ERNST & YOUNG

Ernst & Young LLP
5 Times Square
New York, NY 10036

Phone: (212) 773-3000
www.ey.com

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Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-9303

Exposure Draft of Final Report of SEC Advisory Committee on Smaller Public Companies (Release Nos. 33-8666; 34-53385) Commission File No. 265-23

Dear Ms. Morris:

Ernst & Young LLP is pleased to comment on the draft final report (the Report) of the Securities and Exchange Commission's (the Commission or the SEC) Advisory Committee on Smaller Public Companies (the Advisory Committee). While there are a number of areas where we support the recommendations of the Advisory Committee, there also are several areas where we are not persuaded that the recommendations would be in the best interests of investors. We particularly do not agree with the Advisory Committee's Primary Recommendations in Section III of the Report regarding internal control over financial reporting.

Internal Control Over Financial Reporting

Most of the focus of the Advisory Committee's slate of recommendations is on implementation by smaller public companies of requirements related to internal control over financial reporting. The Advisory Committee makes a variety of recommendations to address concerns raised by many Advisory Committee members and others.

We believe it is critically important to focus on, understand and appreciate the significant benefits resulting from implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. We have spoken to such benefits on many occasions. At the same time, we appreciate the concerns regarding the unique characteristics of many smaller public companies and the disproportionate level of effort that they might incur in implementing Section 404 requirements. Here, we wish to focus on the opportunity for improvement in the process for smaller public companies and discuss various proposals and our views on them.

We do not believe broad-based exemptions, weakened standards, or audits that attest to the appropriateness of the design and implementation of internal controls but skirt the question of their actual effectiveness, are appropriate policy considerations in response to concern over the application of Section 404 to smaller public companies. Such proposals would, in our view, undermine significant gains in financial reporting, corporate accountability and investor protection.

We do, however, believe additional policy actions are in order to enhance the effectiveness and efficiency of the first year implementation of Section 404 by non-accelerated filers, the one-half of U.S. public companies that have yet to implement Section 404 as a result of deferrals extended by the SEC. We believe additional action is warranted that provides practical performance guidance to smaller public companies, whose management teams and audit committees are seeking to implement the requirements for reporting on internal control over financial reporting in an effective and efficient manner. Today, despite significant time having passed, and significant effort by the SEC, PCAOB, COSO and others, the type of practical performance guidance that is warranted does not yet exist in our view.

Today, the views of many observers of the Section 404 process are based on a first-year implementation experience for accelerated filers that was, by all accounts, challenging and difficult. We have previously commented that no party – management, auditors, or regulators – performed perfectly in that first year of execution. Clearly, the second year experience was markedly improved, and the third year experience promises further benefits in effectiveness and efficiency. Notwithstanding the improvements brought on by time, experience and previously issued regulatory guidance, we believe that additional steps should be taken to further benefit the first year implementation experience of the smallest half of U.S. public companies, so they will not have a first year experience akin to that of many of their larger accelerated filer counterparts. The concern and interest in this regard underlies our view that the SEC and others undertake a collaborative effort to develop practical materials outlining what management of a smaller, non-complex public company needs to do in identifying, evaluating, and testing key controls to assess their operating effectiveness.

We believe it is important for any effort that is focused on issuer guidance to have the full and active support of the SEC, and note that many parties have advocated more guidance for issuers from the SEC. Such an effort holds considerable promise for clarifying how management of smaller public companies can discharge their responsibilities under SEC rules and regulations in an effective and efficient manner. We note that the time, effort and expense required of management on average comprised two-thirds to three-fourths of an issuer’s total Section 404 first-year costs for an accelerated filer. Thus, focusing on management’s actions has the potential for considerable positive effects on the stress and cost inherent in implementing Section 404.

Importantly, such a collaborative effort to develop practical performance guidance holds promise not only for the non-accelerated filers who have yet to implement Section 404, but also for smaller accelerated filers that are seeking improvements in their ongoing processes. While such companies have been through the most challenging aspects of Section 404 implementation, there remain opportunities for improving management's processes and we should seek to do so.

As noted above, we are opposed to both large scale permanent exemptions from Section 404 requirements and "watered down" issuer and auditor standards for smaller public companies. Therefore we disagree with the Advisory Committee's Primary Recommendations in Section III of the Report. In our view, it would be a disservice to investors and not in the best interests of smaller public companies to, after nearly three years, provide broad exemption to internal control reporting and, in effect, abandon the efforts of COSO to develop additional guidance for the application to smaller public companies. Further, we believe the Advisory Committee's suggestions do little to preserve the benefits of Section 404 and appear to us to be more reactive to symptoms than responsive to the true drivers of cost and effort that concern smaller companies. The benefits of Section 404 are manifest. Therefore, measures to effectively manage effort for smaller public companies must leave those benefits largely intact. We believe the Advisory Committee's recommendations fail that very important test. Finally, we do not believe that it would make sense to now exempt or apply "watered down" standards to many public companies that have already completed their second year of assessing and reporting on internal control over financial reporting.

In the following sections we lay out in greater detail our concerns with the Advisory Committee's Primary Recommendations in Section III of the Report. More importantly, we discuss the need for the SEC and others to collaborate in the development of guidance that focuses on the special challenges faced by smaller public companies. We believe that providing practical guidance that can be efficiently and effectively implemented is the best way to reduce and manage Section 404 costs while retaining the important benefits derived from the process.

The Advisory Committee's Recommendations

Broad-Based Exemptions

Few argue that the benefits of Section 404 are not significant and do not continue to accrue. The challenge has been rationalizing the costs, which are immediate and measurable, against the benefits, which are longer term and more difficult to quantify. With year two of Section 404 recently completed for most accelerated filers, experience continues to show that the significant majority of overall costs have been internal to the issuer and are not auditor attestation costs. We also note that issuers' internal costs, as well as audit fees attributable to Section 404 attestations, continue to trend down. Studies have projected significant reductions in issuers' second year overall Section 404 costs.

Much has been said and written about the benefits of effective internal controls and more reliable financial reporting, and in particular the protection thereby afforded to investors. There is little debate here. What has been discussed less are the direct benefits to companies that have implemented Section 404. The discipline, rigor, and focus on financial reporting and the associated evaluation and reporting on internal controls helps management and boards of directors, including their audit committees, better identify and manage the specific risks they face. Implementing the requirements of Section 404, along with other requirements of the Sarbanes-Oxley Act of 2002, has promoted significant improvements in the culture in which many public companies now operate. Many members of management and directors have benefited, not just investors, and in the long run the successful implementation of Section 404 should help smaller public companies compete for talent and capital. In many ways, it would seem that the very issuers (and related investors) that would be scoped out under the Advisory Committee's recommendations would likely benefit the most from Section 404. There simply are better ways to deal with the concern of disproportionate level of effort and cost than exemption from Section 404 or watered down application through weakened standards.

Reporting on Design and Implementation but Not Effectiveness

It makes little sense to us to introduce an alternative to Section 404 assessment and reporting that does nothing meaningful to increase the reliability of financial statements. Yet, the recommendation to limit the auditor's attestation to the appropriateness of the design and implementation of controls while not testing the effectiveness of controls would do just that. Our view is that many of the improvements in internal control that have resulted from the identification, and then remediation, of significant deficiencies and material weaknesses would not have occurred had the scope of the independent auditor's procedures excluded testing and evaluating the operating effectiveness of internal control over financial reporting.

We believe that design and implementation only evaluations, such as those suggested by the Advisory Committee for some group of smaller public companies, would increase the likelihood of some material weaknesses going undetected. In addition, we believe the introduction of such an approach or a second standard applicable only to a portion of smaller public companies would lead to investor confusion and widen the current expectation gap around audits. In fact, while we are not advocating exemption, an exemptive approach (should it ultimately be determined by policy makers to be appropriate for the very smallest of public companies) would provide greater clarity and less confusion for investors than a design and implementation only attestation. A clear, prominent disclosure that a company has not undergone a Section 404 audit would be understandable to investors, but they cannot be expected to assess the relative protection afforded by gradations of standards, let alone factor them into their investment decisions.

The Need for Practical Implementation Guidance for Smaller Public Companies

There has been a longstanding request from issuers and auditors for additional guidance on applying the COSO criteria for effective internal control to smaller public companies and clarifying how management of smaller public companies should conduct their assessment of internal control over financial reporting.

In adopting its Final Rule on implementing Section 404 in June 2003, the SEC acknowledged that many commenters had indicated that additional guidance regarding the extent of evaluation, including the documentation required, would be beneficial to issuers. However, in adopting the Final Rule the SEC chose not to provide significant implementation guidance or to provide examples to aid management in conducting its assessment. The Final Rule instead provides general requirements for management's assessment and also indicates that the company's auditors will require that the company develop and maintain evidential matter to support management's assessment. It is therefore understandable that in many cases management teams turned to the independent auditors and the PCAOB's *Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS2), for guidance in conducting their own assessments.

Subsequent to the SEC issuing its Final Rule and the PCAOB issuing AS2, the SEC and the PCAOB staffs have issued several Questions and Answers directed to issuers and auditors, respectively. Taken together, this body of guidance is helpful in clarifying certain aspects of the rules and standards and in providing interpretation for auditors in performing an audit of internal control over financial reporting, but does not provide a roadmap for management of smaller public companies to conduct their own assessments.

The first year experiences of accelerated filers made apparent the need for implementation guidance designed specifically for management. As we compile and assess year two observations and experiences, we believe the need remains for additional issuer implementation guidance of a practical nature that particularly recognizes the uniqueness of the small public company environment. This refrain continues despite the most recent round of SEC and PCAOB guidance and COSO undertakings to provide guidance for smaller public companies in applying the COSO criteria.

In granting an additional deferral of the implementation of internal control reporting for non-accelerated filers in September 2005, the SEC acknowledged that more time was needed to provide an opportunity for COSO to develop guidance for smaller companies and for the Advisory Committee to deliberate, among other things, the cost and benefits of implementing internal control reporting by smaller public companies.

However, there has been insufficient progress in the development of such implementation guidance, or for that matter, to provide examples of effective internal control for smaller public companies consistent with the five components of the COSO framework.

The Way Forward to Develop Additional Guidance for Smaller Public Companies

We believe it is important for the SEC to be at the forefront of collaborative efforts to develop this needed guidance. Issuers will rightly want to know that their regulator, the SEC, has determined the appropriateness of any published guidance or examples on applying the criteria for effective internal control to a smaller, less complex public company, and what constitutes appropriate testing and assessment procedures in such an environment.

While additional guidance is clearly needed, that is not to suggest the “standards” for effective internal control should be lowered for smaller public companies. We believe issuers of all sizes need to achieve reasonable assurance that their internal controls prevent or detect material misstatement of the financial statements. Likewise, management’s required annual assessment needs to provide reasonable assurance that material weaknesses in internal control over financial reporting will be identified. The means to those ends, but not the overall objective, is the subject of this discussion.

Specifically, we recommend that the SEC take immediate steps to (1) coordinate completion of the COSO guidance for applying the COSO criteria to smaller public companies, and (2) establish a process for developing practical “how to” guidance and examples for smaller public companies in making their internal control assessments through identification, evaluation, and testing of key controls. We support efforts to complete the COSO undertaking, but we believe the COSO guidance on criteria alone will not sufficiently address the needs of smaller public companies in complying with the internal control reporting requirements. As noted, there is a need for practical performance guidance to provide management of a small, less complex public company with a useful “roadmap” to approach performing its assessment. There are a number of different processes that could be undertaken to create this guidance. Whatever the process, the performance guidance crafted must be practicable and bridge the gap between improved COSO guidance and the realities facing smaller public companies.

The SEC will need to oversee the process, or at least play an active role in establishing the process and place its stamp of approval on the output such that the resulting guidance is objective, practicable, authoritative and most important, germane to the issues faced by smaller public companies. The SEC, PCAOB, issuers, and auditors will need to have a hand in the development of this guidance to achieve the desired outcome.

How the COSO Guidance for Smaller Public Companies Can Be Improved

We commend COSO on its efforts to develop guidance for smaller public companies to apply the COSO criteria. Although the principles articulated in the COSO guidance might be a useful way of thinking about the five components that represent the criteria in the COSO framework, we have serious doubts that management of a smaller public company could effectively make an assessment of internal control over financial reporting without practical examples and the more detailed implementation guidance referenced above. In order to develop practical examples, COSO needs to better address the characteristics that differentiate smaller companies (e.g., small number of employees, noncomplex operations, single product line, single or few locations). It is these characteristics that affect the nature and complexity of the control system that needs to be in place.

We believe more work needs to be done to make the attributes, approaches, and examples more easily understood by management of smaller public companies. In our view, there is a need to state in the simplest of terms possible how the COSO criteria can be applied to these smaller public companies, and in a way that fully recognizes the unique attributes of such companies – smaller public companies likely rely more on detective monitoring controls, personal involvement by top management in setting a control environment, and competent personnel in key positions providing oversight of internal control over financial reporting. We also believe the attributes, approaches, and examples do not deal effectively with the challenges of smaller public companies cited in the draft COSO guidance – segregation of duties; management override of controls; qualified accounting personnel; and less formal policies and procedures, documentation, and lines of communication.

In our experience, smaller public companies necessarily rely more heavily on the involvement of key personnel rather than formal processes. As companies grow and the system of internal control matures, more formal processes and lines of communication grow in importance and the heavy reliance on key personnel declines. It also is our experience that smaller organizations can more effectively deal with the internal control challenges of limited finance and accounting staff if executive management and the board of directors, including the audit committee, understand and appreciate these challenges and take steps to address them. For any guidance on criteria to really be helpful to management of a smaller public company in establishing effective internal control over financial reporting, the guidance will need to specifically address the matters discussed in this section of our letter.

Uniqueness of Small Company Environment Must Be Recognized

As noted above, we do not believe that guidance on the COSO criteria alone will sufficiently address the needs of smaller public companies in complying with the internal control reporting requirements. There still will remain a need for practical performance guidance to provide management of a small, less complex public company with a useful "roadmap" to approach its assessment process. We believe additional guidance on performing the assessment will be required that specifically recognizes the unique considerations – practical realities – in the small public company environment that must be considered and addressed, including the following:

- Less formality in the way the company operates and a much wider span of control by management with more direct channels of communication.

- Direct supervision of employees and a more "hands-on" approach to management review and oversight.

- Detect controls and monitoring, rather than prevent controls generally play a more prominent role.

- The unique approaches to risk assessment.

- The risk of management override is likely different.

- Additional challenges relative to the segregation of duties and in some cases retaining competent accounting personnel.

- Board level oversight plays a more critical role in the system of internal control.

- Unique documentation challenges as many important controls may be undocumented and the need to develop guidance and practicable examples regarding the required level of documentation.

- The roles of the board of directors, audit committee, senior management, the CFO and other financial accounting personnel can be tailored to optimize the system of internal control.

- The unique characteristics and role of IT in a small company environment, including how, in some instances, the nature of the accounting software (e.g., purchased accounting software packages) may serve as a control.

The guidance on performing the assessment should complement other guidance for applying the COSO criteria to smaller public companies. It should address how management of smaller public companies can implement comprehensive programs to enhance the company's internal control, perform periodic assessments of internal control, and report on its effectiveness.

We cannot overemphasize that whatever form the additional guidance takes, active involvement by management of smaller public companies, the SEC, the PCAOB, and auditors is in order so that the guidance developed will be objective, useful and authoritative.

In our view, the steps outlined here are the appropriate course of action to balance the needs and interests of all parties in a manner that maintains the significant gains in financial reporting, corporate accountability and investor protection that result from implementation of the Section 404 process.

Scaling Securities Regulation for Smaller Companies

We favor the Advisory Committee's recommendation that the SEC revisit its current definition of a "small business issuer" and expand the number of companies eligible for the associated relief. We also favor the general approach recommended by the Advisory Committee that would result in periodic recalibrations of the quantitative thresholds used to determine whether or not a company meets the revised criteria. We have been a consistent proponent of using indexed, rather than static, quantitative thresholds in various securities regulations.

The Advisory Committee has recommended defining "microcap" and "smallcap" companies based solely on their market capitalization. Because the computation of market capitalization is simpler and more widely understood than the calculation of public float, we support the use of market capitalization rather than public float in revising the definitions of smaller public companies.

The Advisory Committee has recommended defining smaller public companies to include those consisting of the lowest 6% of aggregate U.S. market capitalization, which would include approximately 80% of all public companies. We question whether it is appropriate to define smaller public companies to include the substantial majority of all public companies. As proposed, a company with market capitalization of nearly $800 million would qualify as a smallcap company. Under the Advisory Committee's approach, an established company that experiences financial distress could become eligible for relief as a smaller public company. Similarly, a company with relatively high levels of revenue (with concomitant levels of risk and complexity), but with a low valuation multiple, could continue to qualify as a smaller public company. Accordingly, as with the current definition of a small business issuer, we suggest that the revised definitions of smaller public companies retain a quantitative measure based on annual revenue (or perhaps total assets in the case of a financial institution).

In reassessing the definition of smaller public companies, we suggest that the SEC reassess and coordinate its existing definitions of accelerated filers, large accelerated filers and well-known seasoned issuers. We see no reason why companies meeting the definition of a smaller public company should be subject to accelerated filing deadlines. Similarly, it would not seem appropriate that a smallcap company also could be a well-known seasoned issuer, which could occur under the definition of a smallcap company recommended by the Advisory Committee.

Capital Formation, Corporate Governance and Disclosure

In Recommendation IV.P.1., the Advisory Committee recommends incorporating the disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K, making them available to all microcap companies, and ceasing to prescribe specialized registration and reporting forms for smaller companies. Similarly, in Recommendation IV.P.2., the Advisory Committee recommends incorporating the financial statement accommodations currently available to small business issuers under Regulation S-B into Regulation S-K or Regulation S-X and making them available to all microcap and smallcap companies.

We would support an initiative to eliminate Regulation S-B and integrate the disclosure relief for smaller public companies into Regulations S-K and S-X, which would appear to be a simpler approach to understand and maintain. If the SEC eliminates separate registration and reporting forms for smaller companies, we recommend that there be a clear indication on the cover page of reports and registration statements whether the registrant qualifies as a smaller public company and is following the associated disclosure relief.

We also agree with the Advisory Committee's Recommendation IV.P.2. to require smaller public companies to provide comparative balance sheets. Regulation S-B only requires one balance sheet in the annual and quarterly reports of small business issuers. As we commented to the SEC in 1992 (File No. S7-4-92), we continue to believe that comparative balance sheets provide investors with a more meaningful financial statement presentation without any significant incremental cost or burden to the registrant.

In Recommendation IV.P.3., the Advisory Committee recommends that seasoned reporting companies with securities traded on a national securities exchange, NASDAQ, or the Over-the-Counter Bulletin Board be eligible to use Form S-3 for primary offerings of securities as long as the company is current in its Exchange Act reporting at the time of filing. We are concerned with such a broad expansion of the eligibility to use Form S-3 and the associated shelf registration of securities. While we appreciate the benefits of Form S-3 in promoting capital formation and reducing the cost of capital, we question whether investors would be served by allowing shelf registrations by companies that elect reduced disclosures as an accommodation for their smaller size.

We note that in 2005 the SEC amended Form S-1 to allow the incorporation by reference of Exchange Act reports, which provided substantial administrative relief to seasoned public companies ineligible to use Form S-3. Previously, we have recommended that the SEC reassess the Form S-3 eligibility criteria for primary offerings of securities, particularly the current requirement of $75 million in public float. In reassessing the regulation of smaller public companies, the SEC should bar shelf registration by any company that does not yet fully comply with the Section 404 assessment and audit of its internal control over financial reporting. In our view, reliable internal control over financial reporting, and reliable disclosure controls and procedures, are necessary for the protection of investors when securities may be sold "off the shelf." Accordingly, shelf registration should be reserved for those larger public companies that fully comply with all of the disclosure requirements of Regulations S-K and S-X, including the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002.

Implicit in the Advisory Committee's Recommendation IV.P.3. is the elimination of timely Exchange Act reporting for one year as a condition to use Form S-3 (but the retention of the requirement to have filed all required reports). We also would urge the SEC to reconsider this Form S-3 criterion as it applies to all public companies. In our view, the loss of Form S-3 eligibility is a draconian penalty for missing an Exchange Act reporting deadline. Notwithstanding Exchange Act Rule 12b-25 and the limited safe harbor applicable to certain items within Form 8-K, accelerated periodic and current reporting deadlines heighten the likelihood of an occasional delinquent filing. Accordingly, we urge the SEC to eliminate or substantially reduce the associated penalty of the registrant's losing Form S-3 eligibility for one year.

Accounting Standards

In Recommendation V.P.1., the Advisory Committee recommends that the Commission and other bodies develop a safe-harbor protocol for accounting for transactions that would protect well-intentioned preparers from regulatory or legal action when the process is appropriately followed. The Report acknowledges that this recommendation is responsive to the risk of second-guessing professional judgments with hindsight, and the excessively litigious environment.

The exercise of professional judgment by both preparers and auditors is fundamental to the financial reporting process, and we are concerned, as is the Advisory Committee, that the exercise of professional judgment is increasingly being challenged by regulators and securities litigants. In the financial accounting and reporting arena, the threat of such second-guessing is a major reason for the use of "rules" rather than "principles" in the U.S. as compared to the rest of the world. Professionals – both preparers and auditors – need confidence that their judgment, appropriately exercised, will be respected. Without instilling confidence in the individual that a good faith or well-intentioned exercise of professional judgment will be respected by all authorities, we will continue to struggle to converge with the world's capital markets, which operate in a framework based more on principles rather than rules.

This issue goes beyond securities and audit profession regulation, and we agree with the Advisory Committee regarding the effects of the U.S. litigation system. Unwarranted litigation, which challenges the well-intentioned exercise of professional judgment, poses fundamental threats to the private sector public company auditing function. This is not an issue that is new or one necessarily within the power of the SEC or PCAOB to fix, but we concur that it is a matter that must be addressed.

In Recommendation V.P.2., the Advisory Committee recommends the FASB provide for microcap companies to apply the same effective dates as private companies in implementing new accounting standards. As stated in our May, 2005 comment letter on the Advisory Committee's proposed agenda, we believe that smaller public companies, with fewer resources, face significant challenges when joining larger companies in implementing new accounting standards and therefore should be considered for possible delayed, phased implementation. We suggest that both microcap and smallcap companies, as ultimately defined, be considered for such relief in the implementation of new accounting standards.

In Recommendation V.P.3., the Advisory Committee recommends that the SEC consider additional guidance for all public companies with respect to materiality related to previously issued financial statements. We agree that this area merits additional attention and guidance. In our experience, many of the restatements in recent years have had relatively minor effects on previously issued financial statements. In many cases, these restatements have occurred due to regulatory interpretations of quantitative materiality and focus on individual line items within the financial statements rather than the effects of errors and omissions on the financial statements taken as a whole. In other cases, the consideration of the qualitative factors enumerated in SAB 99 has been the subject of challenges to professional judgments. These trends need to be examined and addressed. In addition, we concur with the observations in the Report that the assessment of materiality in quarterly periods would benefit from further guidance from the SEC and others.

Ernst & Young takes compliance with all aspects of auditor independence very seriously. We have committed significant resources to continuing to expand and enhance our independence policies, processes, compliance/monitoring and training activities consistent with our role as independent auditors. We also recognize that the public companies we audit have a vested interest and responsibility in maintaining our independence and that their audit committees are a critical part of the auditor independence framework. We do, however, believe that the examination described in Recommendation V.P.4. would be a worthwhile one for the SEC to undertake. The potential development of a mechanism for relief for certain types of *di minimis* violations of its independence rules, with the appropriate audit committee oversight, seems worthwhile and a step that might enable auditor independence rules to evolve from a rules-based regime into a principles-based framework that would consider threats to independence and the application of relevant safeguards.

As discussed in Recommendation V.S.2., we support the FASB continuing to pursue objectives-based accounting standards. We also believe the FASB's efforts to codify all existing accounting literature under U.S. GAAP, combined with efforts at reducing complexity in accounting standards, will benefit all companies.

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We would be pleased to discuss our comments with the Commission or its staff at your convenience.

Very truly yours,

Ernst & Young LLP