



Section 404: Lessons learned and value earned?

Introduction

The Mid-Atlantic Audit Committee Network (MAACN) 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.

On June 4, 2004, the Audit Committee Leadership Network (ACLN), a group of audit committee chairs from some of America's most admired companies, expressed their views on Section 404 in the publication *ViewPoints*. *VantagePoint* has been developed as a companion to *ViewPoints*, comparing and contrasting the perspectives of the MAACN with those of the ACLN. Both reflect a synthesis of key issues arising from facilitated discussions among members of the respective networks.

The ultimate value of *ViewPoints* and *VantagePoint* lies in their power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives these publications may share them 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 Mid-Atlantic Audit Committee Network held its first meeting in Baltimore on September 8, 2004. The discussion covered the implementation of Section 404:

- What are the lessons learned?
- What is the value earned?
- What are the unanswered questions regarding Section 404?

The members of the network present at the meeting, who sit on the boards of more than 15 large-, mid-, and small-cap public companies between them, were:

- Charlie Hopkins, Audit Committee Chair, Charming Shoppes
- Bill Jews, Audit Committee Chair, MBNA Corporation
- Mike Ressler, Audit Committee Chair, Magellan Health Services
- John Schwieters, Audit Committee Chair, Smithfield Foods
- Larry Small, Audit Committee Chair, Marriott International
- Mark Bartlett, Partner, Ernst & Young
- John Tierney, Partner, Ernst & Young

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

At its meeting in May 2004, the Audit Committee Leadership Network expressed the feeling that large, well-run corporations that emphasize effective internal controls have less to fear, or to learn, from implementing Section 404. ACLN members see compliance with Section 404 as more of a public good than a specific benefit to individual companies' shareholders. However, they also believe that smaller companies may create real value for their shareholders by developing good internal controls and by improving the efficiency of financial processes.

Some ACLN members feel that external audit firms and the Public Company Accounting Oversight Board (PCAOB) that regulates them have not helped to define the terms "material weakness" or "significant deficiency" adequately. Members were also concerned that external auditors might adopt overly conservative positions in an attempt to balance the interests of the PCAOB and the audit firms' clients.

At their September 8, 2004 meeting, Mid-Atlantic Audit Committee Network members shared the ACLN's skepticism about the value of Section 404 and also spoke of the relatively conservative positions taken by audit firms that are still trying to understand regulators' expectations. Compared with a similar group of audit chairs that met at the end of June, the MAACN was more accepting of increasing Section 404 costs and more optimistic about the degree of compliance activity required in future years.

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

- **Members are not surprised by the increasing cost of Section 404** *(Page 3)*

Members said that their Section 404 activities were generally on schedule, although they expressed some frustration at trying to hit a moving target. Cost estimates have risen dramatically since the start of the year, but members were not surprised and said that estimates were difficult given the lack of precedents.

- **Section 404 compliance may offer less value than alternative use of resources** *(Page 4)*

Members were unable to identify any immediate hard value from their 404 implementation, noting that the benefits of 404 were largely intangible (including broad market confidence and political capital accruing to legislators). Furthermore, even when viewed through the lens of process reengineering, they felt that Section 404 would have been considered a low-priority project.

- **Despite uncertainty, members are somewhat optimistic about the future** *(Pages 4-5)*

While the external costs of Section 404 compliance are not expected to drop significantly after the initial year of adoption, members expect far lower internal costs in the coming years. They also hope to implement process improvements that were identified this year but put on hold due to resource limitations.



Members are not surprised by the increasing cost of Section 404

With less than four months to go before the first attestation, MAACN members say that they are on schedule, although the cost of compliance has far exceeded their initial expectations. However, none of the members' companies have completed the necessary work, and some members are concerned about the ability of smaller companies to complete the process by year-end.

Despite significant costs associated with external auditors, consultants, and software vendors, much of the work has been handled by company resources, including internal audit and line operations. Describing the initiative as *"all-consuming,"* one member said, *"We've really forced this down to line executives, to take ownership [of] their control processes."* Another member was worried about the impact of Section 404 on other important corporate activities, observing that *"Internal audit is leading the charge on all this, and they have done [nothing] in the last six months but 404."*

Unlimited budget

In contrast with most corporate initiatives, members said that it was not practical to manage Section 404 work within a traditional budget. As one member said, *"[The cost has] almost become irrelevant – you just have to do it."* Another observed, *"You keep spending and spending ... it's like it's never ending."* On the same theme, one member commented ironically, *"We had an unlimited budget, and we overspent it."*

While agreeing that there is an obligation to comply irrespective of cost, one member expressed alarm in the context of his fiduciary responsibility: *"It's one of those things where cost is no object; it's pretty frightening as a corporate director considering the use of corporate assets."*

Moving target

Members expressed frustration at the way the process has unfolded, noting that time and money were wasted because *"people started and then stopped because the rules were unclear."* Many members felt that the regulators have not provided adequate guidance to companies or their auditors. As one member described the experience, *"We're trying to aim at ... a moving target."* In striving to comply with the regulations, the lack of specificity is clearly creating an uneasy reaction among some members.

No surprise at cost increases

In January 2004, Financial Executives International (FEI) released a survey estimating the total internal and external cost of Section 404 compliance at \$4.6 million for companies with over \$5 billion of revenue. However, in a revised version of the survey published in July 2004, this figure had jumped by over 70% to \$8 million. Although few members have been carefully tracking internal costs associated with Section 404, they broadly agreed with the FEI figure. In light of the complexity of the process and the absence of any comparable benchmarks, members were not surprised that Section 404 costs had exceeded initial estimates. One member asked, *"How [in January] could you have clarity, because there are no tracks in the snow?"*



Section 404 compliance may offer less value than alternative use of resources

Some members are willing to concede that Section 404 might deliver benefits, but they all agreed that any value from Section 404 would be more than offset by its cost. In evaluating the shareholder benefits of Section 404 relative to other corporate alternatives, one member said, *“It’s essentially a government-mandated transfer of resources that would have had greater impact if it had been put toward increased R&D, product development, advertising. I could say optimistically I’ll get value, but the ROI of this relative to other initiatives such as R&D doesn’t compute, even though I might sleep better at night.”*

In the March 2, 2004, edition of *InSights*, CEOs of ACLN member companies expressed their hope that Section 404 would be an “enabling vehicle” for process reengineering. Two of the CEOs said that they had already tied the internal controls work to “broader systematic process reforms,” such as Six Sigma.¹

MAACN members did not agree that Section 404 offered a model for process reengineering, noting that it tended to focus on lower-value activities. Said one member, *“There is no lack of commitment to do the right thing, but it’s not something anyone would have chosen on their own.”*

One member compared implementing Section 404 to telling a healthy man to get a full set of medical tests – including CAT scan, X-rays, prostate exam, etc. – and to pay for them out-of-pocket. In the end, the man will have gone through substantial effort and expense to confirm something that he already knows.

Members also agreed that the one thing Section 404 would not do is deter wrongdoing. Said one member, *“The premise is that it is supposed to catch criminal activity ... but that is a completely flawed premise.”*

Despite uncertainty, members are somewhat optimistic about the future

In spite of huge cost overruns in 2004, members are hopeful that Section 404’s cost and administrative burden will be reduced significantly next year. Members believed that while internal efforts would continue to be significant, the ongoing internal cost of Section 404 compliance might only be one-third of this year’s. They also felt that external costs might represent as much as 75% of the cost incurred this year. As one member said, *“It doesn’t mean that you have to rebuild the books every year.”* Another member agreed, observing about next year that *“it’s just updating.”*

While most audit committees have taken an unusually active role in Section 404 compliance this year, members hope that their direct involvement will decline over time. One member said of the ongoing Section 404 compliance activity, *“It’s got to be managed, but I’m not sure that the audit committee is where it should be managed.”*

Some management teams had initially planned to use the Section 404 activity to identify and immediately implement some best practices. However, one member said that tight deadlines precluded any meaningful changes this year. He noted that the company has initiated a “parking lot” for ideas that were developed this year but will not be implemented until next year.

¹ Audit Committee Leadership Network, *InSights*, “The CEO’s perspective on the audit committee,” March 2, 2004: 6



In addition, as audit committees start to look ahead toward 2005, some members expect Section 404 to work to help define their committee agenda. One member observed, *“One of the pluses [of Section 404] is a better assignment of risk, more agenda items for audit committees to focus on next year.”*

Conclusion

In spite of their concern about cost and skepticism about value, members are hopeful that they will successfully complete their Section 404 certification by the end of the year. However, one member cautioned the group against celebrating too soon. He said that while relationships with external auditors are generally positive, most companies have not yet had to face a pass/fail scenario. As we approach year-end, he said, *“Some companies are going to fail ... The ante is going to rise.”*

The views expressed in this document represent those of the Mid-Atlantic Audit Committee Network, a group of audit committee chairs drawn from some of America's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. 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.

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