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The Honorable Christopher J. Dodd
Chairman, Senate Committee on
Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20515

The Honorable Richard C. Shelby
Ranking Member, Senate Committee on
Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20515

Dear Chairman Dodd and Ranking Member Shelby:

As representatives of the auditing profession, the Center for Audit Quality (CAQ)¹ is writing to urge you to resist efforts to weaken the Sarbanes-Oxley Act of 2002 (SOX) by exempting small businesses from compliance with Section 404(b) of the Act, which requires an independent audit of a company's assessment of its internal controls.

If, as proposed by some members of the House of Representatives, Congress agrees to a permanent waiver for small companies, there may be little independent scrutiny of financial reporting safeguards at an estimated 6,000 small companies. As one recent news report concluded, "There'll be more flaws in those safeguards that won't be found and fixed. That, in turn, means it's more likely that errors and fraud will make their way onto small companies' financial statements, and that they won't be found until it's too late to avoid hurting investors."²

Reporting under Section 404 provides investors with meaningful information regarding a company's internal control over financial reporting (ICFR). In addition, we believe that the required independent audit of management's assessment of the effectiveness of ICFR, as required by SOX Section 404(b), has been integral to the achievement of the intended

¹ The CAQ is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. We foster high quality performance by public company auditors, convene and collaborate with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants. This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

² "IN THE MONEY: Small Co's Win Sarbanes-Oxley Help; Investors Lose," Dow Jones News Service, Nov. 9.

objectives of ICFR reporting under SOX Section 404. The Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have expended considerable resources since the adoption of SOX evaluating the manner in which management assessments and independent audits of ICFR are conducted. Through this process, the SEC and PCAOB have received feedback from all stakeholders on the impact of the internal control reporting provisions via roundtable discussions, comment letters on various rule proposals and other venues.³

As a result of the feedback received, the SEC and PCAOB underwent a process to replace the PCAOB's original ICFR auditing standard with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements* (AS No. 5).⁴ The adoption of AS No. 5 brought significant improvements to the audit of ICFR by better enabling auditors to focus their effort on those areas that were critical to a company's ICFR, utilize their judgment in the design and performance of audit procedures, and scale the procedures necessary to conduct the audit to a company's particular facts and circumstances. In addition, the PCAOB created a task force and developed additional guidance in applying the requirements of AS No. 5 in audits of smaller public companies.⁵ This additional guidance was developed with assistance from auditors with smaller public company experience. It explains and illustrates how auditors can tailor their procedures to a smaller public company's particular facts and circumstances.

In addition to these activities, other stakeholders such as the CAQ and the Committee of Sponsoring Organizations of the Treadway Commission (COSO) have created significant resources to help smaller public companies and their independent auditors conduct an audit of internal control. COSO issued guidance for applying its internal control framework,⁶ which represents the basis by which both management and auditors evaluate the effectiveness of ICFR at smaller companies. In addition, the CAQ, in conjunction with its member firms, developed resources specifically to assist auditors of smaller public companies.⁷

³ See, for example, transcripts from May 10, 2006 and April 13, 2005 SEC and PCAOB roundtables (available at <http://www.sec.gov/spotlight/soxcomp/soxcomp-transcript.txt> and <http://www.sec.gov/spotlight/soxcomp/soxcomp-trans.txt>, respectively) and comments received by SEC and PCAOB related to AS No. 5 at <http://www.sec.gov/comments/pcaob-2007-02/pcaob200702.shtml> and http://www.pcaobus.org/Rules/Docket_021/index.aspx, respectively).

⁴ The SEC approved AS No. 5, which was the replacement for Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, on June 17, 2007.

⁵ See PCAOB Staff Views, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of the Financial Statements – Guidance for Auditors of Smaller Public Companies* (January 2009), available at http://www.pcaob.org/Standards/Standards_and_Related_Rules/AS5/Guidance.pdf.

⁶ A summary of the COSO's Internal Control Over Financial Reporting – Guidance for Smaller Public Companies, is available at http://www.coso.org/documents/SB_Executive_Summary.pdf.

⁷ These resources include the CAQ's "Lessons Learned" – *Performing an Audit of Internal Control in an Integrated Audit*, which identified 21 practical insights for auditors when conducting an audit of internal control as well as a recently-concluded, three-part Webcast series on AS 5 implementation for audits of non-accelerated filers.

We believe that these initiatives have had their intended effect of rationalizing the effort required to conduct Section 404 assessments, which is evidenced by the overall significant reductions in costs associated with the external audit of ICFR for 404(b) compliant companies as illustrated in the SEC's recently released study of the costs and benefits of Section 404.⁸ In addition, we believe these resources provide auditors of smaller public companies the opportunity to successfully plan and conduct more effective and efficient audits of ICFR.

While we recognize that there is a cost to conducting an audit of a company's ICFR, we believe it is also important to note that investors and other users of financial information have consistently expressed the view that the independent audit of management's assessment of ICFR provides significant benefits to them when making their investment decisions. Some of the feedback received includes the following:⁹

- The independent audit of management's assessment increases investors' confidence in the quality and reliability of a company's financial reports and ICFR assessment.
- The independent auditor's involvement in ICFR reporting results in a more disciplined management assessment, as well as provides a valuable independent perspective on the effectiveness of a public company's ICFR.
- The independent auditor's expertise can provide management with an additional perspective on the quality of a public company's ICFR, which can facilitate improvements in internal control that have a positive impact on the quality of a company's financial reporting.
- Section 404 reporting, including the independent audit, provides benefits that are valuable regardless of a public company's size and represents an appropriate use of a public company's resources given the significant role a strong internal control structure has in providing reliable financial reports for investors.

This feedback illustrates the significant benefits investors derive from the Section 404(b) requirements, which we believe are particularly meaningful given the fact that well over half of the financial statement restatements have traditionally been by smaller public companies, which represent over half of the public companies listed in the U.S. In addition, recent research noted that restatement rates for companies that disclosed to investors that their ICFR was effective was 46% higher for smaller companies that did not have an independent audit of ICFR as compared to companies that were required to have an independent audit of ICFR.¹⁰ We believe this highlights the important role independent auditors have in achieving the benefits intended by SOX for investors. As such, we support the SEC's position that there will be no further delay in Section 404(b) compliance for smaller public companies.

⁸ See SEC, Office of Economic Analysis, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* (September 2009), available at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

⁹ These views were expressed, for example, as part of the SEC's Study of Section 404 (see footnote 8) as well as at roundtable discussions and comment letters received as part of the SEC and PCAOB projects related to ICFR (see footnote 3).

¹⁰ See Audit Analytics, *Restatements Disclosed by Two Types of SOX Issuers: 1) Auditor Attestations Filers and 2) Management-Only Report Filers*, November 2009.

Small business may be the backbone of America, but small investors are its nervous system. Weakening this critical element of SOX at a time of lingering economic uncertainty may appear to be a step forward for small companies, but in reality it is two steps backward for investors.

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We would welcome the opportunity to respond to any questions you may have.

Sincerely,



Cynthia M. Fornelli
Executive Director

cc: Sen. Jack Reed, Chairman, Subcommittee on Securities, Insurance, and Investment
Sen. Jim Bunning, Ranking Member, Subcommittee on Securities, Insurance, and Investment
Mary L. Schapiro, Chairman, Securities and Exchange Commission
Luis Aguilar, Commissioner, Securities and Exchange Commission
Kathleen L. Casey, Commissioner, Securities and Exchange Commission
Troy Paredes, Commissioner, Securities and Exchange Commission
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Daniel L. Goelzer, Acting Chairman, Public Company Accounting Oversight Board
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Steven B. Harris, Member, Public Company Accounting Oversight Board
Charles D. Niemeier, Member, Public Company Accounting Oversight Board