

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Email

February 13, 2007

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

I am writing on behalf of the Council of Institutional Investors (“Council”), an association of more than 130 public, corporate and union pension funds with combined assets of over \$3 trillion. As a leading voice for long-term, patient capital, the Council believes that Section 404 of the Sarbanes-Oxley Act of 2002 has been critical in restoring investor confidence and the overall integrity of the United States (“US”) capital markets and welcomes the opportunity to comment on the Public Company Accounting Oversight Board’s (“PCAOB”) proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals* (“Proposal”).

We believe that effective internal controls, long required of public companies by the Foreign Corrupt Practices Act of 1977, are the backbone of high quality financial reports. All companies tapping the public markets to raise capital, regardless of size, should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors.

Section 404 is improving companies’ internal controls. A recent study revealed that the number of restatements filed by large public companies, which adopted Section 404 in 2004, fell by nearly twenty percent in 2006, the first such decline since 2001.¹ By contrast, the number of restatements by smaller public companies with a public float of less than \$75 million, companies that have yet to adopt Section 404, increased in 2006 by forty-two percent.²

¹ David Reilly, *Restatements Still Bedevil Firms*, Wall St. J., February 12, 2007, at C7.

² *Id.*

In May 2006, following our participation on the US Securities and Exchange Commission (“SEC”) and PCAOB Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions, we provided several broad-based recommendations to the SEC and PCAOB.³ Those recommendations were designed to “preserve the investor protections provided by Section 404”⁴ while addressing those legitimate concerns raised by some parties about certain difficulties and costs⁵ in implementing the Section 404 requirements. They included the following:

. . . *The PCAOB should offer clarification for and/or amendments to Auditing Standard No. 2 while maintaining the underlying principles behind the standard.* Although Roundtable participants appeared to be in agreement about the importance of maintaining the principles espoused in AS2, anecdotal evidence suggests some auditors have yet to fully embrace the related May 2005 Questions and Answers and Policy Statement issued by the PCAOB, specifically the guidance on using the work of others and producing integrated risk-based audits taking into account the scale, scope, and complexity of the companies operations. . . . The Council also supports additional guidance from the PCAOB to address remaining implementation problems and, if deemed helpful, integration of that guidance and the May 2005 Questions and Answers and Policy Statement into AS2.

. . . The Council recommends that guidance tailored to the unique issues faced by smaller . . . audit firms be issued.⁶

The Council believes the Proposal is largely responsive to the Council’s recommendations and we strongly support its prompt adoption and implementation as a final standard.⁷ We also offer the following brief comments on four areas addressed in the Proposal that are of particular interest to investors.

Scaling the Audit for Smaller Companies

On average, Council members have more than fifty percent of their US equity holdings invested in indexed funds, including significant investments in the Russell 3000 stock index. Moreover, the evidence indicates that smaller public companies are especially prone to misstatements and restatements of financial information.⁸ Thus, an audit of the internal control of the generally riskier smaller public companies is as important to our members and many other investors as an audit of the internal control of larger public companies.

³ Letter from Ann Yerger, Executive Director, *The Council of Institutional Investors*, to The Honorable Christopher Cox, Chairman, *U.S. Securities and Exchange* and The Honorable Bill Gradison, Acting Chairman, *Public Company Accounting Oversight Board 2-3* (May 17, 2006).

⁴ *Id.* at 2.

⁵ Of note, Glass, Lewis & Co., LLC., has reported that a review of company filings for the Standard and Poor’s 500 indicates that audit fees as a percentage of revenues *declined* in 2005. Lynn Turner, Remarks at the Duke-ILEP Conference on Reform Proposals of Committee on Capital Market Regulation and U.S. Chamber of Commerce 37 (February 2, 2007).

⁶ *Letter from Ann Yerger*, at 2-3.

⁷ *Cf.* Letter from Jeff Mahoney, General Counsel, *The Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission 2-3* (September 14, 2006) (Explaining why a “serial extension of the Section 404 requirements” is not in the best interests of investors).

⁸ *See, e.g., Lynn Turner*, at 24.

We generally support the Proposal's guidance on "Scaling the Audit for Smaller Companies."⁹ We, however, would respectfully request that the final standard emphasize that a scaled audit for a smaller company does not mean a less rigorous audit. For example, the final standard should explicitly state that a scaled audit for a smaller company does not exempt the audit from *any* of the principles set forth for planning the audit, testing controls, evaluating identified deficiencies, and reporting on internal control.

In addition, we generally support the guidance requiring the auditor to evaluate the size *and* complexity of a company in planning and performing the audit.¹⁰ We would therefore oppose any revisions to the Proposal that would permit the scaling of the audit for smaller companies based solely on the rules-based size limits contained in the final report of the SEC Advisory Committee on Smaller Companies.¹¹ There is no evidence that we are aware of indicating that the size of a company decreases the risks of misstatement.¹²

Using the Work of Others

We generally support the Proposal's guidance on "Considering and Using the Work of Others in an Audit."¹³ We, however, believe that an excessive use of the work of others in performing an audit of internal controls, particularly using work performed by company management, may weaken investor protection and impair the credibility of the independent audit and regulatory processes. Our support for the proposed guidance is therefore conditioned on the final standard containing a framework for evaluating the persons performing the work that is *no less restrictive* than that currently contained in the Proposal.¹⁴

For example, we would oppose the removal of any of the proposed factors for assessing the competence and objectivity of individuals performing tests, including the proposed factor that focuses on a company's policies addressing compensation arrangements for individuals performing the testing.¹⁵ As indicated in many of the ongoing stock option backdating investigations, compensation arrangements can erode an employees' objectivity about the quality of, or even the need for, internal controls over financial reporting.¹⁶

⁹ Proposed Auditing Standard, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, ¶¶ 9-12 (December 19, 2006).

¹⁰ *Id.* ¶ 9.

¹¹ *Id.*

¹² *Cf.* COSO, Internal Control over Financial Reporting—Guidance for Smaller Companies, FAQ, Item 19 (June 2006) ("Size of the organization does not decrease the need for effective internal control").

¹³ Proposed Auditing Standard, Considering and Using the Work of Others in an Audit (December 19, 2006).

¹⁴ *Id.* ¶¶ 10-19.

¹⁵ *Id.* ¶ 15(c).

¹⁶ *Cf. Lynn Turner*, at 13 (Noting that 40 of 225 companies that have announced internal or governmental reviews of stock-option backdating have reported material weaknesses and 99 have reported restatements).

Special Considerations for Subsequent Years' Audits

We generally support the Proposal's guidance on "Special Considerations for Subsequent Years' Audits."¹⁷ We agree that the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision making process for determining the nature, timing, and extent of testing necessary in the current year.¹⁸ Those requirements would appear to be consistent with applying sound professional judgment as part of an audit of internal control.

We continue to strongly oppose any form of rotational testing of sections of internal control.¹⁹ The final standard should be clear that auditors are not permitted to assume that the company's controls are functioning each year without testing them. As we have stated in prior comment letters on this topic, rotational testing

. . . is comparable to telling drivers that the state police will only patrol the interstate on Tuesdays and Fridays. Any such alternative would likely only confuse investors and open the process to problems that could harm the investing public.²⁰

Clarifying the Role of Materiality in the Audit

We generally support the Proposal's guidance on "Materiality."²¹ We agree with the proposed clarification that the auditor should plan and perform the audit of internal control using the same qualitative principles-based materiality measures used to plan and perform the audit of the annual financial statements.²²

We would oppose any revision to the Proposal that would establish a rules-based numerical formula, such as five percent of net income, for assessing materiality in the audit of internal control. Numerical thresholds for materiality in the context of financial reporting have been extensively studied by many parties over many years.²³ We note that the SEC,²⁴ the Financial Accounting Standards Board,²⁵ and the US Supreme Court²⁶ have all reached generally consistent conclusions indicating that investors are best served by a qualitative principles-based approach to materiality.

In conclusion, we applaud the PCAOB on developing a thoughtful proposed standard that is responsive to the recommendations of the Council. We look forward to a prompt adoption and implementation of the Proposal as a final standard. Investors have long demanded, and have long deserved, a full and cost effective implementation of the requirements of Section 404 by all companies—large and small—that access the public markets.

¹⁷ *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, ¶¶ 65-69.

¹⁸ *Id.* ¶ 65.

¹⁹ Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission 5* (September 14, 2006).

²⁰ *Id.*

²¹ *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, ¶¶ 14-15.

²² *Id.* ¶ 14.

²³ See, e.g., SEC Staff Accounting Bulletin: No. 99 – Materiality, 17 C.F.R. § 211 (August 12, 1999).

²⁴ *Id.*

²⁵ *Id.* at 3.

²⁶ *Id.*

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The Council appreciates the opportunity to comment. We would be happy to respond if you have any questions or need additional information.

Sincerely,

A handwritten signature in black ink that reads "Jeff Mahoney". The signature is written in a cursive, flowing style.

Jeff Mahoney
General Counsel