

# COUNCIL OF INSTITUTIONAL INVESTORS

Via Hand Delivery

January 25, 2008

The Honorable Christopher Cox  
Chairman  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

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Dear Chairman Cox:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 130 public, corporate and union pension funds with combined assets of over \$3 trillion. As a leading voice for long-term, patient capital, the Council strongly believes that the accuracy of public company financial statements is critical to the integrity of the capital markets.

*Reliability of financial reporting promotes investor confidence and allows investors to make more sound investment decisions. A crucial element supporting the reliability of financial reporting are the independent external auditors that provide assurance that the company's financial statements accurately reflect the condition of the business. In the wake of egregious accounting scandals at the start of this decade resulting in implosion of corporate giants such as *Enron Corp.* and *WorldCom Inc.* maintaining the integrity of the covenant among external auditors, the audit committee, and investors remains a pressing issue for our members.*

At the Council's fall 2007 meeting, the Council's general membership unanimously voted to adopt a "best practices" policy on external auditor departure and disclosure. The new addition to the Council's policies states:

The audit committee should publicly provide to shareowners a plain-English explanation of the reasons for a change in the company's external auditors. At a minimum, this disclosure should be contained in the same Securities and Exchange Commission filing that companies are required to submit within four days of an auditor change.<sup>1</sup>

<sup>1</sup> The Council of Institutional Investors Corporate Governance Policies, Board of Directors, II, p. 4 (Updated Sept. 18, 2007) <<http://www.cii.org/policies/Current%20CII%20Corporate%20Governance%20Policies%2009-18-07.pdf>>

Consistent with this new policy, the Council respectfully requests that the Securities and Exchange Commission ("SEC") pursue rule-making that would require public companies to provide shareowners with a plain-English descriptive narrative of the reasons for a change in external auditors in *all* cases of such a change. As you are aware, existing SEC rules require companies to disclose their reasons for changing audit firms only when there is a disagreement between the company and the external auditor, or in certain other limited circumstances, such as when the auditor concludes that it could not trust company management.

In our view, the current requirements fail in most cases to provide investors with adequate information about the details behind the dismissal or departure of external auditors. The obscurity surrounding the reasons for the switch encourages speculation and precludes investors from differentiating between legitimate reasons for the change and those that raise a red flag.

Perfectly legitimate reasons for changing auditors may include a firm wanting an auditor that promises better services or that possesses more expertise in a particular industry. However, there are also worrisome reasons for the "break-up" between a company and an external auditor such as the management refusing to provide information necessary for adequate verification of financial statements or disagreement over accounting rules. Such reasons behind the change could be an indicator of management trying to hide questionable accounting manipulation, internal control problems, unsound corporate governance practices, or poor performance.

Shareowners need to be aware of when auditor changes are indicative of activities within the leadership of the company that are inimical to the integrity of the capital markets and long-term value creation. Although some companies give additional details with respect to the change in outside auditors, most do not.

A study by proxy advisory and consulting firm, Glass, Lewis & Co., LLC, found that in 2006 about three-fourths of the 1,322 auditor changes in US companies provided no reason for the switch.<sup>2</sup> Similarly, in 2005, 1,430 public companies changed auditors and companies chose not to provide reasons for their departure in 72% of those the cases. This was up from a 59% non-disclosure rate in 2004, when 1,451 companies changed auditors.

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<sup>2</sup> Grothe, Mark & Post, Blaine. Speak No Evil: 2006 Auditor-Turnover Report. Glass, Lewis & Co., LLC (May 21, 2007).

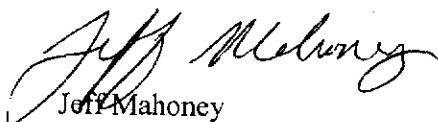
The case of Computer Associates provides one illustration of why the SEC should improve their rules in this area.<sup>3</sup> According to a July 28 2006, *New York Times* article:

In 1999, when Computer Associates dismissed Ernst & Young as its auditor, it told investors there was no disagreement on accounting, and no "reportable event." A few years later, when the S.E.C. and the Justice Department went after company officials, they told a different story, claiming that Computer Associates fired Ernst in retaliation for the firm's requiring the company to disclose things that it did not want to disclose regarding compensation of top executives. And yet, the disclosure, or lack of it, may have complied with the rules. Was there an accounting disagreement? Not when the firm was fired. Computer Associates had made the required disclosure, and so there was no continuing dispute. And how could anyone be sure it was retaliation?<sup>4</sup>

As the Computer Associates case implies, the current highly limited SEC requirements for disclosing reasons why an auditor is dismissed or resigns may permit companies to escape reporting on certain external auditor changes which may signal troubles in their governance practices or in other areas. Moreover, many experts in this area believe that more rigorous requirements for disclosure of auditor changes would provide numerous other benefits to investors and other capital market participants by: (1) highlighting acceptable business reasons for changing audit firms; (2) reducing the risk that investors and analysts will misinterpret an auditor change; (3) providing context for audit firms to study by revealing reasons why companies choose to change auditors; and (4) promoting competition among audit firms to retain current clients and win new business through improving the quality of the audit.<sup>5</sup>

In summary, the Council believes that improving existing SEC rules to require public companies to provide a plain English descriptive narrative for all departures or dismissals of their external auditors would provide a boost to the integrity of financial reporting and the overall capital market system to the benefit of investors and other market participants. We, therefore, would greatly appreciate your serious consideration of this request for rulemaking. If you have any questions, please do not hesitate to contact me.

Sincerely,



Jeff Mahoney  
General Counsel

CC: Commissioner Paul S. Atkins  
Commissioner Kathleen L. Casey  
Commissioner Annette L. Nazareth

<sup>3</sup> Norris, Floyd. Deep Secret: Why Auditors Are Replaced. *New York Times*. July 28, 2006.

<sup>4</sup> *Id.*

<sup>5</sup> E.g., Fusco, R. Cono. Governance Imperative: Auditor Choice. The Opportunity Now Exists to Have Wider Choice Among Qualified Audit Firms. *Directorship*. June/July 2007.