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Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20540-1090

File No. 265-23
Exposure Draft of Final Report of the Advisory
Committee on Smaller Public Companies to the Securities and Exchange Commission

Dear Ms. Morris:

KPMG LLP welcomes this opportunity to comment on the Draft Final Report of the Commission's Advisory Committee on Smaller Public Companies (Committee). First and foremost, we wish to acknowledge the substantial efforts of the Committee, and we believe that the Draft Report demonstrates a comprehensive and thoughtful analysis of challenges faced by smaller public companies as U.S. capital market participants.

We support many of the primary and secondary recommendations outlined in the Report. This letter of comment will focus on those concepts and recommendations that we do not support, or for which we believe further analysis may be necessary prior to finalizing the Report. We hope that you find our comments constructive.

PART II. SCALING SECURITIES REGULATION FOR SMALLER COMPANIES

Smaller Public Company Definitions. We generally support the six determinants identified in the Report for use in defining a "smaller public company", and the need for scaled or proportional securities regulation for entities so defined by these determinants.

Further, we acknowledge the Committee's observation that any classification system developed must be integrated with the categories of entities established in the securities offering reform initiatives. In addition to eliminating intersections that arguably are counterintuitive (e.g., cases where the definition of "smallcaps" overlaps with the definition of "well-known seasoned issuers"), the classification of entities for purposes of scaling securities regulation should not entail a matrix of different categories for different purposes. Any changes to the existing categories of entities under the securities laws to adopt some form of the Committee's Recommendation II.P.1 must allow for transparent application by issuers, be understandable by investors (e.g., what accommodations are applicable to a particular issuer), and be consistent with the Commission's mandate of investor protection.

As noted later in this letter, we do not support the Committee's Recommendations III.P.1, III.P.2, and III.P.3. However, if the Commission were to adopt these Recommendations, resulting in some form exemption from Section 404 of Sarbanes-Oxley for a significant majority of public companies, we question whether the definitions of "microcap companies", "smallcap companies" and "smaller public companies" in the Report are consistent with the Commission's mandate of investor protection. The public interest must be considered in determining both the categories of gradation to be applied to the population of issuers, and to the accommodations that would apply to these issuers.

Finally, we note the Committee's rationale for recommending special scaled regulation for "smaller public companies", based on an analysis of the lowest 6% of total U.S. equity market capitalization. The Committee notes that its recommended standard "assures the full benefits and protection of federal securities regulation for companies and investors in 94% of the total public U.S. equity capital markets", and "acknowledges the relative risk to investors and capital markets as it is currently used by professional investors." While we appreciate this rationale, we believe that the Commission should specifically consider whether the concept of "relative risk to investors and capital markets" referenced by the Committee is consistent with the SEC's overarching investor-protection mandate.

PART III. INTERNAL CONTROL OVER FINANCIAL REPORTING

Recommendations III.P.1, III.P.2 and III.P.3. Fundamentally, we believe that compliance with the provisions of Section 404 provides needed protections to investors in all public companies, regardless of size. In addition, we believe that PCAOB Auditing Standard No. 2 is sound and scalable, and should not be considered for amendment at this time. Accordingly, we do not agree with the Committee's recommendations III.P.1, III.P.2 and III.P.3 in the Report.

Specifically, recommendation III.P.3 referencing a standard providing for an audit of the design and implementation of internal control is, in our view, unacceptable. While clear disclosure that a company has not undergone an audit of internal control over financial reporting is understandable to investors, those same investors cannot be expected to assess the relative gradations of assurance provided by this proposed distinction in reporting on internal control.

An alternative providing for an auditor's report only on design and implementation of internal control, at a time when much attention has been directed toward reporting on the operating effectiveness of internal control, undoubtedly will result in users' misunderstanding the level of assurance provided by the auditor. It is important to note that a well-designed system of internal control, while vital, does not equate to the generation of reliable financial information in the absence of effective operation of internal control. Accordingly, we believe that recommendation III.P.3 would serve to widen the current expectation gap relative to auditor assurances at a time when emphasis should be directed toward narrowing that gap.

In addition, we oppose recommendations III.P.1 and III.P.2 based on our belief that Section 404 has made, and will continue to make, significant contributions to improving financial reporting, corporate governance, and audit quality, each serving to enhance investor protections and confidence in our capital markets. We believe that sound public policy dictates that the benefits derived from these contributions should be available to investors in all public companies, regardless of size.

Alternative Proposal. As noted previously, we believe that PCAOB Auditing Standard No. 2 is sound and scalable, and should not be considered for amendment at this time. In addition, we believe that compliance with the provisions of Section 404 by issuers, and application of the provisions of PCAOB Auditing Standard No. 2 by auditors, represent evolutionary skills that will become more effective and efficient with experience. Consistent with that belief, our experience clearly indicates that the effectiveness of Section 404 compliance has improved over the first two years of execution – for both management and auditors. While this increased effectiveness has resulted in cost efficiencies, the results are not likely to address all of the concerns of certain smaller public companies. We believe that the missing element in the formula to furthering cost efficiencies in a smaller public company environment is enhanced management guidance for developing an effective internal control structure and completing an assessment and evaluation of internal control over financial reporting consistent with the provisions of Section 404.

Accordingly, we believe that additional management guidance should be developed that addresses establishing and maintaining effective internal controls, and for completing an assessment and evaluation of internal control over financial reporting. To that end, we recommend that the Commission sponsor a collaborative effort by regulators, issuers, investors and auditors, to examine the practical challenges of Section 404 compliance facing smaller public companies. The charge of this collaborative group should be to develop guidance for smaller public company managements in developing, maintaining, assessing and evaluating internal control over financial reporting, all in a cost-effective manner. We stand ready to commit resources to support any efforts of the Commission directed toward developing further guidance for management relative to compliance with the provisions of Section 404.

Prior to its issuance, we recommend that such guidance be field tested, including appropriate cost analyses, to facilitate well-informed decisions regarding the reasonable application of the provisions of Section 404 in a smaller public company environment. This field test should involve smaller public companies applying the additional guidance to “real life” facts and circumstances, with ongoing monitoring by the collaborative group to confirm and/or modify the guidance as deemed appropriate. We envision that the resulting management guidance would include an analysis of best practices and lessons learned that would be beneficial in effectively scaling internal control concepts in a smaller public company environment. This additional management guidance should reflect the operational realities of smaller public companies, including less formalized internal control structures, lack of “textbook” segregation of duties, increased risk due to management override, and significant reliance on effective monitoring controls.

As a by-product of this collaborative effort, it may become evident that additional auditor guidance for scaling the provisions of PCAOB Auditing Standard No. 2 to a smaller public company environment is warranted. We encourage the PCAOB to closely monitor the activities of the collaborative group to determine if, and to what extent, additional auditor guidance may be warranted.

We believe that this alternative proposal retains the investor protections embodied in Section 404 of Sarbanes-Oxley, and provides a pragmatic solution to enhancing the effectiveness and efficiency of performing audits of internal control in a smaller company environment. In addition, while this guidance is being developed, we recommend the continued deferral (up to one year) of Section 404 requirements for all smaller public companies that have not already complied with the provisions of Section 404. Further, we believe that COSO's proposed guidance for Smaller Public Companies Reporting on Internal Control Over Financial Reporting would be most effective if issued in final form contemporaneously with the Commission-sponsored guidance.

It may become evident, as a result of field testing and meaningful cost analyses, that an audit of internal control over financial reporting may not be justified for smaller public companies that evidence certain characteristics. For those smaller public companies, an exemption from compliance with Section 404 may be warranted, but such an exemption should be considered only after careful analysis of the data derived from the field test.

In addition to those matters noted above, we believe that the Report includes conclusions in a number of areas that decidedly are open for debate. These conclusions appear, in a number of cases, to be unsubstantiated and/or to reflect a more negative view of the benefits of compliance with the provisions of Section 404 than our experience indicates. These matters include: the equating of limited choice in Big 4 firms to a lack of competition in the public accounting profession; the burdens of Section 404 compliance as crippling capital formation in the U.S.;[1] and that benefits of Section 404 compliance are far outweighed by the cost of compliance.[2]

PART IV. CAPITAL FORMATION, CORPORATE GOVERNANCE AND DISCLOSURE

Recommendation IV.P.2. We generally concur with this recommendation, and believe that certain components should be considered for all issuers. The Report cites technological advancements and increased access to financial information, including EDGAR, as support for eliminating the need for a three-year financial statement presentation. In addition, we believe that implementing a two-year

[1] While the number of IPOs has declined since the peak of the internet bubble, IPO numbers in recent years are strong. There were more than triple the number of IPOs in 2004 as compared to 2002. This data point suggests that companies are entering the U.S. public markets principally due to market conditions. In addition, the pace of IPOs in the U.S. during 2006 is the highest since 2000, and is up 14% over 2005.

[2] While we recognize the substantial cost to issuers of Section 404 compliance, particularly in the first year, we have noted significant enhancements to managements' and audit committees' understanding of internal control, a renewed focus on corporate ethics throughout organizations, improved financial reporting processes, and a clearer understanding of management and audit committee accountability. These benefits are difficult to measure objectively, but are critically important to any deliberation of the cost-benefit balance associated with Section 404 compliance.

financial statement presentation requirement, including two years of audited balance sheets, would serve the investors' interests by eliminating the burden and additional cost associated with obtaining an auditor's consent for the earliest of the three years presented and performing reaudits of financial statements for this same period when GAAP requires retrospective application of accounting changes and the predecessor auditor no longer is independent. Accordingly, we believe that a two-year financial statement presentation standard should be considered for all issuers.

We believe that the Commission should consider the implications of any rulemaking associated with this recommendation on the Commission's international convergence of financial reporting initiatives. A two-year financial statement presentation currently is consistent with the provisions of International Accounting Standard 1. However, the International Accounting Standards Board recently released an exposure draft that, if issued in final form, would require companies complying with International Financial Reporting Standards to present three years of balance sheets and two years of statements of operations, cash flows, and equity.

In addition, we believe that the reduced financial statement presentation requirements for acquired businesses pursuant to Item 310(c) of Regulation S-B outlined in this recommendation should apply to all issuers. Currently, an S-B filer generally is required to provide two years of an acquired entity's audited financial statements if the assets or pre-tax operating income of that entity exceeds 50% of the S-B filer's assets or pre-tax operating income. Consistent with our previously noted comment, we believe that the financial statement requirements for acquired businesses filed pursuant to Rule 3-05 of Regulation S-X should be limited to two years for all issuers. Similarly, we believe that the financial statement requirements for equity method investees filed pursuant to Rule 3-09 of Regulation S-X should be limited to two years for all issuers, other than smaller public companies (for which audited financial statements of equity method investees would not be required under this recommendation).

PART V. ACCOUNTING STANDARDS

Recommendation V.P.1. We agree with the Committee's recommendation that a "safe harbor" protocol should be developed for all issuers that follow an appropriate process in reaching accounting conclusions when those conclusions have a reasonable basis in GAAP. However, we believe that the Committee should provide additional guidance in its final report addressing considerations relevant to determining whether a conclusion has a reasonable basis in GAAP. For example, criteria that may be relevant when considering whether an issuer has a reasonable basis in GAAP for its particular accounting treatment include:

- Is management's accounting conclusion consistent or inconsistent with other areas of analogous GAAP?
- Are there a number of varying industry practices regarding accounting for the same or similar transactions (i.e., practice is mixed)?

- Are other accounting alternatives considered preferable?

We also agree with the Committee's suggestion that disclosures in the financial statements and in Management's Discussion & Analysis regarding the transaction and related accounting treatment would be an important component of the protocol.

Recommendation V.P.3. We agree with the Committee's recommendation that additional guidance from the Commission related to materiality is needed for all public companies, specifically relative to quarterly periods. In particular, additional guidance on applying paragraph 29 of APB Opinion No. 28, "Interim Financial Reporting," is critical. Paragraph 29 indicates that, for purposes of determining materiality for the correction of an error, "amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings." Clear guidance relative to the application of paragraph 29 of APB Opinion No. 28, and its interplay with other Commission guidance on materiality, should be developed to assist all issuers and their auditors in assessing error corrections on a consistent basis. We believe this guidance will improve the comparability of financial reporting, including disclosures, and ensure that the concept of "reasonable assurance" in the preparation of financial statements is appropriately considered.

Recommendation V.P.4. We agree with the recommendation that the Commission should establish a deminimis exception when considering the implications of inadvertent and inconsequential independence violations. The Commission's rules currently require that a registrant's audit committee pre-approve all services provided by the company's independent auditor. These rules also provide for a deminimis exception in certain limited circumstances.

However, this deminimis exception is applicable only with respect to permitted non-audit services. If the non-audit service in question represents a prohibited service, then a literal application of the Commission's rules could result in a conclusion that the auditor's independence is impaired, notwithstanding the qualitative and quantitative insignificance of the non-audit service in relation to the audit of the company's financial statements.

In reality, no system of internal control can be expected to prevent *all* violations at *all* times (a fact that is recognized in the securities law,[3] Commission rules,[4] and PCAOB Auditing Standard No. 2[5]). In addition, the Commission's rules recognize that an accounting firm's quality control system is not expected to be fool-proof. However, under a literal interpretation of the Commission's independence rules, a registrant may find itself in the position of having to incur substantial costs to have its financial statements reaudited due to an inconsequential independence violation.

[3] See, e.g., Securities Exchange Act of 1934, Section 13(b)(2)(B).
[4] See, e.g., Regulation S-X, Rule 2-01(d) and Rel. No 33-8238, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.
[5] PCAOB Auditing Standard No. 2, Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

The Sarbanes-Oxley Act has required, and the Commission has codified, the model through which an accounting firm is held accountable to the shareholders through the audit committee. The Commission has "recognized the critical role that audit committees can play in the financial reporting process and in helping accountants maintain their independence from audit clients."[6] The audit committee is in a unique position to promote the independence of the accounting firm both in fact and in appearance which serves "to align the auditor's interests with those of shareholders."[7]

Also important to this analysis is the fact that the Commission's auditor independence rules are predicated on a "reasonable investor" standard.[8] Under the reasonable investor standard, there may be situations, for certain violations of the auditor independence rules, where replacement of the auditor may not be the most appropriate or prudent course of action. With respect to inadvertent violations of the Commission's prohibited services rules, we believe that a deminimis standard can be applied in a manner that is fair to registrants and their registered public accounting firms, and will not dilute investor protections. Consistent with the Committee's recommendation, any standard developed would require discussion with and approval by the company's audit committee. We stand ready to commit resources to support efforts to address the concepts of "inadvertent" and "deminimis" relative to application of the independence rules.

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Again, we would like to acknowledge the substantial efforts of the Committee and the comprehensive and thoughtful analyses evidenced in the Report. We appreciate the opportunity to provide comments on the recommendations included in the Report. If you have any questions regarding information included in this letter, please do not hesitate to contact Sam Ranzilla at 212-909-5837 or sranzilla@kpmg.com.

Very truly yours,

KPMG LLP

[6] SEC, Rel. No 33-8183, Strengthening the Commission's Requirements Regarding Auditor Independence.
[7] SEC, Rel. No 33-8220, Standards Related to Listed Company Audit Committees.
[8] Regulation S-X, Rule 2-01(b).

Cc: SEC Commissioners

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