

## COMMITTEE ON CAPITAL MARKETS REGULATION

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Office of the Secretary  
Public Company Accounting Oversight Board (“PCAOB”)  
1666 K Street, N.W.  
Washington, DC 2006-2803  
[comments@pcaobus.org](mailto:comments@pcaobus.org)

Re: Release No. 2006-007, Rulemaking Docket Matter No. 021

Dear Office of the Secretary:

The Committee on Capital Markets Regulation (the “Committee”) appreciates this opportunity to comment on proposals made by the PCAOB relating to the obligations of auditors under Section 404(b) of the Sarbanes-Oxley Act of 2002 (“SOX”) to assess the adequacy of internal controls.

The Committee is independent and bipartisan, composed of twenty-two corporate and financial leaders drawn from the investor community, business, finance, law, accounting, and academia. The Committee issued its Interim Report on the state of the U.S. public equity capital market on November 30, 2006. The Committee’s purpose is to explore a range of issues related to maintaining and improving the competitiveness of U.S. capital markets. As stated in its Interim Report, the Committee believes that maximizing the competitiveness of U.S. capital markets is critical to ensuring economic growth, job creation, low cost of capital, innovation, entrepreneurship, and a strong tax base.

The loss of U.S. public market competitiveness compared to other major markets worldwide results from a number of factors: foreign markets have closed the technology gap and narrowed the confidence and liquidity gaps that traditionally favored the U.S. market. Clearly, regulation and litigation play central roles in protecting investors and the efficient functioning of our capital markets, particularly in light of recent, highly-publicized abuses. Yet excessive regulation, problematic implementation, and unwarranted litigation—particularly when occurring simultaneously—make the U.S. capital markets less attractive and, therefore, less competitive with other financial centers around the world. Enhancing shareholder rights and reducing overly-burdensome regulation and litigation are the twin pillars of the recommendations released by this Committee in November.

In the late 1990s, the U.S. exchange-listed capital markets were attracting forty-eight percent of the value of all global initial public offerings (“IPOs”). By 2006, U.S. market share had fallen to 7.2 percent. If U.S. investors are to have access to a vibrant U.S. IPO market and all the protections it affords, then U.S. regulators must work to reverse this trend.

Our report also documents the tremendous growth in private equity capital and going-private transactions—which deprive public investors of access to a growing share of U.S. equity investments. One of the reasons for the increasing attractiveness of private equity markets is concern over the costs of going or remaining public. Since 2001, the number of venture capital (“VC”) backed acquisition exits with disclosed values has exceeded the number of VC-backed IPO exits by more than ten-to-one (1919 to 171), with a difference of value of \$95 billion as compared to \$12 billion, albeit that IPO exits, unlike private exits, typically involve the sale of only a portion of the company.

The Committee believes that Section 404 has provided significant benefits to both investors and business by increasing the reliability of financial statements, strengthening internal controls, improving the efficiency of business operations, and helping to reduce the risk of fraud. The Committee strongly supports the need for effective internal controls. However, the Committee also believes that this objective can be achieved at much lower overall cost than the average cost per company during the first year (approximately \$4.4 million) and second year (\$3.8 million) of SOX implementation, as reported by the Financial Executives International (FEI) in its cost survey of 2006

We commend the PCAOB for its stated intent to make Section 404 implementation more efficient while working to ensure its effectiveness. We support the top-down, risk-based approach that allows auditors to make use of management judgment in tailoring their evaluations of controls to the individual circumstances of the companies they audit. We also support the proposal that eliminates the requirement for an auditor to examine management’s evaluation process. We further support the increased flexibility provided for auditors to rely upon the work of others and to limit the testing of low-risk controls. Auditors should be able to adjust the nature, timing, and extent of their procedures based on knowledge obtained during previous audits, particularly as such knowledge impacts the auditor’s assessment of risk.

We believe the PCAOB's proposal importantly directs the auditor to scale the audit so that it is appropriate *vis-à-vis* a company's size and complexity. This is much preferable to a “design-only” standard for small companies, under which outside auditors would only assess the overall adequacy of the design of controls without testing their operating effectiveness.

We also believe, however, that the PCAOB’s revised guidance on materiality is the most important issue affecting the cost of Section 404(b) implementation and must be considerably strengthened if SOX costs are to be significantly decreased. Under current guidance, a material weakness is defined as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We support the PCAOB’s proposal to replace this standard with a requirement that there be a “reasonable possibility” that a

misstatement could result in a material misstatement. Nevertheless, we believe the PCAOB should go farther in clarifying the definition of materiality.

There is no reason to examine internal controls that, even if deficient, could have no material impact on the financial statements of the company. Unfortunately, this appears to be happening today. As the Committee's report shows (Figure V.3, p. 123), based on an analysis by Mercer Oliver Wyman of the 2006 GAO study, fifty-three percent of the restatements between 2002-05 had either a negligible negative (less than one percent) or a positive impact on company market value.

The Committee has recommended that materiality for internal control reviews should be defined consistently with the definition of materiality in financial reporting. Specifically, the Committee recommends that materiality for scoping an assessment should be defined, as it was traditionally, in terms of a five percent pre-tax income threshold. This standard would be consistent with the overall risk-based approach taken by the PCAOB in this proposal. In cases where the five percent test would not be meaningful, the PCAOB should allow companies and their auditors to exercise their reasoned judgment in choosing other measures to evaluate materiality in ways that are relevant to investors. We also believe that this standard should be applied to annual, rather than interim, financial statements.

Finally, with only three years of experience, the fact base relating to Section 404 implementation is still fairly limited. As a result, we believe the SEC and PCAOB should continue to collect better and more complete information relating to the costs and benefits of Section 404.

The Committee's Interim Report may be accessed through its website at <http://capmksreg.org/research.html>. Specific references to SOX 404 may be found on pages 19-21 and 115-135 of the Interim Report. If the PCAOB staff should have any questions or comments concerning this submission, please do not hesitate to call Hal S. Scott (617-495-4590) at your convenience.

Sincerely,



Hal S. Scott  
Director  
Committee on Capital Markets Regulation