

Section 404: Lessons learned and value earned?

About this document

The Audit Committee Leadership Network is a select group of audit committee chairs from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from a facilitated discussion among members of the Audit Committee Leadership Network.

The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Audit Committee Leadership Network held its fifth meeting in New York on May 21, 2004. The discussion covered the implementation of Section 404:

- **What are the lessons learned?** What is the current status of Section 404 implementation?
- **What is the value earned?** What are the potential returns on investment in compliance?
- **What are the unanswered questions regarding Section 404?** What are the ramifications of Section 404 reporting?

The members of the network present at the meeting, who sit on the boards of more than 20 large-, mid-, and small-cap public companies between them, were:

- Mr. Jim Adams, Audit Committee Chair, Texas Instruments
- Dr. Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Mr. John Ferraro, Vice Chairman, Ernst & Young
- Mr. Gene Fife, Audit Committee Chair, Caterpillar
- Mr. Tom Flannery, Americas Director, AABS Quality, Ernst & Young
- Mr. Roland Hernandez, Audit Committee Chair, Wal-Mart
- Mr. Fred Salerno, Audit Committee Chair, Viacom
- Mr. Sandy Warner, Audit Committee Chair, General Electric Company

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations.

Executive summary

When the Audit Committee Leadership Network met in September 2003, the discussion of Section 404 focused on what approach to implementing the legislation would be in the best interests of investors. Members agreed that closing holes in internal controls would reduce risk and thereby create value. Where they did not reach consensus was regarding how much detail would be needed for verification and when the cost would exceed any benefit.

Eight months later, following the postponement of the compliance dates for companies with reporting periods prior to November 15, as well as for foreign registrants, what are members' views on Section 404 as they are completing implementation? What practical lessons have been learned, and what value (if any) is being earned on behalf of investors? The issues found to be most important to members are highlighted below, with more detailed discussion on the following pages.

- **Implementation status: Company size and access to resources are critical** (*Page 3*)

Large, well-run corporations that emphasize effective internal controls have less to fear, or to learn, from implementing Section 404. The main concern of network members now is the readiness and resource availability of external auditors who will manage testing, identify any material weaknesses, provide timely feedback to enable remediation, and complete retesting before the end of the year.

Members also worry about the position of many smaller companies that lack dedicated internal resources and now face the scarcity of external resources.

- **Cost-benefit: Large companies are increasing investor confidence and small companies are creating shareholder value** (*Page 4*)

With larger companies, network members see compliance with Section 404 as more of a public good – improving confidence in financial markets – than a specific benefit to shareholders. While there are some incremental improvements in process and risk management, members described Section 404 as “*building confidence in what already existed.*” However, they do believe that smaller companies are creating real value for their shareholders by putting in place internal controls that should always have been there and by making real improvements in the efficiency of financial processes.

- **Dealing with ambiguity: The onus is on management and audit committees** (*Pages 5-6*)

Audit committee chairs are concerned about the lack of definition around what constitutes a “material weakness” or a “significant deficiency.” Questions also remain over the issuance of management and auditor reports on internal controls. This ambiguity puts the onus on management and the audit committee to evaluate material weaknesses and significant deficiencies, and the related disclosure, and then seek the external auditor’s agreement.

Members did not think the external audit firms had brought additional clarity to the situation and were concerned that the external auditors might take more conservative positions in attempting to balance the interests of the regulator and clients.

Implementation status: Company size and access to resources are critical

In talking to members, the main lesson learned from implementing Section 404 seems to be that large, well-run corporations put more emphasis on effective internal controls and so have less to fear, or to learn, from implementing Section 404. One member summed up the current status of his corporation's implementation of Section 404 by noting, *"It is impossible to understand all the internal controls, but I am confident that, at the standard we are doing this, we are delivering on our obligations."*

Large companies will be ready to hand over their Section 404 documentation to the external auditors in the final quarter of 2004. One audit committee chair commented, *"This is a Herculean task, but we are ahead of schedule."* Audit committees are receiving regular reports on progress against milestones, and some audit committee chairs are also spending time talking directly to Section 404 project team leaders.

Several members talked about the importance of managing risk in the implementation process. One audit chair described the approach adopted by his audit committee: *"We structured the engagement to mitigate risk. [For example,] we were not sure whether to use [an audit firm] or an outside consultant. Going outside meant different internal policies on documentation and testing. We decided it would create unnecessary exposure to have arguments on policy."* Audit chairs can best navigate this risk by ensuring that they know what resources will be available at any given point, regardless of where those resources originate.

External auditor readiness and implementation in international subsidiaries

Members' primary concern is whether the external auditor is ready and has the appropriate resources to manage the testing process, identify any material weaknesses, provide timely feedback to enable remediation, and complete retesting before the end of the year. One audit chair confided, *"I worry about their ability to do this, to the quality we expect, in a compressed timeframe."*

Members are also concerned about implementation in international business units, which seems to be taking longer than it is in domestic units. One audit chair raised two important questions: *"Our foreign operations in China and Latin America have good internal control systems but is the quality of process as high, and do we have the quality of documentation?"*

Lack of dedicated resources a problem in smaller companies

Given the relative calm in which larger companies are undertaking work on Section 404, it is perhaps unsurprising that network members discussed intensively the position in which smaller public companies may find themselves. As one member put it, *"I am worried about smaller companies being able to comply. They do not have the resources to cope with it. [Meeting the deadlines] will be very tight, as they are not ahead of the curve."*

The lack of dedicated resources in smaller public companies drew much comment. One member observed, *"Many [smaller companies] are very control-oriented, but they need additional resources which are drying up. It's just like Y2K."* Executive leadership was cited as the critical difference in those smaller companies that were ahead of the curve on Section 404 implementation. One member said, *"The people make a difference, particularly the people at the top."*

Cost-benefit analysis: Large companies are increasing investor confidence and small companies are creating shareholder value

The latest estimate from Financial Executives International (FEI) of the cost of compliance with Section 404 is \$4.6 million on average for companies with over \$5 billion of revenue.¹ Estimates within the network range from \$3.5 million to \$30 million for General Electric Company, which went public with that number at their 2004 annual meeting.

One expense raised by members is the opportunity cost of the internal audit function's time. As one audit committee chair put it, *"Section 404 has taken a tremendous amount of internal audit staff [time]. There is an opportunity cost. What is not being done? And what is the risk of that? This raises questions for the audit committee: What is the future role of internal audit if we are successful? Do they go back to the framework and paradigm they had before?"*

For larger companies, compliance with Section 404 can be seen more as a public good – improving confidence in financial markets – than a specific benefit to the companies' own shareholders. One audit committee chair commented, *"We are really building confidence in what already existed."* Much of this confidence is generated through the Section 302 certification process. One member noted, *"This [work on Section 404] increases the confidence [of the CEO and CFO] in dotting the I's and crossing the T's."*

Where is the value?

Some boards of directors and their audit committees are considering whether what they had initially perceived as a "compliance tax" might instead be considered an investment. They believe their Section 404 work will produce a return in areas such as reengineering (through linkage to programs such as Six Sigma) and risk management.

This improvement in confidence fits with the SEC's own cost-benefit analysis, which indicates that the ultimate benefit of Section 404 is in "improving investor confidence in the reliability of a company's financial disclosure and system of internal control over financial reporting."²

Despite their concern for smaller companies, network members believe those businesses are gaining real value from the implementation of Section 404. Many small-cap companies are putting in place internal controls that should always have been there. Others are finding value in what one member describes as *"reducing do-over work and manual routines in the finance function and controller's office."* He added, *"They will have made a wise investment."*

Some members felt that large companies' international subsidiaries will gain similar value. One audit committee chair commented, *"The lesson for me is that some subsidiaries were not as well documented as they should have been."*

¹ The Financial Executives International survey of 321 companies, published in January 2004, estimates that for the largest companies in its sample, the cost of compliance with Section 404 will consist of 35,000 hours of internal manpower, \$1.3 million of external consulting and software, and additional audit fees of \$1.5 million.

² Securities and Exchange Commission, "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," <http://www.sec.gov/rules/final/33-8238.htm>

Dealing with ambiguity: The onus is on management and audit committees

As the large companies move towards completion of their first year of Section 404 implementation, one theme keeps returning to the forefront of conversation among audit chairs: the lack of definition in the process. One audit chair described the frustration: *“The lack of definition in the process is troubling – what is a ‘significant deficiency’? It drives people crazy as they don’t know what standard they have to meet.”*

Questions also remain over the issuance of management and auditor reports on internal controls, such as:

- What constitutes a material weakness? What is the threshold for a significant deficiency?
- How should a company aggregate what one member described as a “string” of individual deficiencies to determine whether collectively they constitute a material weakness?
- What degree of disclosure is required for material weaknesses and significant deficiencies?

Many members felt the level of ambiguity is deliberate policy to put the onus on management and the audit committee to set the standard and then seek the external auditor’s agreement. Several members cited similar experiences with the implementation of FDICIA³ Section 112 controls in the banking industry. One audit chair commented, *“as long as you have basic levels of internal control ... I don’t see the auditors coming back with a material weakness.”*

The process of evaluating material weaknesses and significant deficiencies, and the related disclosure, presents an interesting challenge for the audit committee, management, and the external auditor.

If the reports do not contain material weaknesses or significant deficiencies, and a problem emerges later related to the internal controls and the financial statements, what will the SEC discover during a possible investigation and review of documentation, and how might it respond? A similar question might hold for an inspection of the external audit firm by the Public Company Accounting Oversight Board (PCAOB). And if companies opt for additional disclosure of significant deficiencies, could that trigger an investigation by the regulators?

Role of the external auditors

Members did not think the external audit firms had brought any additional clarity to a confusing situation. They mentioned that the audit firms do not all use the same definitions of material weakness and significant deficiency, and even within a single firm the definitions vary by partner. One member said this was *“creating healthy tension in the relationship with the audit committee.”*

Members also raised questions about and expressed sympathy for the difficult position in which the audit firms now find themselves. Effectively they are now caught in the middle between the “rock” of the new regulator – the PCAOB – and the “hard place” of the clients who engage them. Members are concerned about the possible impact that the additional oversight and inspection by the PCAOB will have on the behavior of the audit firms’ national leadership. As one audit chair commented, *“the scrutiny from the PCAOB will cause judgments to be more conservative.”*

³ Federal Deposit Insurance Corporation Improvement Act 1991

This more conservative approach could have a potentially adverse impact on the outcome and timing of Section 404 attestation. One audit chair described his apprehension: “... the [audit firm] partner doesn’t see something as a material weakness but he runs it up the flagpole. Now we have people looking at it who might get nervous and want it fixed, but it’s not fixable in the timeframe.”

Given these issues, many of the network members are seeking to understand the challenges confronting the leadership of the Big Four audit firms. As one member commented, “It matters how audit firms are run.” The implementation of Section 404 requires the relationship between the audit committee and its external auditor to continue to develop.

One area where members are unconcerned about the role of the external auditor is in the assessment of audit committee effectiveness. The standard set by the PCAOB includes the requirement that external auditors comment on the effectiveness of the audit committee, including whether the committee is independent of management. Members describe regularly receiving informal feedback on their performance at audit committee meetings, and they wonder whether the formal process will add value.

What constitutes success?

Audit chairs are unhappy about the potentially higher cost of compliance caused by unproductive effort that may have crept into Section 404 projects because of the ambiguity of key definitions. Even those audit chairs that are comfortable with ambiguity feel that the lack of a track record with Section 404 means they can neither predict the consequences of failure nor understand what constitutes success.

Conclusion: After year one ...

The current focus for members is meeting the compliance deadlines for Section 404, but many are beginning to explore what next year’s activities will look like. They are searching for ways to manage the cost of compliance more effectively and to generate more value for investors. One response is the move from short-term, project-based implementation to longer-term dedicated compliance efforts.

One estimate from a Big Four audit firm is that between 50% and 70% of first-year effort (which includes the activities of various internal functions, committees, and project teams) will be required in subsequent years. Capturing best practices in documentation, in evaluation and testing, and in reporting and remediation may help to reduce future costs and increase value.

The views expressed in this document represent those of the Audit Committee Leadership Network. They do not reflect the view nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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