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April 8, 2005

Mr. Alan L. Beller
Director, Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: SEC Roundtable Discussion Regarding the Implementation of <u>the Internal Control Provisions of the Sarbanes Oxley Act of 2002</u>

Dear Mr. Beller:

This statement is submitted in connection with the roundtable panel discussion concerning the implementation of the Internal Control Provisions of the Sarbanes Oxley Act of 2002 (the "Act") on April 13, 2005. I am a partner at the law firm of Shearman & Sterling LLP, where I lead our Mergers and Acquisitions Practice Group and regularly advise a number of our U.S. and foreign clients on disclosure and governance issues. I appreciate this opportunity to speak on behalf of Shearman & Sterling and to convey the views of many of our clients who provided input concerning their experiences with the implementation of the Internal Control Provisions of the Act.

We are of the view that the implementation of the internal control provisions of the Act has had some salutatory effects, but that such benefits have been gained at too high a cost, that the implementation of Section 404 has given rise to several issues that should be addressed and that there are options available to regulators that could realize most of the benefits of Section 404 in its present form at a significantly lower cost.

Background

Section 404 of the Sarbanes Oxley Act of 2002 ("Section 404") was adopted with the intention of improving the internal control systems of companies with securities registered with the SEC in the United States. In anticipation of the roundtable discussion today, we polled many of our clients that have implemented, or are in the process of implementing, Section 404. We sought their comments on the ways in which the Section 404 review has been effective, as well their thoughts on issues that came to light in implementing Section 404 and their ideas as to how Section 404 could be improved.

Several of our clients indicated that they believe that the implementation of Section 404 could have a moderately positive effect in deterring corporate fraud and improving the quality of financial reporting. Some clients also suggested that they expect a portion of the costs they have incurred in implementing Section 404 this year to be 'one off' expenses, so that their compliance costs can be expected to decrease in future years as they and their independent registered public auditors ("external auditors") gain experience with Section 404. However, according to most of the clients with whom we spoke, these modest benefits did not justify the extremely high costs of implementing Section 404. In addition, our clients identified a number of issues of concern that arose in the course of implementing Section 404 and suggested several ways in which this implementation could be improved in the future.

High Cost/Benefit Ratio

Layers of Direct and Indirect Costs. Our clients most frequently commented to us that the costs of implementing Section 404 exceeded their initial cost estimates as well as the discernable benefits to their shareholders. These clients identified several layers of direct and indirect costs that, in their view, significantly exceeded the amounts anticipated when the provision was adopted. The most obvious consequence of the implementation of Section 404 was that many companies found it necessary to supplement their internal audit function by hiring a second audit firm or a financial consulting firm, as well as additional personnel to assist them in designing and implementing additional or enhanced internal control systems and the documentation of internal control systems that permitted their external auditor to audit their internal control system in order to be able to give an attestation report. Another cost consequence was the substantial increase in fees paid to the external auditor for the internal control audit. A number of our foreign private issuer clients estimated that external audit fees for the internal control audit would amount to an additional 30-50% of their conventional financial statement audit fees on an on-going basis. Beyond these external expenses, clients reported other significant costs, some of which are more difficult to quantify, including (1) hiring incremental internal audit and control personnel, (2) dedicating significant senior management time to Section 404 compliance issues, (3) delaying important corporate projects due to resource constraints and the opportunity costs of such delays, and (4) deferring the installation of improved systems and controls because such systems and controls could not be adequately tested and documented in a timely fashion under the rubric of Section 404.

Benefits of Compliance Not Evident. Several clients suggested that they and their shareholders did not realize benefits commensurate with the high cost of compliance with Section 404. Although it is still early in the process, some commentators have suggested that the markets do not appear to attribute any value to securities issued by companies that comply with Section 404 as compared to companies that do not. Moreover, several of our foreign private issuer clients suggested that the effort and expense necessary to comply with Section 404 does not appear to be warranted, given that these companies are, in many cases, already subject to substantially comparable regulations in their home countries. As such, they view Section 404 as an expensive layer of duplicative regulation. At least some of these companies and, we believe, other foreign private issuers are considering whether it is appropriate as a fiduciary matter to incur such costs or, instead, to comply with only a single regulatory scheme in their home country. A few foreign private issuers mentioned to us that the implementation of Section 404 using Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Framework"), which is the system generally mandated by the major registered public accounting firms in the United States, is not consistent with "principles-based" control systems under the Turnbull Guidance, an internal control system applicable in the United Kingdom. We have observed in recent months that the prospect of Section 404 compliance has had a chilling effect among foreign private issuers considering the registration and listing their securities in the United States. Indeed, Section 404 has caused a number of foreign private issuers to announce the de-registration of their securities in the United States, and we expect more to follow.

Imprecise Application. Several clients indicated that Section 404, as presently in effect, represents an imprecise approach to dealing with the problem of potential corporate fraud. They noted, for instance, that Section 404 does not discriminate between well-controlled companies and companies that require improvements – all companies had to incur the same high costs of compliance because of the external audit required. Also, as currently applied, there often appears to be no meaningful distinction made between a significant restatement and a *de minimis* restatement – both seem to give rise to a conclusion that a "material weakness" exists in a given company's internal controls. Likewise, no distinction is drawn between a restatement caused by a mistake or by fraud, as compared to a restatement driven by changing interpretations of GAAP or prevailing accounting standards. As such, several of our clients questioned the manner in which Section 404 has been interpreted and implemented and its utility to investors.

Materiality Threshold Too Low; Potential High-level Fraud Not Adequately Addressed

Broad Standards Induce Excessive Audit Procedures. Auditing Statement 2 – An Audit of Internal Control over Financial Reporting Performed in conjunction with an Audit of Financial Statements ("Auditing Standard 2") of the Public Company Accounting Oversight Board ("PCAOB") sets forth broad language with respect to the standards that external auditors must apply in determining whether there exists a 'significant deficiency' ("more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected") or a 'material weakness' ("a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected"). Several clients indicated that this broad language has driven their external auditors to mandate extensive additional internal control documentation and conduct audit procedures at a microscopic level, which should not be necessary to identify actual "material weaknesses" in internal controls. Some clients asked whether Section 404 could be tailored so that companies and their external auditors could focus on key controls that have an actual bearing on truly material weaknesses and on the prevention of truly meaningful misstatements in financial reporting. As discussed in more detail below, potential liability with respect to their role under Section 404 has, in some cases, caused external auditors to adopt an overly conservative approach and to disregard conventional notions of materiality in analyzing possible deficiencies.

Limited Regulatory Guidance with Respect to Implementation. Several clients stated that limited regulatory guidance on issues related to the implementation of Section 404, and in particular a lack of guidance with respect to the application of the COSO Framework, delayed their implementation process and contributed to higher costs than would otherwise have been necessary. Specific areas with respect to which external auditors, and more importantly, companies, would have welcomed additional interpretive guidance include (1) suggestions on how to properly aggregate identified control deficiencies at the 'whole entity' level, (2) appropriate sample-sizes for tests of operational controls and (3) appropriate time frames for determining operational failures. With respect to the timing of assessments of operational failure, there appears to have been inadequate guidance as to whether identified operational failures as of the end of an interim period could, if remedied prior to the end of the fiscal year, be disregarded as a deficiency at year-end. We believe that additional pronouncements regarding these and other interpretive issues would enable companies to comply more effectively with Section 404 in the future.

Indiscriminate Documentation. Several clients told us that their external auditors placed undue emphasis on documentation and testing of routine transactions and processes. Under the current framework, companies and their external auditors felt constrained in their ability to discriminate between significant sources of risk and routine, low-risk items. As a result, Section 404 implementation became, in many cases, an exercise in form over substance, with procedural documentation substituting for a substantive assessment of the effectiveness of a company's overall control environment and the oversight provided by the audit committee. To accommodate the requirements of Section 404, several of these companies created extensive audit trails where none had previously been perceived as necessary. At the same time, the review of internal controls mandated by Section 404 addressed only marginally the proactive fraud by senior management that seems to have been a principal cause of accounting fraud in recent years.

No Alternative to Documentation. Under the COSO Framework, there is a statement asserting that a lack of formal documentation should not necessarily lead to a conclusion that an internal control system is ineffective or that it cannot be evaluated. Our clients felt that external auditors, in the absence of adequate regulatory guidance on the issue, were unable to give credence to this assertion. Therefore, our clients undertook extensive, painstaking documentation of what were, in many cases, relatively immaterial operations, so as to avoid any imputation that a lack of documentation constituted a significant deficiency. This emphasis on process over risk avoidance seemed to us and to some of our clients to be ill placed, given that most major corporate frauds that have come to light in recent years did not occur in peripheral operations, but rather at the highest levels of major public companies. This focus on rote documentation also significantly increased the cost of implementing Section 404.

Small and Mid-sized Companies Challenged by Economics of Compliance

One Size Fits All. Several clients indicated that Section 404 appears to apply a generic approach to the assessment of internal controls that does not make sufficient allowance for the size or complexity of companies. As a percentage of revenues and/or profits, the cost of the review mandated by Section 404 disproportionately impacts small and medium-sized companies, regardless of their desire to comply or of the relative quality of their existing internal controls.

Resource Constraints and Generic Assessments. In the current environment, in which most registered public accounting firms were resource constrained and striving to serve a large number of public companies, all of whom were trying to review their internal controls concurrently, there was a natural tendency among external auditors to adopt standard policies and mechanical rules to accelerate reviews. In the view of some clients, this approach did not take into account the idiosyncrasies of particular companies. In this environment, we understand that small and medium-sized companies were most likely to find that generalized interpretations did not properly reflect their particular circumstances. Yet, because there are relatively few registered public accounting firms from which to choose, and because of the stigma of switching external auditors, most small and medium-sized companies had no choice but to abide by the judgments of their existing external auditors.

Adverse Impact on Relationship between Companies and Independent Auditors

Impaired Company/Auditor Communication. Several clients reported that the implementation of Section 404 inhibited their ability to communicate effectively with their external auditors. As companies sought to avoid any determination that a significant deficiency existed, they became particularly wary of responding to requests for information from external auditors, because they feared that any mistake – no matter how minor – included in such a response could constitute grounds for a finding of a significant deficiency. Similarly, several clients reported that they and their external auditors became very measured in their exchange of information, and external auditors resisted requests for comments and interpretive advice. This has caused companies to seek to resolve issues on their own, or with the advice of legal counsel, and to delay exchanges of information, both of which added to the cost of Section 404 implementation and, in the case of seeking interpretive advice, foreclosed the company's best source of interpretive guidance on accounting issues. At least one client reported that the atmosphere between companies and their external auditors had become "downright hostile."

Predictable External Auditor Response to Uncertainty and Risk. In conducting their reviews of internal controls of clients as mandated by Section 404, external auditors faced significant uncertainty, particularly during this first year of implementation. We understand that these audit firms perceived that the potential cost of incorrect assessments of their clients' internal controls is very high in the current regulatory environment. Consequently, external auditors were understandably cautious in their interpretations and assessments of clients' internal controls. To address such concerns, external auditors established and applied uniform rules and standards to their various clients and insisted on documentation of internal controls at minute levels of detail within a company and its subsidiaries. While this approach was undoubtedly warranted by the uncertainty and risk inherent in reviewing internal controls under Section 404, and while the external audit firms were only properly seeking to minimize their risks in conducting such reviews, this approach often had the unintended effect of minimizing the "give and take" between external auditors and their clients that is normal and appropriate in such an assessment.

Subjective Assessments by Auditors Necessary. Several clients commented that internal control reviews required subjective assessments of risk on the part of auditors, as compared to the factual and statistical assessments more typical of the audit process. As external auditors sought to assess the risks incumbent in their clients' internal control systems, the traditional dynamic between audit firms and their clients changed, and external auditors become enmeshed in procedural decisions regarding their clients' control systems. At the same time, the traditional role of a reporting company in assessing risk and designing appropriate internal controls and financial reporting systems was appreciably diminished.

Suggestions for Reform:

Limit Auditor's Report to a Review of Management's Attestation Rather than Requiring an Independent Opinion with respect to Internal Controls

Under Auditing Standard 2, each external auditor of a U.S. public company is required to report on the management's attestation with respect to its internal controls and to opine independently on the adequacy of such company's internal controls. We believe that substantially the same benefits could be attained under Section 404 if only the first part of this report by the external auditors were required, namely if the external auditors were merely required to review the attestation of management, without more. If this change were made, external auditors would return to their traditional role as auditors of the systems and procedures of their clients. This would eliminate some of the duplication of effort now required of companies and their external auditors, which would lower the overall cost of implementing Section 404. It would also permit public companies once again to exercise independent judgment in designing and implementing internal control systems and procedures.

Modify Standard for Report of Independent Registered Public Auditors

Based on the feedback we received from our clients, we believe the PCAOB should consider modifying the standard set forth in the Auditing Standard 2 from a standard based on "more than a remote likelihood" to a clearer, more defensible standard. For example, we suggest that a "reasonable possibility" standard be adopted. We believe this standard would provide a comprehensible assessment of internal control risks to investors and other users of a company's financial statements. At the same time, such a clear standard would enable companies and external auditors to exercise more professional judgment with respect to the materiality of identified deficiencies in internal controls.

Limit the Application of Section 404 in Time or Scope

Several clients expressed concern that, while they would derive some efficiencies in their Section 404 review process in future years, they expect to continue to expend significant resources and management time on an annual basis in order to remain in compliance with Section 404. Given the manner in which this review is now conducted, these clients did not expect to realize any appreciable decline in such compliance costs going forward. Toward that end, we suggest that the PCAOB and the SEC consider modifying the Section 404 review so that these costs would more properly align with the perceived benefits to companies, their shareholders and other users of financial information. For example, a Section 404 review could be required of each public company on a rolling three-year basis or, alternatively, Section 404 and the related regulations could be modified so as to limit such reviews after the first year to cover only incremental changes in a company's internal controls, rather than requiring a de novo review. That is, with a relatively small reduction in perceived effectiveness, an internal control review process could be designed that would enable companies to reduce their ongoing compliance expenditures.

Very truly yours,

Peter D. Lyons

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