

April 3, 2006

Ms. Nancy M. Morris
Federal Advisory Committee Management Officer
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:

PricewaterhouseCoopers LLP appreciates the opportunity to provide written comments to the Securities and Exchange Commission's ("SEC") Advisory Committee on Smaller Public Companies' ("Advisory Committee") request for input on ways to improve the current regulatory system for smaller companies under the securities laws of the United States, including the Sarbanes-Oxley Act of 2002 ("SOX").

In the attachment to this letter, we have specifically addressed several of the recommendations included in the Advisory Committee's exposure draft. Of our comments, we wish to highlight our position with regard to the proposed exemption for microcap and smallcap companies from some or all of the requirements of Section 404 of SOX.

As discussed further below, we do not agree with the proposals to exempt what would amount to approximately 80% of public company registrants from the requirement for an auditor's opinion on the effectiveness of internal control over financial reporting. We also do not agree with the proposal that approximately 65% of those companies would also not be required to issue a management attestation on the effectiveness of their internal control over financial reporting.

Section 404 has resulted in profound changes in behavior among those who comprise key stakeholder groups in the capital market network and the corporate reporting process, including: management teams, audit committees, boards of directors, investors, regulators, attorneys, analysts, and auditors. We believe this changed behavior and heightened focus on the production of reliable financial reporting, predicated on effective internal control, is very positive. The marked improvement we saw in year one of Section 404 compliance has continued in year two. Specifically:

- Registrants' have a heightened focus on the maintenance of effective systems of internal control and the identification and remediation of internal control deficiencies before material misstatements occur. These efforts benefit investors and preparers by enabling companies to avoid possible costly material misstatements, improving the reliability of the financial information provided to the marketplace, reducing the

likelihood of material frauds, and potentially improving business processes. In year one, Section 404 provided the catalyst to reduce the backlog of deferred maintenance on existing systems of internal control. With a significant portion of the deferred maintenance completed in year one, in year two we have seen management focus on making more permanent control remediations that may have been informal, or manual "patches". The continuation of process and control improvements serves to further strengthen the reliability of financial statements. For example, although the data for year two filers is not yet complete, we have noted that as of March 24, 2006, 250 of the approximately 570 companies who reported ineffective internal control over financial reporting in year one of Section 404 compliance have addressed their material weaknesses and have asserted that their internal control over financial reporting is effective in year two. As of March 24, 2006 only 50 companies with material weaknesses in year one continue to disclose material weakness in year two. In the past year, we have also seen a shift in management's approach to Section 404 from a periodic compliance exercise into an ongoing process and sustainable mindset embedded into everyday operations. We have also seen positive change in that internal control ownership has evolved from one primarily vested with the finance and accounting functions to one of broader ownership, including executive, business unit, and operating management.

- Audit committees and boards of directors are more attentive to their fiduciary responsibilities related to financial reporting. They have become substantially more engaged in overseeing the financial reporting processes and internal control environments of the companies they serve.
- Investors and analysts are currently being provided greater transparency into the quality of registrants' financial reporting processes, thus allowing them to make more informed investment decisions.
- Audit firms have enhanced their relationships with audit committees, extensively trained their people on auditing internal controls, and enhanced their audit approach to integrate the focus on the evaluation of internal controls with the performance of the financial statement audit. These changes and enhancements, coupled with external regulation, have improved the quality of audits. Smaller public companies will benefit from the accumulated knowledge and experience of their auditors as they adopt Section 404 for the first time.

While companies have been required to maintain effective internal controls under the Foreign Corrupt Practices Act of 1977, it was not until the Sarbanes-Oxley Act and Section 404 that we witnessed the behavioral changes described above. We believe that this can be largely attributed to Section 404's requirement for an auditor attestation.

There is nearly unanimous agreement from all stakeholders in the capital markets on the benefits of having effective internal control over financial reporting. The primary complaint against Section 404 is not that it fails to deliver value, but the high cost of compliance.

We believe that the achievement of the most efficient and effective Section 404 compliance process is still a work in progress. Experience in the first year of adoption contributed to

significant efficiencies in year two for both management's and the auditor's processes. Experience will allow management and auditors to continue to make improvements in the efficiency and effectiveness of the attestation process for companies of all sizes. We recognize the specialized characteristics and needs of the companies defined by the Advisory Committee as microcap and small companies, many of which have yet to report under Section 404. We believe that they will benefit from the experiences of earlier adopters which will result in a more efficient year one audit than that experienced by accelerated filers. We also expect them to experience continued efficiency improvements after the initial year of adoption as they progress on the learning curve. It would be unfortunate if the preparers, the profession and regulators were not given the opportunity to develop processes that are responsive to the unique challenges of smaller companies and achieve the intended goals of Section 404 in a cost-effective manner, while still preserving the investor protection objective of the Act. That said, it may be helpful for this sector of the market to have available additional tools and guidance to minimize disruption in the initial year of compliance and to effectively apply the best practices of larger registrants.

In order to provide time to conduct additional study and field testing of additional guidance, communications, and practice tools that may be necessary to improve efficiency on these smallest of registrants, we would not object to an additional one-year deferral of the requirements of Section 404 for those companies within this group that qualify as non-accelerated filers. We do not believe that an optional, temporary deferral should be offered to smaller public companies that are accelerated filers and have already complied with Section 404.

We believe that this additional study would provide valuable information to companies and audit firms of all sizes. We envision a cooperative process whereby the audit approach for a small sample of companies could be evaluated by a task force of regulators, auditors and issuers. Working collaboratively, this task force would bring together the best minds in the profession to determine the most effective, efficient, and minimally disruptive means to obtain the support necessary for management's assertion and the auditor's opinions on the effectiveness of internal control over financial reporting on a real-time basis. The results of this study would be used to determine the adequacy of the existing communications and tools related to the requirements of Section 404.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the Advisory Committee may have. Please do not hesitate to contact Vincent Colman (973-236-5390) or Ray Beier (973-236-7440) regarding our submission.

Sincerely,


PricewaterhouseCoopers LLP

**Recommendation II.P.1:**

Establish a new system of scaled or proportional securities regulation for smaller public companies using the following six determinants to define a “smaller public company”:

- the total market capitalization of the company;
- a measurement metric that facilitates scaling of regulation;
- a measurement metric that is self-calibrating;
- a standardized measurement and methodology for computing market capitalization;
- a date for determining total market capitalization; and
- clear and firm transition rules, i.e., small to large and large to small.

PwC Response:

We believe that scaled regulation creates unnecessary complexity and hinders the ability of users to compare financial results among companies.

Among other things, the adoption of the Regulation S-B accommodations would limit the breadth and depth of MD&A disclosures, reduce the numbers of years of financial statements presented, and eliminate the requirement for 5-year summary financial data. Microcap and smallcap companies are not widely followed by the sell-side analyst community. As a result, the financial statements are the main source of information for many investors. We believe that the trend information provided by the additional years of primary financial statements and the 5-year data provided in the summary financial data table take on even greater importance to investors in smaller companies. In order to maintain investor protection, we do not support the expansion of Regulation S-B to a category broader than that to which it currently applies.

Recommendation IV.P.1:

Incorporate the scaled disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K, make them available to all microcap companies, and cease prescribing separate specialized disclosure forms for smaller companies.

PwC Response:

See response to Recommendation II.P.1 above.

Recommendation IV.P.2:

Incorporate the primary scaled financial statement accommodations currently available to small business issuers under Regulation S-B into Regulation S-K or Regulation S-X and make them available to all microcap and smallcap companies.

PwC Response:

See response to Recommendation II.P.1 above.

**Recommendation III.P.1:**

Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from Section 404 requirements to microcap companies with less than \$125 million in annual revenue and to smallcap companies with less than \$10 million in annual product revenue that have or expand their corporate governance controls that include:

- adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Exchange Act;
- adoption of a code of ethics within the meaning of Item 406 of Regulation S-K applicable to all directors, officers and employees and compliance with the further obligations under Item 406(c) relating to the disclosure of the code of ethics; and
- design and maintain effective internal controls over financial reporting.

PwC Response:

See response to Recommendation III.P.2 below.

Recommendation III.P.2:

Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from external auditor involvement in the Section 404 process to the following companies, subject to their compliance with the same corporate governance standards as detailed in the recommendation above:

- Smallcap companies with less than \$250 million in annual revenues but greater than \$10 million in annual product revenue; and
- Microcap companies with between \$125 and \$250 million in annual revenue.

PwC Response:

As discussed in the cover letter, we believe that Section 404 is beneficial to all companies, regardless of size and that it is contrary to the intent of the Sarbanes-Oxley Act to provide exemptions to nearly 80% of public company registrants.

In addition, we do not believe that a new framework for assessing internal control is necessary. The existing internal control framework can be effectively applied to companies of all sizes. With regard to Section 404 specifically, the amount of time necessary to conduct management and the auditor's testing does not increase or decrease proportionate to the size of the account on which the procedures are applied. However, we expect the idea of a study of a sample of microcap and smallcap companies to identify the additional tools, templates, training, and guidance that may be necessary to assist both management and auditors in conducting their procedures in as efficient and effective a manner as possible.

**Recommendation III.P.3:**

While we believe that the costs of the requirement for an external audit of the effectiveness of internal control over financial reporting are disproportionate to the benefits, and have therefore adopted the second Section 404 recommendation above, we also believe that if the Commission reaches a public policy conclusion that an audit requirement is required, we recommend that changes be made to the requirements for implementing Section 404's external auditor requirement to a cost-effective standard, which we call "ASX," providing for an external audit of the design and implementation of internal controls.

PwC Response:

We believe that all companies subject to the internal control over financial reporting requirements should be subject to the same independent auditor attestation requirements.

A design-only audit will cause some material weaknesses to go undetected.

A different auditing requirement for audits of internal control over financial reporting for larger versus smaller companies will undoubtedly create confusion among financial statement users as to the conclusions that should be drawn on the effectiveness of internal control over financial reporting. The level of reliance appropriate for a design-only opinion will likely be misunderstood. We believe this would increase an already considerable expectation gap as to the amount of comfort provided by the auditor's attestation.

In addition, if the primary motivation for lessening the requirement is the burdensome cost of compliance, it is unlikely that the elimination of the auditor's testing of operating effectiveness will have a significant impact. The performance of a design-only audit will only result in the elimination of a portion of the external audit costs, and the external audit costs are a minority of total 404 compliance costs¹.

Furthermore, one of the benefits of Section 404 is the efficiency resulting from the integration of the internal control over financial reporting and financial statement audit testing. The inability to leverage the internal control testing to obtain financial statement comfort will result in the need to increase substantive audit procedures, reducing the financial impact of the elimination of auditor testing of operating effectiveness.

¹ CRA International, in a survey commissioned by the largest audit firms, found that only 35% of the cost of compliance was attributed to external audit costs.

**Recommendation III.S.2:**

Determine the necessary structure for COSO to strengthen it in light of its role in the standard-setting process in internal control reporting.

PwC Response:

In the United States, the COSO Internal Control Integrated Framework is the most widely accepted framework for evaluating a company's internal controls. The SEC, PCAOB, and other regulatory bodies recognize the COSO framework as meeting the evaluation criteria outlined in the Sarbanes-Oxley Act. Although originally developed in 1992, this framework has proven to be a solid foundation that we believe is capable of being scaled to companies of all sizes and of different and increasing complexity. At this time, we do not believe that a more permanent structure is necessary for COSO or that another standard-setting body is required.

We acknowledge, however, that over time, businesses, technology, and processes will continue to change and develop. As a result, while we believe the fundamental principles of COSO provide a solid foundation, these future business environment changes may highlight a need to revisit the COSO framework to ensure that its principles continue to be relevant.

Recommendation V.P.1:

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.

PwC Response:

Over the years, the accounting standards have become more complex. This complexity has been driven by many factors, including the existence of multiple standard setters, intricate rules including bright lines and carve-out exceptions, and the desire for specificity in a litigious environment where decisions are often second-guessed. The preparation of financial statements in this environment requires the exercise of professional judgement by preparers in many areas, including the selection and application of accounting standards. We believe that it is important for regulators to support and respect reasoned judgments. We believe that it would be inappropriate to establish safe-harbor protection based upon the level of effort expended by preparers in arriving at an incorrect conclusion, or one for which reasonable judgement was not applied.

**PwC Response (continued):**

In addition, the exposure draft includes a discussion of how the proposed safe harbor would assist preparers in working with their auditors who, the release states, are motivated by their fear of being second guessed by regulators. Auditors should be a key resource to large and small companies for their knowledge, experience and judgment in all accounting and financial reporting matters, including unusual or complex transactions. We believe that the proposal has the potential of creating an environment where preparers would be more comfortable ignoring the advice of their auditors, creating disagreements between preparers and auditors that will reduce the effectiveness of the audit process.

Recommendation V.P.2:

In implementing new accounting standards, the FASB should permit microcap companies to apply the same extended effective dates that it provides for private companies.

PwC Response:

While we believe it is acceptable to modify implementation periods for smaller public companies to allow them additional time to understand and apply new accounting standards with their more limited resources, we believe that the extended effective dates should be permitted for non-accelerated filers. As we understand it, the definition of "microcap" is subject to change annually based on what constitutes 1% of total US equity market capitalization. In the interest of reducing complexity and confusion, we believe that the established and fixed definition of an accelerated filer be used for this purpose.

We expect that such additional time will have minimal impact on investors and markets as long as adequate SAB 74 disclosures are made. In addition, investors will benefit from the resulting improvement in the quality of financial reporting.

Recommendation V.P.3:

Consider additional guidance for all public companies with respect to materiality related to previously issued financial statements.

PwC Response:

While we acknowledge that significant judgement is necessary when considering qualitative factors, and when considering quantitative materiality against breakeven or aberrant earnings or interim periods, we believe that a meeting of the minds among regulators, preparers, auditors and the investor community is possible without the need to provide additional guidance. This meeting of the minds is best achieved by regulators providing a clear message by the consistent application of the existing guidance and the support of reasonable judgements.

**Recommendation V.P.4:**

Implement a de minimis exception in the application of the SEC's auditor independence rules.

PwC Response:

Under the existing guidance, inadvertent violations of the scope of services independence rules could result in a conclusion that an audit firm's independence is impaired regardless of how limited the impact of the prohibited service may be in terms of materiality or distance from the audit process. If the audit firm's independence is deemed to be impaired, the registrant could be forced to replace the audit firm. In that circumstance, a registrant may be required to incur the substantial cost for a re-audit to redress a problem arising from a minor and inadvertent matter.

With respect to inadvertent violations of the prohibited services rules, we believe that a "de minimis" standard can be applied in a manner that is fair to registrants, to their audit firms, and to registrants' investors. Further, we believe that such a de minimis exception, if adopted, should be available for companies of all sizes.

In order to determine that an inadvertent violation does not impair the audit firm's independence, we believe that the audit firm should have effective quality control processes, including procedures designed to prevent the firm from providing prohibited non-audit services to audit clients. Control procedures should also be present in the registrant's organization to ensure an effective audit committee pre-approval process for non-audit services to be provided by the auditor. If such systems are in place at both the audit firm and the registrant, we believe that certain limited violations could be deemed not to impair the audit firm's independence, provided that:

- The violation is "inadvertent".
 - To be inadvertent, the violation must be infrequent and the audit firm and the registrant must demonstrate that it has an adequate quality control system in place.
- The service is inconsequential to the financial statements and the audit.
- Upon discovery, appropriate remedial action is taken.
- The registrant's audit committee is promptly notified, deems the corrective action to be appropriate, and concludes that auditor independence has not been impacted.

**Recommendation V.S.1:**

Together with the PCAOB and the FASB, promote competition and reduce the perception of the lack of choice in selecting audit firms by using their influence to include non-Big Four firms in committees, public forums, and other venues that would increase the awareness of these firms in the marketplace.

PwC Response:

The marketplace for audit services is competitive. We believe that it is important for companies to be aware of their ability to select any qualified audit firm. It is also important to include representation of audit firms of all sizes on committees and public forums. Audit firms of all sizes regularly voice their opinions and contribute to the development of standards and regulations through public comment processes.

Recommendation V.S.2:

Formally encourage the FASB to continue to pursue objectives-based accounting standards. In addition, simplicity and the ease of application should be important considerations when new accounting standards are established.

PwC Response:

We, the FASB, and others, have been vocal supporters of the move toward more objectives-based, or principles-based, accounting standards.

A predicate of the successful implementation of principles-based standards is the application of professional judgment that is respected by the regulatory process.

We also note that the capital markets must accept that a natural consequence of a principles-based set of standards is that similar transactions may be treated differently by different companies. This occurs because the economic substance of a transaction may be viewed differently by each company executing the transaction.

We concur with FASB Chairman Bob Herz who stated, “for principles-based standards to work effectively and be successful, they need to be complemented by a more principles-based regulatory review and enforcement and a more principles-based legal framework around financial reporting.”

We also believe that it is important to recognize that complexity will continue to exist due to the complex nature of financial transactions in today's marketplace.