

Via Facsimile

October 26, 2009

The Honorable Barney Frank  
Chairman, House Committee on Financial  
Services  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Paul E. Kanjorski  
Chairman, Subcommittee on Capital  
Markets, Insurance, and Government  
Sponsored Enterprises  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Spencer Bachus  
Ranking Member, House Committee on  
Financial Services  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Scott Garrett  
Ranking Member, Subcommittee on  
Capital Markets, Insurance, and  
Government Sponsored Enterprises  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Frank, Subcommittee Chairman Kanjorski, Ranking Member Bachus and  
Subcommittee Ranking Member Garrett:

As representatives of the investor community, we wish to express our concern regarding any proposed amendments to the Sarbanes-Oxley Act of 2002 (SOX) that would undermine the important investor protections provided by SOX. More specifically, we would strongly oppose any such effort to further defer or exempt public companies from the internal control requirements of Section 404. Such efforts would do a grave disservice to investors whose trust in the markets is an essential ingredient in any financial recovery.

We believe SOX has contributed significantly to restoring investor confidence, which was shaken from the scandals that occurred just prior to its enactment. In particular, we believe that the external auditor's involvement under Section 404(b) has played a crucial role in promoting reliable financial reports, which are essential to providing investors with the information they need to make confident investment decisions. In fact, according to a 2007 survey conducted by the AARP, over half of the respondents noted that SOX made them more confident in the information they receive from companies before they decide to purchase their stock.<sup>1</sup>

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<sup>1</sup> Jeffrey Love, *Sarbanes-Oxley: A Survey of Investor Opinions* 7 (2007) (AARP & Knowledge Network survey, on file with the Council of Institutional Investors) ("Over half (53%) say this legislation [Sarbanes-Oxley] makes them more confident in the information they receive from companies before they decide to purchase their stock.").

Internal control reporting under Section 404 of SOX was intended to provide investors with insights into the effectiveness of a company’s system of internal control over financial reporting. In addition, we believe that the external auditor’s involvement under Section 404(b) is an integral part of the benefits provided by internal control reporting to investors.

While early implementation of Section 404 requirements at larger companies clearly required more effort than was contemplated, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have expended considerable efforts to identify areas where improvements should be sought and develop guidance to make evaluations more efficient. However, through this process, investors have consistently expressed that the independent auditor’s involvement in the evaluation of a company’s internal control system provides significant benefits to investors when evaluating investment decisions.<sup>2</sup>

Some of the more common views expressed include that the independent auditor’s involvement provides investors with increased confidence in the quality of a company’s public reports by providing an independent “check” on management’s assessment and results in a more rigorous management process.<sup>3</sup> In addition, investors believe that auditor’s expertise can provide management with additional perspective on the quality of its system of internal control, which can have a positive impact on the quality of a company’s financial reporting.<sup>4</sup>

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<sup>2</sup> See, e.g., Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Mary L. Schapiro, Chair, SEC 1 (Oct. 9, 2009), available at <http://www.cii.org/UserFiles/file/resource%20center/correspondence/2009/Oct9LetterSEC.pdf> (“Consistent with the language and intent of Section 404 of SOX, we have long held the view that any company tapping the public markets to raise capital should be required to have appropriate internal controls in place that have been subject to a meaningful review and attestation by external independent auditors” (footnotes omitted)).

<sup>3</sup> These views have been expressed to the PCAOB and SEC through various mechanisms. See, for example, the AARP survey, the SEC’s recently released study on Section 404 implementation, as well as various roundtable discussions and comment letters received as part of the SEC and PCAOB projects related to internal control over financial reporting requirements.

<sup>4</sup> See, e.g., SEC, Office of Economic Analysis, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* 92 (Sept. 2009), available at [http://www.sec.gov/news/studies/2009/sox-404\\_study.pdf](http://www.sec.gov/news/studies/2009/sox-404_study.pdf) (“Among these users, some highlighted that auditors’ involvement benefits investors and users because auditors provide professional expertise in evaluating internal controls and risk their professional reputations by signing auditor opinions, both of which are perceived to positively affect the quality of the auditor’s assessment of ICFR compared to that management” (footnote omitted)).

We recognize that these benefits do not come without costs. However, we believe the costs have often been exaggerated by SOX opponents, particularly with regard to the costs for small companies, and that the benefits more than outweigh those costs. We believe these benefits are even more meaningful given the fact that smaller companies, which make up more than half of the public companies in the U.S., are also the source of well over half of the financial statement restatements.<sup>5</sup>

Moreover, the SEC and PCAOB have bent over backward to reduce those costs. The PCAOB replaced its existing Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, with a less prescriptive Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements* (AS No. 5). In addition, the SEC developed additional guidance for managers in conducting their control assessment, and the PCAOB developed additional guidance for applying the principles of AS No. 5 to assist auditors of smaller public companies in conducting more efficient and effective audits of smaller public companies.<sup>6</sup> The combination of these efforts should better enable auditors to focus the audit on those areas that pose the highest risk to a company's financial reporting and utilize their judgment to scale the audit to a smaller company's particular facts and circumstances. We believe that these initiatives have had a significant impact on the effort required to conduct the independent audit of internal control, as evidenced by recently released SEC study of Section 404.<sup>7</sup>

In addition, we note that issuers have had an extensive period of time to tailor the design of their internal control assessments – efforts that auditors have witnessed as part of their involvement in the audit of the financial statements. We believe that this knowledge, combined with the resources noted above, provide auditors of smaller public companies with ample opportunity to prepare for effective and efficient initial audits of internal control.

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<sup>5</sup> Cf. Letter from Jeff Mahoney, *supra* note 2, at 1 (“The need for strong internal controls is particularly important for generally riskier smaller public companies that have been the beneficiaries of the Commission’s deferrals” (footnote omitted).).

<sup>6</sup> PCAOB Staff Views, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of the Financial Statements – Guidance for Auditors of Smaller Public Companies* (Jan. 23, 2009), available at [http://www.pcaob.org/Standards/Standards\\_and\\_Related\\_Rules/AS5/Guidance.pdf](http://www.pcaob.org/Standards/Standards_and_Related_Rules/AS5/Guidance.pdf).

<sup>7</sup> SEC, *supra* note 4, at 69 (“On average, companies perceive the 2007 reforms to have helped reduce the cost of complying with Section 404, both when the reforms are considered in isolation as well as when they are considered in combination . . . .”).

In fact, given the substantial efforts directed at providing smaller companies with the tools needed to successfully comply with the auditor attestation requirements, one could question whether it would be in the best interests of investors and all capital market participants if those companies and their auditors that are not prepared should be excluded from accessing the many benefits derived from participating in U.S. public markets.<sup>8</sup> The AARP survey mentioned above made clear that investors strongly oppose providing any such exemption for smaller companies.<sup>9</sup>

As stated previously, it is our view that the Section 404(b) requirements under SOX provide significant benefits to investors, are valuable regardless of a company's size and represent an appropriate use of a company's resources given the importance a strong system of internal controls has in producing reliable financial reporting.

We would welcome the opportunity to respond to any questions you may have.

Sincerely,



Jeff Mahoney  
General Counsel  
Council of Institutional Investors



Barbara Roper  
Director of Investor Protection  
Consumer Federation of America



John Markese  
President  
American Association of Individual Investors



Kurt Schacht  
Managing Director  
CFA Centre for Financial Market Integrity

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<sup>8</sup> Letter from Jeff Mahoney, *supra* note 2, at 2.

<sup>9</sup> Jeffrey Love, *supra* note 1, at 8 ("Similarly, less than one-fifth of investors think small companies should be exempt from Sarbanes-Oxley . . .").