2006 Roundtable on Second-year Experiences with Internal Control Reporting and Auditing Provisions

Statement of Michele Hooper, Director
National Association of Corporate Directors (NACD)
Washington, D.C.

Submitted May 1, 2006

I am honored to comment on Section 404 compliance in Year 2 (2005) from the perspective of a corporate director. In this statement, I will briefly review Years 1 and 2 and make recommendations for Year 3 (2006) and beyond.

Review of Year 1
In NACD's comment letter for the April 2005 Roundtable, we looked back at Year 1. Noting high compliance costs—a 57 percent increase in audit fees in 2004 compared to the previous year according to the Financial Executives International (FEI)—we made three recommendations:

1. *Regulators should allow auditors to take into account previous and ongoing work by internal audit staffs and previous and ongoing internal controls oversight by the audit committee.*

2. *In Year 2 and subsequent years, when it is time to re-evaluate internal controls, regulators should allow auditors to rely on the cumulative knowledge gained from earlier 404 work, and not simply start from scratch.*

3. *The audit committee should be able to rely on the protection of the business judgment rule as they determine the nature of internal controls and the scope of the audit of internal controls. The business judgment rule is a judicial doctrine that protects director decisions made in good faith with due care and loyalty, based on a standard of reasonableness. To supplement this rule, the SEC could consider writing a safe harbor similar to the one it created for Regulation FD.*

In May 2005, the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) issued post-Roundtable guidance clarifying Standard 2. In this guidance, you affirmed that regulators would allow auditors to take previous work and knowledge into account (as NACD recommended in our points 1 and 2). However, to date, you have not addressed the issue we raised in point 3. This year, as the Roundtable reconvenes, I would reiterate this point.

Review of Year 2

Now, in 2006, as we look back on the compliance experience in Year 2, we note that costs have gone down, but not as much as anticipated. FEI's recent (April 2006) study notes that "for companies in their second year of compliance with Section 404 of the Sarbanes-Oxley Act of 2002, year-two costs of compliance were [only] somewhat less than the corresponding year-one costs." For example, auditor fees dropped only 13 percent—only half of the reduction generally expected.

From the boards where I serve as director and from my interaction with directors of other companies, particularly smaller ones where the burden falls the most heavily, it appears that the costs of this effort still greatly exceed the benefits—we have not yet balanced the equation.

The costs arise in part from auditor conservatism. Whereas corporate boards have prioritized their oversight of risks, auditors have tended to make "all rocks the same size," as one experienced director has noted. The Big Four audit firms, while accepting of the concept of higher level risk-based testing, still require companies to perform too many detailed transactional tests. Despite the above-mentioned clarification of Standard 2 (published a year ago under Chairman Bill McDonough), the Big Four were not comfortable making significant changes to the testing process in Year 2. Consequently much of the testing for Section 404 compliance is completed more for the comfort of external auditors than for the comfort of company management.

The root causes of auditor conservatism may be traced to the PCAOB, which can be part of the solution.

- PCAOB inspectors may not be consistently embracing the guidance of the PCAOB when they do their inspections. This in turn causes auditor conservatism. The PCAOB should *consider issuing a statement with specific examples of the flexibility that you will accept in order to assure the accounting firms that the PCAOB inspectors do understand what is acceptable*. Alternatively, the PCAOB could *publish examples of companies that have benefited from a robust interpretation of risk-based testing*.

- Another root cause for higher costs may be the length of time it is taking to publish the PCAOB inspection reports. To address this issue, the PCAOB could try to *set stricter deadlines on publication of these reports*.

Recommendation for Year 3 – Safe Harbor Rule for Section 404 Compliance
The continuing high cost of audits, combined with the other costs of compliance (internal audit staff) is only one cost borne by companies. Another cost—a greater one for companies affected—is an increased risk of liability.

The topic of director liability exposure extends beyond Section 404. In the words of Peter J. Wallison of the American Enterprise Institute, the Sarbanes-Oxley Act's emphasis on the role of independent directors in preventing financial wrongdoing appears to have created a "political rationale for exposing them to special liability when losses occur." http://www.aei.org/publications/pubID.22648/pub_detail.asp
He cites the WorldCom settlement: directors did not discover a fraud and had to pay more than $2 million each out of their personal assets.

The WorldCom case did not involve Section 404 per se, but it does illustrate the fact that independent directors are bearing an ever larger liability burden these days. Furthermore, there have been actual cases filed against directors citing Section 404. As of March 2006, there had been at least four lawsuits against directors and officers over alleged failure to comply with Section 404. I am referring to lawsuits filed against Countrywide Financial, Cray Inc., The Tribune Co., and Watchguard Technologies.

To illustrate a typical case occurring in Year 2, consider the case of Cray, Inc., as described in a recent article in CFO.com:

> *On May 3, 2005, management at Cray Inc. notified the Securities and Exchange Commission that it had uncovered material deficiencies in eight of its internal controls over key financial systems. In the disclosure (an amendment to the company's 10-K), Cray also indicated that the business' external auditor, Deloitte & Touche LLP, had concluded that many of the supercomputer maker's internal controls demonstrated a "material weakness."*
>
> *Predictably, when word about the problems got out, the company's share price took a nosedive, dropping nearly 30 percent. Even less surprising: about two months later, directors and officers at Cray were socked with a class-action lawsuit filed by disgruntled shareholders. Among several charges, the suit alleges that Cray's audit committee violated sections of the Sarbanes-Oxley Act. The litigants claim that directors knew about the problem with the company's internal controls but did not report it. For its part, Cray's management denies any wrongdoing.* http://www.cfo.com/printable/article.cfm/5598477?f=options

Without commenting on the merits of this particular case, I will say that it illustrates the need for clear guidance on the scope of director and officer liability in the case of alleged failure to ensure adequate internal controls. Such guidance will benefit not only directors of the large and mid-sized companies that have had to comply with 404 for the past two years, but also for the smaller companies who are just starting on this journey, with a compliance date of July 15, 2006 (extended per the SEC's March 2, 2005, decision).

For all companies, it would be beneficial to pass a safe harbor rule that would lessen the incidence and success rate of merit less litigation against boards and directors complying with Section 404 in good faith while exercising due care and loyalty.

Two examples of safe harbor rules may be instructive:

- One safe harbor rule is the SEC's final rule on Selective Disclosure and Insider Trading. Note 85 to that rule explicitly states that "because a violation of Regulation FD is not an antifraud violation, *it would not lead to loss of the safe harbor for forward-looking statements* provided by the Private Litigation Securities Act of 1995."

- Another safe harbor rule is the one included in the rules implementing Section 407 (http://www.sec.gov/rules/final/33-8177.htm), which clarifies that "The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item *will not make the person an 'expert' for any purpose, including without limitation for purposes of Section 11 of the Securities Act;…does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification; and…does not affect the duties, obligations or liability of any other member of the audit committee or board of directors…under federal and state law."*

The SEC might use similar language to craft a safe harbor rule to prevent increased director liability under Section 404. Such a rule would make it clear that the discovery and disclosure of material weaknesses in internal controls in compliance with Section 404 should not subject those overseeing or making the discovery to higher liability under either federal or state law.

Respectfully submitted,

Michele Hooper
Corporate Director
Member, NACD Board of Directors
Washington, D.C.