April 3, 2006

United States Securities and Exchange Commission
Advisory Committee on Smaller Public Companies
100 F Street, NE
Mail Stop 1103
Washington, DC  20549-1103


Chairman Cox, Commissioners and Advisory Committee Members,

I've been engaged in financial reporting my entire career, a period exceeding 30 years. I currently serve small publicly-held businesses as an audit partner. I am also a member of the PCAOB's Standing Advisory Group.1

I have read the proposed Final Report carefully and in its entirety. This letter sets forth the reasons why I generally believe that you should accept the majority of the recommendations in the proposed Final Report of the Advisory Committee on Smaller Public Companies, except as set forth below. The Committee was thorough in approach and bold in assessment; its proposed Final Report is straightforward and demonstrates common sense. It is a landmark document deserving serious debate and consideration.

I applaud the Committee on the foresight to not only identify problems but to propose practical solutions. Without doubt, this took a great deal of work but also the courage to clearly set forth a framework focusing on systemic issues. The advantage is that now the Commissioners can respond with a truly well-thought out and integrated plan to intelligently regulate small business.

Because of my leadership role in the accounting profession, I have been heavily lobbied by those opposed to the Final Report. It is interesting to note the intensity of the arguments both for and against the recommendations. In many instances, it appears that the debate has become personal. It seems that those with the most intense sentiment against the proposal have limited experience in working with small business. In many instances, they have been heavily involved in the development of Section 404/ASB#2, but are also emotionally invested in that worthy effort. However, I don’t believe they are always interested in fairly addressing the distinguishing differences of small businesses. Conversely, those in favor of the Final Report appear to have an influential small business constituency. That also may be self-serving, and should be

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1 I have an extensive background working with small businesses. For the first 8 years of my audit career, I held staff and managerial positions at Arthur Andersen working with large and small public companies. In 1983, I accepted a position as senior audit manager with Price Waterhouse dealing exclusively with small emerging technology-based clients. Almost all of those businesses were entrepreneurial with venture capital backing and a desire to “go public.” The past 20 years, my clients have either been or wanted to be Regulation S-B filers. I assist these companies to comply with their 1933 and 1934 Act filing responsibilities. This frequently involves capital formation activities, such as reverse mergers, private investments in public equity, leveraged buy-outs, acquisitions and mergers, initial and secondary offerings. I currently am employed as Gordon, Hughes & Banks’ Director of SEC Practice. I am a gubernatorial appointee to the Colorado State Board of Accountancy and its current president. I also serve as a director of the National Association of State Boards of Accountancy and on an AICPA senior technical body, the Professional Ethics Executive Committee. From 1995 to 2001, I served on the Colorado Securities Board, including two terms as Chairman. As noted above, I am a member of the PCAOB Standing Advisory Group. Despite affiliation with all of these wonderful groups, the views expressed herein are solely my own.
approached with caution. Given my background, if there is a bias that I can be accused of, it would be that I fall in the latter category.

Anyone who doesn’t believe that small business internal controls and processes are not different than those of big businesses has never participated in the small business audit arena. This may be an indication that they either are not interested in solving this small business dilemma, or are simply unwilling to be objective.

I have also read last years’ clarifying and progress reports from the SEC, PCAOB and COSO. For the most part, I was unimpressed with their “going forward” recommendations. My disappointment is not a reflection of the significant efforts of those esteemed bodies. Rather, I don’t believe they demonstrated a basic understanding of the fundamental operations and controls that distinguish small businesses. They generally cite broad antidotes such as the auditor “should use judgment,” “should address significant areas of risk,” and “should use a top-down focus.” These are hardly new or innovative concepts. Passing those prescriptions off as a quick fix doesn’t work. They do not strike at the heart of the fundamental need to balance investor protection with compliance cost that is so well articulated in the proposed Final Report.

Accounting did not cause either the ENRON or WorldCom debacles. Section 404/AS#2 may have highlighted the Tyco employee loans and possibly the incorrect handling of AIG’s risk-free insurance. But lynch-pinning those isolated large company losses with costly new preventative measures for all circumstances is illogical. As now set forth in 404/AS#2, the cure is worse than the illness.

Effective internal controls are also dependent on a reliable management system that is incontrovertibly linked with strong governance. No matter how reliable financial reporting controls are, they can be circumvented in the face of renegade managers. In those situations, other higher level controls must be present, but those controls are in all reality outside of the accounting process and represent an “enterprise risk.” What 404/AS#2 fails to address is that the enterprise risk of a Fortune 500 company is appropriately different from that of the venture capital backed small business with its few employees.

Despite the emotional appeal, strong internal controls do not alone solve all financial reporting problems as implied by the proponents of 404/AS#2. It is not the panacea that we would all welcome. Indeed, many of the recent restatements are actually related more to the complexity of GAAP than internal accounting and reporting controls. I don’t believe that SOX 404 in present form is a good fit for small businesses, and the scaling approach is a reasonable solution.

Regulation S-B filers frequently have a single in-house accountant. They use simple but flexible accounting software; on occasion there is a controller, sometimes a CFO, but these positions are not static since they typically do not offer long-term career opportunities. The extensive check and balance systems of larger companies are absent. Documenting small companies’ procedures as required by AS#2 will constantly change, and the related controls will still not be strong enough to be relied on in a meaningful way. Consequently, an alternative approach must be taken to identify misstatements.

An entire cottage industry of consultants has grown up around Section 404. While the bulk in that community is honestly committed to the goals of SOX, this will not necessarily be the case when non-accelerated filers are pulled into the mix. The vast majority of small companies will have no alternative but to seek out this very costly assistance. I see a lot of bad actors in that process making promises that will not be delivered. A lot of resources will be wasted, and there be no net gain; the next year there will be a new controller, a new strategy, and the misplaced energy will be repeated again. This is not a one-time cost; it will recur annually and it will be an enormous tax on our society, with very little associated benefit.
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The regulator in me wants uniformity that will subject everyone to the same standard. My practitioner side sees companies that are dynamic, constantly changing and thirsting for capital. Faced with choices, the forced cost and focus of 404/AS#2 to these small companies will be devastating.

My clients hope you will take steps to modify the impact of Section 404 on them. I believe that it would be serious mistake to extend Section 404 again, since it will continue to inject uncertainty into the markets. This problem needs to be dealt. We have had plenty of time to come up with a workable solution.

In the event that Section 404 is not scaled, I believe widespread non-compliance will occur, not by choice, but lack of resources. That in turn will have an adverse impact on this highly dynamic economic sector and put the U.S. at a huge disadvantage in the international marketplace.

Although I believe a scaling approach is appropriate, revenues should not be part of that filter. Revenues in disparate industries cannot be meaningfully compared. For example, the retail, utility and manufacturing industries have vastly different revenue to ROI profiles. If revenues are made part of the filter, there would be enormous compliance cost inequities among industry sectors.

While I believe that scaling is a reasonable approach, I take no specific position on the breakpoints set forth by the Committee. I cannot believe that exempting 80% of all public companies would be appropriate in the current environment. Companies at the higher end of the range are in fact very large businesses and have both the resources and the responsibility to adopt Section 404. They should not be exempted.

My only reservation on scaling is that it will likely result in even greater Big 4 dominance and consolidation of the public accounting marketplace. The big firms will likely be the only ones with the expertise and ability to report on internal controls. That would be unhealthy for both the accounting profession and investors.

Finally, if the SEC and the PCAOB is going to continue to place significant reliance on COSO, such reliance should be documented and subject to greater public scrutiny. I am unaware of the source of COSO’s authority as a standard-setter; furthermore, I don’t see any meaningful regulatory oversight of its activities. I don’t believe its body of work has been subjected to any field testing, consequently the validity of its pronouncements I find questionable. Frankly, I believe that a good deal of the current debate could have been avoided if the role and operation of COSO had been clearly defined by regulators prior to the adoption of its standards.

Thank you for your consideration,

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