April 1, 2005

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609
Attention: Jonathan G. Katz, Secretary

Re: Roundtable on Section 404 of the Sarbanes-Oxley Act; File No: 4-497

Dear Mr. Katz:

Ciena Corporation is pleased that the Securities and Exchange Commission has acknowledged the concerns expressed about the costs to the issuer community of compliance with Section 404 of the Sarbanes-Oxley Act and is holding a round-table discussion to explore the issue. This letter offers comments on our experience with and observations about Section 404 in hopes that they will assist in your inquiry.

**Introduction**

It is widely agreed that the Sarbanes-Oxley Act constitutes the most far-reaching legislative intervention into the regulation of public companies since the enactment of the securities laws in the early 1930’s. As significant as the statute is, however, many, if not most of its provisions can be said to have required only marginal changes in corporate behavior beyond what was already required by pre-existing norms arising from regulations, stock exchange rules, accounting and auditing standards, and “best practices.”

Without doubt the greatest burden Sarbanes-Oxley has imposed on business results from Section 404’s requirements regarding internal controls over financial reporting. Section 404 does not, on its face, make any changes to the substantive law relating to internal controls. Section 13(b)(2)(B) of the Securities Exchange Act has long required U.S. public companies to “devise and maintain a system of internal accounting controls.” The new law adds not an iota to that basic mandate. Nevertheless, as it has been interpreted, it has brought about radical changes in the procedures that most issuers must follow to maintain compliant control systems, changes that are particularly great for smaller issuers.
Since it was originally published in 1992, the “COSO Report”\(^1\) has been the principal authority on the design of systems of internal controls. As both the Commission\(^2\) and the Public Company Accounting Oversight Board (PCAOB)\(^3\) have recognized, the COSO Report remains the leading (if not the only) authoritative framework against which to measure the adequacy of a system of internal controls. What seems not to have been generally acknowledged, however, is that Section 404, as implemented, has effected major changes in what had heretofore been thought to be required to meet the COSO standards.

The result, intentional or not, has been to cause corporate America to make significant changes in the way it does business. Estimates of the first-year compliance costs of Section 404 have varied, but they are all in the billions of dollars. These costs are particularly significant for smaller public companies, for which the burden of compliance is disproportionately great.

Ciena Corporation is a smaller public company in the business of designing and selling telecommunications networking equipment, software and services. We went public in 1997 and our stock is traded on the Nasdaq Stock Market. In fiscal 2004 we had revenues of just under $300 million, and we have approximately 1600 employees worldwide. Our market capitalization is currently on the order of a billion dollars. Ciena’s fiscal year ends on October 31, and we will have to comply fully with Section 404 for the first time when we file our Form 10-K late this year, later than most other accelerated filers whose fiscal years subjected them to earlier compliance deadlines. In this letter we offer our perspective on the effects of Section 404, both its costs and its benefits.

The Purposes and Benefits of Section 404

Section 404 of the Sarbanes-Oxley Act was patterned after Section 36(b) of the Federal Deposit Insurance Act, 12 USC § 1831m, to which it is virtually identical. Section 404 appears to have been incorporated in the statute with little debate, perhaps on the theory that rules to which thousands of federally-insured depositary institutions have accommodated should not impose undue burdens on publicly-traded companies. If indeed that was the theory, it failed to consider the significant differences between financial institutions and other types of business when it comes to implementing strict internal controls.

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Sarbanes-Oxley was passed in response to a wave of scandals involving fraudulent activity by senior officers of public companies. The majority of the provisions of the Act are directed at preventing such frauds from being repeated, at bringing them to light at an early stage, or at punishing the perpetrators more severely.

Section 404 may also help deter fraud, as that is one of the functions of any well-designed system of internal controls. It seems unlikely, however, that better internal controls would have prevented Enron, WorldCom, or the other similar massive frauds that provided the impetus for Sarbanes-Oxley. Most of those cases involved collusion by senior officials, who were in positions that enabled them to circumvent their companies’ internal controls. It is at least open to question whether simply strengthening those controls would have produced a different outcome.4

It seems reasonable to say, that the primary purpose of Section 404 was more modest: generally to improve financial disclosure by requiring that companies put in place systems designed “to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and procedures . . .” (Rule 13a-15(f) (defining “internal control over financial reporting.”))

Section 404 has had the practical effect of causing virtually every public company to put its business processes under a microscope. The inevitable result of any such exercise is improvements in process that go beyond simply strengthening internal accounting controls. In weighing the benefits of Section 404, it is only fair to include in the balance the intangible, but nevertheless significant, gains in effectiveness and efficiency that are bound to result.

In sum, Section 404 is likely to produce three types of benefit: First, it will have some effect in deterring major corporate fraud, though the effect of other parts of Sarbanes-Oxley will probably be considerably greater. Second, Section 404 will result in improved financial reporting by making it less likely that, due to inadequate procedures or resources, corporations will inadvertently fail to capture, record and report significant transactions. Finally, in complying with Section 404, public companies will probably reap some benefits in improved effectiveness and efficiency of their financial processes.

4 This is not to suggest that nothing in Sarbanes-Oxley is likely to be successful in reducing corporate fraud. Several aspects of the statute, including strengthening auditor independence, tightening auditing standards, and encouraging “whistle-blowing,” are likely to have much greater direct effect in preventing similar major frauds in the future.
The Costs of Compliance

Applicable law (specifically Section 13(b)(2) of the Securities Exchange Act) and good accounting practice have long required corporations to maintain adequate internal controls over financial reporting. Section 404 has, however, brought about massive changes in the way that requirement is interpreted and applied. Compliance with it has required virtually every public company to go through an extensive process to review, document, and assess its internal controls and to “remediate” those found to be deficient.

There have been numerous efforts made to estimate the cost of compliance with Section 404. Whichever of the various reports one believes, they all are measured in the billions of dollars. The financial burdens fall disproportionately heavily on smaller issuers, which are less able to absorb the costs of compliance. This is partly because there are irreducible minimum costs of compliance that must be borne by all issuers; and partly because smaller issuers lack the infrastructure to carry on their business, while managing the process of review, documentation, remediation and testing, without substantial assistance from outside consultants.

Section 404 did not simply legislate what well-managed public companies should have been doing all along. Indeed, as observed above, standing alone, Section 404 creates no new substantive obligations. As it has been interpreted by implementing rules, however, Section 404 has imposed a procedural overlay that has resulted in major changes in what had previously been considered sound practice. This is particularly true for smaller companies, for which less rigorous systems of internal controls had long been thought acceptable. A review of these changes wrought by Section 404 illuminates the reasons why the costs of compliance have proved so high.

Review

The most important driver of high compliance costs has been the number and magnitude of the changes in practice and structure required by Section 404. Like virtually all public companies, Ciena had internal controls in place before the enactment of Section 404, and those controls had served us well. Like the overwhelming majority of public companies, we had never had a serious accounting problem, had never been required to restate our financials, and were proud to consider our financial statements and public disclosures to be accurate and reliable. In short, we were confident that our internal controls over financial reporting were adequate to the task.

Section 404 and the implementing regulations of the Commission and the PCAOB changed all that. It was clear to us, as we believe to virtually all other public companies, that our existing systems of internal controls could not meet
the new and significantly more rigorous standards. At the outset, however, it was far from clear what controls we would have to change or what new controls we would have to institute. Moreover, like many of our peers, we relied in part on some controls that were not thoroughly documented, something that, as discussed below, we would no longer be able to do.

In consequence, the only path to compliance was to conduct a comprehensive review of virtually all of our business processes. The goals of the review were to identify the processes that acted as controls on financial reporting, document those that were undocumented, determine which were necessary to prevent material misstatements in our financials, and “remediate” any that were deemed not strong enough. This represented for Ciena, and for most of our peers, a massive effort, which not only placed major demands on our internal resources but required us to hire outside consultants to assist us.

Documentation

One consequence of the rules under Section 404 is that controls that are not documented are no longer considered effective.\(^5\) This represents a major change from previously accepted practice. The COSO Report was quite explicit in recognizing, “The fact that controls are not documented does not mean that an internal control system is not effective, or that it cannot be evaluated.”\(^6\) The new requirements are particularly burdensome for smaller companies, that, as the COSO Report recognized, have less need for formal documentation: “The extent of documentation of an entity’s internal control system varies with the entity’s size, complexity and similar factors . . . Smaller companies typically have considerably less documentation.”\(^7\)

The cost of our documentation effort has been significant. Our own personnel have spent thousands of hours on it. Moreover, like most smaller issuers, we found that we also had to retain outside consultants (at significant expense) to complete the work on time.

Uncertainty

We have found that one of the greatest challenges of Section 404 stems from its very novelty. Notwithstanding the long-standing existence of requirements to maintain systems of internal control, as demonstrated above Section 404 has effected radical changes in how those controls are implemented,

\(^5\) See Auditing Standard No. 2, ¶¶ 42-46 (2004); Regulation S-K, Item 8, Instruction 1: “The registrant must maintain evidential matter, including documentation, to provide reasonable support for management’s assessment of the effectiveness of the registrant’s internal control over financial reporting.”

\(^6\) COSO Report, 73.

\(^7\) Id.
documented, tested and audited. Those procedural changes, in turn, are having effects on the substantive design and operation of control systems.

On its face, Section 404 is simplicity, itself, consisting of a mere 159 words arranged in only four sentences. That simplicity belies, however, the complexity inherent in implementing its requirements. Designing, implementing, testing and auditing systems of internal controls that meet the new standards calls for making a myriad judgments about how the requirements apply to particular situations in particular companies. Does this account or assertion require a control? What is an effective control in this situation? Is the existing control “deficient?” Is the deficiency “significant?” Do we have to hire additional staff in order to create a separation of functions, or can we rely on a compensating control? Is there some other available control? When does a deficiency become a “material weakness?”

The ability to make judgments about questions like these is the essence of professional expertise, and accountants and securities lawyers are regularly called on to make such judgments. They have, for example, been forming judgments about financial statement materiality for decades. The variation among seasoned professionals in their determinations about materiality is almost always quite narrow, as they draw from a deep and well-understood reservoir of experience.

But that experience was not developed overnight. What is different about Section 404 is that we lack an experience base built up through decades of interpreting and applying it and its implementing rules. Although the PCAOB has provided definitions of key terms such as “significant deficiency” and “material weakness,” they are still just verbal formulations. It is not surprising that, during the early phases, there has been considerable uncertainty among those who have to work with the rules. Until the relevant professionals have worked with these terms for a few years, there is likely to be significant variation in how they are applied in practice.8

As a result, even though professionals in the fields of accounting and securities regulation have participated in a massive effort to develop guidelines for reducing Section 404 to practice, those of us who are charged with complying with it on a day-to-day level still find ourselves navigating in largely uncharted waters. We have found that even the “experts” to whom we

8 There are some verbal formulations to be found in the regulations implementing Section 404 that practitioners have virtually no experience in applying. Item 308(c) of Regulation S-K requires that issuers disclose any “change in . . . internal control over financial reporting . . . that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting.” We know of no guidance to assist issuers in determining when a particular change in internal controls crosses this particular threshold of materiality.
turn for advice are not always certain about where to draw the line between accounts that are “significant” and those that are not; between controls that are “key controls” and those that are not; between controls that could reasonably affect financial statements and those that merely govern business processes; between controls that are adequate and those that are deficient; and a host of other distinctions that, together, make up the difference between compliance and non-compliance.

Uncertainty is an undesirable quality in any regulatory environment. Among other negative effects, it tends to increase the costs of compliance. The burden of uncertainty falls particularly heavily on smaller public companies like Ciena, as we are less able to absorb the additional costs of creating controls that are sufficiently conservative to assure they fall on the right side of the line.

Structural bias

It is universally understood that a system of internal controls need not be perfect to be sufficient. Implementing, maintaining, testing and auditing controls all impose costs on issuers; and it is obvious that in designing their controls they must weigh the anticipated benefits of controls against their costs. Unfortunately, in practice the system tends to tilt the balance toward more costly alternatives.

Like most of our peers among smaller issuers, Ciena has been forced by lack of internal resources and expertise to retain the services of outside consultants to help us design, document and test our internal controls. In assisting us, they have had to cope with the uncertainties described above.

In this condition of uncertainty the incentives operating on consultants are strongly biased toward conservatism. They do not have to bear the costs of carrying out their advice, their clients do. Moreover, consultants risk little by giving conservative advice leading to stronger – and more costly – controls; whereas they risk censure, or perhaps even liability, if their client experiences a breakdown in a control they recommended that, in hindsight, appears to have been not sufficiently robust.

The same conservative bias is at work in the audit of internal controls by a company’s independent auditors. One of the results of Sarbanes-Oxley, and the scandals that gave rise to it, is that the public accounting profession is under greater scrutiny than ever before. Not only is their work now subject to

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9 See, e.g., COSO Report at 81 (“Resources always have constraints, and entities must consider the relative costs and benefits of establishing controls.”) See also PCAOB Release 2004-001, 4-5 (discussing benefits of internal controls) and 8-10 (discussing costs) (March 9, 2004).
oversight by the PCAOB, but their exposure to liability for alleged malpractice has never been higher. It should surprise no one if they tend to tilt the cost-benefit balance toward more and stronger controls.

To observe that, in the current environment, consultants and accountants may be subject to a bias toward conservatism is by no means to impugn their integrity or professionalism. Who could blame them for being conservative? A realistic examination of the way Section 404 is functioning in practice, however, should take this structural bias into account. It leads, we believe, to the inevitable result that the costs of internal controls designed to meet the requirements of Section 404 will be greater, in both the short and the long run, than their benefits.

Because our fiscal year ends October 31, Ciena has not yet been through an audit of its internal controls. We are still, in fact, working through the process of reviewing and documenting our controls systems, and it is too early for us to have a longer perspective on the costs and benefits of the process. We can say, however, that in the course of our compliance efforts, we have seen evidence of the structural bias described above.

This is not to say that we are displeased with the work of the consultants and advisors that are assisting us; quite the contrary. It is fair to say, however, that on occasion we have resisted their suggestions as unwarranted by the benefits to be achieved. Moreover, because we are anxious to assure that our internal controls measure up to the standards by which our auditors will measure them, it is not unlikely that, in the final analysis, we will adopt controls whose costs are not fully justified by the benefits we can expect to derive from them. If our experience is typical, as we expect it is, it seems likely that this structural bias will result in costs that outweigh benefits across much of the entire issuer community.

Assessment

A key aspect of Section 404 is its requirement that management conduct an annual assessment of a company’s internal controls over financial reporting, and that the company’s auditors audit and report on that assessment. This, too, represents a significant change from prior practice. The COSO Report makes it clear that “monitoring” is an essential part of a system of internal controls, but it describes monitoring as consisting of both “ongoing monitoring procedures . . . built in to the normal recurring operating activities of an entity” and “separate evaluations.” It is clear that the Report envisions that

10COSO Report at 18, 69-78.
11 COSO Report at 69. According to the Report, ongoing monitoring procedures “are more effective than procedures performed in connection with separate evaluations.” Id. at 70.
many companies would assess their controls less often than annually. We urge the Commission to consider whether, if a company establishes an adequate program to monitor the operation of its internal controls, comprehensive assessments and audits might safely be conducted less frequently than once a year.

**Conclusion**

On the first page of its Executive Summary, the authors of the COSO Report warned about the dangers inherent in imposing requirements governing internal controls systems by law:

“Internal control means different things to different people. This causes confusion among businesspeople, legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an enterprise. Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule.”

While there is no doubt that there will be benefits that flow from Section 404 of the Sarbanes-Oxley Act, we also believe that the COSO Report was prescient in predicting “problems.” Now that the first wave of compliance activities is nearly completed, it is time to consider whether heavy procedural overlay imposed by Section 404 on the already existing substantive obligations regarding internal controls – and the associated costs of creating and maintaining the resulting new procedures – are justified by the benefits in reduced fraud and improved disclosure intended by Congress. At a minimum, we urge the Commission to review the results of Section 404 thoroughly and to seek ways to alleviate the burdens it has imposed on the issuer community, especially smaller companies like Ciena.

Sincerely,

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12 “Some entities with sound ongoing monitoring activities will nonetheless conduct a separate evaluation of their internal control system, or portions thereof, every few years.” COSO Report at 70. “Evaluation of an entire internal control system – which will generally be needed less frequently than the assessment of specific controls – may be prompted by a number of reasons: major strategy or management change, major acquisitions or dispositions, or significant changes in operations or methods of processing financial information.” COSO Report at 71.

13 COSO Report at 3.