# War on Section 404

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By Donna Block and Ron Orol
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Three years ago Congress was applauded for its quick action in passing the Sarbanes-Oxley Act.

Now SOX is being pilloried by executives who say Section 404 is devastating their bottom lines. That's the provision that makes managers responsible for maintaining an "adequate internal control structure," as well as procedures for financial reporting. It requires a company's auditors to attest to management's assessment of these controls and disclose any material weaknesses.

The cost of implementing SOX is a source of complaint by companies large and small. But the benefits of the reforms are already coming to light, investors say, in the form of higher investor confidence and a buoyant stock market. Meanwhile, intense scrutiny of accounting methods and internal controls has unearthed lingering problems in the way companies operate.

"Our members are satisfied with the reforms because they feel they create increased value and protection," says Ann Yerger, spokeswoman for the Washington-based Council of Institutional Investors, a shareholder advocacy organization. "When you think about what people suffered because of the scandals, the costs of the reforms do not outweigh the benefits."

A recent study by Chicago-based Huron Consulting Group found that for 2004 there was a 28% increase in financial restatements of public companies due to accounting errors over the same period in 2003.

"Without question, it was the new Section 404 requirements ... that triggered an unprecedented level of scrutiny of how registrants produce financial results for investors," the report says.

"This is deferred maintenance," says Cynthia Richson, corporate governance officer at the Ohio Public Employees Retirement System.

Outgoing Securities and Exchange Commission chairman William Donaldson has predicted that, in time, renewed investor confidence in companies' reports will pay off. "I believe that the time, energy and expense that companies are now investing in their internal controls will earn a handsome return in the years to come," Donaldson said at a recent hearing before the House Finance Committee.

Donaldson also noted that of the 2,500 companies that filed their financial reports in March, 8% of them reported material weaknesses in their internal controls. He said this is "an important statistic," illustrative of the positive impact of the 404 approach.

"I do believe, in our conversations with corporate executives, that many of them after they get done complaining about the costs talk about the improved management oversight they have now and welcome this exercise that they've gone through to identify their own weaknesses," he told

the panel.

But a backlash against the law has taken hold, especially among small companies, which have launched a public relations and lobbying campaign to change the law. Donaldson is being replaced with someone less sympathetic to a tougher regulatory regime. And there has been a drumbeat of commentary and stories predicting that increasing numbers of public companies will go private. All, apparently, because of the obligations of this draconian law.

Take, for example, the American Electronics Association, a Washington-based trade association representing more than 3,000 technology companies. It reports that 404 is having a "devastating impact" on its small and midsized member companies. A study released by the group in February claims 404 compliance costs serve as a "regressive tax on small business." Small businesses, the organization says, are paying a higher percentage of revenues on compliance because external auditors are taking a "one size fits all" approach to small and big companies alike.

But the numbers, especially for larger companies, make one wonder what all the fuss is about. A survey by Financial Executives International, an association of top executives, found that larger companies paid an average of $4.36 million for their audits last year, compared with the $3.14 million they expected to pay and more than the statute's designers had envisaged. FEI says the increase stems largely from a 66% leap in external costs for consulting, software and other vendors and a 58% increase in the fees charged by external auditors. FEI recently surveyed 217 public companies with average revenues of $5 billion to gauge 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% higher.

As is typical, the fight to dilute the law is taking place in the regulatory sphere. While two legislators have introduced bills a measure by Rep. Jeff Flake, R-Ariz., would allow companies to choose whether or not to report on the adequacy of internal controls over financial reporting; another from Rep. Ron Paul, R-Texas, would repeal Section 404 entirely neither is expected to see daylight. But just how much change can be rammed through in the regulatory realm isn't clear.

Institutional investors and consumer groups say business groups have been mobilizing around the country, including local chapters of the U.S. Chamber of Commerce, to fight the rules. Supporters of the regulations have a harder time getting heard. "They are tenacious and well-funded and have high visibility in Washington," Richson says. "We are a public pension fund and we don't have the resources to go to D.C. every week."

Barbara Roper, an analyst at Washington-based Consumer Federation of America, agrees. "When you look at efforts to loosen Sarbanes-Oxley, there clearly is a coordinated campaign with a number of different parties participating," she says. "The business lobby has a media strategy with periodic releases of surveys and the whole thing is very well run and orchestrated to a T."

She says investor groups should listen carefully to the business lobby's comments on SOX

reform. "No one ever tells you that they are going to gut the law they are just looking to 'streamline' it. It's very difficult to distinguish between rhetoric of someone getting ready to gut the law and someone who wants to make some small adjustments."

Accounting firm Ernst & Young LLP, in an April 4 comment letter to the SEC, said the agency could consider allowing executives to attest less frequently, perhaps every other year, on internal controls over financial reporting if costs become "unacceptable" in relation to the benefits provided to investors in small public companies. The Ernst & Young letter also suggested that the agency consider completely eliminating the requirement that management report annually on the company's internal controls.

Damon Silvers, general counsel at the AFL-CIO, doubts that the agency will allow executives at smaller businesses to only periodically attest to internal controls. If it did, his union and other investor groups would consider litigation. "The SEC does not have the authority to grant that kind of exemption to Section 404," he says.

Sen. Carl Levin, D-Mich., also has concerns about such biennial attestations. "Such suggestions are inconsistent with both the letter and intent of the law which is aimed at compelling public companies to strengthen their internal controls, produce more reliable financial statements, and put an end to the long line of accounting scandals that have so damaged U.S. capital markets since the collapse of Enron [Corp.] four years ago," Levin wrote in an April 12 comment letter to the SEC.

Eliminating certain requirements for small companies also raises questions about a "dual track approach," with different sets of rules in the equity market, says Raymond Beier, a partner at PricewaterhouseCoopers. "This type of regulation doesn't address the investor confidence question and doesn't really make sense," he says. Beier notes that anecdotal evidence suggests investors are pleased with SOX. Proxy adviser Glass, Lewis & Co. LLC in San Francisco in April completed a study that indicated that in a number of cases where the auditors found material weakness in internal controls, executives had not previously identified any problems and management had certified that everything was fine.

Herbert Wander, co-chair of an SEC small-business advisory committee and a partner at law firm Katten MuchinRosenman LLP in Chicago, says there are some areas where regulatory relief could be granted to small businesses without violating the statute. He notes that SOX does not require a company's external accounting firm to do its own audit of internal controls of the business. Rather, the statute only requires the external auditor to report on management's assessment of internal controls.

Wander says that perhaps small public companies could be released from the requirement to have all their subsidiaries audited every year. "Maybe you may not have to audit every seven subsidiaries every seven years," Wander says. "Instead these facilities could be audited based on risk profile the auditor could look at the really risky things every year."

Roper blasts such ideas, saying that auditors cannot report on management's assessment of internal controls unless they have some basis for their knowledge. "Auditors can't attest to

something without testing it," she says. "They don't want the external auditor to do extensive independent testing to determine what management is saying about the state of internal controls is true."

She adds that external auditors will want to do a reasonable evaluation of the company's internal controls before attesting to management's assessment of the controls. "Auditors won't want to approve something without making sure it's correct," Roper says.

In their fight to keep SOX intact, institutional groups are arguing that the SEC should consider the amount of compensation executives receive before approving cost-cutting changes to SOX. "Corporate chieftains defend their massive compensation packages with their life and whine incessantly about the costs of Sarbanes-Oxley," says Roper. She adds that perhaps corporations should be allocating some of their executives' ever-increasing compensation to help pay the costs of implementing the new regulations.

Coupling the issue of executive pay to the costs of Sarbanes-Oxley gives the management class fits. The U.S. Chamber of Commerce, for example, calls the comparison irrelevant. David Chavern, director of the Chamber's corporate governance initiative, says anyone who tries to compare the two is only out to "score political points" and is "not really paying attention to what's going on." He says regulators should look at costs of auditing redundancies and waste.

Rep. Barney Frank, D-Mass., and the ranking member on the House Financial Services Committee, made it clear at a recent hearing on the impact of SOX that while the cost of compliance is high, it's negligible to what top executives are paid, even as those same corporate leaders bitterly complain about the burdens put upon them by the law.

"At least in one area of some importance to them setting their own salaries Sarbanes and Oxley might as well be Donald and Daisy Duck, because nobody lays a glove on these people when it comes to setting their own salaries. This is something that we have to address," Frank said.

Donaldson responded by saying the SEC doesn't want to discourage companies from rewarding good performance but will call for clearer disclosure that shows investors how and why executives are compensated.

Executives at small-cap companies, those yelling the loudest about Sarbanes-Oxley, earn a larger percentage of the company's earnings than CEOs of companies with medium and large stock market capitalizations. According to a soon-to-be released study by Lucian Bebchuk, director of the corporate governance program at Harvard Law School, the top five executives at small-cap companies received in earnings more than 25% of the profits of the companies between 2001 and 2003. "Executive compensation is much more of a big deal for small companies," Bebchuk says.

Increasingly, shareholders are challenging boards to temper executive pay. A number of proposals to curb pay, set performance guidelines and limit severance packages have sprung up on shareholder ballots this proxy season, notes Shirley Westcott, associate managing director of policy for Proxy Governance. Many boards have resisted similar proposals and often ignore them despite overwhelming shareholder approval. However, Westcott notes that shareholder pressure

is prompting some companies to adopt their proposals.

In contrast to the business lobby, which has seen the SEC as too activist under Donaldson, Yerger of the Council of Institutional Investors has criticized the commission for recently delaying efforts to give shareholders, in some circumstances, an ability to nominate a candidate to a corporate board. That proposal, which has been languishing at the SEC for almost two years, is considered dead by many observers because of pressure by corporate interests.

In April, the agency gave listed companies a six-month reprieve from a new rule that requires companies to deduct the cost of employee stock options from profits, another move by accounting regulators to give investors a clear picture of a company's financial condition.

On March 2, after heated corporate pressure, small and foreign companies were given an extra year, until July 15, 2006, to comply with Section 404 of the statute. It is the second time the SEC has extended its compliance deadlines for Section 404. A year ago the commission gave accelerated filers (companies with a market cap of more than $75 million) a deadline of Nov. 15, 2004, instead of the original June 15, 2004, while the deadline for nonaccelerated filers was extended until July 15, 2005, from April 15, 2005.

She says these recent moves demonstrate a pro-corporate bias that is working against investors. "There has been pushback by the SEC on a lot of key investor protection areas," Yerger says.

Corporate America, on the other hand, saw in Donaldson someone who pursued a regulatory agenda too fervently. The Bush administration's choice, Rep. Christopher Cox, R-Calif., will likely be even less prone to support rules that interpret Sarbanes-Oxley strictly.

For now, it's changes to the law regarding smaller businesses that worry shareholder advocates.

"It's a slippery slope," Silvers says. "You knock a hole into the statute this time around for small companies and then next year you go after widening that hole for bigger companies."