

April 3, 2006

Ms. Nancy M. Morris  
Federal Advisory Committee  
Management Office  
Securities and Exchange Commission  
100 F Street, NE, Washington D.C. 20549-1090

**Re: File No. 265-23 Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies**

Dear Ms. Morris:

The American Institute of Certified Public Accountants (AICPA) is pleased to have the opportunity to submit written comments on the exposure draft of the final report of the Securities and Exchange Commission's (SEC or the Commission) Advisory Committee on Smaller Public Companies (Advisory Committee).

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 commend the efforts of the Advisory Committee and recognize its hard work, in addition to the challenges it faced, in developing the proposed recommendations on improving the current securities regulatory system for smaller public companies. Below are our comments as it relates to some of the recommendations proposed in the report. The comments in this letter are offered from the perspective of members who audit public companies.

## **Part II. SCALING SECURITIES REGULATION FOR SMALLER COMPANIES**

### **Recommendation II.P.1:**

Establishing a new system of scaled or proportional securities regulation for microcap companies and smallcap companies (hereinafter collectively referred to as "smaller public companies"), utilizing the six determinants identified in the draft report, raises some concerns as to the process for ensuring that the scaling is done properly, whether the advantages to smaller public companies outweigh any disadvantages that may impact investors, and whether the added complexity is warranted.

Some of our members believe that scaled regulation in this fashion may create unnecessary complexities in the U.S. marketplace and may hinder the ability for users of financial statements

to compare financial results among companies. Some have concerns that this recommendation would provide two classes of smaller public companies, which would be regulated differently, and could create confusion for companies and investors. When this is combined with tiers of accelerated filers and large accelerated filers, one questions whether the need for simplicity is lost to complexity.

If, however, the Commission decides to adopt this recommendation, we urge that the methodology used to calculate the selected metrics would need to be clearly defined and the related implementation rules should be carefully designed in order to minimize complexity and the likelihood of frequent changes in a company's classification.

### **Part III. INTERNAL CONTROL OVER FINANCIAL REPORTING**

#### **Recommendations III.P.1 and III.P.2:**

The task of striking an appropriate balance between the protection of and benefits to investors with the burdens on issuers is a very difficult one. Most of our members who audit public companies believe that protections provided by Section 404 should be afforded to investors in all public companies, regardless of size. Anything short of this outcome would diminish such protection.

We believe that the increased focus on internal controls by company management, auditors and audit committees, coupled with greater engagement between external auditors and audit committees regarding financial reporting and internal control matters, has served to improve the provision of reliable and transparent financial information to investors. We believe that these and other changes have resulted in an improvement to the nature and transparency of information, resulting in increased investor confidence in the capital markets. In addition, we do not believe that companies that are already complying with the Section 404 requirements for the last two years should now be exempted from the auditor requirement of Section 404 thereby weakening investor protection for such companies.

When analyzing the costs associated with Section 404 compliance, one must also consider the benefits. First year implementation costs are easier to quantify and articulate than the related, less quantifiable, yet significant benefits. Benefits include the thousands of control deficiencies that were remediated prior to the filing of management and external auditor's reports on the effectiveness of internal control over financial reporting. Benefits also include the material weaknesses that management and external auditors are required to disclose, which improves the quality of information to investors. It is also important to note that it is impossible to measure the value to investors of an avoided financial fraud.

To exempt microcap companies from all Section 404 requirements would not benefit investors of these companies. Investor protection should not be weakened for these companies. Rather, we

believe it should be strengthened. A study conducted by Glass Lewis<sup>1</sup> indicates that the smallest companies have the highest risk of restatement. In fact the report revealed that restatement rates for companies with less than \$75 million in market capitalization had the highest restatement rate for 2005 of any size category, with one in eight of such companies reporting a restatement in 2005. This indicates the need for greater focus on controls for this category of public companies.

Moreover, a study conducted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) on *Fraudulent Financial Reporting: 1987-1997 – An Analysis of U.S. Public Companies*<sup>2</sup>, revealed that “companies committing financial fraud were small” and that “[t]he relatively small size of fraud companies suggests that the inability or even unwillingness to implement cost-effective internal controls may be a factor affecting the likelihood of financial statement fraud...” As a result, we believe that Section 404 compliance by microcap companies is in the public interest.

Furthermore, Section 302, Corporate Responsibility for Financial Reports (commonly referred to as CEO and CFO certifications), will still be a requirement for companies subject to the proposed exemptive relief from Section 404. Having the Section 404 compliance process in place will provide these individuals with greater confidence when conducting their duties and executing their certifications. This was acknowledged by a public company representative at the SEC’s 2005 Roundtable on Implementation of Internal Control Reporting Provisions. He stated that the most significant impact for his organization was the awareness that was created as a result of Section 404 at the senior management level throughout the organization and through the business lines which was “significantly strengthened which helped them have the confidence to make those assertions<sup>3</sup>.”

We do not believe that the solution to the issue of scaling Section 404 compliance to smaller public companies is to exempt microcap companies from Section 404 compliance. Effective internal controls over financial reporting are an important mechanism to ensure accurate financial reporting, investor protection, and market integrity.

We also believe that efficiency of the implementation of Section 404 has improved and will continue to improve. We acknowledge that fully integrated audits were not always performed in the first year of implementation for many reasons. The May 16, 2005 guidance from the SEC and the PCAOB, and the efforts of issuers and auditors to improve their respective approaches, has resulted in further integration of the financial statement and internal control audits in the second year which has served to reduce the total cost of compliance with Section 404. Importantly, we believe that guidance for issuers is necessary, especially for smaller public companies, with respect to identification and testing of key controls. Implementation guidance

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<sup>1</sup> See report entitled “*Getting It Wrong the First Time: 2005 Restatements Report*” at [www.glasslewis.com](http://www.glasslewis.com)

<sup>2</sup> See summary of study at [http://www.coso.org/publications/executive\\_summary\\_fraudulent\\_financial\\_reporting.htm](http://www.coso.org/publications/executive_summary_fraudulent_financial_reporting.htm)

<sup>3</sup> Statement made by Robert Miles, Senior Vice President, Controller, Washington Mutual, Inc. See transcript of the Roundtable Discussion on Implementation of Internal Control Reporting Provisions held on April 13, 2005 at the following link: <http://www.sec.gov/spotlight/soxcomp/soxcomp-trans.txt>

for issuers coupled with the evolution of the process and the lessons learned has the potential to significantly impact the effectiveness and efficiency of the Section 404 compliance effort.

Recommendation III.P.1 indicates that the PCAOB should adopt the AICPA's proposed Statement on Auditing Standards on *Communications of Internal Control Related Matters Noted in an Audit*. Such recommendation would not be needed if no exemption from Section 404 is employed. Further, however we note that the conforming amendments to the PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* already address such requirements.

Please see our recommendation below for an alternative solution.

**Recommendation III.P.3:**

Generally, PCAOB's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2), is fundamentally sound. We believe that AS 2 can be applied to the audit of controls of smaller public companies and that it would be preferable to create additional guidance as to the application to smaller public companies than to create a new, parallel standard for that purpose.

Furthermore, in a two tier system users may become confused about the nuances in the different types of auditor assurance provided under this alternative recommendation. This may result in investors misunderstanding the level of assurance provided by the auditor and how it should be factored into their investment decisions. It is also important to note that a well designed system of internal controls may not necessarily equate to effective operation of internal control over financial reporting and that independent evaluation of operating effectiveness is a key element of the process. Control weaknesses are more often identified when testing operating effectiveness of internal controls over financial reporting, than when evaluating its design. In addition, under such a second standard approach the auditor would be reporting on different matters than management through its assessment. This could lead to additional confusion in the marketplace.

Please see our recommendation below for an alternative solution.

**Recommendation III.S.1:**

Generally, we support this recommendation and believe, as stated above, that smaller public companies are in need of such guidance to assist management in assessing internal control over financial reporting in a cost-effective manner. That said, we believe there should be an aggressive effort to develop guidance, specific examples, and tools for assessing internal control over financial reporting for smaller public companies that recognizes their specific characteristics that would be scalable to apply to the smallest of companies.

**Recommendation III.S.2:**

With respect to COSO, their Internal Control – Integrated Framework (the Framework) has been recognized by regulatory standard setters and others as a comprehensive framework for evaluating public companies' internal control over financial reporting for the purpose of Section 404 compliance. As such, we believe the SEC should carefully consider the Advisory Committee's recommendation that a structure be determined to make COSO a more formalized body that has recognized standard-setting authority to promulgate changes to the Framework to address environmental changes (e.g., financial reporting, corporate governance, regulatory, etc.) that have already taken place or that could take place in the future.

***Alternative Solution Recommended***

We respectfully suggest that instead of exemptive relief or an alternate reporting standard for auditors on the design and implementation of internal control over financial reporting, that the SEC develop a definitive plan that will include the participation of smaller public companies, the PCAOB, and the auditing profession, as follows:

- We suggest that there be an aggressive effort, in conjunction with the efforts of COSO, to develop guidance, examples, and tools for smaller public companies in assessing internal control over financial reporting that recognizes their specific characteristics that would be scalable to apply to the smallest of companies.
- The conduct of an SEC-led pilot program for a prescribed number of smaller public companies during 2006 that would serve as a field test and lead to the development of internal control and Section 404 compliance tools for management of such companies. Additional guidance on the application of AS 2 for auditors in that environment should be developed for this program as well.
- This pilot program could build on the experience of smaller public companies that have already complied with the requirements of Section 404 in addition to smaller public companies that have yet to comply. Lessons learned from this effort could be used to further amend the guidance to prepare the application to the broader population.

Our members would be willing to participate in this effort should this alternative solution be supported by the SEC. This would include efforts to gather evidence, field test the new guidance, and develop tools for management and auditors that will further contribute to the efficiency and effectiveness of Section 404 compliance.

**Part IV. CAPITAL FORMATION, CORPORATE GOVERNANCE AND DISCLOSURE**

### **Recommendation IV.P.1 and IV.P.2**

Generally, we believe that incorporating the scaled disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K, and making them available to all microcap companies, is appropriate. We also believe that incorporating the primary scaled financial statement accommodations currently available to small business issuers under Regulation S-B into Regulation S-K or S-X, and making them available to all smaller public companies is also in the public interest.

We believe that making these accommodations available to microcap and/or smallcap companies and the elimination of prescribing separate specialized disclosure forms for smaller companies will reduce the complexity within SEC rules and regulations. Integrating the provisions of Regulation S-K and S-X would create a single set of registration and reporting rules and forms further achieving the goal of less complexity.

### **Recommendation IV.S.5**

We are supportive of the Advisory Committee's recommendation and that the Commission should continue to pursue the use of eXtensible Business Reporting Language (XBRL) and protocols in the EDGAR modernization project as a method to reduce costs. We also believe that the use of XBRL will make it easier for all companies, regardless of size, to comply with the filing requirements and will facilitate the ability of investors, analysts, and other users to search, download, and otherwise access and use electronic filings.

## **Part V. ACCOUNTING STANDARDS**

### **Recommendation V.P.1**

We believe that preparers should adequately document their rationale for accounting judgments and would agree that they follow the recommended protocol in the Advisory Committee's Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies (pages 98-99). However, we do not favor a "safe harbor" protocol for accounting transactions that would protect well-intentioned preparers from regulatory or legal action because it may diminish an issuer's need to take responsibility for its financial statements. That said, we would encourage the Commission to dedicate additional resources, especially in the area of highly complex transactions and emerging issues, to address questions issuers may have in these areas.

### **Recommendation V.P.2**

We believe that extension of the effective dates for new accounting standards would ease the burden of implementation and serve to reduce costs. Smaller public companies do not have the resources to enable them to implement complex or new standards in an effective manner as

quickly as larger companies. If additional time is afforded, this would enable smaller public companies to implement new standards in a more efficient and effective manner. In addition, learning from the experiences of larger companies that implement in advance of smaller companies is also very helpful.

We support the guidance issued by the SEC and PCAOB in May 2005 that encourages public companies to seek advice and assistance from their auditors in addressing accounting and reporting issues. The public interest is served through more reliable and accurate information, arising from early communications and candid discussions between auditors and management.

### **Recommendation V.P.3**

We understand the need for the consideration of additional guidance for all public companies with respect to materiality related to previously issued financial statements, however, whether seeking additional guidance or clarifying and understanding the existing guidance, is the key question. We therefore, suggest that consideration be given to whether it may be to better to understand the existing guidance and have a meeting of the minds amongst regulators, preparers, auditors and the investor community as opposed to issuing additional guidance that may create more ambiguity. We support APB Opinion 28, paragraph 29 and understand that in many respects SAB 99 does not provide guidance as to materiality in interim financial statements, or misstatements in previously issued financial statements.

### **Recommendation V.P.4**

Generally, we support the recommendation and agree that the SEC examine its independence rules and consider establishing a rule provision that provides relief for certain types of violations that are de minimis in nature as long as these are discussed with and approved by the company's audit committee. We believe that this should apply to all issuers, regardless of size. An amendment to the SEC's independence rules that would enable the audit committee to evaluate the facts and circumstances around de minimis independence violations of an accounting firm would be an improvement to the current status, has the benefit of achieving a "common sense solution" and will not dilute investor protections. We would also recommend that the amendment include a requirement that audit firms have policies and quality controls in place to monitor services and allow timely reporting of exceptions that occur. To affect any such amendment to the independence rules, we recommend further research and examination by the SEC.

### **Recommendation V.S.2**

We support the recommendation to formally encourage the FASB, working with the SEC and others, to continue to pursue objectives-based accounting standards and agree that simplicity and the ease of application should be important considerations when new accounting standards are established.

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#### **Recommendation V.S.4**

We commend the Commission and the PCAOB for their May 16, 2005 guidance issued on internal control over financial reporting and the roundtable on the first year and upcoming roundtable on the second year experiences with implementation of internal control reporting. Such initiatives by the SEC and the PCAOB help gauge the issues that may have arisen including monitoring the state of interaction between the auditors and their clients in evaluating internal controls over financial reporting. We recommend that this process continue in the future as it is helpful to those involved in the financial reporting process which in the end results in better information and stronger capital markets.

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The AICPA appreciates the opportunity to comment on the exposure draft of the final report of the SEC's Advisory Committee on Smaller Public Companies. We are firmly committed to working with the SEC and are pleased to discuss these comments with you at your convenience.

Sincerely,



Susan S. Coffey, CPA  
Senior Vice President – Member Quality and State Regulation  
AICPA

cc: Chairman Christopher Cox  
Commissioner Cynthia A Glassman  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Annette L. Nazareth  
John W. White  
Scott Taub