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April 3, 2006

Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Release No. 33-8666; 34-53385; File No. 265-23

Exposure Draft of Final Report of the Advisory Committee on Smaller Public Companies

Dear Ms. Morris:

Deloitte & Touche LLP ("Deloitte &Touche") is pleased to submit written comments to the Securities and Exchange Commission (the "SEC") on the Exposure Draft of Final Report of the Advisory Committee on Smaller Public Companies (the "Advisory Committee"), and recognizes the work of the Advisory Committee in assessing, evaluating, and recommending changes to the current regulatory system for smaller public companies.

We have organized our letter by sub-committee recommendation and have limited our comments to those recommendations that relate to auditing and financial reporting matters. We also observe that the Draft Report includes a number of assertions that appear to be either unsupported in fact or overstated. For instance, there are several assertions that documented internal controls are less relevant and beneficial to small companies than to large companies. No facts or studies were cited to support that claim, and based on our experience, we believe that controls that are not somehow documented often do not actually exist. We also noted various negative remarks about the auditing profession's conduct of audits of internal control over financial reporting, that fail to acknowledge the special challenges of the first year of implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 or the ongoing efforts of the profession to improve the efficiency and effectiveness of internal control audits. Because comments were not requested on the statements in the explanatory text surrounding the recommendations, we will not attempt to address these matters individually, even though we do not agree with certain of the remarks made in the body of the report.

PART II. SCALING SECURITIES REGULATION FOR SMALLER COMPANIES

Recommendation II.P.1: *Establish a new system of scaled or proportional securities regulation for small public companies.*

Conceptually, we are supportive of creating a well defined, scaled disclosure system for smaller public companies. The use of a self-calibrating size measurement, as proposed, appears reasonable, so long as the methodology for computing the selected metrics is clearly defined. In addition, the related implementation rules should be carefully designed in order to minimize complexity and the likelihood of frequent changes in a company's classification. For example, the effects of market volatility on an individual company's market capitalization could potentially subject smaller registrants to repeated changes in classification over consecutive periods.

Although we support the concept of scaled regulation, we believe that there is a need for further study to determine the appropriate thresholds for microcap and smallcap companies and the nature and extent of accommodations that should be granted to each group. The proposed upper limits (of approximately $128 million in market capitalization for microcaps and $787 million for smallcaps) are five times and over 30 times higher, respectively, than the current Regulation S-B maximums of $25 million in revenue and public float. If the recommendation is adopted as proposed, approximately 80% of all public companies would qualify for the reduced reporting and disclosure requirements. This would be a radical departure from the current structure, and based on our experience, companies in much of the suggested "smallcap" range can be quite complex. Reduced disclosure for such companies may not be in the best interests of investors.

We also question the appropriateness of a one-dimensional test based solely on market capitalization. At a minimum, we believe that the test should consider revenue as well as market capitalization (as Regulation S-B currently does) in order to avoid inappropriately reducing disclosure requirements for companies which are large on a revenue basis but which, because of a depressed stock price or for other reasons, fall under the cutoff for market capitalization. Further study might identify other factors that should also be considered, such as stock price volatility or the number of employees.

PART III. INTERNAL CONTROL OVER FINANCIAL REPORTING

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 revenue that [have certain specified corporate governance controls].*

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 smallcap companies with less the $250 million but greater than $10 million in annual revenue,* *and to microcap companies with between $125 million and $250 million in annual revenue, subject to their compliance with the same corporate governance standards as detailed in the recommendation above.*

Recommendation III.P.3: *[I]f the Commission reaches a public policy conclusion that an audit requirement is required [for companies in Recommendation III.P.2 above], we recommend that changes should 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.*

As further discussed below, Deloitte & Touche opposes the Advisory Committee's recommendations for permanent exemptions to the Section 404 reporting requirements under the Sarbanes-Oxley Act of 2002 (Recommendations III.P.1 and III.P.2). We also strongly oppose the adoption of weakened standards of reporting on internal control over financial reporting, particularly reporting on design and implementation only (Recommendation III.P.3).

We believe that the internal control assessments required by Section 404 bring important and valuable benefits to investors in companies of all sizes: they increase the reliability of financial statements, reduce the risk of fraud and identify opportunities for operational efficiencies. However, we also recognize that costs of implementation and the level of effort in the first year of 404 reporting were higher than expected, and that additional guidance and tools need to be developed to make Section 404 reporting cost-effective for smaller businesses.

Alternative Solution Recommended - In lieu of the Advisory Committee's Recommendations III.P.1-3, we propose a plan for the development of implementation guidance for smaller companies, along with field testing of this guidance through a pilot program, led or endorsed by the SEC, during 2006 and 2007.

A plan and pilot program to develop guidance for smaller companies and their auditors should have as its objectives the development, testing and refinement of the following:

- Clear standards for management assessment, including guidance on the performance of a top-down risk assessment, the identification of key controls, the necessary level of documentation of the control structure and of management's assessment, as well as the scope, nature and timing of testing which management should perform.

- Simplified COSO principles for smaller companies, which could provide a simpler control framework, and should include examples as to how such principles can be satisfied in practice.

- An implementation guide, which should provide guidance on the key project management elements of management's assessment effort, including technology tools and related content to facilitate implementation, best practices in project organization and suggested resources that can support cost-effective implementation of 404 reporting for smaller companies.

- A summary of common challenges and solutions for smaller public companies, which should deal directly with such issues as the role and design of entity level controls (including monitoring controls) at smaller issuers, the risk of management override, the difficulty of achieving segregation of duties, the depth of experience of issuer personnel responsible for financial reporting, and the level of detail necessary in documentation of controls and management's assessments. This guidance should be vetted and enhanced throughout a field testing process, to ensure that it is practical and addresses most of the common challenges smaller public companies face in their internal control reporting.

- Complementary guidance and tools for auditors on the application of AS 2 in a smaller company environment. This could provide direct guidance in such areas as testing monitoring controls, evaluating the risk of management override, and assessing segregation of duties limitations, which can be specific challenges in auditing smaller issuers. This guidance should be evaluated through a field test program, and could support the increased cost-effectiveness in the application of AS 2 to smaller companies.

SEC Leadership or Endorsement - We further recommend that the SEC lead the pilot program effort or endorse it by appointing a respected, independent third-party to oversee this activity. The project should include all affected constituents – issuers, investors, the PCAOB, auditors and technology providers. As part of this process, cost drivers could be tracked and analyzed, and technology providers could be encouraged to develop tools, including related internal control content, to be used as part of this effort. In addition, a diverse group of smaller public companies (including both non-accelerated and smaller accelerated filers) should be invited to participate in the pilot program, possibly with a safe harbor during the pilot effort. The concurrent field testing, as additional guidance is developed and finalized, should help ensure that it is as practical as possible, and that it forms a sound foundation for smaller public companies to meet internal control reporting requirements on a cost effective basis.

Disadvantages of Exemptive Relief - The internal control reporting requirements under Sarbanes Oxley are part of a comprehensive effort to restore investor confidence and enhance financial reporting, and there have been significant benefits from the implementation of these requirements. In our view, investor confidence, though still fragile, has been enhanced and the SEC, consistent with its mission of investor advocacy, should not step away from these reforms. In April 2005, Moody's Investors Service commented in their publication, "Section 404 Reporting on Internal Control: Our Early Experience", that reports on internal controls are a significant development in restoring investor confidence in financial reporting. Companies are strengthening their accounting controls and investing in the infrastructure needed to support quality financial reporting. Most of the control problems disclosed do not appear to be new, but are coming to light because of closer scrutiny, not because new problems are occurring.

The fundamental pillars of Section 404 -- that management should periodically assess its control structure, that it should document this assessment, and that an auditor should independently test this assessment -- are reasonable, regardless of the size of a public company, and corporate governance standards are no substitute for internal controls. In that regard, the proposal in Recommendation III.P.1 that management be required to report known material weaknesses to the audit committee appears to be well short of what Congress intended in crafting Section 404. If neither management nor the auditor is required to assess a company's internal control, then it is unlikely that a material weakness would be identified except by chance or after the fact, when a material error or fraud was discovered.

Moreover, it is particularly important that a sound structure of internal control be constructed and keep pace with a company as it grows, as opposed to being delayed until control weaknesses and gaps emerge in a much larger public company. The provisions of Section 404 appropriately require management and a company's independent auditor to focus on the adequacy of a company's control environment throughout its life cycle.

Many recent studies have demonstrated that as a group, smaller companies are more likely than larger companies to need improved internal control. For instance, the statistical data included in Appendix I of the Advisory Committee report show that 19.6% of the microcap companies and 15.4% of the smallcaps reported material weaknesses in the initial year of Section 404 reporting, compared to 8.5% of the larger cap companies. In addition, a research report from Glass Lewis & Co. found that the incidence of restatements at smaller companies is significantly greater than for accelerated filers. We believe that the internal control assessments required by Section 404 will reduce material control weaknesses and the resultant errors and opportunities for fraud that can precipitate restatements. The outcome will be more reliable financial reporting, which will benefit both companies and investors and increase overall confidence in the capital markets.

Furthermore, a new study by Lord & Benoit LLP raises questions about the effectiveness of a management-only assessment as proposed in Recommendation III.P.2. and demonstrates the importance of an independent assessment of internal control over financial reporting. Of all accelerated filers issuing Section 404 reports, Lord & Benoit found that in only 12% of the instances where companies and their auditors reported ineffective controls in their Section 404 reports, did management separately identify and report ineffective controls in their Section 302 certifications in as recent a period as the preceding quarter.

<u>Disadvantages of Internal Control Reporting on Design and Implementation Only</u> - We strongly oppose the recommendation for developing a "design-and-implementation-only" standard of reporting for internal control for the following reasons:

<u>Unclear Reporting</u> - Recommendation III.P.3 requires that management of smaller public companies *fully* assess and report on the design, implementation *and* execution of controls, but specifies that the independent auditor, in the same SEC filing, should assess and report *only* on design and implementation. Thus the auditor's report will not address the question most critical to investors – are the controls working?

Many investors will likely not understand the significance of these different bases of reporting for management and the auditor and will not grasp the distinction between a "full" audit of internal control over financial reporting and a weakened "partial" audit. These investors will likely not appreciate the limitations of a standard that assesses design and implementation but not operating effectiveness (accuracy and consistency in ongoing execution), and they therefore could be misled as to the level of assurance provided. Alternatively, other investors may view the "full" internal control audit as superior reporting and hesitate to invest in smaller companies – in effect recreating the two-class system that the Advisory Committee is attempting to eliminate with its recommendations to do away with Regulation S-B.

Overall, the adoption of a weakened standard of internal control reporting for smaller public companies is an ineffective and hazardous substitute for a resolution of the real problem – which is the current lack of guidance customized to the characteristics and needs of smaller issuers. Adopting the proposed lesser standard could decrease investor understanding of internal control reporting, diminish investor confidence, and increase the "expectation gap" – at a time when all capital markets participants need to work together to reduce it.

To further illustrate the anomalies that can result from different bases of reporting for management and auditors, it is important to consider the reporting if a materially important control were properly designed and implemented, but not properly or consistently executed in practice. In this case, management would be required to issue an adverse opinion on its internal control structure. On the other hand, the auditor, required to focus only on design and implementation, would technically be required to issue an unqualified opinion. Although in practice many auditors would nonetheless issue an adverse report, the fact that the technical application of the rules would lead to an unqualified opinion in this case demonstrates the confusion that would result from two bases of reporting.

<u>Potential Impact of Undetected Material Weaknesses</u> - In a summary report on the first year of Section 404 implementation, Audit Analytics has reported that approximately 16% of all accelerated filers reported material weaknesses, and as mentioned above, many predict that the percentage of material weaknesses encountered by non-accelerated filers will be higher. A significant number of those material weaknesses resulted from deficiencies in the *execution* of properly designed controls. However, an audit only of the internal control design and implementation will not test for -- and therefore frequently will not detect -- material weaknesses resulting from inadequate control execution. Some of these material weaknesses inevitably will be discovered at a later date. When this occurs, particularly if it is in connection with a business failure, investor confidence will be undermined, economic loss may result, and serious questions will arise about the public policy advisability of diluting the requirements for smaller companies to assess and report on internal control over financial reporting.

<u>Limited Cost Savings</u> – The proposal to exempt certain smaller companies from the requirement for an internal control audit and to require only a limited scope audit for other smaller companies is intended to strike a more appropriate balance between the costs and benefits of Section 404. However, we believe that the actual cost savings may be less than anticipated because the auditor will be unable to use the control assurance obtained in the internal control audit to reduce testing in the financial statement audit. In order to rely on specific controls in the financial statement audit, the auditor will first have to conduct additional tests to confirm that they are operating effectively. Such testing will at least partially offset the cost savings from a weakened internal control audit.

Increased Litigation Risks - Weakened standards permitting a "partial" audit of internal control will also likely increase the litigation risk for those registered public accounting firms that choose to provide this service. The increased exposure would arise because of the heightened risk that a material weakness might not be identified in the "partial" audit but would come to light at a later date in conjunction with a business failure. Even if such a material weakness resulted solely from inadequate or inconsistent application of a properly designed control (which would not have been subject to auditor testing under the standard recommended by the Advisory Committee), a legal argument might still be asserted that the cause of the weakness was inadequate design, instead of or in addition to inadequate execution. In a litigious environment, the distinction between these causes could be difficult - and costly - to demonstrate.

As a consequence, some registered public accounting firms may place limits on the circumstances in which they would be willing to provide this type of report, and some firms could decide not to provide this service at all. Our firm has not yet made any determination in this regard. However, in the event that some registered public accounting firms choose to limit or not provide this service, the PCAOB and SEC should consider the implications of this circumstance on the overall market, including any steps that may be necessary to preserve the availability, cost and choice associated with audit services. The reluctance by some registered accounting firms to provide this service, and the requirement that the same firm perform both the financial statement audit and internal control reporting, may cause more firms to restrict the companies for whom they would perform financial audit services, and further limit auditor choice for smaller public issuers.

PART IV. CAPITAL FORMATION, CORPORATE GOVERNANCE AND DISCLOSURE

Recommendation IV.P.1: Incorporate the scaled disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K, make then available to all microcap companies, and cease prescribing separate specialized disclosure forms for smaller companies.

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 or smallcap companies.

Integration of the scaled disclosure and financial statement provisions of Regulation S-B into Regulations S-K and S-X would create a single set of registration and reporting rules and forms and would be consistent with the goal of reducing the complexity of public company reporting.

As noted in our response to Recommendation II.P.1, we agree that it is appropriate to continue to provide disclosure relief to smaller companies and to revise the eligibility criteria for relief. However, the eligibility tests should include a revenue measure as well as a market capitalization measure, and there is a need for further study to determine the thresholds for microcap companies and smallcap companies, and the extent of the accommodations that are appropriate for each group, based on their relative risk profiles and complexity. Companies in much of the proposed small cap range can be extremely complex, and we question whether significant disclosure accommodations for those companies are in the best interests of investors. Rather than scaling back the basic financial statement and related disclosure requirements, relief might be considered from the supplemental financial statements required under Rules 3-05, 3-09, and 3-10 of Regulation S-X. Such relief is especially appropriate if the relevant supplemental financial statements are otherwise publicly available.

Recommendation IV.P.3: Allow all reporting companies on a national securities exchange, NASDAQ or the OTCBB to be eligible to use Form S-3, if they have been reporting under the Exchange Act for at least one year and are current in their reporting at the time of filing.

We are supportive of this recommendation, so long as appropriate standards are adopted governing the availability of all financial information incorporated by reference. If a company is allowed to use Form S-3, especially a company that is not widely followed in the securities markets, then there should be explicit requirements that, for all relevant periods, all financial statements and other financial information incorporated by reference must be easily accessible on the company's website. The Form S-3 should include clear instructions about how to find the information on the website.

Recommendation IV.S.3: Form a task force of SEC and appropriate federal bank regulatory agencies to discuss ways to reduce inefficiencies associated with SEC and other governmental filings.

We would encourage the SEC to work with other regulatory agencies to eliminate unnecessary reporting requirements and particularly duplication in reporting requirements. Especially in light of the expanded auditing and reporting requirements of Section 404, it is in the best interests of investors and issuers that resources not be expended on overlapping or redundant reporting.

Recommendation IV.S.5: Evaluate upgrades of technological alternatives to the EDGAR system so that smaller public companies can make required SEC filings without the need for third party intervention and associated costs.

We are supportive of any alternatives or enhancements to EDGAR that would make it easier for all companies, regardless of size, to comply with the filing requirements. We also support any upgrades that would facilitate the ability of investors and other users to search, download, and otherwise access and use electronic filings.

<u>PART V. ACCOUNTING STANDARDS</u>

<u>Recommendation V.P.1:</u> 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.

Preparers should already be adequately documenting well-intentioned and well-considered accounting judgments. We do not favor changes that would in any way diminish issuers' responsibilities for their financial statements, and in general we are not supportive of this sort of safe harbor. However, we would encourage the Commission, especially in the area of highly complex transactions and emerging issues, to devote additional resources to pre-filing consultation, in order to help all issuers "get it right the first time" and reduce the potential for avoidable restatements. The model of encouraging consultation has significantly facilitated the filing process for foreign private issuers, and we believe it would also benefit other issuers.

<u>Recommendation V.P.2:</u> In implementing new accounting standards, the FASB should permit microcap companies to apply the same extended effective dates that it provides for private companies.

We support this recommendation, and we also endorse the Advisory Committee's related conclusion that different accounting standards should not be created for smaller and larger companies. We believe, however, that the recommendation as to effective dates should be extended to apply to smallcap companies, in addition to microcap companies, subject to our earlier comments that the specific thresholds for defining smaller issuers need to be carefully considered. The report does not provide sufficient evidence to support limiting this flexibility solely to microcaps. Additionally, if this recommendation is adopted, the related communications should emphasize that issuers will still be required to provide disclosures on the future impact that recently issued accounting standards will have on their financial statements, as specified in SEC Staff Accounting Bulletin No. 74, "Disclosures by Registrant When an Accounting Standard Has Been Issued But Not Yet Adopted".

We believe that the fundamental issue behind this recommendation relates less to effective dates themselves than to the difficulties that all companies, but especially smaller companies, encounter in interpreting and implementing new standards. Those difficulties could be significantly reduced by thorough field testing of all new standards before issuance. Therefore, whether or not this recommendation is adopted, we encourage the Financial Accounting Standards Board to develop comprehensive field testing protocols, so that new pronouncements may be implemented smoothly by all companies.

<u>Recommendation V.P.3</u>: Consider additional guidance for all public companies with respect to materiality related to previously issued financial statements.

We believe that existing professional literature provides adequate guidance related to the assessment of materiality in previously issued financial statements. If additional guidance is issued, in our opinion, we would not attempt to differentiate materiality standards for previously issued financial statements from materiality standards for currently issued financial statements. One area, though, where we see difficulty in practice is in the need for clear guidance with respect to application of materiality to interim financial statements, particularly as it relates to quarters.

<u>Recommendation V.P.4</u>: *Implement a de minimis exception in the application of the SEC's auditor independence rules.*

The application of a de minimis exception to the SEC's auditor independence rules relating to scope of services matters and business relationships would be cost effective, serve to improve compliance and could be used to align the rules with the existing "safe harbor" for accounting firms for certain independence violations created by individuals who are covered persons. The SEC's 2000 revisions to the auditor independence rules provided that an accounting firm's independence would not be impaired as a result of certain violations by an individual covered person so long as the violation was corrected, and the accounting firm maintains a system of quality controls meeting the requirements set forth in the rule.

However, neither the independence rules adopted in 2000 nor the rules adopted by the SEC in 2003 include any "safe harbor" for inadvertent or de minimis violations of the SEC's scope of service prohibitions. Since those rules have been in operation, there have been numerous reported violations where international firms deemed associated with a US accounting firm have provided prohibited services to a non-US operation of a US-based registrant audited by a US accounting firm. These exceptions often have arisen because the international accounting firm associated with the US firm did not recognize that the non-US operation was owned by or affiliated with the US registrant audit client. This often occurs when the non-US operation either operates under a different name or is a third or lower tiered subsidiary of a company owned by the US registrant audit client.

An amendment to the SEC's independence rules that would enable the audit committee to evaluate the facts and circumstances around de minimis independence violations and, where appropriate, accept the continued independence of an accounting firm, would be reasonable and cost effective. It would have the additional benefit of maintaining choice and competition. Such a change should include a requirement that policies and quality controls be in place to monitor services and require timely reporting of exceptions that occur.

<u>Recommendation V.S.2</u>: *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.*

We believe it is vitally important to reduce complexity, and we encourage the FASB, SEC and other standards setters to develop a formal collaborative plan toward that goal. We also endorse principles-based standards, when supported by adequate implementation guidance.

The Advisory Committee Report suggests that objectives-based standards and simplicity will also allow for greater consistency and comparability. Notwithstanding our support for less complex standards, we would observe that objectives-based standards will require the application of judgment to differing circumstances, with the resulting likelihood of some degree of variability in conclusions and related accounting and disclosure.

We do not agree with the suggestion that industry and certain other considerations should be addressed by FASB staff positions rather than in FASB statements. Limiting the due process and opportunity for constituent input in this aspect of the standard-setting system will not necessarily simplify the resulting accounting standards. On the contrary, it may lead to less well considered conclusions and create the potential for inconsistency among staff positions on different issues.

Recommendation V.S.3: *Require the PCAOB to consider minimum annual continuing professional education requirements covering topics specific to SEC matters for firms that wish to practice before the SEC.*

Continuing education requirements are currently set by the individual states as part of their process for licensing CPAs and by the AICPA as part of its membership requirements. There are various initiatives in progress, which we strongly support, to conform the different jurisdictional requirements and make them consistent. In light of this effort, we would recommend that a new, separate CPE jurisdiction not be established. Any specific SEC or other accounting issues that warrant additional continuing professional education should be handled through the AICPA and the National Association of State Boards of Accountancy, in a consistent fashion.

Recommendation V.S.4: *Monitor the state of interactions between auditors and their clients in evaluating internal controls over financial reporting and take further action to improve the situation if warranted.*

We believe that the ongoing monitoring by the PCAOB and SEC of reporting on internal control is helpful and consistent with their public interest mandate. In that regard, we are pleased that the additional guidance issued by the SEC and the PCAOB in May 2005 appropriately clarified the boundaries of communications and consultation between management and their auditors on accounting and reporting matters, and we believe that guidance is working effectively.

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We appreciate the opportunity to comment and would be pleased to discuss these matters with you further. If you have any questions or would like to discuss any issues related to this Exposure Draft, please contact Robert Kueppers at 212-492-4241.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Chairman Christopher Cox
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