



## Section 404: year two and beyond

### Synopsis

With Section 404 more embedded but still evolving, audit committees and management are focusing on extracting further value from an expensive, time and labor intensive process that has, nevertheless, already yielded many benefits. Hours spent on Section 404 by internal audit have decreased, and companies are exploring automating controls, testing, and reporting. However, companies that decided to push the management of internal controls down to process owners inside the company may find it harder to reduce external costs, due to regulatory requirements on the external auditor.

### Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Pacific Southwest region of the United States. The network held its third meeting on March 9, 2006, to discuss the topic “Section 404: year two and beyond.” This document is a synthesis of insights from that meeting.

In addition, members raised other matters in an unreported open session, including the regulatory environment and relations with the external auditor, alternative dispute resolution provisions in engagement letters, sustainable investing as an emerging shareholder concern, audit committee members’ compensation, CEO participation at audit committee meetings, and board and audit committee continuing education.

Members of the Pacific Southwest Audit Committee Network who attended the meeting, listed below, collectively sit on the boards of more than 20 large-, mid-, and small-cap public companies.

- Barbara Alexander, Audit Committee Chair, Harrah’s Entertainment
- Ray Dittamore, Audit Committee Chair, Invitrogen
- David Engelman, Audit Committee Chair, Fleetwood Enterprises
- George Farinsky, Audit Committee Chair, Broadcom Corporation
- Diana Laing, Audit Committee Chair, The Macerich Company
- Vic Lund, Audit Committee Chair, Borders Group
- Martin Melone, Audit Committee Chair, Countrywide Financial Corporation
- Paula Rospot Reynolds, Audit Committee Chair, Coca-Cola Enterprises

Also attending the meeting were:

- Glenn Burr, Partner, Professional Practice Group, Ernst & Young Los Angeles
- Bruce Stump, Pacific Southwest Area Senior Client Service 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

As organizations grow more accustomed to the process of complying with the requirement for evaluating and opining on internal controls over financial reporting, as governed by Section 404 of the Sarbanes-Oxley Act of 2002, audit committees are becoming more focused in their oversight activities. Members of the Pacific Southwest Audit Committee Network discussed a range of practices and shared insights on the evolution of Section 404, summarized below. Additional information appears on the pages indicated.

- **Audit committees are driving continuous improvement of the Section 404 compliance process** *(page 3)*

Now that most companies have gone through their initial rounds of compliance, the challenge for audit committees is not to relax. The focus in year two and beyond is on extracting broader business value from the extraordinary investment of time and money all have made in complying with Section 404. Audit chairs believe management ought to revisit key controls, determine which to automate, and examine underlying business processes to maximize the return on investment.

- **Audit committee chairs see benefits from Section 404 and anticipate more from automation** *(page 4)*

Network members outlined the benefits accruing from implementation of Section 404, such as better infusing tone at the top; more stable, centralized reporting systems for decentralized companies; broader awareness of risk management; and increased audit committee insight into the finance organization's capabilities. Members expect further benefits in the future as manual controls become more automated. Additionally, many companies may use technology to convert detective controls (which report failures) into preventive controls (which avoid them). However, members caution that it is not the audit committee's place to decide on automated over manual controls; it is management's decision.

- **Internal audit's time is shifting back to operational audits** *(page 5)*

Most companies continue to use internal audit for testing of controls, but the percentage of time spent on it is declining. Among those who relied heavily on internal audit for Section 404 work in year one, there is a preference in year two to have the function return to more operational audits. Lower internal costs in year two are also driven by increased efficiency and gains in the learning curve, year-one remediation efforts that should not need to be repeated in year two, and less use of outside consultants.

- **Reductions in external audit fees may nearly have bottomed out** *(page 6)*

Ironically, some members' desire to involve process owners more in controls work (to reduce the burden on internal audit and enhance process owners' responsibility) may increase the external auditor's fees, because the external auditor cannot rely on the work of process owners when attesting to management's assertions, as it could when testing was performed by a qualified and objective internal audit department. While reporting moderate reductions in total Section 404 costs in year two, members recognize that external auditors' fees are not falling commensurately with internal costs, in part due to regulatory requirements.



## Audit committees are driving continuous improvement of the Section 404 compliance process

Now that most companies have “*gotten through the fire drill of compliance*,” the challenge is not to relax. “*Section 404 is not put to bed*”; it still appears on every audit committee agenda, whether for fifteen minutes or an hour. If the first year was “*educational, with everyone figuring out what ‘compliance’ meant and how to get through it*,” years two and three are somewhat more routine, less costly, and less time intensive – which means that audit committees and management can step back and reassess.

The focus ahead is on extracting broader business value from the extraordinary investment that all have made in Section 404 compliance. Audit committees are the “*cheerleaders and supporters*” of Section 404 who remind management that “*financial controls are important to the board*.” While there is an understandable “*reluctance to change what passed certification*,” audit chairs believe management ought to revisit key controls, determine which to automate, and examine underlying business processes to maximize the return on investment.

One member suggested the audit committee should “*be the fire that challenges*” management, internal audit, the external auditor, and other service providers “*to strive for maximum efficiency and effectiveness*.”

### How audit committees oversee continuous improvement in Section 404 compliance:

- Devote time at audit committee meetings to review Section 404 control reports. Audit chairs also hold pre-meetings with those leading the Section 404 internal efforts (e.g., internal audit, the controller, or other process owners) and the external auditor prior to each meeting.
- Focus on areas of potential deficiency. Some members are reviewing management’s testing, which occurs throughout the year, to learn early if control issues arise.
- Select controls to test randomly and examine the associated documentation. This could include walking through “*the life of a control*” – requesting presentations to the audit committee to understand more deeply each step of the process.

Some audit committee chairs acknowledge that out of concern for their personal exposure, they may skate closer to the bright line between oversight and operational management to ensure that they are protected by the right systems and processes over controls which, often embedded and unknowable, can leave them feeling vulnerable. One member said, “*The audit committee has legal liability; in order to serve, [I have to ask] ‘what gives me comfort versus what management needs us to do?’*”

The process of certification and sub-certification throughout the corporation is one answer. Another member said, “*Rely on tone at the top and good systems. Be sure every operating entity knows what it’s doing and is certifying to the CEO or CFO that they know what they are doing. The CFO needs a strong dotted line or more to every operating CFO. Ask questions of every operating CFO. Empower some of these CFOs to tell the top CFO, ‘If I’m signing it, this is right.’*”



## Audit committee chairs see benefits from Section 404 and anticipate more from automation

Network members believe that Section 404 compliance has been beneficial, as shown in the box below, and expect additional benefits as manual controls become more automated.

### Benefits accruing from Section 404 compliance include:

- Establishment of *“a stabilized form and centralized systems [of] reporting”* across decentralized companies in diverse markets.
- Broader awareness of risk management. Working with internal controls over financial reporting in a top-down, risk-based process surfaces questions about how the organization and its external auditor think about risk.
- Increased audit committee insight into the financial organization’s capabilities. In reviewing manual controls, audit committees have had a chance to *“observe the competency and business acumen of the finance group. We used to rely too much on management’s presentations. We get a better feel for the issues this way.”*
- Emphasis by the CEO and audit committees on tone at the top, with appropriate discipline for those who violate codes of conduct and ethics.

Companies can use technology to monitor, report on, and automate controls, often within the existing enterprise resource planning (ERP) system, rather than relying on manual spreadsheets. Virtually all companies have tracking reports and processes in place, members said, using third-party vendors’ software.

The next phase for many companies is to use technology to convert what are largely manual and detective controls, which report failures, into a system of automated and preventive controls that avoid them. With every accounting control theoretically documented, audit committees have a unique opportunity to challenge management, outside consultants, and auditors to *“tell us how they’ll get rid of all these manual controls and get more efficient.”* One member pointed out, *“The documentation of manual controls is only as good as the people doing them. It’s only the audit committee’s continuous focus on those manual controls that makes it work. So, does the audit committee have to remain involved?”*

The argument for attempting automation is what a member calls *“the exponential risk of error in having too many manual processes at a high level of putting together financial statements. You’ll mess up on consolidation if high-level controls are in spreadsheets.”* However, another member countered, *“If you make an error in an automated control, everything thereafter is wrong. If you make an error in a manual control, maybe it’s just that one place.”*

However, members caution that it is not the audit committee’s place to rush to judgment about whether to use automated or manual controls: *“We may ask ‘should we?’; not say ‘we must.’”* The audit committee can also share insights and best practices it may have seen. However, it is up to management, after weighing the costs and benefits, to decide whether to retain manual controls or to move to automated controls.



Members say the results from automation differed depending on whether companies were centralized or decentralized:

- **Centralized companies** and those in regulated industries were more likely to have had smoother and less expensive Section 404 experiences and were more able to use the “top-down approach” to controls. In one centralized company with a single ERP system, *“We started with the area of greatest exposure (in our case, revenue recognition), got input from management, internal audit, and Section 404 managers on what to automate, and worked our way down.”* The advantage of doing all Section 404 testing from the top down was that *“if something was covered by a higher-level control, we didn’t continue testing, and just [tested] several hundred”* in total.
- **Decentralized companies**, by contrast, found it more difficult to achieve the benefits of automation at the beginning. One decentralized company, self-described as not well automated on an enterprise basis, expects additional efficiencies and a reduction in key controls, already pared by several hundred, *“as we get our ERP system rolled out across locations ... We [also] see shared processes as an opportunity to reduce costs.”* Members observed that as line managers in historically decentralized companies take responsibility for certification, those line managers are more willing to cede control to senior management over areas they used to protect, such as dispersion of payroll. *“Demand is bubbling up”* for automated processes, one member reported.

### Internal audit’s time is shifting back to operational audits

Companies have measured the internal cost of Section 404 primarily in resource hours. Members’ companies displayed great variation in the extent to which internal audit was involved in Section 404. Most companies continue to use internal audit for testing, but the percentage of time spent on Section 404 work, though declining, can be expected to account for anywhere from zero to 50% of internal audit’s time. Some internal audit departments were nearly overwhelmed, with Section 404 work absorbing up to 80% of their time in year one.

Several members’ companies did not involve internal audit from the start, using outsourced services or a special *“404 team,”* as in one regulated company that tried to have internal audit *“do nothing [on Section 404] other than post a senior audit executive”* on a steering committee. In another company, *“internal audit is only involved with controls when it is conducting an operational audit; if they have any qualms, they go to the ‘404 people’ who take the question to management.”*

Among those who relied heavily on internal audit for Section 404 work in year one, there is a preference in year two for *“more operational auditing and maintenance of Section 404,”* with internal audit departments doing more operational audits and controls testing (as they did before Section 404) and far less documentation work. One internal audit department spent just 20% of its time on operational audits in year one and is *“clawing its way back toward 50% – and that’s still too much Section 404.”* For some, *“operational auditing never went away,”* sustained at around 75% in one regulated company whose people checked issues that came up in Section 404 work.



This shift away from Section 404 work can be achieved by “*pushing [Section 404 work] to process owners*” or by “*focusing internal audit’s [Section 404] testing where there is a risk of significant deficiency.*” Reductions in internal costs in year two are also driven by increased efficiency and gains in the learning curve, remediation efforts that should not need to be repeated in year two, and less use of outside consultants.

### **Reductions in external audit fees may nearly have bottomed out**

First-year Section 404 audit-related fees comprised about \$1.9 million, or 26%, of total compliance costs estimated at \$7.3 million for large companies, according to a study undertaken by CRA International at the request of the Big Four accounting firms. Its December 2005 update<sup>1</sup> found that larger companies expect total compliance costs of Section 404 to fall about 42% on average to \$4.3 million in year two. Yet, other assessments suggest that “SOX 404 compliance [is] not getting any cheaper. Year two will [still] be a resource drain ... Companies need to start thinking longer-term ... about what organization structure they need to have in place to facilitate ongoing compliance and to drive value out of the process by making the internal controls and financial reporting processes more efficient and more effective.”<sup>2</sup>

Ironically, “*pushing controls to process owners*” to lessen the burden on internal audit, reduce external fees, and enhance process owners’ responsibility may actually increase the external auditor’s fees, because the external auditor cannot rely on process owners’ work when attesting to management’s assertions, as it could when testing was performed by a qualified and objective internal audit department. There is also a concern about the quality of process owners’ work. One member commented, “*Most process owners aren’t accountants, nor do they know much about internal controls.*”

In its Auditing Standard No. 2, the Public Company Accounting Oversight Board (PCAOB) requires the external auditor to test key controls (e.g., fraud, IT) and significant estimation processes. Internal audit can test most routine controls, and the external auditor can rely on the work of internal audit staffs it deems independent, objective, and qualified.

Members say they expect that audit “*fees will never come back to where they were*” because accounting rules have become too complex and the accounting firms are still trying to figure out exactly what their regulator wants them to do. While reporting moderate reductions in total costs of Section 404 in year two, members began to recognize, as one said, that “*[overall] costs internally in good companies are falling, but [the] external auditors’ [fees] are not [falling] commensurately – and it’s not their fault,*” given regulatory requirements. Another member said, “*Year two will be about 20% less [than] year one; maybe we’ll get another 10-15% after that, but then it will level off... effort is required, and the external auditor can’t get away from all of it; much is mandated.*”<sup>3</sup>

<sup>1</sup> CRA International, *Sarbanes–Oxley Section 404 Costs and Implementation Issues: Survey Update* (Washington, DC: CRA International, December 2005). Available as a pdf file at [http://www.crai.com/pubs/pub\\_4896.pdf](http://www.crai.com/pubs/pub_4896.pdf).

<sup>2</sup> Melissa Klein Aguilar, “SOX 404 Deficiencies Preceded By ‘Effective’ 302 Reports,” *Compliance Week*, July 26, 2005.

<sup>3</sup> The PCAOB and the Securities and Exchange Commission will hold a roundtable in May 2006 to discuss companies’ experiences in year two and will be “open to suggestions ... including modifications of the PCAOB’s auditing standard,” PCAOB Acting Chairman Bill Gradison stated in a press release available at <http://www.sec.gov/news/press/2006-22.htm>.



A member observed that *“historically, we developed our internal audit program without [the] external auditor’s input; [the] mind-set was ‘do as much as you can.’ – that has to change.”* Working together in *“still-murky year three,”* members suggest that *“proactive communication, setting expectations with the external auditor, planning an efficient process, clarity about who has what responsibilities, and understanding the external auditor’s standards and responsibilities”* will improve the value of the external audit.

## Conclusion

Audit committees are continually adjusting their level of oversight on Section 404 as their companies evolve from sustaining an effort focused primarily on compliance needs, to seeking to benefit the entire organization by improving underlying business processes. Efforts to ensure that the right controls have been identified as “key,” and to automate controls, will occupy many companies in the next several years. As internal audit departments increasingly return to operational audits, and audit committees find some time freed up from the initial laser focus on Section 404, some members have begun to ask, *“How can boards get off the ‘governance treadmill’ and be more the strategic advisers they signed on to be?”*

## About this document

The Pacific Southwest Audit Committee 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. *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 this document 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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