. However, such a high level of assurance may not be needed for smaller issuers. We believe that a reporting model could be crafted that addresses only certain controls. Company level controls, controls over the application of generally accepted accounting principles and the preparation of financial statements, and controls over certain financial statement components where errors have historically been detected (such as revenue recognition) should be addressed at all companies. Recent studies have indicated that revenue recognition issues may be the number

² In our previously cited letter to the Commission, we offered several recommendations which would have a positive, practical impact on helping smaller public companies comply with the requirements while better managing costs. In our letter to the Commission dated February 20, 2006, commenting on an earlier draft of the Report, we stated “...a process focusing on those controls most likely to result in a material weakness and reducing or eliminating the effort applied to more mechanical controls...would allow for substantial savings on internal costs while still meeting the intended purpose of SOX.”

one reason underlying restatements, and perhaps reporting on controls could be focused on such likely areas instead of covering all controls, however unlikely they may have been found to relate to fraud or error. This could be accomplished under a model that identifies the specific controls within the scope of testing and describes the results. Statement on Auditing Standards No. 70, *Service Organizations*, is an example of a current model for control testing which is more limited in its application yet provides specific assurance regarding specified controls.

The alternative approach described within the Report is another scaling model. We generally feel that a "design and implementation" standard would have questionable effectiveness without at least some form of operational testing. However, a standard which combined an organization-wide design and implementation approach with operational testing of a much smaller population of controls in higher risk financial statement areas could better match costs and benefits for smaller public companies than the more comprehensive requirement of AS2.

The approaches described in the preceding paragraphs may result in two internal control reporting standards. We understand that many commentators have strongly resisted a dual standard approach because of a fear that the market would not understand the distinctions. We understand that point of view, but we believe that the market would become educated on the differences fairly quickly, just as Regulation S-B quickly came to be accepted. Frankly, many market participants are not clear on the meaning of the single internal control standard already in place.³

A third approach would be to attempt to achieve scaling within the current rules. To date, companies and auditors have focused primarily on compliance. The cost of failure—a report reflecting ineffective internal control—is simply too high for managements to take chances on a deficient implementation or deficient documentation. However, as companies and auditors learn how to apply AS2, we believe that both will learn how to develop much more effective testing patterns. Our firm intends to undertake a comprehensive review of the internal control portion of our integrated audits, side-by-side with management, during 2006 to again attempt to identify excessive testing of redundant controls and other opportunities for achieving audit (and management documentation) cost savings. We know that many companies and auditors intend to

³ In our letter to the Commission in connection with the Roundtable on Implementation of Internal Control Reporting Provisions, we commented that the current reporting model for internal control auditing is inadequate. For the company's financial results the reader gets financial statements, footnotes, an auditor's report and management's discussion and analysis. For internal control, the reader gets a report from management and a report from the auditor, each of which state simply that internal control is effective or ineffective. Only if the ineffective conclusion is reached is more discussion provided. In our earlier letter we recommended "Develop model management reports on internal control over financial reporting to explain and describe the COSO model, to provide an indication to the reader about what internal control over financial reporting does and does not include, and to describe the major internal control categories or subdivisions used by the company in performing its analysis and assessment. Right now the report on internal control is equivalent of management saying 'we had a good year' without presenting any detail to support what 'we had a good year' means." This type of disclosure would help market participants understand the internal control reporting model much better.

undertake similar analyses. We are optimistic that ongoing analysis and learning can have a meaningful impact.

It is possible that this scaling through analysis and learning could be accomplished more quickly and more effectively if a group of issuers and firms worked together to develop best practices. We would support, and participate in, a joint effort aimed at developing the most cost effective approach to applying the current standards in a small company environment. Such an effort, a model audit or pilot program, would probably be most effective if conducted under the auspices of the Commission.

Auditing Standard Requirements

We believe that it is possible to revise Auditing Standard #2 (AS 2), perhaps only for smaller companies, to make it more cost-effective. We would support such a modification to AS 2.

For example, we note that AS 2 requires the auditor to obtain the evidence all over again in each year, with limited consideration to prior evidence. This could be changed to accept more information and conclusions reached in prior year testing. AS 2 also requires consideration of areas that have no significant control issues but that are quantitatively material, such as (frequently) fixed assets. AS 2 requires a walkthrough of a single transaction from start to finish, when it is often more cost-effective to "move" from one transaction to another when performing a walk-through (an example is a complex system where one transaction is walked through to a certain point in the system during the auditor's initial interim testing (perhaps done in the first quarter's interim review), and when it may be more efficient to resume from that point at the auditor's next interim testing (perhaps done in the second quarter's interim review) instead of trying to reconstruct the trail of the first transaction some three months ago. Some significant areas, such as the accrual for income taxes, may not really be subject to an internal control structure but may be handled by the company in a single calculation of its tax expense, and thus this area may not be considered as part of an internal control structure, especially in smaller companies with simpler tax calculations. Consideration of all the user control considerations in SAS 70 reports on internal control at service organizations may not be needed, since many of these user control considerations may be best practice suggestions rather than needed controls. There are other opportunities to make AS 2 a more cost-effective standard for smaller companies.

We wish to note that if recommendation III P 2 is adopted, auditor involvement would be eliminated in reporting of internal control over financial reporting for public companies with under \$250 million in revenue. Our first-hand experience is that management's assessment process significantly benefits by the discipline brought by auditor involvement. Without auditor involvement, there is a risk that internal control assessment will become a middle management compliance process rather than a real assessment of the effectiveness of internal controls. At the same time, recommendation III P 2 would still continue the largest portion of the cost of internal control assessment, which is the cost of the assessment, not the cost of the auditor involvement. Also, this recommendation may likely lead to an unintended consequence, because smaller auditing firms, handling perhaps a few or even no audits of internal control under this

recommendation, would have a limited chance to demonstrate their capabilities of being able to handle audits of internal control. Thus they would be less favorably viewed in the auditor selection process, leading to more concentration of audits involving audits of internal control into the four largest audit firms.

Audit Costs

The most significant factor behind the outcry over internal control auditing is cost. The cost is substantial, but we believe that market participants are assigning the entire audit cost increase arising from the Sarbanes Oxley Act to the internal control reporting provisions. That is simply not the case.

The idea of more and better auditing is a cornerstone of the Sarbanes Oxley Act. In addition to internal control auditing, "more and better auditing" meant the creation of the PCAOB, the organization charged with making sure the audits are done effectively. Through the issuance of new standards, and the inspections process, the PCAOB is prodding public accounting firms to do "more and better auditing." And we are. Changes in auditing brought about by the PCAOB's rulemaking and inspection processes have been implemented alongside the internal control auditing rules. Some of the analyses of increasing audit costs have compared costs from the year prior to implementing internal control auditing to the first year with internal control auditing and described the difference as "SOX 404" cost. However, in that same year there were likely significantly higher costs arising from other aspects of the new audit regulatory process because the PCAOB was attempting to expand the work done by the auditor. There is no effective way to document how much cost has arisen from which cause. But we believe it is important, as policymakers debate the future of internal control auditing, to understand it is but one component of the overall upward pressure on audit costs.

We also note our experience on the initial audits of both internal control and the financial statements, where the costs approximately doubled from the prior year costs when we performed only a financial statement audit. This no doubt reflects that on these relatively smaller public companies we had mainly adopted a substantive audit approach in the past. Significantly, we further note that each of the PCAOB inspection comments we received on our audits of internal control wanted more testing, documentation, and assessment performed.

Once again, thank you for the opportunity to provide our comments. If you have any questions, please contact Rick Ueltschy or Jim Brown.

Very truly yours,

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