



May 6, 2014

The Honorable Jeb Hensarling  
Chairman  
House Financial Services Committee  
2228 Rayburn House Office Building  
Washington, DC 20515

The Honorable Maxine Waters  
Ranking Member  
House Financial Services Committee  
2221 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

We are writing in opposition to any legislation that would erode Section 404(b) of the Sarbanes Oxley Act or revise the definition of accelerated filer, as defined in SEC Rule 12b-2 (17 C.F.R. 240.12b-2). Companies that meet the definition benefit from enhanced market confidence because their financial information is communicated to investors on a timely basis, which research shows, in turn, can lead to a lower cost of capital.

The Center for Audit Quality (CAQ) is a public policy organization formed in 2007 to serve investors, public accounting firms that audit public companies, and the capital markets by enhancing the role and performance of public company auditors. It is a membership organization with approximately 600 audit firm members, most of which are public company audit firms registered with the Public Company Accounting Oversight Board (PCAOB).

The Council of Institutional Investors (CII) is a nonprofit association of pension funds, other employee benefit funds, endowments and foundations with combined assets that exceed \$3 trillion. CII is the leading voice for effective corporation governance and strong shareowner rights.<sup>1</sup>

We believe that legislation that erodes Section 404(b), including HR 2629, would substantially impact the quality and timing of financial disclosures by sizable public companies to the detriment of investors and our capital markets more generally. According to an analysis by Audit Analytics, an independent research provider, this legislation which would exempt public companies that have a market value below \$250 million or annual revenues under \$100 million, could include companies like TravelCenters of America, the largest full service truck stop chain in North America, and Bon-Ton Stores with 275 stores in 23 states.<sup>2</sup>

Section 404(b) provides investors with important assurance by the independent auditor performing the financial statement audit regarding a CEO and CFO's representations about the effectiveness of their company's internal control over financial reporting (ICFR). This assurance is an important driver of confidence in the integrity of financial reporting and in the fairness of our capital markets.

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<sup>1</sup> For more information about the Council of Institutional Investors (CII), please visit the CII website at [http://www.cii.org/about\\_us](http://www.cii.org/about_us).

<sup>2</sup> This analysis is based on companies that would qualify for accelerated filer status based on their market capitalization at September 21, 2012. As the market capitalization of each company fluctuates, the expected impact of proposed changes to the market capitalization thresholds will also change. Changes to each company's most recent fiscal year revenues will also affect the analysis.

We appreciate Congress's goal to spur innovation, however it is not clear that companies would realize significant cost savings from an exemption from Section 404(b) because the ICFR audit is now fully integrated with the financial statement audit, and the quality of the control environment is an explicit factor auditors must consider in scoping the financial statement audit under the PCAOB's risk assessment standards.<sup>3</sup>

Conversely, there are a number of reasons why the application of Section 404(b) should be retained in its current form. A report released by the Government Accountability Office (GAO) entitled *Internal Controls, SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation (July 2013)*<sup>4</sup>, examined the impact of the permanent Section 404(b) exemption on the quality of financial reporting by small public companies and on investors.

This study was mandated under the Dodd-Frank Act which required the GAO to conduct a study to evaluate whether exempt issuers have fewer or more restatements, and how their cost of capital compares with issuers subject to Section 404(b). As part of its examination, the GAO analyzed financial restatements and audit fee data; surveyed public companies; interviewed regulatory officials and others; and reviewed laws, surveys, and studies.

The GAO found that companies exempted from Section 404(b) experience more financial restatements, as compared to nonexempt companies; and the percentage of exempt companies restating has generally exceeded that of nonexempt companies. According to the report, companies that obtained an auditor attestation generally had fewer financial restatements than those that did not. A majority of the empirical studies reviewed by the GAO also suggested that compliance with Section 404(b) has a positive impact on investor confidence in the quality of financial reports.

Further, GAO and other analyses show that costs have declined for companies of all sizes since 2004. The "Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million" issued by the SEC in 2011 concluded that cost of compliance with Section 404(b), including both total costs and audit fees, declined by approximately 30 percent after the PCAOB adopted AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the SEC issued management guidance on Section 404(a) in 2007.<sup>5</sup>

A February 2013 study found that the cost of equity for companies that voluntarily comply with Section 404(b) is 220-320 basis points lower than peer companies.<sup>6</sup> Research also has demonstrated that Section 404(b) has had a positive impact on the cost of capital. The cost of capital has decreased for public companies since enactment of the Sarbanes-Oxley Act, especially smaller companies.<sup>7</sup>

More than three years ago, a permanent exemption from Section 404(b) was granted to public companies with less than \$75 million in market capitalization under the Dodd Frank Act. And, last year, Congress granted a five-year exemption from Section 404(b) and other securities laws requirements for "emerging growth companies" as part of the Jumpstart Our Businesses (JOBS) Act. While these companies have never had to comply with Section 404(b), other legislative proposals would affect hundreds of companies currently complying with Section 404(b) provisions, thus representing a further unnecessary and significant reduction in current investor protections.

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<sup>3</sup> See e.g., PCAOB Auditing Standard (AS) No. 8, *Audit Risk*, and AS No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>4</sup> <http://www.gao.gov/assets/660/655710.pdf>

<sup>5</sup> <http://www.sec.gov/news/studies/2011/404bfloat-study.pdf>

<sup>6</sup> Cassell, Cory A., Myers, Linda A. and Zhou, Jian, *The Effect of Voluntary Internal Control Audits on the Cost of Capital* (February 12, 2013)

<sup>7</sup> Stephen, Sheryl-Ann and de Jong, Pieter J, *The Impact of Sarbanes-Oxley Act (SOX) on the Cost of Equity Capital of S&P Firms* (2012). *Journal of Applied Business and Economics* vol. 13(2) 2012

In the interest of shareowners and potential investors who are so important to our capital markets, the Center for Audit Quality and CII strongly urges you to oppose any further efforts to further weaken Section 404(b).

Sincerely,



Cindy Fornelli  
Executive Director  
Center for Audit Quality



Jeff Mahoney  
General Counsel  
Council of Institutional Investors

cc: Members of the House Capital Markets and Government Sponsored Enterprises Subcommittee