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SARBANES OXLEY SECTION 404: WHAT IS THE PROPER BALANCE BETWEEN INVESTOR PROTECTION AND CAPITAL FORMATION FOR SMALLER PUBLIC COMPANIES?

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

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WEDNESDAY, MAY 3, 2006

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Committee met, pursuant to call, at 2:00 p.m., in Room 2360 Rayburn House Office Building, Hon. Donald Manzullo [Chairman of the Committee] presiding.

Present: Representatives Manzullo, Bartlett, Kelly, Akin, Velazquez, Davis, Barrow, Moore.

Chairman MANZULLO. Good afternoon. The hearing today will analyze the impact of Sarbanes Oxley on our nation's smaller public companies. In particular, this hearing will focus on Section 404 of SOX. Your White Sox, which are causing the most headaches, well, Herb is from Chicago.

Mr. WANDER. And a White Sox fan.

Chairman MANZULLO. And a White Sox fan. You don't want to wait another 100 years, Herb.

In particular, the hearing will focus on Section 404 of SOX, which is causing the most headaches and expense for our Nation's smaller companies.

In 2002, Congress passed with my support the Sarbanes Oxley Act, or SOX. Ms. Velµzquez and I both serve on the Finance Committee.

This legislation was a response to corporate scandals at the large companies, such as Enron and WorldCom. However, changes made by SOX applied equally to all public companies, regardless of size.

One of these changes was to perform annual testing of internal control under SOX Section 404. These tests require company's management to evaluate whether internal controls are adequate and require an independent auditor to sign off on management's assessment.

Shortly after SOX passed, the SEC estimated in regulations that compliance with Section 404 would cost companies around $90,000 annually. However, the expected costs in reality did not match up. In reality, public companies are paying well in excess of $1 million annually to comply with this mandate.

To its credit, the SEC recognizes that strict compliance with Section 404 may not be beneficial for smaller public companies. This is why the SEC has delayed implementation of this provision for

companies with market values under $75 million until July of 2007.

In addition, in March 2005 the SEC convened the Advisory Committee to Small Public Companies to analyze the effects of this and other SOX provisions on small companies. This panel was also tasked with making recommendations to the SEC on what should be done to help our smaller public companies cope with the burdens of SOX.

The Advisory Committee released its final report last week. In the report, the Committee recommends that companies with market values of less than $128 million be exempt from Section 404 unless and until corporate auditing standards are established for these companies. While, SOX technically applies only to public companies, private companies have plenty of reasons to be nervous. The ability to gain access to public markets now turns on whether they can stomach the huge costs of Section 404.

As the witnesses will discuss today, many are just rejecting the public markets and staying private. Clearly, SOX has an important purpose, however the legislation must not be allowed to overly burden our smaller companies.

Today we will hear testimony on the compliance burdens SOX Section 404 has created for our smaller public companies, and explore whether the recommendations of the SEC Advisory Committee will fix these problems. I look forward to hearing the testimony today, and now yield to the Ranking Minority Member, Representative Velµzquez of New York, for her opening comments.

[Chairman Manzullo's opening statement may be found in the appendix.]

Ms. VELµZQUEZ. Thank you, Mr. Chairman.

This hearing to review the recommendations of the SEC's Advisory Committee has been a long time coming. Small businesses continue to face barriers that hinder their ability to remain competitive and strong.

The sky-rocketing costs of health insurance and start-up capital pose many challenges for entrepreneurs. Both soaring regulatory and compliance burdens have consistently been one of their number one concerns.

Almost every single small business owner and association that has testified before this Committee has put reducing the regulatory burden at the top of their list for legislative package. That is not different with the Sarbanes Oxley Act, as Democrats on the Committee have been hearing from small business owners for nearly two years now. Unfortunately, the situation does not seem to be getting any better.

The Sarbanes Oxley Act was intended to strengthen the corporate governance practices of the business community. But, what we have heard is that this one comes with a cost, and a particularly steep cost at that.

The auditing standards, disclosure requirements, and corporate governance rules of the Act have added significantly to the operating costs of small companies, many who have gotten stuck in the fray.

Democratic members of the Committee held a roundtable back in October, so that we could hear directly from the small business

community on the impact of these reforms. A number of small firms we spoke with agree that it is difficult not to support the intentions of Sarbanes Oxley, most notably strong corporate governance and shareholder accountability. Yet, for the 14,000 publicly traded companies, the majority of which are smaller firms, Section 404 of the Act poses a great burden to their future economy vitality. Numerous stories and surveys point to the staggering compliance costs of Section 404 as a major burden on small companies.

In June, 2003, the SEC estimated the cost of implementing Section 404 on all registrants at almost $1.24 billion or $91,000 per registrant. Yet, time has told that the SEC vastly underestimated its calculations. Recent surveys show that the small companies are paying an average of nearly $1 million to comply with Section 404, and this is simply unacceptable.

Even though some studies show these costs have declined, they are still significant and are bearing a disproportionate burden on small firms.

The complying costs of Section 404 for small companies is approaching 3 percent of revenue, while it is less than 1/10th of 1 percent for larger companies.

Adding to concerns this new evidence showing numerous small companies suffering under the weight of costly regulations have begun to look abroad to go public. There are currently 37 U.S. companies listed on the AIM by the London Stock Exchange, 19 companies alone that have been listed within the last year.

This so-called Sarbanes Oxley free zones have freed some small firms from the strict capital market regulations seen here in the U.S. Both Sarbanes Oxley and Section 404 have been cited as primary drivers in this development, which are, in turn, hurting the American economy.

Clearly, there is no end in sight to the burden that so many of our Nation's small firms are forced to face. My Democratic colleagues and I have cited many of these concerns in two recent common letters to the SEC. I am pleased, though, with the work the SEC Advisory Committee has done toward finding a solution that truly eases the burden and provides relief for small companies.

With the recent release of the Committee's recommendations, I am hopeful this will become the basis for a real regulatory reform proposal. I know that much uncertainty surrounds the SEC's review and consideration of the Advisory Committee's recommendations. However, this situation is resolved, I urge the SEC to address the issue straight on and provide smaller companies with definitive relief from Section 404 sooner rather than later.

I look forward to the testimony of the witnesses today.

Thank you, Mr. Chairman.

[Ranking Member Velazquez's opening statement may be found in the appendix.]

Chairman MANZULLO. And, thank you, Ms. Velµzquez.

Some of the ground rules, we have a system of lights up there. Green is go, yellow is you got a minute to go, and red you are supposed to stop. This is not used in case you don't stop, okay?

It's important to tell your own story. The complete written statements of the witnesses will be made part of the official record, so you don't have to worry that if you miss something it won't be in-

cluded in it. I'm going to keep the record open for three weeks for anybody else that wants to submit written statements, but they cannot exceed two written pages. No tomes, okay? And, the print cannot go below 10 points. So, no footnote prints, for anybody else who wants to submit additional statements, including obviously members, we'll keep it open for that.

Now, we are expecting votes, and having taken the Constitutional Oath to vote. When the bell goes off, we will go out and vote. I think there are three votes and that will take probably about a half an hour. Votes are anticipated any minute. But what we'll do is, we'll start first with Mr. Wander and then, what I don't want you to do is to spend so much time looking at the clock that you don't concentrate on your testimony.

How many here have not testified before Congress before? Oh, my goodness, four out of six. Okay. Well, the other two just assure them, you know, that nothing is going to happen, and this is a very, very serious subject, and it's unusual to get involved in something this esoteric, but sometimes the small businesses want to get larger. There are many companies that come within the SBA definition of small businesses, that is less than 500 employees, and in the aerospace industry less than 1,500 employees, that will be in this situation.

So, Mr. Wander, we will start with you. I look forward to your testimony. You might want to pull the mike as close to your mouth as you can.

Thank you.

STATEMENT OF HERB WANDER, SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES

Mr. WANDER. Thank you, Mr. Chairman. It's a delight to be here this afternoon, and I thank you for this opportunity to provide oral testimony, as well as my written statement.

Who am I? I'm Herb Wander. I am just recently released from my obligations as Co-Chair of the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies. We were established 13 months ago, have gone through a very extensive fact-finding process, and submitted our report to the Securities and Exchange Commission last Sunday, April 23rd. I'm also a partner with the national law firm of Katten Muchin Rosenman LLP.

In my written statement, so I don't have to repeat it, contains information concerning the mission of our Advisory Committee, the overarching principles we follow, lists the diverse membership, indicates to you all the extensive information gathering process that we went through, both in hearings and asking written requests, and then there are a total list of our recommendations, which, by the way, go beyond Section 404. However, this afternoon I will only talk about 404, dealing with internal controls.

As both the Chair, and as indicated, the original estimates of the cost of Sarbanes Oxley, starting with the Senate Report on Sarbanes Oxley, indicated that they thought there would be no increase in auditing costs, have been far off the mark. And so, I am not going through that, I think that's been well documented, I will only add that the latest study that the Big Four Accounting Firms produced two or three weeks ago by the Charles River Associates

indicated that some of the fees are coming down, but they still approach $900,000 to a million dollars for smaller public companies, which in many cases gets to be double digit percentages of their cash flow. So, it is truly a big cost, and, indeed, that study also noticed that total auditing costs, that's both 404 and regular auditing costs were relatively flat, having gone up 200-300 percent over the last three or four years, so that the cost burden is enormous and that's well documented and I don't think disputed by anybody.

We should not forget the fact that, not only have the costs up, but it's the opportunity costs, it's where do you spend your money, do you spend your money on research, and my colleagues who will testify I think are far more qualified to talk to you about loss of opportunity costs and the costs this puts on them.

So, I would like to now concentrate on, essentially, our recommendations, because I think there's ample evidence in the record, and after our 13 months I think that it's well documented. I want to emphasize the following points. Our Advisory Committee was not here to repeal 404, but to fix it. It is clear that internal controls have been controlled since 1977. We think they are important, but they have to work properly for all companies, particularly for smaller companies.

Our recommendations which you read are crafted very carefully, and you must read them very carefully. We say, "Unless and until a framework for assessing the 404 that works for assessing internal controls over financial reporting for smaller public companies is developed that recognize their characteristic needs." So, what we are saying is, it's time now to get it right, before all those companies that you indicated in your opening remarks will become subject to this, that they don't have to go through something that everybody in today's world admits needs a major overhaul. So, we are not saying just totally exempt everything. We have put conditions on everything, and we say we would like to fix it.

I also want to mention that none of the critics, Arthur Levitt, Lynn Turner, all of the critics, really do admit that there are faults, and serious faults, with 404. So the question is, how do we fix it, not whether we let it continue to operate, and hope that it gets fixed all of a sudden.

We also want to emphasize that while we are talking about a large number of companies under our recommendations, they comprise less than 5 percent of the total U.S. market capitalization. People have bandied around, you would exempt 80 percent of the public companies. Actually, the number is 70 percent, but the fact is that these are the smallest capitalization, under 5 percent of total market capitalization.

We also believe very strongly that we think AST2, which is Accounting Standard No. 2 adopted by the PCAOB needs fixing. The PCAOB has done a good job in trying to provide guidance, as well as the SEC providing guidance. The guidance has just not worked, and we think they ought to go back to the drawing board and make changes to the regulation, because those who are applying it look at the rule and they look at the guidance secondarily or not at all.

Chairman MANZULLO. How are you doing on time?

Mr. WANDER. Well, I'm reminded of the story that the Securities Act of-

Chairman MANZULLO. No, on time, you are out of time.

Mr. WANDER. I'm on time, all right. I would just like to close that I think my written statement contains all of the necessary information concerning our recommendations, which we think should be and, in fact, can be adopted by the SEC and the PCAOB.

Thank you very much.

[Mr. Wander's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you very much.

Our next witness is Bill Broderick, Chief Financial Officer and Treasurer of Analytical Graphics, Incorporated. We look forward to your testimony.

STATEMENT OF BILL BRODERICK, ANALYTICAL GRAPHICS, INC.

Mr. BRODERICK. Good afternoon. My name is Bill Broderick. I'm the Chief Financial Officer for Analytical Graphics, a software company based in Exton, Pennsylvania, serving the national security industry. I also serve as a Board Member of the Small Business and Technology Council.

Chairman Manzullo, Congressman Velµzquez, and Members of the Committee, I would like to thank you for holding this hearing and the opportunity to testify.

In the short time we have, I hope to provide some highlights on my prepared statement in regards to the unintended consequences of SOX and small public companies, and how it has affected my company, my small private company.

Since 1989, AGI has grown to a 250-person company, and has been named Best Small Company to Work For in America for 2004 and 2005.

Chairman MANZULLO. Bill, I'm going to restart your clock when we get back. How does that sound?

Mr. BRODERICK. That's okay, Mr. Chairman.

Chairman MANZULLO. All right? Because I don't want to have people walking out in the middle of your testimony. That doesn't look too good, does it?

So, we are going to recess for about a half an hour and then we'll be right back.

Is there anybody here on the panel that has to catch a plane later on this afternoon? Okay, then we'll keep this order.

[Recess.]

Chairman MANZULLO. I'm waiting for the alarm clock to reach 6:00 a.m., and then for somebody to smash the alarm clock and to go looking for groundhogs.

So, Mr. Broderick, if you would like to start all over again, and you may have been through this before.

Mr. BRODERICK. Yes, I have been, Mr. Chairman.

Chairman MANZULLO. For about 40 seconds, is that correct?

Mr. BRODERICK. Yes.

Chairman MANZULLO. So, if I ask you if you've ever testified before Congress before you can say yes now. We look forward to your testimony.

Mr. BRODERICK. I have on the House Armed Services side, Mr. Chairman.

Okay, thank you again for this hearing, Mr. Chairman. I'm just going to pick up where I left off with some company background.

Since 1989, AGI has grown to a 250-person company and has been named the Best Company to Work in America for 2004 and 2005. Over our history, we have been able to assemble a talented team of 140 engineers and scientists to provide a unique and innovative product line, with 12 issued patents to our credit. We are proud that the national security community relies on the fidelity of our software in many critical areas, such as providing battle space situational awareness for efforts in Afghanistan and Iraq, as well as the Pentagon for top level-

Chairman MANZULLO. Well, just a second, you sound like a guy doing a trailer in one of those ads, all right? You can slow down a little, all right?

Mr. BRODERICK. I'm just -

Chairman MANZULLO. Don't worry about it, all right?

Mr. BRODERICK. Okay-as well as top level briefings in the Pentagon.

The key question I pose for today's hearing is, given the disproportional cost of Section 404 on SOX, on small public companies, are we building a safeguard that costs orders of magnitude more than any proven benefit, or simply put, are we being penny wise and pound foolish with respect to small business compliance with SOX?

As cited in the April, 2006 final report of the Advisory Committee on Smaller Public Companies, the discrepancy between the initial Section 404 cost estimate of $91,000 versus the actual cost of $900,000 raises the question of cost benefit for the shareholders of smaller public companies.

Given the ongoing cost of compliance with Section 404, the valuations of smaller public companies are permanently impacted. In my prepared statement, I provided you with a macro level calculation on this impact, which resulted in an on average loss of approximately $8.1 million in shareholder value for each smaller public company, or approximately $60 billion in total equity valuation loss would be incurred on a permanent basis across all smaller public companies.

In addition, the above figures do not include the opportunity costs and lost productivity of management and other personnel related to core business activities. Because the regulations lack cost benefit analysis and professional judgment, investors lose significant shareholder value.

We fully concur that regulatory reforms were needed in the wake of the financial collapses and malfeasance at Enron and other companies. However, there appears to have been a rush to enact sweeping reform, without a basic cost benefit analysis to assess the impact on smaller public companies.

As discussed in my prepared statement, we eliminated the option of going public to liquidate our venture investor, primarily from the significant burdens associated with SOX compliance, which would not only reduce our profitability due to the cost of SOX, but divert senior management time away from core business activities.

Therefore, we were forced to raise $15 million in bank debt and used $13 million of our own cash to liquid out our venture inves-

tors entire holdings. Accordingly, the result and effects of AGI being unable to effectively access the public capital markets are as follows;

1. Our limited capacity to make investments in advanced R&D affects our ability to deliver unique capabilities for national security needs, which is important, not only to stay competitive in a marketplace dominated by large prime contractors, but also to keep our Nation's defense technology far ahead of our adversaries.

2. We have foregone growth opportunities and investments in business development, marketing and sales to the detriment of our long-term sustainability.

3. Limited cash reserves put a strain on existing business operations, preventing scaling up of our infrastructure, which includes financial systems, internal controls, and information technology.

Our recommendations to reduce the disproportional impact of the Sarbanes Oxley Act on smaller public companies are summarized as follows;

First, AGI strongly supports the Advisory Committee's primary recommendations, especially the establishment of a new system of scaled or proportional securities regulations for smaller public companies.

Second, I cannot emphasize this enough, the proper tone at the top is a critical enabler and force multiplier for acceptance of applicable internal controls throughout an organization. To this end, AGI recommends mandated executive level professional education to establish understanding and commitment to the importance of effective internal controls. Internal controls are best implemented with the right tone from top down.

Third, in reference to the Advisory Committee recommendation III(P)(1), AGI recommends that not only the CEO and CFO provide certification for internal controls, but also the Chief Operating Officer or equivalent operations executive should provide certification as well. This executive is key to adoption of an effective internal control system, since he or she is more intimately involved in the day-to-day departmental operations. This key executive should be held accountable and not be disconnected from the internal control certification.

In closing, if the status quo remains, this will reinforce a message to non-public small companies that you must be a larger company to access the public capital markets, and many smaller public companies, especially in the micro category, may be forced to go private.

I applaud the SEC for establishing an Advisory Committee to examine these matters, and commend the Advisory Committee on their diligent comprehensive efforts to provide a framework to establish common sense, proportional regulations under a cost benefit structure.

I'm grateful to this Committee for holding this hearing on topics vital to the health of small business and the opportunity to testify.

I welcome your questions and thank you.

[Mr. Broderick's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you very much.

Our next witness is Keith Crandell, Co-Founder and Managing Director of ARCH Venture Partners. We look forward to your testimony.

STATEMENT OF KEITH CRANDELL, ARCH VENTURE PARTNERS

Mr. CRANDELL. Thank you very much, Mr. Chairman, and Members of the Committee, good afternoon.

I am Keith Crandell, Co-Founder and Managing Director of ARCH, a 20-year old venture capital firm located in Chicago, Illinois. We fund primarily seed and early stage companies in the technology and life sciences area. My partners and I sit on many boards of both public and private companies.

I'm here today in my capacity as a Board Director for the National Venture Capital Association, which represents more than 400 venture capital funds in the U.S. U.S. companies originally funded with venture capital, such as Genentech, Goggle, Archipelago, now represent 10 percent of the annual GEP and employment in the United States.

I want to speak today on behalf of our country's emerging growth companies, which are being stifled by the Sarbanes Oxley law, specifically, Section 404. This law has drained capital and resources from these young companies, distracted management from growing businesses, diverted the major members of the accounting profession, and threatened the future of the U.S. capital market system for growth businesses.

Profitability is critical on Wall Street, and Sarbanes Oxley attacks profitability head on. The cost of complying with SOX 404 at small companies approaches a million dollars a year. If one assumes a healthy company can achieve 10 percent net income, then SOX dictates that such a company would have to garner up to $10 million in additional revenue just to support the cost of compliance.

For those who suggest that the cost of 404 compliance will eventually fall, I would argue that without dramatic change the numbers will not fall enough. A recent CRA international study found that even with a 31 percent drop in SOX compliance costs last year, small cap companies still on average bear a SOX burden of $860,000. It's highly unlikely that SOX costs will continue to drop as precipitously in the future, and the costs remain excessive.

Of equal concern is the drain on human resources to achieve SOX 404 compliance. These companies are being placed in an undesirable position of having to hire additional financial staff and forego hiring engineers and sales teams. These hires do not foster company growth.

To exacerbate the situation, SOX has compelled the Big Four auditors I'm familiar with to shift their focus from auditing companies of all sizes to leveraging lucrative 404 practices at large corporations. As a case in point, I served as a Board Member on a small cap public company that was informed by their Big Four auditor in 2004 that, not only were they too busy with their larger clients to complete the company's audit on time, but that their audit would cost 16 percent more than the previous year. The Big Four auditor provided - suggested that the smaller company re-

lease its numbers late, which we all know, including the auditor, that that would be public market suicide.

Although many have suggested that small companies turn to second and third tier accounting firms, this isn't a realistic choice for many ventured-backed companies, since most investment banks that are willing to take their companies public request that the company use a Big Four firm.

From a macro economic perspective, SOX 404 has contributed significantly to a clog in the IPO pipeline in the United States. The cost of the legal and accounting work for initial public offering processes stands at close to $2 million, up from $500,000 a few years ago. These hurdles to go public in the U.S. today are driving venture capital-backed companies away from our capital market system to other exits and other markets.

In 2005, only 56 venture-backed companies went public on U.S. exchanges. The healthy IPO market historically has been at least twice that level. Only ten IPOs for ventured-backed companies were accomplished in the first quarter of this year, so we are on track for another dismal year for IPOs.

We are seeing pre-IPO companies now embrace two viable alternatives to going public in the U.S. First is the preference for acquisition route, for many companies the cost of going public is too high, and when faced with a cheaper, less risky alternative the acquisition wins. Unfortunately, consolidation acquisitions is much less conductive or conducive to job and technology growth.

The second strategy is companies choosing to go public on foreign exchanges. In 2005, there were 519 IPOs on the London AIM. In the first quarter of 2006 we saw for the first time two of 12 U.S. venture-backed companies went public on the AIM, and decided not to use the NASDAQ.

Eighteen months ago, if you queried a room of ventured capitalists about the London AIM, few would have had the market on their radar screen, I think today it's viewed as a viable and better understood option for many of VC-backed companies.

While specific provisions of the original Sarbanes Oxley law have improved certain practices at U.S. companies, Section 404 has done little in the way of advancing fraud. We have witnessed the information compiled from a 404 audit to be unwieldy, out of date, and of little or no use to investors. I'm not aware of any evidence that Section 404 has been a critical factor in uncovering fraud, such malfeasance is almost always discovered by new employees or auditors joining a firm, rather than from compiling documents.

As a committed investor in small and emerging growth companies, I strongly support the recommendation of the SEC Advisory Board on the smaller public companies, the recommendation for tiered regulations. Size appropriate structure already exists in other regulations, and I would argue that intelligent small company investors would easily exchange a certificate of compliance for the extra million dollars in that income that would come from tiered regulatory relief.

Further, I am very supportive of any provision that will help stimulate more competition in the accounting profession. Our supply of qualified accountants to do work for small companies is not

meeting the increased SOX demands. We would welcome new entrants wholeheartedly.

Companies that seek to thrive and create value will always comply with the highest standards. It's critical for market credibility, but the time has come to set the bar accordingly, and reduce the unnecessary frictional costs of SOX 404, in the best interest of growing companies and growing economy.

Thank you for the opportunity to weigh in on this vital matter.

[Mr. Crandell's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you.

Our next witness, I read the press release you put out last night.

Mr. NEISS. You liked it?

Chairman MANZULLO. It was good.

Mr. NEISS. Right.

Chairman MANZULLO. Yes, you know, if this meeting had been cancelled I don't know what you would have done, you know.

Mr. NEISS. I'd still be here.

Chairman MANZULLO. I appreciate that, it shows your enthusiasm for being here, and, Woodie, is it Neiss?

Mr. NEISS. Neiss, yes.

Chairman MANZULLO. Woodie Neiss is the Co-Founder and Chief Financial Officer of FLAVORx, Inc., a company that puts flavoring into medicines. We look forward to your testimony.

STATEMENT OF WOODIE NEISS, FLAVORx, INC.

Mr. NEISS. Thank you very much.

Chairman Manzullo, Ranking Member Velµzquez, and Members of the Committee, thank you for inviting me here today. My name is Woodie Neiss, and I represent what is great about this country, the ability to take an idea and turn it into a reality.

I'm an entrepreneur and a Co-Founder of the company FLAVORx. We are an INC500 high growth, young energetic small business, helping millions of sick children get better faster by being more compliant with their medicines. We believe we are saving the U.S. healthcare system over $100 million a year in unnecessary medicines, doctor visits, insurance claims, gas, time and resources of parents, and the companies they work for.

I represent a different generation of business owners than those of Enron and WorldCom. We respect the rules and morals, and believe you can run a business fairly. I believe that FLAVORx has what America needs in the form of a public company.

Over the past several years, we have had steady growth, maintained positive cash flow, and consistently grown our bottom line. I often get calls from parents asking if we are publicly traded. It's for this reason that we've been able to attract capital from friends, family and most recently private equity, with the hopes of going public.

Wanting to do it right, we've diligently grown our business by implementing ethical business practices along the way. This wasn't a product of legislation, that's just what you do to grow a business and raise capital.

Part of our process always includes an audit of our financial statements. We feel it is necessary to have an independent auditor review our books to verify their accuracy. It not only reassures us

that what we are doing is right, but provides a vote of confidence to our business partners.

Over time, we've grown our audit relationships, and in 2002 in anticipation of an IPO we hired Ernst & Young. What we didn't realize we faced though were adversarial, theoretical debates over revenue recognition procedures, concentration on overly detailed reporting systems, time consuming discussions over policies and procedures irrelevant to a company of our size, and extra costs in the form of consultants and legal fees.

Our $10,000 a year, two-week audit suddenly jumped to a $70,000 four month audit. On top of that, these fees represented a substantial 14 percent of our net income. There's a fundamental difference between a small company with public aspirations like ours, and a multi-billion dollar company. We do have the deep pockets, unlimited personnel, intricate infrastructure, or complexity they do, and hence don't need the same resources or structure to explain our simple actions.

Trying to dig for problems in a company like ours, where problems don't exist, is counter productive. Spending money to uncover these problems, when I can use it to invest in sales and marketing, seems a waste. To hold us accountable to rules where the challenges are different or non-existent are an unintended result of this legislation that is lining the pockets of auditors, consultants and lawyers.

It was for this reason last year that we decided to drop our relationship with E&Y. We also started to second guess our desire to go public. I mean, why go public when Sarbanes Oxley audits are so expensive and painful? Why put yourself through the agony, when in the end there's nothing to uncover?

When it comes time to audit season, you are guilty until proven innocent. It doesn't sound very American, does it?

I highly doubt FLAVORx is unique when I say we want our investors to know the good and the bad, that transparency is a part of our lives. However, we, like many small businesses, are not complex. Unfortunately, however, Sarbanes Oxley does not take this into consideration. There needs to be some middle ground. There should be a threshold based on the complexity of an organization determined by its revenue to which companies should be held accountable to SOX. Until then, we can use these funds to better grow our companies, rather than reduce our net income.

Of course, the option always exists that we can pass these costs off to the consumers, but I highly doubt this was the intention of Congress. We, as business leaders, can change-can behave ethically without being forced by legislation. To lose confidence in us is to lose confidence in the majority of the good companies out there that are trying to succeed in this challenging business environment of higher costs and increased competition.

Public markets allow companies like FLAVORx access to capital which enables us to grow much faster, hire more people, and consume more American products. This grows our economy more than if we were just to sell to a larger company. However, public markets at the expense of Sarbanes Oxley do not make for attractive options.

I know this Committee represents the interests of small businesses, and I hope you can help influence your colleagues to understand the repercussions that Section 404 is having on us.

Thank you again, Mr. Chairman, for holding this hearing and allowing me to testify. I look forward to your questions and our discussion.

[Mr. Neiss' testimony may be found in the appendix.]

Chairman MANZULLO. Appreciate that. I'm just wondering when people call your company and are put on hold, if that song, "A Spoonful of Sugar," is there.

Mr. NEISS. We tried, but Disney got-we got in trouble with Disney.

Chairman MANZULLO. You did say that you are law abiding, that's great.

Our next witness is Mark Schroeder, with the Independent Community Bankers of America. He's President and Chief Executive Officer of German American Bancorp in Jasper. How many people live in Jasper?

Mr. SCHROEDER. About 15,000.

Chairman MANZULLO. Oh, that's a big city.

We look forward to your testimony.

STATEMENT OF MARK SCHROEDER, GERMAN AMERICAN BANCORP

Mr. SCHROEDER. Thank you.

Thank you for the opportunity to testify today, good afternoon. My name is Mark Schroeder, and as the Chairman said I am President and Chief Executive Officer of German American bancorp. We are located in Jasper, Indiana, and we are a community bank holding company, with approximately $1 billion in assets.

It is my pleasure to speak today on behalf of both my company and the Independent Community Bankers of America, which represents approximately 5,000 community banks in the United States, many of whom are publicly held, and speak on the costs of Section 404 of Sarbanes Oxley, and on the recommendations included in the final report of the SEC Advisory Committee on Smaller Public Companies.

Let me give you a little background on German American. German American bancorp was formed in 1983, and we were formed with the express purpose of providing a vehicle for small community banks to come together to achieve economies of scale and to obtain the liquidity of a publicly-held community banking company.

Since 1983, nine community banks, the majority of which have served their communities in southern Indiana for over a century, have joined our company, allowing their shareholders the opportunity to continue holding an investment in their locally-owned community bank.

German American is listed on NASDAQ. We have approximately 3,500 registered shareholders, and we have a market capitalization of $144 million.

I think I bring a unique perspective among the witnesses today, because German American bancorp is an accelerated filer with the SEC, and we have, therefore, been subject to SOX 404 compliance for the last two years.

For 2004, our direct costs as a company, just for SOX 404 compliance, amounted to nearly $600,000, with an additional estimated $250,000 of internal indirect costs, for total compliance costs of $850,000, which equates to .08 cents per share for our shareholders.

For 2005, our costs declined, but even these declined costs, the direct costs were $350,000, and our indirect costs were $150,000, for a total cost of $500,000, or approximately .05 cents a share.

Now, these costs are extremely high, but these costs fail to consider and take into account the internal operating inefficiencies that have been created because of the duplicative internal controls that we have had to put in place since the implementation of 404.

In an effort to be conservative, and to avoid being questioned by the PCAOB, accounting firms, ours included, are requiring layer, upon layer, of checks and balances, beyond that which can be justified on any kind of risk cost basis beyond that needed for proper segregation of duties, and beyond anything that's ever been required by the banking regulators.

In particular, the cost of duplicate checks and balances, coupled with the requirement for layer, upon layer of documentation of these duplicative processes, have added additional operating inefficiencies through every area of our company.

The cost of this inefficiency is impossible to measure, but it is significant, and at a minimum we believe it is equal to or in excess of the measurable indirect costs.

For many publicly-held community banks and holding companies, the immediate response to the high costs of SOX has been to go private, and cease being registered as SEC filers. Since the beginning of 2003, 75, over 75 community banks have filed to go private. The reasons cited in these filings uniformly include increased legal and auditing hard costs, and management staff time soft costs, associated with the Exchange Act, but unquestionably 404 compliance is the biggest concern.

Unless something is done to ease the burden of 404, we would predict that as the micro cap companies, those below $75 million of market cap, are looking at facing this, you will see a flood of public banks, small public banks, choosing to go private.

The SEC Advisory Committee on Smaller Public Companies should be commended for its fine work in preparing and drafting the final report, and including more than 30 recommendations for scaled or proportional securities regulation for smaller public companies. Among the Advisory Committee's primary recommendations, ICBA strongly endorses exempting micro caps from the internal control attestation requirements of Section 404, and unless and until a framework for assessing internal controls over financial reporting for such companies is put in place for the small cap companies, exempting those small cap companies from the external audit requirements of 404.

We agree strongly with the Advisory Committee that with more limited resources, fewer internal personnel, and less revenue with which to offset the costs of 404 compliance, both micro cap and small cap companies have been disproportionately impacted by the burdens of Section 404 compliance.

We also agree that the benefits of documenting, testing, certifying the adequacies of internal controls, while of obvious importance to large companies are of less value for micro cap and small cap companies who rely to a greater degree on tone at the top and high-level monitoring controls to influence accurate financial reporting.

There has been little attempt by either the SEC-

Chairman MANZULLO. How are you doing on time there?

Mr. SCHROEDER. -okay, I'll wrap up here, Chairman.

There has been little attempt by either the SEC or the PCAOB to tailor or scale regulations to address the disproportionate costs and burdens.

On behalf of the nearly 5,000 members of the Independent Community Bankers of America, we urge the members of the Committee on Small Business to support the Advisory Committee's recommendations, and urge the Securities Exchange Commission to adopt them.

Thank you.

[Mr. Schroeder's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you.

Our next witness is James Burns. Mr. Burns is President and CEO of EntreMed, Inc., speaking on his behalf, and also on behalf of his trade organization, the Biotech Industry Organization or BIO. We look forward to your testimony.

STATEMENT OF JAMES BURNS, ENTREMED, INC.

Mr. BURNS. Thank you, Mr. Chairman.

Chairman MANZULLO. Could you pull the mike a little bit closer, sir?

Mr. BURNS. Sure.

Thank you, Mr. Chairman, Ranking Member Velµzquez, and Members of the Committee. As a native Illinoisan I'm glad to be here, and also to be here to talk about the issues involved in Sarbanes Oxley Section 404.

I am the President and CEO of EntreMed, a public biotechnology company in Maryland. I have been involved in leading the development of biotechnology companies and products for over 20 years. Founded in 1991, EntreMed is a clinical stage pharmaceutical company, focusing on the development of next generation anti-cancer and anti-inflammatory drugs that target disease cells directly in the blood vessels that nourish them. Our focus is on the development of drugs that are safe and convenient, providing the potential for improved patient outcomes.

Our company currently has three drug candidates in clinical trials for cancer, as well as others in pre-clinical development for oncology and non-oncology indications. Our company has no product sales, and will depend on continued investment capital for the foreseeable future to maintain our clinical development programs.

I'm here today to testify on behalf of the Biotechnology Industry Organization or Bio, an organization representing more than 1,100 biotechnology companies, academic institutions, state biotechnology centers, and related organizations in 50 states and 31 nations. Our members are involved in the research and development of health care, agricultural, industrial and environmental biotechnology

products. The majority of our member companies are small research and development oriented companies, pursuing innovations that have the potential to improve human health, expand our food supply, and provide new sources of energy.

My company has a profile that is typical of the high risk capital-intensive, long lead time regulated business environment of the biotech industry. As a representative of one of the most innovative high growth sectors of our Nation's economy, one in which the United States maintains a global leadership position, my testimony is tailored to the issues faced currently or that will be faced by emerging companies in the biotech sector, the micro cap and small cap companies who are among the driving forces of our country's innovative leadership and competitiveness in global marketplace.

Let me, basically, say we appreciate and agree with the congressional intent behind 404, ensuring that companies will have the effective policies, procedures and controls to protect against material mis-statements end product and protect it against fraud. Where Section 404 has gone awry, however, is in the implementation.

The reason for increase cost burden is the imposition of an inflexible Section 404, and companies with fewer personnel, little or no revenues, and minimal resources. Simply put, if the current 404 implementation continues to be imposed, micro cap and small cap companies in our industries will be forced to endure internal processes and organizational changes that are completely contrary to the rapidly changing and highly competitive markets in which we operate.

Let me put 404 into real company context by providing some examples, if you would. One of BIO's member companies has five employees working on Section 404 compliance, at a cost of approximately $1 million per year. This company estimated that its Controller spent approximately 35 percent of his time on 404, while the CFO spent approximately 20 percent of the time, to complete the mandated internal control processes and the checklists dictated by AS2 the company had to increase its accounting staff by 40 percent.

Another member's experience shows the impact of 404 with respect to opportunity cost. This company not only spent approximately $500,000 on its external attestation of internal controls, but also had to endure additional costs in terms of (1) the reassignment of laboratory research personnel to perform internal control work dictated by AS2; (2) the postponement of hiring of five or more additional researchers, the delay of promising R&D programs.

Other issues that this company was trying to deal with was whether they would have had to file additional patents. There's 100 patents in this company right now, and whether and where to file additional patents.

This company could also purchase an entire amount of active pharmaceutical ingredient for one of its clinical product candidates for the same cost associated with complying with SOX 404. To say the least, this is clearly an unintended and unfortunate consequence of Section 404.

The risks in our business are patient safety, FDA compliance, and the uncertainty of research outcomes. SOX 404 does not reduce these risks.

For investors, their confidence and trust in public companies may have increased as a result of the passage of SOX as whole, in spite of Section 404, not necessarily because of it.

We view CEO and CFO certification under Section 302 as beneficial and a requirement that we are not contesting. As we saw in the first and second years of 404 implementation, investors were less concerned when a company reported a material weakness in internal controls than how much a small company was paying to meet Section 404 requirements for much more complicated businesses.

Chairman MANZULLO. How are you doing on time?

Mr. BURNS. I'm just going to wrap up shortly.

Chairman MANZULLO. Okay.

Mr. BURNS. Biotechnology start-up companies early in their histories often have very limited or no product revenues compared to their market capitalization. So, for these reasons BIO has urged the Securities and Exchange Commission to-and the Public Accounting Oversight Board, as expeditiously as possible, to take the necessary steps to adopt a reform framework recommended by the Advisory Committee's final recommendations.

That concludes my testimony. Thank you.

[Mr. Burns' testimony may be found in the appendix.]

Chairman MANZULLO. Okay, Mrs. Kelly.

Mrs. KELLY. Thank you.

I apologize, I have a very busy schedule and I have to leave.

As one of the people who helped to write SOX, and helped to write Section 404, you have to put that into context of what was happening at the time that we wrote it. It was certainly not intended by Congress to put a chill factor on businesses. And, I am concerned, I think we do need to take a look at it.

With that in mind, I'd like to talk to you, Mr. Wander, about a question I had, rather than divide companies by market capitalization, would it have made more of an impact to look at companies that need relief from the cost of compliance in terms of take a look at small businesses that nearly have their profits erased by the cost of the compliance, looking at it that way rather than-in other words, the percentage that it's costing them out of their bottom line. And, is there some reason why you didn't do that?

Mr. WANDER. Yes, one of our mantras was to keep it simple. We think that one of the just general problems, in terms of both legislation and regulation, is that things get so complicated that it's very difficult to comply with it, it takes away the use of professional judgment.

So, we tried to figure out all sorts of metrics that would apply to scaling the regulation for public companies.

Most of the people that commented felt that market cap was best. The second was, essentially, frankly, number of employees or revenue, and we discarded that. And, we considered scaling based on what your profitability was, but again, most of the comments we had felt that that would be no good because, you know, very large companies went into bankruptcy who still, for example, had no income whatsoever and needed-were large organizations, United Airlines being one of those, that still needed to have a robust internal controls over financial reporting.

Mrs. KELLY. Mr. Wander, did you look at the idea that you could maybe look at the mandates relative to the percent of resources that a company needs to devote to compliance, rather than their profitability or numbers of employees and all of that that you just mentioned, did you look at what it cost the company for compliance and think about a sliding scale of percentages in terms of applying 404?

Mr. WANDER. We didn't look exactly at that level. We are out of business, so I can't say we'll go back and look at that, but it sort of gets difficult in my first reaction to sort of figure out, well, if I have revenues of, let's say, $50 million, and I want to spend up to half a million dollars, 1 percent of that, how do you cut that off?

And, the accounting firms were very adamantly against establishing a standard where you would say, okay, for a $50 million company you would have to do a $500,000 internal audit.

On that issue, we ran into, frankly, a total road block by the accounting firms.

Mrs. KELLY. I can understand that, if you have-with a $500,000 audit, however, we do know, and you know because you reported the cost of audits is going down, we have to remember that this was put in place to protect the American investor, and while I am absolutely concerned about small and mid cap companies and their compliance, this was not meant to be a chill factor on business in the United States. But, we still need to have transparency so that people understand what that investment is going to be.

Part of the thing that concerns me in transparency, also with regard to small and mid cap companies, concerns naked short selling, which I was hoping that we-I brought up in a hearing this morning, because that is affecting our small and mid cap companies, and I was kind of hoping that maybe you all might have taken a look at that at the same time that you were doing this.

Mr. WANDER. It was one of the items on our agenda, and, frankly, we concluded that we are a limited life group with some sort of resource constraints, time restraints, and while I agree with you wholeheartedly that that's a very important aspect, it wasn't-we just didn't put it as high on our agenda, because we frankly think the SEC and NASDAQ are addressing that issue.

Mrs. KELLY. I have just one other comment, this to Mr. Crandell.

Mr. Crandell, you were talking about, you represent the venture capitalists, I'm quite concerned that we in government are putting grants out to help people develop ideas and bring everything up to a certain point, where at the point where they are needing to go from a granted position into production, into a prototype model of what they are doing, there's an area that is talked about in the agencies of government called the "valley of death," because the venture capitalists, you can't blame them, won't go in.

It would be very good if we could somehow develop a way to bridge that gap. It may be a public/private partnership or something, because I've been working on that for ten years, and I can't seem to figure out how we can force the agencies of government to bridge that gap, so that the venture caps can come in. I can't blame them, they are out there on the edge of the risk anyway.

Maybe you wouldn't mind engaging in a dialogue. I don't know if you want to talk about it now, but certainly you can find me and

I'd be interested in talking with you, maybe we can bridge a gap to help our companies make that jump, so they become viable and help us grow the economy.

Mr. CRANDELL. Yes, Congressman Kelly, I'd welcome the opportunity, and I'm happy to do that off line.

I would say that there are groups of venture capitalists that do seed and early-stage investing. We have done 115 companies in the last 20 years. We've co-founded most of those with technologists, scientists and, you know, I think it's a really important area to make sure that the U.S. is very efficient and taking inventions and turning them into business' revenue that employ people. So, I'm happy to talk about it.

Mrs. KELLY. Thank you.

Mr. CRANDELL. Sure.

Chairman MANZULLO. I recognize the Ranking Member for her questions and comments.

Ms. VELµZQUEZ. Thank you, Mr. Chairman.

Mr. Wander, let's get right to one of the biggest issues facing the Advisory Committee's reform proposal. Critics suggest that if the Advisory Committee's primary recommendations regarding internal controls are adopted that investor protections will be undermined. What investor protection requirements would still apply to small companies that are afforded relief under the Advisory Committee's recommendations?

Mr. WANDER. Yes, thank you.

First, all of the companies, whether they be micro caps or small companies, would be required to have internal controls over financial reportings. That's been mandated since 1997. They will still be in existence and applicable to all these companies.

Secondly, these companies will have to provide the certifications that are required under Section 302 of Sarbanes Oxley by the Chief Executive Officer and the Chief Financial Officer, attesting to the compliance with both financial disclosures and other disclosures in their narrative portion of their documents. So, those two people will be on the line, and I can tell you from my own experience as a lawyer representing many of these companies, the executives take that role very seriously. It is not something that's sort of a throw away and they sign it.

Third, they will all go through their regular audits, and we have learned, and this is unchallenged by anybody, that for the micro cap companies the regular audit is really the audit that catches errors and fraud. You don't need a separate external audit for those companies. So, that would still be in place.

Ms. VELµZQUEZ. So, you agree that investors will still be sufficiently protected?

Mr. WANDER. Yes, I believe they will.

Ms. VELµZQUEZ. Mr. Burns, we have heard that what drives investment in the high-growth setup, biotech and hi-tech sectors, is proof of concept, not Section 404, and that some companies are spending the equivalent of six months of R&D funding to cover the costs associated with Section 404.

Based on your experience, how much of an impact does Section 404, as currently implemented, have on increasing investors confidence?

Mr. BURNS. Investor confidence is primarily driven by progress to proof of concept. Money goes into, typically, companies like ours and it's expensed, it's expensed internally and externally, and the progress that's made on R&D, the progress that is made in clinical trials, the compliance with safety requirements of the FDA and so on are the things that investors particularly pay attention to, whether or not their investments in the company are being spent efficiently on R&D and efficiently on clinical trials, and whether the company is making progress toward ultimately getting approval.

And, they expect that when an audit is completed, and the CEO and the CFO certify to the financial, the accuracy of the financial statements, that that is what they are certifying to.

Ms. VELµZQUEZ. Thank you.

Mr. Wander, last week, and I sit on the Financial Services Committee, Marsh Carter, Chairman of the Board of the New York Stock Exchange group, testified before the House Financial Services Committee on maintaining the international competitiveness of the U.S. financial markets.

In order to keep U.S. markets competitive Mr. Carter proposed that the SEC and PCAOB move to a three-year Sarbanes Oxley Section 404 review cycle, as a way to reduce regulatory burdens. He noted that this could be accomplished without having to pass legislation to amend the law.

Do you think this proposal will help small companies by reducing the cost of compliance?

Mr. WANDER. We considered that very seriously in our deliberations, and concluded, again, we ran into actually opposition from both the issuers and the accounting firms, and their arguments were that once you get subject to 404 it's a shock, and having it every three years would be worse than having it every year. It's like going into an ice cold water.

And, we thought, and still think, that the better approach is to scale the regulations for smaller public companies, so that they still have to go through rigorous internal control establishment and examination, but that it should be scaled to the size of the company, and it should be every year.

So, but I don't throw out the three-year requirement off hand. We did look at it, and thought ours was better.

Ms. VELµZQUEZ. Thank you.

My next question is to you, Audit Standard No. 2 implements Section 404, AS2, as it is known, is long on guidance for accountants, but short on guidance for small companies. COSO has attempted to fill this void and provide additional guidance for small companies. What is your opinion of COSO guidance in this area?

Mr. WANDER. It's still deficient, and they came out, they worked very hard to produce some guidance at the request of the SEC, and I believe the PCAOB. The exposure draft came out, oh, three, four, five months ago. Comments were almost uniformly negative. It was a 200 and some page guide, and the problem was the guide, by the time you read it you were more confused than when you started.

And, it's unfortunate, because I value COSO and the people who work there who are, I think, truly trying to find a solution. They

are now revising it, I don't know what the revision will be, but I think in general it was just too long and not pointed enough.

Ms. VELµZQUEZ. My time is up.

Mr. BARTLETT. Thank you very much.

I have here a copy of a letter from the Office of Advocacy of the Small Business Administration to the Honorable Christopher Cox, with whom I had the privilege of serving in the House. And, Roman Numeral I says, "SEC should not impose disproportionate burdens on smaller companies by excluding them from access to capital markets."

I'd first like to apologize for not being here for your testimony. I'm also on the Armed Services Committee, and this is that one day in the year when we have a mark-up. Ordinarily, it lasts til midnight. I think that in the next hour or so it will be over, it's going very well today, and so I couldn't be here for your testimony.I gather that compliance with these regulations is imposing a burden on small business. I would like to ask a couple of questions. First of all, is it your view that when they wrote these regulations, as a result of our law, that they had small business at the table, that they went through the requisite hearings, and hearing from small business how the implementation of this that might be acceptable to large business would be an inappropriate burden on small business, do you think that they went through that required procedure? Any or all of you.

Mr. WANDER. Well, I will start the answer. I'm sure my colleagues here can fill in.

We think that's one of the very serious problems, is that the smaller and mid cap public companies are literally orphans in this process. The original COSO recommendations of the early '90s had very small chapters in the massive two volume set of guidelines dealing with small businesses. And, it sort of said they are very different, and you have to scale the regulations in order to have smaller companies comply on a reasonable and efficient basis.

When AS2 was first promulgated, the PCAOB, in fact, did have an appendix dealing with smaller public companies, which was taken out when the final rules were adopted.

And so, one of the points made by the Advisory Committee is that no one has really taken the time or effort to focus on what the standards should be for smaller and mid cap companies.

Mr. BARTLETT. Anyone else wish to respond?

I'm going to violate some rules probably, but they have a vote and it's just a couple of floors away. I'll be back very quickly, but they are having a roll call vote in Armed Services and I'm needed there. I'm going to do what you should never do and turn this over to a Minority member.

Ms. VELµZQUEZ. Well, continue practicing it.

Mr. Wander, let me continue to ask some questions here. Given the effect of Sarbanes Oxley on the public accounting industry, there was speculation that some smaller CPA firms will drop their public clients.

There was concern that this would lead to fewer companies in an industry already marked by significant consolidation. While the General Accounting Office addressed this issue in a study two years ago, could you please provide your perspective on what role

smaller CPA firms are playing in the market for Sarbanes Oxley audit services?

Mr. WANDER. I believe that particularly the next five in size firms who are actually very active with our Advisory Committee, and many of the regional accounting firms, need the strong support from the SEC, the PCAOB and Congress. They are very talented people. It probably has some limitations, they aren't as global as the Big Four, but they certainly are very fine professionals for businesses that are, essentially, located here in the United States.

And, I think you will see a trend, I don't think it's fast enough, where many smaller public companies will go to the smaller accounting firms. I think one of the witnesses talked about the fact that unfortunately underwriters and banks sometimes insist on a Big Four. In fact, Chairman Cox I think has spoken out in saying people should look at smaller accounting firms, and I think that that will be one way, hopefully, we will have a much more vibrant accounting profession, with more opportunities and choices for all businesses.

Ms. VELµZQUEZ. Thank you.

Mr. Schroeder, how have the compliance costs associated with Section 404 affected your bank's ability to invest in the local community?

Mr. SCHROEDER. Obviously, when you have a cost of a company of our size that in the first year was approaching a million dollars and now has kind of settled it at a half million dollars a year, it impacts our ability to invest in the local businesses that we do business with and the local companies, as well as the local individuals. From a Community Reinvestment Act perspective, it's probably a good place to look at it.

When we are looking to make an investment from community reinvestment, that half million dollars that we are spending on 404 could be allocated towards CAR type investments, but it can't go both places. A half million dollars a year for our company is a significant additional cost that will come out somewhere in the mix.

Ms. VELµZQUEZ. Thank you.

Mr. Wander, none of the top ten initial public offerings last year were registered in the U.S., and 23 of the 25 largest IPOs occurred in foreign markets. Anecdotal evidence suggests that the high costs associated with Section 404 are helping drive this trend and causing U.S. companies to raise capital in foreign exchanges, such as the London Exchange Alternative Investment Market, and some of the witnesses raised this issue, too.

To what extent has the burden associated with the Sarbanes Oxley Act deterred private companies from going public in the U.S., and to instead list on foreign exchanges, such as AIM?

Mr. WANDER. I think that's a growing phenomenon that you will see more and more of. AIM is coming to the United States, they almost have full-time representatives.

And, I would add with that the Toronto Stock Exchange, which is really the TSX, which also tries to capture smaller businesses with a model somewhat similar to the AIM market. They, in fact, presented a program at the Business Law Section of the American Bar Association meeting last month in Tampa, all foreigners gave the presentation, and they are going around to various cities in the

United States trying to get listings. And, I don't think there's any question that they will gain many more companies to go into their system, because for a small public company to take so much of their revenue or their cash resources to comply with Sarbanes Oxley, particularly, 404, especially 404, that they will continue to move to foreign markets.

And, I think Sarbanes Oxley is one of the big factors. I think as a New York Stock Exchange representative testified, litigation is another one.

Ms. VELµZQUEZ. But, do you believe that the Advisory Committee's recommendation will help reverse this trend?

Mr. WANDER. Yes, ma'am.

Ms. VELµZQUEZ. Okay.

Mr. Broderick, if the Advisory Committee's recommendations are enacted, would you consider your decision to not go public?

Mr. BRODERICK. If they were enacted to have a scaling proportional regulation, yes, we would then, right now, Congresswoman, the way we look at it is, an IPO is not feasible right now, but we say into the foreseeable future for a technology company that's, you know, three years at best, but we look at that we need to get to a certain level of critical mass in order to absorb the SOX compliance issues.

For us, that would be, we are a $50 million company right now, the way we look at it we roughly would have to get to $150 million to give us enough market capitalization, roughly about a half a billion dollars or so, to absorb that cost.

I would say, Congresswoman, just small cap companies, especially micro cap companies, in order to get liquidity in their stock, and institutional investors and other investors awareness to buy their stock, the time commitment and resources that the CEO and CFO to put at that is tremendous. When you add SOX on top of that, we looked at it and we just, it was a no brainer, we said we can't go public because we'll put our shareholder value more at risk. For a small cap public company, you put estimates out there. We are not like Google, we don't have to give guidance. If you don't give some kind of guidance, no one will follow you, no one will be interested in your stock.

So, you are out doing your own marketing efforts to get that interest, and that's just the general dynamics and the burdens on executive management to create liquidity in the stock. If you miss an estimate, a quarterly estimate, you know, by a penny, your stock can drop 50 percent easily.

So, when we look at it, the risk of that was so great, and the diversion of time and management towards SOX compliance, that we said we have a chance to lose 70 percent of our value, we might as well just stay private, build the company, and move forward with our strategies.

Ms. VELµZQUEZ. Thank you.

Thank you, Mr. Chairman.

Mr. BARTLETT. Thank you.

I'm privileged to serve on three of the least partisan committees in the Congress. This is certainly one of them. I don't know of anybody here who isn't a small business supporter. I serve on Armed

Services, and I serve on Science, so I had little fear that turning the Chair over to the Minority would be abused.

In another life, I was in business, as a small business person, and I learned very quickly that regulations that were acceptable to large businesses, if you have 300 people and it takes three people to comply with the regulations, that's a burden, but not a burden you cannot bear. If you have four employees and it takes three to comply with the regulations, that's clearly a burden that you can't bear. And so, you need to be careful whose business advice you are getting, because the strongest competitors for big business is frequently small business, and regulations are a way of neutralizing, neutering in many cases, a small business. You need to be careful who you are asking about whether these are acceptable regulations or not, because they may be acceptable to big business because it's a burden they can easily bear as a part of their overhead, and, furthermore, it now puts their small business competitors at a disadvantage. I see a number of you nodding your heads in assent, so you've been there and you understand this.

It's quite clear from your testimony that compliance with the regulations resulting from this law is imposing an undue burden on small business. The question I need answered is, is there a regulatory fix for this, or do we need to have a legislative fix for it? Is this something that we can hold the bureaucrats responsible for? Can they, within our law, promulgate regulations that will be effective and yet consistent with the view that small businesses should not be unduly disadvantaged by these laws? Can the regulators fix it, or do we have to legislatively fix it?

Mr. BRODERICK. Congressman, I think if the SEC adopts the scaling proportion, it's just common sense, I don't see any reason why they wouldn't adopt this and move forward with a framework, and then they can tweak that framework as they see fit.

To me, if they don't anything, if they just bury their heads in the sand about it, you are going to have small companies just, you know, not being able to attract any capital, even VC capital. Early-stage companies are going to be knocked out of the marketplace, because they see too much risk. Now, a VC comes in and he puts a certain level of infrastructure into a company, an early-stage company, and that's, you know, basic accounting, finance, HR type of infrastructure, but now you've got to take that extra layer on top of that, and based upon the risk models of VC firms they don't know if they are ever going to get to a public marketplace.

So, if those resources are diverted, you are not properly growing your company to get adoption of technology products and services in the marketplaces that you serve.

So, as far as - I believe it was a very, very good study and report, taking something and boiling it down, as complex as it is, and simplifying it, I think it was-I commend the Advisory Committee, I think they did a heck of a job with it, and I don't-it's just common sense, and we need more common sense.

Mr. BARTLETT. Is it your general view that if the recommendations of the Advisory Committee were implemented that it would largely fix the problem?

Mr. SCHROEDER. Speaking as a company that has been an accelerated follower, and has been through 404, absolutely. For German

American bancorp, and for many of the community banks, public community banks, that ICBA represents, those recommendations would absolutely fix the problem for us, or a significant portion of it.

The portion that we would be left with are good controls, they are controls we can live with, they bring value to our investors, but it is the 404 compliance and this piling on of layers and layers of bureaucracy that it would fix.

So, for us, absolutely, it would fix it.

Mr. BARTLETT. Yes, sir.

Mr. BURNS. Mr. Chairman, I believe that it would certainly help my company, and it would more than likely help most of the other companies that are biotechnology companies, and rely on the capital to grow their companies.

And, it's also my understanding that the Commission has the authority to implement the recommendations and we fully support that. The sooner the better, sir.

Mr. BARTLETT. Do you believe that the recommendations they made are consistent with law? Was there any ever discussion, any discussion that we might need new legislation to permit them to do what seems so reasonable to you?

Mr. WANDER. Perhaps I should at least try to answer that question.

One of our goals, it wasn't in our mission statement, but one of our goals since we were an advisory committee to the Securities and Exchange Commission, was that we wanted the Securities and Exchange Commission to implement our recommendations. So, we believe wholeheartedly that the SEC does have authority under the various securities laws to implement our recommendations.

I should be totally frank with you, there are people who question that, because of a quirk, Section 404 is not part of the Securities Exchange Act of 1934, where the SEC has some broader authority to adopt regulations. But, we make a case for this in our report, and I believe that Congressmen Oxley and Baker have, in fact, written to the SEC a letter indicating that they believe wholeheartedly that the SEC does have the authority to adopt our recommendations.

On the other hand, Senator Sarbanes is probably on the other side on that question.

Mr. BARTLETT. Yes, so often what you see depends on where you sit, doesn't it?

Mr. WANDER. Yes.

Mr. BARTLETT. These two people are kind of the extremes of the political spectrum, and they are looking at the same law and come to different conclusions.

But, it's my understanding that Chairman Cox would be responsible for implementation of this.

Mr. WANDER. He, together with the rest of the Commissioners, yes, sir.

Mr. BARTLETT. Is it your understanding that this has come to his attention?

Mr. WANDER. Oh, yes, he has commended our report, and said that it would be studied quite thoroughly, which I'm sure it will. The SEC is a very responsible agency.

We, as someone just said, hope that they do it on a rapid pace, and that they do adopt most of our recommendations, if not all of them, but we will see how that pans out. It's only been a week since they've gotten the report, although I think they knew it was coming and what the recommendations have been for probably two to three months.

Mr. BARTLETT. These regulations were promulgated before Chairman Cox took over?

Mr. WANDER. Yes.

Mr. BARTLETT. So, this is not his child?

Mr. WANDER. That's correct.

Mr. BARTLETT. Okay.

I want to ask my Ranking Member if she has any additional questions or comments?

Ms. VELµZQUEZ. No, I don't.

Thank you, Mr. Chairman.

Mr. BARTLETT. Okay.

Well, I want to thank you all very much for the contribution that you've made. We will wait a reasonable time to see if SEC responds responsively. If they do not, why I suspect that they will be sitting in your chairs telling us why they have not.

I know Chris Cox very well. He's a genuinely thoughtful good guy, and if he doesn't respond promptly it will be because there's just a lot of other things on his plate which have kind of pushed this aside. We'll make sure that that doesn't happen for very long.

You are in a better position to judge than we as to how soon they ought to have responded to this. We would like your commitment to get back to us when you think they should have responded and they have not, and then we will follow through on it.

I want to thank you all very much for your testimony, and our Committee is adjourned.

[Whereupon, at 4:13 p.m., the Committee was adjourned.]

House Committee on Small Business
Hearing— *Sarbanes Oxley Section 404: What is the Proper Balance Between Investor Protection and Capital Formation for Smaller Public Companies?*
May 3, 2006, 2 PM

Opening Statement of Chairman Manzullo

The hearing today will analyze the impact of SOX on our nation's smaller public companies. In particular, this hearing will focus on section 404 of SOX, which is causing the most headaches and expense for our nation's smaller companies.

In 2002, Congress passed with my support the Sarbanes Oxley Act or SOX. This legislation was a response to corporate scandals at large companies, such as Enron and WorldCom, but the changes made by SOX applied equally to all public companies, regardless of size. One of these changes was to perform annual testing of internal controls under SOX section 404. These tests require a company's management to evaluate whether internal controls are adequate and require an independent auditor to sign off on management's assessment.

Shortly after SOX passed, the SEC estimated in regulations that compliance with section 404 would cost companies around $90,000 annually. However, the expected costs and reality did not match up. Reality is that public companies are paying well in excess of $1 million annually to comply with this mandate.

To its credit, the SEC recognizes that strict compliance with section 404 may not be beneficial for smaller public companies. That is why the SEC has delayed implementation of this provision for companies with market values under $75 million until July 2007. In addition, in March 2005, the SEC convened the Advisory Committee to Smaller Public Companies to analyze the effects of this and other SOX provisions on small companies. This panel was also tasked with making recommendations to the SEC on what should be done to help our smaller public company cope with the burdens of SOX.

The Advisory Committee released its final report last week. In the report, the Committee recommends that companies with market values of less than $128 million be exempt from section 404 unless and until appropriate auditing standards are established for these companies.

While SOX technically applies only to public companies, private companies have plenty of reasons to be nervous. Their ability to gain access to public markets now turns on whether they can stomach the huge costs of section 404. As the witnesses will discuss today, many are just rejecting the public markets and staying private.

Clearly, SOX serves an important purpose. However, this legislation must not be allowed to overly burden our smaller companies. Today, we will hear testimony on the compliance burdens SOX section 404 has created for our smaller public companies and explore whether the recommendations of the SEC Advisory Committee will fix these problems.

I look forward to hearing the testimony today. I now yield to the ranking minority Member, Rep. Velázquez of New York, for her opening comments.

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
108th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
of the
Honorable Nydia M. Velázquez
House Committee on Small Business
Hearing on "Sarbanes-Oxley Section 404: What is the Proper Balance between Investor Protection and Capital Formation for Small Public Companies"
May 3, 2006

Thank you, Mr. Chairman. This hearing to review the recommendations of the SEC's Advisory Committee has been a long time in coming.

Small businesses continue to face barriers that hinder their ability to remain competitive and strong. The skyrocketing costs of health insurance and start-up capital pose many challenges for entrepreneurs – but soaring regulatory and compliance burdens have consistently been one of their number one concerns.

Almost every single small business owner and association that has testified before this Committee has put reducing the regulatory burden at the top of their list for legislative change. That is no different with the Sarbanes-Oxley Act – as Democrats on the Committee have been hearing from small business owners for nearly two years now. Unfortunately, the situation does not seem to be getting any better.

The Sarbanes-Oxley Act was intended to strengthen the corporate governance practices of the business community. But, what we have heard is that this comes with a cost – and a particularly steep cost at that. The auditing standards, disclosure requirements, and corporate governance rules of the Act have added significantly to the operating costs of small companies – many who have gotten stuck in the fray.

Democratic Members of the Committee held a roundtable back in October, so that we could hear directly from the small business community on the impact of these reforms. A number of small firms we spoke with agree that it is difficult not to support the intentions of Sarbanes-Oxley – most notably, strong corporate governance and shareholder accountability. Yet for the 14,000 publicly traded companies – the majority of which are smaller firms – Section 404 of the Act poses a great burden to their future economic vitality.

Numerous studies and surveys point to the staggering compliance costs of Section 404 as a major burden on small companies. In June 2003, the SEC estimated the cost of implementing Section 404 on all registrants at approximately $1.24 billion – or $91,000 per registrant.

Yet time has told that the SEC vastly underestimated its calculations. Recent surveys show that small companies are paying an average of nearly $1 million to comply with Section 404 – and this is simply unacceptable.

Even though some studies show these costs have declined, they are still significant and are bearing a disproportionate burden on small firms. The compliance cost of Section 404 for small companies is approaching 3 percent of revenue – while it is less than one-tenth of one percent for larger companies.

Adding to concern is new evidence showing numerous small companies, suffering under the weight of costly regulations, have begun to look abroad to go public. There are currently 37 U.S. companies listed on the AIM run by the London Stock Exchange – 19 companies alone that have been listed within the past year.

These so-called "Sarbanes-Oxley Free Zones" have freed some small firms from the strict capital market regulations seen here in the U.S. Both Sarbanes-Oxley and Section 404 have been cited as primary drivers in this development – which are in turn hurting the American economy.

Clearly, there is no end in sight to the burden that so many of our nation's small firms are forced to face. My Democratic colleagues and I have cited many of these concerns in two recent comment letters to the SEC.

I am pleased though with the work the SEC Advisory Committee has done toward finding a solution that truly eases the burden and provides relief for small companies. With the recent release of the Committee's recommendations, I am hopeful these will become the basis for a real regulatory reform proposal.

I know that much uncertainty surrounds the SEC's review and consideration of the Advisory Committee's recommendations. However this situation is resolved, I urge the SEC to address the issue straight on – and provide smaller companies with definitive relief from Section 404 sooner rather than later.

I look forward to the testimony of the witnesses today.

Congress of the United States

House of Representatives

109th Congress

Committee on Small Business

Hearings of the Committee on Small Business
To Explore the Impact of Section 404 of
Sarbanes-Oxley on our Nation's Small Public Companies

May 3, 2006

Written Statement of

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WRITTEN STATEMENT
OF
HERBERT S. WANDER

This Written Statement consists of:

- A brief history and overview of the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies.
- The Separate Statement of the Advisory Committee Co-Chairs, James C. Thyen and Herbert S. Wander; I shall concentrate my oral testimony on the portion of the Separate Statement dealing with internal controls over financial reporting (pages 7-10).
- Appendix A contains the Table of Contents of the final Report of the Advisory Committee and a list of Committee members, Official Observers and Staff.[1]
- Appendix B contains a list of all of the Recommendations of the Advisory Committee (which appears as Appendix D to the Advisory Committee's final Report).

* * * *

A BRIEF HISTORY AND OVERVIEW
OF
THE ADVISORY COMMITTEE'S ACTIVITIES

- Established December 2004 by then Chairman Donaldson.
- A diverse committee consisting of 21 members and three Official Observers were named in March 2005.
- The mission of the Advisory Committee was to advise the SEC on how best to assure that the costs of regulation for smaller companies under the Sarbanes-Oxley Act and other securities laws are commensurate with the benefits.

Overarching Principles of the Advisory Committee

- Further Commission's investor protection mandate.
- Seek cost choice/benefit inputs.

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[1] The Advisory Committee's final Report can be found at the following link: http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

- Keep it simple.
- Maintain culture of entrepreneurship.
- Capital formation should be encouraged.

Information Gathering Phase

- Published Agenda in April 2004 and requested and received comments.
- Published Master Schedule in April 2004.
- Held Hearings in:
    - New York city (June and October 2005)
    - Chicago (August 2005)
    - San Francisco (September 2005)
- Received approximately 270 responses to 29 questions published in August 2005.
- Received over 200 comments on February 28, 2006 near final exposure draft.

Interim Recommendations – August 2005

- Delay implementation of Section 404 for non-accelerated filers [SEC adopted].
- Delay acceleration of Filing Dates for Annual and Quarterly Reports for Smaller Public Companies [SEC Adopted].
- Adopted a working definition of Smaller Public Companies.

Definition of Smaller Public Company – Size Criteria

After considerable study, the Advisory Committee adopted a definition for defining a smaller public company. The following six determinants were used 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.

The Advisory Committee then concluded that public companies ranking in the bottom 6% of total U.S. public market capitalization, as defined by the SEC, when the capitalization of all public companies is combined, would qualify as a smaller public company. Companies ranking in the bottom 1% of total U.S. public market capitalization would qualify as a microcap.

The following table presents information on how the Advisory Committee's definition for proportional securities regulation will operate. It is not intended to present direct information on the number or percentage of companies that would be affected by the Advisory Committee's second and third primary recommendations, which relate to Section 404 of the Sarbanes-Oxley Act. Information on the impact of those recommendations is presented in Table 2 below.

Table 1: Recommendation on Scaled or Proportional Regulation for Smaller Public Companies

	Market Capitalization Cutoff	Percentage of Total U.S. Equity Market Capitalization	Percentage of All U.S. Public Companies
Microcap Companies	<$128.2 million	1%	52.6%
Smallcap Companies	$128.2-$787.1 million	5%	25.9%
Smaller Public Companies	<$787.1 million	6%	78.5%
Larger Public Companies	>$787.1 million	94%	21.5%

Source: SEC Office of Economic Analysis, Background Statistics: Market Capitalization and Revenue of Public Companies, Table 2 (Apr. 6, 2006) (included as Appendix E to the final Report). The universe of publicly traded companies and their governance is explained in Appendix F to the final Report.

Final Recommendations

- In response to the approximately 200 written comments to the Advisory Committee's exposure draft published on February 28, 2006, the Advisory Committee met on April 11, 2006 to discuss the comments and make changes to the final Report.

- The full Committee met on April 20, 2006 and unanimously approved the Report.[2]

[2] As noted in the Report, three members dissented from three of the Recommendations concerning internal controls over financial reporting and one member abstained on the Recommendation dealing with defining smaller public companies.

Advisory Committee Recommendations Concerning Internal Controls Over Financial Reports

The Advisory Committee's primary Recommendations dealing with internal controls over financial reporting are set forth below:[3]

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 small cap companies with less than $10 million in annual product revenue, that have or add corporate governance controls that include:

- Adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Exchange Act; and
- Adoption of a code of ethics within the meaning of Item 406 of Regulation S-K applicable to all directors, officers and employees and disclosure of the code in connection with the company's obligations under Item 406(c) relating to the disclosure of the code of ethics.

In addition, as part of this recommendation, we recommend that the Commission confirm, and if necessary clarify, the application to all microcap companies, and in deed to all smallcap companies also, of the existing general legal requirements regarding internal controls, including the requirement that companies maintain a system of effective internal control over financial reporting, disclose modifications to internal control over financial reporting and their material consequences, apply CEO and CFO certifications to such disclosures and have their management report on any known material weaknesses.

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 more than $10 million in annual product revenue; and
- Microcap companies with between $125 and $250 million in annual revenues.

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[3] Primary Recommendations are identified with a "P" and Secondary Recommendations are identified with an "S". The Roman numeral identification refers to the chapter in the final Report where the Recommendation is found.

Recommendation III.P.3:

While we believe that the current 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 Recommendation III.P.2 above, we also believe that if the Commission reaches a public policy conclusion that an audit 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.

Under Recommendations III.P.1 and III.P.2, approximately 95%, or $16,046 billion, of the total U.S. equity market capitalization of $16,891 billion, would remain fully subject to Section 404. Companies accounting for the remaining 5%, or $845 billion, would be eligible for relief unless and until an appropriate framework for assessing internal control over financial reporting for such companies has been developed. In addition, the following table presents information on the number and percentage of public companies eligible for relief under these two recommendations:

Table 2: Public Companies Eligible for Relief Under Recommendations III.P.1 and III.P.2 Unless and Until Appropriate Framework is Developed

	1	2	3	4	5
	Number of Companies in Category	**Category as Percentage of Public Companies**	**Percentage of Public Companies Eligible for Recommendation III.P.1 Relief**	**Percentage of Public Companies Eligible for Recommendation III.P.2 Relief**	**Percentage of Public Companies Eligible for Recommendations III.P.1 & III.P.2 Relief (Col. 3 + Col. 4)**
Microcap Companies	4,958	52.6%	49.6%	1.6%	51.2%
Smallcap Companies	2,444	25.9%	6.7%	12.2%	18.9%
Smaller Public Companies	7,402	78.5%	56.3%	13.8%	70.1%
Larger Public Companies	2,026	21.5%	0.0%	0.0%	0.0%
All Public Companies	9,428	100.0%	56.3%	13.8%	70.1%

Source: SEC Office of Economic Analysis, Background Statistics: Market Capitalization & Revenue of Public Companies, Tables 1, 2, 27 (Apr. 6, 2006) (included as Appendix E).

SEPARATE STATEMENT OF COMMITTEE CO-CHAIRS, JAMES C. THYEN AND HERBERT S. WANDER

We are publishing this Separate Statement for a number of reasons:

- to thank our committed Committee Members and Official Observers and the SEC staff;
- to provide an overview of how we reached our conclusions and recommendations, now that our Final Report is completed; and
- to identify a number of issues that we believe the Commission should pursue based on our overall analysis of the information presented to the Committee but which the Committee had neither the time nor resources to pursue.

A Million Thanks

We could not have published this Final Report and recommendations without the dedicated, loyal and expert advice and active participation of the members of our Advisory Committee as well as the Official Observers. Everyone performed to our highest expectations and the final product is a reflection of the collective efforts of everyone. We are very proud of our work accomplishments being on time and under budget. The second thank you is to Gerry Laporte and his staff (Anthony Barone, Mark Green, Will Hines and Kevin O'Neill). Their outstanding guidance and performance is in large measure the reason we were able to produce this Final Report and recommendations. They were careful in providing support and direction, but left to the Committee the final decisions. They worked under stress and severe time demands and throughout the entire process were true professionals. Finally, we wish to thank former Chairman Donaldson and current Chairman Cox, all the SEC Commissioners, and Alan Beller and John White for their foresight in establishing and supporting the work of the Advisory Committee. We all truly appreciate the honor of being named to the Advisory Committee and trust that our Final Report and recommendations live up to the expectations of the Chairmen and Commissioners.

Overview

We believe the Advisory Committee has accomplished two major objectives. We believe we have done so while maintaining a keen focus on the mission assigned and strong adherence to the overarching principles included in our charter. First, we have validated the effectiveness of most of the provisions of the Sarbanes-Oxley Act. This conclusion has not generally been recognized, but we believe it is both a positive and important statement. Although costly, the bulk of the provisions of the Sarbanes-Oxley Act appear to be working and, at least, the smaller and mid-cap companies that responded to our many inquiries, believe in large measure that they can live with most of the Sarbanes-Oxley provisions and that these provisions provide a path to better corporate governance, disclosure and transparency and will help to avoid (but not eliminate entirely) the scandals that precipitated the adoption of the Sarbanes-Oxley Act. The

second major accomplishment is that we have studied carefully the application of internal control over financial reporting to smaller public companies and have exposed what we believe are universally acknowledged defects that need correction. We found that the participants in the 404 environment have either consciously or unconsciously avoided scaling the internal control provisions for smaller public companies.

Beyond these two major accomplishments, we uncovered a number of overarching ideas that we were unable to comprehensively study because of time and resource constraints, but which we believe the Commission should place on its agenda. These include:

- the growing necessity to examine the litigation climate in the United States
- complexity of existing rules
- the effects of globalization on our markets and our issuers
- the absence of any real field or beta testing before rules are declared effective

Internal Control Over Financial Reporting

Our Advisory Committee has carefully studied the 404 issue and has sought and listened to the views of the major participants over a sustained period of time. We believe our recommendations in Part III of our Final Report are both responsible and will provide the relief needed without destroying the benefits of internal controls. We categorically state that when we initiated our analysis of the effects of Section 404, we had no preconceived notions of what our conclusions or recommendations would be. Indeed, we believe that our Section 404 Subcommittee and the Committee were literally driven to our recommendations because the major players insisted that the alternatives we explored would not work or be acceptable.

We emphasize the following points, each of which we believe is critical:

- Our intent is to fix 404, not repeal it, so that it is both effective and efficient.
- Our recommendations are carefully crafted; they state:

  "Unless and until a framework for assessing internal control over financial reporting for [smaller public companies] is developed that recognizes their characteristics and needs ..."

  As expressly stated, our goal is to have a framework that works before smaller public companies are forced to undergo a process that almost everyone recognizes needs a major overhaul.
- The critics of our recommendations do not really dispute that 404 needs fixing; instead they argue that other solutions are better. Hence, we firmly believe that

future debates should concentrate on how to fix 404 and not whether it needs fixing.[4]

- We believe that the central spotlight should be on the market capitalization of the smaller public companies, namely, approximately 5% of total U.S. equity market capitalization, rather than on the number of companies affected.

- Smaller public companies compete on skill. By definition they do not have the leverage of scale. Fundamental to this reality is that different challenges exist in the attestation of internal controls than those in larger public companies. While this is generally acknowledged, no one wants to address this reality.

- Overall, we believe that AS2 should be revised. Both the PCAOB and the SEC have provided helpful guidance, but based on our extensive study, it is absolutely clear to us that this guidance is not being followed in the field. The rule is the rule is the rule — if the rule isn't right, it should be fixed.

- The PCAOB's inspection process as presently constituted is a root cause of the 404 issue because it destroys the use of judgment by accounting professionals. We believe greater care and oversight is needed to ensure that alignment of authority, responsibility and accountability is achieved, for the best interest of investors. We believe application of greater transparency and disclosure principles will aid in improvement.

- We do not believe, moreover, that time will cure these ills. First, history has not supported the view that additional time will both make 404 more effective and bring down costs significantly. Second, the health of our smaller public companies demands that they not be subject to a regime that nearly everyone agrees needs to be overhauled.

- We believe that advocates for internal control have overstated their case. We fully agree that internal controls are important and should be implemented despite the numerous comments we received (primarily from issuers) that 404 provides little or no benefits. But no one should expect that internal controls will eliminate all

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[4] Our critics generally recognize that our economy needs healthy and growing smaller public companies for, among other reasons, job growth and innovation. They also agree that AS2/404 needs fixing and has exceeded by multiples everyone's original cost expectations. The latest example of this is former SEC Chairman Harvey Pitt's commentary in the April 13, 2006 Wall Street Journal "The statute [Sarbanes-Oxley] was hastily — and, therefore, badly — drafted; but it was, and remains, necessary.... The most significant problem with SOX is its `one-size-fits-all' approach to regulation. Those who complain about the disproportionately high costs on small- and mid-cap companies are correct." A careful reading of the three Separate Statements by Messrs. Jensen, Schacht and Veihmeyer, furthermore, shows they agree that improvements in the application of Section 404 are necessary; they differ with the majority on how to accomplish this.

errors or fraud in financial statements. For example, some have advocated that Section 404 has had a positive effect because it precipitated last year's substantial increase in restatements. To us, the evidence does not warrant this conclusion. There are a number of potential other reasons for the substantial increase in restatements, among them, the present complexity of our accounting standards and the definition of materiality. Moreover, no one has explained why so many of the issuers who received effective 404 attestations for 2004 have had to withdraw them.

- We wish to stress that our recommendations for microcap companies and smallcap companies should be analyzed separately. We believe we have made a strong case for our recommendations concerning microcap companies.[5] They are different and less complex and many experts without any real contradiction have informed us that it is the substantive audit in these situations that in fact uncovers the errors and fraud. Furthermore, as reflected in our Final Report the Commission has a long history of scaling regulation.[6]

- Unfortunately, we have not been able to get a good grasp on what investors generally wish to see with respect to internal control over financial reporting. True, some large public pension funds are strong supporters of internal controls, but most of them admitted that they do not invest in smaller public companies. We did hear from a number of professional money managers and their views were not as supportive of internal controls as were the large public pension funds. They indicated that they analyze many factors in making investment decisions including, of course, whether an issuer has reported material weaknesses in financial reporting. In this regard, some advocates believe that without external auditor attestation of internal controls, smaller public companies will suffer in the marketplace. This is yet to be proven and the opt-in approach we propose that includes active audit committee participation may lead to a sounder solution, at least until there is more definite evidence on this issue.[7]

- We had one investor representative take a position of dissent and that position is explained in his separate statement. Our Committee, while being very diversified in background, experience and representation, also included three other voting and one Official Observer investor representatives. Those four investor representatives expressed strong support for our recommendations. Three voting members cast their vote in affirmation, and the Official Observer representative stated that had he been allowed to vote, he would fully support the recommendations. The three investor representatives are: James A. "Drew" Connolly III, Robert E. Robotti and Ted Schlein, and the Official Observer is Jack Herstein. We believe it is quite telling that one of the nation's major investor

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5 See supra note 97 of the final Report.

6 See supra Part II of the final Report.

7 See supra pages 40-42 of the final Report.

groups, the National Venture Capital Association, whose members invest billions of dollars in American companies, strongly supports our recommendations.

- The SEC should act promptly on our primary recommendations so that issuers and the marketplace know where we are going. Indecision is harmful.

Litigation

At each step in the Committee's analysis on almost all the issues we examined, we were all struck by the problems caused by the threat of litigation that in many instances prevents the application of judgment by professional service providers to issuers.[8] Moreover the problem is exacerbated because of the enormous stakes that could be involved under the present litigation system. We confidently believe that responsible public policy experts should investigate this issue to determine whether our system is working effectively or could be improved. We are not advocating a political slogan campaign to stamp out frivolous litigation. On the contrary, we believe that the litigation serves many useful purposes in our economic climate, environment and culture. Nevertheless, a number of responsible parties have begun advocating that the litigation issued should be carefully studied on a non-emotional basis. Our Recommendation V.P.I, dealing with the creation of a safe-harbor for accounting judgments, is a first small step in this direction. We believe the comments we received on this recommendation were very thoughtful and could form the basis for future study and possible implementation. The increasingly risk averse environment and cost burden is unduly harmful to U.S. public market competitiveness.

Keep It Simple

This has been one of the mantras of the Advisory Committee. We strongly recommend that this precept be followed in both the statutory and rulemaking process. We know that this is difficult to effectuate because we ourselves in determining our recommendations found that too frequently we were trying to cure everyone's problem. We are not alone in this advocacy as many thoughtful commentators are pushing for more principles-based statutes and rules. Perhaps the model to follow is the Supreme Court's certiorari process. The Court hears only those cases of major importance and lets stand many lower court decisions that are wrong or create some form of injustice. At the end of the day, we should recognize that we cannot fix every problem. This is especially true in light of the growing global economy where we are subject to competitive forces over which we have little or no control.

Global Competitiveness

Complexity adds cost burden and reduces flexibility and agility. Consumers do not care about cost burden added for the U.S. public market venue. Consumers care about value received. Consumers have many choices. The cost burden tolerated by consumers is a function of the specific vertical market (customer value chain) cost structure, not solely the capital market.

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[8] We believe that service providers and advisors to issuers clamor for precise and detailed rules to avoid being second guessed. The difficulty is that such precise rules create the complexities that are in themselves a cause of many of the deficiencies in our disclosure and financial reporting system.

Investor equity (wealth/value) is created by a positive customer/consumer experience over time. Forced complexity means greater opportunity for error. It lessens innovation, creativity and desire to accept risk. These are the characteristics upon which a smaller public company must compete to be effective against other lower cost venues. We believe the current path of increasing complexity and forced cost choices is decreasing the precise ability that U.S. public companies need to survive and grow. A decision of no change is a decision, telling many small public companies to choose other alternatives for sourcing of capital.

The Rulemaking Process in General

We are pleased that many of the comments we received have urged a field testing process for new rules, regulations and accounting pronouncements. This is long overdue and we fully support this proposition. Again, our rules and regulations should be both effective and efficient. The connectivity and speed with which the economies of the world function today mandate this care in implementation. Like a finely tuned race car, companies competing in our U.S. capital markets cannot remain effective in performance and profitable in results if the balance of the car is rapidly upset. We all know and recognize that the "irrational exuberance" of the 1980s and 1990s, like "stomping on the accelerator," set the stage for the integrity crises and the harm that followed. We must also recognize that the process by which we implemented Section 404 was not unlike "stomping on the brakes" and also greatly upset the balance in many companies. In both cases, the investors ultimately pay the cost.

Appendix A to
Written Statement

Final Report
of the
Advisory Committee on Smaller Public Companies
to the
U.S. Securities and Exchange Commission

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Partner, Katten Muchin Rosenman LLP
(*Ex Officio* Member of All Subcommittees and Size Task Force)

James C. Thyen, Co-Chair
President and CEO, Kimball International, Inc.
(*Ex Officio* Member of All Subcommittees, Chairperson of Size Task Force)

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Appendix B to
Written Statement

Appendix D

Committee Recommendations by Category

SCALING SECURITIES REGULATION FOR SMALLER COMPANIES

Primary Recommendation

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.

Develop specific scaled or proportional regulation for companies under the system if they qualify as "microcap companies" because their equity market capitalization places them in the lowest 1% of total U.S. equity market capitalization or as "smallcap companies" because their equity market capitalization places them in the next lowest 1% to 5% of total U.S. equity market capitalization, with the result that all companies comprising the lowest 6% would be considered for scaled or proportional regulation.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Primary Recommendations

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 add corporate governance controls that include:

- adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Exchange Act; and
- adoption of a code of ethics within the meaning of Item 406 of Regulation S-K applicable to all directors, officers and employees and disclosure of the code in

connection with the company's obligations under Item 406(c) relating to the disclosure of the code of ethics.

In addition, as part of this recommendation, we recommend that the Commission confirm, and if necessary clarify, the application to all microcap companies, and indeed to all smallcap companies also, of the existing general legal requirements regarding internal controls, including the requirement that companies maintain a system of effective internal control over financial reporting, disclose modifications to internal control over financial reporting and their material consequences, apply CEO and CFO certifications to such disclosures and have their management report on any known material weaknesses.

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 more than $10 million in annual product revenue; and
- Microcap companies with between $125 and $250 million in annual revenue.

Recommendation III.P.3:

While we believe that the current 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 Recommendation III.P.2 above, we also believe that if the Commission reaches a public policy conclusion that an audit 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.

Secondary Recommendations

Recommendation III.S.1:

Provide, and request that COSO and the PCAOB provide, additional guidance to help facilitate the assessment and design of internal controls and make processes related to internal controls more cost-effective; also, assess if and when it would be advisable to reevaluate and consider amending AS2.

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.

CAPITAL FORMATION, CORPORATE GOVERNANCE AND DISCLOSURE

Primary Recommendations

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.

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.

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.

Recommendation IV.P.4:

Adopt policies that encourage and promote the dissemination of research on smaller public companies.

Recommendation IV.P.5:

Adopt a new private offering exemption from the registration requirements of the Securities Act that does not prohibit general solicitation and advertising for transactions with purchasers who do not need all the protections of the Securities Act's registration requirements. Additionally, relax prohibitions against general solicitation and advertising found in Rule 502(c) under the Securities Act to parallel the "test the waters" model of Rule 254 under that Act.

Recommendation IV.P.6:

Spearhead a multi-agency effort to create a streamlined NASD registration process for finders, M&A advisors and institutional private placement practitioners.

Secondary Recommendations

Recommendation IV.S.1:

Amend SEC Rule 12g5-1 to interpret "held of record" in Exchange Act Sections 12(g) and 15(d) to mean held by actual beneficial holders.

Recommendation IV.S.2:

Make public information filed under Rule 15c2-11.

Recommendation IV.S.3:

Form a task force, consisting of officials from the SEC and appropriate federal bank regulatory agencies to discuss ways to reduce inefficiencies associated with SEC and other governmental filings, including synchronizing filing requirements involving substantially similar information, such as financial statements, and studying the feasibility of extending incorporation by reference privileges to other governmental filings containing substantially equivalent information.

Recommendation IV.S.4:

Allow companies to compensate market-makers for work performed in connection with the filing of a Form 211, with full disclosure of such compensation arrangements.

Recommendation IV.S.5:

Evaluate upgrades or technological alternatives to the EDGAR system so that smaller public companies can make their required SEC filings without the need for third party intervention and associated costs.

Recommendation IV.S.6:

Make it easier for microcap companies to exit the Exchange Act reporting system.

Recommendation IV.S.7:

Increase the disclosure threshold of Securities Act Rule 701(e) from $5 million to $20 million.

Recommendation IV.S.8

Extend the "access equals delivery" model to a broader range of SEC filings.

Recommendation IV.S.9

Shorten the integration safe harbor from six months to 30 days.

Recommendation IV.S.10:

Clarify the Sarbanes-Oxley Act Section 402 loan prohibition.

Recommendation IV.S.11:

Increase uniformity and cooperation between federal and state regulatory systems by defining the term "qualified purchaser" in the Securities Act and making the NASDAQ Capital Market and OTCBB stocks "covered securities" under NSMIA.

Recommendation IV.S.12:

Clarify the interpretation of or amend the language of the Rule 152 integration safe harbor to permit a registered initial public offering to commence immediately after the completion of an otherwise valid private offering the stated purpose of which was to raise capital with which to fund the IPO process.

Recommendation IV.S.13

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.

ACCOUNTING STANDARDS

Primary Recommendations

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.

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.

Recommendation V.P.3:

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

Recommendation V.P.4:

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

Secondary Recommendations

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.

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.

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.

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.

Statement of
Mr. William Broderick
Chief Financial Officer, Analytical Graphics, Inc. (AGI)
And Board Member of the Small Business Technology Coalition

Before the House Committee on Small Business

Regarding SEC Advisory Committee Report on Smaller Public Companies

May 3, 2006

Chairman Manzullo, Congresswoman Velázquez, and Members of the Committee, I am Bill Broderick, Chief Financial Officer of Analytical Graphics, Inc. (AGI), a 250-employee software company serving the national security and space industry. I also serve as a board member of the Small Business Technology Coalition (SBTC).

First, I would like to thank the Chairman and members of the Committee for the opportunity to testify. I hope to provide some insight into the impact of Sarbanes-Oxley Act (SOX) on small business and some thoughts on the recommendations of the Securities Exchange Commission (SEC) Advisory Committee with respect to full and partial exemptions from implementation of Section 404 for smaller public companies. Even though AGI is a privately-held company, we have been significantly impacted by the unintended consequences of SOX, as explained in the Final Report of the Advisory Committee on Smaller Public Companies. In an effort to strike a balance between the cost of internal controls for small companies and that of proper investor protection, we at AGI commend this Committee for examining these issues of great importance to small business growth, productivity, and innovation.

Company Background

AGI produces commercial-off-the-shelf (COTS) software for analysis and visualization of land, sea, air, and space assets. The company was founded in 1989 by three former GE Aerospace employees who saw a need for commercialization of space applications that did not exist at the time. Over the past 17 years, AGI has grown to a 250-person company with approximately 190 shareholders consisting of founders, board of directors, employees and outside private investors. AGI has been named the best small company to work for in America for 2004 and 2005 by the Great Place to Work® Institute and Society for Human

Resource Management. Over our history, we have been able to assemble a dedicated and talented team of employees to support a unique and innovative product line with twelve issued patents to our credit.

Through our team of more than 140 engineers and scientists, we have developed more than three million lines of commercially available code, providing national security and space organizations with unparalleled, cost-effective capabilities that can be rapidly deployed. We are proud that the national security community relies on the fidelity of our software to serve in many critical areas such as military efforts in Afghanistan, Korea and Iraq and in the Pentagon for top-level reviews and daily status briefings.

Disproportionate Impact on Smaller Public Companies

We at AGI fully concur that regulatory reforms were needed in the wake of the financial collapses and malfeasance at Enron, Worldcom, Tyco, Adelphi, and other companies. However, the rush to enact sweeping reform occurred without a basic cost-benefit analysis to assess the impact on smaller public companies. Initially, a June 2003 SEC report estimated that the average annual internal cost to comply with Section 404 over the first three years would be $91,000 and would be proportional to the size of the company. However, actual costs documented by the Advisory Committee on Smaller Public Companies proved the initial estimate to be grossly understated.

Contained in the April 2006 Final Report of the Advisory Committee on Smaller Public Companies, a recent study commissioned by the Big Four accounting firms indicated that the second year average costs to comply with Section 404 are approximately $900,000 for companies with market capitalizations between $75 million and $700 million. The report graphically depicts the dramatic lack of proportionality of Section 404 compliance costs borne by smaller public companies as a percentage of revenues, showing they are 16 times greater for a small company with a market capitalization of $100 million or less as compared to a larger company with a market capitalization in the range of $1.0 billion to $4.9 billion.

Given the on-going costs of compliance with Section 404, the valuations of smaller public companies are dramatically impacted as well. Using the $900,000 cost figure above and

applying a tax rate of 40%, the average after-tax cost of compliance is approximately $540,000 for a company with a market capitalization between $75 million and $700 million. Applying a reasonable average price-to-earnings multiple of 15 times results in a permanent valuation loss of approximately $8.1 million or 8.1% for a company with a $100 million market capitalization. Further extending this calculation across all smaller public companies as defined in the Advisory Committee's report (small companies with market capitalizations less than $787.1 million, a total of 7,402 companies); **approximately $60 billion in total equity valuation loss would be incurred on a permanent basis.** In addition, the above figures do not include the lost productivity of management and other personnel related to core business activities, which we believe would at least double the $900,000 cost figure. Accordingly, under the current regulatory environment, Section 404 compliance for small companies has the effect of being "penny wise but pound foolish." Because the regulations lack reasonable cost-benefit analysis and professional judgment, investors are significantly harmed from a shareholder value perspective, rather than protected.

Due to the discrepancy between the initial SOX cost estimates versus the actual costs, it is now necessary to call into question the Section 404 regulations to ensure that regulatory costs are properly scaled for smaller public companies.

Impact of the Sarbanes-Oxley Act

In 1995, AGI was able to secure a $2.5 million venture capital investment when the company had approximately 30 employees with $2.5 million in annual revenue. After eight years, when the company had grown profitably to approximately $38 million in annual revenue and 175 employees, our venture investor was seeking liquidity of their 1995 investment. Given the venture investor's need to maximize their investment, they requested we review going public.

After careful analysis by executive management, the board of directors, and other advisors, we quickly eliminated the option of going public primarily from the significant burdens associated with SOX compliance, which would not only include the reduction of our profitability due to the cost of SOX, but also the diversion of senior management time away from core business activities. The costs and risks of being a small public company

far outweighed the benefits of accessing the public capital markets for financing and ultimately would put shareholder value at far greater risk. We also concluded that a public offering was not a viable financing alternative for the foreseeable future until the company reached a certain level of revenue and estimated public company market capitalization (enough critical mass) to absorb the costs of SOX.

The venture investor unfavorably regarded our decision and they still required liquidity of their investment. After reviewing other alternatives such as an acquisition and private equity financing, we determined neither were in the best interest of our shareholders. Therefore, we raised $15 million in bank debt and used $13 million of our own cash to liquidate our venture investor's entire holdings in January of 2005. Accordingly, the resultant effects of AGI's inability to effectively access the public capital markets are as follows:

- Given our cash constraints as a result of liquidating our venture investor, the ability to undertake advanced research and development efforts to deliver unique capabilities for national security needs has become increasingly difficult. The aerospace, defense, and intelligence industry we serve requires our company to be extremely innovative in order to compete in a marketplace dominated by large prime contractors. Being able to provide cost-effective and superior capabilities for this community is of vital importance not only from the perspective of staying competitive but also to keep our nation's defense far ahead of our adversaries technologically.

- The $13 million in internal cash resources used to liquidate the venture investor's holdings and the cash flow required to service our debt has limited our ability for additional investment in other critical areas of the business beyond research and development. We have forgone growth opportunities and investments in business development, marketing, and sales to the detriment of long-term sustainability.

- With limited cash reserves, the company has been forced to operate much more conservatively, which is not only at odds with our need to stay on the cutting-edge of innovation, but also puts the company at risk for spreading existing resources too thin. Our inability to scale up our infrastructure, which includes financial systems, internal controls, and IT, puts a strain on existing business operations.

AGI Recommendations

The current "one-size-fits-all" approach of SOX and the disproportionate impact of Section 404 clearly put small businesses, like AGI, at a disadvantage. First, AGI confirms the necessity to tailor regulations to fit the requirements of smaller companies, based on the recommendations made in the Final Report of the Advisory Committee on Smaller Public Companies. AGI strongly supports the Advisory Committee's primary recommendations, especially the establishment of "a new system of scaled or proportional securities regulation for smaller public companies."

Second, AGI advocates executive-level training to create awareness of the importance of effective internal controls, which are optimally implemented from the top down. Executives and senior management must have the proper "tone at the top" for acceptance of applicable internal controls throughout the organization. This refers to all internal controls, whether mandated by SOX or otherwise under existing regulations and standards, as well as those that are inherent to the execution of fiduciary duties to shareholders.

Third, in reference to Advisory Committee Recommendation III.P.1, AGI recommends that not only the CEO and CFO provide certifications for internal controls, but also the Chief Operating Officer (COO) or equivalent operations executive should provide the same certification.

At AGI, we are thankful that progress is being made to resolve the problems smaller companies face in regards to SOX and especially Section 404. We applaud the SEC for establishing the Advisory Committee to examine these matters; and commend the Advisory Committee on their diligent, comprehensive efforts. Their analysis of the impact of SOX regulations on the smaller business community, along with their 33 recommendations included in their Final Report to the SEC, provide a framework to establish common-sense, proportional regulations under a cost-benefit structure.

We are grateful to this Committee for holding this hearing on topics vital to the health of small business, and for the opportunity to testify. We are also available, at your convenience, to discuss in greater detail any of the above material discussed in this testimony. I welcome your questions. Thank you.

Hearing of the House Small Business Committee

on

Sarbanes Oxley 404 Relief

Thursday, May 4, 2006

Written Testimony of Keith Crandell

Managing Director, ARCH Venture Partners

Mr. Chairman and Members of the Committee, good afternoon. I am Keith Crandell, co-founder and managing director of ARCH Venture Partners located in Chicago, Illinois. ARCH is a 20-year-old venture capital firm that invests in emerging growth companies on a national basis. We fund primarily seed and early stage companies in information technology, life sciences and the physical sciences, often from inception until they go public or become acquired. As venture investors, my partners and I also sit on the boards of public and private companies where we have a first hand view of the challenges these small companies face on a daily basis.

I am here today in my capacity as a Board Director for the National Venture Capital Association (NVCA), which represents more than 480 venture capital firms like my own in the United States. As you know, venture capital is the investment of equity to support the creation and development of new, growth-oriented businesses. Venture capital backed companies are critical to the U.S. economy in terms of creating jobs, generating revenue, and fostering innovation. This segment of the economy, the entrepreneurial segment, is the true differentiator for the U.S. in terms of global

competitiveness. U.S. companies originally funded with venture capital now represent 10% of annual GDP and employment, despite accounting for only 2% of invested capital. These organizations include AOL, Intel, Cisco, Home Depot, Google, EBay, Starbucks, FedEx, Archipelago, and Genentech.

I want to speak today on behalf of the Genentechs of tomorrow - our country's small, emerging growth companies, both private and public, which are being stifled by a law that has burdened them in countless, unintended ways. As a venture capitalist that represents investors and shareholders first and foremost, I understand and appreciate the critical importance of financial transparency. But we have gone too far. The Sarbanes-Oxley law, specifically Section 404 (SOX 404), has drained capital and resources from these young enterprises, distracted management from growing businesses, diverted the major members of the accounting profession away from small companies, and threatened the future of the United States based capital markets system for growth businesses. And, in spite of its best intentions, I would argue that the SOX 404 law has done very little to prevent the massive frauds it was designed to detect.

Profitability is crucial on Wall Street and Sarbanes Oxley attacks profitability head on. From a pure financial perspective, the cost of complying with Sox 404 at smaller companies approaches $1 million each year. If one assumes a healthy company can achieve 10% net income, then SOX dictates that such a company would have to garner up to $10 million in additional revenue just to support the cost of compliance. For technology companies, this additional burden has coincided with one of the most severe downturns in demand in recent history – making such a hurdle impossible to clear. By penalizing the bottom line, we are weakening our smaller companies, making them less

attractive to investors and more vulnerable to consolidation acquisitions on unfavorable terms– neither of which serves our economy well.

For those who suggest that the cost of 404 compliance will eventually fall, and even cite studies that demonstrate this, I would argue that without exempting the companies from these provisions, the numbers will not fall *enough* to be remotely meaningful. Case in point, the recent CRA International study, which found that companies with market capitalizations between $75 – 700 million experienced a significant 31% drop in SOX compliance costs last year, still has the average compliance cost at **$860,000**. It is highly unlikely that SOX costs will continue to drop as precipitously in future years – and the cost will remain excessive.

Of perhaps even greater concern is the drain on human resources to achieve SOX 404 compliance. At larger corporations, there is a segregation of duties and entire departments to handle the compliance process. This is not the case at smaller companies where the financial staff usually takes on multiple roles – all critical to the operation of the business. As a result of the added burden of SOX 404, small companies today are being placed in the undesirable position of having to forgo increases in sales and technology headcount to hire additional financial staff. These hires do not foster company growth in any way. Rather they just keep the company's head above water against a tidal wave of ill considered regulation. Even more insidious is the distraction that SOX 404 places on company management which is pulled away from strategic business functions to monitor additive processes and procedures that do not help the bottom line.

To exacerbate the situation, at a time when small companies need their accounting firms more than ever, Section 404 has created an unhealthy motivational shift in the accounting profession as it relates to supply and demand. In response to Sarbanes-Oxley, the Big 4 auditor, I am familiar with have shifted their focus from auditing companies of all sizes to leveraging lucrative 404 practices at large corporations. Thus they are abandoning the smaller companies whose needs are equally as critical. As a case in point, I have served as a board member of a small cap public company that was informed by their Big 4 auditor last year that they were "too busy" with larger clients to complete the smaller company's audit on time. The Big 4 auditor also informed the company that their audit would cost 16% more then the previous year. Effectively, they decided to put their talent to work against the big clients who would pay the most fees. The Big 4 provider suggested that the smaller company release its numbers late, which we all -- including the auditor – know equates to public market suicide. This situation was presented by the auditor to the company just a few months before the audit was scheduled to commence and sent company management scrambling to find a new auditor – which they did, but certainly paid for. Unfortunately, this scenario is playing itself out all around the country.

Although many have suggested that small companies turn to second or third tier accounting firms, this isn't a realistic choice for many venture-backed companies. Already, fewer investment banks are willing to take our companies public. Those that are working with us generally request that the company use a Big 4 firm. It is a credibility issue and the end result is that venture backed firms are held hostage. SOX 404 has

reduced the choice of accountants, and consequently raised fees, as these businesses cannot compete with larger corporations for attention.

From a macroeconomic perspective, SOX 404 has contributed significantly to a clog in the IPO pipeline in the United States. For companies we are familiar with, the cost of the legal and accounting work for the initial public offering process stands at close to $2 million up from $500,000 a few years ago. The costs and regulatory hurdles to go public in the US today are driving venture-backed companies away from our capital markets system to other exits and other markets. In 2005, only 56 VC-backed companies went public on US exchanges. This is a significant shortfall – a healthy IPO market should be at least double this level. With only 10 IPOs in the first quarter of 2006, we are on track for another dismal year.

We are seeing pre-IPO companies now embrace two viable alternatives to going public in the US. First is the preference for the acquisitions route which has grown in the last year. . For many venture backed companies the cost and risk of going public is too high and when faced with a cheaper, less risky alternative, the acquisitions wins. From an economic standpoint, an acquisition is much less conducive to growth as jobs and technologies are almost always absorbed rather than developed. Imagine a world in which Google was acquired by Excite.... or Starbucks was acquired by Krispy Kreme... or eBay was acquired by Amazon. Imagine the jobs, revenues and innovation that would have been lost. The US economy is better served with active, innovative companies that stand alone and create value – not by those that get gobbled up.

The second strategy that is beginning to take hold is companies choosing to go public on foreign markets so as not to be burdened by heavy regulation. In 2005, there

were 195 new listings on US exchanges; there were 519 on the London AIM. In the first quarter of 2006, we saw two of the twelve US venture backed companies that went public choose the London AIM market over the NASDAQ. Eighteen months ago, if you queried a room of venture capitalists about the London AIM, few would have the market on their radar screen. Today, it is a viable and well understood option for every VC-backed company. We are also seeing US investment banks actively marketing these exchanges to US companies. The consequence is a declining use of the U.S. marketplace. This game is still ours to lose – but the threat is very, very real.

While specific provisions of the original Sarbanes Oxley laws have improved certain practices at US companies, including making Boards of Directors more active, accessible and accountable, Section 404 has done little in the way of advancing fraud detection. We have witnessed the information compiled from a 404 audit to be of little or no use to investors. It is unwieldy and out of date and does not reflect the current state of any company operations. In many cases, the information required defies logical comprehension. For example, as part of Section 404 diligence, small companies are required to certify that their vendors are SOX compliant. To have a $20 million dollar annual revenue enterprise spend time and money to certify a multi billion dollar outsource payroll provider such as ADP serves no one's interests.

Further, there has been no evidence that Section 404 has been more effective at uncovering fraud. Such malfeasance is almost always discovered by people rather than from compiling documents. As has been the case historically, new employees or auditors entering a company are more likely to make these detections. Making the audit

committee accessible to employees through an 800 number costs a few thousand dollars a year to implement and advances the detection of fraud.

At private companies, contrary to what some may believe, GAAP accounting is not a matter of choice but a de facto requirement. Venture-backed start-ups generally report their financials under GAAP because they do expect to one day move through an initial public offering or become acquired by a public company. They also need this credibility with their vendors and commercial banks. They wisely choose to be GAAP – and SOX – compliant early on.

As a venture capitalist and committed investor in small emerging growth companies, I strongly support the recommendations of the SEC Advisory Committee on Smaller Public Companies. The Committee's work was thoughtful and accurately addressed the challenges that our country's small companies are facing under the Sarbanes-Oxley shadow each day. It strikes the right balance between investor protection, shareholder value and economic growth.

Specifically, I support the recommendation that the SEC tier its regulations to differentiate among microcap, small cap and large cap companies and that compliance with the most costly components of SOX 404 be staged based on company size. For those who suggest that a detrimental tiered system would create a second class of company, I disagree. Scaled or size appropriate structure already exists in other regulations such as the difference in listing requirements between the NASDAQ and NYSE. Investors will continue to look for value in small cap companies as they always have. In fact, I would argue that intelligent investors, if they could choose, would easily forgo a certification of compliance of little practical use in exchange for the extra million

in net income that would come with regulatory relief. Lastly, it is important to note that the committee's recommendations include several new governance provisions with which microcap companies would have to comply in exchange for a reduced SOX burden. As the companies moved up to the small level, there would be additional requirements. We are not recommending total exemptions – just reasonable tiers.

Further, I am very supportive of any provisions that will help stimulate more competition in the accounting profession, including allowing accredited firms to perform attestation work. Our supply of strong and qualified accountants to do work for smaller companies is not meeting the increased SOX demands and we would welcome additional resources and new entrants whole heartedly.

Right-sizing the SOX 404 burden for smaller companies will not undermine the law and its intentions. Sarbanes-Oxley has many provisions outside of 404 that will continue to address the issues that gave rise to the legislation. Companies that seek to thrive and create value will always comply with the highest standard. It is critical for market credibility. But the time has come to set the bar accordingly and reduce the unnecessary frictional cost – financial and human-- of SOX 404 in the best interest of our growing companies and growing economy.

Thank you for the opportunity to weigh in on this vital matter.

Woodie Neiss

Entrepreneur & Chief Financial Officer of
FLAVORx, Inc.

On

"Sarbanes Oxley Section 404: What is the Proper Balance Between Investor Protection and Capital Formation for Smaller Public Companies?"

Committee on Small Business
United States House of Representatives
Washington, DC

May 3, 2006

Chairman Manzullo, Ranking Member Velazquez, and members of the committee.

Thank you for inviting me to appear before you today to testify on the implications of Section 404 of the Sarbanes-Oxley Act on small businesses. I sincerely hope that my testimony will not only educate you about the thriving nature of entrepreneurialism that exists within our company but how the good intentions of Congress are having consequences for our company and many like ours far beyond what I believe was the intent of the law.

My name is Woodie Neiss and I represent what is wonderful about this great country; the ability to take an idea and turn it into a reality. To grow a company from a team of a few into a structured organization of many that gives back to our country and economy in the form of employment, wages, taxes and countless opportunities for other businesses that want to work with us as well as the businesses where our employees wish to spend their hard earned dollars.

I owe a debt of gratitude to my parents for instilling in me morals as well as a passion to succeed. I am indebted to our country for providing me with the loans needed to receive my advanced education and "expand my brain." And I am indebted to my niece Hadley and brother-in-law Kenny Kramm who took a problem, found a solution and took a risk to build what I believe is one of the coolest companies in the United States! The U.S. is truly the land of opportunity and I am eternally grateful to be a citizen of this great country.

I am an entrepreneur and a co-founder of a company by the name of FLAVORx. FLAVORx is an INC500, high growth, young, energetic, and intrepid small business helping millions of sick children, adults and animals get better faster by being more compliant with their medicines. FLAVORx developed a system to safely add FDA-approved flavors to mask the awful, often acrid, taste of medications without destroying their stability or efficacy, leaving their integrity intact. We have solved the universal problem of getting children suffering from the common cold to those suffering from cancer to take their "yucky tasting" liquid medicines. Today you can walk in over 37,000 pharmacies in the US, Canada and Australia and ask the pharmacist to flavor your medicine in such yummy flavors like apple, bubblegum, grape and watermelon. If you are a parent, chances are you've heard of us. If you haven't, hopefully the next time you are faced with the dilemma of trying to get your child to take a yucky medicine you will ask for FLAVORx. (Sorry just had to get a plug in there).

We have eased the burden for millions of parents who previously had to struggle to medicate their children. We have included children in the process of medicine time which has proven to increase compliance from about 50% to over 90% and thousands of doctors and pharmacists sing our praises because children are getting better faster and they don't have to rescript medicines. We believe we are saving the U.S. healthcare system over $100 million a year in unnecessary medicines, doctor office visits, insurance claims, gas, time and resources of the parents as well as the companies they work for.

I represent a different generation of business owners than those of Enron and WorldCom. We respect rules and morals and believe that you can run a business fairly. I did my undergraduate at Tulane University and received my MBA from Thunderbird. I studied business, finance, cross cultural communications and yes business ethics. I did my years of apprenticeship on the trading floors of Wall Street before venturing on to Silicon Valley and finally breaking out on my own. I am an active member of Young Entrepreneur's Organization where collectively we help each other grow our businesses and deal with the moral and business challenges that face us everyday.

I believe FLAVORx has what America needs in the form of a public company. Over the past several years we have had steady growth, maintained positive cash flow and consistently grown our bottom line. It is for this reason that we've been able to attract capital from friends, family and private equity with the hopes of "going public." I also believe that while it is important to have a solid business model, in order to succeed in the public markets, you need to have a company that people understand. Companies like Starbucks or 1-800-Pet Meds, to me, are examples of public companies where consumers of their products are most likely to be their investors because they understand the business and the margins. Getting kids to take medicine by flavoring it is a pretty simple concept; consumers who try our product immediately see its impact and understand how we have solved a universal problem that faces children. It is for this reason that I consistently get calls from parents asking if we are publicly traded or how they can invest in our company.

Wanting to "do it right" we've diligently grown our business by implementing policies, procedures, and systems along the way. Much of this was done not only out of the sheer need to apply standards to the way we conduct business, but also because we knew that we wanted to raise capital and that in order to do so, potential investors would need to be able to come into our business and clearly understand what we do, how we do it, what our challenges are, and where our opportunities exist. This wasn't a product of legislation, it was a product of "that's just what you do to grow a business and raise capital."

Part of the process always included an audit of our financial statements. We always felt it was necessary to have an independent auditor review our books to verify their accuracy. It not only reassured us that we were doing everything right, but provided a vote of confidence to our bankers as well as select vendors. As we grew, we also grew our audit relationships. In anticipation of a public offering we made the move in 2002 to hire Ernst & Young as our auditors. Clearly, they saw they opportunity in the form of a public offering for our company as well.

What we didn't realize we faced were adversarial, theoretical debates over revenue recognition procedures which bare no semblance to our business practices, concentration on minutia in reporting systems, ridiculous and timely discussions over policies and procedures irrelevant to a company of our size, and extra costs in the form of consultants and legal fees. Our $10,000 a year, 2-week audit suddenly jumped up to a $70,000, 4-month audit. On top of that, these fees represented a substantial 14% of our net income!

It was all justified by the auditors with the following statement, "if you want to be a public company you need to start acting like one."

There is a fundamental difference however between a small company with public aspirations like ours and a huge multibillion dollar company. And that comes down to the simple fact that we don't have the deep pockets, intricate infrastructure or complex problems they do and hence don't have the same resources, structure or problems to explain our simple actions. Trying to dig for problems in our company where problems didn't exist is counterproductive. Spending money to uncover "these problems" when I can use it to invest in marketing or provide a higher return to the shareholders seems a waste. To me a company is much like an individual, we evolve over time. The challenges we face as we grow become harder and we adjust to deal with them. I expect to be held to a higher standard as we grow because we will have years of experience behind us. But to hold us accountable to rules where the challenges are different or nonexistent are an unintended result of this legislation.

It was for this reason that last year we decided to drop our relationship with Ernst & Young. (Quite frankly I think they were fine with this because they are making millions of dollars off of Sarbanes-Oxley from their much larger clients). We also started to second guess our desire to go public. Why go public when Sarbanes-Oxley audits are expensive and painful? Why put yourself thru the agony of a Sarbanes-Oxley audit when in the end there is nothing to uncover? There is something unconsciously objectionable

to the fact that when it comes time to audit season you are guilty until proven innocent. Doesn't sound very American, does it?

I highly doubt FLAVORx is unique when I say we want our investors to know the good and the bad. That transparency is a part of our lives and ethics plays a huge role in how we conduct business. In fact, among my Young Entrepreneur's Organization peers, we are all in agreement that this is how a smart company should run its operations. However, given their level of complexity and how many times the left hand doesn't know what the right hand is doing in these huge multibillion dollar corporations, it doesn't surprise me that these CEOs try to mask or conceal information, and even avoid responsibility, in hopes that problems remain uncovered. Luckily, I don't believe that this level complexity exists in the majority of businesses in America. Unfortunately, however, Sarbanes-Oxley doesn't take this into consideration.

The countless small businesses, like FLAVORx, that run this country help contribute to the economy in ways we all understand. To divert our attention to the unintended results of Section 404 is counterproductive when we could be investing these resources back into our companies as well as the economy. The amount of time and resources this represents on a percent basis is also much greater than it is for a huge multibillion dollar corporation. I understand that as a private company we can "pick and choose" the provisions of Sarbanes-Oxley to which we want to adhere but if we desire to go public or even sell our company to a public firm, and SOX represents "best practices" then we must conform to the full extent. However, there needs to be some middle ground. Lining

the pockets of auditors, consultants and lawyers who specialize in Sarbanes-Oxley compliance when in fact there is nothing to uncover was never, I believe, the intent of congress. There is a threshold, at which companies should be held accountable to Sarbanes-Oxley. It is a threshold that is similar to many other thresholds we have in our lives and it is based on the complexity of organizations and the revenue milestones around them. Until then, we can use those funds to better grow our companies rather than reduce our net income and increase our earnings per share. Of course, the option always does exist to pass these costs on to the consumers thru higher prices, but I highly doubt that inflation was the driving force behind Congress's action.

While I believe it is too late to start over, I do believe that it is important to state that we as business leaders can behave ethically without being forced to by legislation. America is not run by corrupt individuals and to hold us accountable to such policies assumes that we all are. I can only speak for myself and my peers when I state that we believe in fairness and ethics in business. To lose confidence in us is to lose confidence in the majority of the good companies out there that are trying to succeed in this challenging business environment of higher costs and increased competition. Help foster our growth and allow us to reach the heights that our larger counterparts have as this approach will allow us to contribute more to our country and economy than we ever could being scrutinized under a microscope.

As stated by former Speaker of the House Newt Gingrich last week, "The good intentions of Congress have met with the law of unintended consequences." There is no doubt that

the companies that control the economy of the U.S. are being held accountable to the faults of much larger companies with resources to handle the cost of compliance. Clearly the actions of all business across the U.S., including FLAVORx, changed faster after the collapse of Enron and WorldCom than in the time it took for the legislation to take effect. I do not advocate for noncompliance. I believe that as we work our way to the public markets that we grow into our methodologies. I do not advocate for putting into effect rules that have no basis in a company of our size. Doing so only acts as a deterrent to growth and that quite frankly is un-entrepreneurial and un-American.

Public markets allow companies like FLAVORx access to capital, which enable us to grow much faster than if we did not seek it. Public markets allow companies like ours to expand and hire more people and consume more American products which in effect grows our economy more so than if we just sell to a larger company. However, public markets at the expense of Sarbanes-Oxley given the proportion of the cost it takes to implement and maintain do not make for an attractive option. I know that this committee represents the interest of small business and hope that you can help influence your colleagues to understand the repercussions that Section 404 is having on us.

Thank you again Mr. Chairman for holding this hearing today and for giving me the opportunity to testify before your committee. I look forward to your questions and our discussion.

Testimony
of
Mr. Mark A. Schroeder
President and Chief Executive Officer
German American Bancorp
Jasper, Indiana

On behalf of

Independent Community Bankers of America
Washington, DC

Sarbanes Oxley Section 404: What is the Proper Balance Between Investor Protection and Capital Formation For Smaller Public Companies?

United States House of Representatives

Committee on Small Business

May 3, 2006

Good afternoon. My name is Mark Schroeder and I am President and Chief Executive Officer of German American Bancorp in Jasper, Indiana, a community bank holding company with approximately $1 billion in assets. It is my pleasure to speak on behalf of the Independent Community Bankers of America[1], which represents approximately 5,000 community banks in the United States many of whom are publicly held, on the costs of Section 404 of the Sarbanes-Oxley Act (SOX)[2] and the recommendations included in the Final Report of the SEC Advisory Committee on Smaller Public Companies (the "Advisory Committee").

Summary of ICBA's Position

The Advisory Committee's Final Report provides an excellent roadmap for the SEC to adopt a system of scaled or proportional securities regulation of smaller public companies. With the exception of its recommendation to amend SEC Rule 12g5-1 to interpret "held of record" to mean "held by beneficial holders," ICBA endorses all of the recommendations made by the Advisory Committee. We strongly support exempting micro-cap companies from the internal control audit requirements of SOX Section 404 and exempting small-cap companies from the external audit requirements of that section. This relief would significantly benefit hundreds of publicly held community banks and holding companies like German American Bancorp that are struggling with the high costs of complying with SOX Section 404 and enable them to devote more of their resources to lending and providing banking services to customers in their local communities. ICBA strongly urges members of this Committee to support the Advisory Committee's recommendations and urges the SEC to adopt them.

German American Bancorp

German American Bancorp ("German American") was formed in 1983 with the expressed purpose of providing a vehicle by which small community banks could join forces to gain the economies of scale needed to compete in a very competitive industry while providing the shareholders of those community banks with the liquidity of a large publicly held community bank holding company. Since the formation of German American in 1983, nine community banks, the majority of which have served their respective communities for over a century, have joined our company allowing their shareholders the opportunity to continue holding an investment in a locally owned community bank. German American is listed on Nasdaq, has approximately 3,500 registered shareholders and a market capitalization of about $144 million.

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[1] [1]*The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

[2] Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002)

At first glance, it might appear that there exists incongruence between the size of our company's registered shareholder base, at approximately 3,500 registered shareholders, and our relatively small level of market capitalization, at about $144 million. However, this combination of a relatively large level of registered shareholders in comparison to the overall level of market capitalization is reflective of the manner in which many small publicly held community holding companies and banks are capitalized. Generally, their shareholder base is widely-held throughout a local community with few institutional holders. In the case of German-American, no single shareholder or affiliated group of shareholders holds more than 4% of our outstanding shares. Often, community bank or holding company stockholders are also customers of the bank.

Because their stock is so widely held, community banks represent one of the largest components of small public companies reflected in the recently introduced Russell Micro-cap Index. But being widely held also has its drawbacks, one of which is that if the company has a class of stock held by more than 500 shareholders and has over $10 million in assets, then the company is subject to the costly and burdensome reporting and disclosure requirements of the Securities Exchange Act of 1934 (the "Exchange Act).[3] Many small publicly held banking companies, such as German American Bancorp, are registered SEC filers and therefore are significantly impacted by the burdens of complying with the SOX and particularly SOX Section 404.

German American's Experience with Section 404

German American is an accelerated SEC filer and therefore has been subject to SOX Section 404 for the past two calendar years. **For 2004, our direct costs just for SOX 404 compliance amounted to nearly $600,000 with an estimated additional $250,000 of internal indirect costs, for a total compliance cost of $850,000, or approximately $.08 per share. For 2005, our costs declined; direct costs were $350,000 and indirect costs were approximately $150,000 for a total cost of $500,000, or approximately $.05 per share.**

These considerable costs fail to take account of the internal operating inefficiencies that have been created because of the duplicative internal controls we have had to put in place since the implementation of Section 404. In an effort to be conservative and avoid being questioned by the PCAOB, the accounting firms are requiring a layering of checks and balances beyond that which can be justified on a cost/return basis, beyond that needed for proper segregation of duties, and beyond anything ever required by the banking agencies. In particular, the costs of duplicate checks and balances, coupled with the requirement for layer upon layer of documentation of these duplicative processes, has added additional operating inefficiencies throughout every area of German American. The cost of this inefficiency is impossible to measure, but it is significant and is, at a minimum, equal to or in excess of the measurable indirect internal costs.

Even as we improve the directs costs and measurable indirect costs of Section 404 compliance, the total annual cost to German American, inclusive of these inefficiencies, will never decline below $500,000. Best case, Section 404 will cost our shareholders one-half million dollars each and every year going forward. These costs contrast sharply with the SEC's prediction in June of

[3] 15 USC 78m or 78o(d). Also see 17 CFR 240.12g5-1.

2003 that the average annual cost of Section 404 for all companies would be $91,000.[4] The trade association of financial executives known as the Federal Executives International recently released their SOX 404 survey for 2005 which showed that average costs for Section 404 compliance for the 274 public companies they surveyed was $3.8 million.[5]

Impact of Costs on Community Banks

The costs of Section 404 on top of the enormous regulatory burden that community banks already face from the vast array of other types of regulation such as the anti-laundering rules under the Bank Secrecy Act and the privacy rules under the Gramm-Leach-Bliley Act—to name two of the 129 regulations catalogued by banking regulators—have had a severe and disproportionate impact on the ability of community banks to continue doing business. By providing funding and lending to households, businesses and municipalities, community banks play a vital role in the economic well being of countless individuals, neighborhoods, businesses, organizations and communities throughout the country. But that role is being threatened by the burden of regulations such as Section 404.

While the banking industry as a whole has been profitable particularly over the past five years, smaller community-based banks and thrifts, especially when confronted with increasing competition from a variety of fronts and growing regulatory and compliance costs, have not been nearly as profitable. As shown by FDIC statistics, many smaller institutions have significantly lower returns on assets (ROA) and returns on equity (ROE). The erosion of this profitability by regulations such as Section 404, which weigh more heavily on smaller banks that have less ability to spread the costs across their asset base, is causing many community bankers to consider selling or merging. The loss of community-based financial institutions would be a great loss to local communities, but unless there is a drastic reversal of public policy and a reduction in regulatory burden, the community bank may very well go the way of the corner grocery store and the local hardware store.

For many publicly held community banks and holding companies, the immediate response to the high costs of SOX has been to "go private" and cease being registered SEC filers. Since the beginning of 2003, over 75 community banks have filed to go private.[6] The reasons cited in these filings uniformly include the increased legal and auditing "hard costs" and management/staff time "soft costs" associated with the Exchange Act, but unquestionably Section 404 compliance is the biggest concern. Unless something is done to ease the burden of Section 404, the number of banks seeking to go private may turn into a flood.

ICBA Supports the Recommendations of the Advisory Committee

The SEC Advisory Committee on Smaller Public Companies should be commended for its fine work in preparing and drafting the Final Report and including more than thirty recommendations

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[4] SEC Release No. 33-8238 (June 5, 2003)

[5] FEI Survey on Sarbanes-Oxley Section 404 Implementation, published April 6, 2006. These average Section 404 costs for 2005 were down only by 16.3% from 2004. A complete copy of the survey is on FEI's website at www.fei.org.

[6] This data on community banks going private was provided by the law firm of Powell Goldstein, LLP.

for scaled or proportional securities regulation for smaller public companies. **With the exception of its recommendation to amend SEC Rule 12g5-1 to interpret "held of record" to mean held by actual beneficial holders, ICBA endorses all of the recommendations made by the Advisory Committee.**

Among the Advisory Committee's primary recommendations, ICBA strongly endorses (a) exempting micro-cap companies (with equity capitalizations of $128 million or less) and revenue of less than $125 million from the internal control attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) and (b) unless and until a framework for assessing internal controls over financial report for such companies is developed that recognizes their characteristics and needs, exempting small-cap companies (with equity capitalizations of between $128 million and $787 million) that have revenue of less than $250 million from the external audit requirements of SOX Section 404. We agree with the Advisory Committee that with more limited resources, fewer internal personnel and less revenue with which to offset the costs of Section 404 compliance, both micro-cap and small-cap companies have been disproportionately impacted by the burdens associated with Section 404 compliance. We also agree that the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large companies, are of less value for micro-cap and small-cap companies, who rely to a greater degree on "tone at the top" and high-level monitoring controls, to influence accurate financial reporting.

The proportionately larger costs for smaller public companies to comply with Section 404 adversely affect their ability to compete with larger public companies and even with foreign competition. This reduction in the competitiveness of U.S. smaller public companies hurts their capital formation ability and, as a result, hurts the U.S. economy. For community banks, Section 404 costs have been particularly significant. ICBA's 2005 survey of Section 404 costs for community banks revealed that the average community bank would spend during 2005 more than $200,000 and devote over 2,000 internal staff hours to comply with the Section 404.[7] These costs far outweigh the benefits for these small companies. Furthermore, there has been little attempt by either the SEC or the PCAOB to tailor, or "scale" regulation to address the disproportionate costs and burden that micro-cap and small-cap companies now experience.

We agree with the Advisory Committee that part of the problem with the high costs of SOX Section 404 is due to the fact that neither Auditing Standard No. 2 (AS2)[8] nor any other source provides a clear definition or guide for management as to what constitutes adequate internal controls. Moreover, even though auditors maintain that they are taking a risk-based approach to the AS2 audit, the evidence from publicly held community banks shows that **the implementation of AS2 has resulted in very rigid, prescriptive audits utilizing a "bottom-up" rather than a "top-down" approach. The accounting profession and in particular the increasingly dominant Big Four accounting firms have adopted this approach without**

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[7] For a complete description of ICBA's Section 404 Survey of Community Banks, see ICBA's comment letter to the SEC dated March 31, 2005 concerning the formation and goals of the Advisory Committee.

[8] *An Audit of Internal Control Over Financial Reporting in Conjunction with an Audit of Financial Statements* issued by the Public Company Accounting Oversight Board in March, 2004.

exception, resulting in skyrocketing audit fees and internal costs for smaller public companies.

While a separate auditing standard for smaller public companies would probably reduce some of the high costs of SOX Section 404, ICBA believes that micro-cap companies must be exempted from Section 404 and small-cap companies should be exempted from the external audit requirements of that section in order to be competitive with larger companies and foreign competition. Even with a separate auditing standard, we believe that smaller public companies would still be subject to extensive auditing of detailed control processes under Section 404 by auditors excessively concerned about liability and being second guessed by the PCAOB.

It is also important to note that, under the Advisory Committee's recommendations, all micro-cap and small-cap companies would still be subject to other internal control, auditing and securities requirements under SOX and the Exchange Act even if they are fully or partially exempted from SOX Section 404. These requirements include: (1) maintaining a system of internal controls that provides reasonable assurances as to accuracy, as required by the Exchange Act Section 13(b)(2)(B) enacted under the Foreign Corrupt Practices Act of 1977 or FCPA[9]; (2) providing chief executive officer and chief financial officer certifications under SOX Section 302; (3) receiving external financial audits; (4) complying with the controls and procedures disclosures required by Forms 10-K and 10-Q, and (5) disclosing, consistent with current Section 404 rules, all material weaknesses known to management, including those uncovered by the external auditor and reported to the audit committee.

Furthermore, the enhanced corporate governance controls proposed by the Advisory Committee will ensure that there are sufficient investor protections in place if micro-cap and small-cap companies become fully or partially exempted from SOX Section 404. These include (1) adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Securities Exchange Act of 1934 (the "Exchange Act")[10] and (2) the adoption of a code of ethics for all directors, officers and employees. Please remember that if the SEC fully or partially exempted micro-cap and small-cap companies, these companies represent only 6% of the total market capitalization of public companies in the U.S.

As for the other primary recommendations made by the Advisory Committee, we strongly support (1) incorporating the scaled disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K and making them available to micro-cap companies, and (2) incorporating the scaled financial statement accommodations currently available to small business issuers under Regulation S-B into Regulation S-K or Regulation S-X and making them available to all micro-cap and small-cap companies. We are particularly pleased that the Advisory Committee has recommended that smaller public companies be required to file only two years of audited income statements. Eliminating the third year of audited income statements will reduce costs and simplify disclosure while not adversely impacting investor protection in any significant way..

[9] Pub. Law. No. 95-213, tit. I (1977)
[10] 15 U.S.C. 78a *et seq.*

The Advisory Committee's Secondary Recommendations

ICBA also endorses all of the Advisory Committee's secondary recommendations. However, we do have serious concerns about amending SEC Rule 12g5-1 to mean "held by actual beneficial holders" in lieu of "held of record." If Rule 12g5-1 were amended, small public companies would be forced to make extensive inquiries of broker-dealers and banks that hold their stock in nominee name to determine the number of beneficial holders and to verify that they are still over the 500-shareholder threshold under Section 12 of the Exchange Act. Furthermore, in order to verify beneficial ownership, they would need to determine who has investment control and voting control in each instance where a stock is held by a trust, a family corporation or by an affiliated stockholder. Since it is much easier for smaller public companies to count the number of stockholders on their stockholder ledger than to determine and count beneficial owners, ICBA believes that amending Rule 12g5-1 is unnecessary and will just increase the regulatory burden on smaller public companies.

However, we do agree with the Advisory Committee's recommendations that the SEC's Office of Economic Analysis conduct a study to consider whether the 500-shareholder threshold under Section 12 of the Exchange Act should be modified or raised. This standard has not changed since 1964 and should be updated for inflation. **ICBA recommends that the 500-shareholder requirement under Section 12 of the Exchange Act be increased to reflect the increased size of companies and the increased value of the dollar. ICBA also recommends that Sections 12(g)(4) and 15(d) of the Exchange Act also be updated so that the threshold for de-registration is increased from 300 shareholders to a higher number that reflects the size of small companies and the value of the dollar.**

ICBA also strongly supports the Advisory Committee's recommendation to form a task force of SEC and banking regulators to consider ways to reduce duplicative regulatory reporting. Publicly held banks and holding companies file extensive quarterly Call Report information with the banking regulators including balance sheet and income statement information with very detailed schedules about each of their significant assets, liabilities and capital items. Call Report information is often due at the same time that publicly held banks or holding companies are required to file their SEC Form 10-K and 10-Q information resulting in a major burden for them, particularly at yearend. **The task force should study how bank regulatory Call Reports can be synchronized with the SEC reports to eliminate duplicative reporting, as well as the feasibility of the SEC extending incorporation by reference privileges to Call Report information filed by banks and bank holding companies.**

We also agree with the Advisory Committee that the PCAOB should consider amending Auditing Standard No. 2 by developing a more reasonable and risk-based standard for smaller public companies. During the first year of Section 404, many community banks complained of having to document more controls than were necessary and this work could be reduced if AS2 was more cost effective and risk-based. Furthermore, we believe that Section 404 does not require a separate audit opinion but only an auditor attestation. Eliminating the audit opinion would help reduce the costs of the audit.

Conclusion

ICBA supports all of the recommendations in the SEC Advisory Committee's Final Report except for the recommendation to amend SEC Rule 12g5-1. Among the Advisory Committee's primary recommendations, we strongly support the recommendation to exempt micro-cap companies from Section 404 of SOX and to exempt small-cap companies from the external audit requirements of Section 404 of SOX. As for the Advisory Committee's secondary recommendations, we strongly endorse (1) a study to determine whether the 500-shareholder requirement under the Exchange Act should be updated and raised and (2) a task force of SEC and bank regulatory representatives to consider ways to reduce duplicative reporting by banks and bank holding companies. Adopting the recommendations would greatly enable community banks and holding companies like German American Bancorp — which supply about a third of small business lending by banks nationwide — to further support economic development and job creation in their local communities.

On behalf of the nearly 5,000 members of the Independent Community Bankers of America, we urge the members of the Committee on Small Business to support the Advisory Committee's recommendations and urge the Securities and Exchange Commission to adopt them.

Hearing Testimony
James S. Burns
President and CEO
EntreMed, Inc.

On Behalf Of
The Biotechnology Industry Organization

Before the Small Business Committee
U.S. House of Representatives

"Sarbanes Oxley Section 404: What Is The Proper Balance Between Investor Protection And Capital Formation For Smaller Public Companies?"

May 3, 2006

Chairman Manzullo, Ranking Member Velazquez, and the Members of the Small Business Committee:

Thank you for providing the opportunity to testify before you today on Sarbanes-Oxley Section 404 and finding the proper balance between investor protection and capital formation needs of smaller public companies.

My name is James Burns, President and CEO of EntreMed, a public biotechnology company in Maryland. I have been involved in leading the development of biotechnology companies and products for over 20 years. Founded in 1991, EntreMed is a clinical-stage pharmaceutical company focusing on the development of next generation multi-mechanism oncology and anti-inflammatory drugs that target disease cells directly and the blood vessels that nourish them. Our focus is on the development of drugs that are safe and convenient, providing the potential for improved patient outcomes. Our Company has three drug candidates currently in clinical trials for cancer, as well as others in preclinical development for oncology and non-oncology indications. Our Company has no product sales, and will depend on continued investment capital for the foreseeable future to maintain its clinical development programs.

Today, I am here to testify on behalf of the Biotechnology Industry Organization (BIO), an organization representing more than 1,100 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 50 U.S. states and 31 other nations. BIO members are involved in the research and development of health care, agricultural, industrial, and environmental biotechnology products. The majority of BIO member companies are small, research and development oriented companies pursuing innovations that have the potential to improve human health, expand our food supply, and provide new sources of energy. My Company has a profile that is typical of the high-risk, capital-intensive, long lead-time, regulated business environment of the biotech industry.

As a representative of one of the most innovative high growth sectors of our nation's economy -- one in which the Unites States maintains a global leadership position—my testimony is tailored to the issues faced currently, or that will be faced, by emerging companies in the biotech sector – the microcap and smallcap companies who are among the driving forces of our Country's innovation leadership and competitiveness in the global market place.

One Size Does Not Fit All

Let me start by saying that we fully appreciate and agree with the Congressional intent behind Section 404 – ensuring that companies have in place effective policies, procedures and controls to protect against material misstatements in financial reports, and to protect against fraud. However, where Section 404 has gone awry is in the implementation of the requirements.

The current implementation of Section 404 is not tailored, and does not work, for smaller public companies. The one-size-fits-all approach of Section 404 is highly burdensome to smaller companies, and such companies are bearing disproportionate costs on a relative basis. This has been recognized, and documented, by the SEC Advisory Committee for Smaller Public Companies (Advisory Committee) in its Final Report, and by the 18-3 vote by the Advisory Committee in favor of Section 404 reform.

The reason for the increased cost burden is the imposition of an inflexible Section 404 on companies with fewer personnel, little or no revenues and minimal resources. Simply put, if the current 404 implementation continues to be imposed, or, in the case of non-accelerated filers, is imposed in the future, microcap and smallcap companies in our industry will be forced to endure internal processes and organizational changes that are completely contrary to the rapidly changing and highly-competitive markets in which we operate.

The Costs of the One-Size-Fits-All Approach to the Industry and U.S. Competitiveness

For most biotechnology companies, the actual costs of Section 404 compliance, including both internal costs as well as external auditor costs, are substantial. In fact, the opportunity costs of Section 404 for smaller companies can be even greater, impeding the

ability to invest in and even sometimes, to continue ongoing, critical research and development activities. Biotech companies are at the forefront of developing new treatments for many diseases, and biotech companies presently are engaged in over 350 clinical trials for over 200 diseases, from cancer to multiple sclerosis.

Under the requirements of Section 404, significant time and money are spent to put in place complex systems and processes dictated by the Auditing Standard No. 2 (AS2) and required by external auditors. If the current system is not changed, these effects will also be felt by non-accelerated filers as they prepare for compliance next year, as well as private companies preparing for an initial public offering of their stock.

As a specific example, one of BIO's member companies had five employees working on Section 404 compliance at a cost of approximately $1 million per year. This company estimated that its controller spent approximately 35% of his time on Section 404, while the CFO spent approximately 20% of his time. To complete the mandated internal control processes and the "checklist" dictated by AS2, the company had to increase its accounting staff by 40%. Further, this company reports only a 7% decrease in costs in year two as compared to its first year of compliance.

Another public company member's experience shows the opportunity costs of Section 404 compliance. This company not only spent approximately $500,000 on its external attestation of internal controls but also had to endure additional costs in terms of (i) the reassignment of laboratory research personnel to perform internal control work dictated by AS2 and the company's external auditors, (ii) the postponement of the hiring of 5-10 additional researchers, and (iii) the delay of promising R&D programs. Such diversion of resources away from research activities can delay critical product development and has, in turn, a deleterious effect on a company's ability to raise capital. To say the least, this is clearly an unintended and unfortunate consequence of Section 404.

It is the experience of BIO members that the current problems with Section 404 are not merely growing pains where the costs and burdens will decrease once the auditors and companies become more familiar with the process and requirements. The current implementation of Section 404 imposes the same requirements, steps and reviews on all companies, by the same individuals year after year. As a result, the costs are fixed and ongoing, impacting the long-term investment resources of microcap and smallcap companies.

For the investors, their confidence and trust in public companies may have increased as a result of the passage of SOX as a whole in spite of Section 404 and not necessarily because of it. The other provisions in SOX include whistleblower protections, increased enforcement powers, such as the SEC's increased ability to obtain officer and director bars, auditor independence requirements and, perhaps most importantly, CEO and CFO certifications of company financial statements under section 302 of SOX. As we saw in the first and second years of Section 404 implementation, investors and the market generally had no market reaction when a company reported a "material weakness" in

internal controls under Section 404.[1] As we discussed further above, the costs of the implementation of Section 404, particularly for smaller public companies, clearly outweigh any benefits that are directly related to Section 404.

The impact of Section 404 costs on the U.S. economy and our industry's competitiveness abroad is also of great concern. As many Members on the Committee may have undoubted heard and read, there is evidence that foreign firms, the largest of which will be subject to Section 404 compliance beginning July 15, 2006, are foregoing the U.S. markets and listing overseas due, in large part, to Section 404, not necessarily because of SOX in general. In addition, it is the experience of our private company members that an initial public offering is becoming less and less the optimum path to liquidity for their investors due to the timing issues associated with accessing the market while at the same time ensuring readiness for Section 404. This issue has been previously noted by the recently-appointed head of the Division of Corporation Finance at the SEC.[2] Further, there have been reports of increases in the number of companies "going private" or deregistering from the SEC in order to avoid the continued compliance burden of Section 404.

As currently implemented, we suspect the actual beneficiaries of Section 404 may be the large public auditing firms. Due to Section 404, audit firms now have a required audit process, entirely separate from the typical financial statement audit process, for which they charge fees almost equal to what they charge on a financial statement audit. This is rather ironic since this was clearly not the intent of Congress. The Senate Committee Report on Section 404 was specific: "The Committee does not intend that the auditor's evaluation be the subject of a *separate* engagement *or the basis for increased charges or fees* [emphasis added]". Such windfall is attributable not only to the process imposed by the large accounting firms but also to the AS2, as promulgated by the Public Company Accounting Oversight Board (PCAOB). The current standards are very prescriptive in the procedures auditors must go through to perform the separate attestations, with little room for auditor judgment.

Scaled Reform Needed for Smaller Public Companies

As embraced by the Advisory Committee in its final recommendations, it is critical that the Section 404 reform framework establishes a risk-based approach that provides scaled reforms based on a "revenue filter" condition. This approach recognizes that the level of risk and the level of product revenues are clearly interrelated and that the level of product revenues should drive the level of internal control procedures. An approach that scales Section 404 requirements based on the level of product revenues also provides a risk-based approach, more appropriate for microcap and smallcap companies in our industry. Biotechnology start-up companies early in their histories often have very limited product

[1] See, e.g., Neil O'Hara, An Analysis of the (Non) Impact of SOX 404, Compliance Week, March 8, 2005. In addition, at the 2005 SEC and PCAOB Roundtable on Section 404, a representative of Moody's on one of the panels stated that, of the 71 companies disclosing material weaknesses they considered in detail, they ultimately issued a negative rating action on 12, or 20%, of the companies. Thus, credit rating agencies had no adverse reaction to approximately 80% of the companies.

[2] See, the letter from John W. White, the new and current head of the Division of Corporation Finance at the SEC, submitted in connection with the SEC's 2005 Roundtable on Section 404, available at http://www.sec.gov/news/press/4-497.shtml.

revenues compared to their market capitalizations. For example, it is not uncommon for a public biotechnology company to have a market capitalization of $700 million or greater with product revenues of $1 million, or less.

Thus, BIO has urged the Securities and Exchange Commission (Commission) and the Public Company Accounting Oversight Board (PCAOB) to, as expeditiously as possible, take the necessary steps to adopt the following reform framework as recommended by the Advisory Committee:

- As per the Advisory Committee's recommendations, establish risk-based, scaled Section 404 reform for smaller public companies based on the level of product revenues (as defined in Section 5-03 of SEC Regulation S-X, 17 CFR 210.5-03, excluding revenues from license fees, and research and development payments, milestone payments, and other payments received from an unrelated third party before product sales have commenced under the terms of a collaborative contractual agreement to develop a product).
    - Provide full Section 404 relief for smallcap companies with less than $10 million in annual product revenues and microcap companies with less than $125 million in annual revenues.
    - Provide relief from the auditor attestation requirements of Section 404 and AS2 for microcap companies with between $125 million and $250 million in annual revenues, and for smallcap companies with less than $250 million in annual revenues, but greater than $10 million in annual product revenues.
    - Require that in order to take advantage of the above reforms, microcap and smallcap companies would be required to (i) comply with the audit committee requirements under Section 10A-3 of the Securities Exchange Act of 1934, and (ii) adopt (and disclose) a code of ethics applicable to directors, officers and employees in addition to other required corporate governance standards.
- If the Commission and PCAOB ultimately determine that an auditor attestation requirement is necessary for microcap and/or smallcap companies, it is imperative that the PCAOB re-open AS2 to revise the standards to devise a cost-effective, risk based standard that is tailored to the product revenue size and the level of complexity of smaller companies.
- For the smaller public companies, as defined by level of product revenues, the above reform framework should focus on the internal controls necessary for CEO and CFO certifications of company financials as currently required under Section 302 of the Sarbanes-Oxley Act. The proposed reform supports management's incentive to maintain effective systems of internal controls and produce accurate financial reports which are most important to the investors. Section 13(b)(2)(B) of the Exchange Act requires, as it has since 1977, that public companies maintain a system of internal controls that provide reasonable assurances as to the accuracy of financial reports.

The proposed reforms, in effect, would provide added assurances to investors based on the degree of risk and cost effectiveness while providing Section 404 relief for smaller public companies.

With the submission of the Advisory Committee's final reform recommendations on April 23, 2006, time has come for the Commission to act on the recommendations. It is critical now more than ever that the Commission take expeditious action, before non-accelerated filers have to start gearing up on and around July 15, 2006, for their compliance deadline in 2007. Without reform, the current Section 404 framework will continue to impose substantial cost burdens on smaller companies as a result of external auditors continuing to apply the same standards and methods across all companies, large and small.

Thank you for your time and consideration of our views. We urge the Committee to request expeditious action by the Commission on the Advisory Committee's reform recommendations for smaller public companies, providing the continued opportunity for high growth sectors to lead, innovate, and compete in the global market place.

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