



Section 404: market and regulator reaction

Introduction

The North Central Audit Committee Network (NCACN) is a group of audit committee chairs from leading companies based in the Lake Erie and Ohio Valley regions. 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.

This document reflects a synthesis of key issues arising from the network's fourth meeting, which was held via teleconference on July 18, 2005. The session focused on market and regulator reaction to the first year of Section 404, the audit committee's relationship with the external auditor, and the role of internal audit.

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

- John Baily, Audit Committee Chair, Erie Indemnity Company
- Jim Boland, Audit Committee Chair, The Goodyear Tire & Rubber Company
- Jim Broadhurst, Audit Committee Chair, National City Corporation
- Olivia Kirtley, Audit Committee Chair, Papa John's International
- Mike Losh, Audit Committee Chair, TRW Automotive
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Al Paulus, 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

During their teleconference on July 18, 2005, members of the North Central Audit Committee Network discussed market and regulator reaction to the first full year of Section 404 compliance. They also shared perspectives on their relationship with the external auditor and on the future role of internal audit.

The issues members found most important are highlighted below, with more detail on the following pages:

- **Unchanged approach to Section 404, despite market and regulator response** (*Page 3*)

Despite relatively limited market reaction to companies reporting material weaknesses, network members reported no reduction in management or audit committee focus on Section 404. Members expect the market to be less forgiving of such disclosures in the future. While members appreciated regulators' efforts to provide additional guidance on the implementation of Section 404¹, they said it may not be possible to gauge the resulting impact on the approach of external audit firms until inspections by the Public Company Accounting Oversight Board (PCAOB) have been completed.

- **Audit committees press external auditors on integrated audits, guidance, and fees** (*Page 4*)

In 2004 most financial statement audits were not fully integrated with the internal control audits required by Section 404. In 2005 audit committees expect auditors to integrate these activities in order to increase efficiency and reduce cost. Members say that a slow transition to a fully integrated audit is not acceptable and that the audit committee must take a leadership role, maintaining pressure on auditors to deliver an integrated audit. Members are also asking their external auditors to provide greater clarity as to how the regulators' guidance of May 16 is impacting their 2005 audit approach.

- **Internal auditors: returning to their pre-Section 404 role?** (*Page 5*)

In a number of companies, Section 404 compliance testing is beginning to move from internal audit to operating units or compliance functions. As a result, internal auditors will refocus on other pressing matters, such as risk management and internal audit coverage. In this context, "integrated audit" takes on a second meaning and challenge: helping operating units to integrate Section 404 into their daily work and establishing mechanisms for them to report back to the Section 404 project management office and the audit committee so as not to lose accountability.

¹ See, for example, Division of Corporation Finance, Office of the Chief Accountant, U.S. Securities and Exchange Commission, *Staff Statement on Management's Report on Internal Control Over Financial Reporting* (Washington, DC: U.S. Securities and Exchange Commission, 2005), <http://www.sec.gov/info/accountants/stafficreporting.htm>, and 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



Unchanged approach to Section 404, despite market and regulator response

In late 2004 and early 2005, many observers speculated that widespread reporting of material weaknesses under the requirements of Section 404 would inevitably lead to substantial reductions in market capitalization. However, market reaction has generally been described as mild. One analyst, for instance, reported 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.”² A network member described an example of the market’s relative indifference to Section 404 disclosures: *“Soon after one company had reported [a number of] material weaknesses, [they] did a multi-billion-dollar debt refinancing. The underwriters didn’t bring up the issue once.”*

Despite concerns that the relatively mild market reaction might lead to complacency from management, members said their companies have not reduced focus on Section 404. Said one member, *“We’re not doing it [for market reaction] anyway. Management will do everything to ensure successful compliance at less cost.”* Tone at the top remains one of the most important control functions. As one member observed, *“Without it, every company will have a problem somewhere down the road.”* Members felt any temporary slowdown in Section 404 implementation was the result of burnout associated with meeting a tight deadline and *“not a de-prioritization of its importance.”*

However, most members expected the second year to continue to be difficult. If companies report material weaknesses in year two (for example, if they allow significant deficiencies to go uncorrected and become material weaknesses), the market could – and most members believed, should – react. In order to keep a focus on correcting last year’s significant deficiencies, many audit committees are receiving quarterly reports from management indicating the remediation status of the significant deficiencies identified during the first year of Section 404 testing.

PCAOB inspections may trump May 16 guidance

On May 16, 2005, the Securities and Exchange Commission (SEC) and PCAOB issued guidance designed to clarify outstanding questions about the 404 implementation process. Nevertheless, one member expected that *“this summer’s inspections will likely have more impact [on the process].”* In the meantime, one member said, *“The audit committee is intent on having more robust discussions with the audit firms, paying attention to guidance, [and] waiting for audit review comments to come out. We’re in wait-and-see mode. I’m worried that we’ll end up right where we were last year – having to do the work without guidance. We really don’t know what [the guidance] means until the inspections [are complete], so expect audit firms to be conservative again.”*

² Stephen Taub, “Material Weaknesses and Share Price,” *CFO.com*, March 11, 2005, http://www.cfo.com/article.cfm/3758698/c_3758740?f=TodayInFinance_Inside



Expectation of lower costs

Having absorbed significant up-front costs to implement Section 404 during the first year, members were hopeful that compliance costs, both internal and external, would decline substantially in 2005. Some savings were expected from having in-house personnel take on work previously done by third parties. Other reductions were anticipated from documentation completed in 2004, efficiencies in processes and systems established in year one, control weaknesses identified and remediated, and institutional knowledge gained.

One member commented on a different type of cost that has not received great attention. While *“everyone talks about the market’s non-reaction,”* he noted that there has been a *“big opportunity cost of the Section 404 efforts: P/E and EBITDA multiples didn’t go up; expenses went to the bottom line. That’s why in year two it’s important to continue to focus on process and to pay attention to capturing efficiencies from institutional knowledge, continuity, and resolution of what came up in the first pass.”*

Audit committees press external auditors on integrated audits, guidance, and fees

Championing the integrated audit

In past meetings, members have commented on increasing tension between auditors and their clients. While this tension appears to be lessening, members say it has not entirely disappeared. Members are anxious to have external auditors provide a single, integrated audit rather than have Section 404 attestation be a separate assignment from the financial statement audit. However, they believe that the response of the audit firms will likely depend on the individual audit partner involved. While some members thought an integrated audit would evolve gradually, others expect it to be implemented in 2005, for the simple reason that *“if accounting firms don’t wake up and do it, there will be trouble, and the tension will get worse.”*

Audit committee chairs now see themselves as drivers of change in championing an integrated audit. One member declared, *“If it’s going to happen, we’re going to have to keep attention on it.”* As someone who serves on several boards, this member recalled some early attempts at integrated audits last year: *“Those who had a vision of it, tried; those who didn’t have a vision, still don’t. It’s up to the audit committee to challenge the thought process, otherwise, it won’t happen.”*

Seeking further guidance

Several members also cited tension arising from what one member called a tone of *“you decide, we’ll opine,”* which leaves companies to make difficult decisions without their auditor’s guidance. In addition, many network members were frustrated by their audit partners’ need to consult frequently with their national office, taking decision-making authority away from the local partner.

One network member, however, empathized when the local audit partner wouldn’t make decisions but pushed it up to national, saying that under the circumstances, he *“would be scared as an audit partner to make decisions, too.”* Defending the Big Four, he stated, *“The PCAOB took a cheap shot at the accounting profession for not using more judgment when the rules were late. At a roundtable I attended, 50*



audit committee chairs told the Big Four CEOs, ‘You should stand up to the PCAOB – you got late guidance.’”

Continued concern about fees

The cost of Section 404 compliance also remains a concern and an area of tension for members. 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 these total compliance costs. Members focused their attention on external audit costs, but spoke less about how to control internal costs, even though internal costs account for a greater portion of the total.

Members disagreed on whether an integrated audit proposal should contain a single audit fee. One member stated, *“The cost improvements won’t be there unless we see [audit fees] quoted as integrated.”* However, other members said they found it easier to compare fees when auditors itemize them. Another audit committee asked their external auditor to quote audit fees both ways.

Commenting on what to expect in fees this year, one member stated bluntly, *“There is no way to know. None of the audit firms I deal with have gotten out their own guidance. They’re still interpreting the PCAOB and SEC. Our viewpoint is, ‘we’ll revisit your fees once we have your guidance.’”* Another member recommended a novel approach to negotiating fees in the second year: *“Forget last year’s fees. Go back two years, and build it up based on what we know now from last year’s experience.”*

Internal auditors: returning to their pre-Section 404 role?

In its recent guidance, the PCAOB confirmed that “Auditing Standard No. 2 provides the auditor with considerable flexibility to use the work of others.”³ The greatest source of fee reductions may come from enabling external audit to rely more on internal audit and management’s work as well as from bringing in-house external audit work and work performed by other external advisers in 2004. Not all the additional effort will fall on internal audit. Members described shifting some Section 404 compliance work to the controller, various operating units, or a special compliance function.

Bringing Section 404 work in-house *“helps create institutional ownership, keeps the knowledge base in-house, lowers costs, and produces benefits from the work on an ongoing basis,”* one member said. In year one, another member said, *“Internal audit tested, then external audit did. This year, it’s operating units’ responsibility. We’re trying to get manpower reallocated and push down ownership and benefit at the operating level.”*

One member was quick to observe that even if internal audit cooperated more with external audit or passed some responsibilities on to other functions, *“We’re not giving up anything: we’re growing the function 25-30%.”*

³ Public Company Accounting Oversight Board, “Policy Statement Regarding Implementation Of Auditing Standard No. 2, *An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*,” PCAOB Release No. 2005-009, May 16, 2005, 9-10. Complete document available in pdf format at http://www.oversightsystems.com/pdfs/PCAOB_PolicyStatement05162005.pdf



Another member, whose company already did much of the 404 work internally, expected to increase internal audit headcount only 5-8%. The same work must be accomplished whether using internal or external resources, but one member felt that having the work done internally would yield a net savings. That member noted, *“Cost per hour is certainly a lot less internally, we’ll get a more integrated approach, plus greater efficiency – internal audit keeps doing its other work – and we reduce the costs of burnout and turnover. Section 404 is not an aspiration for a future role.”*

Another member disagreed that bringing 404 work in-house would bring costs down, noting that pushing 404 compliance efforts into the operating units might cause companies to incur additional costs for associated training, reporting, staffing, and IT systems. Obtaining feedback from dispersed compliance officers would require additional effort, including *“inviting operating people to report to the audit committee in cases where we’re not seeing the progress we would like.”* The notion of training and enabling multiple, perhaps dispersed, operating units to fold Section 404 compliance into their work and then to report back to the audit committee adds new meaning to the term “integrated audit.”

Retaining and hiring talented internal audit staff remains an ongoing concern for many members. *“Our ‘404 people’ are valued, promoted in finance and accounting, based on respect for their work,”* one member commented, *“but senior internal auditors do not like doing compliance work.”* As operating units take on more of the 404 compliance testing, internal audit can return to focusing on pre-Section 404 audit work. *“There is a stampede to risk management among management, so we want internal audit to do audit. We’re also beginning to struggle with the IT audit side and [to] focus on IT audit competency. Audit is not up to snuff in that area.”*

Conclusion

Audit committee chairs will continue to pursue integrated audits aggressively, taking on a leadership role on the subject, a clear by-product of Sarbanes-Oxley and the audit committee’s evolving role. The second year of Section 404 compliance also brings expectations of lower costs and a desire for additional guidance from audit firms and regulators. Companies anticipate benefits as their own processes improve and become institutionalized, enabling them to return internal audit staff to pre-Section 404 audit activities.

About this document

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.

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