

August 21, 2006

U.S. Securities and Exchange Commission  
Washington, D.C.  
Attention: Ms. Nancy M. Morris, Secretary

Re.: Concept Release, File No. S7-11-06

Dear Ms. Morris:

Thank you for the opportunity to comment on the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting. I respectfully submit the following comments and recommendations.

#### In General

It is essential and timely for the SEC to address the problems which have made the implementation of Sarbanes-Oxley Section 404 the cause of excessive and wasteful expense, bureaucracy and paperwork. Because the costs have clearly outweighed the benefits, this implementation has been to the detriment, not the benefit, of investors. In addition, it has reduced the international competitiveness of U.S. enterprises and capital markets.

However, the Concept Release throughout moves in the direction of "additional guidance." May I respectfully suggest that what is needed is not additional guidance, but different and better guidance. Thus I believe the required project is more fundamental than the Concept Release seems to presuppose.

#### Specific Recommendations

##### 1. Smaller Companies

Section 404 should be made voluntary for smaller companies; alternately stated, they should have the ability to "opt out," with corresponding disclosure to investors, including

the reasons for the company's decision. In British parlance, this would represent a "comply or explain" regime.

Former SEC Chairman Arthur Levitt and others have stated that Section 404 compliance should be mandatory for companies, because it will cause investors to pay more for their securities ("lower their cost of capital"). But in fact this is a perfect argument for a voluntary system. If it be true that investors will pay more for a company's stock and bonds because it implements Section 404, it will voluntarily do so.

But what if it is not true? What if investors conclude that Section 404 costs far more than it is worth and thereby reduces the value of their investment? Companies will respond accordingly.

I believe the judgments and the point of view of investors should prevail, not the point of view of accountants trying to protect themselves from PCAOB criticism or from the fate of Arthur Andersen, while at the same time making exceptional profits from expanding the burden on companies. Thus a voluntary approach is superior, at a minimum for small companies.

I know that this approach was considered by the SEC when it rejected the recommendation of its Advisory Committee on Smaller Public Companies, but I respectfully recommend that this decision be reconsidered. A voluntary approach is not only better suited to a market economy and a free society, but it is the way to let market discipline reduce the morass of expense and bureaucracy which Section 404 implementation has unintentionally created.

## 2. Materiality Standard

I believe an essential reform, touched on in your question 25, is to fix the audit review standard of "other than a remote likelihood," which has caused Section 404 implementation to be everywhere associated with nitpicking and trivial paperwork. This should be changed to reasonable material weakness criterion, specifically: "a material risk of loss, misstatement, or fraud."

## 3. Audit Frequency

In my opinion, a simple and sensible way to reduce the heavy cost of Section 404 audits, in either a mandatory or voluntary system, would be to make them less frequent after the first year of compliance. Every three years would be reasonable, for example.

#### 4. Auditor Advice

Section II of the Concept Release includes the question of “the appropriate role of the auditor.” I believe a key reform of Sarbanes-Oxley implementation is to make it clear that rendering advice on the application of accounting standards is not only permitted, but expected and required of external auditors as part of their professional responsibility. One of the most unfortunate unintended effects of implementation has been in many cases to make the audit engagement team unwilling or unable without excessive internal accounting firm bureaucracy, to perform this essential professional function.

As part of this reform, it would be most helpful if the SEC could make it clear to the press and the public that accounting is not something objective, but that it is replete with more or less subjective judgments, choices among highly debatable accounting theories, and estimates of the unknowable future—all making professional consultation and advice essential.

Of course no one at the SEC has the naïve belief that accounting is something objective, nor does any other financial professional, but such belief appears common among journalists and others.

#### 5. Auditor Conflict of Interest

Question 10 and Sections III and V of the Concept Release deal with the role of accounting firms in creating Sarbanes-Oxley implementation problems. I believe that implementation reform needs to address the fundamental conflict of interest for accounting firms which is involved. As is well known, Sarbanes-Oxley implementation has been and continues to be a financial bonanza for these firms at the expense of corporate shareholders. The more detailed and burdensome they make the Section 404 routines, the more generous are the profits of the accounting firm partners.

The problem is compounded by the existence of only four principal firms, which in reality gives most companies very little choice; hence there is much less than optimal competition. As Peter Wallison has written, “Regulation itself limits the ability of smaller accounting firms to compete with the big four, giving the largest firms added pricing power.”

It would greatly help matters for the SEC to implement the Congressional intent of Sarbanes-Oxley as expressed by the Report of the Senate Banking Committee on Section 404: “The committee does not intend that the auditor’s evaluation be the subject of a separate engagement or the basis for increased charges or fees.”

## 6. Principles-Based Alternatives

Question 8 asks whether companies would benefit from the development of additional assessment frameworks, such as the more principles-based British Turnbull Guidance. In my opinion the answer is clearly yes. Having a more principle-based alternative would be advantageous in every respect.

Thank you for the opportunity to comment and for your consideration.

Yours truly,

Alex J. Pollock  
Resident Fellow  
American Enterprise Institute  
Washington, D.C.