



Section 404: market and regulator reaction

The future of internal audit

Introduction

The Mid-Atlantic Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Mid-Atlantic region of the United States. 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.

The fourth meeting of the network was held in Washington, D.C., on June 1, 2005, and focused on two topics: regulator and market reaction to the first year of Section 404, and the future of the internal audit function.

This document reflects a synthesis of key issues arising from the meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues. Anyone who receives this publication may share it with those in their own network. The more board directors, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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

- Mark Bartlett, Partner, Ernst & Young
- Janet Haugen, Audit Committee Chair, SunGard Data Systems
- Charlie Hopkins, Audit Committee Chair, Charming Shoppes
- Bill Jews, Audit Committee Chair, MBNA
- Mike Ressler, Audit Committee Chair, Magellan Health Services
- Stephanie Shern, Audit Committee Chair, Nextel
- Larry Small, Audit Committee Chair, Marriott International
- John Tierney, Partner, Ernst & Young
- Jim Zug, Audit Committee Chair, Amkor Technology

VantagePoint 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

During their meeting on June 1, 2005, members of the Mid-Atlantic Audit Committee Network discussed the reactions of financial markets and regulators to the first full year of Section 404 compliance. Given internal audit's substantial role supporting Section 404 work in many companies, members also shared their perspectives on the role the internal audit function should play in the future.

The specific issues members found to be most important are highlighted below, with more detailed discussion on the following pages:

Section 404: market and regulator reaction

- **Financial markets treated Section 404 as a non-event** *(Page 3)*

Of the approximately 10% of public companies that disclosed material weaknesses in internal controls, as few as one-third experienced stock price decline greater than 2%. Members said investors recognized that internal control weaknesses did not necessarily impact a company's underlying economic value.

- **Regulator responses elicit skepticism and uncertainty** *(Pages 3-4)*

While members appreciate the efforts of regulatory leadership to reflect market feedback in their recent guidance, they are concerned that regulators' words may not be translated into action through the inspection process.

- **Lower costs are expected in 2005; management may de-prioritize Section 404** *(Page 4-5)*

Substantial up-front investment in year one will result in lower Section 404 costs going forward. Much of the work is being pushed from central, corporate functions, such as internal audit, down to operating business units. Furthermore, given market reaction and signals from regulators, members expect management to place renewed emphasis on revenue-enhancing activities rather than Section 404.

The future of internal audit

- **Internal audit renews focus on enterprise-wide risk management** *(Page 5)*

Toward the end of 2004, many internal audit groups were supporting Section 404 compliance, often at the expense of other activities. Although members recognize that change will take time, they would like to see internal audit play a broader role in support of enterprise-wide risk management.

- **Staffing is a challenge** *(Pages 5-6)*

The best internal auditors are in high demand, and companies are having difficulty retaining these people. Companies are restructuring roles in order to make the opportunity more attractive.

- **Section 404 represents a "permanent layer of expense"** *(Page 6)*

While companies differ in the way they plan to structure compliance activity in year two and beyond, members agree that it will lead to a permanent increase in companies' cost structures.



Section 404: market and regulator reaction

Financial markets treated Section 404 as a non-event

Throughout 2004, many observers speculated on the impact Section 404 would have on the financial markets. Some more-pessimistic voices predicted that widespread failures would inevitably lead to substantial reductions in market capitalization. However, those worries appear to have been unfounded.

One journalist, commenting recently on a study by *Compliance Week* and Raisch Financial Information Services, noted that “just 12 of the 18 companies that made material-weakness disclosures in February saw their share price fall the day after... [and] in 6 of the 12 cases, the decline was less than 2 percent.”¹ Considering the market reaction, one member said, “*If you get a material weakness, the reaction of the capital markets is, ‘Oh well, what the heck.’*”

At some level, this response is surprising, given that about 10% of public companies have reported material weaknesses in internal controls.² One member noted that disclosures of material weaknesses have been rare in the past, and the sudden jump in disclosures represents a discontinuity in the historical pattern. However, other members pointed out that Section 404 reflected a change in the definition of a material weakness and the establishment of more substantive procedures and a more consistent framework for dealing with those weaknesses. Furthermore, Section 404 established an obligation for management to report material weaknesses in internal controls where no such obligation had existed previously.

More than 60% of the overall market capitalization is owned by institutional investors³, and members observed that these institutional investors are smart business people. Although Section 404 reassures investors that the financial information on which they rely is accurate, they tend to focus investment decisions on the integrity of management and the underlying business model. Members said the market typically reacts to news of internal control weaknesses only when it results in a restatement. Highlighting the importance of viewing Section 404 disclosures in context, one member said, “*Markets are trying to value the underlying business, and as long as there is not a roaring fire, they are not concerned with taxation policy on closing a particular plant.*”

Regulator responses elicit skepticism and uncertainty

Members and external auditors alike have reported that the cost and stress resulting from Section 404 were caused by regulators’ failure to properly define appropriate standards in a timely manner, which left the accounting firms to interpret the rules in an overly conservative way. On this issue, Bill McDonough, the chairman of the Public Company Accounting Oversight Board (PCAOB), recently said, “It is clear to us that the internal control assessment and audit process has the potential to significantly improve the quality and

¹ Stephen Taub, “Material Weaknesses and Share Price,” *CFO.com*, March 11, 2005, http://www.cfo.com/article.cfm/3758698/c_3758740?f=TodayInFinance_Inside

² Data provided by Raisch Financial Information Services and *Compliance Week*, May 17, 2005.

³ Murray Steele, “Time for investors to come in from the cold,” *Financial Times*, May 19, 2005, http://news.ft.com/cms/s/ef31f4d8-c86d-11d9-87c9-00000e2511c8,dwp_uuid=1d0ff528-c86c-11d9-87c9-00000e2511c8.html



reliability of financial reporting. At the same time, it is equally clear to us that the first round of internal control audits cost too much. Through the guidance we issue today, as well as our upcoming inspections, we are committed to seeing that [Auditing Standard] No. 2 is implemented in a manner that captures the benefits of the process without unnecessary and unsustainable costs.”⁴

Regulators have expressed concern at the cost of Section 404 compliance in year one. Although members are encouraged by messages coming from the PCAOB and the Securities and Exchange Commission (SEC), some members questioned whether regulators’ comments derived from strongly held views, or whether they were motivated instead by political objectives. Members said the implications of recent regulatory guidance cannot be assessed until the audit firms have been through their first round of post-Section 404 inspections.

At a meeting with the Audit Committee Leadership Network held in March 2005, one of the Big Four accounting firm leaders said, “There is a lot of second-guessing in the system. The level of stress is at its highest in over 30 years. The National Office people become very conservative, and they second-guess the engagement team, so they [in turn] second-guess the client beyond the natural skepticism we are trained in, and the whole system becomes dysfunctional.”⁵

Mid-Atlantic Audit Committee Network members echoed the concerns of this Big Four leader, noting that with the PCAOB only now starting to inspect the large accounting firms, it was too soon to predict how the inspection process would affect the relationship between auditors and their clients. Members felt that “[auditors] haven’t changed yet” and recognized that the accounting firms were still understandably wary about deviating from the policies they adopted during the last year.

Lower costs are expected in 2005; management may de-prioritize Section 404

In a recent study commissioned by the Big Four accounting firms, Charles River Associates found that the average Fortune 1000 company spent a total of \$7.8 million to implement Section 404 in 2004; this cost represented slightly more than 1/10 of 1% of total company revenue. Audit fees were approximately 25% of the total compliance costs.⁶ Members described the first year of Section 404 compliance as “a difficult period with peaks and valleys.”

Although all the companies on whose boards members sit were able to certify effective internal controls over financial reporting in 2004, members said companies needed to remain vigilant, with one member warning, “I don’t think you can relax in 2005.” However, with companies having made significant start-up investments in technology and documentation, most members expect the ongoing costs to be lower. One member said, “Everybody will spend less, unless they made big mistakes.” While they recognize that it is technically possible for companies that passed in 2004 to fail in 2005, members feel this is unlikely.

⁴ Public Company Accounting Oversight Board, “PCAOB Issues Guidance on Audits of Internal Controls,” press release, May 16, 2005, http://www.pcaobus.org/News_and_Events/News/2005/05-16.asp

⁵ Audit Committee Leadership Network, “The future of the accounting profession,” *ViewPoints*, April 22, 2005, 3.

⁶ Charles River Associates, *Sarbanes-Oxley Section 404 Costs And Remediation Of Deficiencies: Estimates From A Sample Of Fortune 1000 Companies* (Washington, DC: Charles River Associates, 2005), 2.



Members referenced several studies that demonstrate the importance of pushing responsibility for internal controls down to the business unit level rather than concentrating responsibility in a centralized, corporate financial or internal audit function. As a result, several members reported a shift in roles and resources toward operating units. Although business units sometimes lack consistency in approach, this drawback is more than offset by an increase in ownership of compliance among line managers.

Still, several members speculated that management would de-prioritize Section 404, given the substantial investments of time and effort with little perceived return and a limited market penalty for failure. Describing Section 404 as “*a crime against the American economy,*” one member pointed out that the capital market has effectively declared that Section 404 is not as important as revenue growth. Members expect management to refocus their efforts on issues that are more fundamental to the business, and worry that it may be difficult to motivate business unit process owners to give Section 404 compliance the same attention it received in 2004.

One member recognized that de-prioritizing Section 404 posed a certain amount of risk, but said, “*As an audit committee chair, I’m willing to let [management] take that risk ... we won’t fail because we don’t [pay enough attention to Section] 404. We’ll fail because we don’t pay enough attention to the business.*”

The future of internal audit

Internal audit renews focus on enterprise-wide risk management

Members said that for the last half of 2004, internal auditors at many companies were “*mired almost 100% in Section 404 to get over the hump,*” but agreed this was “*the wrong place for internal audit.*” Several members felt internal audit should play a more active role in enterprise-wide risk management, but observed that Section 404 had “*delayed that from happening.*”

One member said the audit committee decided at its last meeting that internal audit should no longer concentrate exclusively on Section 404. Noting that internal auditors frequently had “*the last cars in the lot at night,*” members said it would be unrealistic to expect the same level of intensity going forward.

Although members supported internal audit’s becoming involved in enterprise-wide risk management, there was little consensus on the specific risks that the function should review. Members discussed the challenges in developing even a “Top 10” list of risks and agreed that internal audit was not qualified to offer an opinion on certain important risks (e.g., competitive forces, shifts in consumer demand, etc.). Some members cautioned against expecting dramatic changes in internal audit’s role in the near term, with one member asserting that such a change might take three to four years.

Staffing is a challenge

Members described the challenge of retaining the best internal auditors, some of whom are getting two or three calls a week from recruiters offering substantial salary increases. However, other members observed that there has always been “*inevitable turnover*” among internal audit staff, given that the most talented are often hired away by other departments. As one member said, “*People join internal audit with the*



expectation of moving on.” Another member warned that internal audit currently enjoys management’s attention, but “when it’s not sexy anymore, we’ll move back to less capable people.”

Members believed that Section 404 compliance work made the internal audit function less attractive, and one member said it would be impossible to recruit the best internal auditors into a purely compliance-centered function. In order to manage auditor workloads and to make career opportunities in internal audit more attractive, some companies have separated out compliance functions that focus on Sarbanes-Oxley-related activities, removing those responsibilities from internal audit’s purview.

Section 404 represents a “permanent layer of expense”

While members agreed the cost of Section 404 would decline over time, they recognized that compliance with the legislation will always require more activity than had been necessary before the passage of Sarbanes-Oxley. With many companies unwilling to dedicate the internal audit function solely to compliance, one member said, *“I don’t see how you can get away from a larger internal audit group ... [the function] has to staff up if you are going to do the [non-Section 404] work you did before.”*

Regardless of whether this incremental work is handled by internal audit or a separate compliance function, and regardless of whether the costs are centralized or pushed down into the business units, members agreed that Section 404 represented a *“permanent layer of expense.”*

Conclusion

With the first year of Section 404 now in the past for most companies, management, board directors, and audit firms are seeking clarity as they strive to shift regulatory compliance from a short-term project to a more sustainable long-term process. Although the broad outlines of a future state are starting to emerge, significant questions persist, and ambiguity continues to surround roles, resources, and the relationships between key players. This ambiguity will undoubtedly strain relationships and potentially result in sub-optimal allocation of resources. It will take months, and probably years, before the American capital markets can begin to reasonably assess the legacy of Section 404.

The views expressed in this document represent those of the Mid-Atlantic Audit Committee Network. They do not reflect the views 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.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.