National Association of Corporate Directors

DM EXTRA!

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Section 404 Roundtable Sparks SEC, PCAOB Action

Are you a director, officer, or advisor of a company that has experienced daunting challenges and heavy costs in complying with Sarbanes-Oxley's section 404? If so, some good news (if not a "happy ending") may be at hand. At a recent (April 13, 2005) Roundtable on "Implementation of Internal Control Reporting Provisions," two chief regulators—**Securities and Exchange Commission (SEC)** chairman **William H. Donaldson** and **Public Company Accounting Oversight Board (PCAOB)** chairman **William J. McDonough**—promised action. **Chairman Donaldson** requested staff guidance for companies "as soon as possible," and **Chairman McDonough** asked his staff to issue guidance for external auditors by May 16, 2005.

Director Summary >

This *DMX* explains reasons for the Roundtable, describes NACD involvement, quotes panelists, and makes hopeful predictions about the forthcoming guidance.

Reasons for the Roundtable

As every public company director knows, section 404 of Sarbanes-Oxley requires an internal control report in annual reports. Specifically, the report must state the responsibility of management for establishing and maintaining an "adequate internal control structure and procedures for financial reporting," and assessing the "effectiveness of the internal control structure and procedures of the issuer for financial reporting." Section 404 also requires that company auditors "attest to, and report on, the assessment made by the management of the issuer." The SEC sets the standard for management, while the PCAOB sets the standard for auditors.

This year, as the March 16 deadline for section 404 compliance by companies and their auditors loomed, complaints arose over implementation of both management's 404 report and the PCAOB's Auditing Standard No. 2 (AS No. 2), *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. The standard describes what process independent auditors should use in assessing the internal controls of companies. In a letter to **NACD** president and CEO **Roger Raber**, **Sturm, Ruger & Company** treasurer **Thomas A. Dineen** lamented that fulfilling these requirements "has occupied limited resources and manpower that would have been better utilized improving the true economic value of the company" (as quoted in our March 23, 2005, *DMX*).

NACD Involvement

Mr. Dineen was not alone in expressing his concerns. By the day of the Roundtable, the SEC had reportedly received some 185 comment letters, many of them from company officers or

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directors addressing similar complaints. One such letter came from NACD Chicago Chapter president **Michele Hooper**, joined by **Dr. Raber**, and NACD chairman **B. Kenneth West**. The NACD letter, dated March 31, 2005, Re File No. 4-497, made three main points:

- Regulators should allow auditors to review and rely on previous and ongoing work by internal auditors.
- Regulators should allow a risk-based approach to prioritize the scope of the internal control audit based on cumulative knowledge and judgments gained from earlier 404 work, and not simply repeat the same process approach and walk-through as required the previous year.
- Audit committee members should be able to rely on the business judgment rule as they determine the nature of internal controls and the scope of the audit of internal controls.

For the full text of the letter, see http://www.sec.gov/news/press/4-497.shtml.

Ms. Hooper had an opportunity to express NACD's concerns in person at the Roundtable, which featured 52 other distinguished panelists, including NACD director **Barbara Hackman Franklin**, and NACD members **J. Michael Cook**, **James E. Copeland, Jr.**, **Nick S. Cyprus**, **Timothy P. Flynn**, **Debbie Lambert**, **Rebecca McEnally**, and **Dr. Albert M. Teplin**. Also present as dignitaries of the day were three prominent NACD members: National Capital Area Chapter president **Joanne O'Rourke Hindman**, special advisor to PCAOB member **Kayla Gillan** (present along with her colleagues); NACD member **Mary Sjoquist**, special counsel to the PCAOB; and **Herbert Wander**, co-chair of the SEC's Small Business Advisory Committee. NACD president **Roger W. Raber** was also present with staff.

Roundtable Comments

Chairman Donaldson opened the session by noting trends. Of more than 2500 companies that filed their internal control reports by March 31, 2005, 8 percent reported "material weaknesses" (that is, internal control deficiencies major enough to have a likely impact on a financial statement). This number may seem high, but it does not take remediation into account. Many companies that have deficiencies are able to fix them promptly. Chairman Donaldson cited the example of one accounting firm where managers and auditors found and *remediated* a total of approximately 63,000 control deficiencies in 225 companies—hundreds per company. (**Sam DiPiazza**, CEO of **PricewaterhouseCoopers**, gave similar, rounded numbers in his comments.)

Chairman McDonough urged "flexibility and judgment" in assessing internal control systems, warning that auditors should not adopt a "checklist" mentality. These words were welcome to many present, since most complaints about 404 and AS No. 2 implementation boil down to a complaint that assessment has been too rigid. The words did not sound like rote boilerplate. Chairman McDonough, who has been involved in sophisticated risk assessment in the banking sector through his past experience as chairman of the **Basel Committee on Banking Supervision** and president of the **Federal Reserve Bank of New York**, seemed to speak with the conviction of hard experience when he said, "No one size fits all."

The opening remarks set the stage for the six panels, moderated by several SEC staffers, including **Alan L. Beller**, Division of Corporation Finance, and **Donald T. Nicolaisen**, Office of the Chief Accountant.

Panel One—The First Year. **Casey J. Sylla**, chairman and president of **Allstate Financial**, claimed a "positive" experience through increased involvement in and awareness of internal controls, and a stronger emphasis on updating and maintenance. **Mary K. Bush**, a director of **Millennium Chemicals**, said 404's formalization of controls had been "good" for audit committees. Most participants touched on all the problems described by Chairman Donaldson in his opening remarks, namely:

- *Companies pulling staff from other strategic projects to help with internal control reporting*—what panelist **Colleen Cunningham** of **Financial Executives International** called "opportunity costs."
- *Substantial and unanticipated expenses, including internal overhead, audit fees, and software expenses*—especially for smaller companies, which have a compliance cost 50 times higher than large ones, as a percentage of revenues (as noted in Panel Three).
- *Duplicative testing procedures with little or no reliance on the work of others*—or as **New York Stock Exchange** CEO **John Thain** said, "attestation has become duplication" (a point explored in Panel Four).
- *Management and auditors talking past one another* (noted in Panel Five).

Former SEC chief accountant **Lynn Turner** noted that the smallest companies (under $200 million in revenues) were more likely to have weak internal controls, while the largest companies (over $5 billion) had the strongest controls. But not all large companies are comfortable with 404 and AS No. 2. **Dr. Klaus Patzak**, corporate vice president and controller of the German multinational **Siemans AG**, noted that Siemans operates in 190 countries, and many of its member firms are very small, with unique control systems. Auditing each of these systems, even ones with no material impact on the balance sheet, has been

a waste of resources, said Dr. Patzak. **Robert H. Miles**, senior vice president and controller of **Washington Mutual**, and **University of Chicago** economics professor **Randall Krosner** noted that banks already have a stringent internal reporting regime under the 1991 FDIC Improvement Act—why do compliant banks need the rigors of AS No. 2? Several panelists cited a Big Four audit firm study that said audit fees would go down by an average of "46 percent" next year. J. Michael Cook, who has written on board oversight of risk (in *Directors Monthly* and elsewhere), seemed skeptical about steep price drops. The former **Deloitte & Touche** CEO and current **Comcast** audit committee chair said at best we can hope that "both parties will be equally unhappy."

The remaining panels delved into particular problems and solutions. Here are some quotes from just a few of the many insightful panelists.

Panel Two—Reporting to the Public. NACD director Barbara Franklin, former U.S. Secretary of Commerce and a director of **Dow Chemical**, emphasized the need for an "enterprise risk management" assessment that included a sense of the "magnitude and probability of risk," particularly as the risks "impact financial statements." NACD member Copeland, an audit committee member at three major companies including **Equifax**, suggested that regulators allow for a qualitative rather than a "pass-fail" assessment of internal control assessment. He urged a greater emphasis on "materiality." **Mark J. P. Anson**, chief investment officer of the **California Public Employees Retirement System**, said investors want "more rather than less information." But **Latham & Watkins** partner **John J. Huber** said disclosures should be limited to signaling important risks—like a "canary in a mineshaft." He also wondered why companies that have fixed their problems need to report them. "We fixed it. Why do we have to carry this cross?"

Panel Three—Planning and Design. **Charles Bowsher**, former comptroller general of the **U.S. Government Accounting Office** (now called Government Accountability Office) asserted that assessments would be more "effective and efficient" if they were rated by risk—with a distinction between those that still pose risks vs. those that have been remediated. NACD member Dr. Teplin concurred, and said auditors should have more discretion in determining audit "scope." **Alex Davern**, chairman of the **American Electronics Association** committee on Sarbanes-Oxley reform, pointed out that 404 compliance costs represented only 0.5 percent of revenues for companies over $5 billion but 2.5 percent of revenues for companies with revenues under $100 billion. **James S. Turley**, chairman and CEO of **Ernst & Young**, reported on some data collected by the Big Four. On average, each big company discovered 350 deficiencies, and remediated the most significant ones (leaving a very small number of unremediated material weaknesses—about 4 percent). Like many panelists, he said he hopes the PCAOB will give more guidance on where to focus, since so many control "weaknesses" appear to be insignificant.

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Panel Four—Documentation and Testing. This panel got into the real nitty gritty of the subject matter—which only an auditor or audit committee member could love. **Charles H. Noski**, audit committee chairman of **Microsoft**, noted that only one-third of his audit pertained to scope (a tone-at-the top issue); fully two-thirds pertained to documentation and testing (transactions-based). He believes the ratio should be the reverse, with more emphasis on issues of substance. The company identified 1500 processes and subprocesses and 60 information technology systems, with 9000 "key controls." When moderator Beller called the idea of 9000 "key" controls an "oxymoron," Mr. Noski replied: "Not at Microsoft." The company put in 90,000 hours of testing. He said companies should not have to test "every control every year." Similar testimony came from **Lee Level**, corporate vice president and CFO of **Computer Sciences Corporation**, whose company tested 1500 process controls and 1300 information-technology general controls, and from **Lockheed Martin Corporation**'s internal auditor **Kimberly Parker Gavaletz**, who said her company has tested 6000 controls. **Peter F. Minan** summarized a good portion of the discussion when he said that there was "too little effort at the entity level, and too much emphasis on process and IT controls."

Panel Five—Using Judgment in Communications and Conclusions. **David Shedlarz**, an executive vice president with **Pfizer Corporation**, spoke of the "ultraconservative" climate gripping the nation, and said that the "absolute assurance" sought by excessive rules was "unattainable." He argued, like many others, for "reasonable" goals and rules. **William J. Brunner**, CFO, vice president, and treasurer, **First India Corporation**, said that 404 and AS No. 2 had been "chilling" communications between

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companies and auditors with respect to accounting treatments. "The dialogue is lost," he lamented. NACD member Stauffer, senior partner, risk and quality, **PricewaterhouseCoopers**, said that was "not good policy." His wish list for AS No. 2 reform would include aggregate reporting of weaknesses (not lots of separate reports of minutia) and descriptions of *compensating* controls (not all controls have to be direct). He wanted more clarification of what regulators consider to be potential deficiencies that "could" become material.

But **Robert Hodgkinson**, secretary of the **FRC Turnbull Review Group**, a panelist who crossed the ocean to testify, warned against getting trapped in an "endless Russian doll of definitions." He noted that the U.K. guidance on internal controls, the Turnbull Report, was only 15 pages long. (AS No. 2 is 301 pages long.)

Panel 6—Next Steps. **David M. Walker**, comptroller general of the United States as head of the **Government Accountability Office**, recommended that the SEC and PCAOB adopt some of the methodology used by the GAO in its risk assessment reports. (Since 1990, the GAO has periodically reported on government operations that it considers high risks. Its most recent report, *GAO's 2005 High-Risk Update*, was published February 17, 2005.) NACD's representative Hooper emphasized the need for a "reasonable" approach based in enterprise risk, and urged the SEC and PCAOB staff to issue guidance "soon," pointing out that we cannot wait for months, since 2005 is already well under way. Panelists Flynn (of **KPMG**) and McEnally (of the **CFA Centre for Market Integrity**), joined by **Ann Yerger** (executive director of the **Council of Institutional Investors**), all spoke from their own viewpoints about the transparency and trust needed for efficient equity markets.

The SEC commissioners seemed quiet compared to last year's March Roundtable, when they jumped often and forcefully into the debate about shareholder proxy access. (See the April 1, 2004, *DMX*.) At the 2005 Roundtable, they mostly listened intently, asking for points of clarification, rather than making their own points. Commissioners **Roel Campos** and **Harvey Goldschmid** seemed inclined to support the current standards. In response to criticisms that the current AS No. 2 standard is too prescriptive, commissioner Goldschmid chided that there is already a general standard in the Foreign Corrupt Practices Act of 1977 but the law was "not taken seriously." By contrast, commissioners **Cynthia Glassman** and **Paul Atkins** seemed to be more sympathetic to those who had complaints. Commissioner Glassman suggested that requiring such detailed disclosure of minor deficiencies might be "diluting the meaningfulness of ones that are important," and commissioner Atkins noted that AS No. 2 was extremely "granular."

Future Action

Chairman Donaldson's closing remarks reflected the balanced views of the panelists and his fellow commissioners.

- On the plus side, he noted, many companies have experienced "benefits and improvements to their internal controls as a result of implementing these requirements. The internal control requirements also have led to an improved focus on internal controls by all stakeholders involved."
- Yet he admitted that implementing this requirement "has not been without costs, and not without a learning curve." He said he would instruct SEC and PCAOB staff to "evaluate the feedback we've received on these topics and to consider whether and how we can *improve the guidance available to management and auditors in order to improve the effectiveness of the process*."

Echoing the message from NACD's Michele Hooper, he urged his staff to complete their evaluation "*as quickly as possible.*" He acknowledged "special challenges that smaller companies may face," and said that he would make section 404 a priority issue for the SEC's Advisory Committee on Smaller Public Companies.

PCAOB Chairman McDonough, who earlier that day had told the press that the PCAOB would act within "30 and 45 days" seemed to feel a greater urgency following the afternoon panels. In his closing remarks, he promised guidance from his staff by May 16, 2005, and said that AS No. 2 would be the theme for its Sector Advisory Group meeting June 8. McDonough also pledged that when the PCAOB grades auditors for their work, he will keep the Roundtable's concerns in mind. "It is at least as likely that we will find that the work they did was excessive as it was inadequate. Now, will we throw someone in jail for excessive audit? Not likely. However, will we have a very severe conversation with the management of that audit firm? You bet."

Predictions (Wish List)

The overall mood of the Roundtable was upbeat—and for good reason. People had complaints not about the substance of the regulations, but about interpretations, and the regulators vowed to issue interpretations that would meet their concerns. Based on the foregoing, we predict the following (in a best case scenario):

Regulators

- SEC staff will say that managers assessing its internal controls should focus on areas of highest risk, and report risks in the aggregate.
- In the staff guidance it issues on May 16, PCAOB staff is likely to say that external auditors need not repeat the work of internal auditors except in the case of material risks.
- In evaluating auditors' 2004 work, PCAOB staff will question why they didn't rely more on internal audit work for nonmaterial areas; they will also emphasize the role of judgment in setting the scope of a review.
- When the PCAOB does its regular inspections of auditing firms, it will keep materiality in mind as it reviews procedures (less of what some have called "nitpicking").

Auditors

- Auditors, having already undergone the cost of an initial learning curve, will reduce their fees significantly for 2005 work in recognition of these regulatory changes, and in light of client relations.
- Auditors, who have tended to play the role of internal control "police," will return to a more collegial (although independent) conversation about other important matters, such as accounting treatments.

Companies

- Internal audit staff will insist that audit committees recognize their work, and argue against having the external auditor duplicate it unnecessarily.
- Company reports will differentiate between material and nonmaterial risks, and, in the case of material risks, between remediated and unremediated risks.

Boards

- Audit committees, having spent most of 2004 on internal controls, will get back to other agenda items, such as financial reporting and risk oversight. As a result, these three areas will become more integrated.

Investors

- Investors will respond positively to remediated risks, and respond negatively only to unremediated material risks (companies won't be punished for improving).

In conclusion, we may not all live happily ever after, but this Roundtable certainly increased the chances for such a positive outcome. ■

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