COUNCIL OF INSTITUTIONAL INVESTORS

Via Email

July 12, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Public Company Accounting Oversight Board; Notice of Additional Solicitation of Comments on the Filing of Proposed Rule on Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and Conforming Amendments (File Number: PCAOB-2007-02)

Dear Ms. Morris:

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 believes that Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") has been critical in restoring investor confidence and overall integrity of the United States ("US") capital markets and welcomes the opportunity to further comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and Conforming Amendments* ("AS5").

We believe that effective internal controls, long required of public companies by the Foreign Corrupt Practices Act of 1977, are the backbone of high quality financial reports. All companies tapping the public markets to raise capital, regardless of size, should have appropriate controls with meaningful review by external auditors.

Suite 500 • 888 17th Street NW • Washington, DC 20006-3310 • 202.822.0800 • Fax 202.822.0801 • www.cii.org

Section 404 is improving companies' internal controls. A study of financial restatements revealed that the number of restatements filed by large public companies, which adopted Section 404 in 2004, fell by nearly twenty percent in 2006, the first such decline since 2001.[1] By contrast, the number of restatements by smaller public companies with a public float of less than $75 million, companies that have yet to adopt Section 404, increased in 2006 by approximately forty-two percent.[2]

We believe AS5 is largely responsive to the Council's previous comments and recommendations.[3] We are also confident that the PCAOB's ongoing inspection process will play a critical role in ensuring that AS5 is implemented in the high quality manner necessary to serve the needs of investors and other capital market participants.

---

[1] Audit Analytics, *2006 Financial Restatements—A Six Year Comparison* 5 (Feb. 2007), *available at* http://www.auditanalytics.com/doc/report-re-20070212.pdf.

[2] *Id.* Of note, the Council strongly opposes legislative efforts to further defer for the fifth time the internal control requirements of Section 404 for smaller public companies. *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to the Honorable José E. Serrano and the Honorable Ralph Regula, Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives 4 (June 27, 2007), *available at* http://www.cii.org/library/correspondence/06-27-07%20-Serrano.pdf.

[3] *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors ("Council"), to Office of the Secretary, PCAOB 2 (Feb. 13, 2007), *available at* http://www.cii.org/sarbanes_oxley/pdf/February%2013%202007%20PCAOB%20Comment%20Letter%20_Final_.pdf.

We, therefore, encourage the Securities and Exchange Commission ("SEC" or "Commission") to act promptly to adopt the AS5 as a final standard.[4] Investors have long demanded, and long deserved, a full and faithful implementation of all of the requirements of Section 404 by all companies –large and small—that access the public markets.

******

In response to your request for further feedback on AS5, we are pleased to respond to the following selected SEC questions on this matter as follows:

(2) Please comment on the requirement in Paragraph 80 that the auditor consider whether there are any deficiencies or combinations of deficiencies that are significant deficiencies and, if so, communicate those to the audit committee. Specifically, will the communication requirement regarding significant deficiencies divert auditors' attention away from material weaknesses?

[4] Of note, the general membership of the Council earlier this year adopted the following policy supporting the independence of the Public Company Accounting Oversight Board:

> **Independence of Accounting and Auditing Standard Setting**
>
> Audited financial statements and their related disclosures are a critical source of information to institutional investors making investment decisions. The well-being of the financial markets—and the investors who entrust their financial present and future to those markets—depends directly on the quality of the information audited financial statements and disclosures provide. The quality of that information, in turn, depends directly on the quality of the standards that: (1) preparers use to recognize and measure their economic activities and events; and (2) auditors use in obtaining reasonable assurance that the preparers' recognition and measurement is free of material misstatement. The result should be accurate, transparent, and understandable financial reporting. The responsibility to issue and develop accounting and auditing standards should reside with independent private sector organizations with an appropriate level of government input and oversight. Those organizations should possess adequate resources and the technical expertise necessary to fulfill this important role. Those organizations should also include significant representation from investors and other users of audited financial reports on the organizations' boards and advisory groups. Finally, those organizations should employ a thorough public due process that includes solicitation of public input on proposals and consideration of user views before issuing final standards. The United States Congress, the Securities and Exchange Commission ("SEC"), and other federal agencies and departments should respect and support the independence of the designated accounting and auditing standard setting organizations and refrain from interfering with or overriding the decisions and judgments of those bodies.
>
> (adopted March 20, 2007).

The Council believes that the requirement in Paragraph 80 is appropriate and consistent with long-standing audit practice.[5] As significant deficiencies in internal controls may lead to material weaknesses that negatively impact the profitability and valuation of a company,[6] the requirement appropriately provides for a productive dialogue between management, the auditor, and the audit committee that is in the interest of both investors and management. Thus, we do not believe the communication requirement regarding significant deficiencies will divert auditors' attention away from material weaknesses, but rather is an essential element of an audit that will enhance the early identification and remediation of shortcomings that could develop into material weaknesses.[7]

(4) Please comment on whether the definition of "material weakness" in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective.

The Council generally supports the PCAOB's definition of "material weakness." The definition appears to be an appropriate approach that avoids rule-based numerical thresholds that, in the context of financial reporting, generally have been found to be insufficient in serving the needs of investors.[8]

(5) Is AS5 sufficiently clear about the extent to which auditors can use the work of others?

The Council, as indicated in our previous comment letter on this topic, believes "that an excessive use of the work of others in performing an audit of internal controls, particularly using the work performed by company management, may weaken investor protection and impair the credibility of the independent audit and regulatory processes."[9] Thus, we believe that the auditor's assessment of "competence and objectivity" and the related "risk" analysis in paragraphs eighteen and nineteen of AS5, respectively, are paramount in permitting the work of others. In our view, those requirements and the other requirements contained in the AS5 section entitled "Using the Work of Others" are sufficiently clear.

---

[5] Codification of Statements of Auditing Standards, AT §501.44, AU §325.02 (Am. Inst. of Certified Pub. Accountants 2003) (describing the reportable conditions and material weakness communication requirements for internal controls that have existed in the auditing literature for many years).
[6] *See* Weili Ge & Sarah McVay, *The Disclosure of Material Weaknesses in Internal Control after the Sarbanes-Oxley Act,* 19 Acct. Horizons 137, 154 (Sept. 2005) ("We find that firms disclosing material weaknesses tend to . . . be less profitable.").
[7] *See, e.g.,* Neri Bukspan et al., *New Section 404 Guidance Will Increase Efficiencies and Cost-Effectiveness,* Standard & Poor's 8 (June 25, 2007).
[8] *See* SEC Staff Accounting Bulletin: No. 99 – *Materiality*, 17 C.F.R. § 211 (Aug. 12, 1999) (Noting that the SEC, the Financial Accounting Standards Board, and the United States Supreme Court have all reached generally consistent conclusions indicating that investors are best served by a qualitative principles-based approach to materiality).
[9] Letter from Jeff Mahoney *supra* note 3, at 3.

(6) Will AS5 reduce expected audit costs under Section 404, particularly for smaller public companies, to result in cost-effective, integrated audits?

The Council believes that the experience gained by auditors and management over the first few years of implementing Section 404, as well as the greater emphasis on risk assessment contained in AS5, should further reduce audit costs under Section 404 for all companies, including smaller public companies.[10] We note that a recent Financial Executives International ("FEI") survey of 200 members asked companies to summarize their experiences with Section 404.[11] The survey revealed that the average Section 404 compliance costs for 2006 decreased twenty-three percent from 2005 totals.[12] Moreover, compliance costs fell approximately thirty-five percent from 2004 totals.[13] Whether or not the costs of Section 404 continue to decline, we believe those costs are far outweighed by the benefits of Section 404.

---

[10] *See, e.g.*, Bukspan et al. *supra* note 7, at 6.
[11] News Release, Financial Executives International, *FEI Survey: Management Drives Sarbanes-Oxley Compliance Costs Down by 23%, But Auditor Fees Virtually Unchanged* 1 (May 16, 2007), *available at* http://fei.mediaroom.com/index.php?s=press_releases&item=187
[12] *Id.*
[13] *Id.*

We note that a study focusing on the internal control requirements of Section 404 found "clear evidence" that internal control risk matters.[14] More specifically, the study found that firms reporting effective controls, or firms remediating previously disclosed internal control deficiences, benefit through a lower cost of capital by as much as 151 basis points.[15] Consistent with the results of that study, a recent report analyzing Section 404 filings concludes:

> As the first significant wave of third year Section 404 filings begins to ebb, one thing should be clear: the quality and reliability of public company financial statement reporting has improved dramatically under SOX directives. Based on the results of the first 3,000 third year Section 404 filers (out of approximately 4,500 that will file throughout the entire year), the adverse Section 404 opinion rates have dropped precipitously. As of filings through April 1st, the year 3 adverse opinion rate had dropped to 5.4%, down from 10.5% in year 2 and 16.9% in year 1. . . .
>
> In short, companies . . . have benefited from the requirements of Sarbanes Oxley and more specifically Section 404. Financial statements . . . have been materially improved. One could claim that every investor, big or small, has benefited from the elimination of substantial deficiencies in registrant financial reporting.[16]

---

[14] Hollis Asbaugh-Skaife et al., *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity* 38 (Apr. 2006 & rev. Feb. 28, 2007). We believe the SEC is overdue in recognizing credible evidence of the benefits of Section 404. For example, the SEC's analysis of the aforementioned study in an earlier rule relating to Section 404 was disappointing given the study's important contribution to the cost-benefit debate. *Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies*, Securities Act Release No. 33-8760, Exchange Act Release No. 34-54942, at 39 n.103 (Dec. 15, 2006), *available at* http://www.sec.gov/rules/final/2006/33-8760.pdf.

[15] *Id.* at 3-4.

[16] Audit Analytics, *Second Year 404 Dashboard With Updates for Year Three* 1 (Apr. 2007) (footnotes omitted), *available at* http://www.auditanalytics.com/doc/report-ic-2007-04.pdf.

(7) Does AS5 inappropriately discourage or restrict auditors from scaling audits, particularly for smaller public companies?

The Council, as indicated in our previous comment letter on this topic, generally supports scaling audits based on the size *and* complexity of a public company.[17] We believe AS5 is consistent with our view that a scaled audit of a smaller and less complex public company: (1) does not exempt the audit from any of the principles set forth in AS5, including for planning the audit, testing controls, evaluating identified deficiencies, and reporting on internal control; and (2) does not result in a less rigorous audit.

******

The Council appreciates the opportunity to provide our comments on AS5. We would be happy to respond if you have any questions or need additional information.

Sincerely,

Jeff Mahoney
Jeff Mahoney
General Counsel

[17] Letter from Jeff Mahoney, *supra* note 3, at 2-3.