

# DM EXTRA!

March 23, 2005

## Section 404— Oversight or Overkill?

**Some claim risk/reward imbalance in comments to the SEC.**

### Director Summary >

After more than a year of implementation, section 404 has emerged as the single most challenging section of the sweeping governance legislation known as Sarbanes-Oxley (SOX). Under this section of the law, public company managers must establish and assess effective “internal controls” (see Box 1 on p. 3), and public company auditors must report on these controls and on management’s assessments of them. 2004 reports are not all in, but sources from the **Securities and Exchange Commission (SEC)** estimate that by the time this current reporting cycle is over, some 500 companies will have disclosed material weaknesses in their internal control systems.<sup>1</sup>

Overall, the news is good. With more than 15,000 public companies to consider, a tally of hundreds is hardly gargantuan. And for those companies that did discover material weaknesses, the discoveries clearly have value. “Shock News, SOX Is Working,” claims one researcher, pointing to these discoveries of control deficiencies.<sup>2</sup> In recent comments to the SEC, however, internal accountants, external accountants, managers, and directors have identified problems with the application of 404. **This DMX recaps section 404; describes director, manager, and auditor response so far; and recommends coping actions for boards and audit committees.**

### About NACD

**National Association of Corporate Directors (NACD)**, an independent not-for-profit organization founded in 1977, is the country’s only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director’s Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



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# President's Letter

**Roger W. Raber**  
CEO and President, NACD

Section 404 makes sense in theory. Public companies should have an internal control function, and this system needs to be evaluated. This was one message the *Report of the NACD Blue Ribbon Commission Report on Audit Committees*, issued six years before section 404.

The importance good internal controls is obvious from recent news reports covering the trial of former **WorldCom CEO Bernie Ebbers**, which ended in a guilty verdict March 15, 2005. On the evening of March 18, 11 directors settled, agreeing to pay \$20.2 million (total) out of their own pockets, and on March 21, the former chair of WorldCom joined them, agreeing to pay \$4.5 million of his own money. The conviction of Mr. Ebbers, which is being appealed, is based on the argument that Mr. Ebbers should have known about the fraud, and evidence suggesting that he did. One of the key parts of the fraud was the accounting treatment of \$2 billion in line costs (fees for connecting with other phone and data companies). Instead of deducting these costs as expenses, which would have been charged against earnings, company accountants booked them as capital spending. The SEC's official definition of internal controls includes accounting treatment. Thus, a strong internal control system in this

sense might have disallowed this incorrect accounting approach, and uncovered the fraud.

But regulations implementing the law may have been too prescriptive. Some companies are finding it to be unnecessarily expensive, compromising their ability to fulfill their corporate mission for the benefit of shareholders, customers, and employees. Section 404 issues may also be, causing strains between some boards and their auditors. One external auditor cited in this issue (**Paula Jourde**) goes so far as to say that boards, not auditors, should be "criminally liable" for failures in internal controls. These words are extreme. They show how tense things have gotten in the auditors' side of the world. Yes, it is good to have a healthy distance between particular auditors and the companies they audit; this is one of the lessons Corporate America learned from the Enron scandal and the downfall of Arthur Andersen. But the sentiment expressed here appears to be an extreme case of shifting liability.

The real point is that if internal controls are reasonable, there should be no "liability" to share. Companies and their auditors should rally together to create a reasonable model for internal control assessment, and for protection from meritless litigation over such assessments.

## Recap of Section 404

Section 404 has two parts.

- First, it requires that annual reports contain an "internal control report" stating "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting" and must "contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." The law made the SEC responsible for setting this standard.
- Second, it requires that company auditors must "attest to, and report on, the assessment made by the management of the issuer." The law made the **Public Company Accounting Oversight Board (PCAOB)** responsible for this standards.

Both the SEC and the PCAOB have prescribed the methods for assessment in great detail.

As for management's assessment, SEC rules implementing section 404 state that "the assessment of a com-

pany's internal control over financial reporting must be "based on procedures sufficient both to evaluate its design and to test its operating effectiveness."<sup>3</sup>

<http://www.sec.gov/rules/final/33-8238.htm>

In particular, "an assessment of the effectiveness of internal control over financial reporting must be supported by *evidential matter*, including documentation, regarding both the design of internal controls and the testing processes." Controls subject to such assessment (quoting verbatim from the SEC final rule) include:

- Controls over initiating, recording, processing, and reconciling account balances
- Classes of transactions and disclosure and related assertions included in the financial statements
- Controls related to the initiation and processing of non-routine and non-systematic transactions
- Controls related to the selection and application of appropriate accounting policies; and
- Controls related to the prevention, identification, and detection of fraud.

As for the auditors' assessment of controls and their assessment, on March 9, 2004, the PCAOB released Auditing Standard No. 2—*Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* [http://www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_2.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/Auditing_Standard_2.pdf), with some amendments on November 17, 2004. (Auditing Standard No. 1 explained how audit reports should reference to PCAOB standards.) The long-awaited Standard No. 2 gives an overview of what auditors should assess. Part of the assessment of company internal controls includes “Evaluating the Effectiveness of the Audit Committee’s Oversight of Internal Controls” (sections 55 through 59 of this standard—see Box 2 on p. 4). The standard concedes that the board is responsible for evaluating the audit committee, so it is not necessary for the auditor to conduct a detailed evaluation of the board. Nonetheless, the standard says, “Within the control environment, the audit committee helps to set a positive tone at the top” and “Within the

### Box 1. What is Internal Control?

The SEC’s final rules define “internal control over financial reporting” as follows:

A process designed by, or under the supervision of, the registrant’s principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

1. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant’s assets that could have a material effect on the financial statements.

Source: Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC <http://www.sec.gov/rules/final/33-8238.htm#iia>

**“Within the monitoring component, an effective audit committee challenges the company’s activities in the financial arena.”**

**— PCAOB**

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### Response to Section 404

There is universal agreement that implementation has been expensive. A new survey from the **Financial Executives Institute** shows the steep price tag. (See Box 3 on p. 6.) For some time now, directors and internal auditors have been commenting on SOX. NACD’s **Hal Shear**, director of chapter development for NACD, has written excellent guidance on compliance in the October 2003 issue of *Directors Monthly* (“The Hidden Dangers of Sarbanes-Oxley,” p. 5). Shear anticipated high expenses, and suggested ways that audit committees can cope—including more frequent rotation of audit committee members, internal audit staff, and external auditors.

Longtime *DM* contributor and NACD member **Curtis Verschoor** of **DePauw University** recently wrote an editorial in *Strategic Finance* magazine arguing that section 404 implementation should emphasize ethics and values, because they are the single most important determinant of internal control efficiency. He notes that these are essential to internal control as defined by the **Committee of Sponsoring Organizations (COSO)**—the audit firms that sponsored the original **Treadway Commission** and continue its work now nearly 20 years later. The current definition (from the PCAOB and approved by the SEC) is based on another standard, not COSO (see Box 1). Verschoor says that the current standard for internal controls makes auditors spend too much time documenting and testing routine transaction systems, running up costs unnecessarily.<sup>4</sup>

NACD president and CEO **Roger Raber** recently (March 16, 2005) received a letter from **Thomas A. Dineen**, treasurer and CFO of **Sturm, Ruger & Company**, a firearms manufacturer in Southport Connecticut with 1200 employees in plants in Arizona, Connecticut, and New Hampshire. (He wrote Dr. Raber at the suggestion of **Gen. P.X. Kelly**, a director of Sturm Ruger and a member of NACD.) Mr. Dineen’s letter says that section 404 has strained his company’s resources:

## Box 2. Evaluation Audit Committee Oversight of Internal Controls— An Assessment from the PCAOB

*An excerpt from PCAOB Auditing Standard No. 2, sections 55–59.*

### 55. Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting.

The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee helps to set a positive tone at the top. Within the monitoring component, an effective audit committee challenges the company's activities in the financial arena.

Note: Although the audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting, management is responsible for maintaining effective internal control over financial reporting. This standard does not suggest that this responsibility has been transferred to the audit committee.

Note: If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company. The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack

of independent directors at these companies indicative, by itself, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3 are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2). Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2). Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that preapproves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

56. The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee; this standard does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. However, because of the role of the audit committee within the control environment and monitoring components of internal control over financial

reporting, the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating those components.

57. The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor focuses on factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management and the clarity with which the audit committee's responsibilities are articulated (for example, in the audit committee's charter) and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer.

58. The auditor might also evaluate whether the right questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the responsiveness to issues raised by the auditor.

59. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

Our company is built around a small core of managers. The internal effort to comply with Standard No. 2 and administer the related audit by our independent auditors was well in excess of two man-years. Fulfilling the requirements of Standard No. 2 has occupied limited resources and manpower that would have been better utilized improving the true economic value of the company.

In addition to the depletion of company resources, the cost of the independent audit required by Standard No. 2 totaled \$400,000, 170 percent greater than our customary annual financial statement audit of \$235,000.

In closing, Mr. Dineen expresses the hope that more practical standards will be forthcoming.

Such guidance may be on the horizon. Over the past six weeks, the SEC has been receiving comments on this topic in preparation for a “Roundtable on Implementation of Internal Control Reporting Provisions” to be held April 13, 2005. NACD will be represented by Chicago Chapter president Michele Hooper. The comments are mostly from mid-cap and larger companies, who had to report on their internal controls for fiscal years beginning after June 15, 2004. (Companies with a market capitalization of below \$75 million, as well as some foreign companies with shares listed in the U.S., can wait until their first fiscal year beginning after July 15, 2006—extended from an earlier date of April 15, 2005). As of noon March 22, 2005, the SEC had received 41 comments—mostly from internal audit and financial staff complaining about the costs of implementation. **Amy Hargrett**, the SEC’s assistant chief accountant, says that the Commission is expecting many more comments by the comment deadline of April 1. For a link to all the comments, see <http://www.sec.gov/news/press/4-497.shtml>.

Most comments show that compliance with section 404 has strained the resources of both companies and their external auditors. Companies (including their directors, managers, and accounting and finance staff) say that external auditors are overdoing their assessments, just to protect themselves. They want reasonable, consistent standards for internal and external assessments. (See for example comments from controller **John Ross** and director **John A. Yerrick**, below.) Most external auditors have stayed silent, but one has complained about the pressures on external auditors. She wants the responsibility to be placed on boards. (See comments below by auditors **Paula Jourde**.) A lone shareholder (**Lori Hacking** of the **Ohio Public Employee Retirement System**) has voiced unqualified support for the rules.

#### *View from the Boardroom*

**John A. Yerrick**, a retired CPA and a director of **Williams Industries**, which provides of specialized services and products for the construction industry, submitted a *Washington Post* editorial (dated December 13, 2004, entitled “Reform Overshoots”) noting that “*auditors have no incentive to hold back.*” The *Post* editorial continues: “If they crawl over a company’s systems with a fine-toothed comb, they can be sure to avoid blame for scandals and they can bill extra as well; on the other hand, there’s risk but no reward in restraining their investigations. As a result, auditors have sometimes refused to curb their efforts even when encouraged informally to do so by the new audit oversight board.” (The editorial writer does not cite a source for this statement.) The editorial concludes by saying that in order to align auditor scrutiny to the realities of risk, auditors could benefit from having formal guidelines (from the PCAOB) on the level of scrutiny that is actually required for their work. <http://www.sec.gov/news/press/4-497/jayerrick030505.htm>

#### *The Inside View (CEOs, CFOs, and Internal Auditors)*

Most comments came from managers and internal auditors asking for reduction in regulatory burden and clearer boundaries on the scope of the assessment.

**Dennis Burnette**, president of **Cherokee Banking Company**, stated that “Our bank holding company and our board of directors are very disappointed in the Sarbanes Oxley Act’s and the PCAOB’s (1) total disregard for the banking industry’s existing federal regulation for safety and soundness, and (2) unwillingness to provide direction to accounting firms dealing with small (in market cap, number of employees, revenues, etc.) public companies.... The bank has 40 full and part-time employees. SOX is an unnecessary and extremely costly (hard and soft costs) burden. Consequently, we hope to go private in the best interests of our shareholders.” <http://www.sec.gov/news/press/4-497/dburnette022705.htm>

**Leon J. Level**, chief financial officer of **Computer Sciences Corporation**, submitted detailed testimony outlining many problems with the law, including too much emphasis on documentation, not enough reliance on internal auditing staff, and a lack of definition for the notion of “significant deficiency.” His testimony includes the picture of a target with many arrows in it. Only one hits the bull’s eye: “audit committee expectations of management.” (His letter does not elaborate on this point, but see more about this in our conclusion.) <http://www.sec.gov/news/press/4-497/ljlevel030705.pdf>

### Box 3. Sarbanes-Oxley Compliance Costs: Recent Survey Results from the Financial Executives Institute

Public companies have had to dig even deeper than previously estimated to pay the costs of complying with section 404 of the Sarbanes-Oxley Act, according to a just-completed survey by **Financial Executives International (FEI)**. FEI is a professional organization of chief financial officers (CFOs) and other senior financial executives.

Companies' total costs for year one section 404 compliance averaged \$4.36 million, up 39 percent from the \$3.14 million they expected to pay, based on FEI's earlier July 2004 cost survey. The increase stems largely from a 66 percent leap in external costs for consulting, software and other vendors and a 58 percent increase in the fees charged by external auditors.

With March 16 as the general deadline for public companies to complete an assessment of their internal controls over financial reporting, FEI recently surveyed 217 public companies with average revenues of \$5 billion to gauge section 404 compliance costs. Their total cost of compliance averaged \$1.34 million for internal costs, \$1.72 million for external costs and \$1.30 million for auditor fees. The auditor fees are in addition to companies'

financial statement audit fees, on average 57 percent higher. (See table below for a comparison of actual costs to previously estimated costs and [www.fei.org](http://www.fei.org) for more details.)

Just over half, 55 percent, of companies surveyed believe section 404 gives investors and other external audiences more confidence in a company's financial reports, and 83 percent of large companies (over \$25 billion) agree. Significantly, however, 94 percent of all respondents said the costs of compliance exceed the benefits.

In general, companies applaud the added focus on internal controls, but many respondents believe that the level of detail required is impractical and bureaucratic. "The spirit was right on," wrote a respondent. "However, the execution to the level of detail that was required was much more than necessary."

"Now that we've gone through the first run of this mammoth compliance effort, it's time to review what we have learned and identify ways to improve the annual assessment process going forward," said **Colleen Cunningham**, president and CEO of FEI. "Essentially, section 404 is well intentioned, but the

implementation effort is guilty of overkill.

"FEI was one of the first business groups to support Sarbanes-Oxley, but we recommend a more efficient implementation of the existing rules," continued Ms. Cunningham. "Going forward, we recommend that regulators allow auditors to rely on the cumulative knowledge gained from earlier 404 work, and not simply start from scratch when it is time to re-assess companies. Further, we suggest a true risk-based audit approach that defines key controls, allowing for auditors to obtain a reasonable assurance of the integrity of a company's systems."

When asked about year-two costs, 85 percent of respondents said they expect non-auditor expenditures to decrease (by an average of 39 percent), and 68 percent said they believe the costs of their primary auditor will also decrease (by an average of 25 percent).

In order to improve the effectiveness and efficiency of the section 404 process, companies identified the following top recommendations (more than one answer permitted):

- Allow for a more risk-based audit approach (71 percent).
- Reduce degree of documentation (66 percent).
- Provide flexibility for remediating control problems in Q4 (60 percent).
- Increase judgment allowed in aggregating deficiencies (55 percent).
- Permit roll-forward procedures (54 percent).

Source: Financial Executives Institute, Florham Park, NJ. March 21, 2005 [www.fei.org](http://www.fei.org).

#### Year One Costs of Sarbanes-Oxley Section 404 Compliance

	March 2005	Estimated in July 2004	Estimated in January 2004
<b>Internal Costs*</b>	\$1,337,935	\$1,283,385	\$613,250
<b>External Costs</b>	\$1,716,987	\$1,037,100	\$732,100
<b>Auditor Attestation Fees</b>	\$1,301,050	\$ 823,200	\$590,100
<b>Total</b>	\$4,355,972	\$3,143,685	\$1,935,450

\* Internal costs assumes full-time professionals (at 2,000 hours per year) at a compensation rate (salary plus benefits) of \$100,000 per year.

**Julio Rodriguez**, who describes himself only as a “team leader” for section 404 compliance at a “*Fortune* 500 company” in Atlanta, Georgia, lamented, “My complaint with 404 is that in my opinion the Law assumed an ‘atomic bomb’ approach to documentation and testing instead of a ‘laser-guided missile’ strategy. I believe it would have been much more effective to focus on the general internal control environment, the most critical controls that affect the most significant accounts (at the transaction level), and the non-routine processes that can directly affect the financial statements (e.g., accounting estimations).” <http://www.sec.gov/news/press/4-497/jro-driguez022305.htm>

**Bob Ross**, controller of a publicly held mid-cap retail company, makes an important point about risk management. “A business inherently relies on risk and reward decisions to drive [operating margins] and maintains its operations to balance this risk. *Section 404 is opposed to his concept*. It attempts to cover too many control variables and places emphasis on reviewing areas that do not indicate a history of risk. The scope of these recommendations is too broad. The shift from management of a process to documenting the process is a distraction that will hurt the process.” And further, “The requirements demand a level of scrutiny that requires my department to spend thousands of hours justifying the company’s forthright actions (as opposed to managing the business). It is a struggle to explain common sense.” <http://www.sec.gov/news/press/4-497/bross030205.pdf>

By contrast to these critical comments from managers on the job, one retired accountant sees benefit to section 404. **Lee Ann Dear** of Houston, Texas, speaking from past experience as internal auditor, sees some benefits from section 404. “It’s sad that you have been forced to legislate corporate systems of internal controls. Of course up-front compliance cost has been high [but] these internal systems have been gyrating out of control and communications at the top did not accurately reflect the true, and in many cases, material conditions. Thus, in addition to other benefits, I sincerely hope compliance initiates a reeducation from the top down, and equally important, from the bottom up.” <http://www.sec.gov/news/press/4-497/ladear022505.htm>

#### *External Auditor Comments*

Very few external auditors have submitted comments, and those that have are independent CPAs who generally support section 404 (although CPA **Jeffrey Roberts** wrote that the real problem is management override of controls, not the controls themselves. <http://www.sec.gov/news/press/4-497/jrroberts031805.pdf>). Only one external auditor has registered any detailed complaints so far.

**Paula Jourde**, an auditor who has helped 10 companies with SOX 404 compliance for 2004, notes the late timing (March 2004) of final PCAOB guidance, leaving too much to interpretation. “For example, the level of detail documentation required varied by partner and resulted in unnecessary costs as firms redirected their teams approach toward documentation and testing.” To make matters worse, “lack of standardization of the approach across the accounting firms has resulted in varying levels of scrutiny of controls.” For example, one Big Four partner said if the same person can initiate and post a journal entry, this is a significant design deficiency. But another partner in the same firm, auditing a different company with the same practice, did not recognize this as a deficiency. Jourde’s letter also cites lack of knowledge and training in controls documentation and testing, outsourcing to third parties who themselves had insufficient training, and the unfairness of similar deficiencies at different entities being reported differently. Jourde concludes her comments with this surprising statement. “Focus of the effort should also be placed on the Board i.e., they should be criminally and financially responsible for SOX violations....At the end of the day, if the executives of a public company want to manipulate their financial results, they can still do it.” <http://www.sec.gov/news/press/4-497/pjourde2635.htm>

*A Shareholder Speaks*

So far, only one shareholder group has submitted comments. **Lori Hacking**, executive director of the \$64.5 billion **Ohio Public Employee Retirement System (OPERS)** supports section 404 rules entirely. She urges the SEC to make no changes to section 404 rules. <http://www.sec.gov/news/press/4-497/lfhacking030105.pdf>

#### *An Academic View*

**Sonja Olhoft Rego**, an assistant professor at the **University of Iowa’s Tippie College of Business** sent in a research study that found “significantly positive stock returns for events that resolved uncertainty about the Act’s final provisions or were informative about its enforcement.” Professor Rego continues, “Overall, our empirical results are consistent with investors expecting the Act to have a net beneficial effect of improving the accuracy and reliability of financial reports by constraining earnings management and enhancing corporate governance.” <http://www.sec.gov/news/press/4-497/sorego031505.pdf>

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## Action Steps for Boards

What does all this mean for boards right now? Here are some action steps to take.

1. **Talk to your internal auditors—and get real.** These are the people doing the most important work without any direct financial gain (unlike external auditors who can bill by the hour). How are they holding up under the strain? Do they need more employees on their team? What are they learning? What do they need to learn? How is training and development proceeding for them? Now is not the time to stint on internal audit staffing and training.
2. **Talk to the PCAOB to get a sense of what they expect of audit committees.** The PCAOB is widely regarded as taking a sensible approach to this topic. Some complain that the advice is too little or too late, but to our knowledge, no one has accused it of being flawed.
3. **Connect your ethics and your controls.** Don't let your ethics code and your internal control charter exist separately. The same concepts should permeate them, and they should reference each other.<sup>5</sup>
4. **Consider rotation.** This applies not only to external auditors but everyone else involved in assessing risk, including internal audit staff, board risk management advisors, and board audit committees. As mentioned, this was a key point in Hal Shear's opinion piece back in 2003. It's still true.
5. **Be available to read and comment on management's report on internal controls.** Directors can add valuable perspectives to reports on internal controls. Since the definition of a material weakness is not written in stone, directors can help determine what is and is not significant. For guidance, directors can turn to Auditing Standards No. 2, which includes "Illustrative Reports on Internal Control over Financial Reporting." For those who prefer concrete examples to theoretical descriptions (and many directors do), this document provides valuable guidance for section 404 compliance.
6. **Encourage and support continuing director education.** Every director can benefit from learning about the workings of audit committees, one of the modules in our new **Corporate Directors Institute** and a regular subject for customized in-boardroom education. (<http://nacdonline.org/services/>) Another hot topic is board-CFO relations. NACD has teamed up with the Financial Executives Institute to offer this course in a public seminar for both directors and CFOs. [http://nacdonline.org/seminars/seminar\\_detail.asp?meetingID=185](http://nacdonline.org/seminars/seminar_detail.asp?meetingID=185). In addition, directors should be encouraged to learn more about internal controls from experts in that

topic. The **Institute of Internal Auditors**, an NACD Associate Member, is an excellent source of authoritative guidance [<http://www.theiia.org>].

7. **Express your views now to the SEC**, while there is still time to reshape section 404 rules. The link for filing electronically is [http://www.sec.gov/cgi-bin/ruling-comments?ruling=4-497&rule\\_path=/news/press/4-497&file\\_num=4-497&action=Show\\_Form](http://www.sec.gov/cgi-bin/ruling-comments?ruling=4-497&rule_path=/news/press/4-497&file_num=4-497&action=Show_Form). For instructions on paper filing, see <http://www.sec.gov/news/press/2005-20.htm>. Be sure to reference File No. 4-497.

The NACD board of directors will be submitting its comments to the SEC soon. We believe that the SEC should give more discretion to independent board audit committees to set the scope of the internal control program and its assessment. At the same time, the SEC should explicitly support a safe harbor for these committees by citing the business judgment rule from state common law. As reported in recent issues of *DMX*, directors face a litigious climate. NACD would oppose any standard that would heighten liability exposure for directors.

What are your concerns about section 404? How have strong internal controls helped you in your oversight role? Has the existence of section 404 helped or hindered your work? Whatever your point of view, the NACD board encourages you to express it. Section 404 can work, if we all take a reasonable approach to internal controls.

## Endnotes

- 1 See "The Reports Are In — Or Are They?" March 4, 2005, from [IRontheNet.com](http://IRontheNet.com), quoting John Nestor of the Securities and Exchange Commission, <http://www.irmag.com/newsarticle.asp?current=1&articleID=3889>.
- 2 Tim Leech, "Shock News — Sox is Working," *Global Risk Reporter*, February 2005 (globalrisk.com).
- 3 *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Securities and Exchange Commission*. Release Nos. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03] Source: SEC <http://www.sec.gov/rules/final/33-8238.htm#iia>. This rule is effective August 14, 2003 for fiscal years starting on or after June 15, 2004, with exception of small companies, which have until July 15, 2006.
- 4 Curtis C. Verschoor, "Sarbanes-Oxley section 404 Implementation Needs Modification," *Strategic Finance*, March 2005, pp. 17-18. (We thank Dan Swanson, assistant vice president of professional development at The Institute of Internal Auditors, for calling this excellent article to our attention and for keeping us informed on emerging risk oversight issues.)
- 5 See Verschoor, op. cit., note 4 (Ibid).