

American Federation of Labor and Congress of Industrial Organizations



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Statement of the American Federation of Labor and Congress of Industrial Organizations Securities and Exchange Commission Roundtable on Internal Controls

April 13, 2005

Two and a half years ago when Congress passed and President Bush signed into law the Sarbanes Oxley Act of 2002, there was widespread agreement that the roots of wave of corporate scandal that had been growing since the collapse of Enron were to be found in part in the ineffectiveness of public companies' independent auditor in detecting and addressing flaws in public company financial reporting. One important way in which the Sarbanes-Oxley Act addressed this problem was by mandating in section 404 an annual audit by public companies' outside auditor of the adequacy of each public company's internal controls.

Section 404 and its implementation by the Securities and Exchange Commission and the Public Company Accounting Oversight Board (PCAOB) are a vital part of the new protections investors and the public demanded in the aftermath of the Enron, Worldcom and other scandals. Without an independent audit of the strength of material internal controls, investors really are in the position of taking a public company's financial statements on faith—because there is no way to know whether there is integrity to the processes that generate those statements.

In addition though, the AFL-CIO believes there is substantial anecdotal evidence that the process of complying with section 404 of Sarbanes-Oxley has led to substantial new learning on the part of the financial management of public companies, learning that has helped these managers to improve the overall quality of financial and, more importantly, to run their organizations more effectively. This experience is best stated by General Electric CEO Jeffery Immelt in GE's 2004 Annual Report when he stated that Section 404 is "helpful" because "(I)t takes the process control discipline we use in our factories and applies it to our financial statements."

We do recognize and are concerned that for a variety of reasons independent audit firms in carrying out their mandate to conduct internal control audits may be overly rigid or inattentive to concepts of materiality. In response, on both a formal and an informal level, the AFL-CIO believe the SEC and the PCAOB have adopted wise standards and have acted effectively to discourage abuse by the auditing profession of the new business opportunities created by the requirements of Section 404.

Nonetheless, in the last year, section 404 has become the most controversial aspect of Sarbanes-Oxley. Some business groups and individual corporations have expressed a variety of concerns about the implementation of

Section 404, and some have advocated a variety of possible potential changes in the implementing standards issued by the PCAOB.

We would like to make a series of general observations about the implementation of Section 404.

Section 404 Appears to be a Cost-Effective Measure

Financial Executives International, an advocacy group representing chief financial officers of corporations, has published data suggesting that public companies will spend on average \$3 million to comply with the rule in the first year. FEI's study finds that companies with more than \$5 billion in revenue will spend \$8 million on average, while those with revenues of less than \$100 million will spend \$550,000 on average.

These numbers are relatively small compared to the risks that are being managed. Assuming market capitalization of public companies is certainly no less than 1x revenues on average, these numbers suggest a first-year cost of between 10 and 50 basis points on total at risk investment in these public corporations, a cost that is likely to fall significantly in the second year of Sarbanes-Oxley implementation.

These are very small amounts in relation to the risks of financial fraud and the attendant catastrophic losses that these expenses are addressing, even in smaller companies. Section 404 compliance is a vital loss prevention expense, and in relation to the scale of the investments it is protecting, the costs involved are of limited significance.

Small Companies Deserve Some Flexibility—But not Exemption from Section 404

Much attention has been given to the concern that smaller publicly traded companies are having significant difficulties complying with Section 404. The AFL-CIO sympathetic with smaller firms and believe the SEC and the PCAOB's approach of giving some of them additional time to comply is correct.

However, the AFL-CIO is also concerned that many of the most serious problems in this area exist at smaller public companies. Ultimately, companies that cannot establish and maintain adequate internal controls should not be marketing their securities to the investing public. Rather they should be seeking capital from sophisticated private capital investors who have the capacity to independently assess the relationship these companies' financial statements have to reality.

Dates Matter in Relation to the Auditing of Public Companies

The American Electronics Association has suggested that the standards governing the implementation of Section 404 be altered to only require testing of internal controls every three years. The AFL-CIO does not believe this idea is consistent with the language of Section 404, which mandates an annual audit of internal controls. Further, we believe it undermines the central auditing concept that an auditor's opinion letter does in fact represent a state of affairs on a certain specific date.

Independence Matters in Relation to the Auditing of Public Companies

Some have also suggested that the Commission or the PCAOB or should allow the independent auditor in its audit of internal controls to rely, without testing, on representations by the issuer's internal audit staff. This idea seriously undermines the critical concept that independent audits are conducted by independent auditors, not the employees of the preparer. Like the above idea on timing, this concept is in conflict with the language of Section 404, and is beyond the power of the SEC or the PCAOB to effectuate.

The PCAOB and the SEC need to continue to focus attention on audit firm conduct

Audit firms who are seeing a further narrowing of their ability to market non-audit services to their audit clients are clearly tempted by alternative sources of revenue and profitability. In this context, some will try to pad costs or otherwise make getting a clean opinion on internal controls overly costly. This type of conduct is not in

investors' interest and the AFL-CIO supports the steps being taken by the SEC and the PCAOB to ensure that the public company audit process is not overburdened and that the lines between the material and the immaterial are not blurred to the detriment of companies.

Background on the AFL-CIO and contact information

The AFL-CIO is the federation of America's unions. AFL-CIO member unions themselves have approximately 13 million members, and sponsor pension funds with approximately \$400 billion in assets. Approximately \$5 trillion is invested by union members and benefit plans in which union members participate in, primarily to fund union members' retirement security.

The AFL-CIO appreciates the opportunity to participate in the Commission's Roundtable on Internal Controls. Please contact Damon Silvers, Associate General Counsel, at 202-637-3953 if the AFL-CIO can be of further assistance.