

# COUNCIL OF INSTITUTIONAL INVESTORS

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## Via Email

September 14, 2006

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

*Re: Concept Release Concerning Management's Reports on Internal Control  
over Financial Reporting (File Number: S7-11-06)*

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors (“Council”), an association of 140 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 the overall integrity of the U.S. capital markets and is pleased to comment on the Concept Release Concerning Management’s Reports on Internal Control over Financial Reporting (“Release”).

The Council believes the post-Enron reforms promulgated by the U.S. Congress, the Securities and Exchange Commission (“SEC” or “Commission”), the Public Company Accounting Oversight Board (“PCAOB”), the stock exchanges, and other regulatory agencies have been paramount in repairing the confidence lost through the shocking series of corporate scandals that plagued the U.S. capital markets in the early part of this decade. These reforms have been successful in strengthening investor protections, modernizing corporate governance standards for public companies, enhancing the “tone at the top,” decreasing earnings management, improving the accuracy of financial statements, energizing boards of directors and audit committees, ensuring internal control systems are adequately developed, tested, and maintained and not dismissed as “cost centers,” and increasing overall accountability of corporate executives and directors. Although these changes are in some cases a work in progress, long-term in nature, and difficult to quantify, the Council believes the resulting benefits will far outweigh the costs.

The Council considers Section 404 a core element of the post-Enron reforms. Effective internal control over financial reporting is the backbone of high-quality financial statements. All companies tapping the public markets to raise capital—large or small—should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors.

The Council opposes any softening of Section 404's requirements for annual internal control assessment and reporting for any and all companies, and is pleased that the SEC has resisted recent calls to exempt most public companies from this important provision. As investors, the Council shares the concern in the business community over implementation problems with Section 404, including the relatively high cost of compliance in the initial roll-out of the provision.

Evidence shows that some of those costs are beginning to fall: a 2006 survey by Financial Executives International, a group advocating the views of corporate financial management, found that the total average cost of compliance with Section 404 fell 16.3 percent from 2004.<sup>1</sup> In addition, a recent analysis by Ventana Research, a performance management research advisory services firm, concludes that ongoing changes to accounting systems and processes to ease compliance with Section 404 is often "reducing the cost of finance operations generally."<sup>2</sup> That conclusion is consistent with a recent CFO Magazine survey of 213 finance executives that found "7 out of 10 finance executives at public companies say they have seen at least some benefit from Section 404; 93 percent of those cite business-process improvements."<sup>3</sup>

The Council also agrees with those experts who have concluded that there is "scant evidence" that Section 404 is harming the competitiveness of the U.S. capital markets, as some Section 404 critics continue to claim.<sup>4</sup> Many of those experts agree that the increase in initial public offerings ("IPOs") on exchanges outside the U.S. is, in large part, "simply because the increasing pool of savings in other countries will drive the growth of those markets."<sup>5</sup>

Notwithstanding the increased competition from foreign markets, the U.S. remains the largest national source of IPO activity in the world with a record setting 210 IPOs and \$33 billion in capital raised in 2005.<sup>6</sup> In addition, May 2006 was one of the most successful months for IPO's in the U.S. since the high-tech bubble burst, and the first five months of 2006 saw an almost 20 percent increase in U.S. IPOs from the comparable period in 2005.<sup>7</sup> Finally, a recent survey of 108 U.S. technology-based private companies found that "when companies were questioned about whether their decision to go public was delayed by SOX, companies highly disagreed with the statement that SOX was a reason for the delay."<sup>8</sup>

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<sup>1</sup> Press Release, "FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping" (April 6, 2006).

<sup>2</sup> Robert D. Kugel, "Sarbanes Oxley Starts a Foreign Affair" (August 14, 2006), page 2 of 2 (available at [www.ventanaresearch.com](http://www.ventanaresearch.com)).

<sup>3</sup> Kate O'Sullivan, "The Case for Clarity," CFO Magazine (September 1, 2006), page 1 of 4.

<sup>4</sup> Robert D. Kugel, "Sarbanes Oxley Starts a Foreign Affair," page 2 of 2.

<sup>5</sup> *Id.* at page 1 of 2.

<sup>6</sup> Ernst & Young/Thomson Financial, "Accelerating Growth Global IPO Trends 2006," page 19.

<sup>7</sup> "Learning to Live with Sox," CIO Insight (June 6, 2006), pages 3 of 5 & 4 of 5.

<sup>8</sup> Lynn Stephens & Robert G. Schwartz, "The Chilling Effect of Sarbanes-Oxley: Myth or Reality?," CPA Journal (June 2006), page 4 of 5.

The Council does not disagree that more might be done to reduce the costs of compliance with Section 404. We therefore commend the SEC for issuing the Release and soliciting comment from market participants on how Section 404 implementation can be improved and made more cost-effective.

The following are the Council's responses to several of the questions raised in the Release that are of particular interest to many of our members in their role as institutional investors:

- 1. Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?**
  
- 13. In light of the forthcoming COSO guidance for smaller public companies, what additional guidance is necessary on risk assessment or the identification of controls that address risks?**

As indicated above, and in the Council's most recent correspondence with the Commission on this topic, we strongly support the issuance of additional "practical, plain English guidance to management on how to assess the effectiveness of internal control over financial reporting."<sup>9</sup> It is our understanding that additional management guidance on the nature and extent of tests to be performed in assessing the effectiveness of internal controls would likely be useful to all reporting companies subject to the Section 404 requirements. We also continue to strongly support guidance that, when appropriate, is "tailored to the unique issues faced by smaller companies . . . ."<sup>10</sup>

We also believe that any additional management guidance should be consistent with the recent guidance issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), "Internal Control over Financial Reporting—Guidance for Smaller Public Companies" ("COSO Report").<sup>11</sup> Though targeted to smaller public companies, the COSO Report contains "principles-based" tools with examples that should be helpful to businesses of all sizes in performing cost-effective assessments of internal controls consistent with the requirements of Section 404.<sup>12</sup>

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<sup>9</sup> Letter from Ann Yerger, Executive Director, Council of Institutional Investors to The Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission and the Honorable Bill Gradison, Acting Chairman, Public Company Accounting Oversight Board (May 17, 2006), at page 3.

<sup>10</sup> *Id.*

<sup>11</sup> COSO, "Internal Control over Financial Reporting—Guidance for Smaller Companies" (June 2006).

<sup>12</sup> *Id.* at FAQ, Item 17.

We note that the COSO Report discusses and reaches conclusions on several issues that have been frequently raised by some of the critics of Section 404. For example, the COSO Report discusses the costs and benefits of Section 404 and concludes that the benefits are “significant” despite having received little attention.<sup>13</sup> The COSO Report explains:

Management and other stakeholders of public companies, particularly smaller ones, have focused great attention on the cost of complying with Section 404, with less attention given to the associated benefits. Although it may be difficult to measure impacts associated with inaccurate financial reporting, market reactions to corporate misstatements clearly signal that the investment community does not readily tolerate inaccurate reporting, regardless of company size. In that respect and with other benefits described below, effective internal control adds significant value.

Among the most significant benefits is the strengthened ability of companies to access the capital markets, providing capital which drives innovation and economic growth. Other benefits include reliable and timely information supporting management’s decision-making, consistent mechanisms for processing transactions across an organization enhancing speed and reliability, and ability to accurately communicate business performance with partners and customers.<sup>14</sup>

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<sup>13</sup> Id. at Volume 1, page 2.

<sup>14</sup> Id. at Volume 1, pages 2-3.

In addition, the COSO Report discusses the issue of whether small businesses should be exempt from internal control requirements.<sup>15</sup> The COSO Report rejects exemptions for small businesses, explaining:

COSO believes that any organization (public, private, governmental, non-profit, or family-owned) should maintain effective internal control to ensure the accuracy of information, completeness of transaction recordings, and appropriate financial disclosures. In addition, organizations should maintain effective internal control to address financial reporting, compliance, and operational risks. Developing and implementing effective internal control is simply good business. Size of the organization does not decrease the need for effective internal control. COSO does believe that the structure of internal control systems will vary, based on the size and complexity of the organization.<sup>16</sup>

**10. We also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b). Should possible alternatives to the current approach be considered and if so, what? Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?**

The Council generally supports the manner in which outside auditors currently provide the attestation required by Section 404(b). We believe that regular independent testing and assessment of internal controls is essential to delivering quality information to investors which is relevant, accurate and complete enough to enable well-informed investment decisions. Recent history has shown that simply testing internal controls for the purposes of an audit of financial statements does not provide sufficient assurance as to whether a material weakness exists. The regular external testing of the existence and effectiveness of controls, and the reporting of the testing results to investors, must be part of the framework to ensure that there is compliance.

Allowing alternative approaches to the attestation required by Section 404(b), such as internal control reviews every three years, is comparable to telling drivers that the state police will only patrol the interstate on Tuesdays and Fridays. Any such alternative would likely only confuse investors and open the process to problems that could harm the investing public.

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<sup>15</sup> Id. at FAQ, Item 19.

<sup>16</sup> Id.

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Finally, the Council believes that Section 404 is a necessary adjunct to Section 302 of SOX, which requires Chief Executive Officers and Chief Financial Officers to certify that the annual and quarterly financial reports fairly represent the financial condition and operating results of the companies and to acknowledge that they are establishing and maintaining internal controls. We note that since Section 302 is an ongoing requirement, it seems entirely appropriate that Section 404 remain at least an annual requirement.

In closing, Section 404 is working. As evidenced by the recent stock options backdating revelations, Section 404 is playing an important role in assisting companies and their auditors in identifying problems with internal controls and financial accounting and reporting. Some of those problems must be reported to investors as material weaknesses but many others are being identified and remediated before disclosure is required. From an investor's standpoint and for the marketplace at large, this is a good outcome. Clearly, earlier as opposed to later identification and remediation of internal control and reporting problems is a more cost-effective approach for investors, companies, auditors, and the overall capital market system.

The Council appreciates the opportunity to comment on the Release. We would be happy to respond if you have any questions or need additional information.

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney". The signature is written in black ink and is positioned above the typed name and title.

Jeff Mahoney  
General Counsel