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Council of Institutional Investors
The Voice of Corporate Governance

April 22, 2010

The Honorable Christopher J. Dodd
Chairman, Senate Committee on
Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20515

The Honorable Richard C. Shelby
Ranking Member, Senate Committee on
Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20515

Dear Chairman Dodd and Ranking Member Shelby:

We are writing to urge you in the course of your efforts to reform the financial sector to resist efforts to weaken protections for investors in the Sarbanes-Oxley Act of 2002 (SOX). Specifically, we oppose exempting smaller public companies from compliance with Section 404(b) of the Act. Further, we are troubled by evidence of a proposal to roll back to an arbitrary market capitalization point strengthened internal controls requirements for larger companies that are already in compliance with the provision.

As you know, Section 404(b) requires an independent audit of a public company's assessment of its internal controls. If Congress agrees to a permanent 404(b) waiver for smaller companies, there may be little independent scrutiny of financial reporting safeguards at half of all listed companies nationwide. *Compliance Week* recently reported that, "as much as non-accelerated filers denounce the burden of Section 404(b) compliance, they're still confronted with one stubborn counter-argument: fraud happens." The publication went on to note that numerous studies indicate that small companies are particularly vulnerable to fraud.¹

Reporting under Section 404 provides investors with meaningful information regarding a public company's internal control over financial reporting (ICFR). In addition, we believe that the required independent audit of management's assessment of the effectiveness of ICFR, as required by SOX Section 404(b), has been integral to the achievement of the intended objectives of ICFR reporting under SOX Section 404.

A congressionally-mandated study by the Securities and Exchange Commission (SEC) has found that Section 404 provides benefits that are valuable regardless of a public company's size. Reporting requirement reforms, including the Public Company Accounting Oversight Board's adoption of Audit Standard No. 5 and the SEC's management guidance, are reflective of the real-world lessons learned since the law's enactment. The result has been a decline in compliance costs of approximately 30 percent.²

¹ "Small Filers Struggle With Internal Controls Over Fraud," *Compliance Week*, March 16, 2010.

² See SEC, Office of Economic Analysis, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* (September 2009), available at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

As important, the SEC's study determined that investors and other financial statement users "regard ICFR disclosures to be beneficial and indicated that Section 404(a) and Section 404(b) compliance has had a positive impact on their confidence in the companies' financial reports. The users generally indicate that Section 404 compliance leads management to better understand financial reporting risks, put in place appropriate controls to address financial reporting risks, and address internal control deficiencies in a more timely fashion than in the absence of the disclosure requirement."³

Investor confidence in public companies' financial reports is imperative to the successful operation of our capital markets. As such, it only makes sense to apply the benefits of Section 404(b) to investors to public companies of all sizes, even those that have not yet had to comply. This is especially meaningful in view of the fact small companies are more likely to issue earnings restatements. In fact, a November 2009 study by Audit Analytics suggests that companies that have not yet had auditors review their internal control reports have a restatement rate that is 46 percent higher than larger public companies, despite claiming they have effective controls.⁴ Moreover, a 2009 analysis of restatements of small companies by Glass Lewis for the Ohio Public Employees Retirement System found a correlation between internal control problems and poor stock performance.⁵ The analysis revealed the large costs incurred by investors in the form of continued stock underperformance of small companies with deficient internal controls.⁶

There is no compelling or credible reason to create a dual class system of investor protection in the United States. By waiving Section 404(b) compliance for all but the largest public companies, however, Congress sets us on a path to do just that. We urge you maintain the benefits of Section 404 to investors in all public companies.

Sincerely,



Cindy Fornelli
Kurt Schacht
Executive Director
Center for Audit Quality



Kurt N. Schacht
Managing Director
CFA Institute



Jeff Mahoney
General Counsel
Council of Institutional
Investors

cc: Members of the United States Senate

³Ibid, p.7.

⁴ See Audit Analytics, *Restatements Disclosed by Two Types of SOX Issuers: 1) Auditor Attestations Filers and 2) Management-Only Report Filers*, November 2009.

⁵ Council of Institutional Investors, *Glass Lewis Finds Poor Internal Controls at Smaller Companies Hurt Investors*, Council Governance Alert, Dec. 10, 2009, <http://www.cii.org/UserFiles/file/resource%20center/council%20governance%20alert/2009%20Archive/2009%20Alert%2048.pdf>.

⁶ Ibid.