COUNCIL OF
INSTITUTIONAL
INVESTORS

Suite 512 • 1730 Rhode Island Avenue, N.W. • Washington, D.C. 20036 • (202) 822-0800 • Fax (202) 822-0801

May 1, 2006

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

Bill Gradison
Acting Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Dear Chairman Cox and Acting Chairman Gradison:

The Council of Institutional Investors, an association of more than 130 corporate, union, and public pension plans with more than $3 trillion in assets, is pleased to comment on Section 404 of the Sarbanes-Oxley Act of 2002. We commend the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) for hosting the May 10 roundtable to discuss issues relating to implementation of Section 404.

The Sarbanes-Oxley Act was enacted in response to a shocking series of corporate scandals, including many resulting from lax or inadequate internal controls. The costs of these scandals—from company-specific losses to a widespread loss of confidence in the integrity of the U.S. capital markets—were staggering. From the stock market peak in 2000 to the market trough in the third quarter of 2002, the S&P 500 lost almost half of its value. From the start of 2002 through the fall of 2002—a period of widespread corporate scandals and frauds—the S&P 500 lost about 19.5 percent of its value. All investors in the U.S. markets, from large institutional investors to individuals investing their hard-earned savings, were impacted by these frauds.

As a leading voice for long-term, patient capital, the Council believes the post-Enron reforms promulgated by Congress, the SEC, the PCAOB, the stock exchanges and other regulatory agencies have played a vital role in restoring investor confidence and the overall integrity of our financial markets by strengthening investor protections, modernizing corporate governance standards for public companies, enhancing the "tone at the top," invigorating boards of directors and audit committees, ensuring internal controls are adequately funded and not dismissed as "cost centers," and increasing the

overall accountability of corporate executives and directors. These changes are long-term in nature and difficult to quantify, but the Council believes the benefits over time will far outweigh the costs and will be a positive for all involved in the U.S. capital markets.

The Council considers Section 404 a core piece of the Sarbanes-Oxley Act and believes it is appropriate for all publicly traded companies, large and small. Effective internal controls are the backbone of high quality financial statements. Any company—large or small—tapping the public to raise capital should have appropriate internal controls, and management should be responsible for assessing those controls and receiving an auditor report on the assessment.

The Council opposes any softening of Section 404's requirements for annual internal control assessment and reporting for small companies. A proposal recently approved by the SEC Advisory Committee on Smaller Public Companies recommends exempting or softening Section 404 requirements for a group of companies accounting for roughly 6 percent of U.S. market capitalization but comprising an estimated 80 percent of all U.S. publicly traded companies.

The Council believes such an approach goes too far. First, 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." Second, 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. Finally, smaller companies already face challenges related to access to capital, analyst coverage and even investor interest due at least in part to their perceived increased risks. Setting lower standards for internal controls may only harm smaller companies by raising their costs of capital and reducing their access to capital.

We share the Advisory Committee's concerns over implementation problems with Section 404, and we join the business community in calling for these problems to be addressed. However, we disagree that rollbacks or wholesale exemptions are the solution. Instead, the Council believes implementation problems can and should be handled by guidance from the SEC and the PCAOB.

The Council acknowledges the costs of compliance with Section 404 have been higher than anticipated. Some of the outlays can be attributed to expected one-time, start-up costs associated with complying with *any* new regulatory standard. Some reflect "deferred maintenance" expenditures required to make up for years of neglecting internal controls and failing to comply with Foreign Corrupt Practices Act of 1977, which requires companies to maintain a system of internal accounting controls for proper verification of records and transactions. Others may be due to:

- Management challenges understanding the scope of their responsibilities under Section 404 and having access to "right-sized" guidance from the Committee of Sponsoring Organizations of the Treadway Commission (COSO);
- Audit firms failing to comply with the spirit and/or intent of the PCAOB's Auditing Standard No. 2 and/or;
- Auditing Standard No. 2 requiring modifications.

The Council urges the SEC and PCAOB to take all necessary steps to address these issues. To address concerns of 404 redundancies and inefficiencies, guidance from COSO, the SEC and the PCAOB on certain issues is warranted. Of particular importance is guidance from the SEC on how management should assess and test internal controls. The Council believes this guidance should help address some of the inefficiencies and solve some concerns that 404 is disproportionately burdening small/mid-sized firms.

Such guidance would help ease costs associated with Section 404 and contribute to the trend of declining 404 compliance costs. A survey of public companies under Section 404 jurisdiction released by Financial Executives International (FEI) in April found average compliance costs fell 16.3 percent over the two full years since the regulation went into effect. FEI attributes the lower costs to reductions in staff time, external compliance-related costs, and auditor fees. A CRA International study commissioned by Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers found declines of year one and year two total 404 costs of 43.9 percent for companies with market capitalization exceeding $700 million and 30.7 percent for companies with market capitalization between $75 million and $700 million.

But any analysis of 404 should not focus solely on costs. The Council believes the benefits of the provision to investors are significant. Unfortunately it is impossible for shareowners—who ultimately pay the costs of internal controls, audits and financial fraud—to quantify the benefits of Section 404. However, the non-quantifiable benefits—including stronger internal controls, more reliable financial statements and improved confidence in the quality of reported financial statements—are significant.

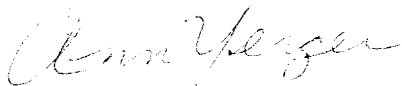
Companies also benefit. A study by Hollis Ashbaugh-Skaife of the University of Wisconsin-Madison, Daniel W. Collins of the University of Iowa, William R. Kinney Jr. of the University of Texas at Austin, and Ryan LaFond of the MIT-Sloan School of Management found that "firms with internal control deficiencies have significantly higher idiosyncratic risk, systematic risk and cost of equity capital. They also found that:

> *...a remediation of an internal control deficiency is followed by a significant reduction in the cost of equity capital. The magnitude of the cost of equity capital effects of the internal control deficiency are economically important ranging from 50 to 150 basis points depending on the analysis. Overall, the results of our cross-sectional and change analysis tests are consistent with strong internal controls being valued by the capital market.*

In closing, Section 404 is working. It is identifying problems with internal controls. Some 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 good outcome. Clearly, early identification is preferable to late and much costlier announcements.

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