April 24, 2006

Participant Statement For Roundtable
On Section 404 Of Sarbanes Oxley
(MAY 10, 2006)

I am Robert C. Pozen, currently Chairman of MFS Investment Management and formerly Vice Chairman of Fidelity Investments. I also serve as an independent director and member of the audit committee of Medtronics and Bell Canada Enterprises (BCE). However, my statement is made on my own behalf[*], and does not purport to represent the views of any of the entities mentioned above.

The most controversial part of the Sarbanes Oxley ("SOX") Act is Section 404, which requires an annual assessment by the executives of public companies of their internal controls over financial reporting. Critics question whether the benefits of Section 404 outweigh its costs, which have been much higher than originally estimated. Because of these concerns, an advisory committee of the Securities Exchange Commission (Commission) recently proposed a total exemption from Section 404 for small companies and a partial exemption for middle-size companies. However, some commentators have strongly opposed such exemptions, since these small and medium-size companies constitute 80% of all publicly listed firms and are the ones most susceptible to financial frauds. These commentators also point out that the costs for reviews under Section 404 have declined substantially from the initial year to the second year of its effectiveness.

[*] Parts of this statement were included in my editorial published in the Wall Street Journal on April 5, 2006.

This comment takes a middle ground. In my view, the current rules on assessing internal controls for all public companies should be revised, greatly reducing the costs of these assessments while preserving most of their benefits. Under the approach proposed below, the management of every public company would be required to publish an annual assessment of the company's internal controls, attested to by the company's auditors; but such assessments would be focused on the company's internal controls over material information, defined under traditional criteria of probability and size of financial impact, contained in the company's financial reports to the Commission. This middle-ground approach would serve well the interests of investors in public companies. Investors are primarily concerned about whether the internal controls of a company are sufficient to prevent material misrepresentations or material omissions in the company's financial statements and other publicly filed reports. They are generally reluctant to have a public company spend millions of dollars on internal controls aimed at transactions or processes that are financially insignificant for the company.

This comment letter discusses four main aspects of internal controls reviews, and makes proposals to improve each aspect:

1. The need to consolidate Commission rules on the subject;
2. The appropriate definition of materiality for Section 404;
3. The scope and timing of auditor attestation; and
4. The form of auditing guidance.

1. Consolidation of Commission Rules

The Commission has adopted two different requirements for internal controls. First, it has defined "internal control structure and procedures . . . for financial reporting" under Section 404 to include more items of information with more details than those ordinarily included in the financial reports of public companies. In the Commission's view, internal controls must provide reasonable assurance not only that material information in the company's financial statements is accurate, but also "that receipts and expenditures of the company are being made only in accordance with authorization of management and directors of the company." By unlinking "internal controls" from "financial reporting" in Section 404, the Commission encourages management and auditors to scrutinize detailed procedures for controlling ordinary expenditures -- e.g., reimbursing travel expenses and handling petty cash -- even in cases where they are clearly immaterial to the company's financial reports.

Second, the Commission requires management to assess a public company's "disclosure controls" -- defined as "controls and other procedures . . . designed to ensure that information required to be disclosed by the issuer in the reports it files" with the commission "is recorded, processed, summarized and reported" in a timely manner. This second rule on "disclosure controls" is very confusing since it overlaps with the first rule on "internal controls." To the extent that this second rule is based on Section 302 of SOX, rather than Section 404, it should focus on “material” information. Section 302 is aimed at “material” information in a company’s financial statements (except for fraud, whether or not material).

Moreover, the two rules provide somewhat different treatments of quarterly reports on internal controls. The quarterly report in the first rule may be limited to any material "change in the issuer's internal control over financial reporting" that occurred during the last quarter. Under the second rule, by contrast, management must evaluate "the effectiveness of the issuer's disclosure controls and procedures, as of the end of each fiscal quarter…".

The Commission should end this confusion by combining both rules into one on "internal controls" over "financial reporting." This consolidated rule should cover management's assessment of internal controls on the accuracy and timeliness of "material" information submitted by public companies in their annual financial reports to the Commission, and "material" changes to such controls in quarterly reports.

2. The Appropriate Definition of Materiality

The courts have traditionally looked at "materiality" as encompassing two related elements: the likelihood of an event occurring and the financial impact of that event on a company. However, a much broader concept of "materiality" is applied to Section 404 by the Public Company Accounting Oversight Board (PCAOB). According to its Auditing Standard No. 2, an auditor must apply materiality "in an audit of internal controls over financial reporting at both the financial-statement level and at the individual-balance level". This extension of materiality to individual balances tends to lead management and auditors to incur great expenses by examining controls over

balances that are not financially significant for the company as a whole -- for example, reserve balances in a minor subsidiary, or inventory balances in a small factory.

The PCAOB's broad definition of materiality is exacerbated by its expansive standard for assessing the likelihood of a problem occurring in a company's internal controls. According to Auditing Standard No. 2, "reasonable assurance" that internal controls are effective means that there is only a "remote likelihood that material misstatements will not be prevented or detected on a timely basis." Conversely, a company will have a "significant deficiency" if a problem with its internal controls is "more than remote", which is equated by the PCAOB with "reasonably possible." These terms are taken from FASB #5, which provides guidance on when companies should establish reserves on their balance sheets for contingencies, such as litigation, as opposed to textual disclosures in their financial reports.

Although the PCAOB chose the terminology of FASB #5 because it is familiar to the accounting profession, the use of phrases like "remote likelihood" or "more than remote" could easily lead to auditor concerns about internal controls based on hypothetical situations that have not occurred and are not very likely to occur. A more appropriate standard for determining that internal controls are effective would be that a problem is "unlikely to actually happen." Suppose one employee signature is required for customer refunds under $100 and two signatures above that amount. The auditors may maintain that mishandling of small customer refunds is not "remote" because the one employee signing could, in theory, conspire with the customer to defraud the company.

Yet the mishandling of small customer refunds is "unlikely to actually happen" because the one employee knows that his or her signature can easily be traced if any problem becomes evident on customer refunds.

3. Scope and Timing of Attestation

Auditing Standard No. 2 states categorically: "There is no difference in the level of work performed" by the auditors when attesting to management's assessment of the company's internal controls, versus when the auditors express an opinion directly on the effectiveness of the company's internal controls. This approach leads to a substantial amount of redundant work. Management must test all of the company's internal controls. Then the auditors can rely in part on management's testing, but only for less important areas of internal controls. A more efficient approach would be for the auditors to evaluate the design of the control systems, review the testing plan of management, and test a reasonable sample of internal controls (presumably in high risk areas).

Moreover, the Commission and the PCAOB should consider taking a multi-year approach to testing internal controls. Suppose in year one, a company's management performs full testing to reach an assessment that the company's internal controls are effective. After an appropriate review of management's assessment, the auditors find no "material weakness" in the company's internal controls. In addition, the company does not have to restate its financial statements. In year two, such a company's auditors might be permitted to test only the effectiveness of company-level controls. These include; tone at the top, management's risk assessment process, centralized processing and controls,

the internal audit function and audit committee and the period-end process for financial reporting.

Such a multi-year approach would reward companies with good internal controls, while reaching a more appropriate balance between the costs and benefits of auditor review. Although the auditor's attestation would be limited to company-wide controls every other year, these are the controls that are most critical for financial reporting by public companies. Furthermore, the major fraud cases, such as Enron and WorldCom, involved failures of internal controls at the company level.

4. Form of Auditing Guidance

In formulating their current rules, the PCAOB and the Commission were heavily influenced by an internal controls framework promulgated in the early 1990's by COSO (a committee of sponsoring audit organizations) after public comment. COSO is one of the few frameworks that meets the Commission's condition of "a suitable, recognized control framework that is established by a body or group that has followed due process procedures…". While the COSO framework is excellent for many purposes, the PCAOB and the Commission recognize that COSO is too broad for Section 404 because the framework covers compliance with all laws and effectiveness of corporate operations as well as internal controls. COSO is now developing for small companies a control framework limited to financial reporting, which should be extended to all public companies. This narrower version of COSO should be explicitly deemed to meet the Commission's condition of "a suitable, recognized control framework" under Section 404.

The PCAOB has published many questions and answers, which provide useful and sensible guidance to auditors on attesting to internal controls. However, the status of these questions and answers could be debated in the event of class action litigation against auditors. Therefore, it would be preferable for Auditing Standard No. 2 to be revised to reflect the guidance in these questions and answers, or for them to be formally incorporated into Auditing Standard No. 2.

Conclusions

All of the above suggestions can, in my opinion, be implemented without a legislative amendment to SOX. Consistent with Section 404, the Commission may focus management's assessment on internal controls with respect to the material information contained in the company's financial reports. Consistent with Section 404, the PCAOB may allow auditors to attest to management's assessment by reviewing the design of the company's internal controls, evaluating management's plan for testing and performing sample testing. Both the Commission and the PCAOB should apply to Section 404 the traditional criteria for judging materiality – the probability of a problem and the financial impact of such a problem on the company as a whole. Finally, the Commission should explicitly acknowledge the utility of the narrower version of COSO, and the PCAOB can formally incorporate its questions and answers on internal controls into Auditing Standard #2.