April 12, 2005

The Honorable William Donaldson
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Filed electronically at rule-comments@sec.gov

Re: **Roundtable on Implementation of Section 404 of the Sarbanes-Oxley Act Establishing Internal Control Reporting Provisions for Public Companies, SEC File No. 4-497**

Dear Mr. Chairman:

This letter responds to the invitation issued by the Securities and Exchange Commission (SEC) for written submissions related to implementation of Section 404 of the Sarbanes-Oxley Act of 2002, establishing internal control reporting requirements for public companies. The purpose of this letter is to express strong support for Section 404's requirements and to oppose efforts to narrow, weaken, or further delay its implementation.

Accurate financial reporting by public companies is the foundation of a vibrant capitalist system. Financial statements guide investors, lenders, regulators, and public officials charged with developing U.S. fiscal, trade, and market policies. Accurate financial reporting is impossible without corporate internal controls designed to provide reasonable assurance that a company's financial reports are reliable. In light of ongoing evidence that some of the largest corporations in the United States employ deficient internal control systems and issue unreliable financial reports, efforts to narrow, weaken, or further delay Section 404 requirements should be rejected as short-sighted and ill-advised. The expense associated with ensuring reliable internal controls is not just a necessary cost of doing business, it is essential to this country's economic future.

Four Years of Major Accounting Failures. The past four years have provided ample evidence of accounting failures and inadequate internal control systems at some of the largest and best known public companies in the United States.

Some of these accounting failures have been extensively documented in hearings held and reports issued by the U.S. Senate Permanent Subcommittee on Investigations, on which I serve. A leading example is the Enron Corporation, which was the subject of an intensive Subcommit-ee investigation from 2002 to 2003, involving four hearings, two bipartisan reports, over 100 interviews, and more than 2 million pages of documents. The Subcommittee's hearings and reports describe multiple instances in which Enron engaged in accounting deceptions, including through using special purpose entities (SPEs) and unconsolidated affiliates to move poorly performing assets off its books, using questionable hedging arrangements to hide investment losses, "monetizing" the company's investments in large capital assets like power plants, and using forward prepaid contracts or "prepays" to obtain immediate cash payments on contracts to deliver energy over a period of years.[1] Another Subcommittee report details how the Enron Board of Directors, and in particular its audit committee, were kept informed of the company's fiscal policies and performance, and "knowingly allowed Enron to engage in high risk accounting practices."[2] The Subcommittee report concludes that the "Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the company by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation."

Additional Subcommittee hearings and reports show that major U.S. financial institutions, including Citigroup, J.P. Morgan Chase, and Merrill Lynch, knowingly contributed to Enron's accounting deceptions. A 2002 hearing, for example, presents detailed evidence that Citigroup and J.P. Morgan Chase helped Enron hide nearly $5 billion in debt by constructing phony energy trades that disguised loans as prepaid forward contracts and enabled Enron to record borrowed funds as cash flow from operations instead of as cash flow from financings.[3] The 2002 Subcommittee hearing also showed how Merrill Lynch participated in a sham asset sale with Enron, pretending to purchase Nigerian barges for $12 million just before the end of 2000, so that Enron could include the "sales revenue" in its year-end financial statement. A subsequent Subcommittee report details how Citigroup participated with Enron in two sham joint ventures, Bacchus and Sundance, which allowed Enron to inflate its year-end earnings by $112 million.[4] This report also details how J.P. Morgan Chase sold Enron a $5 million tax shelter known as Slapshot which, in addition to reducing Enron's tax payments in Canada, was designed to provide Enron with $65 million in phony net income "improvements" over five years.[5]

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[1]See, e.g., "The Role of the Financial Institutions in Enron's Collapse," S.Hrg. 107-618 (July 23 and 30, 2002); and "Oversight of Investment Banks' Response to the Lessons of Enron," S.Hrg. 107-81 (Dec. 11, 2002). See also letter from Sen. Levin to the Financial Accounting Standards Board re File Reference No. 1082-200 (Aug. 28, 2002)(summarizing Enron's SPE abuses).

[2]"The Role of the Board of Directors in Enron's Collapse," S.Prt. 107-70 (July 8, 2002), at 3.

[3]"The Role of the Financial Institutions in Enron's Collapse," S.Hrg. 107-618 (July 23 and 30, 2002).

[4]"Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions," S.Prt. 107-82 (Jan. 2, 2003).

[5]Id. at 26. In response, in 2004, the SEC, Federal Reserve, Office of the Comptroller General, Office of Thrift Supervision, and Federal Deposit Insurance Corporation conducted a review of major banking and securities firms selling complex structured financial products in the United States and issued a joint policy statement requiring U.S. financial institutions to strengthen their internal controls and stop participating in abusive structured finance transactions that result in misleading financial statements, tax evasion, or other improper conduct. See "Policy

Additional evidence reviewed by the Subcommittee indicates that major accounting firms also participated in Enron's accounting deceptions. Documents show, for example, that Arthur Anderson had designated Enron a "high risk" client and senior Anderson accountants were well aware of Enron's aggressive accounting practices. The documents show that, while Anderson had, at times, raised objections to some of Enron's accounting, the firm failed to stop the abuses and, at times, helped Enron structure questionable transactions. A separate Subcommittee investigation, initiated in 2003, found that major accounting firms were also active in the tax shelter industry and expended significant resources to develop, market, and implement abusive tax shelters which, among other consequences, can be used to improve a corporation's reported financial results.[6] A 2005 study by the Government Accountability Office found multiple instances of major accounting firms selling tax shelters to the public companies they audited, raising conflict of interest concerns as well as questions about the reliability of the tax liabilities reported on those companies' financial statements.[7]

Many other public companies and financial institutions operating in the United States have also engaged in significant accounting deceptions, involving millions or even billions of dollars. In many cases, the outside auditor claims to have relied on the company's internal financial reporting and missed the deception. Worldcom, for example, hid over $8 billion in expenses; Parmalat claimed a $5 billion bank account that did not exist; Rite Aid overstated its profits by $1.6 billion; and Tyco issued hundreds of millions of dollars in allegedly unapproved executive bonuses and loans, among other problems. Over the past four years, numerous other companies, including Aldephia, HealthSouth, Computer Associates, Quest, and others, have also been accused of accounting fraud. The latest accounting scandal, involving AIG, is still unfolding. In 2003, AIG reached a $10 million settlement with the SEC for selling a suspect insurance product to a company called Brightpoint Inc. to improve the company's financial statements. This year, AIG has admitted engaging in a range of transactions designed to achieve specified accounting results on its own financial statements, including inflated earnings and liability reserves, that may require a restatement in excess of $1.7 billion. Altogether over the past four years, hundreds of public companies have filed restatements of their financial results, providing additional proof of ongoing, widespread deficiencies in corporate internal controls.

Section 404. In 2002, in response to Enron, Worldcom and other accounting scandals, Congress enacted the Sarbanes-Oxley Act to revamp oversight of the U.S. accounting industry, improve accounting standards, and strengthen corporate financial reporting. Section 404 of the Act directs the SEC to require public companies to include in their annual SEC reports an "internal control report" describing management's responsibility to establish and maintain an

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Statement: Interagency Statement on Sound Practices Concerning the Complex Structured Finance Activities," SEC Release No. 34-49695, File No. S7-22-04.

[6]See, e.g., "The Role of Professional Firms in the U.S. Tax Shelter Industry," (Feb. 8, 2005); "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," S.Hrg. 108-473 (Nov. 18 and 20, 2003).

[7]See "Tax Shelters: Services Provided by External Auditors," Report No. GAO-05-171 (Feb. 2005).

adequate internal control structure and procedures for financial reporting, and assessing the effectiveness of those corporate controls. Section 404 also requires each corporation's auditor to attest to the effectiveness of the corporation's internal controls, using standards established by the Public Company Accounting Oversight Board.

Section 404 builds upon long-standing, but long-ignored requirements for effective corporate internal controls – requirements which date back over 25 years to the Foreign Corrupt Practices Act of 1977. These internal controls are supposed to provide reasonable assurance that the financial data being collected by a company provides meaningful and reliable information that can be used to produce an accurate financial statement. Although U.S. public companies are supposed to have had these internal controls in place for decades, some corporations have complained about the difficulty and expense of meeting the requirements of Section 404. In response, the SEC delayed requirements for full implementation of Section 404 and gave public companies more time to establish and test their internal controls. In addition, the SEC extended new accelerated filer reporting deadlines for a year, primarily to ease Section 404 compliance.

Despite the flexibility shown by the SEC, some corporations have continued to complain about Section 404. Some of these complaints apparently arise from uncertainties over how the law is intended to be implemented, what testing should be conducted by accounting firms, what documentation should be compiled by corporations regarding their compliance with the law, and what information should be communicated by corporations to the public. Identifying and addressing these uncertainties during the Roundtable should help resolve implementation issues and clarify compliance expectations.

A second set of complaints involves cost issues and management resistence to spending the funds needed to implement an effective system of internal controls. While empirical cost data has yet to be compiled by the SEC, and analysis will be needed to separate one-time outlays to improve deficient systems versus ongoing costs to test generally reliable systems, it may be useful during the Roundtable to consider Section 404 compliance costs in the context of total company revenues, total company expenses, and the importance of accurate financial data to both individual companies and U.S. capital markets. As mentioned earlier, accurate financial statements are critical to investors, lenders, analysts, and public officials charged with developing and protecting America's capital markets. Inaccurate financial statements can damage not only the offending corporation which may be hit with stockholder distrust, falling stock prices, increased capital costs, accounting and legal expenses, and increased regulatory oversight, but also U.S. capital markets as a whole which may be hit with a loss of public confidence, capital flight, and significant enforcement costs. To avoid such damaging effects, the corporate costs associated with maintaining an effective system of internal controls that reasonably assures reliable financial statements should be seen by every market participant as a necessary and fundamental cost of doing business as a public company in the United States.

A final set of complaints revolves around attempts by some corporations to reinterpret the Sarbanes-Oxley law and weaken its requirements for annual attestations and external evaluations of the effectiveness of a company's internal controls. For example, some corporations are apparently calling for biennial rather than annual attestations and for an external auditor's attestation to derive not from its own testing, but from the findings of a company's own internal audit or compliance function. Such suggestions are inconsistent with both the letter and intent of the law which is aimed at compelling public companies to strengthen their internal controls, produce more reliable financial statements, and put an end to the long line of accounting scandals that have so damaged U.S. capital markets since the collapse of Enron four years ago.

Thank you for this opportunity to comment on the implementation of Section 404.

Sincerely,

Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations

CL:ejb

cc: SEC Commissioner Paul S. Atkins
SEC Commissioner Roel C. Campos
SEC Commissioner Cynthia A. Glassman
SEC Commissioner Harvey J. Goldschmid