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

December 6, 2010

Office of the Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: File No. S7-29-10 – Request for Comment Related to a Study Required by Section 989G(b) of the Dodd-Frank Act Regarding Compliance with Section 404(b) of the Sarbanes-Oxley Act

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates 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 (AICPA).

The CAQ appreciates the opportunity to respond to the Securities and Exchange Commission's (SEC or the Commission) request for comment related to how the Commission could reduce the burden of complying with Section 404(b) – the auditor attestation requirement - of the Sarbanes-Oxley Act of 2002 (SOX) for companies whose public float is between $75 million and $250 million (subject issuers), while maintaining investor protections for such companies. In addition, the SEC is requesting comment on whether any methods of reducing the compliance burden or a complete exemption for such companies from the auditor attestation requirement in Section 404(b) would encourage companies to list on exchanges in the United States in their initial public offerings (the Release). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

SOX was enacted with the intention of restoring investor confidence in public companies and enhancing investor protection by improving corporate governance and increasing the accuracy and transparency of financial reporting. We believe that the reforms under SOX are meeting those objectives. Specifically, Section 404 – the requirement that is focused on internal control over financial reporting (ICFR) – plays a critical role in promoting high quality financial reporting, which is vital to the successful operation of our capital markets. Effective internal controls are the bedrock of reliable financial reporting.

The request of Congress, which is incumbent upon the SEC, is to study how the Commission could reduce the burden of complying with Section 404(b) for subject issuers, while maintaining investor protections for such companies. We believe that investors and issuers have benefited from auditor attestation on ICFR in accordance with Section 404(b). As we will discuss in greater detail below, we believe that auditor attestation of ICFR has, among other things, enhanced the reliability of financial statements, resulted in lower rates of restatements (as noted in *Cost Trends of Section 404(b)* below) compared to those issuers that are not required to comply, increased the accountability of individuals involved in the financial reporting process, resulted in better corporate governance practices, and enhanced investor confidence. Further, the PCAOB's revised internal control auditing standard, AS 5,[1] as well as the additional guidance issued by the PCAOB, the SEC, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and other professional organizations have led to more efficient and effective Section 404 processes for both issuers and auditors. Moreover, efficiencies in the effective implementation of Section 404 have been gained as a result of issuers and auditors becoming more experienced with assessing the design and operating effectiveness of ICFR. Ultimately, the combination of these factors has contributed to a general decline in costs associated with management's assessment of and auditor attestation on ICFR.

Since the adoption of SOX, the SEC has appropriately taken steps to reduce the compliance burden in this area by allowing certain deferrals of Section 404(a) and 404(b), including deferring compliance with the Section 404 requirements for newly public issuers until their second annual report and allowing a one-year deferral when an acquisition occurs and the acquired entity's size and/or complexity makes it not possible for the acquiring entity's management to complete its assessment of the acquired entity's ICFR before the next annual reporting deadline. As explained in more detail below, we believe that Section 404(b) provides significant benefits to investors and we strongly urge against any further exemptions from the auditor attestation requirements of ICFR for public companies. Subject issuers that are currently complying with Section 404(b) have had ample time and opportunity to implement the requirements and in many cases have been complying for multiple years. Given the benefits of compliance, combined with the declining trend in costs associated with both management's assessment and the external audit, we do not believe it would be prudent to roll back existing internal control requirements for a population of issuers that are currently complying with Section 404(b).

We do, however, have some recommendations that we believe could further enhance the efficiency of Sections 404(a) and 404(b) implementation, while still preserving the effectiveness of implementation and the fundamental investor protections of Section 404. Our recommendations are provided in greater detail below.

The CAQ's comments and recommendations are organized in the following manner:

- Benefits of Section 404(b) to Investors
- Cost Trends of Section 404(b)
- Concerns with Expansion of Section 404(b) Exemptions
- Recommendations for Further Efficiencies in the Section 404(b) Process

Benefits of Section 404(b) to Investors

We believe, and a number of studies support, that investors significantly benefit from the auditor attestation requirements of Section 404(b).

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[1] PCAOB Auditing Standard No. 5 *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (AS 5)

We have highlighted some of the more significant benefits as follows:

- An auditor's involvement in the annual evaluation of the design and effectiveness of ICFR encourages additional accountability of individuals involved in financial reporting with respect to the design and maintenance of internal control, which enhances the quality and reliability of companies' financial reports. For example, as noted in the SEC's SOX study released in 2009,[2] Section 404(b) causes management to devote more resources to a disciplined financial reporting process in order to better understand financial reporting risks, implement controls to address those risks, and address control issues more timely. The SEC SOX study also noted that an auditor's professional expertise in evaluating ICFR provides incremental benefit to management's assessment, and ultimately a benefit to investors, similar to the audit of the financial statements. In addition, the study suggests that providing an auditor's perspective on an issuer's internal control system fosters improved evaluations and more timely and/or effective improvements in internal control. We believe that the discipline and accountability that the Section 404(b) attestation requirement fosters in an issuer's management is crucial in today's reporting environment given the complexity and pace of change of accounting standards and the increasing reliance on management's judgment in adopting and implementing those standards.

- Another benefit to investors is a reduction in the rate of restatements of financial information. A number of studies have shown that companies that are not required to obtain auditor attestation on ICFR pursuant to Section 404(b) have a greater number of restatements. Some of these recent studies include:

    - A 2010 study conducted by Albert L. Nagy, a professor of accounting at John Carroll University, found that companies subject to Section 404(b) are less likely to issue materially misstated financial statements than companies not subject to the auditor attestation requirements and suggests that the Section 404 regulation is meeting its objective of improving the quality of financial reports. [3]
    - A 2009 study conducted by Audit Analytics found that companies that disclosed ICFR was effective and were not subject to auditor attestation of ICFR under Section 404(b) had a 46 percent higher restatement rate than those companies that disclosed that ICFR was effective and had auditor attestation on ICFR.[4]
    - Another 2009 study conducted by Audit Analytics noted that since 2003 non-accelerated filers (companies with public float less than $75 million and were not required to have an ICFR audit) have accounted for 65 percent of the total financial statement restatements (3,979 restatements out of a total of 6,116).[5]

  The results of these studies therefore support the view that auditor involvement in ICFR reporting via the attestation process of Section 404(b) incentivizes management to add more discipline, rigor and accountability to its ICFR processes which leads to lower rates of restatements, and thus, results in higher quality financial reporting.

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[2] Section V of the SEC's Office of Economic Analysis *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* found at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

[3] Study entitled, *Section 404 Compliance and Financial Reporting Quality*, was published on September 15, 2010 and can be found at http://scitation.aip.org/getabs/servlet/GetabsServlet?prog=normal&id=ACHXXX000024000003000441000001&idtype=cvips&gifs=yes&ref=no.

[4] www.auditanalytics.com

[5] Ibid

- Section 404 compliance, including the related auditor attestation of ICFR, enhances the accuracy of a company's financial statements, which has a positive impact on the confidence of investors and other users of financial information. In a 2007 Financial Executives International survey, 50.3 percent of public company representatives polled have increased confidence that financial reports are more accurate and 56.0 percent of them have confidence that financial reports are more reliable, as a result of compliance with Section 404.[6]

- Finally, another incremental benefit to investors is that Section 404(b) has fostered improvements to corporate governance. For example, auditors are required to communicate to the audit committee all significant deficiencies and material weaknesses in ICFR that have been identified during the audit. However, AS 5 enhances the ability of auditors to detect weakness and therefore have a basis to make such communications, specifically regarding significant deficiencies, given the greater extent of ICFR-related work. This communication fosters important discussions about ICFR among management, the audit committee, and the auditor including any remediation efforts. These discussions enhance the audit committee's oversight of the ICFR process, which fosters improvements to the quality of an issuer's financial reporting.

Cost Trends of Section 404(b)

Certain stakeholders have the perception that total Section 404 compliance costs do not exceed the benefits. However, recent studies have shown that attitudes may be changing. For example, a 2010 Protiviti study found that 70 percent of the executives surveyed currently believe the benefits outweigh the costs of compliance with Section 404.[7] Additionally, several executives of public companies have supported the benefits of Section 404 reporting in public forums.[8] Further, costs – both first time and recurring - have continued to trend downward, as illustrated in the examples below. Changing stakeholder perceptions combined with declining cost trends have an overall positive impact on the cost/benefit evaluation of Section 404(b) implementation.

We note that significant costs of Section 404 relate to management's assessment of the effectiveness of ICFR pursuant to Section 404(a).[9] However, we will focus the majority of our comments on the costs of Section 404(b) given the SEC's request for comment is focused specifically on costs related to Section 404(b).

First, we note that significant start-up costs are incurred in the first year of implementation of Section 404. However, the start-up costs associated with the first year of Section 404 implementation are not as high as they were when the requirements were new. Further, as the work of auditors and issuers in this area has evolved over the years, there continue to be efficiencies gained by both auditors and issuers which results in declining ongoing Section 404 costs. For example, management's processes and activities that support an issuer's required assertions about ICFR under Section 404(a) have become more integrated with their day-to-day activities and related financial reporting. Further, auditors have made significant progress in integrating the ICFR and financial statement audit and have also looked for additional ways to leverage management's work, where appropriate.

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[7] Protiviti's *2010 Sarbanes Oxley Compliance Survey* can be found at http://www.auditnet.org/articles/KL201010.pdf

[8] For example, Dan Crowe, CFO, Hastings Entertainment - Crowe says his company [which is a non-accelerated filer] has benefited from being fully 404-compliant…"it's nice for our shareholders to know that we got an opinion from our auditors, whether or not we're required to do so." (CFO.com, July 12, 2010)

[9] SEC's Office of Economic Analysis *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* found at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

601 13th Street NW, Suite 800N, Washington, DC 20005, (202) 609-8120 www.thecaq.org

A recent academic study supports this notion by illustrating that there was a significant drop in first time Section 404(b) implementation costs, as a percentage of the overall audit fee, of over 50 percent since 2004, and over 30 percent since the 2007 reforms went into effect.[10] In addition, a 2010 survey conducted by Protiviti concluded that across organizations internal control related SOX costs have declined as compared to the initial compliance year.[11] Approximately one-quarter of survey respondents indicated that since the initial compliance year, they had a reduction of greater than 70 percent, while more than 60 percent of respondents indicated they had a reduction of greater than 30 percent.

A number of factors have contributed to these cost reductions. As noted above, efficiencies gained as a result of the learning curve associated with SOX result in decreasing costs. In addition, in the years since SOX legislation was passed, both the SEC and the PCAOB have undertaken targeted reforms that have resulted in more effective and efficient implementation of Section 404. These reforms include the following:

- SEC released management guidance for companies to utilize when conducting their assessments under Section 404(a) (2007).[12] This contributed to improved management assessments, which we believe has contributed to an increase in auditor efficiency.

- PCAOB released AS 5, which replaced the initial standard, AS 2,[13] and revised the requirements related to auditing ICFR. AS 5 is intended to "focus auditors on the most important matters in the audit of internal control over financial reporting and eliminate procedures that the Board believes are unnecessary to an effective audit of internal control (2007)."

- PCAOB published staff guidance on AS 5 for audits of smaller public companies.[14] This guidance was intended to provide further guidance to facilitate more efficient and effective audits of internal control over financial reporting for smaller, less complex public companies (2009).

The PCAOB also conducted forums across the country for auditors of smaller registered firms, dedicating a portion of the agendas at these meetings during 2009-2010 to implementation issues around AS 5. These forums allowed auditors to ask questions and hear directly from PCAOB inspection and standard-setting staff.

Additionally, there have been a myriad of resources developed by others that have contributed to efficiencies in the Section 404 process, including the auditor attestation pursuant to Section 404(b). Some of these resources include the following:

- In 2006 COSO issued a publication, *Internal Control Over Financial Reporting – Guidance for Smaller Public Companies*, which highlights twenty key principles of COSO's 1992 *Internal Control – Integrated Framework*, and provides a principles-based approach to internal control. While this guidance is targeted at smaller public companies, it may be applied to entities of all sizes.

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[10] *Do control effectiveness disclosures require internal control audits? A natural experiment with small U.S. public companies*, William R. Kinney Jr. and Marcy L. Shepardson, page 40 (January 4, 2010)
[11] Protiviti's *2010 Sarbanes Oxley Compliance Survey* can be found at http://www.auditnet.org/articles/KL201010.pdf
[12] SEC *Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934.* http://www.sec.gov/rules/interp/2007/33-8810.pdf
[13] Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*(AS 2)
[14] PCAOB Staff Views *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements Guidance for Auditors of Smaller Public Companies*

- In 2009 COSO issued a publication, *Guidance on Monitoring Internal Control Systems*, which was developed to assist companies with monitoring the quality of their internal control systems in an effective and efficient manner.[15]

- In February 2009, the CAQ issued a practice aid, *CAQ Lessons Learned – Performing an Audit of Internal Control Over Financial Reporting in an Integrated Audit*, for public company auditors, that provides lessons learned from integrated audits of ICFR. This practice aid was developed to further support the objective of performing effective and efficient integrated audits, and particularly to assist in the initial implementation of integrated audits by smaller auditing firms.[16]

Studies support that the learning curve, various activities and guidance noted above, have contributed to the downward trending costs associated with conducting an ICFR audit. For example, according to the SEC's SOX study[17]:

- The median Section 404(b) costs declined approximately 23 percent from $380,000 to $294,000 from 2006 – 2008 for all companies that were subject to the requirements of Section 404(b).

- Cost trends for companies who had to comply for the first time after the 2007 reforms were enacted were as follows:

  - Total implementation costs (Sections 404(a) and 404(b)) decreased approximately 14 percent compared to companies who implemented for the first time before the 2007 reforms.
  - Section 404(b) costs declined approximately 21 percent compared to companies who were initially subject to the auditor attestation requirements before the 2007 reforms.

Concerns with Expansion of Section 404(b) Exemptions

Given the substantial benefits to investors outlined above, we would strongly urge against any further exemptions of the auditor attestation requirements of ICFR for public companies. Companies with a market capitalization between $75 million to $250 million not only already have been obtaining auditor attestation on their ICFR assessments but also have the most expensive implementation years behind them (as studies noted above would support). As such, there is no clear and compelling reason to roll back the current requirements given the potential reduction in benefits from auditor attestation on ICFR. We believe that having yet another tier of companies that also are not subject to the Section 404(b) requirements will likely confuse investors and may undermine their confidence in the quality of financial reporting.

According to the CAQ's 2010 Main Street Investor Survey, "…investors say they would be concerned should Congress expand [the 404(b)] exemption to companies with market capitalization of $75 million or more." Approximately 24 percent are "concerned" about the possibility of extending the exemption and 57 percent are "very concerned" about this possibility resulting in a

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[15] Monitoring is one of the five key components of effective internal control delineated in COSO's *Internal Control – Integrated Framework*.

[16] CAQ's Lessons Learned practice aid can be found at: http://www.thecaq.org/newsroom/pdfs/404LessonsLearned-PerformingIntegAudit.pdf

[17] Table 8, Panel A of the SEC's *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control Over Financial Reporting Requirements* found at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

total of 81 percent of investors having concerns in this area.[18] In addition, we note that during Congress's debate over financial regulatory reform under the Dodd-Frank Act, a number of investor and stakeholder organizations issued joint letters in support of investor protection provisions in SOX, specifically opposing exempting smaller public companies from compliance with Section 404(b).[19] The concerns raised by these organizations would equally apply to any further considerations of extending the exemption.

We also believe that Section 404(b) requirements contribute to preventing fraud because of the increased rigor, accountability and discipline imposed by issuers such as those in the subject issuer category. As noted by a *Compliance Week* article regarding the exemption of Section 404(b) for non-accelerated filers, "as much as non-accelerated filers denounce the burden of Section 404(b) compliance, they're still confronted with one stubborn counter-argument: fraud happens." The publication went on to note that numerous studies indicate that small companies are particularly vulnerable to fraud.[20] A research study conducted by COSO determined that between 1998 and 2007 the median assets of companies experiencing fraudulent financial reporting was approximately $100 million.[21] Thus, any consideration given to the expansion of the exemption from Section 404(b) requirements should include the fraud prevention and detection aspects of the requirements for subject issuers.

Recommendations for Further Efficiencies in the Section 404(b) Process

The CAQ believes that the benefits of issuer and auditor experience with reporting on ICFR, coupled with the 2007 regulatory reforms and additional resources now available, will continue to enhance the effectiveness and efficiency of Section 404 implementation. We believe that issuers and auditors have appropriate and sufficient resources available to conduct their assessments and evaluation pursuant to Sections 404(a) and 404(b) both effectively and efficiently.

However, the CAQ has the following suggestions for your consideration on how to enhance the efficiency related to auditor attestation of ICFR under Section 404(b), for all issuers currently required to comply, while maintaining its effectiveness:

PCAOB Insights

Notwithstanding that the PCAOB inspections are focused on identifying instances where audit procedures or evidence are insufficient, through the course of its work the PCAOB is in a unique position where its inspection teams might identify efficient and effective audit approaches that could be vetted with its standards-setting staff with the objective of identifying "best practices" for AS 5 audits. If the PCAOB were to identify any such "best practices" that both the standard-setting and inspection staffs agreed were in accordance with AS 5, the communication of them to the audit profession would enable auditors to make adjustments and refinements to their ICFR procedures where appropriate.

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[18] Represents a telephone survey of 1001 investors. Investors were defined as individuals over the age of 18 with investments valued at greater than $10,000. Found at http://www.thecaq.org/newsroom/pdfs/2010toplineresults.pdf.

[19] http://www.thecaq.org/newsroom/pdfs/404bSenateletter042210.pdf, http://www.thecaq.org/publicpolicy/pdfs/CAQCIICFAInstituteletter toConfereesRESOX404b61510.pdf

[20] "Small Filers Struggle With Internal Controls Over Fraud," *Compliance Week*, March 16, 2010

[21] COSO's study entitled, *Fraudulent Financial Reporting: 1998-2007 can be found at http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf.*

Issuer Forums on Internal Control

Similar to how the PCAOB conducted forums with auditors and audit committees of smaller public companies across the country on the implementation of Section 404 (including SEC staff participation for the presentation to audit committees), we recommend that the SEC explore the merits of working with the PCAOB to conduct similar events for subject issuers, audit committee representatives and auditors, perhaps in conjunction with the SEC's Government Forum on Small Business Capital Formation.[22] We believe this could provide a forum for all participants in Section 404 evaluations to share best practices, discuss concerns or challenges related to Section 404 implementation, etc. and for the SEC and PCAOB to highlight issues observed in practice. The result of such shared experiences could have positive impacts on both the effectiveness and efficiency of Section 404 evaluation.

Update of COSO's Internal Control – Integrated Framework

COSO recently announced in November 2010 that it has undertaken a project to review and update its *Internal Control – Integrated Framework (the Framework).*[23] The Framework is used by many issuers as an internal control standard for implementing and evaluating ICFR in compliance with Section 404. COSO's intent in refining the guidance is "to reflect the evolution of the operating environment [and] changed expectations of regulators and other stakeholders." We expect this effort will lead to additional efficiencies in the effective implementation of Section 404. As such, we encourage the Commission to actively participate and monitor the work of COSO to better inform the SEC's Section 404(b) study.

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The CAQ appreciates the opportunity to comment on the Release and would welcome the opportunity to respond to any questions you may have regarding any of the comments and recommendations included in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: <u>SEC</u>
Chairman Mary L. Schapiro
Commissioner Luis A. Aguilar
Commissioner Kathleen L. Casey
Commissioner Troy A. Paredes
Commissioner Elisse B. Walter

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[22] http://www.sec.gov/info/smallbus/sbforum.shtml
[23] http://www.coso.org/documents/COSOReleaseNov2010.pdf

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