

# COUNCIL OF INSTITUTIONAL INVESTORS

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May 17, 2006

The Honorable Christopher Cox  
Chairman  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

The Honorable Bill Gradison  
Acting Chairman  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006

Dear Chairman Cox and Acting Chairman Gradison:

Congratulations to you and your respective staffs on a timely Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions. The discussions regarding costs, implementation and plans going forward were of particular interest to the investors who place their monies and trust in the U.S. capital markets. I am writing on behalf of the Council of Institutional Investors, an organization of large public, labor and corporate pension funds, which actively seeks to address investment issues affecting the size or security of plan assets. Our members represent more than \$3 trillion in pension savings and, like all investors, lost billions of dollars due to corporate scandals.

Our members represent long-term, patient capital and the Council believes that the Sarbanes-Oxley Act of 2002, including the related regulations and other guidance issued by the U.S. Securities and Exchange Commission and the Public Company Accounting Oversight Board, have played a vital role in restoring investor confidence in the integrity of our financial markets. With monies and confidence returning to the market, initial public offerings are rebounding to highs not seen in over five years—a fact that appears to contradict the allegations Sarbanes-Oxley “goes too far” and creates a climate hostile to growth. The Council considers the Act a major factor in this rebound and Section 404 a core piece of the Act.

The Council reiterates its position against any rollback of Section 404’s requirements for annual internal control assessment and reporting for all publicly traded companies, large and small. Effective internal control, long required by the Foreign Corrupt Practices Act of 1977, are the backbone of high quality financial statements. All companies tapping the public markets to raise capital, regardless of size, should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors.

As Roundtable participants noted, evidence points to a decline in the costs of compliance with Section 404. A survey of accelerated filers released by the Financial Executives International on April 6, 2006, found average compliance costs for Section 404 fell 16.3 percent from 2004 to 2005. FEI attributes the lower costs to reductions in staff time, external compliance-related costs, and auditor fees.

The Council acknowledges the available data appears to indicate smaller public companies already in compliance have experienced disproportionately higher costs (as a percentage of revenues) in their initial implementation of these improved internal control reporting requirements. However, the Council believes that the recommendations made by the SEC's Advisory Committee on Smaller Public Companies—to eliminate or significantly weaken Section 404 requirements for an estimated 80 percent of all U.S. publicly traded companies—go too far.

As noted in a March 2, 2006, report by Glass Lewis & Co., “the smallest companies are where strong internal controls arguably are needed most, because they are where the risk of restatement is the highest.” Similarly, a 2006 report by Lord & Benoit, LLC predicts that if the SEC Advisory Committee's recommendations are adopted, the highest rates of material weaknesses in Section 404 internal control will occur at smaller public companies with revenue of less than \$250 million.

The Council believes imposing requirements differentiated by company size—whether pertaining to accounting standards, audit standards, disclosure requirements and/or basic governance requirements—is bad public policy and confusing for the investing public. On average, Council members have more than 50 percent of their assets invested in indexed funds, including the Russell 3000 stock index. If the SEC and PCAOB adopt the approach advocated by the Committee, 42 percent—or nearly 1,300 companies—listed in the Russell 3000 would be exempt from Section 404 requirements. Setting lower standards for internal control will only harm smaller companies by raising their costs of capital and reducing their access to capital.

Roundtable participants highlighted many of the realized and expected benefits for accelerated filers in the second year of compliance, including improvements in “tone at the top,” increased transparency in financial reporting, more engaged boards, and more robust and well-executed external audits. These benefits are just as relevant to smaller companies and should not be discounted.

The Council recommends that the following actions be taken to preserve the investor protections provided by Section 404:

- 1) *The SEC should offer guidance, in plain English, to management.* Under Section 404, management must assess “the effectiveness of the internal control structure and procedures . . . .” The Council urges the SEC to issue practical, plain English guidance to management on how to assess the effectiveness of internal control over financial reporting.
- 2) *The PCAOB should offer clarification for and/or amendments to Auditing Standard No. 2 while maintaining the underlying principles behind the standard.* Although Roundtable participants appeared to be in agreement about the importance of maintaining the

principles espoused in AS2, anecdotal evidence suggests some auditors have yet to fully embrace the related May 2005 Questions and Answers and Policy Statement issued by the PCAOB, specifically the guidance on using the work of others and producing integrated risk-based audits taking into account the scale, scope, and complexity of the companies operations. The Council supports the PCAOB's plan to focus its 2006 inspections on the efficient implementation of that guidance. The Council also supports additional guidance from the PCAOB to address remaining implementation problems and, if deemed helpful, integration of that guidance and the May 2005 Questions and Answers and Policy Statement into AS2.

- 3) *The SEC and PCAOB should issue separate guidance for smaller companies and audit firms.* The Council recommends that guidance tailored to the unique issues faced by smaller companies and audit firms be issued. The SEC and the PCAOB might consider working together with other market participants to develop right-sized guidance to help management understand the scope of its responsibilities under Section 404. The Council likewise supports similar guidance for smaller audit firms. As recommended by the General Accountability Office in their April 2006 report any guidance should be "targeted and limited." The GAO report also noted that the number of audits performed by smaller firms increased from 22 percent to 30 percent between 2002 and 2004 despite the concentration of audit services by large audit firms. The GAO posits Section 404 "may reduce some of the competitive challenges faced by mid-sized and small accounting firms." Additional guidance from the PCAOB, including through seminars and written materials with salient examples directed to these smaller firms, would likely only help to increase that competitiveness.

In closing, Section 404 is working. It is helping to restore confidence in the U.S. capital markets and is identifying problems with internal control. Some of those problems must be reported to investors as material weaknesses, but many others are being identified and remediated before disclosure is required. From an investor's standpoint and for the marketplace at large, this is a beneficial outcome.

The Council appreciates the opportunity to comment. We would be happy to respond if you have any questions or need additional information.

Sincerely,



Ann Yerger  
Executive Director

cc: The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate  
The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking, Housing, and Urban Affairs, United States Senate

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The Honorable Michael G. Oxley, Chairman, Committee on Financial Services, United States House of Representatives

The Honorable Barney Frank, Ranking Member, Committee on Financial Services, United States House of Representatives

John W. White, Director, Division of Corporate Finance

Scott A. Taub, SEC Acting Chief Accountant