



## **Section 404: reflections on year one**

### **Introduction**

In the wake of several high-profile accounting scandals in 2001 and 2002, the United States Congress passed the American Competitiveness and Corporate Accountability Act of 2002. Better known as the Sarbanes-Oxley Act, this legislation is intended to restore investor confidence by cracking down on corporate fraud and preventing future accounting scandals.

Although the Sarbanes-Oxley Act has 66 distinct sections, it is a single section, fewer than 200 words long, that has generated the greatest amount of controversy. Addressing management's assessment of internal controls, Section 404 has proven to be a lightning rod for criticism, with corporate management and board directors expressing outrage at the cost and complexity of compliance.

Because of a common desire to share experiences and best practices, both the Mid-Atlantic Audit Committee Network and the North Central Audit Committee Network held meetings of their members, and their discussions included reflections on Section 404.<sup>1</sup> The networks are 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.

Network members present at the meetings were:

- Mark Bartlett, Partner, Ernst & Young
- Jim Boland, Audit Committee Chair, The Goodyear Tire & Rubber Company
- Jim Brady, Audit Committee Chair, Constellation Energy Group
- Michael Gellert, Audit Committee Chair, Humana
- Frank Gori, Partner, Ernst & Young
- Bill Jews, Audit Committee Chair, MBNA
- Michael Losh, Audit Committee Chair, TRW Automotive
- Al Paulus, Partner, Ernst & Young
- John Schwieters, Audit Committee Chair, Smithfield Foods
- Larry Small, Audit Committee Chair, Marriott International
- George Smart, Audit Committee Chair, FirstEnergy Corporation
- Bill Smithburg, Audit Committee Chair, Corning
- John Tierney, Partner, Ernst & Young
- Ken Wolfe, Audit Committee Chair, Bausch & Lomb

---

<sup>1</sup> The North Central Audit Committee Network met by teleconference on February 16, 2005. The Mid-Atlantic Audit Committee Network met in Philadelphia on March 2, 2005.



This document contains a synthesis of key themes that emerged during the network meetings. *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

By the end of March 2005, auditors of most large U.S. companies with a December 31 year-end will for the first time have certified management's assessment of internal controls under Section 404. Board audit committees, which have a key role in overseeing Section 404 compliance, are just now coming to terms with final costs and potential benefits resulting from the first year of implementation. They are also beginning to consider ways to comply with Section 404 at lower cost and with less disruption in year two.

During the meetings, members focused their frustration over Section 404 on audit fees, which are an obvious target. They had less to say about internal costs and other third-party fees, which actually make up the majority of Section 404 costs (about 80%, by some estimates).

- **High cost, but some value – both unanticipated** (*Pages 2-3*)

Network members continue to express concern about the cost and complexity of Section 404 compliance, but many are starting to acknowledge that the exercise may have created some value, as it has uncovered undiscovered flaws in many financial processes.

- **Planning for 2005 is not yet a priority** (*Pages 3-4*)

Management and board directors have been focused on receiving a clean internal controls certification from their audit firm and have not yet begun to turn their attention to planning the Section 404-related efforts for 2005. As they look for ways to reduce cost, several companies are looking to the PCAOB to provide guidance with respect to the external auditors' ability to leverage internal auditors' work. Some members believe Section 404 may prompt companies to centralize key financial and IT processes.

- **Aside from Section 404, Sarbanes-Oxley has been positive** (*Page 5*)

Members feel that many aspects of the Sarbanes-Oxley legislation have improved corporate governance. However, members generally believe that the materiality threshold for Section 404 was set too low, resulting in Section 404 compliance costs that significantly exceed value.

## High cost, but some value – both unanticipated

During 2004, members of the North American Audit Committee Leadership Network and the two regional audit committee networks became increasingly concerned about the escalating costs of Section 404 compliance, while remaining doubtful that the effort would yield any meaningful value. When the issue of Section 404 was first discussed at earlier meetings of the networks, several 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 commented ironically, “We had an unlimited budget, and we overspent it.”<sup>2</sup>*

In their recent meetings, members stood by their earlier analysis, asserting that the “*complexity, [and the] number of hours [spent on Section 404 compliance] is just staggering.*”

However, with the first year nearly behind them, several members admitted that they had found some value in the process and that Section 404 “*buttoned down some things that weren’t as tight as they should have been.*” Even one of the more outspoken critics of Section 404 admitted, “*I can’t say that we’ve learned nothing, because that would be simplistic.*”

Describing a “*pleasant surprise,*” another member said that although “*we’re all kicking and screaming,*” his chief financial officer felt they had come out of the process with material improvements to the company’s internal controls. Another member said the exercise had identified inconsistencies in several processes, admitting, “*We learned that our systems weren’t as perfect as we thought they were.*”

Several members identified information technology as a primary beneficiary of Section 404 value. This view is shared by chief information officers (CIOs) at several large and mid-sized companies. *InSights* recently reported that CIOs agreed that despite its cost, “Section 404 is making us do some ... things that we needed to be doing. Policies that were differentially adhered to in implementation [across the business units] are now being standardized.”<sup>3</sup> Another CIO observed, “Section 404 is insisting on things that we should be doing for the business anyway; we have not done one thing for Sarbanes-Oxley that doesn’t make good business sense.”<sup>4</sup>

### **Planning for 2005 is not yet a priority**

Many members felt that it was still too early to focus on planning for 2005, given that companies had not yet filed their internal control certifications for 2004. Describing a single-minded focus on just “*getting it done*” in the first year, one member wondered “*how to institutionalize a sustainable model*” going forward. In 2005 several members hope to streamline Section 404 compliance by undertaking what one member called “*kaizen on the whole process.*”<sup>5</sup> Some members were hoping to begin this discussion soon on their boards and in their audit committees, and one member acknowledged, “*I see us wanting to come to grips with resources as we do next year’s budget.*”

### **Audit committee chairs expect lower audit fees**

Audit committee chairs signed off on substantially higher audit fees in 2004 because of Section 404, and members complained they do not see fees accompanied by a corresponding increase in value. Looking ahead, members expect Section 404 fees to decline over time; they also expect auditor confidence in the

<sup>2</sup> Mid-Atlantic Audit Committee Network, *VantagePoint*, “Section 404: lessons learned and value earned?” September 22, 2004, 3.

<sup>3</sup> Audit Committee Leadership Network, *InSights*, “The CIO’s perspective,” February 28, 2005, 3.

<sup>4</sup> *Ibid.*, 2.

<sup>5</sup> Kaizen is a Japanese word which reflects the idea of continuous incremental improvement (usually around a process).



internal controls to lead to less work and lower fees for the audit itself. One member said, *“I will not be tolerant of an audit partner saying [that additional audit services that cost] 150% of the audit fee [have] no impact on the [cost of the] audit. That’s not a reasonable answer.”*

### **Role of internal audit is not yet defined**

Midway through 2004, members were concerned that internal audit was being swamped by Section 404 work, with one member reporting a nagging feeling that Section 404 *“deprives [internal audit] of the ability to do anything else.”* Another member pointed out that *“internal audit was doing useful work [before] that they can’t do [anymore].”*<sup>6</sup>

Nearly eight months later, members are no longer suggesting that internal audit should return to its pre-Sarbanes-Oxley role. Several members felt that internal audit might actually take on an expanded role in Section 404 compliance going forward. Some companies plan to allocate more resources to internal audit in an effort to take Section 404 work back from the external auditor and thereby contain costs. One member said the company was *“trying to work out effective trade-offs”* between internal and external audit, while another said, *“Our perception is [that there is] a lot of duplication between the physical activities of internal audit and external audit.”* Despite the appeal of handling more of the Section 404 work in-house, members also recognized that the Public Company Accounting Oversight Board (PCAOB) needed to *“bless the approach,”* and they were not certain that regulators would support the external auditor’s relying extensively on the work of internal auditors.

### **Section 404 may be a centralizing force**

Members said that Section 404 compliance had highlighted the challenges associated with an inconsistent application of systems and processes across business units, noting that the problem was most acute *“in companies that were built by acquisition that never fully integrated what they acquired.”* As a result, several members expected a renewed emphasis on shared services and common operations and systems in order to avoid the *“hell and expense of dealing with non-common processes.”* These members felt that a focus on centralization of controls would help to drive efficiencies in Section 404 compliance going forward.

Given that companies with decentralized operations and systems face a more expensive, more complex Section 404 compliance process, some members predicted a move to centralize accounting, finance, and IT activities. This transition cost was described as *“a hidden expenditure of 404.”* Members worried that centralization might also increase risk, since a single person with malicious intent can access centralized systems more easily than decentralized ones.

Members’ views echoed those expressed by members of a network of European audit committee chairs at a meeting in December 2004. A participant at that meeting commented, “If you are not careful, Sarbanes-

---

<sup>6</sup> North Central Audit Committee Network, *VantagePoint*, “Section 404: lessons learned and value earned?” July 14, 2004, 4.



Oxley drives you towards typical U.S. centralized command and control. If you have a decentralized organization it adds more complexity.”<sup>7</sup>

### **Aside from Section 404, Sarbanes-Oxley has been positive**

Despite frustration with Section 404, several members feel that the rest of Sarbanes–Oxley has been a net positive. One member said that having management certify the financial results had caused people to *“look and ask questions they didn’t ask before.”* Discussing the full Act, another member said, *“There are elements of this regulation that have been very positive for corporate governance in America.”*

### **Materiality must be redefined**

Members of both networks feel that Section 404 adds value when it highlights weaknesses in important controls. However, they are frustrated by the time and resources devoted to *“controls that are not all that critical or significant.”* Members described the audit process as *“overkill”*; they feel that *“materiality went out the window”* with Section 404. Some members think regulators should revisit the definition of materiality going forward.

One member was frustrated that some auditors had interpreted Section 404 to require internal controls at every subsidiary to be certified, even though for some smaller subsidiaries *“you can almost write off the whole sub and people wouldn’t care.”* Members think that regulators should not try to define materiality too narrowly; one member said that the PCAOB should *“allow accounting firms to come to conclusions using judgment [within the] scope of [the company’s] financial statements.”*

### **Conclusion**

Although many companies are reaching the end of their first year working within Section 404, the story is far from over. Audit committee chairs recognize that they are still in the early stages of a process that will almost certainly evolve in the coming years.

Few corporate leaders or board directors expect Section 404 to eliminate unethical behavior. However, many audit committee chairs are starting to accept that Section 404 may have some value, and they are working hard to ensure that their fiduciary responsibility to shareholders is upheld.

---

<sup>7</sup> European Audit Committee Leadership Network, *ViewPoints*, “Section 404: Challenges facing European SEC registrants,” January 25, 2005, 3.



## About this document

The Mid-Atlantic Audit Committee Network and the North Central Audit Committee Network are select groups of audit committee chairs from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are 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.

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

*The views expressed in this document represent those of the Mid-Atlantic Audit Committee Network and the North Central 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.*