Preliminary Recommendations Proposed by the Accounting Standards Subcommittee of the SEC Advisory Committee on Smaller Public Companies

Summary of Preliminary Recommendations

The Accounting Standards Subcommittee submits the following preliminary recommendations, listed in order of importance, to the full Advisory Committee for their consideration:*

1. MicroCap companies should be permitted to apply the same effective dates that the FASB provides for private companies in implementing new accounting standards.

2. The SEC should implement a de minimis provision in the application of independence rules.

3. The SEC should consider additional guidance for all pubic companies with respect to materiality related to previously issued financial statements.

4. The SEC should change the requirements for Smaller Public Companies, including MicroCap companies, from reporting three years of financial information to reporting two years of financial information.

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

6. The SEC should 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.

7. The SEC and the PCAOB should promote competition among audit firms by using their influence to include non-Big 4 firms in committees, public forums, etc. that would increase the awareness of these firms in the marketplace. The PCAOB should also consider minimum annual continuing professional education requirements covering topics specific to SEC matters for firms who wish to practice before the SEC.

8. The PCAOB should monitor the impact of its May 2005 guidance regarding the interaction between the auditor and its clients through the spring of 2006 reporting season. If the guidance is being appropriately applied, no further action would be recommended, except for the matter discussed in recommendation #2.

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* As referenced in the last page of the appendix to the Advisory Committee's letter to SEC Chairman Christopher Cox dated August 18, 2005, all public companies having a market capitalization of less than $700 million, as of March 2005, are defined as "Smaller Public Companies." All companies having a market capitalization of less than approximately $100 million, as of March 2005, are defined as "MicroCap Companies." For a copy of this letter, please see the Advisory Committee webpage available at the SEC website at: http://www.sec.gov/info/smallbus/acspc/coxacspcletter081805.pdf

9. The SEC should determine the necessary structure for COSO to strengthen it in light of its role in the standard-setting process in internal control reporting.

10. The SEC should commit more resources and professional staff to an office of ombudsman or “help desk” to provide assistance to smaller public companies. The SEC should also publish guidance on reporting and legal requirements aimed at assisting smaller public companies.

Process

The Accounting Standards Subcommittee consists of Patrick Barry, John Veihmeyer and Leroy Dennis. In addition, George Batavick served as an advisor to the Subcommittee. Finally, Tony Barone and Alison Spivey represented the SEC staff in connection with the Subcommittee’s activities. The Subcommittee wishes to recognize the efforts of its members, advisors and SEC staff for their efforts in reaching these preliminary recommendations. The preliminary recommendations included herein represent the collective views of the subcommittee, as opposed to the individual views of subcommittee members or the organizations they represent.

In drafting the preliminary recommendations, the Subcommittee considered the overarching principles of the Advisory Committee, which are:

- To further the Commission’s investor protection mandate
- To seek cost/choice benefit inputs
- To keep it simple
- To maintain a culture of entrepreneurship
- To encourage capital formation

The Subcommittee considered the written comments submitted to the Advisory Committee in response to its posted questions, the written and oral testimony given by various individuals during the past four months, interviews with members of the CPA profession and the PCAOB, preliminary recommendations and input from the SEC Forum on Small Business Capital Formation and the experience of the various members and advisors of the Subcommittee. The Subcommittee believes the preliminary recommendations will further the Advisory Committee’s overarching principles and encourages the Advisory Committee to consider them in their final report to the SEC.

The Subcommittee considered the Committee Agenda as approved in June 2005. In addition, the Subcommittee considered other areas for preliminary recommendations. The areas addressed by the Subcommittee are as follows:

- Evaluate “one size fits all” versus “Big GAAP-Little GAAP.”
- Identify priority accounting principles, if any, where modifications might be considered for smaller public companies, including but not limited to, stock option expensing.
- Analyze overlay and impact of other regulatory schemes (financial institutions, insurance, government contractors, etc.).
- Analyze role of outside audit firms with respect to smaller companies, e.g., environmental shift in role of auditors, communications with outside auditors, concentration of Big Four accounting firms, and difficulty in switching audit firms.
- Analyze whether extended effective dates for smaller public companies are appropriate for future accounting principles.

During the September 2005 meeting in San Francisco, the Advisory Committee asked the Subcommittee to consider COSO’s structure and if it needs to be strengthened in light of its increasing role in the standard setting process.

In addition, as part of the discussions of the above matters, the Subcommittee also provides preliminary recommendations in other areas relevant to financial accounting and reporting.

The Subcommittee first considered the advisability of adopting two standards of reporting for public companies (Big GAAP/Little GAAP). The Subcommittee does not believe it would be appropriate to create different standards of financial reporting and disclosure for smaller public companies. We believe such an approach would confuse investors and that the financial community would, in many cases, require smaller companies to follow the more stringent standards. Further, some public companies indicated that if a two-tiered system of standards existed, they would voluntarily follow the more stringent standards, so as not to be perceived as a less sophisticated entity. Also, we believe that two financial reporting standards would add significant cost to the system of financial reporting, and potentially increase the cost of capital as risk premiums are attached to what might be perceived as less stringent reporting standards. Finally, we did not see evidence of overwhelming support for this position in the testimony or in the responses to the Advisory Committee's questions. Therefore the Committee rejected the notion of a "Big GAAP-Little GAAP" approach for public company accounting standards.

Recommendation #1 - MicroCap companies should be permitted to apply the same effective dates that the FASB provides for private companies in implementing new accounting standards.

The Subcommittee understands that smaller public companies oftentimes may not have the resources of larger companies. In addition, accounting standards have become more complicated in recent years, requiring greater study and expertise by the preparers and auditors' of financial statements. Accordingly, the Subcommittee believes that allowing MicroCap companies more time to implement new standards is appropriate. The Subcommittee recommends that MicroCap companies be allowed to apply the same effective dates that the FASB provides for private companies in implementing new accounting standards. The Subcommittee notes that for most of the more complicated standards issued by the FASB, it has allowed private companies an extended period of time in which to adopt the new standard. The Subcommittee considered and rejected the notion that all Smaller Public Companies be allowed extended effective dates. We believe that, in general, these companies have more resources than the MicroCap companies and should be able to adopt new standards on the same time line as other public companies.

Recommendation #2 - The SEC should implement a de minimis provision in the application of independence rules.

The Subcommittee discussed the rules of independence applied to the auditor-client relationship and considered whether these rules should be modified for Smaller Public Companies. We specifically discussed whether an auditor should be permitted to go beyond the PCAOB guidance issued in May 2005 as it relates to assisting a Smaller Public Company with new and/or complicated accounting standards or with unusual/complicated transactions. Ultimately, the Subcommittee believes no modification to the rules is warranted. In making this recommendation, the Subcommittee notes the specific underlying presumption that auditors should not audit their own work. We believe this basic premise is critical to ensuring auditor independence and the confidence of investors in the financial statements of all companies, including Smaller Public Companies.

We do note instances where a seemingly insignificant violation of auditor independence rules could have significant consequences. These consequences could require a company to immediately change audit firms, to declare its previous filings invalid and to engage an audit firm to re-audit its prior financial statements, creating significant cost and disruption to the company and its stockholders—the very people the independence rules are attempting to protect. We recommend that the SEC and PCAOB examine the independence rules and consider a deminimus rule in applying certain of the independence standards.

Recommendation #3 - The SEC should consider additional guidance for all pubic companies with respect to materiality related to previously issued financial statements.

The SEC should consider additional guidance for all public companies with respect to materiality related to previously issued financial statements to ensure that investor confidence in the U. S. capital markets is not being adversely impacted. The Subcommittee is concerned that restatements are occurring where the impact of the error is not likely to be meaningful to a reasonable investor. Two specific fact patterns should be considered in developing additional guidance:

- The effect of the previously undetected error is not material to any prior annual or quarterly financial statements, the effect of correcting the cumulative error is not expected to be material to the current annual period, but the impact of correcting the cumulative error is material to the current quarter's financial statements. In this circumstance, we recommend the SEC consider whether the appropriate treatment would be to correct the cumulative error in the current period financial statements, with full and clear disclosure of the item and its impact on the current quarter, with no restatement of prior year or quarterly financial statements. We believe this treatment is consistent with the guidance in paragraph 29 or APB Opinion No. 28, *Interim Financial Reporting.*
- The effect of a previously undetected error is not material to the financial statements for a prior annual period, but is material to one or more of the quarters within that year. In addition, the impact of correcting the cumulative error in the current quarter's financial statement would be material to the current quarter, but is not expected to be material to the current annual period. In this circumstance, we recommend the SEC consider whether the appropriate treatment would be the same as described above since the impact on the previously issued annual financial statements is not material. In this event, full disclosure in the current quarter financial statements would be required.

Recommendation #4 - The SEC should change the requirements for Smaller Public Companies, including MicroCap companies, from reporting three years of financial information to reporting two years of financial information.

The Subcommittee received numerous comments regarding the high cost to change audit firms and how this cost reduces competition. The Subcommittee recognizes that a new auditor will undergo a "learning curve" in any new relationship. However, one cost incurred when changing auditors is the requirement that the prior auditor re-issue their report on the prior year's financial statements included in the 10-K annual filings. When re-issuing their report, the prior auditor reviews the entire filing in addition to performing certain procedures to update their report. The Subcommittee recommends that the Smaller Public Companies be required to report only two years financial statement information instead of three years. By reducing the number of years being reported, the company is only required to obtain a consent for one year from the predecessor auditor. The Subcommittee believes that elimination of the third year from 10-K filings does not reduce the usefulness of the financial statements to the investors. In addition, the Subcommittee believes this will serve to increase competition for audit services.

Recommendation #5 - The SEC should formally encourage the FASB to pursue objectives-based accounting standards. In addition, simplicity and the ease of application should be important considerations when new accounting standards are established.

The Subcommittee recognizes the complexity that exists in today's financial reporting system. This complexity disproportionately impacts smaller public companies due to their lack of resources. Complexity is created because of:

- An unfriendly legal and enforcement environment that diminishes the use and acceptance of professional judgment because of fears of second-guessing by regulators and the plaintiff's bar
- Development of complex business arrangements and accounting-motivated transactions
- Constituent concerns about earnings volatility and desire for industry-specific guidance and exceptions
- Frequent requests by preparers and auditors for detailed accounting guidance to limit potential inconsistencies in the application of accounting standards and second guessing by the legal community and enforcement

Certain accounting standards create complexity because:

- The lack of a fully developed Conceptual Framework leads to inconsistent concepts and principles being applied across standards
- Scopes in standards are at times unclear and may contain exceptions
- There are different measurement attributes (such as historical cost versus fair value) and treatment alternatives (such as FAS Statement No. 115 classification alternatives for investments in debt and equity securities)
- Rules and bright lines provide opportunities for accounting-motivated transactions versus reflecting the true economics of the transactions
- The standards themselves have become extremely lengthy and difficult to read

Additional complexity in accounting standards also comes about because:

- There were multiple standards setters (AICPA, APB, SEC, EITF and FASB) in prior years
- Standard setters may compromise to accommodate their own views or the views of constituent groups
- Interpretations resulting from SEC filing and targeted reviews and PCAOB inspections that conflict with the accounting practices of preparers previously accepted as consistent with GAAP by their auditors
- Phased projects produce only interim changes

The Subcommittee believes that the current financial reporting environment could be modified to reduce the reporting burden on smaller public companies as well as large public companies, while improving the quality of financial reporting.

The Subcommittee applauds the efforts of the SEC and FASB to pursue "objectives-based accounting standards." We recognize that success will require preparers, financial advisors and auditors to apply the intent of the rules to specific transactions rather than using "bright-line" interpretations to achieve a more desirable accounting treatment. Success will also require regulators to accept good faith judgments in the application of objectives-based standards. We believe these goals will be accomplished by long-term changes in culture versus short-term changes in regulations. The Subcommittee believes that simplicity and the ease of application of accounting standards should be important considerations when new conceptually sound accounting standards are established. This will allow for greater consistency and comparability between financial statements.

In this regard, the Subcommittee offers the following considerations aimed at simplifying future standards:

- There should be fewer (or no) exceptions for special interests.
- Industry and other considerations that do not necessarily apply to a broad array of companies should be addressed by FSPs (spell out – Gerry agrees that this should be spelled out.) rather than in the FASB statement.
- Statements should attempt to reduce or eliminate "bright-line tests" in standards, and in cases where the intent of the standard-setter is that a "bright-line" application exists, make that clear in the guidance.
- There should be no political interference with FASB standard setting.

Recommendation #6 - The SEC should 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 Subcommittee notes that preparers still sometimes find it difficult to determine appropriate accounting in new or emerging areas. In that regard, the Subcommittee recommends that a "safe-harbor" protocol be developed that would protect well-intentioned preparers from regulatory or legal action when a prescribed process is appropriately followed. A possible outline for this protocol is as follows:

- Determine if there is appropriate "on-point" accounting guidance.
- If no on-point guidance exists, develop and timely document the preparer's conceptual basis for their conclusion as to the appropriate accounting.
- Determine and timely document how the proposed accounting treatment reflects the economic realities of the transaction.
- Disclose in the financial statements and in Management's Discussion & Analysis the nature of the transaction, the possible alternative accounting treatments, and the rationale for the approach adopted.

Recommendation #7 - The SEC and the PCAOB should promote competition among audit firms by using their influence to include non-Big 4 firms in committees, public forums, etc. that would increase the awareness of these firms in the marketplace. The PCAOB should also consider minimum annual continuing professional education requirements covering topics specific to SEC matters for firms who wish to practice before the SEC.

The Subcommittee recognizes that there is a large concentration of all public companies audited by the Big Four audit firms. The Big Four audit firms have earned a well-deserved reputation for auditing all public companies. We noted testimony from several non-Big Four audit firms that are also capable of serving smaller public companies. We note that the PCAOB has registered over 900 U.S. audit firms. Finally, we noted a trend for smaller public companies to consider options other than the Big Four audit firms. The Subcommittee believes that the market forces will ultimately determine which firms will audit public companies. The SEC and the PCAOB should promote competition among audit firms by including non-Big 4 firms in committees, public forums, etc. that would increase the awareness of these firms in the marketplace.

As noted above, the PCAOB has registered over 900 U.S. audit firms. We note that approximately 82% of these registered firms audit five or less public companies. We suggest that minimum annual SEC training requirements be established for registered audit firms.

Recommendation #8 - The PCAOB should monitor the impact of its May 2005 guidance regarding the interaction between the auditor and its clients through the spring of 2006

reporting season. If the guidance is being appropriately applied, no further action would be recommended, except for the matter discussed in recommendation #2.

The Subcommittee noted the substantial amount of testimony surrounding the relationship between audit firms and smaller public companies. We also noted the PCAOB and the SEC issued joint guidance to audit firms in May 2005 regarding the interaction between an auditor and its client. In interviews with several large and smaller audit firms, we believe that the guidance is having its intended effect. In these interviews, we note that audit firms believe that it is acceptable to advise their clients with respect to new standards and/or complicated transactions consistent with the guidance issued by the PCAOB/SEC, while remaining fully cognizant of the need for company management to take full responsibility for their financial statements, and the underlying decisions on the application of accounting principles. The Subcommittee recommends that the PCAOB monitor the impact of its guidance through the spring of 2006 reporting season. If the guidance is being appropriately applied, no further action would be required, except for the matter discussed in recommendation #2.

Recommendation #9 - The SEC should determine the necessary structure for COSO to strengthen it in light of its role in the standard-setting process in internal control reporting.

The Subcommittee recognizes that COSO has been placed in an elevated role in the standard setting process by virtue of being referenced in PCAOB auditing standards and thereby being the framework used by most U.S. public companies in analyzing their internal controls. In addition, we note that COSO has issued preliminary guidance for smaller public companies. COSO therefore has become a de facto standard setting body for preparers of financial statements, however is not recognized as an official "standard setter" nor is it funded and structured as such. We recommend that the SEC determine the necessary structure for COSO to strengthen it in light of its role in the standard-setting process.

Recommendation #10 - The SEC should commit more resources and professional staff to an office of ombudsman or "help desk" to provide assistance to smaller public companies. The SEC should also publish guidance on reporting and legal requirements aimed at assisting smaller public companies.

The SEC should commit more resources and professional staff to an office of ombudsman or "help desk" for smaller public companies which role is currently being conducted by the SEC Office of Small Business Policy. These resources should be devoted to assisting smaller public companies with questions or comments about federal securities regulations. The SEC should also publish guidance, such as frequently-asked-questions manuals, guidelines, etc. to help smaller pubic companies understand and fulfill the basic regulatory requirements involved in the private placement of securities, initial public offering process and the on-going periodic reporting requirements of a publicly-held company.

Submission

This report is respectfully submitted to the full Advisory Committee.

Leroy Dennis Patrick Barry John Veihmeyer