

March 31, 2005

Re: File No. 4-497

Mr. Jonathan Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street  
Washington, DC 20549

Dear Mr. Katz:

On behalf of the governing board of the National Association of Corporate Directors (NACD), we commend the Securities and Exchange Commission for the decision to hold a *Roundtable on the Implementation of Sarbanes-Oxley Internal Control Provisions*, and to seek comments on this topic. As the nation's only membership organization for corporate directors, NACD values the opportunity to speak at the Roundtable and to submit this comment letter. Michele Hooper, undersigned, will represent NACD at the Roundtable. NACD board member Hon. Barbara Hackman Franklin will participate in the Roundtable as well.

NACD supports the intention of the internal control provisions of the Sarbanes-Oxley Act (Section 404). Oversight of internal controls is a key duty of audit committees. Since our founding in 1977, we have asserted the importance of strong internal controls. This is a key message of the Report of the NACD Blue Ribbon Commission on Audit Committees, as well as all of our other publications and programs pertaining to the audit committee. NACD also supports the work of the Public Company Accounting Oversight Board (PCAOB) and the process by which it arrived at its Standard 2, *Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. The NACD sees value in using a "comply or explain approach" to these rules and others, but that should be the subject of a separate comment letter.

With respect to implementation of Section 404 and Standard 2 at this time, we have three recommendations:

1. Regulators should allow auditors to review and rely on previous and ongoing work by internal audit staffs and previous and ongoing internal controls oversight by the audit committee. This would be consistent with current financial statement audit procedures.
2. Regulators should allow a risk-based audit approach to prioritize the scope of the internal control audit based on the cumulative knowledge and judgments gained from earlier 404 work, and not simply repeat the same process approach and walk-through as required in the prior year. This is consistent with the current financial statement audit approach and with the suggestion of Colleen Cunningham, President of Financial Executives International (FEI), based on a recent FEI survey (see below).
3. More generally, audit committee members 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 assurance similar to the one it articulated for Regulation FD. (The SEC final rule on Selective Disclosure and Insider Trading, in Note 85, asserts 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 Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. See Securities Act Section 27A(b), 15 U.S.C. 77z-2(b); and Exchange Act Section 21E(b), 15 U.S.C. 78u-5(b).” [http://www.sec.gov/rules/final/33-7881.htm#P12\\_1307](http://www.sec.gov/rules/final/33-7881.htm#P12_1307))

As background for these recommendations, we note that 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 were in addition to companies’ financial statement audit fees, which were 57 percent higher than the previous year. In order to improve the effectiveness and efficiency of the Section 404 process, respondents to the FEI survey 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)

We concur with these recommendations. We also agree with Cunningham's advocacy (in a press release dated March 21, 2005) of 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.” (Emphasis added.)

The key word here is *reasonable*. Many of the efficiency problems come from the fact that the implementation of Section 404 has far exceeded the requirements of the original law and the SEC’s own definition of internal controls as “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.” (Emphasis added.)

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#jia>

We hope that the SEC will continue its long tradition of affirming the value of reasonableness, and will follow our recommendations.

Sincerely,  
Michele J. Hooper, President, Chicago Chapter, NACD  
Roger W. Raber, President and CEO, NACD  
B. Kenneth West, Chairman, NACD