STATE BOARD OF ADMINISTRATION
OF FLORIDA

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VIA EMAIL

February 26, 2007

Office of the Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

The State Board of Administration (SBA) of Florida is writing to provide commentary 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.* The SBA manages the Florida Retirement System (FRS), the fifth largest public pension plan in the United States with approximately 970,000 beneficiaries and retirees, and assets totaling approximately $136 billion. As a large institutional investor in global capital markets, the SBA has a significant interest in promoting accurate financial information in order for investors to make reasonably informed decisions and for the orderly functioning of the U.S. capital markets.

The SBA believes that Section 404 of the Sarbanes-Oxley Act of 2002 has been essential in restoring investor confidence and maintaining the overall integrity of our capital markets. We believe that effective internal controls, long required of public companies by the Foreign Corrupt Practices Act of 1977, are integral to high quality financial reports. Any publicly traded company, regardless of size, should have appropriate controls in place and management should be responsible for assessing those controls with meaningful review by external auditors. We continue to support Section 404 because we believe, as has been demonstrated empirically, that improved internal controls reduce the incidence of financial restatements and reduces equity risk.

The SBA views the Proposed Auditing Standard as flexibly structured, comprehensive, and timely for many of the issues that have arisen during the implementation of internal control auditing requirements imposed by Sarbanes-Oxley. As the proposal encompasses a top-down, risk-based approach, it should result in a reduction of the number of hours required to perform internal control audits without sacrificing effectiveness. To be clear, as long-term investors, we believe the Board should focus on quality and accuracy of financial statements above all else. While we support improving audit efficiency, the effectiveness of internal control audits should not be impaired in any way. The SBA strongly supports the proposal's adoption and implementation as a final standard. Below, we share our views on several of the key aspects of the proposal and note a few areas that could be clarified and/or improved in order to maintain its effectiveness.

ROLE OF THE AUDIT COMMITTEE

The competence of a board's audit committee is central to the development of high quality and transparent financial statements.[1] The proposal lists examples of strong indicators of material weakness, one of which is the, "ineffective oversight of the company's external financial reporting and internal controls over financial reporting by the company's audit committee." In our view, a weak audit committee is highly likely to foster an ineffective control environment, and as such, the audit committee as a topic should be an integral component of this auditing standard. While the proposal does not place responsibility for performing a separate evaluation of the audit committee upon the external auditor, neither does it adequately define and describe the circumstances for external auditors to evaluate the audit committee's oversight. The SBA urges the Board to provide additional clarity in the final standard for external auditors to use when assessing the effectiveness of a board's audit committee—specifically including examples of both effective as well as ineffective characteristics of oversight. As well, a meaningful evaluation of the audit committee members' competence and knowledge of accounting matters should be included as part of this evaluation.[2] We suggest a note or other clarification that external auditors should evaluate any circumstances they feel could impact an audit committee member's independence, and not limit such an evaluation to only using the current stock exchange listing standards for determining independence.

AUDITS OF SMALLER COMPANIES

The SBA supports the proposal's guidance on scaling the audit for smaller companies. Because smaller public companies may have less developed corporate governance frameworks and financial restatements are more frequently encountered by their shareowners, an audit of the internal control environment of these companies is certainly as important as an audit of the internal controls of larger firms. We respectfully request that the final standard clearly state that a scaled audit for a smaller company does not exempt the auditor from any of the principles set forth for planning the audit, testing controls, evaluating identified deficiencies, and reporting on internal control. We urge the Board to oppose any potential revisions to the Proposed Auditing Standard that would permit the scaling of the audit based simply on absolute or relative size thresholds (for example, a company's market capitalization or total revenues). Consistent with our general views on most corporate governance matters, we do not believe there is any justification for such bifurcation of auditing standards.

MATERIALITY IN THE AUDIT

We generally support the proposal's guidance on materiality and 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 to plan and perform the audit of the annual financial statements. However, we urge the Board to keep the current proposed guidance and

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[1] See "Audit Committee Financial Literacy: A Work in Progress" by Douglas J. Coates, M. Laurentius Marais, Roman L. Weil, 2005. The authors found that firms with improving financial literacy (as measured by accounting certification, experience, etc.) of audit committees experienced annualized abnormal, excess returns of 4.6 percent per year above those firms which did not improve audit committee financial literacy.

[2] According to Huron Consulting, approximately 11 percent of all audit committee members in the United States are accountants. There are similar nuances related to the interpretation of the "financial expert" designation applied to audit committee directors.

avoid any revisions to the Proposal that would establish a rules-based numerical formula for assessing materiality in the audit of internal control (for example, a minimum percentage of net income). We believe that investors are best served by a qualitative principles-based approach to determining materiality.

FRAUD DETECTION AND USE OF OTHER QUALITATIVE MEASURES

The SBA urges the Board to provide additional guidance on fraud detection and the evaluation of risk, including coverage of non-traditional issues that can have a significant impact on a company's financial statements and how auditors can approach risk identification. We believe the inclusion of these other metrics can be highly effective for incorporating a stronger fraud detection component as part of the audit of internal controls. External auditors should triangulate accounting and financial information by evaluating fundamental industry benchmarks (for example, analyzing absolute and relative profit margins to identify elevated risks of fraud), reviewing a company's corporate governance (for example, analyzing incentive compensation plans and procedures used by a board's compensation committee), and assessing current market research (for example, research reports of major investment banks and ratings agencies). We believe the inclusion of such an orientation would further improve the effectiveness of internal control audits, with only de minimis cost implications.

The SBA commends the PCAOB's efforts to promote and enhance accurate financial information for the investment community and supports the full and cost effective implementation of the Proposed Auditing Standard. We also appreciate having the opportunity to provide input. If we can provide any further information or you have any questions, please contact Michael McCauley, Director of Corporate Governance, at (850) 413-1252 or me.

Sincerely,

Coleman Stipanovich
Executive Director

cc: Honorable Christopher Cox, Chairman, Securities and Exchange Commission