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

26 February 2007

RE: SEC File No. S7-24-06. Comments on Proposed Rule: Management's Report on Internal Control Over Financial Reporting

Disclaimer: The interpretations and comments expressed in this letter are entirely mine. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.

The final goal of the proposed rule File No. S7-24-06 is to give some general guidelines for management regarding its evaluation of internal control over financial reporting. It does not provide a check-list of "to do" things when evaluating the effectiveness of the internal controls, thus avoiding the danger of a "ticking-box" approach to internal controls. The theoretical underpinning of the proposed approach is to leave flexibility to companies because one-approach-does-not-fit-all: companies are heterogeneous entities, hence they should implement the approach that best suit them. In principle, this is the correct answer to the existing uncertainty over the valuation principles, which has led to an excessively conservative application of the PCAOB standards, standardized to all types of companies. I would like to comment on the institutional foundations in which the proposed rule would be operating, what the academic literature stylizes in its complicated models, and what could be the possible outcomes of such regulation.

In matters of regulation, there are two concepts of flexibility: flexibility in compliance or in interpretation. The former is epitomized by the *comply-or-explain* approach, which the Cadbury Report (1992) pioneered in the UK, characterized by voluntary compliance coupled with mandatory disclosure: companies are not obliged by

law to follow the proposed guidelines, but, if not, they have to provide a valid justification. Basically, companies can choose which aspects of the regulation to comply with, but they have to provide an explanation for the regulatory aspects they are not embracing. The type of flexibility proposed by the rule File No. S7-24-06 is slightly different from the above concept, because each company must comply with the rule, although it is left flexibility in evaluating compliance. In place of the word "flexibility", I would use "discretion" because not much choice is left to companies: they have to *comply-and-explain.*

In theory, absence of a clear guidance in the evaluation of the internal controls should leave companies with free hands, in a cost-benefit analysis, when choosing the optimal evaluation approach. In practice, too much discretion (as the guidance seems to allow) could lead to two different outcomes in equilibrium: 1. under/upwardly disclosure; or 2. excessive compliance.

1. Why do companies disclose less? The academic literature gives at least 4 reasons:
    a. When proprietary information is revealed to competitors;
    b. When there are few sophisticated investors (non-sophisticated investors may interpret disclosure as a bad news, hence companies are less keen to disclose information);
    c. When there is too much discretion over what to disclose;
    d. When there are different types of companies in terms of quality of internal controls: the "good type" tends to disclose more, the "bad type" tends to disclose less.

In particular, I am referring to the disclosure of material weaknesses identified in the evaluation process as of the end of the fiscal year. What is exactly a material weakness? How do a material and a non-material weakness differ in their form and consequences? What is the incentive for the management to *fully* disclose such negative information to investors? What would be the role of the auditors in judging the material weakness and

what would happen if the judgment differs from the management interpretation? My last question directly leads to the point of excessive compliance.

2. Suppose that in equilibrium the management elaborates an optimal cost-effective evaluation process, but less stringent and rigorous than the PCAOB Auditing Standard No. 2. Does it provide a safe harbor for companies in matters of litigation? It could be that external pressures (media, shareholders) and/or litigation pressures (use of the disclosed information and of the chosen auditing approach in the eventuality of a lawsuit) force a company to deviate from its optimal equilibrium and to "over-control" the internal evaluation.

My general impression is that the intention of the proposed rule is to converge to a more principle-based approach like the UK Turnbull Report on Internal Controls (of which, incidentally, I could find many similarities and implicit references to the underlying concept of flexibility) without considering the different institutional settings between the UK and the US: British companies can *comply-or-explain*, American companies have to *comply-or-be-damned*.

What to do, then? A greater level of flexibility in the US straight-jacket regulatory system could be achieved with the following compromise: a minimum standard coupled with some flexibility. All companies (with no exceptions) could be required to comply with a minimum standard of internal controls, as specified in a detailed guidance, with auditors asked to certify the degree of compliance. Further evaluations should be left at companies' discretion and totally voluntary, with no auditors certification. I.e., companies should use the flexibility allowed by the law for the implementation of more complex assessments and explain why they opted for a specific evaluation. This would provide greater flexibility, especially for smaller companies which would likely opt out from more complex forms of regulation (with valid reasons), while still complying with a minimum standard. The judgment of the company's evaluation choice and its explanation would be then left to the market.

Thank you for your consideration.

Valentina G. Bruno

Economist
The World Bank
Washington DC

References

Arcot, S.R. and V.G. Bruno, 2006, One size does not fit all, after all: Evidence from Corporate Governance, *Mimeo.*

Bruno, V.G. and S. Claessens, 2007, Corporate Governance and Regulation: Can There be too Much of a Good Thing?, *FMG, ECGI and CEPR Working Paper*

Financial Reporting Council, 2005, Revised Turnbull Guidance

Tirole, J., 2006, The Theory of Corporate Finance, Princeton University Press.