June 15, 2010

House and Senate Conferees
Wall Street Reform and Consumer Protection Act Conference
2128 Rayburn House Office Building
Washington, DC 20515

Dear Conferee:

As you confer on the composition of financial regulatory reform legislation, we ask that you exclude from the final bill an amendment in the House Act that would permanently exempt public companies with less than $75 million in market capitalization from compliance with Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX).

As you know, Section 404(b) requires an independent audit of a public company's assessment of its internal controls over financial reporting (ICFR). We dispute the notion that investors in smaller public companies do not deserve the same financial reporting safeguards as investors of large public companies.

The Securities and Exchange Commission (SEC) has conducted a Congressionally-mandated study which found that Section 404 provides benefits that are valuable regardless of a public company's size. Additionally, the study found that reporting requirement reforms, including the Public Company Accounting Oversight Board's (PCAOB) adoption of Audit Standard No. 5 and the SEC's management guidance, are reflective of the real-world lessons learned since the enactment of SOX. The result of these reforms has been a decline in Section 404(b) compliance costs of approximately 30 percent.[1]

An independent audit of ICFR is also an important safeguard against financial fraud. Those who suggest that such frauds occur only in large companies are mistaken, as a recent study issued by The Committee of Sponsoring Organizations of the Treadway Commission found that between 1998 and 2007, the median market capitalization of companies experiencing fraudulent events was approximately $100 million.[2]

For your reference, we have included with this letter a summary of pertinent research on the benefits of Section 404(b) expressed by investors; the reforms undertaken by the SEC and

[1] 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.

[2] Fraudulent Financial Reporting: 1998-2007, *An Analysis of U.S. Public Companies, Commissioned by the Committee of Sponsoring Organizations of the Treadway Commission* (May 2010), available at http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf.

PCAOB to facilitate more efficient and effective audits of internal control over financial reporting; and the impact of the SEC and PCAOB reforms on cost trends for public companies.

Exempting smaller companies from Section 404(b) compliance may also result in a dual class system of investor protection and effectively undermine investor confidence in the effectiveness of exempted companies' financial control mechanisms. If investors lose confidence in the financial reports of companies not required to comply with Section 404(b), they are likely to demand higher rates of return. Ultimately, long-term capital costs associated with assuring investors of the quality of internal controls could far surpass the expense of complying with the provision.

Like you, our organizations recognize the positive impact small businesses have on the economy and job creation. However, we cannot support actions, no matter how well intentioned, that threaten investor confidence and the stability of the U.S. capital markets. For investors' sake, we urge you to strike from the conference report the Section 404(b) compliance waiver.

Sincerely,

Cindy Fornelli
Executive Director
Center for Audit Quality

Kurt Schacht
Managing Director
CFA Institute

Jeff Mahoney
General Counsel
Council of Institutional Investors

Attachment

Sarbanes-Oxley Act of 2002
Section 404 – Internal Controls over Financial Reporting

<u>Cost Trends of Management's Assessment and the Audit of ICFR post 2007 Reforms</u>

SEC Study

- General Cost Trends[3]
    - Average Section 404(b) costs declined ~ 30% from $950k to $701k from 2006 – 2008 for ALL companies that complied with 404(b)
        - Median costs[4] declined ~ 23% from $380k to $294k over the same period
- Smaller public companies (<$75 million in public float)
    - For companies with less than $75 million in market cap that were required to comply with Section 404(b), median costs declined ~42% from $200k to $116k from 2006-2008[5]
- Companies who had to comply for the 1st time AFTER 2007 reforms were enacted saw compliance costs trend as follows:
    - Total compliance costs (section 404a and 404b) – decreased ~14% compared to companies who complied for the first time BEFORE the 2007 reforms
    - Section 404(b) costs declined ~21% compared to companies who complied for the first time BEFORE the 2007 reforms
    - ILLUSTRATES IMPACT 2007 REFORMS HAD ON REDUCING COSTS FOR NEWLY COMPLIANT COMPANIES
- Statistics also show that total costs <u>decline significantly</u> with experience
- Perspective on potential 404(b) costs for smaller public companies (non-accelerated filers)
    - Percentage of Financial Statement Audit Fees attributable to 404(b) per the SEC study for companies that have complied with 404(b) – 32.5%[6]
        - Median Total Audit Fees
            - $25 million market cap or less – median of $70K
            - $25 million - $50 million market cap – median of $158k
            - $50 - $75 million market cap – median of $193k
        - Calculated Potential 404 (b) Audit Fees based on SEC projections (above x 32.5%)
            - $25 million market cap or less – median of $23k
            - $25 million - $50 million market cap – median of $51k
            - $50 - $75 million market cap – median of $63k
    - This helps put into perspective the potential 404(b) costs for smaller public companies – in contrast to the ~584k of average 404(b) costs ($275k median) for all companies responding to the SEC survey.

---

[3] Derived from Table 8, Panel A of SEC Study.

[4] Median costs represent the amount at which an equal number of companies had a higher level of costs as did lower levels of costs. This measure is helpful to the extent there are a few larger companies that raise the average but who may not be representative of the broader population.

[5] See Table 9, Panel A of SEC Study.

[6] See Table 10, Panel A of SEC Study

Benefits of 404 Expressed By Investors

SEC Study[7]

- Separate annual evaluations of ICFR by the auditor increases investors and other users' confidence in the quality and reliability of companies' financial reports for a variety of reasons
  - Process causes management to devote more resources to a disciplined financial reporting process including 1) better understanding of financial reporting risks, 2) put in place controls to address those risks, and 3) address control issues more timely.
- Independent audit of ICFR provides an incremental benefit to management's assessment
  - Provides necessary discipline to management's financial reporting process and assessment (similar to the audit of the financial statements)
  - Auditor's professional expertise in evaluating internal controls benefits management's evaluation by providing their perspective to a company's internal controls, which fosters improved evaluations and more timely and/or effective improvements in internal control. This, in turn, provides a benefit to investors due to improvements to the financial reporting that the above process engenders.
- Section 404 compliance was an appropriate use of a company's resources given the improvements it facilitates to a company's financial reporting.
- Companies have also noted benefits of 404 compliance
  - 73% of companies noted that Section 404 compliance improved the quality of their internal control structure
  - 49% noted that it improved the quality of a company's financial reporting
  - 48% noted that it improved the company's ability to prevent and detect fraud

FEI Survey (2007)[8]

- Represents poll of 185 companies
- Noted the following benefits
  - 50.3% agreed that financial reports are more accurate; up from 46% in 2006.
  - 56.0% agreed that financial reports are more reliable, up from 48% in 2006.
  - 43.6% agreed that compliance with Section 404 has helped prevent or detect fraud; up from 34% in 2006.
  - 69.1% agreed that compliance with Section 404 has resulted in more investor confidence in their financial reports, up from 60% in 2006.

Impact of 404(b) on Risk and Cost of Capital/Equity

- 2008 Study noted that auditor-confirmed changes in ICFR effectiveness are followed by significant changes in the cost of equity that range from 50 – 150 basis points.[9] This illustrates,

---

[7] Derived from Section V of SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements (SEC Study), available at http://www.sec.gov/news/studies/2009/sox-404_study.pdf

[8] Seventh Sarbanes-Oxley Compliance Survey; Financial Executives International (April 30, 2008); summary available at http://fei.mediaroom.com/index.php?s=43&item=204

[9] *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity*, June 10, 2008, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=896760

in part, the value investors place in the auditor's involvement when making investment decisions.

Audit Analytics

- 2009 Study[10] reviewed restatements disclosed by two types of SOX 404 issuers (those that had an ICFR audit and those that did not).
- Study found that companies who disclosed that ICFR was EFFECTIVE that DID NOT have an external audit of ICFR under 404(b) had a 46% HIGHER restatement rate than those companies that disclosed that ICFR was effective and HAD an audit of ICFR.
- Information from study illustrates that the external auditor's involvement provides a meaningful benefit to investors by providing more timely and more accurate disclosures of internal controls.
- The fact that restatement rates are lower indicates that auditors are highlighting remedial activities that companies take related to their internal controls in advance of a misstatement in the financial statements.

Restatements

- A 2009 Audit Analytics study[11] noted that since 2003, non-accelerated filers (companies with public float less than $75 million) have accounted for 65% of the total financial statement restatements (3,979 restatements out of a total of 6,116)
- Non-accelerated filers restate their financial statements at almost twice the rate of accelerated filers
- 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. The analysis revealed the large costs incurred by investors in the form of continued stock underperformance of small companies with deficient internal controls.[12]
- Numerous studies show that restatements have significant ramifications for investors, including
    - 2002 GAO study[13] noted that stock prices typically drop approximately 10% just after the restatement announcement, and appear to have a negative impact on stock performance over a longer period of time
        - GAO study also cited negative impact restatements have on investor confidence
    - 2004 Study[14] corroborated the GAO study and found that stock prices generally drop around 9% immediately after the announcement of the restatements

---

[10] *Restatements Disclosed by the Two Types of SOX 404 Issuers – (1) Auditor Attestations Filers and (2) Management-Only Report Filers*; Audit Analytics (November 2009)

[11] *2009 Financial Restatements: A Nine Year Comparison*; Audit Analytics (February 2010)

[12] 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.

[13] *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* (October 2002) available at http://www.gao.gov/new.items/d03138.pdf.

[14] *Determinants of Market Reactions to Restatement Announcements*; Palmrose, Richardson, Scholz (June 13, 2004) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=474384

<u>2007 Reforms and Impact on Management's Assessments and the Audit of ICFR</u>

- 2007 reforms include (these reforms went into effect in 2007):
  - SEC release of guidance for companies to utilize when conducting their assessments under Section 404(a) (http://www.sec.gov/rules/interp/2007/33-8810.pdf)
  - PCAOB released Auditing Standard No. 5, which was a revised auditing standard for audits of internal control over financial reporting (http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx)
  - PCAOB released Guidance for Audits of Smaller Public Companies, which was intended to provide further guidance to facilitate more efficient and effective audits of internal control over financial reporting (http://pcaobus.org/Standards/Auditing/Documents/AS5/Guidance.pdf)
- Key points related to 2007 reforms
  - SEC interpretive guidance –
    - Empower management to focus its compliance efforts on those that pose the greatest risk to reliable financial reporting – this is what matters most to investors. This is a key investor protection point and scalability point by ensuring that companies allocate resources and spend the most time in areas where problem are likely to occur
    - Allows companies of all sizes and complexities to tailor their compliance efforts to their own individual facts and circumstances
  - PCAOB Auditing Standard No. 5 and Smaller Auditor Guidance
    - Auditing Standard No. 5, developed by the PCAOB and approved by the SEC in July 2007, is designed to remove unnecessary, expensive and inefficient procedures from audits, <u>especially for smaller companies</u>.
    - Makes the Audit Clearly Scalable to Fit the Size and the Complexity of Any Company
      - The new standard includes guidance throughout explaining <u>how to conduct audits of smaller or less complex companies cost-effectively by allowing the audit to be tailored to the particular facts and circumstances of the company rather than the company's control system being made to fit the audit standard</u>
    - Directs Auditors to Focus on What Matters Most
      - Directs auditors to those areas that present the <u>highest risk that a company's internal control will fail to prevent or detect a material misstatement in the financial statements - areas that are key to achieving the benefits for investors intended by SOX</u>
    - Allows auditors to reduce testing, particularly in lower risk areas – a key provision that allows for the <u>conduct of the audit efficiently without compromising the effectiveness</u>
    - The PCAOB published guidance specifically targeting auditors of smaller companies, to help those firms understand how to scale the internal control audit to the circumstances <u>of smaller companies</u>.
      - This guidance was developed with the assistance of auditors who were experienced with audits of smaller companies and provides guidance for scaling the audit in a number of areas that are particularly challenging at smaller public companies