



CENTER FOR AUDIT QUALITY  
*Serving Investors, Public Company Auditors & the Markets*



Council of Institutional Investors  
The Voice of Corporate Governance

September 20, 2011

The Honorable Spencer Bachus  
Chairman  
House Financial Services Committee  
2129 Rayburn House Office Building  
Washington, DC 20515

The Honorable Barney Frank  
Ranking Member  
House Financial Services Committee  
B371A Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Bachus and Ranking Member Frank:

We understand that the Committee is considering legislation that could weaken certain investor protections of the Sarbanes-Oxley Act of 2002 (SOX). The Center for Audit Quality, the Council for Institutional Investors, and CFA Institute are writing to urge you to resist efforts to further weaken SOX by exempting even more public companies from compliance with Section 404(b) of the Act, which requires an independent audit of a company's assessment of its internal controls as a component of its financial statement audit.

Indeed, effective internal controls have become more central to the financial statement audit, a fact that has contributed to an increase in overall audit quality in the years since the passage of the Sarbanes-Oxley Act.

The processes associated with attesting to a company's internal control effectiveness have become more integrated into the financial statement audit and, as a result, are more cost-efficient than in the early days of Sarbanes-Oxley Act implementation. Additionally, the original PCAOB standard that implemented auditor attestation of effective internal controls (AS2) was revised in 2007 to allow for greater efficiencies, and the SEC also issued guidance to management on implementation of Section 404, both of which contributed significant cost savings after the first few years of SOX implementation.

While we recognize efforts to address redundant and unnecessary regulation that provides little value, we believe effective internal controls to be a critical component of the financial statement audit. The financial statement audit, in turn, continues to be important to well-functioning capital markets by improving the quality of, and confidence in, the financial reports provided to investors and other stakeholders.

In fact, in a 2010 CAQ survey<sup>1</sup>, two-thirds of the nation's individual investors made clear their concern about exempting smaller public companies from Section 404(b). Further, 8 in 10 of those investors were uneasy over the possibility that the Congress may consider extending the exemption to larger companies.

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<sup>1</sup> Center for Audit Quality, "2010 Main Street Investors Survey," <http://www.thecaq.org/newsroom/pdfs/2010SummaryInvestorSurvey.pdf>, September 9, 2010.

As you know, Section 989G(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the Securities and Exchange Commission (SEC) to conduct a study to determine how the SEC could reduce the burden of complying with Section 404(b) for companies whose market capitalization is between \$75 and \$250 million, while at the same time maintaining investor protection. In the resulting study, published last April<sup>2</sup>, the SEC concluded that the existing requirements for issuers with a \$75-\$250 million public float to comply with the auditor attestation provisions of Section 404(b) should be maintained and that no new exemptions should be granted. Specifically, the SEC found that, “There is strong evidence that the auditor’s role in auditing the effectiveness of ICFR [Internal Control for Financial Reporting] improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Commission’s staff also determined that over time the costs and burdens of Section 404(b) compliance have declined and that eliminating them would not “justify the loss of investor protections and benefits to issuers...”

Additionally, other research has underscored the benefits of an independent audit of a public company’s internal controls:

- The authors of a 2011 paper on “The Effect of Voluntary Internal Control Audits on the Cost of Capital” concluded that companies that voluntarily comply with Section 404(b) enjoy a lower cost of capital and enjoy a decline in the cost of equity and debt capital in the first year of compliance. “Our findings are important because they demonstrate an important benefit that small companies can derive from purchasing internal control audits,” they wrote.<sup>3</sup>
- Based on survey responses from more than 3,000 individuals, a 2010 paper concluded that, “the common view that Section 404 adds layers of financial reporting procedures to no avail seems to be overstated, and the evidence indicates that standardization by regulatory intervention is beneficial, as attested by the decrease in reported costs and concomitant increase in perceived net benefits following the 2007 reforms, regardless of company size.”<sup>4</sup>
- Another researcher described as problematic the likelihood that exempting smaller reporting companies from Section 404 will significantly increase the information asymmetry between smaller reporting companies and their investors, “since ordinary shareholders are the

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<sup>2</sup> Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million, U.S. Securities and Exchange Commission, <http://www.sec.gov/news/studies/2011/404bfloat-study.pdf>, April 2011.

<sup>3</sup> “The Effect of Voluntary Internal Control Audits on the Cost of Capital,” Cassell, Myers and Zhou, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1734300](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1734300), January 2, 2011.

<sup>4</sup> “The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective,” Alexander, Bauguess, Bernile, Lee, and Marietta-Westberg, <http://apps.olin.wustl.edu/FIRS/PDF/2010/1608.pdf>, March 2010.

predominant external shareholders for smaller reporting companies and have historically demonstrated themselves to be vulnerable to just this type of information asymmetry.”<sup>5</sup>

- In addition, a 2010 survey by the consulting firm Protivity found that a significant majority (70 percent) of executives experienced with SOX Section 404 compliance believe the benefits outweigh the costs.<sup>6</sup>

In the final analysis, we believe that all investors should receive equal protections with respect to the effectiveness of internal control over financial reporting by publicly traded companies. Like you, we recognize the positive impact small businesses have on the economy and job creation. However, we cannot support actions, no matter how well intentioned, that threaten investor confidence and the stability of the U.S. capital markets.

We therefore remain firmly committed to retention of 404(b) to the fullest extent.

Sincerely,



Kurt Schacht  
Managing Director  
CFA Institute



Cindy Fornelli  
Executive Director  
Center for Audit Quality



Jeff Mahoney  
General Counsel  
Council of Institutional Investors

cc: The Honorable Tim Johnson, Chair, Senate Banking Committee  
The Honorable Richard Shelby, Ranking Member, Senate Banking Committee

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<sup>5</sup> “The Case Against Exempting Smaller Reporting Companies from Sarbanes-Oxley Section 404: Why Market-Based Solutions are Likely to Harm Ordinary Investors,” Orcutt, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1421844](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1421844), 2009.

<sup>6</sup> “Where U.S.-Listed Companies Stand: Reviewing Cost, Time, Effort and Processes,” 2011 Sarbanes-Oxley Compliance Survey, <http://www.protiviti.com/en-US/Insights/Browse-by-Content/Surveys/Pages/2010-Sarbanes-Oxley-Compliance-Survey.aspx>, Protivity Inc., June 2011.