

Defining Issues[®]

KPMG LLP



Draft Advisory Report on SEC Regulation of Smaller Public Companies

Proposals recently published for public comment by an advisory committee of the SEC recommend relief for smaller public companies from some requirements of the securities laws.¹ New categories of smaller public companies would be exempt from some requirements, including reporting on internal control over financial reporting. A few of the recommendations of the Advisory Committee on Smaller Public Companies would affect all public companies, regardless of size.

The draft report presents 32 recommendations. This edition of *Defining Issues* summarizes recommendations the advisory committee designated as the highest priorities.

The advisory committee's charter sets as its objective to assess the current regulatory system for smaller public companies under U.S. securities laws and to make recommendations for changes. The charter directs the advisory committee to conduct its work "with a view to furthering the Commission's investor protection mandate, considering whether the costs imposed by the current regulatory system [for smaller companies] are proportionate to the benefits, identifying methods of minimizing costs and maximizing benefits, and facilitating capital formation by smaller companies."

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New Regulatory Categories

The report recommends a new scaled securities regulation system for smaller public companies based on their size. The new system would replace the SEC's current regulatory distinctions for "small business issuers" and "non-accelerated filers."

Smaller public companies would be segregated into two groups, "microcap" and "smallcap." Microcaps would consist of companies whose outstanding common stock (or equivalent)

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¹ Exposure Draft of the Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission, available at www.sec.gov/rules/other/33-8666.pdf.

makes up the lowest 1 percent of the total U.S. equity market capitalization, and smallcaps would consist of companies whose outstanding common stock (or equivalent) makes up the next highest 5 percent of the total U.S. equity market capitalization. These companies would represent only 6 percent of total U.S. equity market capitalization, but a substantial percentage of the total U.S. public companies.

The accompanying table, an adapted excerpt from the draft report, shows the percentage-of-equity market-capitalization criterion in terms of dollars of equity and in terms of the percentage of all U.S. public companies as of June 10, 2005.² The advisory committee recommends that the SEC use equity market capitalization, rather than “public float” that has been used in similar regulatory contexts, to determine eligibility for smaller public company treatment.

Internal Control Reporting Obligations

The report recommends exemptions for some smaller public companies from the SEC requirements on internal control over financial reporting under Section 404 of Sarbanes-Oxley, “unless and until” a framework is developed for assessing internal control over financial reporting that recognizes the characteristics and needs of smaller public companies. The requirements of Section 404 include disclosing, in an annual report, a statement of management responsibility for establishing and maintaining internal control over financial reporting with an assessment of the effectiveness of internal control over financial reporting. Section 404 also requires

Effect of Proposed Criterion (Percentage of Equity Market Capitalization) as of June 10, 2005			
Category of Company	Defining Percentage of Total U.S. Equity Market Capitalization	In Terms of Market Capitalization	Percentage of All U.S. Public Companies
Microcap	1%	< \$128.2 million	52.6%
Smallcap	5%	\$128.2-\$787.1 million	25.9%
Smaller Public (includes both microcap and smallcap)	6%	< \$787.1 million	78.5%
Larger Public	94%	> \$787.1 million	21.5%

a public company’s external auditors to report on the effectiveness of internal control over financial reporting.

The proposed exemptions would depend on whether a public company is a microcap or smallcap company and on its level of annual revenue.

- Microcap companies with less than \$125 million in annual revenue would be exempt from all Section 404 requirements.
- Microcap companies with between \$125 million and \$250 million in annual revenue would be exempt from only the requirement for *external* auditor reporting.
- Smallcap companies with less than \$10 million in annual revenue would be exempt from all Section 404 requirements.
- Smallcap companies with between \$10 million and \$250 million in annual revenue would be exempt from only the requirement for *external* auditor reporting.

These proposed exemptions would be available only to companies that adhere to audit-committee requirements in conformity with Rule 10A-3 under the Securities Exchange Act and that adopt and comply with a code of ethics applicable to all directors, officers, and employees within the meaning of Item 406 of Regulation S-K. Certain smaller public companies that are not subject to listing standards of the national securities exchanges and associations will be required to adhere to their listing standards relative to Rule 10A-3 and Item 406 to benefit from the proposed exemptions.

The proposal also recommends that the SEC confirm and, if necessary, clarify the applicability of existing internal-control requirements to smaller public companies, including the requirements that companies maintain effective internal control over financial reporting and disclose any modifications to internal control. In addition, the advisory

² The table is derived from the table on page 5 of the draft report. The table in the draft report was prepared by the SEC Office of Economic Analysis and includes only the 9,428 U.S. companies listed on the New York and American Stock Exchanges, the NASDAQ Stock Market, and the OTC Bulletin Board as of June 10, 2005. The table does not include the approximately 4,586 securities of 4,504 U.S. public companies whose stock trades only on the Pink Sheets and therefore understates the percentage of U.S. public companies represented by smaller public companies.

committee recommends that management be required to disclose any known material weaknesses in internal control over financial reporting.

Under the advisory committee's proposals, the alternative to the SEC's adoption of the exemptions from Section 404 is that the PCAOB develop a new auditing standard for smaller public companies that limits the audit of internal control over financial reporting to

testing and reporting on only design and implementation. The requirement would exclude testing and reporting on operating effectiveness. The alternative recommendation specifies steps to be taken by the SEC and PCAOB to develop guidance. The advisory committee expects that if the alternative is pursued instead of the exemption and the SEC and PCAOB complete the additional guidance, the alternative could be effective for fiscal years beginning after December 31, 2007.

Dissenting Opinions

The 21 members of the advisory committee unanimously approved the issuance of the draft report for comment, but three members included written dissents.* All three written dissents pertain to the recommendations to exempt smaller public companies from certain of the Section 404 requirements on internal control over financial reporting. Two of the written dissents also expressed concern about the alternative recommendation for an audit of only the design and implementation of internal control over financial reporting (excluding any testing of operating effectiveness). A third member dissented to this alternative recommendation, but did not provide a written dissent, and a fourth member abstained from voting on this alternative recommendation.

The dissents relative to the exemptions argue that the protections provided by Section 404 should be available to investors in all public companies, regardless of size. Acknowledging the concerns raised by the initial costs of implementation, the dissents encourage the development of additional implementation guidance for assessing and auditing internal control over financial reporting for smaller public companies that recognizes the characteristics and needs of small companies. Consistent with that encouragement, the dissents provide various suggestions for the development of this guidance, including field testing to assemble reliable cost-benefit information necessary to facilitate well-informed decisions regarding the reasonable application of Section 404 in a smaller public company environment.

The two written dissents that address the alternative recommendation express concerns that a lesser auditing standard (testing design and implementation, not operating effectiveness) could result in a misunderstanding of the level of auditor assurance, widen an already existing expectation gap with respect to audit services, and reduce investors' confidence in smaller public companies' financial reporting processes. One of these dissents indicates 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.

* John B. Veihmeyer, Deputy Chairman of KPMG LLP, a member of the advisory committee, provided one of the written dissents. Mr. Veihmeyer dissents from the recommendations to exempt smaller public companies from certain of the Section 404 requirements on internal control over financial reporting and the alternative recommendation for an audit of only the design and implementation of internal control over financial reporting. Mr. Veihmeyer's written dissent begins on page 134 of the Exposure Draft.

Capital Formation, Corporate Governance, and Disclosure

The advisory committee believes that the following changes in regulation could be made to reduce compliance costs without compromising investor protection.

- Microcap companies should receive the disclosure accommodations currently available to small business issuers under Regulation S-B.
- Microcap and smallcap companies should use the same forms, such as Forms 10-K, 10-Q, S-1, and S-3, as large companies thereby eliminating the need for the separate forms used by small business issuers under Regulation S-B, including Forms 10-KSB, 10-QSB, 10-SB, SB-1, and SB-2.
- Microcap and smallcap companies should be required to file two years of audited statements of income, cash flows, and stockholders' equity (three years are required for larger companies) as well as two years of audited balance sheets.
- Policies should be adopted to encourage and promote the dissemination of investment research on smaller public companies.

Accounting Standards

The advisory committee recommends that microcap companies be permitted to apply any extended effective dates for applying new accounting standards that the FASB provides to nonpublic companies.

Recommendations Affecting All Registrants

Some of the advisory committee's recommendations could affect all public companies, regardless of size.

- The SEC, other regulators, and legislators should develop a "safe-harbor" protocol for accounting for transactions that would protect well-intentioned preparers from regulatory or legal action. The protection



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would be available if the protocol is followed and the registrant has a reasonable basis for its accounting.

- The SEC should consider additional guidance for all public companies with respect to the materiality of previously undetected accounting errors in issued financial statements.
- The SEC should consider establishing relief for some types of *de minimis* violations of auditor independence rules conditional on the violations being discussed with and approved by the company's audit committee.
- Reporting public companies should be permitted to use Form S-3, which maximizes incorporating previously filed information by reference, if they are traded on a national securities exchange, NASDAQ, or the OTC Bulletin Board; they have been reporting under the Securities Exchange Act for at least one year; and they are current in their reporting at the time of filing.
- A new private offering exemption from the registration requirements of the Securities Act should be adopted that permits general solicitation and advertising for purchasers who do not need all the protections of the Act's requirements. In addition, the prohibitions against general solicitation and advertising in Rule 502(c) of the Securities Act should be relaxed.
- A multi-agency effort should streamline the National Association of Securities Dealers registration process for finders, merger-and-acquisition advisors, and institutional private placement practitioners.



The comment period for the draft report ends April 3, 2006. The final report to the SEC is due by April 23, 2006.

The descriptive and summary statements above are not intended to be a substitute for the text of any of the cited documents or any other potential or actual requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for specific transactions or filing reports with the SEC should refer to the texts of the applicable documents that set out GAAP and SEC requirements and consult their accounting and legal advisors.